

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., Thursday, March 2, 1939.

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

PROCEEDINGS

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

HENRY A. HORNE

was called as a witness for and on behalf of the Commission, and being first duly sworn, was examined and testified as follows:

The EXAMINER. Will you give the reporter your full name and address, Mr. Horne?

The WITNESS. My name is Henry A. Horne. My address—business address is 50 Broadway, New York. Residence, 39 Plaza Street, Brooklyn, N. Y.

The EXAMINER. Mr. Horne, at the Commission's hearings, it is customary to apprise a witness of his constitutional privileges. You have the privilege of refusing to answer any question if you believe such answer will tend to degrade you or subject you to a fine, imprisonment, or forfeiture. That privilege extends to each and every question that may be propounded to you.

The WITNESS. Thank you, sir.

I. AFFILIATIONS AND BACKGROUND

Q. (By Mr. WERTZ.) Mr. Horne, will you state your present firm affiliation and how long you have been a partner?

A. I am a partner in the firm of Webster, Horne & Blanchard, and in its predecessor firms, since 1933.

Q. What was the name of that predecessor firm?

A. Well, it would be Webster, Horne, Blanchard & Taylor, before that.

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

A. I have been in accounting work for 41 years; of which—private practice 12 years, public practice 29 years.

As to private practice, I was a bookkeeper for Walsh & Floyd, stockbrokers, members of the New York Stock Exchange, for 2 years, and a bookkeeper for Bigelow Carpet Company, New York, for 10 years.

In public practice, I was on the staff of Niles & Niles, C. P. A.'s of New York in 1910, and for 5 years thereafter—5 years after 1910 I became a partner in Niles & Niles, remaining as a partner in that firm until 1932, except for the time that I was in the United States Army in 1918 and 1919.

I have been in the present firm 6 years.

My total practice of public accountancy has been 5 years as a staff employee and 24 years as a principal.

Q. Had you any educational training in accounting before going into your private accounting work?

A. No; except such as, incidentally and casually, one got in public school and high school.

Q. Are you a certified public accountant?

A. Yes; I am. I am a certified public accountant in New York and Connecticut.

Q. Could you indicate briefly the size of your present firm?

A. Well, our present firm has 4 partners, has 2 offices, 1 in New York, 1 in Hartford, Conn. Has no foreign affiliations; has a present personnel of 25, all permanent staff; as a general policy we do not employ a temporary staff. Occasionally we have had a few temporary employees.

Q. Could you characterize briefly the type of business in which your firm is engaged; the type of clients, and so forth?

A. We are in general practice and we do not specialize, nor do we exclude any class of recognized accountancy engagements, but we have not done any work in what are called the "needle" trades. Among our clients have been many public utility systems and corporations for which we have made regular annual audits and also special investigations for purchases of other properties.

Also, we have assisted such clients in revisions of accounts classifications to conform to orders of public service commissions, and we have represented them in rate cases and in tax controversies.

We have acted as consultants in connection with reorganization plans and have directed the accounting necessary to make such plans effective.

Our clients have included many manufacturing and merchandising companies in businesses as varied as heavy machinery, other metal products, textiles, glassware and ceramics; also engineering and construction companies, chain stores, stock brokers, investment companies, art dealers, real-estate companies, estates, trusts, and individual investors.

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

A. Yes, I am a member of the New York State Society of Certified Public Accountants, of the Connecticut Society of Certified Public Accountants, of the National Association of Cost Accountants and of The American Institute of Accountants, and I am a director of the New York State Society of Certified Public Accountants.

Q. Have you been active in any of the committee work in any of these various societies?

A. In the course of the past 20 years I have served as a member and as the chairman of a number of committees of professional accounting societies. From 1935 to 1937 I was a member of the committee of The American Institute of Accountants on inventories.

At the present time I am a member of the State society's technical committees on federal taxation and public utilities accounting, of the committee appointed to confer with the Attorney General on accountancy matters, and of the special committee on accounting procedure. In the American Institute, I am chairman of the committee on public utility accounting and a member of the committee on accounting procedure.

Q. Have you engaged in other types of accounting work, such as publications or teaching?

A. I have prepared editorial articles for accountancy publications; some signed articles have been printed in magazines, but I have published no books. I have done no teaching; some lecturing, a few formal addresses.

II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

Q. Can you indicate and distinguish the types of accounting services rendered by public accountants which lead to or result in the certification of financial statements?

A. Well, I think the distinction that would be made would be as between detailed audits and those examinations that we refer to as examinations. And we do both, and of course, we are prepared to certify the statements that have been produced as a result of either the audits or the examinations.

Q. Which type of such services do you customarily render in preparing statements for use under the Securities Act of 1933, the Exchange Act of 1934 or for annual reports to stockholders?

A. Well, I think usually it is the examination rather than the detailed audits.

Q. You could, however, give a certification for such statements on the basis of a detailed audit?

A. Yes, there is no question about that; even more so.

Q. In the questions which follow, Mr. Horne, I would like you to distinguish, if you will between the practice as it was before the recent hearings and if there have been changes, indicate those. Are you familiar with Commission's Exhibit 117, which is the examination of financial statements bulletin prepared and published by the American Institute of Accountants?

A. Yes, I am.

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

A. No, I did not, nor did any member of my firm. We were not on those committees.

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

A. Well, to answer that I would have to go back to the genesis of this series of papers that has resulted in this bulletin. The Federal Reserve Board did solicit the assistance of the American Institute of Accountants back in 1917 in the preparation of a document which then was issued by it. I think it was based on information that came originally from the Federal Trade Commission.

The American Institute, as I said, did have a committee which participated in preparing an outline of what then was referred to as balance sheet audits and I think the purpose was that the Federal Reserve Board desired to do what it could to produce uniformity in financial statements, uniformity in form, and also uniformity in the procedure for the examination and verification of those statements.

Q. Were there any different purposes in mind in connection with the recent revision, the 1936 edition?

A. That was undertaken by the institute itself. I think there must have been a feeling that there had grown up variations in practice as indeed there had in the interval between the last preceding revision of that bulletin as we have been referring to it, and the institute thought it would be better to get up to date on the alterations in practice.

Q. Would you say that the bulletin is widely different from the 1917 edition, or is it comparatively similar?

A. I would say it was comparatively similar. That would be the comment that I would make; of course, there are differences and a number of differences. I don't think that they are greatly important, though.

Q. Now, among the types of services which your firm renders, how would you classify the examination contemplated by this bulletin?

A. I would call that an examination as contrasted with a detailed audit.

Q. In such examinations, do you feel that the principles of this bulletin are of general application to all types and sizes of companies?

A. Yes; I think the principles are applicable to all types and all sizes of business. I think we would have to limit it to principles there because the detailed procedures, of course, would have to vary with each individual type of business and with each individual company.

Q. In your own practice, do you follow this bulletin as a guide in such examinations?

A. I think the answer to that is yes, that we do, that it is a very useful guide to be had for the guidance of men who haven't had all the experience that they should have and those who need to be checked up on the work they are doing.

Q. Do you require the men in your staff to be familiar with the bulletin?

A. Yes; I think that the answer is properly yes. I don't know that we insist that they know it perfectly but they must be familiar with it.

Q. Speaking generally, do you regard the steps which are prescribed by the bulletin as a maximum or minimum procedure?

A. I think the answer to that is that it is a minimum procedure; not every detailed item mentioned in the bulletin will be used in the examination but every one that is applicable will be used and when used it is the minimum procedure that should be adopted.

Q. If you eliminate the steps in any particular case because they are not applicable, because the conditions of the case are not present, would you say the remainder represented a minimum?

A. Yes, I intended to say that.

Q. How would you compare, generally speaking, the scope of the examination as outlined in this bulletin with that followed by your firm in such examination?

A. Yes, I would say it is about the same. I think that we do more in some respects than is called for by the bulletin, and then I think that I couldn't very well express that in greater detail without taking it up step by step.

Q. Historically speaking, did the publication of this bulletin result in any changes in your own audit?

A. I am not conscious of any changes. I feel that the bulletin simply expressed what we had been doing and I think in general that that was so with respect to all of the reputable accounting firms. That is, the bulletin tried to express what was the then present practice and I am not conscious, myself, that it produced any change at all.

III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. When a new client comes to you, do you make any independent investigation of their reputation or credit rating before accepting the engagement or before you complete your first audit?

