

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., Friday, March 3, 1939.

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

PROCEEDINGS

The EXAMINER. Will you be sworn, Mr. Couchman?  
Whereupon:

CHARLES B. COUCHMAN

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. Couchman?

The WITNESS. Charles B. Couchman.

The EXAMINER. Your address?

The WITNESS. The business address is 120 Broadway, New York; home address or residence address, 395 Riverside Drive, New York.

The EXAMINER. Mr. Couchman, it is customary at the Commission's hearings 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 fine, imprisonment, or forfeiture. That privilege extends to each and every question that may be propounded to you.

I. AFFILIATIONS AND BACKGROUND

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

A. I have a typed reply to the first few questions regarding that if you care to use it.

Q. I think you might read them.

A. I am a general partner of Barrow, Wade, Guthrie, and Co., since November 1, 1930.

Q. How long have you been engaged in accounting work and in what capacities?

A. In public accounting since about 1911.

Q. And prior to that had you any accounting experience, educationally or otherwise?

A. I had served as a bookkeeper, internal auditor, chief accountant and comptroller in a number of different organizations, including

railroading, book publishing, meat packing, manufacturing, inland waterways navigation, and others.

Q. Are you a certified public accountant?

A. Yes.

Q. In what states?

A. In New York, Pennsylvania, Michigan, Missouri, Kansas, Oklahoma, Texas, California, Oregon, Washington. I believe that is all.

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

A. The normal accounting staff of our firm is about 260. At the present time we have an additional temporary staff of approximately 90.

Mr. WERTZ. Off the record.

(Discussion off the record.)

A. (Continuing) There are 17 partners. General partners.

Q. Do you have branch offices?

A. Sixteen in the United States besides the home office here in New York.

Q. Will you indicate, briefly, any foreign affiliations that you may have?

A. Well, we have reciprocal arrangements through connections with public accounting firms in Canada, Great Britain, continental Europe, certain South American countries, South Africa, India, and Australia.

Q. Could you indicate, briefly, the principal types of clients you serve; the principal type of business you do?

A. Well, our clients represent a general range of industries. It includes manufacturing, merchandising, importing, real estate, public utilities, banks, brokerage, insurance, mining, oil and gas, publishing, railways, fiduciary, shipping, and other lines.

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

A. I am a member of the American Institute of Accountants, the New York State Society of Certified Public Accountants, and similar state societies of public accountants in one or two other states.

Q. Do you hold office in any of those societies?

A. At the present time?

Q. At the present time.

A. No; no offices.

Q. Have you in the past?

A. I was president of the American Institute of Accountants, 1930 to 1932.

Q. Have you been active, or have you engaged in any committee work in professional interests?

A. I have been at various times a member of committees both in the New York State Society and in the American Institute of Accountants.

Q. Are you presently a member of any of the committees?

A. I am at present a member of several committees such as the committee on the natural business year of the New York State Society, of which I am chairman, the committee of—in cooperation with the Securities and Exchange Commission at the institute, committee on accounting procedure at the institute, member of the council of the institute, and I think I belong to one or two other committees.

Q. Have you published any works on accounting or engaged in teaching accounting?

A. I am the author of the book known as *The Balance Sheet*, published in 1924 by the *Journal of Accountancy*, and co-author of a book called *Hotel Management, Accounts and Control*, published in 1927 by McGraw-Hill Publishing Co., and, of course, I have written a number of other articles on accountancy and allied lines that have been published in numerous magazines in this country and a few abroad.

Q. Have you engaged in teaching accounting?

A. I have at various times given series of talks or lectures, as they are sometimes termed, on accountancy, and on allied subjects before various schools and more particularly the Pace Institute in New York, where I gave a series of lectures on auditing and accounting principles and on taxes. And then I have spoken before groups at various colleges and universities, including Columbia and New York Universities, City College of New York, University of Michigan, University of Illinois, Washington University, and before clubs and chambers of commerce, bar associations, bankers' associations, and a few national conferences such as the National Association of Cost Accountants, National Association of Credit Men, and others.

## 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 and result in the certification of financial statements?

A. It is difficult to draw an exact distinction between the various groups but there are examinations for annual reports and examinations for registration statements and examinations such as for the purchase of a business.

Generally speaking that might be classified in a different way by saying reports which are balance sheets only. Those are very rare. There are other types of specialized reports such as a report on cash only, if you were reporting on a treasurer's accounts, for instance.

