

Q. As to that extent it would be necessary, I take it, for the accountant to distinguish between sales in small quantities and sales in large quantities? That is, if they came in a different market, so to speak.

A. In any particular case now where you are dealing with replacement costs, you are more apt to be governed by what the concern buys, what it actually has paid, than any published quotations or anything like that, because those prices would relate to the quantities which are ordinarily dealt in by the particular concern.

Q. Now, what procedures do you follow, Mr. Bell, in determining that goods held or shipped by a company on consignment have been properly treated in the inventories?

A. It is altogether likely that if the company holds goods on consignment, or ships goods to another on consignment, some evidence of that will be found in the accounts. As to any goods that may be held on consignment but included in the inventory, we also make whatever investigation is possible. That's about as far and as definite as I can answer that question. It's a very difficult question. It would all depend upon the particular business.

Q. If you found the business which had been receiving goods on consignment from a particular group of people, and according to their records now held none on consignment, would you confirm that with those consignors?

A. They now held none on consignment?

Q. And from the records.

A. I might. I might, but I might not. I'd say that that would depend upon how important this thing is. The dealings on consigned goods might be very important in relation to the dealings in other goods for this particular client, or they might be insignificant.

Q. I mean, assuming this a significant situation, not one that is relatively small.

A. I don't know that I ever was confronted with a situation like that. I might very well, but I wouldn't guarantee it.

Q. How about consignees, would you confirm goods from consignees that you have out with the consignees?

A. Confirm them or see some statement from them. Not necessarily obtain an independent confirmation. As a rule, we'll see some statement that the company has and in the absence of any irregularity will accept it.

Q. If certain of those consignees had been dealing with the company in a significant amount of goods and at that particular period apparently had none of the company's goods with them on consignment, would you confirm the absence of goods with them?

A. No; I wouldn't see any occasion to do that. Because any goods held by the consignees would be included in the inventory of our client.

If he had none in the inventory there would be no assets to confirm.

Q. Suppose they had some out on consignment, but had not included it in the inventory?

A. You don't see much of that sort of thing.

Q. Now, coming to the inventory that is actually on hand, that you know to be on hand. Do you make any other test to determine that, in fact, the company owns it?

A. If the company is in the habit of holding goods for others, having billed them but not having shipped them, or holding them for processing or something of that sort, that's almost certain to be developed through the examination of the accounts.

Q. Do you make any independent verification of that, other than would be disclosed by the records?

A. You may or may not. I don't know.

Q. And speaking again of significant amounts, of course, not of minor items.

A. If there was any particular—if any important question arose as to whether these goods are, in fact, the property of the company or of someone else, then we certainly would want some assurance—satisfactory assurance of some sort and that might very well take the form of an independent confirmation.

Q. I see. What procedure do you follow, Mr. Bell, to determine that there have not been included in sales goods shipped during a subsequent period? What evidence as to the sale and shipment do you examine for this purpose? Let's distinguish there between goods shipped from the company's own warehouse and goods shipped from places not under its control.

A. As to inclusion in sales of goods shipped in the subsequent period, no real harm can be done unless the goods are included in the inventory. Sometimes it is possible to identify items in these inventories with sales of the last few days. It is necessary, in any event, to examine the records of shipments for a few days following the end of the fiscal period with a view to discovering any such duplication of assets.

This would apply whether the goods are shipped from a company's plant or warehouse, or a warehouse not under control of the company.

The only difference as to the latter being that ordinarily there would not be a shipping record, but there would be some other kind of record.

Q. Now, what documents or papers would you examine to determine the fact of shipments in this connection?

A. Sales invoices, actual shipping records kept in the shipping department, if there were such.

Q. Would you examine anything else?

A. Oh, there might be a question, conceivably, as to the precise time of shipment or something like that in which you might possibly look at a bill of lading, freight bill of lading or something like that. Those things don't often happen where you have to be so precise as that.

Q. In examining these documents, what do you look for, particularly? That is, what is the information you are seeking to get?

A. A cut-off as to date, whether there is any duplication of assets or creation of assets without the creation of a liability. See that both sides of a transaction are handled in the same accounting period.

Q. So you would be looking, particularly, for the date involved in this?

A. Yes.

Q. I see. Now, in going over the inventory computations which the company may have prepared verifying extensions and footings, do you make use of comptometer operators?

A. Yes, frequently, but we never get them from among the regular employees of the client, we get them from some outside agency.

Q. Are there any difficulties with the use of that sort of person that you have found?

A. Not particularly. I think it is a waste of money to have a junior accountant, who doesn't know how to add anyway, most of them, spend their time on adding up inventory sheets and multiplying them.

Q. Now, turning to the purchase side of the transaction. What inquiries and tests do you customarily make to determine that purchase invoices from stock included in inventory have, in fact, been entered on the books, and what evidence do you rely upon to indicate that, or to establish that all stock received has been included in the inventory?

A. For this purpose it is necessary to examine receiving records and purchase invoices for a few days before and after the end of the fiscal year, with a view to determining whether any merchandise is included in the inventory which has not been received and entered on the books until later.

Q. Are you looking again for the date in particular?

A. Yes.

Q. And what documents would you examine in this connection?

A. Receiving records. That is, the records of the receiving department and purchase invoices and inventories.

Q. I see. Now, if you have completed the procedure outlined in the bulletin as to inventories and completed it satisfactorily, do you include in your accountant's report, or in the statements, any qualification as to your responsibility for the quality, the condition or the quantity of inventories?

A. It has been our practice whenever inventories are a material factor in the determination of financial conditions and results of operations, that is to say, generally in the case of manufacturing and mercantile companies, if we do not make any physical tests of inventory quantities to say so in effect, in our certificate generally by saying that the inventory quantities and so on were certified by officials.

Sometimes we make a more definite negative statement to the effect that we ourselves have not done it. But as a rule it is an indirect statement that we haven't done it by saying that they were certified by officials.

Q. Now, looking at the sentence which appears in item 3 under "inventory", the last sentence:

Make reasonable inquiries and tests to ascertain that quantities have been carefully determined and that quality and condition has received due consideration.

If you indicate in your report that you have relied upon responsible officials for information as to these factors, do you feel that this avoids the necessity of making the tests and inquiries referred to in this sentence?

A. There is considerable doubt in my opinion about what is meant by the word "test" as used in that sentence in relation to quantity.

It may mean making physical tests or merely test examination of records, or both. In the greater number of cases in the past, the terms of our engagement have specifically excluded making physical tests checks of inventories. By that I mean testing by actually seeing, counting, measuring or weighing the goods. In cases where this work has not been done by us, we have in the absence of any suspicion of irregularities relied upon documentary evidence and inquiries as indicating that in compiling the inventories the representatives of the company had given due attention to quantities, quality and condition of inventories, but we have, nevertheless, stated in our certificates something to the effect that the inventories were certified as to quantities, quality and condition by the officials of the company.