A. Well, I think I remember one case where we felt that we would like to know a little more and asked our bank to find out something about that client, but usually the clients come to us recommended by somebody in whom we have a great deal of trust. We don't know of any reason for questioning the general decency of the client. No, we do not want to get into disreputable connections at all, and so we would be rather careful of that. So far as credit rating is concerned, that is, as to whether our bill would be paid, we know that pretty soon when we get working in the company's accounts.

Q. From your experience, Mr. Horne, who would you say exercises the prerogative of appointing auditors to certify annual reports to stockholders of companies having a public ownership of their stock?

A. Well, the word "prerogative" makes me wonder a bit. I think the one that does employ the auditors or transmits the request for the auditors to come on the work is some one of the operating officials of the company. Sometimes it is the president; other times it has been the vice president; sometimes the vice president in charge of finance; the treasurer, of course, more often than not, I guess, and sometimes a man who will have the title of comptroller.

Q. Did you mean to imply that they were doing that at the direction of some other body or person?

A. Yes, I think that in every case which I can think of that the board of directors has at least tacitly approved of it. It sometimes definitely has been expressed in the minutes of the board of directors that our firm should be selected as the auditors.

Q. Who would you say initiated the appointment of auditors? Would you say that comes from the board to the officers or from the officers to the board?

A. I would think usually from the officers to the board, although I do know of cases in which directors have suggested that that would be their wish, and there being no objection on the part of other directors and it being perfectly acceptable to the officers, that has been done that way.

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

A. The responsibility, of course, runs to the company, and the company, I think, means the stockholders.

Q. Do you recognize any responsibility to the board of directors or to the management, the people that employ you?

A. You mean as separate from the company?

Q. Yes.

A. That is, put their interests aside from the company? No; I would distinctly not recognize any responsibility to them at all. That is, if there was any point in which their interests were divergent from that of the stockholders, that would be just too bad for them.

Q. When you accept an engagement, Mr. Horne, by what representative of your firm would the scope of the audit be determined?

A. Well, by the partner with whom the matter was discussed. It would be discussed—naturally, there would be some sort of an oral agreement between the representative of the company to be audited and a partner of our firm and that partner would be the one who would decide what would be the scope of the work to be done.

Q. Does that apply to these annual examinations for the purpose of certifying statements for public use?

A. Yes; I would say that that would be so. Certainly it would be a decision as to whether there should be a detailed audit or an examination only.

Q. Do you reexamine the scope of your audit at intervals in the course of a continuing engagement?

A. Yes; I think that it is reconsidered every time that an audit is done or an examination is done.

Q. Do you approach that as a new problem or do you start your work from the auditor's outline previously?

A. Well, the fact that we have done it in the previous year would lead to a presupposition that we do about the same thing, but we would have that confirmed.

We would say to some representative of the company, "Well, now, are we to do the same as last year, or shall we do something more?"

Q. Do you attempt to vary the steps that you would follow in any given year from what had been followed the previous year?

A. Well, if you are now speaking only of the examination that is outlined here, I rather doubt that there would be any particular change. Sometimes we have received the acquiescence of our clients in extending the scope of the work to cover other features which we think of as something beyond what is absolutely necessary for the signing of the annual statements. That sort of thing is very frequently changed. In fact, we recommend to our clients to let us do that sort of thing, go into this department this year and another department of the activity of the office another year and make a more extensive survey than we would need to, and that is agreed to in many cases.

Q. Might you characterize it this way: That you try, in connection with an examination, to make what you might call a detailed audit of some part of the business?

A. Yes. Yes; that's it. I am thinking of a case where in one year we will make an examination of their methods of shipping and billing, and another year we will make an examination—an audit, perhaps, is proper to say, of the pay-roll procedures, and so forth; there may be a variety of things.

Q. From your experience who would you say makes the decision as to the scope of the audit on the part of the client?

A. Well, I think that the administrative officer with whom our partner will consult is the one who makes the decision. I think that he has, generally, the acquiescence of the board of directors; at least a passive acquiescence, but I think that as to deciding whether it shall be a detailed audit or whether it is merely an examination, that that particular officer, the treasurer, president or vice president, whatever he is, is the one who makes the decision.

Q. Looking to the future, Mr. Horne, would you recommend any changes in the method of appointing auditors, or in determining the scope of the audit?

A. I think that the suggestion that has been made in the public press recently that there be generally adopted a practice of the board of directors selecting from among themselves an auditing committee, which auditing committee would then assume the responsibility of selecting the auditors, selecting them in advance, presumably, and of having the auditors report to them. I think that that would be a good alteration.

Q. When you say "select in advance," what do you have in mind there?

A. Well, select them some time substantially before the end of the year, at least. Perhaps at about the time of the annual meeting.

Q. In the spring of the year?

A. In the spring of the year, if we are speaking of a calendar year as the fiscal period.

Q. Yes. Would you feel that that auditing committee should be composed of directors who are also officers, or of directors who are not officers or have you no feeling in that respect?

A. Well, if there were both classes of directors I should suppose the prudent thing would be for that auditing committee to be composed of those who were not officers. That would seem to be the way that I would like to do it, were I a director in such situation.

Q. Now, turning to the organization of your own firm, Mr. Horne. Do you classify your personnel as between, say, juniors and seniors, and others?

A. Yes; we do. There are those who are seniors and there are those who are juniors. There are some in between, some folks would call them semiseniors. I don't think that is a very happy phrase, but nevertheless we use it.

Q. And above the rank of senior, what have you?

A. Why, the seniors report directly to the partner. You see ours is not a really large firm.

Q. You have no intermediate classification?

A. No; we have no intermediate supervisor.

Q. When an engagement is accepted, Mr. Horne, how do you determine which partners, seniors, and juniors will work on the particular audit? Do you have any criterion there?

A. Well, of course, the partner who has made the contact and who had the discussions with the company will, almost assuredly, be the one who will direct the work. And I think we simply look over our staff and see which man is probably, taking everything into con-

sideration, best adapted to do that job, as well as is free to do the job at the time that it needs to be done. Those things have to be considered.

Q. Are such assignments permanent for successive audits?

A. No, they are certainly not permanent though it does happen that they are often repeated. That is, a man who has become familiar with a client's office is undoubtedly able to find his way around more quickly and more surely than one who is not.

Q. When you say not permanent but repeated, you mean they are repeated only once or repeated year after year?

A. Well, I wouldn't want to say with any candor that we had any fixed rule about that. Actually there is a fair amount of rotation but it happens through circumstances rather than through deliberate intent.

Q. How about the juniors on the job, are they rotated at all?

A. Why, yes, of course. They are very decidedly shifted around so that those who have not achieved the rank of senior probably work on about every piece of work that you have in the office.

Q. Do you recognize any disadvantages in your practice that you feel—would there be advantages gained by more frequent rotation or less frequent rotation?

A. Well, do you know, I think there would not be. I think that there does happen in our organization enough of rotation to make us perfectly sure that the senior himself hasn't gone stale on the job, which is about the only thing that I would think of in that connection because we really do make enough careful surveys and investigations of our men to know that we can depend on them.

With us, of course, there is always a possibility and I think that is the thing that is thought of, that a man might get a bit indifferent because of familiarity. I think we move our men around enough so that they are just bound to have a fresh point of view.

Q. Now, when you are looking for juniors for your permanent staff, how do you go about recruiting them, from what sources?

A. Our procedure is to go to the colleges. We have made it a point for a great many years to try to get only young men from colleges.

Q. Do you require any special type of training in the college?

A. Well, we prefer, of course, that they have taken an accountancy course and so we like Harvard business-school men, Columbia men and especially men from Dartmouth; the Tuck school in Dartmouth has been quite a favorite of ours.

Q. You have mentioned, I believe, earlier that you ordinarily have no, what might be called, temporary staff.

A. Well, we have no temporary staff. I did say that occasionally we do need to get a temporary man and so we do.

Q. Does he sometimes become a member of your permanent staff later?

A. Yes. If he demonstrates that he has real abilities, why he may stay on and has.

Q. Now, after you have obtained these juniors do you have any further requirements as to self-education or teaching them yourselves?

A. Well, we do not run regularly any training classes. We do put a great deal of pressure on our young men to prepare themselves for the C. P. A. degree—C. P. A. certificate and to pass the examination.

We have at times, when there were several of our young men in training for the C. P. A. examinations, we have asked the seniors to organize little coaching classes, rotate themselves around so as not to make too much of a burden on one man but to take on the job of coaching these younger men to take the C. P. A. examination.