The most general examination, of course, is the one which involves the balance sheet, the operating or income account, and the analysis of surplus. That is the most common.

And then, of course, examinations still resulting in the use of a certificate might be for a number of other purposes.

Q. Would you say that those all represented examinations or would some of those be detailed audits.

A. The one I referred to as the examination of cash, would probably be a detailed audit of cash accounts.

Q. Which type of those services, if you can group them, do you customarily render in preparing registration statements under the 1933 Act or annual reports under the 1934 Act? Do they represent a separate class?

A. That would be the type of examination I referred to covering financial statements usually presumed to include the balance sheet and statement, under whatever name, stating operating results over a period together with such schedules and analyses as are required.

Q. Would that be a detailed audit?

A. It would not.

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

A. Reasonably familiar with it, yes.

Q. Did you or other members of your staff participate in the preparation of this pamphlet?

A. No.

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

A. I believe that the purpose is set forth in the bulletin and I am not in a position to state very definitely what that purpose was as I was not a member of the group concerned at that time with its detailed preparation.

Q. Have you any understanding or feeling as to what its purpose may have been?

A. Yes; I think it was intended as a summary, as brief as possible, of what may be termed a guide of audit procedure.

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

A. I don't know as I understand exactly what you mean by that, but I presume you refer to the fact that it emphasizes primarily the audit features rather than the general accounting principles, that one has to consider and apply.

Q. Let us put it this way: Would you say that in all examinations of the type which we are discussing, that is the annual reports or statements under the two acts, that the general principles of this bulletin would be applicable?

A. The general principles, yes.

Q. Do you follow this bulletin as a guide in your own practice?

A. As a guide, yes.

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

A. We supply copies of it I believe; I think, it is my understanding of it, we supply copies of it to our staff men. I do not know that I could say that they are all familiar with it.

Q. Speaking generally, do you regard the procedures contemplated by this bulletin as a maximum or minimum for this type of examination?

A. There are some cases where it would unquestionably be a maximum. There are other cases where it is doubtful if one would follow all the procedures that are set forth in that.

Q. Would you say that if you omitted those steps which were inapplicable because the conditions were not present that the remaining procedures would be a minimum or maximum?

A. I do not know that one could make a very definite statement there as to whether they are minimum or maximum because even in cases where you eliminated those that you referred to as perhaps not being applicable, still the accountant has to use his judgment as to how many of those procedures he considers it necessary to apply in order to enable him to obtain a reasonable assurance or a satisfaction, if you please, that the accounts are what they purport to be.

Q. Speaking generally, how would you compare the scope of the examination which you customarily make for the purposes we mentioned with the scope of the examination made as contemplated by this bulletin? Would it be broader or narrower?

A. It would include items in the bulletin. It might include items which were not in the bulletin. It should be sufficient to give us that assurance which the accountant must have with regard to those facts which he reports.

Q. Historically speaking, would you say that this bulletin resulted in changes of your own audit practice or audit practice in general so far as you know?

A. No; I do not think it did. I think it was merely an attempt to put into some form procedures which were generally accepted or recognized as being valuable in certain cases.

### III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. Now, in these next questions, I would ask you to distinguish between practices which were in effect prior to the present case, McKesson & Robbins case; and any practices or procedures which may have been adopted subsequent to that.

When a new client comes to you, Mr. Couchman, do you make any independent investigation of the client's reputation or credit rating either before you enter into an engagement or during the course of the first audit?

A. Usually new clients are introduced to us by old clients or by bankers or attorneys or other people with whom we have had sufficient business association to give us confidence in their integrity and therefore give us some reliance in considering the new client and if it is a corporation, we frequently consider the personnel of the board of directors and other information that we may be able to obtain in the normal routine of considering the client.

Q. What is your practice if it is not recommended to you? You say usually it is. Have you any instances when it was not?

A. Clients do not frequently arise in any way except some such procedure as I have indicated. If one were to happen to, I would be pleased to try to figure out what I would do in that case. It would be very nice.

Q. From your own experience, who would you say exercises the prerogative of appointing auditors?

A. Generally, the chief administrative officers of the corporation or the partners, if it is a partnership.

Q. You are speaking there of companies whose stock is publicly held?

A. Either.

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

A. I think an auditor's primary responsibility runs to his own conscience, to his firm and his partners as necessitating a thorough and independent investigation on his part with as dispassionate a display as possible. I think that is his primary responsibility in order to maintain his independence and his own standing in his profession.