But, perhaps, to answer your question more explicitly, under the practice that I believe to have been generally followed by accountants, an assertion in the accountant's certificate, or in the financial statements to the effect that the inventories have been certified by a responsible official as to quantities, quality and condition, would not relieve the accountant from responsibility for making reasonable inquiries and inspection of documents to ascertain that the quantities have been carefully determined and the quality and condition have received due consideration.

Q. I take it, then, that you feel this sentence merely refers to tests and inquiries as to the records, and you have some doubt in your mind as to whether it refers to physical tests.

A. As well.

Q. As well.

A. Yes.

Q. Is that correct?

A. Yes.

Q. In connection with your examination of inventories, Mr. Bell, do you review the methods followed by the client in taking that physical inventory? And also, can you indicate what you believe to be important features in a satisfactory method of taking inventories?

A. Yes. We review the methods followed by the client in taking physical inventories. I can hardly say, briefly, what are the important points and a satisfactory method of taking physical inventories, because that depends on the individual situation. I might say, however, that there must be a complete cut-off so that the effective date of the inventory will coincide with the recording of purchases and sales and in the case of a factory of processes of operation.

There must also be a good procedure of determining the quantities and descriptions and of tabulating the results.

In the absence of supervision or physical observance of the inventories by ourselves, the only way we can tell whether the client has observed the important points is to read the instructions for inventory taking, if there are any, or otherwise to follow the successive steps as to detailed counts and tabulations and see that the tickets and sheets bear evidence of personal responsibility for the respective operations.

If we have any reason to believe that the methods used are unsatisfactory, sometimes we require a recount or the setting up of a substantial reserve against the inventory valuation or in extreme cases qualify our certificate.

Q. You have said that you tried to find out by looking at the various inventory sheets whether they bear evidence of personal responsibility. What, exactly, did you have in mind there?

A. Names or initials of persons who were supposed to have done the counting, checking, the pricing and what-not.

Q. In connection with your system of internal control, or study of the accounting procedure, do you check up on that procedure also; procedure of taking inventory or is that a special investigation?

A. I think that is rather outside the general scope of what we would call a system of internal control.

Q. Would you follow the same methods of developing information about the inventory procedure? That is, talking to the people who take the inventory?

A. Oh, yes.

Q. That is, you have indicated you would rely on initials and so forth?

A. Oh, yes. If there weren't anything to talk about. But there might be. I would say that if we saw John Jones and Bill Smith and Tom Robinson's name on an inventory sheet, that we would not go out and ask Jones, Smith, and Robinson, respectively, if they did this thing and look at them to see if they looked husky and could count that much money or this much goods.

Q. I didn't have that exactly in mind, Mr. Bell. Would you make any—would you make any inquiries of the persons responsible for the inventory taking—presumably responsible, to see whether, in fact, they did that work? Not check back on each sheet, but as a general inquiry?

A. I don't think so in the usual case. That's where we don't do anything ourselves about this.

Q. And when you don't do anything physical, you qualify it?

A. And furthermore it is where the whole atmosphere of the case is one that inspires confidence. There is nothing about it that causes us to be suspicious.

Q. I see. Now, in apprising the integrity and accuracy of the inventory, quality, quantity, and condition, from the records, do you ascertain and give weight to the nature of the shipping, receiving and stock-keeping records? Would you feel in this connection that independence of the personnel is important?

A. The nature of a shipping, receiving, and stock-keeping method is, of course, important in relation to the integrity and accuracy of the inventories. The stock-keeping records are particularly important in the case of a book inventory which is checked from time to time by physical inventories. And, of course, the efficiency of the stock-keeping methods depends upon, to a large extent, the accuracies of the shipping and receiving records.

The segregation of duties is manifestly important with respect to these operations and to all others affecting the accounts.

Q. Now, in your opinion, Mr. Bell, should the auditor be reasonably familiar with the general nature of the more important products manufactured or dealt in by the company?

A. Yes; he should be reasonably familiar with the general nature of his client's business, including his more important products.

Q. Is it the practice of your firm, Mr. Bell, to make spot checks of any portion of the inventories by actual counts or inspection?

A. We believe that in the case of an industrial concern, where inventories have so important a bearing upon financial condition and operations, the reader of the financial statements may reasonably require some assurance from others than the management as to the substantial correctness of the inventories.

We also believe that in most businesses the public accountant, by reason of his familiarity with the affairs of the company and, without being expert in the technical refinements of the business, can serve a useful purpose by physically testing the inventory quantities, thus enabling him together with his other work on the accounts and records to form an independent opinion regarding the substantial correctness of the inventory as a whole. Accordingly, it has been our practice when taking an engagement to have an understanding with our client as to whether or not we were engaged to make physical test inspections of the inventory.

In some cases we have been permitted to do such work; in other cases we have not. When we have done so, it has been our practice to select merchandise which constituted a fair percentage in valuation of the total inventory and to satisfy ourselves that the goods were actually on hand.

This we have been able to do in our capacity as accountants without holding ourselves out as experts in the particular industry and without assuming any more responsibility than we assume, for example, in counting securities as to which we realize, and we believe others realize, that we may not know whether the securities are genuine or are forgeries.

In other words, as to inventories, except in rare cases, we find it entirely practicable to identify goods with reasonable satisfaction, relying, of course, to some extent, on information and explanations which we receive from the client's representatives in situations where we believe we are justified in thus relying.

Q. In connection with that, Mr. Bell, do you also rely to any extent upon the ordinary course of business of the particular firm? That is, for example, that in the case of package goods, you rely upon that in the packages the goods that are supposed to be there are there?

A. Yes; by observation of conditions. Now, of course, an accountant can be fooled. A package can consist—can be utterly empty or can consist of sand instead of something else, but we undertake to use our own judgment.

Some boxes sometimes will be opened, others will be sounded to see whether they are entirely empty. As a general rule we can get a pretty good idea as to whether we are safe in relying upon labels. Most things are labeled.

We know that in the ordinary course you see stuff in a stock room, a shipping order comes out, a colored porter goes out and gets a dozen of these things. He doesn't look inside of them to see whether there is anything in there or not, he just takes the labels and dumps them on a truck and out they go.

We think that we can depend upon, in the first instance, people not trying to fool themselves. Of course, there have been situations where we have had reason to believe that people were not so honest as they might be, where we, in some cases, wouldn't—would be very,

very careful and go to extremes. We have never, so far as I know, had a situation where there had been any great difficulty in any job that we have ever tackled.

Now, in testing inventory quantities, we have never had any particular difficulty with descriptions of goods.

Q. I see. Would you say, then, speaking generally again, that the theory by which you apply spot checks to the records, sampling, is equally applicable to inventories?