Q. Do you have any requirements for them to take further courses, part-time courses?

A. We haven't had such requirements. Certainly that would be indicated if they needed the preparation.

Q. Do you require the obtaining of a C. P. A. certificate as a prerequisite for advancement?

A. Yes; I think it is a fair thing to say we require it. I just wonder if we would dismiss a man if he hasn't done it? They don't ever fail to do it, they go ahead and get the certificates.

Q. Could you describe briefly the type of duties which you assign to juniors?

A. Well, I should say that the senior on the work has always the obligation to consider what large amounts of work of a similar, habitual, sort or nature can be assigned to somebody and that sort of work will be assigned to the juniors.

The conventional answer would be to say that we put them at checking vouchers and so on. Now, I don't think that is a wholly accurate answer because I have very clearly in my mind a case 2 or 3 years ago in which I said to the senior—

Now, we learn that there is a great deal of dispute in this,

Which was a closed corporation—

as to the propriety of the cash disbursements and so I am going to ask you, Mr. Senior, to arrange the work so that you, yourself, will examine all of the vouchers, all of the checks, so that you will be alert to see everything that we might feel that would be necessary to report in connection with this controversy.

So that in that case, though he had two assistants with him, he, himself, did the vouching of all of the cash disbursements and that was for a period, I think, of 2½ years.

He assigned them other parts of the work, laid it out so that the assistants who were with him could do that. That is, he gave them analyses to make and then he went over the analyses afterwards, but that which is often spoken of as being work that was assigned to—the work that is ordinarily assigned to juniors was definitely, by myself, assigned to him as a senior.

Q. Would you say that for the work that is customarily assigned to juniors, that a knowledge of accounting is necessary?

A. Yes; I think that that's so.

Q. Now, turning to your seniors. From what sources do you customarily obtain them?

A. We just promote them through the ranks.

Q. What quality do you look for, particularly?

A. Well, of course, we want a man who is alert, imaginative, who has a pleasant personality so he may meet the clients well and may not arouse any antagonisms and, of course, he will be thoroughly skilled in accounting matters. Very much more skilled, of course, than we would expect juniors to be.

Q. Could you characterize the duties of a senior? What kind of duties do you assign to them?

A. Well, of course, a senior has the task of taking care of the engagement, laying out the work for the juniors who are under him and generally seeing that the work is carried out in accordance with the conduct that has been laid down by the partner who has conferred with him before; that is, whether it shall be a detailed audit. If so, he shall see that that is made.

If it is an examination such as is comprehended in this bulletin, then he shall see that that is made.

Q. Do you consider it a part of his duties to train the men under him; the juniors assigned to him?

A. Yes.

Q. How would he do that?

A. Why, he would assign them their work and I would expect that every time he would take some of the documents, let's say if we are talking about the vouching of disbursements, would call to their attention the things that should be observed in respect to those documents and of the records through which, let's say, he was checking, go through the motions of checking half a dozen or so, telling how he expected the pages to be footed and the footings carried forward.

Q. Would you expect there would be any difference there between a raw junior and one who had been with you for some time?

A. Obviously there would be a difference in what I have been speaking about. Undoubtedly it would be the procedure a senior would take with respect to a junior whom he had not had any chance to train before. After he has done that several times he just tells him to go ahead and do as he did before.

Q. He would ascertain whether the junior knew the work he was supposed to do?

A. There would be no question about that. He would find out that was so, some way or another.

Q. How do you satisfy yourselves that the juniors have actually carried out the instructions and done a satisfactory piece of work on the documents or on the duties assigned to them?

A. Well, of course, we have the seniors do that for us. When you say, "How do you satisfy yourselves," you mean the firm?

Q. And what does the senior do?

A. The senior's task is to go over the papers that the juniors have prepared, ask them all the penetrating questions he can, ask them how they did their work and determine whether the work was done satisfactorily and, if necessary, go back and see what some of the items were, that were treated in some way that might come to his attention.

If the junior would, as he almost inevitably would, ask questions about this, that, or the other step of his procedure, why, the senior would then have a chance to correct, to guide or instruct the junior under him.

Q. And would he make any examination of the original documents or records that the junior is examining to see whether the junior has done the things he was told to do?

A. Well, if you mean by that, do it all over again, no. But if you mean simply this sampling—testing—I think that that is almost

inevitable and I think that among ourselves our instructions require that all unusual matters shall be noted by the junior in the course of the progress of his work.

He then would call those to the attention of the senior or he wouldn't need to call them, the senior would see his memorandum and would read them and would ask what was meant and, "Let me see the document," and so on.

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

A. Yes; I think that it is a fair thing to say that we do. That is a fair question. I think always while an engagement is under way, one of our partners will visit the place where the work is being done.

Q. What do you do down there?

A. Of course, he will go over the papers to some extent, most of it, of course, at the home office. He will talk with the seniors, with the senior or seniors, if there happens to be more than one, ask them if they have any questions; if there are matters on which they want decisions.

He will see the treasurer of the company and other officers and will generally inform himself. For example, if he has never been there before, he would say:

I would like to go out and see your plant.

They will take him out and see the plant. If there is any question about the method of storing the inventory in the storehouse or warehouse, he would be likely to go out and look at that and see what, if anything, was peculiar or unusual about that.

In general, he would try to inform himself as much as he could in a general way about the business of the client and the personnel of the organization.

Q. On a new engagement, Mr. Horne, would you expect your staff assigned to a particular job to become familiar with the general trade or industry in which the business happens to fall?

A. Yes; we would. We expect our young men to be alert and intelligent and curious and inquisitive enough to want to know about the business in which they are working and the fact is that they do learn a great many interesting things and come back to us with a great many interesting stories about the client's affairs. They do know.

Q. Do you expect the juniors to be sufficiently familiar with the type of records and documents that they will have to examine in the course of their work to be able to recognize any significant irregularities? For example, the lack of endorsement on a check or the lack of proper approving initials on vouchers?

A. Yes; those are among the things to which I referred a few minutes ago. They are supposed not only to observe those things, but to schedule them and report them back to their senior, and he in turn will turn that schedule over to us.

Q. How do they obtain the training as to what an irregularity is?

A. Well, I would hope that the accounting school started them on that training and certainly this initial instruction that I have referred to before, that the seniors shall give the juniors, would be directed, particularly, to that point.

Q. I think that you have already said that you expect them to—definitely to note those and report them. Is that correct?

A. Yes. That's one of our rather rigid rules that they shall be noted and reported.

Q. What instructions do you give the staff as to the course to be followed when such irregularities are discovered? Do you leave that up to the senior?

A. Well, of course, that would be—that would be presumed. The junior certainly wouldn't proceed to run in and commence to scold somebody because he thought he had noted some irregularity. He'd present it to the senior and if the senior felt quite sure that it was simply a matter of clerical inaccuracy, why, he would probably go to the chief clerk of the office and see that the thing got corrected. I think he would keep a note of those things just as definitely in that case as in any other.

If he had any suspicion (and, of course, it is always possible that there might be something suspicious in the way of fraudulent irregularities) about it, why, he might very well keep his counsel entirely to himself. In fact, in not a few occasions the senior has written in to the office and has asked, "Now, what procedure shall I adopt?" And we attempt to give him the best advice we can give him.

I think that there may be cases in which he would just not say anything to anybody in the organization until he gets back to the office and discusses it with the partner and, I can think of a particular case in which all of these things were accumulated to just about the completion of the engagement and then handed to one, this was a partnership, then handed to one of the partners of the firm who was acquainted with the facts and then suitable treatment was applied.

Q. Would you say that before you go to the client, in the case of a significant situation, that you familiarize yourself as far as possible with the—what you think the findings to be before going to him?

A. Oh, of course that would be so. That would only be prudent. I think it would be extremely foolish, and rather prejudicial to one's professional standing, to run to the head of the office and attempt to make a great display of finding errors until one were relatively quite sure that there were errors or irregularities.

IV. CONDUCT OF THE EXAMINATION

A. INTERNAL CHECK AND CONTROL

Q. Now, turning to the system of internal check and control, Mr. Horne. To what extent do you require the members of your staff assigned to a particular engagement to become familiar with the concern being audited? That is, the plant lay-out, the operating methods, the nature of the products, the character of the personnel, the methods of doing business and so forth.

A. Well, of course, I don't think they could do either an audit or examination without becoming very familiar with all of those things. Not the kind of an audit or examination we talk about in any of these hearings. They just have to be.