Q. Do you recognize any special responsibility to the groups that would be normally found in a corporation as opposed to each other? That is, shall we say the stockholders, the creditors, the management, et cetera?

A. No; the accountant's primary responsibility, I feel, is to display the facts as he may find them as nearly as he may possibly display them through financial statements and without regard to whether a particular item is harmful or helpful to some group.

Q. When you accept an engagement, Mr. Couchman, who is it that, on the part of your firm, determines the scope of the audit to be made?

A. The partner who has charge of it may do that. Consideration is usually given to the general character of the organization and, of course, the purpose for which the examination is to be made. The scope is gradually worked out by the supervisor or the seniors in charge of the job in consultation with whatever partners or managers that may be concerned in the work.

Q. Customarily, do you reexamine the scope of the audit in the case of a continuing engagement?

A. We do, from time to time, I mean by that, the scope of the examination is more or less the subject of consideration every time that it may be performed and if it seems desirable to extend or change that scope, it is accordingly done.

Q. Is it customary to vary the procedures from year to year at all; I mean, the detailed procedure which is followed?

A. Only as the procedure may be considered more advantageous for the purpose.

Q. Take a case of sampling. Would you always sample the same month in transactions?

A. No. Instead, in all sampling cases the effect to be gained so far as possible is that over a given period of time you will have examined as many different varieties, as many different months, as many different procedures as is reasonable.

Q. From your experience, Mr. Couchman, who would you say decides these questions as to the scope of the audit on the part of the client?

A. Well; we decide the scope of the audit unless the client desires certain additional work or certain additional emphasis when we may give consideration of course to his suggestion.

Q. Would you say that your firm would consider the minimum audit and the client might then add to that in certain cases?

A. Generally that would be the rule.

Q. And now looking to the future. Do you have any suggestions or recommendations as to changes in the method of appointing auditors or in fixing the scope of the examination?

A. There is something to be said in favor of the auditors being chosen by others than the chief administrative officers. I think perhaps a good suggestion along that line is the appointment of a committee, either by the directors, or by the stockholders, consisting of a certain specified number, but not including the chief officers of administration.

As to the further part of your question, I think it is very desirable that the accountants be notified as early as possible in the year

which they are going to have to examine and be given the right of access to the records at any time so that they may, during the course of the year, make such tests and examinations as they think will be helpful to them in the final examination and also, perhaps, to introduce the element of surprise tests at times, if they consider that is desirable.

Q. And now, turning to your own organization, do you classify your staff into such categories as juniors and seniors? What is that classification?

A. Well; the classification, of course—first of all would be managers of offices and perhaps a group known as supervisors, followed by seniors which would be the major classification from the standpoint of numbers and their assistants which would take in what you refer to as semiseniors and juniors.

Q. The partner would be above the manager?

A. Yes; sir.

Q. Or would the partners be managers? I wasn't quite clear as to your designation there.

A. Well; in some, perhaps I should say, in offices where there are no partners, there is a manager who will have to exercise practically all the functions that a partner will have to exercise.

Q. Would you say, then, in a typical office you have either a partner or manager and then below that supervisor, seniors, and juniors?

A. Yes.

Q. When an engagement is accepted, how do you determine the staff for the audit? Do you have any criteria in mind for selecting it?

A. Well, sometimes it may fall, the engagement may fall into a classification such as brokerage or banking or insurance, in which case the partner who generally assumes supervision of that type of work would usually be the one assigned to it, and in the same manner if a new engagement calls for a special line of experience such as the installation of a cost system, the staff correspondingly would be assigned on that basis or in any other case usually that staff would be assigned to it who we had available and who were best suited or best experienced for that type of engagement. At least that is what we endeavor to do.

Q. Are such assignments permanent for successive years?

A. To a certain extent. A partner, for instance, who is assigned to a particular client would usually continue although that is not an absolute rule by any means. Frequently more than one partner gives consideration to the affairs of a client.

Similarly, the senior in charge may be continued for some time but we usually endeavor to have at all times what we might refer to as an understudy. That is, another senior who is constantly working with the first and who would be available at any time to take his place so that if one senior were not available in a particular year the other one might be, and that plan is the one we try to pursue.

Q. What reasons lead to that policy?

A. First, because it is desirable to have more than one person in our organization familiar with the affairs of a client and more than one senior who is thoroughly familiar with the proper steps

to pursue and the methods of best pursuing the audit in connection with a particular client and also the element of rotation is brought in in that manner to a certain extent which, perhaps, at least we hope, tends to keep one from getting too much into a set procedure.