A. Yes, sir.

Q. That's what I had in mind. Now, is it your practice to make any over-all test of reasonableness of over-all quantities, for example, by comparison with warehouse or storage facilities with the average consumption and production, with average purchases of the company, trade statistics, tax payments, insurance coverage, and the like?

A. In many cases we can make some over-all tests of the reasonableness of the inventory quantities by matching purchases or production against sales or consumption. We would not, ordinarily, attempt to make any comparison with warehouse capacities. And would not place any great reliance upon tax payments or insurance coverage.

Q. Do you ordinarily make this over-all test as to average purchases and sales?

A. It all depends upon the business. In some businesses you can't do it. You take a cotton business that deals in bales of cotton, some other concerns that deal in very few commodities, you take a coal business, sometimes the wheat business, grain business, match up their inventories to begin with, their purchases and sales that are all documented, to see what they ought to have at the end of the year as compared with what they say they have.

Q. Now, turning to the gross profits test which is referred to in item 21. Do you employ that test, and in what way do you apply it, if you do apply it, on an over-all basis or by the departments of the business?

A. Yes, we employ the test and it should be applied to departmental operations whenever ratios vary considerably between departments.

Q. What purposes do you have in mind for such a test, Mr. Bell?

A. The gross profits test is designed to furnish an indication of the reasonableness of the inventory valuation. This valuation depends upon both quantities and prices. In other words, an unduly high rate of gross profit might indicate an inflation of the inventory as to either quantities or basis of valuation.

Q. Now, turning to inventories which are not held on the premises. What do you customarily rely upon to verify the quantities of merchandise held in outside warehouses, either independent or vendors' warehouses? Do you get any financial responsibility—evidence of financial responsibility as to these persons holding the inventories? Do you find out whether the vendor has misappropriated it?

A. As to merchandise held in independent warehouses we would at least examine warehouse receipts and, in most cases, also obtain a confirmation. As to any merchandise held in a vendor's warehouse, we would obtain confirmation. I don't know of any case where we have inquired into the financial responsibility of a vendor who holds

goods for accounts of our clients. Manifestly, the obtaining of a confirmation as to the holding of merchandise by a vendor would not necessarily disclose any misappropriation of merchandise.

Q. Do you have any procedures that would disclose that?

A. No. I think it is a rather rare case, anyway.

Q. Do you make any other tests that we haven't mentioned as to the quality, quantity, and condition of inventories, Mr. Bell?

A. I think I have covered the question of quantities. As to quality and condition, we try to get some evidence from inspection of the goods (that's where we do make some inspection as to quantity), from stock records or from previous inventories.

In addition, we make inquiries of appropriate persons with respect to the salability or usability of the goods.

Q. In one of your previous questions, next to the last one, I believe, you said that that was a relatively rare condition. Did you mean by that that the holding of goods by vendors was rare?

A. It is in my experience, yes.

Q. Thank you. Now, looking to the future, Mr. Bell. You may have covered this in your earlier answers. What procedure do you think auditors should employ in verifying the quantity, quality, and condition of inventories?

A. Well, I think I covered it pretty well, but I don't see why accountants should not serve the useful purpose of making an independent, reasonable, physical substantiation of inventory quantities.

In any case, where quality and condition may be a matter of unusually great importance, it may be desirable to have an expert in the particular industry make an investigation.

Q. What do you think, again looking to the future, what do you think of the auditor participating in the taking of inventory, in a supervisory capacity?

A. The ideal method of substantiating inventory quantities is to supervise, or observe the process of inventory taking by the company.

As I have previously stated, I think this is entirely practical.

It is subject, however, as far as general observance is concerned, to lessening the congestion of auditing work at the end of the year by the wider adoption of the natural business year for corporations.

In this connection, the case of companies which maintain well kept, and controlled perpetual inventory records, and which take annual physical inventories at the time when their business activities have reached the lowest point of their business cycle, that is the close of the natural business date, or at other dates not coinciding with the balance sheet, physical tests could be made by accountants at such other dates supplemented by such review of the records of intervening transactions to the balance sheet date and such supplementary physical tests as they consider appropriate.

Q. Now, our rules require, I believe, Mr. Bell, that is, the rules of the Commission, that the basis of determining inventories be indicated on the balance sheet. For example, cost or market. When we were discussing market, you indicated that there were several types of market that might be used in a particular case. Is there a similar variation in the method of determining cost that might be used?

A. Yes.

Q. Would you indicate one or two of those?



A. Cost may be on the basis of first in-first out, average cost last in-first out; depending upon, to some extent, upon the practice in the particular industry. Now, the last in-first out is not recognized except in certain industries. It is somewhat similar to the base-stock method that has been used a good deal, which results in a minimum cost for the permanent, what might be called the permanent stock.

Of course, it could also be a cost of specifically identified goods. Any one of them may be all right in particular companies, or industries, provided it does not result in any distortion of operating results from year to year, but, in fact, is properly representative of the real operation of the company.

Have I answered your question?

Q. Yes. Would the application of different ones of those methods of cost by the company result in significant differences on the balance sheet in the amount of inventory carried, the value of it?

A. It might very well. Furthermore, I might say with respect to manufacturing companies, there are variations as to what items are put in manufacturing costs. Some companies include certain things in overhead expenses that other companies do not.

As long as they are consistent in their practice, it really makes little difference—consistent in their practice and have a reasonably uniform stock.

There are cases where, by reason of such failure to include certain things, that the profits are unduly affected between years. It might make quite a difference in the valuation of inventory on a cost basis in any case as to which ones of these various methods were followed.

Q. In view of that, would you think it might be desirable to explain, instead of just cost, the method of determining cost?

A. I think that could be carried to extremes, rather, and make it cause unnecessary complications. I do think if there is any particularly unusual method of determining costs, which has a tendency to make an unusually conservative statement, say, or unusually non-conservative statements, would be indefensible in any event, I think.

But, let's say, a last-in, first-out method, or base-stock method, if that were used; I think it would definitely call for an explanation because it is out of the ordinary, but there are so many complications caused by this that I am afraid if there were a requirement for detailed statements—there is another one, estimated cost. You take the so-called retail method in department stores. That is used to some extent in retail businesses, taking their retail price, less estimated percentages of gross profit. It is fairly representative of the actual cost but I am afraid you are going to get into a lot of complications that are not going to serve any very useful purpose if you do that.

That's all.

Q. If the method of determining cost has been changed since the preceding period, that, of course, should be indicated, should it not?

A. Oh, very definitely.

Q. Now, one further question there, Mr. Bell. You indicated a little while ago, perhaps additional responsibilities that might be assumed by auditors in connection with the inventory work. Could you give us any estimate of the extensiveness of the assumption of those responsibilities?