And I answered a while ago that they become familiar with the business in general. Well, they become very much more familiar with this particular business, because that's just exactly what they've gone there to learn about and I think that so far as I am concerned, it's always been one of my instructions that the men do take enough time to go around to see the plant lay-out, and of course, they must

learn the operating methods and they must know what is being produced and, of course, they will make a definite schedule of the personnel, certainly all of the personnel with whom they would conceivably come in contact and learn what are their duties.

Q. Do you prepare an organization chart or its equivalent indicating the accounting duties of the personnel charged with handling accounting transactions?

A. Yes; that is one of the definite requirements that there should be. I think we usually call it schedule of personnel with the duties assigned to each such person.

Q. Do you put that into a permanent file or something?

A. Well, yes; we do not, and I know that other folks do, we do not separate our files into those that are current and permanent, but we do know that certain papers are to be, as we say, transferred forward, to the papers of the next engagement and that paper will be transferred forward or modified or brought up-to-date completely.

Q. What do you understand the term internal check and control to mean, and can you indicate some of the common basic features of such a system?

A. Answering the first question I think that it means, certainly it means to me, that the accounting duties are so divided that things which might be antagonistic to each other are in the hands of different persons, and answering the second query, the purpose is, of course, to try to prevent errors that are made by one person going along without ever having been checked by another, or dishonesty on the part of one person without its having been brought to the attention of any other person in any way. That, I think, is the purpose and the intent of any system of what could be called internal check and control.

Q. Can such a system always be used?

A. No; simply because so many corporations are so small that it is quite impossible to make such a subdivision of duties, and I think that is the fair answer to make to such a question.

I think that in any organization where, because of the quantity of items of work, there must of necessity be a varied personnel, that it is distinctly a shortcoming if there is not a separation of those duties and a classification of work so that there will be just by that fact alone something of internal check and control.

Q. Do you distinguish in any way the phrase "system of internal audit" from "system of internal check and control?"

A. Yes; I do. I think they are two quite different things. The system of internal check and control of which I have been just speaking ought to exist in any case where there is a substantial number of employees, but I do think that a matter of internal audit might be relatively rare, that is, by internal audit, now, I mean a definite plan to go over and review by other persons, work that has to be done initially, and completely done, by some other clerk.

Q. Would you say that the system of audit, the internal system of audit, might be regarded as one feature of a system of internal check and control?

A. In a large enough organization it might very well be.

Q. Now, turning to page 7 of the bulletin, Mr. Horne, there is a statement there that the nature and extent of the examination depends on the purpose of the examination, the amount of detail included in the statement 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.

Now, taking the first of those, the purpose of the examination: Could you explain the effect of that on the scope of the examination?

A. Well, I think I said in the testimony I gave with respect to my qualifications, that we have done a great many examinations for purchases of other businesses and if that were the purpose of the examination, one would naturally go into some things very much more completely than would be necessary if the business was going along in the same ownership as a going business, and the statements were simply prepared in course to go to the same stockholders without there being any thought of change in organization or arrangement of the affairs of the concern.

Now, one can think of a variety of things that would be different in a case of that sort and when one makes a detailed examination, for example, and it is desired to report, let us say, to the members of a partnership or to the few stockholders of a close corporation and it is desired to have a good deal of information given to them which perhaps their own staff have not the skill to prepare for themselves, why, there again there would be a very substantial difference in the method of doing the work, and the amount of work that would be done.

Q. Now, the third factor mentioned was the type of business the accounts of which are to be examined. How would that affect the scope of the audit?

A. Well, of course, I suppose that if one were examining an investment company, that you would almost find it inevitable that you would make a detailed audit. If you were examining a manufacturing or merchandising company with a myriad of small transactions, you would probably make an examination if the cost was desired to be considered at all and so, of course, the type of the business that is being done would make a very substantial difference.

Q. Would you say that the scope of the audit would be adjusted so as to give more weight to those assets which were particularly important, for example, comparing a manufacturing business with a utility on the question of inventory and fixed assets?

A. The answer is yes to that. Of course, the important things will have the most attention paid to them.

Q. Now, as to the system of internal check and control, what effect has that?

A. Well, I should suppose that if there were no system of internal check and control, let us say, if you had a one-man organization so far as the accounting was concerned, that it would just about be a requisite that a detailed audit be made, whereas if you had a large, finely organized office and you could see that there definitely were present all the elements of a good system of internal check and control, it would be just folly to attempt to make a detailed audit.

Q. In several places in the bulletin, a distinction is drawn between the small or moderate sized businesses to which section 2 is applicable,

and large corporations to which section 3 is applicable. Could you explain what criteria are used for this distinction? That is, is the volume of the transactions, the dollar value of sales, of assets, the location of assets, or what is it?

A. Do you mind if I call to your attention the fact that section 3 is modifications of organization for larger or smaller companies.

Q. Yes; I was just using the larger here.

A. Well, I think that the thing that that means to me is a business in which there are a greater number or a smaller number of transactions. I think that that all goes together generally, although not necessarily; of course, there may be a one-man office that handles transactions running into millions and millions of dollars, but generally speaking, I think that a large capitalization and large assets will usually mean a large number of sales items and a large number of transactions and necessarily a large office personnel. And so it is that I think that is in mind. If it must be one thing only, I should say it was the number of transactions.

Q. Would you say that it is about as easy to audit a 50-cent transaction as a \$5,000 one?

A. Roughly speaking, although I should hope that it would not be done quite as casually with a \$50,000 transaction as might be the case with a 50-cent transaction.

Q. On page 9 of the bulletin it is indicated that the extent of the examination is to be determined in part from the accountant's knowledge of the situation. What is your understanding as to the extent of such knowledge of the situation which the accountant should have before he completes his examination? That is on page 9, the last sentence, in the first paragraph.

A. Well, of course, I have said before that I think an accountant ought to know the company that he has been auditing quite thoroughly when he gets done with it. He will be in the process of acquiring this information all through his audit. That is what he is there for, to acquire that information, and I think that of course he uses his prior experience in acquiring that knowledge and this phrase, "on his knowledge of the individual situation," I think just means the knowledge of that particular situation on which he is then working at that time.

Q. In your own firm, Mr. Horne, how do you go about developing information in respect to a client's procedure in its system of internal check and control?

A. Of course, it is a matter of inquiry. I think that we would start it on getting the engagement. First, whoever it was of our office that had the contact with the client's representative would himself begin to ask questions as to what was the basic purpose of the examination, what kind of business was being done or if there were any peculiarities about this business as related to others that might be mentioned, and I think that we would then instruct the senior to pursue that same line of inquiry, learn what he could about the business and develop all the information that seemed to be relevant in any way that would enable us to form an opinion as to the financial condition of the company because basically that is what we are doing all the time; in respect of these audits and examinations we are forming our opinion as to the financial condition of the company that is being examined.

Q. Of whom would such inquiries be made? Would it be any particular person or any one you thought knew about a particular matter; how would you determine that?

A. I think the latter would be the way to go at it because I have always felt I was quite unhampered in these examinations about asking anybody who would have any relevant knowledge. I feel always that we should do it with all sorts of politeness and recognition of the amenities of the situation, but nevertheless I have never felt that we were to be prohibited from asking anybody anything with which that person could be expected to be familiar with respect to the finances and business of the company and I think I have tried to transmit that same sort of feeling down to all our seniors.

Q. Do you utilize any set list of questions or a questionnaire as to the system of internal control or other particular topics?

A. If that means a formal printed questionnaire, we do not. We do not have any specific form that we try to apply to every situation, but we will develop a questionnaire as we go along with the work.

That is, almost inevitably the senior will go out with a group of questions which the partner will want to get answers to and then he will be expected to put on other questions. He will put down: Remember to ask so-and-so about so-and-so, etc.

Q. Are those questions directed to any particular thing? Are they very broad, general questions, or are they specific as to the method of handling the case, or are they both?

A. The things that I am talking about are specific. The general questions hardly need to be written down. They know them. That is, the senior knows them and the partner knows them. The things that need to be written down are the specific things so as to be reminded to watch out for those specific things.

Q. How do you go about determining that the system of internal control, that you have found is said to be in existence, is actually in operation?

A. Well, by no other way than the intelligent, alert observation of the accountants on the job. I said before that I want them to be inquisitive and curious in respect of about everything they can think of that is relevant to the business, and I think they must be just so alertly and intelligently inquisitive about what is done around the office and how it is done.