Q. Would you say there were any disadvantages in sticking to the assignment to that extent? Would you think it desirable to rotate seniors more often—not would you think it desirable but would there be advantages in rotating them more often?

A. There are certain disadvantages in rotating seniors, which, of course, are that it takes a senior a certain amount of time to become thoroughly familiar with the organization and particularly if it is a complicated one, with the best method of carrying out the work. In that case, being familiar with the internal check and control and the various personnel who operate, it is an advantage. If an entirely new senior were put on the job it would take more time to learn those things.

That's why we endeavor, to a certain extent, to get the advantages and minimize the disadvantages of the rotation principle through endeavoring to have two or more people familiar with it.

I do not want to convey the impression that we always do that; it is merely a thing we endeavor to do.

Q. Now, turning to building up your own staff, how do you go about recruiting juniors; what criteria do you look for in them? Distinguish, if you will, between the permanent staff and your temporary staff.

A. Yes. I asked a manager of our office for some information on that and it is out of the scope that I usually have close touch with and I am going to include in my answer some of the points that he brought out, if I may.

Q. I wish you would.

A. Prior to 1930 each year we engaged recent college graduates who appeared to show promise of developing into good staff accountants after the educational period, the cost of which we considered part of our overhead.

Since that time, because of conditions, this practice has not been general. At the present time prospective juniors for our permanent staff are engaged as office boys who must, at least, have graduated from high school, preferably are undergraduates or graduates of colleges.

They are immediately required to start accounting courses in the evening with the obtaining of a C. P. A. certificate as their goal.

The work that they perform is concerned primarily with the finished reports. They become quite familiar with the finished reports as delivered to clients. Then they learn a good deal about the contents, the reason for various things that are contained therein, they become familiar with the process of filing and therefore become more or less familiar with the working papers as we devise them and from that they are moved over to a comparing department, where a part of their work consists in the meticulous proof-reading of the typed reports which gives them a familiarity with the nature and contents of reports.

Then they are required to go through a period of reference checking, wherein all items that appear in the reports affecting figures carried from some other place are checked back to their source.



For instance, if comparative figures are given, the previous report must be obtained and all comparative figures therein checked. And in that manner they work, shall we say, backwards from the old routine of training. But after about a year or two of that we then assign them to some type of junior work, preferably to those cases where a staff is maintained for some considerable period of time under the direct supervision of better trained men where their work is limited to what might be called detailed work in which they gradually acquire experience with the more important features of the material facts. Their progress from there on up to semiseniors has been so satisfactory that we think that that is an excellent plan and we try to follow it throughout the whole scheme.

Of course, as I said, if they are not already graduates of some accounting school, we insist upon their entering upon such work, even if it be at night, and we try to arrange schedules so that they can carry through on that basis.

Q. Did I understand you to say that the obtaining of a C. P. A. certificate is a prerequisite to advancement?

A. No; I said it was a goal.

Q. Is there any point at which it becomes a prerequisite for further advancement?

A. For managers or partners, only. Prior to that it is not a prerequisite, though we much prefer it.

Q. I see. How do you recruit the men for your temporary staff? I think you covered the permanent staff there.

A. Well, I have to add, then, with regard to the other question, that not all juniors are obtained in this manner, but that is the manner we try to follow and almost completely. Occasionally we have employed one who has had training in other organizations.

With regard to the other, temporary staff, we have certain selected lists from which we try to choose these men. For instance, a man may have served us during a season with such efficiency and ability that we would be glad to retain him, but it isn't possible to add him to the permanent staff during the more slack seasons, so we add him back again in the fall, if possible.

In fact, there are quite a number who, year after year, have served us in that capacity.

Then there are others that apply to us for positions and who have held positions as seniors or semiseniors in other accounting organizations. Those, I think, take up the—make up the chief source of our temporary men so far as I am aware.

Q. Do you ever select men for your permanent staff from the temporary employees?

A. Quite frequently.

Q. Now, as to your seniors. How do you obtain them?

A. Usually by promotion.

Q. By promotion?

A. Occasionally by advancing to the permanent staff one of the men from the temporary staff or occasionally a man, even so-called temporary, is of qualified senior caliber and does perform senior work.

If he is a new man, that is in connection with someone who has been in the organization longer.