A. You mean by reason of doing inventories, actually make physical inspections of goods?

Q. That's right. Would it materially increase the audit cost?

A. We think not. We think that—we take a middle ground in any difference of opinion there, maybe. This, you know, everybody knows, has been a cause of a great deal of discussion over years as to the auditors' functions with respect to inventory quantities. There are accountants on the one hand that say perhaps they could do everything just as well as a company representative can, and there are others, on the other hand, that say the accountant should do nothing because he can't do everything absolutely conclusively.

We take a middle ground and say that a good deal can be done by accountants, although they are not expert in technical aspects of the business.

In some businesses they don't require any particular expert knowledge anyway, so far as that is concerned. So we don't think we have to take a 100-percent inventory. We think that judicious testing, actually seeing a lot of this stuff—we pick up the most surprising things in doing that.

Q. Would that be expensive?

A. I'll give you an idea. Five to ten percent of a fairly good-sized company. Rather more in small companies that may have a poor inventory system.

Q. You are speaking now of 5 to 10 percent——

A. Of the total fee.

Q. The total fee.

Mr. WERNTZ. Off the record.

(Discussion off the record.)

Q. (By Mr. WERNTZ.) Again on that topic, Mr. Bell, as to supervision, of participation by the accountants in the process of taking inventory, would that be expensive? If instead of making spot checks?

A. No; it shouldn't be any more expensive. There again—when you say "supervision," I don't like that term "supervision" very much, anyway. I wouldn't undertake to go in and take the place of employees of a company.

Q. Let's say observe the process of inventory.

A. I think observe is a better term, and it is a better procedure; observe. It is much less expensive to observe the inventory taken while it is being taken by the company's representative than it is to go in any other time and pick out things.

Q. You would say, then, you would observe the inventory taking and participation to that extent would be less expensive than your spot-test process?

A. It would be a spot testing in any event, except to observe would give one a better idea as to the effectiveness of the inventory taking, the carefulness with which it is taken, and that sort of thing.

In other words, one of us could watch half a dozen men working and will have an idea of whether they are doing a good job, but when you pick out one operation of five or six, to be sure that the count is correct, gives a better idea as to whether the job has been well done than by merely seeing some instructions that had been issued and

seeing the documentary evidence that Tom, Dick, and Harry have supposed to have done the job.

The EXAMINER. We will recess until 2 o'clock.

(Whereupon, at 12:30 o'clock p. m., a recess was taken until 2 p. m.)

#### AFTERNOON SESSION

##### E. OTHER BALANCE SHEET ITEMS

Q. (By Mr. WERNTZ.) Now, Mr. Bell, on page 21, item 4, under property, plant, and equipment, in the bulletin, how do you determine that amounts capitalized as additions to plant represent real additions or improvements? Do you inspect the plant in this connection?

A. Generally, it is comparatively easy to determine whether property expenditures represent real additions or improvements on the one hand or maintenance on the other. The only real question is whether they represent replacements involving the necessity of relieving the property accounts of the book value of the property replaced. I think accountants rather seldom inspect the plants specifically for the purpose of actually seeing the additions or improvements. They can usually satisfy themselves by documentary evidence.

Q. How about the question of abandoned plant? How do you ascertain that plant units that have actually been abandoned have been removed from the asset account? Do you make a physical verification of units which appear from the records to have been nearly fully depreciated to see whether they have been removed?

A. No; we do not undertake to make any physical inspection of the plant assets, believing it to be outside our competence; we have to rely upon the information obtained from the records and the management.

We have to rely upon the information obtained from the management.

Q. You do make inquiry as to whether there is an abandoned property still on the books, whether there are units which have been written off or are still being used?

A. Well, there would seldom be a question of units which have been written off still being used unless they have been removed from the account because they are fully depreciated but as to that, of course, you would have all the information and really there would be nothing to it. It might be a question as to whether it is desirable to remove them from the account because they have been fully depreciated, because they may have been excessively depreciated.

Q. That is what I had in mind.

A. In such a case, if they are still in use, if there is any considerable amount of the property still in use, the depreciation ought to be adjusted and depreciation continued to be taken in order to get a proper income statement. As far as the property which may have been abandoned but is still carried in the books goes, of course, that all depends upon the size of the business. If it is a relatively small business, all housed or located in one place, the accountant would not have any difficulty, but we have a great many clients with property very widespread, and we make inquiries—oh, you can get information from minutes sometimes—in important situations, especially large

groups of public utilities, we require the operating official, one of the operating officials, to give a certificate that there is no property which has been abandoned and not reflected in the records or that there is no property included unserviceable and should be removed from the records.

Q. Turning to insurance charges for a moment, what procedure do you follow in establishing the amount that should be charged as expense in the current year and the amount that should be deferred, and do you use the information you obtain in that process in any other way?

A. Insurance policies or other records are examined by us not only for the purpose of allocation of charges for premiums between accounting periods but usually also in order to determine whether the concern is reasonably adequately insured. There are some cases where the properties and inventories are so widespread as to justify the maintenance of a separate insurance department where the accountant has reason to believe that the question of the adequacy of insurance is being adequately taken care of and he would, therefore, not make such investigation himself.

Q. Now, on page 24 in item 2-C, there is a suggestion that a test examination be made of the creditors' monthly statements covering large balances. What do you consider to be an adequate test in this connection?

A. I am not at all sure that in the majority of the cases it is necessary to examine creditors' monthly statements. In the first place, where a voucher system is maintained it is usually very difficult to do so. However, if there is any reason to believe that the accounts payable records are not in good condition, it is desirable to examine the statements covering at least all the large balances and even in some cases to obtain independent confirmations from the concerns with which the company does business.

Q. Turning back to page 8 again, what is the significance to your mind of the requirement in the last paragraph on that page that the approval and entry of vouchers will be made by others than the disbursing officer?

A. It is important that the approval and entry of vouchers be made by others than those who handle cash and thus could profit by falsification of the vouchers.

Q. Do you feel that that is an important requirement of a good system of internal control?

A. I do.

Q. Do you expect your regular auditing staff, Mr. Bell, to have a general knowledge of all types of taxes which may affect a particular business?

A. We expect our regular auditing staff to have a general knowledge of all types of domestic taxes but not necessarily foreign taxes.

Q. Do you have anyone who covers the foreign angle for the firm?

A. Well, you said our regular auditing staff. Of course, we have people on our staff who have become familiar with our clients who do foreign business and know about those things but not the general run of them.

Q. You would call upon those people in connection with a case where a foreign problem was involved?

A. Yes, of course, when you say that—now, this may be a foreign subsidiary which has its local tax problems and that we wouldn't necessarily be concerned with in this country at all, you see.

Q. If you had to furnish statements of it, you might be concerned with it, would you not?

A. What I mean to say is the accounts would be audited locally in all probability.

Q. And you would accept that auditor's statement in that respect?

A. Yes; or we might ourselves be the foreign auditors, or have some other firm that is located in that foreign country do it, which would relieve us of the problem of considering the adequacy of provision for foreign taxes and the propriety of payment for foreign taxes and so forth.