Q. Do they make inquiries in this connection of the people who are supposed to be performing the various duties?

A. Well, when they are working in an office, of course they see what is going on. I think that that would be what would be basic to it. Of course, there would be no reason why they should not ask questions about how things are done and, of course, they do ask questions, but they would see what was going on.

Q. Would they also examine various papers used in the office to see that they were properly initialed as evidence that the internal system was working when they weren't there, so to speak?

A. Yes, that, of course, would be part of the thing that they would be making observation of as they examined these various papers and documents.

Q. In checking up on the system of internal control, I think you mentioned earlier in the day that you liked to make perhaps a de-

tailed audit of some specific department in one year and another department in another year.

A. Yes.

Q. Is that done by pre-arrangement, or just when you get permission of the client and then go in and do whichever one you wish?

A. The cases that I was speaking of are always done by pre-arrangement because that, as I think I indicated before, was something above and beyond what we really expect we need to do as a matter of making a report on the financial condition of the company.

Q. Do you do anything of that sort on your own, so to speak, in the course of a regular examination, give more attention one year to particular types of things and another year to other types?

A. I think that that almost sounds as though it could be said in reverse. Do we neglect doing some things in one year that we ought to do, and I don't think we do. That about is the way in which I meant to express it before. I think we would make an examination as fully as we thought was needed, and then if for the client's own purpose, administrative purposes, let us say, he desired that we go further and we have often suggested that we do, why, then, we would get his acquiescence that we do such extra work and presumably I think in every case render a separate and special report on that thing.

In fact, I have that in mind right now, one of our audits is being finished this week and I intended to use that senior, but the client said, "Last year you suggested you might do this particular piece of work and we suggest you do it this year," and so I have lost that senior for the job I wanted to use him on.

Q. If, in your study of the system of internal control, you find what you call weaknesses, would that necessitate further additional audit steps?

A. Yes; that would.

Q. If they were significant weaknesses?

A. Yes; if we went in with the presumption that we would do what we might speak of as only an examination and we found, for example, that which had been told to us was a system of internal check and control, just turned out to be nonexistent, and that might very well happen just by this bit of observation of which I have spoken just a few minutes ago.

If, for instance, the senior should find that the bookkeeper was in the cashier's cage working on the cash book he might make some inquiries as to, "Well, is this the regular thing?" "Oh, well, yes, it happens once in a while. I am pinch-hitting for Mr. Brown."

The senior would pretty well know as respects that division of responsibility, theoretically, that it was not there in fact, and if that were so, we would have to go further by far than we had expected in the first place.

Q. But would you discuss that particular work with your client, or would you go ahead and do it, or what would you do?

A. Well, of course, back in the New Era days I am sure that we would have discussed it with the client and would have expected to get an additional fee for it. In these present days I am not quite so sure that we would. We do the work but I am not quite so sure we talk so much about it. We go ahead and do it.

Q. When you have completed your study and verification of the system of internal check and control, do you feel that that should

have resulted in a real knowledge on the part of the auditor of the accounting system followed by the client, including a knowledge of the papers and documents which are supposed to accompany various steps in the accounting procedure?

A. I think the answer is yes on that. Of course, he wouldn't know about the documents that he hadn't seen, but he would know about the sort of documents that should have been present as supporting evidence for the transactions that he was examining.

He should have known that very thoroughly.

Q. Take the senior: he would not have seen all the documents which would have been prepared for the client or come into the client's office, but he would know what the documents were that were supposed to be attached to a voucher jacket, for example?

A. Yes.

Q. Would you say that an examination in accordance with this pamphlet should disclose fraud? I think you might read in that connection the second sentence of the second paragraph on page 10 of the bulletin. 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 account.

A. Yes; the phrase says it will not necessarily disclose defalcations, and, of course, it would not disclose every defalcation, but I certainly think that the procedure that we have been talking about would disclose defalcations or fraud of any substantial amount.

One might think of it as being a sieve that we are using. If we use a sieve with a coarse mesh which might be the examination, why, a good many things would go through that we would never find. If we use a fine-mesh sieve, which would be our detailed audit, we would catch very many more such transactions, and I think in any event that the answer to that would be yes, that is, that the examination should disclose defalcations.

If you ask me, and I think that you did imply as a question why that phrase was in there, I think I have to turn back in my mind to that original document on verifications of financial statements which was got out in 1917. I think by that time there had arisen a practice that had come to be called the doing of a balance sheet audit. I think a few years before that, possibly 4 or 5 years before that, that was coming to be something of an accepted practice, to certify to the balance sheet only without a statement of income.

I think that that was not approved by most of the better accounting firms, and we were saying during the time that we were doing that kind of examinations, and I think we did a few of them—we were saying, "Well, now, you realize this is not a detailed audit. This will not catch fraud, defalcation"; that is the phrase which persisted on into this present edition of the bulletin, because we were realizing that we were making, to revert to my figure of speech that I used before, that we were making an examination which might be compared with a coarse-meshed sieve and things would get through we wouldn't be able to catch.

Q. Would you say that the auditors should be satisfied as to the general accuracy and integrity of their records before signing a certificate based on a balance-sheet examination such as contemplated by this bulletin?

A. Certainly we are never willing to sign our name to a report unless we are satisfied ourselves that we have formed definitely an opinion that we have got honest records, that we have worked on honest records and that they have fairly shown the financial condition of the company.

Q. Now, within the scope of the examination that you do, say the sampling of records that you do examine, would the examination contemplated here disclose irregularities and defalcations?

A. Yes; indeed.

Q. Within just that part of the record that you examined?

A. Yes; I was having in mind the limitations you put in the question; yes.

Q. Now, speaking generally, do you make samples of various types of transactions such as sales, plant additions, cash disbursements, receipts, etc.?

A. Yes.

Q. Do you feel—

A. That is the thing that is spoken of as test checks or sampling, more than sampling in some cases a great deal. For example, I think that it has been my practice to insist upon a pretty thorough examination of all plant additions.

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

A. Well, verify, of course, may be given a very stiff meaning. My comment about that would be that we are engaged in the case of making an examination of this sort, in accumulating a lot of circumstantial evidence, secondary evidence, so to speak; I think that if we were to find that all of our sampling worked out with entire satisfaction, that the probability was very great that all of the other transactions that were not examined were of the same satisfactory class.

Q. It does not, however, conclusively establish the other transactions as it implies?

A. Well, I think that that just says it doesn't. Of course, it is not conclusive about anything that has not been examined and, of course, if that means proof it does not prove that any other transaction except those that were examined was either right or wrong, but the implication and the inference is bound to be very strong that if we have got a certain result from the sampling, that the same result would follow from a mass of the material.

Q. And you feel, then, that that implication is sufficiently strong so that you should be able to rely on it?

A. Well, if it were not sufficiently strong we would keep right on until it was.

Mr. WERNTZ. May we have a recess?

The EXAMINER. We will have a short recess.

(Thereupon, a short recess was taken.)

AFTER RECESS

B. CASH

Q. (By Mr. WERNTZ.) Now, Mr. Horne, I would like to turn to some of the details of the audit program: First, to cash. Do

you consider the cash program outlined on pages 11 and 12 as a minimum or maximum procedure? In connection with that, would you indicate any additional steps that you customarily perform and any steps that you generally omit?

A. Well, I think that is a minimum procedure. I don't think of anything here that I would be willing to omit. I think that there is an addition that I would like to make because the case does arise fairly frequently, or it has.

There are some cases in which a company will not follow the accepted practice of depositing every day's receipts in the bank as of the day received, but will deposit irregularly, sometimes just smooth, round amounts. In such cases we instruct our men that they must, when they count the cash, and that is the first item you have here in this program, if they have found that that is the procedure I have just outlined, that they must, then, audit back to the balance sheet date, that is, verify the cash by a count of the cash that is in the office then, and get a statement from the bank brought down to that date and take all the checks that have been returned and prepare a new reconciliation and audit the intervening period, whatever it may be, a month or a month and a half, back to the balance sheet date. That is an addition which I think I would want to make to this program in the proper case.

Where, of course, the senior has found that the procedure is persistently and regularly adhered to of disposing of all of the day's receipts in the bank and that the only loose cash, so to speak, around the office is that that is attached to an imprest fund, it isn't necessary to do all that.

Q. On page 33 of the bulletin, a reference is made to reconciliation of bank accounts by employees who are independent of the cashier's department. How important do you consider that feature?

A. Well, where it is applicable, as is suggested here in the bulletin, and if I may read what it says, that would make rather clear where it is important: Where there are a great many bank accounts with a number of relatively small working funds which are reconciled periodically by employees independent of the cashier's department, it may not be necessary for the accountant to reconcile all the working funds, but only to do so for the principal bank account, accepting copies of reconciliations signed by internal auditors for the remainder.

I think very definitely of a case that fits that description perfectly, a large public utility company. This might be a verbatim description of what they do. They had a number of working funds scattered around throughout their wide-flung territory and on our first engagement to do that, the question came up as to whether they should be verified.

I made inquiry: Do you not have traveling auditors; I think you told me you had? Yes. Do they not audit these things? Oh, yes, they do. Well, let me have all of their reports for a period of a year and a half or so back. But I recall that at that first time, though they thought that that had been done very thoroughly, it had not been done very thoroughly, and my recollection is that at that time I asked that the custodian of each of these funds write an acknowledgement so that we might thus ascertain and know that he had such funds. That was the way of covering it that time.

By the time we got to the next year this procedure as outlined here (indicating on book) was in full effect. In the last few months of the year they had examined those funds, had examined the cash, made the reconciliation and of course we accepted that.

Q. From the point of view of internal control, do you feel that reconciliation of bank accounts independent of the cashier's department is an important feature?

A. Yes.

Q. And would its importance or significance vary as the size of the fund increased?

A. Of course, the more money, the greater the risk. Of course, it would be almost an idealistic thing to expect that even if there were only one bank account, that somebody other than the cashier himself might prepare the reconciliation. That probably is done sometimes. Not often, though.

Q. Turning to item 8 on page 12, the last sentence thereof reads:

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

Does your firm insist upon this procedure, and what is the utility of it?

A. That last sentence has to do, of course, with the remainder of the paragraph and it certainly contemplates that there may be some question arising in the minds of the auditor as he is doing the examination, this minimum examination of which I have spoken before, of the last 2 or 3 days, certainly I would say one would go back further than 2 or 3 days. But if we made it as small as that, if the auditor were to examine the cash transactions for the last 2 or 3 days of the period, and he found some entry there which to his mind suggested that he had better see when that was deposited in the bank, let us say, if at all, why, he would then of course have an obligation to find out either by getting a statement anew from the bank, which is the thing which we have done at times, or asking the bank to return or permit him to see the deposit slips that had been turned in to the bank, or examining the duplicate deposit slip that might be kept in the office of the company.

It might not also. If your inquiry is: Do we in general make it a point to examine duplicate deposit slips of the bank just by themselves without any motivating purpose, the answer is no. And yet I know that there comes to my mind a reference to a case that I spoke of here earlier this morning, where a series of irregularities had been accumulated until the end of the period, and it is quite clear in my mind that the thing that made it quite definite that this irregularity was a thing that might be called by a harsher name is the fact that by getting the duplicate deposit slips and comparing them item by item with the items recorded in the cash book, it became quite apparent that some amounts that had been received in currency and had been so recorded in the cash book had never gone to the bank, and that was the step which led to the determination of what proved to be a defalcation not major in amount but genuine.

Q. Now, again in item 8 in the third line, the term bona fide receipts is used. What is your understanding as to what is meant by that term, and how do you determine that receipts are, in fact, bona fide?

A. Well, the context I think pretty well explains that, because—may I read the remainder of that clause:

Determine that they were composed (that the deposits were composed) of bona fide receipts and that no check drawn by the company was deposited in a bank without being deducted prior to the close of the period from the balance at the bank on which the check was drawn.

My understanding of the meaning of the draftsman is that I had in mind that there might be a check-kiting, resultant from the drawing of a check on one bank account, but not recording it in the cash book as a withdrawal, depositing the same check in another bank account and recording that as a receipt, which obviously would not be a bona fide receipt and I think perhaps answering your query as to how one would determine that entries or receipts were bona fide, I think that that would best be said that that would be answered negatively that any such suspicion, if confirmed, would be a clear indication that that was not a bona fide receipt.

Q. Going back to your previous answer on the question of using deposit slips, I think you used the term duplicate deposit tickets. Do you mean the deposit tickets that the company might keep, would that be of value?

A. Yes; that is what I meant and that was the document that I had in mind when I was speaking. This particular partnership, it was, did feel it desirable, though I think it is very rarely done, to have their own deposit slips printed and the original deposit slip had behind it a sheet of paper on which by carbon copy there was a precise imprint of everything that was written on the deposit ticket so that that being available as I knew that it was available, that gave the opportunity of making this final test check item by item, that would test whether or not things were not as they should be.

Q. Would you in any case get the deposit slip or copy thereof from the bank as opposed to that duplicate?

A. I think that I said that we might go to the bank for it. I do not remember any case in which that has ever been done, but I do remember plenty of cases where we have asked that the bank be requested to furnish us a new statement and the canceled vouchers directly to us.

The new statement, of course, would accomplish everything ordinarily that the deposit tickets would, and if it would not, I think in a case of that sort, I think we would go to the bank and ask for the deposit ticket.

I recall one case in which that was done without advising anybody at all in the company's office.

It happened that I had had an introduction to the president of the bank and I went over and asked him to direct that the account be balanced, a new statement drawn up, and all the vouchers be delivered to me in his office, and that was done.

Q. In your opinion, Mr. Horne, is it customary and proper to include in cash in bank amounts which are due from foreign banks or from private bankers?

A. Yes; I think that should be answered in the affirmative. Of course, the exception to that is in these more recent years when we have restrictions on withdrawal of currency or exchange from some foreign country, Hungary and Germany are notorious examples, in

those cases obviously there is very little value to that cash, and so I should say that that should be excluded, but if they were foreign balances in a country where there was no restriction on the withdrawal of those balances I should think it would be an entirely proper thing to include it in cash.

Q. How do you find out whether there are restrictions or not?

A. One would do that by inquiry, but of course you would not have to do very much but read the newspaper. Specifically, one would make inquiry about that matter from those who were handling the transactions every day right in the office of the company where you were working.

Q. Would you make any independent inquiry, that is, independent of the office?

A. I don't think that I would beyond taking judicial notice, let us say, of what is in the newspapers all the time.

Q. Now, as to the next question, how do you determine that a particular person or depositary is, in fact, a bank or bankers. What procedure do you follow there?

A. Of course, you say bankers, and I think that when we get a certificate from J. P. Morgan & Co. or Drexel & Co., I recognize it at once as having come from a private banker. Generally I think we take certificates at their face value so that if we were to get a certificate from the Brown City First National Bank, we would accept that without any further investigation. But I think, though, that it isn't fair to let that answer remain as it is without saying that, of course, the accountant who is in the office will know that there are right along transactions with that bank and with all of the banks.

I would think that if you try and conceive of a wholly impossible circumstance, circumstances that there might be shown, purely hypothetical ones, I can't conceive of it happening, an account on the books of the company that would have, let us say, no transactions in the account whatever, the balance might be the same at the year-end as at the beginning, and we were told that that was a bank account, I should think, then, that one would be under the obligation to make a good deal of inquiry about that.

Q. Do you imply that you would rely upon the regular course of banking transactions in a particular instance? Do you mean by that, if that is your meaning, that you would expect to find the ordinary bank paper such as returned checks, etc.?

A. That is exactly what I meant. That we would expect to find all of the transactions that are ordinarily carried on by the banks.

That is, deposits would be made and checks would be drawn, monthly statements would be received and when you say "rely," I think that they—that all that would be very persuasive evidence to us that there was in existence a bank at that place.

C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, turning to accounts and notes receivable, Mr. Horne. In several places in the bulletin under accounts receivable, particularly paragraphs 3, 5, and 6, the pamphlet indicates the necessity of making inquiries as to particular matters. From what sort of persons would you make such inquiries?

A. Why, from the person that is best informed in the matter.

Now, I think that each of these has to do with collectibility of the account, and if there were an employee known as the credit man, or credit manager, he would be the man with whom we would discuss those things because, presumably, he would know more about it than any other person in the organization, and if there were not such a person, there would be somebody who, at least, fulfilled the functions of that position and he would be the one.

Q. Looking again at item 3, the first sentence reads:

Examine the composition of outstanding balances.

What does the pamphlet have in mind there, in your opinion?

A. Well, I feel very sure that what is meant there is what commonly is spoken of as aging the accounts. I think the context indicates some unusual items that may occur in the accounts.

The next sentence, you will recall, says:

A customer may be making regular payments on his current account while old items, perhaps in dispute, are carried forward.

Now, I think that the thought would be that if this old item in dispute were a year or 2 years old, that you would so age it.