Q. I see. Now, turning to contingent liabilities. What procedure do you follow to determine the existence and amount of contingent liabilities, and you might also indicate what you feel the auditor's responsibility to be in this connection?

A. A clue to contingent liabilities can be had through reading minutes, through records showing that receivables have been discounted and perhaps from other sources. We also get a liability certificate from our clients covering this matter. We assume no responsibility for the existence of contingent liabilities that are not disclosed to us.

Q. Do you discuss the matter with company counsel in regard to pending litigation and so forth?

A. Frequently we get letters from company counsel regarding litigation, and mostly all litigation—it all depends, the company may have a legal department which handles those things or have outside counsel. Of course, we do everything that is necessary in a particular situation to uncover anything of that sort.

Q. How about contracts? Do you read contracts to determine whether they may give rise to contingent liabilities?

A. We read any important contracts that come to our attention through the minutes or otherwise and as to all those contracts, minutes, and what not, we undertake to determine that any related accounting matters have been properly taken care of. Obviously, there may be a lot of contracts that we don't know anything about.

Q. Do you make any specific inquiry?

A. We do.

#### F. PROFIT AND LOSS ITEMS

Q. As to that. Now, on page 30 in item 1, Mr. Bell, there is a suggestion that the working profit and loss statement be obtained or prepared in as much detail as is reasonably possible—as is readily available. For this purpose, to what extent would you obtain statements from the company and utilize them and to what extent would you require those to be prepared by yourselves?

A. I think it is desirable to utilize analyses and statements prepared by the company to a considerable extent in the interest of economy. Of course, any such analyses, or statements, must be checked to the books and records by the auditor.

Q. Would you make any inquiries as to what statements of that sort are available?

A. Oh, yes. We always know that. We get copies of monthly statements or annual statements, whatever they may be, but in addition,

in most cases where they have the force, the clerical force to do it, the facilities to do it, we have lists of this, that and the other thing made up for us and analyses of various things which saves our time and the client's money.

Q. Now, in item 2, on that same page, it is suggested that the auditor obtain budgets, previous annual statements, and monthly statements. Now, what is the purpose of obtaining those things, Mr. Bell?

A. Well, only to inform himself generally—as far as monthly statements are concerned—of course, this would apply mostly when you say “previous annual statements” to where we are engaged for the first time, perhaps. We haven't the information in our own papers as to previous years, but the general purpose, no doubt, is to determine that the operating accounts are fairly uniform during the period as compared with prior periods, unless there is an obvious reason for the fluctuation. In any event, all the operating accounts should be subjected to a critical and analytical review in order to account for any material discrepancies.

Q. If you discover there have been changes, what procedure do you follow? Do you attempt to determine what caused the changes?

A. Oh, yes. Well, it is utterly fruitless if you don't do that. That is the only purpose of the audit, to determine that the changes are proper and do not indicate any irregularity.

Q. I see. Now, in item 3 under sales and cost of sales, there is outlined a procedure for testing allowances to customers for returned merchandise and the like. What is your feeling as to the importance of such an analysis, and do you ordinarily make it?

A. The purpose of investigating allowances to customers for returned merchandise, claims and rebates, is to satisfy ourselves, as well as possible, that the customers have been credited with all claims to which they are entitled and, second, that no credits to customers' accounts have been made fraudulently to cover an interception of cash receipts.

Q. Do you always require such a test to be made?

A. Oh, yes.

Q. Now, turning to the profit and loss statement as a whole. What do you understand to be the responsibility of the accountant for the proper classification between different types of expenses? What procedure do you use to get at that?

A. Well, it all depends upon the size of the business again. No doubt it is the responsibility of the accountant to determine the proper classification of expenses and income within reasonably broad limits. The procedure used to verify the classification is to make test checks of the entries in the accounts to their original sources.

Q. Would the amount of work involved in this connection depend upon the amount of detail in which the profit-and-loss statement is set up?

A. Oh, yes. Well, it would depend upon the detail in which the profit-and-loss statement is set up and the detail in which the accounts are kept. In other words, if an accountant has to go through and make a detailed analysis of one lump expense account, for example, which is almost unthinkable in any size organization, and tabulate all the charges for this and the other purpose, that is a time-consuming

job, you know. But the auditor's work in that connection, of course, is reduced fairly generally in proportion as the adequate analysis is kept in the books.

Q. You might say, speaking generally, that in setting up your accounting classification you have in mind the detail that you want in the profit-and-loss statement and if you change that detail it would be very difficult to unscramble the accounts?

A. Of course, most of the concerns with which the Securities and Exchange Commission is concerned, it is a case of condensation rather than amplification. Very seldom, I dare say, do you get an operating statement in as much detail as it is carried in the books.

Q. And that is less difficult than to amplify?

A. It is much easier to add things together than—synthetic operation is easier than analytic.

Q. Referring back to one of the earlier questions, Mr. Bell. You stated that if there was a competent insurance department you would not make a check of the insurance. What had you in mind there? Would you make no check of the insurance in such a case?

A. What I had in mind was that the accountant would feel in that case, or he might feel in that case, that there was no necessity for him to consider the adequacy of the insurance coverage. Obviously, that has no effect upon the setting up of unexpired charges, deferred charges contrariwise, but that is very much the same as, oh, a railroad has a claim department which is very busy handling all kinds of injury and damage claims. Well, it would be rather futile for an auditor to try to get first-hand information against all the claims against the railroad, for example.

Q. Would you give any attention, in the case of a claim department, to the total amount of claims?

A. Oh, yes indeed.

Q. As distinguished from the individual break-down?

A. Yes indeed. But, because you are interested there in liability, in liabilities. Now, as far as insurance is concerned, there are any number of companies that do not undertake to carry any, or certainly not 100 percent, but rather a small percentage of fire insurance.

Q. Would you undertake to determine what their policy was in that connection?

A. Oh, yes. Yes; but not necessarily to pass judgment upon whether they are carrying insurance that we might consider to be good business under the same circumstances.

#### V. REVIEW OF THE ENGAGEMENT

Q. I see. Now, turning to the review of the work which is done in the course of the field audit. From your practice, Mr. Bell, who is responsible for drawing together the results of the detailed work and preparing the preliminary financial statement?

A. The accountant in charge, under the supervision of the partner or principal.

Q. It is customary in your practice to have the statements and working papers reviewed by anyone other than the person actually supervising the audit, is it not? I take it that person would be the senior in this case?

A. Yes. Yes; the statements and working papers are always reviewed, usually by a partner, but in a few cases by a principal who is under the supervision of a partner.

Q. Now, does the partner in that case review the individual working papers, or does he review only the work that was originally done by the senior?

A. All of them.

Q. In detail?

A. Well, in very considerable detail; yes. We do not expect him to go into all the detail that we expect of the senior accountants, for example. But he must see that the job has been done and the working papers tell the proper story about the job having been done and the results.

Q. How about his review of the work which the senior himself does? Does he review that in detail?

A. Obviously, yes.

Q. And then he test checks, so to speak, or reviews critically the work done by the juniors?

A. Well, the work done by the juniors is only done by delegation by the senior, you see. So the senior is responsible for all the work, including that of his juniors and the next step up the principal or partner is responsible for the whole thing; but naturally as you go up you expect so much less attention to detail.

Q. I see. Now, will you outline, if you will, in some detail the steps in this review procedure? We have seen the senior draw the statements together and you outlined the responsibility for review. Could you outline that in a little more detail?

A. Well, for general purposes to determine that an adequate examination has been made. There have been no errors in assembling or grouping of figures and to discover any failure to observe accepted accounting principals. That's about all I can say unless I misunderstood your question.

Q. I think that about covers it. What lines of inquiry do you pursue as a partner, Mr. Bell, in reviewing these statements? Will you give us an indication as to that?

A. Just about as I have said, to see that all the steps that we consider necessary in an adequate examination have been made down the line and to see by some degree of comparison, not detailed checking but more or less matching one thing up with another, perhaps, that the figures have been brought together. Of course, that depends upon who the client is. If it is a great big company which makes up its own statements and we practically check the client's statements, then there is not much question about the accuracy of our figures as far as arithmetic is concerned or getting things on the wrong line, maybe, so that you put the notes receivable instead of the cash in banks or vice versa, but watching out to see that proper attention has been given to creation of an adequate reserve for bad debts, depreciation, proper distinction made between capital expenditures and maintenance, any provisions of bond indentures, and all that sort of thing have to be observed.

Q. Do you establish the point you have just mentioned by inquiry and reference to the working papers or by some other procedure?



A. Reference to the working papers largely; some inquiry of the senior accountants, but we try to have the working papers informative on those things.

#### VI. THE REPORT OR CERTIFICATE

Q. Now, turning to the certificate, who in your firm would be authorized to sign a certificate or report?

A. Only partners, except in two or three of our smaller offices where the manager is not a partner, but in those cases he is under the supervision of a partner. A final draft of the certificate is always made by the partner, or, as I say, in those two or three cases by a manager.

Q. The earlier draft of certificates are drawn up somewhere along the line by the senior or supervisor if there is one?

A. Yes.

Q. Is it your practice to use a certificate along the lines of that set forth on page 41 of the bulletin in the case of an examination like this?

A. Yes; we use a certificate along those general lines, but in most cases the language is changed somewhat. Our usual form of certificate changes the second sentence of the form given on page 41 to read as follows:

In connection therewith we made a review of the accounting methods and examined or tested accounting records of the company and other supporting evidence in a manner and to the extent which we considered appropriate in view of the system of internal accounting control.

It will be noticed that we do not say that we have obtained information and explanations from the officers and employees of the company, and we do not say that we did not make a detailed audit of these transactions. In the last paragraph we omit the words "during the year under review" as applying to the consistency of application of accepted principles, believing that this may be misunderstood to mean that it was consistent only during the year.

Q. As to the first of your changes, that is, in the second sentence of the certificate, could you indicate the reason why you leave out the phrase "obtained information and explanations"?

A. Because we think that it just clutters up the certificate and does not help us any.

Q. And how about the phrase "Did not make a detailed audit"? What is your reason for omitting that?

A. Because we think it is more pointed for us to say that we made such an examination, that we considered appropriate, in view of the system of internal accounting control and having stated that, we think it isn't very sensible to say that we did not make a detailed audit. As a matter of fact, it is barely possible that to do that possibly we might have had to make pretty nearly a detailed audit.

Q. In some cases?

A. Yes.

Q. In connection with that, I would like to call your attention to a phrase that appears in the instruction book for form 10-K on page 11. That sentence reads as follows:

In certifying to the financial statement independent public or independent certified public accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff.

Do you mean that to mean system of audit as you earlier defined it, system of auditors?

A. A system of internal audit which, as I say, could be part of what we generally refer to as a system of internal control.

Q. In your practice do you rely upon that to include reliance upon a system of internal control?

A. Oh, yes; that is just a part or an aspect of the system of internal control. In other words, a system of internal audit may consist of, let us say, traveling auditors that go out and audit branches or, well, in that case they would do about the same thing we would do.

Aside from that, internal auditors as such just about go over the work of another person as though they were doing it themselves independently, such as a hotel auditor goes over and checks up every entry of arrivals and departures and all the rest of it; those are internal auditors as distinguished from this general internal check that is set up by the division of duties and functions and the inability of one person to get away with anything because he would be caught by somebody else.

Q. What is your understanding as to what this phrase in the language quoted means? It says:

Due weight to an internal system of audit.

Do you interpret that to mean what you have just described as internal control or a staff of internal auditors?

A. Yes, accountants, not necessarily my firm but accountants through committees suggested to the Securities and Exchange Commission several times that that word "audit" be changed to control. We think it is too restrictive, but it is that general situation that we have in mind when we talk about this internal control.

Q. What do you understand to be the function of an accountant's report or certificate in connection with financial statements?

A. Well, the function of the accountant's certificate or report should be to inform the reader that an adequate examination had been made and that in the opinion of the accountant based upon accounting principles and conventions usually applicable to a going concern, the accounts are fairly stated.

Q. Is that also the impression that you mean to convey by the use of your form of certificate?

A. Precisely.

Q. Might I ask you whether you feel that that is the impression that the public has gotten from that form of certificate, so far as you can tell?

A. I think probably not. I think that there is a very considerable portion of the public anyway that takes the accountant's certificate more or less as a warranty for more than what it purports to be. We get evidence of that every now and then. I think there has been a lot of evolution and education in that respect but I am afraid that there is still a lot of misunderstanding about accountant's certificates.

Q. Looking to the form of the certificate that appears on page 41, I take it that the second sentence is intended to be a reasonably comprehensive statement as to the scope of the examination generally in conformity with the bulletin, is that your understanding?

A. Yes, I so understand.

Q. Do you believe that any material omissions from the program indicated in the bulletin should be indicated also in the certificate?

A. Yes, if there are any material omissions from the program indicated in the bulletin the accountant's opinion should be qualified.

Q. Do you believe that the certificate should also include an indication as to any limitations in the audit engagement?

A. Well, it would be the same thing as what you have just said, omissions from the program, if it is to be assumed that the program given in the bulletin is a reasonable, fair, and adequate program for an examination.

Q. Would your opinion be the same as to those steps which the bulletin makes optional as in a number of places it is merely suggested that something might be done.

A. Yes, that is true. If there have been any limitations or restrictions in the scope of the work which would make the audit less than a reasonable and adequate examination and would, therefore, fail to enable the accountant to form an opinion concerning the financial statement, it is quite obvious that that fact should be stated in the certificate. Of course, I have a feeling that it isn't a very good idea to give a certificate at all expressing an opinion that is not based upon a reasonable examination.