Here is an item of a thousand dollars which has been owing for the last year and a half—

Q. How would you go about doing that?

A. By examination of the account.

Q. And preparing a schedule or other device to classify them?

A. Yes. I think that the practice that we would always follow, unless we found extreme unwillingness on the part of the office staff, would be to say to the office manager, "Well, now, you can save the company some time if you will have one of your clerks do this," and we would probably give him some of our wide column analysis paper and head the paper up and indicate that the account should be written in the left-hand margin and that the balance divided up into the several aged groups should be carried out into the columnar arrangements.

Now, then, one of our men, and I would think again, answering one of your prior questions, it would be a junior in this case, would take that schedule and go to the accounts receivable ledger and would then check it out.

Maybe, if we are talking of a sufficient volume of that work, so that it might cover numerous pages, why we might do it as a matter of test check. But in any event it would be checked by one of our men directly to the accounts receivable ledger itself to see that the information contained in this age schedule had been correctly abstracted.

Q. How far back in the accounts would you go to determine the condition?

A. We will go back to analyze the balance entire. I think that for all practical purposes, there would be not very much sense in breaking down any accounts that were more than a year old into any refined distinctions as to whether they were a year and a half or 2 years. Just over a year old might very well be just one block.

Q. Now, do you expect, in connection with that work, that the general condition of the individual accounts receivable would be noted? For example, concentration of charges, unusual conditions as to write-offs, claims, credit adjustments, and so forth?

A. Well, I think in general that the accountant would be told to watch out for those things, although I find myself dissenting a little bit about your suggestion about an unusual concentration of items at the year-end.

While I was a bookkeeper I did work for a concern where that was so much the normal thing that I never for a moment would think of questioning it. It was then our procedure to make our goods on special order with our customers with the understanding that if they had not ordered the goods shipped to them, or to their customers by the end of our season, the end of our natural business year, that we would then bill them en bloc for every amount of goods that we had manufactured on their orders.

So that at the end of the fiscal year there was always a concentration of accounts.

Q. Well, you would say you had to adjust that to the particular case. In that case you might look for a concentration of charges at the beginning of the year?

A. Beginning of the new year. That's possible, of course. Seasonably, you mean, depending upon what the trend of that particular business was.

Q. I was speaking of concentrated charges in the sense of not being an expected thing, of course.

A. Of course any unusual—any irregular thing is just the thing that auditors are supposed to look out for all the time.

Q. Now, at the top of page 15 there is a sentence reading:

While such confirmation—

Speaking of confirmation of receivables:

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

A. No; I don't understand it so. My own feeling about confirming receivables runs the complete gamut from 100 percent to zero.

I would say, as I have often said, that we will not accept an audit, or an examination of a stock brokerage firm without having complete freedom to have a confirmation from every personal account on the books. One can make that just as strongly—stress that just as strongly as he wishes; just will not take the engagement unless we are entirely free to have a confirmation from every personal account.

On the other hand, and at the other extreme, I would not think for one single second seriously about confirming by correspondence the accounts receivable, let's say, of the Consolidated Edison, or any other large utility company. It would be simply an utterly futile waste of money.

Now, in between, there are variations. Generally speaking, I do not, myself, believe very much in the confirmation of accounts receivable by correspondence, recognizing always that there may be special cases in which that might be desirable.

I believe that secondary evidence of which I have spoken before, this matter of circumstantial evidence that can be got from the business itself being done, the goods being manufactured, goods being sold, the sales being recorded in accounts receivable and in sales

accounts, the collection of the accounts receivable, those collections going through the cash book and hence into the bank, all of that affords so much of detailed circumstantial evidence that I think it is of very much more value than an attempt to secure a confirmation by correspondence.

Moreover, I know from a good bit of experience how much trouble there can be and how many headaches there can be connected with attempted confirmations of accounts receivable. There are many people who flatfootedly will not confirm accounts receivable and every time you have accumulated a substantial number of no replies then you are very much concerned as to whether there is some altogether hidden reason for there being no reply. Maybe there is no reason at all except the innate cussedness of the fellow to whom you have written.

Q. You have in mind there a positive confirmation?

A. Yes, that is what I am thinking of.

Q. As between the various types of tests, or test confirmations, that is positive confirmation of as many accounts as you can get, negative confirmation of all accounts and a positive confirmation of sample accounts, if you are going to confirm, which of those do you feel is most satisfactory?

A. Well, in the case in which I said I wanted 100 percent of confirmations, of course, I want positive confirmation and, of course, we will agree that we never get 100 percent of positive confirmations, practically. It may be a most unusual case where we will, but practically speaking that has to be ruled out.

Q. Do you feel there is any value in a sampling confirmation?

A. Why, of course there is some value beyond a doubt. I think that if one selected samples to be confirmed and found that a fair number of them did not respond, why I am inclined to think that you would be in a rather embarrassing position there. Maybe it wouldn't at all be warranted by the facts. You might strike a good deal of that.

Q. What about the negative confirmation?

A. Well, I have never had very much respect for that idea, though I know it has been done and I suppose that there is a sort of minimum cost about it and maybe some advantage.

I am almost sure, though I have never done it, that that would result in bringing in a lot of grumbles and grouches and complaints that might really have no sound foundation.

In other words, you would just be gathering to yourselves all the grumbling that you could possibly get in about the company that you were auditing and it might color very prejudicially your opinion about the company, rather unwarrantedly; by the time you studied them all out you would find that it just wasn't worth while at all.

Q. Now at page 8 and again at page 34 under "Accounts Receivable" reference is made to safeguards surrounding the handling of incoming mail and remittances and to the handling of monthly statements to customers.

What tests or inquiries do you make in connection with establishing the existence of such safeguards?

A. Well, I think one would make the same inquiries that I spoke about before. We would ask whether that was done, and having

been told that it was done, I think that we would be rather, that is our seniors would be rather alert to see that that was the case in respect to incoming mail and certainly if we were examining a bank or a financial institution why, on the day when we examined the cash, why we would be the ones who would examine the incoming mail and no other person so that as respects that we would be very clear about it.

I think you are referring to outgoing mail. As to that I think we would simply have been told that that was the procedure and I do not believe that I would ever suggest that we make any test at all to see that the mail actually was run down the mail chute, or that the mail bag was, in fact, carried and delivered to the post office or anything of that sort.

There would be some observation, of course, and if the accountant should say, "Well, this is part of the plan but we can see that they just don't do it," why that would be our answer and if we generally saw, or thought we saw, that they did it, why that would be the answer, also.

Q. Do you take any particular steps to assure that statements are mailed out to customers?

A. It would depend entirely on the nature of the business. Not every business makes a practice of mailing out monthly statements.

Q. Assuming they did?

A. If it were a business that made a practice of mailing out monthly statements, we would certainly expect to see it at the end of the month, and probably we would be asked to lay off work a bit on the accounts receivable department while they got the statements out. We would probably see that going on.

Q. Do you feel that assurance that statements are actually mailed out to customers is any evidence as to the authenticity of the accounts, their correctness?

A. Well, of course, it is part of that secondary evidence, that circumstantial evidence, that would convince us that—well, if they are mailing the statements out to the people—why, probably they expect to get some replies in the way of cash from those people. I think that that's a fair answer to the question.

Q. Turning to page 34 of the bulletin. What kind of examination do you understand is meant by the expression "relatively limited test" as used in the paragraph on "accounts receivable" in respect to individual customer's accounts?

A. Of course, there we have moved over into section 3 of the bulletin and that is one of the cases where the authors of the bulletin were speaking of larger companies and the whole, I suppose, the whole paragraph I might read:

If there are large numbers of customers and the customers' ledgers are kept by employees who do not have access to incoming cash or cashier's records, who do not mail out the monthly statements nor initiate credits for returned goods or allowances, a relatively limited test of the individual customers' accounts may suffice.

Now, if there were all of those conditions there would almost assuredly be a credit department or a collection department that would have aged schedules of accounts receivable. If they were there and could be inspected and we were learning that that was a regular procedure, that accounts receivable bookkeepers turned them over once

a month to the collection department, we might then, of course, feel that that being a regular routine, we do not need to do that all over again and we would make, as it is said there, a relatively limited test of the individual customers' accounts.