Q. Do you generally have your audit engagement in the form of a written document or is it more or less an oral agreement?

A. Oh, we have them both ways. I suppose we have as many oral agreements as written. We have no standard practice in that respect. I suppose that we, most of the time, will acknowledge in writing an oral engagement but I wouldn't say that we always do.

Q. In those cases where you have a written engagement, does it ordinarily describe the scope of the audit in greater or less detail than what is customary in these certificates?

A. Very frequently not a word is said about it.

Q. Does that mean that there are no restrictions in such a case?

A. No restrictions.

Q. I believe you indicated earlier, Mr. Bell, that you felt the words in the last sentence of the certificate form here:

During the year under review,

were open to a misconstruction as to whether the consistent methods have been consistently maintained only during the year or from year to year; am I correct in my understanding?

A. That is right.

Q. You have remedied it how?

A. We don't say "during the year." We say "consistently followed or consistently maintained by the company." Of course that word "maintained" when used in connection with during the year may be understood as relating to the preceding year at least but we think there is some doubt about it so we don't use those words. It would be probably better to say something to the effect that accepted principles of accounting have been maintained by the company on a basis consistent with that of the previous year or some such language.

Q. In view of your doubt as to whether the reader of the certificate gets the impression that you mean to convey, do you think such clarifications would be desirable?

A. Yes; I do.

Q. Now, looking at the introduction to the accountant's report which appears on page 40. In there I believe you will find that matters said to be included in the accountant's report or in the statement have one of three purposes. That is, it may be merely informative, it may indicate a limitation on the scope of the accountant's work, or it may indicate dissent from particular practices of the company.

Could you indicate how a reader is able to determine as to a particular matter which of these purposes is intended?

A. Well, the only way anyone can tell is from the language used by the accountants and the language ought to be sufficiently explicit so that the meaning will be clear.

Q. Does the position of the language in your opinion have any bearing on this problem?

A. The position, location you mean?

Q. Yes, as between a footnote to the balance sheet, the scope of the audit paragraph, or the opinion paragraph?

A. Oh, very definitely. Anything that is merely informative is much better left out of the certificate entirely in my opinion. It belongs in the financial statement and it is our present practice not to put anything of that character in the certificate unless we think that it ought to go in the financial statement and our client refuses to put it there, in which case we think a reader of the statement ought to know about it and therefore we put it in our certificate, but I think that is a practice that is not to be recommended.

Now, limitations on the scope of the work should be stated in the first paragraph of the certificate after the second sentence and if they are important they should, I think, as a rule at least require a qualification of the opinion in the last paragraph.

Now, there is only one thing that I can think of at the moment, at present, that I would put in the first but not the second paragraph, and that is the question of inventories. It definitely has not become a general practice or at least it is not generally understood as an essential part of an auditor's duty in the performance of a reasonable examination to make test checks of quantities and inventories. And unless and until it becomes so, and in those cases where the auditor does not find anything wrong or has no reason to believe that there is anything wrong from the book record standpoint, we at least shall continue to have something in the first paragraph but not in the second paragraph.

Q. That is, if you don't make any physical test you will put in a note to that effect in the first but nothing in the second?

A. Yes, in other words, we will simply follow the practice we have been following for a great many years.

Q. Am I clear, when you do make physical tests, is it your practice not to put in such a qualification?

A. That is right. As a rule, we say nothing about it except that some of our clients, especially in the last couple of months, have wanted us to say something about it and we have.

Q. Do you feel that this phrase in the second paragraph:

Based upon such examination

is in effect a qualification of your opinion?

A. I have never been able to see that it was or certainly not an effective one. I don't see how an accountant could ever take refuge

in that kind of language if anything material were wrong that he failed to discover by reason of the fact that it was not covered in the scope of his examination as outlined in the first paragraph.

#### VII. GENERAL SUGGESTIONS AND COMMENT

Q. We have had the suggestion that corporations should rotate auditors at frequent intervals. Have you an opinion as to the desirability of such a practice?

A. Yes, I have. In my opinion, there is no good purpose to be served by rotating auditors. It is, however, as I have previously stated, desirable to rotate the men on the staff who do the detailed work and sometimes also the partner in general charge. Many instances could be cited where the familiarity with the broad aspects of the client's affairs obtained by the firm of accountants through long association with the client is of great value to the client and there should be no serious question of the accounting firm's going stale on the job.

Q. Is it customary for a representative of your firm to appear at directors' meetings at which the audited statements are presented and also the stockholders' meetings for the same purpose? Do you feel that such a practice would be desirable?

A. I would not say that it is customary. Fairly frequently we do appear at directors' meetings, never, so far as I know, although there may have been cases, at stockholders' meetings, although in cases we are appointed by the stockholders. We believe that it would be desirable for a representative of the auditors to attend directors' meetings and in some cases stockholders' meetings.

Q. Does your firm send copies of your reports to the directors in advance of the meeting through the management or through officers of the company? How do you feel about such requirements?

A. They don't send them to directors individually, is that what you have in mind?

Q. Yes.

A. They don't, but it would seem to me to be a good idea.

Q. Do you think that auditors, in connection with certified statements, should point out significant developments or changes during the period audited and possibly include recommendations or suggestions and include those also in the published statement?

A. Well, it would undoubtedly be well for the directors to have informative reports and somewhat detailed recommendations from the auditors in addition to the condensed financial statements and certificate. We render such reports in many cases. Now, I don't know about including that sort of thing in reports to stockholders. There are all sorts of varying degrees of detailed information.

Q. How about an inclusion in the statement of the application of funds or comparative balance sheets?

A. Comparative balance sheets are desirable in any case and income statements should be in every published report. But the statement of application of funds, I don't know. I don't think many people can understand them and half of them that I have seen prepared are wrong, anyway, and I think it is a good thing for a man on the job, an accountant, to make up, to get him thinking about the business and what has happened to it.

Q. Is that a regular part of your work, to prepare a statement of application of funds?

A. Yes; but I am afraid it isn't always done.

Q. Now, we have also had a number of suggestions as to the adoption of the natural business year. I believe you have indicated at several points that you feel that that would be a very desirable thing from the point of view of the auditor. Am I correct in that impression?

A. Oh, yes; as a matter of fact, Mr. E. W. Sells, the late head of my firm was, I believe, the first person to agitate the adoption of the natural business year in 1921.

It seems to me that the conclusion is inescapable that it is to the interests of business concerns, credit agencies, governmental authorities as well as auditors, that concerns adopt as fiscal year that period which most nearly represents an annual cycle of their operations.

If this were done, there is no doubt that the profession of accountancy in this country should be conducted more satisfactorily for all interests concerned through the lessening of the terrific congestion at the year-end.

Q. And that would be an addition to the advantages of having the auditor appointed at the beginning of the fiscal year, I believe?

A. Yes, indeed.

Q. Now, Mr. Bell, looking at the present-day auditing procedure in general, would you say that it is mostly concerned in determining that general accounting principles and conventions have been followed in the accounting records of the company?

A. No; I think that's rather too restricted. The company could follow generally accepted accounting principles and conventions and still make many errors unless one is to say that it is an accounting principle that no errors should be made. In other words, it is an important function of the accountant to discover material errors and, although there is a tendency to relegate it to a minor position these days, to detect fraud. It seems to me that entirely too much emphasis has been placed upon the change of the functions of accountants in that they were formerly sleuths, but now they are concerned with matters of principle.

Q. To what extent would you say that the efficacy of your audit procedure—to what extent would you say that the efficacy of the present-day auditing procedure depends upon the following of a prescribed routine?

A. Routine of auditing procedure?

Q. Auditing procedure.

A. Oh, it is desirable to follow more or less standardized practice, but I don't know that it is—that the satisfactoriness of an audit depends upon following a prescribed routine. When I started in auditing 30 years ago, there wasn't any such thing as routine and we used to do some good jobs.

Now, then, in an organization the size of ours and many others, it is necessary to have certain more or less standard uniform practices and it is a good thing to have this bulletin, so-called, to establish a standard of practice so that, especially in these days of government regulations, so that if there is any question as to the adequacy of an examination there will be something to point to that's authoritative.

I don't know that I have answered your question or not.

Q. I think that's what I had in mind. Would you indicate briefly, taking item by item in the balance sheet and profit-and-loss statement, those items which your auditing procedure verifies to your satisfaction by tests, independent of the accounting records and information furnished by officers or employees of the company?

A. I don't quite understand. You mean independent of information furnished by officers as well as independent of records?

Q. Yes. For example, in the cash; I understand you confirm that from the bank directly.

A. Yes. I understand it. Well, there are quite a number of assets, or may be in a given situation. Of course, cash is the outstanding one. I think that's definitely subject to outside verification. Securities may be, although as to certain of them there may be some question as to their value, but you can't get any lesser from the outside than you can from the inside in that case.

Accounts receivable are subject to outside confirmation, although I would be the last to say that in all cases they ought to be entirely confirmed; inventories are to some extent. I think, as I have said, that an accountant can satisfy himself pretty well by going out and seeing the stuff.

On the liability side there is funded debt, subject to confirmation with trustees, if any, capital stock, assuming there are registrars and transfer agents, bank loans, perhaps other things.

The income account, the income from securities, rents and so forth, the interest paid, even sales through confirmation of the accounts receivable, although that's rather indirect.

Confirmation of accounts receivable and examination of cash accounts, that perhaps is not the case in point.

Q. Now, in the second paragraph of the audit certificate set forth on page 41, there is the statement that:

In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained during the year under review, its position at December 31, 19—, and the results of its operations for the year.

When you use this form of certificate, Mr. Bell, do you mean that in your opinion as a public accountant the examination you have made has been sufficient to verify the existence of the assets and liabilities and the authenticity of the transactions?

A. Why, I think I can safely say yes to what I think you have in your mind when you say that.

Q. I wonder if you will expand that just a little?

A. The word "verify," as I said this morning, is a pretty tough word. It is pretty sweeping. It means to establish the correctness, to prove the correctness of it. Inasmuch as auditing practice, any auditing practice is based upon tests, sampling, it does not permit of establishing conclusively the absolute correctness of things. It does enable the auditors to form an opinion that things are substantially correct, reasonably correct, fairly correct.

As to the existence of the assets, the only question there would be perhaps, plant. Now, we know that the money has gone into the plant. In a simple situation we can see the plant, but we don't know that it is, of course, worth as much as it costs. There is no holding out that, on our part, that it is. There are a large number

of machines in there that have been bought to be put in there. If the plant account were analyzed, it might show 40 machines and it might be that two of them have disappeared, they have been scrapped, possibly, without credit being given in the account, through error, which we had not caught.

We are satisfied that the plant account is fairly stated.

I'd hate to be held to each item of the whole balance sheet. We are satisfied that the balance sheet is a fair statement of the financial condition of the company as accountants, and based upon these accounting precepts and conventions, that one of which is, of course, that the plant assets are worth their cost unless something happens to prove to the contrary, less current depreciation and so on.

So I say, I feel quite sure that I could say yes to what you think because I don't believe you mean to say, when you say "verify," to prove conclusively and absolutely accurately, and I don't believe you mean to say as to existence of the assets that we know that everything that is reflected in these dollars in the balance sheet is necessarily there on hand.

Q. Would you issue the certificate if you had any doubts as to the existence of these assets?

A. No.

Q. And do you mean to imply that you made an examination which you believe, as an expert accountant, is reasonable to satisfy you, to establish to your own satisfaction, that these assets are in existence?

A. Well, there again you use the word "existence."

Q. Let me restate that. Do you mean that you, as an accountant, have made such an examination as you feel was necessary under the circumstances?

A. Yes.

Q. Have you anything you would like to add?

A. I don't think so.

Q. One further question, Mr. Bell. When we were discussing the question of qualifications, the meaning of the language included in the certificate as opposed to that included in the statements—I wonder if you could illustrate your thoughts in that connection with specific examples.

Take, for instance, this rather commonly found item:

Inventories have been certified as to quantity, quality, and condition by responsible officials of the company.

A. Well, when we say anything in our certificates to the effect that inventories have been certified by officials as to the quantity, quality and condition, we mean to express a reservation. There has been a large volume of opinion, especially among accountants, to the effect that the scope of an adequate examination did not necessarily include physical test checks of inventory quantities.

For many years we have had considerable doubt that the public at large has had such an understanding and, therefore, we have made a reservation in our certificate to the effect that inventory quantities were certified by officials. Our intention has been to indicate that we have not made test—physical inspections of the goods, but that our work on the records and investigation of procedures and so forth has not resulted in any suspicion that the inventory was materially overstated or understated.



In view of our belief that in most cases physical test inspections would have afforded us greater assurance regarding the correctness of the balance sheet and income statement, we have intended to express a reservation as to the scope of our work in mentioning inventory in the certificate.

The same would, I believe, apply to a similar mention in the balance sheet, although it has not been our practice to mention the matter there since we believe that the balance sheet is the representation of the company and that it is inappropriate for a company to say in its balance sheet that it has accepted responsibility for the inventories.

Mr. WERTZ. I think that's all.

Have you any questions?

Mr. HENDERSON. No.

The EXAMINER. Thank you very much, Mr. Bell.

Mr. WERTZ. Thank you very much, Mr. Bell.

The EXAMINER. We will adjourn until 10 o'clock Tuesday, the 28th.

(Whereupon the hearing was adjourned until 10 o'clock a. m., February 28, 1939.)