I think in such a case as that I would want to take the aged schedules, if we are thinking of that as a basis of investigation that the credit department had, we would take those to the accounts receivable ledger and test them out, test some, maybe in every ledger. Test one ledger; that would be a case of detailed auditing. One of the ledgers tested completely from beginning to end, every item there was, selecting significant items in other ledgers—other accounts receivable ledgers and by that method attempt to make a test or sampling test, that would cover the whole situation. And I think that would be a satisfactory method if all those prerequisites were present.

Q. Now, as to notes receivable. If you deem it unnecessary to make confirmation of open accounts, would that control your decision in respect to confirming notes receivable which grew out of open accounts?

A. Well, I wouldn't think so, Mr. Werntz. I think notes receivable, themselves, are the documents that evidence the asset value there, and I think that that would be a thing that I would expect that the senior himself would do, unless, of course, there was an almost incredible number of them.

I think he would ask whomever had the custody of the notes receivable to let him see them and I think in here it is detailed as to how they shall be scheduled and he would schedule them and as he scheduled them, examine them.

If there were a great many of them, I think he might ask, "Well, now, you, Mr. Chief Clerk of the office, prepare a schedule for me, in advance, and let me have the notes and the schedules." And then he would examine the notes, compare them with the schedule, see that the schedule was an accurate abstract of them and in that way I feel sure that he would have seen the best evidence in respect to the accounts—of the notes receivable that he could see.

Q. In the case of notes that grow out of open accounts, would there be any special circumstances requiring confirmation?

That is, you have had the account, it wasn't paid, and was translated into a note. Would that affect your decision in any way?

A. Well, I would say—I would think that that would be the normal procedure with many, possibly most businesses. That is to say, goods would be shipped on open account and that if this particular customer needed extension of time in which to pay beyond the ordinary terms of payment, that would be granted to any purchaser. He would probably arrange with the credit man that he should be given this added time and he would then issue a note for 2 or 3 months of purchases, which would then be extended on to some other time.

I just don't think that I would presume, as I think you are thinking of presuming, that that means that this was a bad uncollectible account and that transmuting it into the form of a note receivable made it more collectible. I don't think that that would be the ordinary condition. If there were any such condition as to an account that had gone so thoroughly stale that it made it appear as though the debtor was insolvent or close to it, and there had been

a note given to stall off the evil day, why I think certainly we want to make some more inquiries there. But I think that would be an exceptional case.

Q. Now, at page 33 it is indicated—there are indicated circumstances involved in the case of installment companies which have thousands of notes receivable controlled by a satisfactory system of internal control. I assume the same remarks as to confirmation would apply there.

But what would you consider to be a satisfactory system of internal check in such a situation?

A. Well, now, I have never examined an installment company, though we did have a very close contact with a company that rediscounted such paper. And in that case that company had most elaborate records. That was its business and the records were very carefully prepared. There were registers with respect to every note; that is, every note was clearly and logically and sensibly recorded and in that case why it certainly would seem to have been extremely foolish to insist that we examine by itself every note receivable that was therein recorded.

So that what we did in that case was to do that same sampling proposition that we have been speaking about ourselves, would select which ones we would want to see and let us presume that they could not be found where they ought to be found. Then, of course, it would be time to go further, but we had no difficulty whatever. It was a well organized office; the records were good; our sampling and tests worked out all right every time we did them and we felt very well satisfied with having found a substantial proportion of the notes and all that we looked for, why they were all there.

Q. Do you recall whether this company had any internal system of confirmation?

A. Whether they themselves wrote out to the persons whose notes they had?

Q. I had in mind the internal audit staff possibly doing that.

A. I think they had no internal auditing staff and I would not think, as I can recall the circumstances, that that would have been indicated as a desirable thing to do.

I think that the conditions were such that every payment on those notes would have, of necessity, been recorded and it would be indicated by the form of payment that was made that there was a balance due of so much, so that I think, automatically, it is in the correspondence from the debtors into the company holding the note indicating clearly enough that it was a payment on account; the payment that was due on that date and that there was a remaining balance.

D. INVENTORIES

Q. Now, turning to inventories, Mr. Horne. Do you feel that an accountant is responsible for the pricing of inventory in accordance with generally accepted accounting principles?

A. I think the accountant has a duty, you might notice I am dodging the word responsibility, I think he has a duty to form a very definite opinion as to whether or not the inventory has been priced by the company in accordance with generally accepted accounting principles.

Q. Now, in some of the commonly accepted methods of pricing inventory, such as cost or market, it is necessary to determine a market price. In determining that price—first, what is meant by market price? How do you determine it?

A. I think that I mentioned in my qualifications that I had been on the committee on inventories so, of course, there is room to talk at great length on that subject.

There can be a variety of things called market price. I think that the thing that commonly, and generally, is understood to be market price, is what can this company secure the goods in the same quantities that are now here in the inventory for. That is, what will be the cost to the company of replacing the goods in the inventory, if it should desire to replace them. So that that means in the buyer's market, considering that company.

That is generally my thought as to what market means, and I think I would want also to say, I think I did indicate it before in the quantities that are there presented.

Q. There are other definitions of market, however, used in, say the phrase "cost or market"?

A. Yes. Yes; I think that that is so in the case of retail stores. Of course, the retail method is used and that works back from the retail price by the elimination of all those write-ups which have been added to the total cost to determine what shall be the retail price.

Q. What procedures do you employ to satisfy yourselves that the market price is such and such an amount and is applicable to this particular situation?

A. Well, the first procedure would be to look at the more recent invoices by which this company had purchased the same material. That, I think, would be the best evidence, that was their most recent purchase from the market in which they were accustomed to buying the goods and in the quantities in which they were accustomed to buying the goods, so that I think that that is quite the best evidence as to the particular sort of market that it is fair to consider for that particular company at that particular time.

Q. Would you use any other method in determining market? Would you check that against anything?

A. Well, yes. Certainly goods that are currently quoted in trade journals, why we would often use those quotations.

I might speak of a very large chain store group in which we used to check up the cost of eggs, and we found always that they paid the top price for eggs. We made inquiries very much as to why that was so, having been suspicious, and we found that it was their policy always to purchase the very freshest eggs that they could get and hence they had to pay the highest price.

Q. In using quotations in that connection would you have to determine that they were applicable to the quantities, such as the company was customarily purchasing?

A. I think mere common sense would indicate that you would have to do that. It would be perfectly foolish to think of prices that related to very large quantities, if relatively small quantities were being pur-

chased, and certainly it would be foolish if you were buying things in wholesale quantities to talk of anything that might be considered like a retail price.

Q. What procedures do you follow, Mr. Horne, in determining that goods held or shipped by the company on consignment have properly been treated in the inventory?

A. Well, of course, our men would certainly be required to inquire as to whether there were any goods on consignment, and if they received a negative answer and did not find any indication whatever in their examination of the accounts that there was any consignment business, or if it seemed as though it was the sort of business in which there was not likely any consignment, of course, that would be all the answer that would be needed.

If, on the other hand, it was a business in which goods were regularly shipped on consignment, if there was a negative answer, why that might very well precipitate a great deal of inquiry. "Well, how is it? Isn't this business usually done on consignment?" And then there would be the explanations which would have to be followed up, inquiry as to correspondence, all sorts of explanatory and auxiliary facts that might be adduced to support that statement.

Q. In the case of a business in which consignment sales were made, would you confirm quantities with the consignee?

A. Consignments out? Yes; I think we would.

Q. How about consignments in?

A. Well, I think probably, though I do not remember any case in which we have had the necessity of doing that, I think we probably would, though.

Q. Would you confirm with the consignees, who, according to the records, held no goods, but with whom there was a regular course of dealing, that is, confirm they had none?

A. Well, wouldn't it depend a great deal on the circumstances? I think I have just built up a little picture where our senior would be inquiring about those sorts of cases and here would be a case, you say, where there were no consignments, though the records show that there had been for quite a considerable period before. Then, we might get a bad feeling, stir the thing up.

I think if there were such a circumstance, I think if I were doing it myself, I would say, "Let's see some of the correspondence." If there has been a severance of relations of this sort it probably just didn't stop by itself; there probably was some correspondence about that. "Let's have the file and let's understand it." And if that would be so, I think we would understand it.

Q. And if it was not so? I mean, if there was no correspondence indicating a cessation of relationship?

A. Well, I think in that case we would say "Well, please write to your former consignee and have him tell us that at the present time he has no consigned goods in his premises."

Q. Now, as to inventory that is actually on hand, do you make any other tests, or do you follow any other procedures to determine that the company actually owns the goods?

A. Well, I think that the fact that the goods are in their own premises, prima facie, indicates that they own them.