Q. I think you described briefly the type of duties which you customarily assign to juniors in the beginning, so to speak. Would you say that those duties require a knowledge of accounting.

A. Not at the beginning. We would not want them to have or to assume or expect them to assume the responsibility as yet until they have advanced beyond what we call the junior stage. It is merely, as a rule, such things as reconciling cash books and checking items of that kind which are more or less mechanical until they become thoroughly familiar with the type of records of the business and with the various steps that are needed to verify those records which they gradually learn through experience and by inquiry and observing the work of those above them and by instruction.

Q. Now, turning to the seniors. What type of duties do you generally assign to them?

A. A senior is put in charge of an engagement as far as the complete field work is concerned. He may be assisted by a number of men, some of whom may also be qualified seniors and may have been in charge of work in other examinations.

Q. Would you say that the seniors—

A. (Continuing.) There is always one senior who is more directly and definitely held responsible for the engagement.

Q. Would you say that the semiseniors come in between those two in responsibility?

A. Yes.

Q. And do you consider it a part of a senior's duties to train the men who are under him? Particularly the juniors of whom you have spoken.

A. Some seniors have a knack of doing that thing, but others, of course, do not. But he does train them in the sense that when he assigns them to a particular duty he usually indicates what is necessary for its performance and he carefully reviews what they have done and, of course, in that manner, can point out anything wherein they have not come up to his expectations.

Q. And when you say "review what they have done," do you mean that he reviews the working papers, or he makes some sampling of the actual work to see whether they have performed it in a satisfactory manner in the actual underlying documents, for example?

A. Both, unquestionably.

Q. And do you satisfy yourselves that the juniors are doing their work through your reliance on the seniors' observance and control of them?

A. Yes.

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

A. Seldom the actual field work, though there are many exceptions to that. It depends upon the nature of the engagement and upon the—whether or not a partner has the time to actually get out in the field. That is seldom done, I might say, but nevertheless I can think of a great many cases where partners have actually gone into the field work.

Q. And do they visit the client during the course of the audit?

A. Occasionally.

Q. At other times during the year?

A. Occasionally. Again, that depends upon the client, upon the various attendant circumstances. Quite frequently in our organization there are some partners who will spend a great deal of time, from time to time at the office of a client, consulting on various matters of importance to the organization.

There are other clients that we, perhaps a partner, very seldom will visit.

Q. And when you assign a staff to a new engagement, do you expect them to become generally familiar with the trade or the industry, say, prior to the completion of their first audit?

A. One is bound to become somewhat familiar with the trade or industry as it applies to that specific client. As far as the trade or industry as a whole is concerned, we certainly would not.

Q. I was thinking of it in general terms as the general methods of doing business in the trade or something of that kind.

A. In certain lines, yes. For instance, say, commodity brokerage. The accountant in charge of that must know a great deal about the general principles that apply to commodity brokerage.

Q. That is what I had in mind.

A. Yes.

Q. Do you expect your juniors to become sufficiently, or to be sufficiently familiar with the type of records and documents which they are apt—with which they are apt to come in contact so as to be able to recognize, you might term, significant irregularities such as the lack of an endorsement on a check or lack of initials on a voucher or things of that character?

A. Generally, yes, if you allow your emphasis to be on significant or material points.

Q. How do they obtain that training and knowledge?

A. Experience; general experience.

Q. Would the seniors instruct them as to such matters?

A. You were referring to all members of the staff, or were you referring to the seniors in charge?

Q. I was referring to the juniors. Do you expect your juniors to have that?

A. No. I do not understand your question.

Mr. Wertz: Would you read the question again?

(Whereupon, the reporter read as follows:)

Do you expect your juniors to become sufficiently, or to be sufficiently familiar with the type of records and documents which they are apt—with which they are apt to come in contact so as to be able to recognize, you might term, significant irregularities such as the lack of an endorsement on a check or lack of initials on a voucher or things of that character?

A. My answer would still be yes, so far as they are held responsible or anything of that kind. Of course, if a junior discovers anything out of the normal routine he would be presumed to take it up with the next member of the staff above him.

Q. Would the senior see to it that the junior had in mind the type of significant irregularities before he began examination of such documents?

A. That would be presumed to be true, yes.

Q. I think you said you expected the juniors and also the seniors, of course, to be alert to note and report any such irregularities.

A. That is one of the chief things we do expect.

Q. What instructions do you give your staff as to the course of action to be pursued when an irregularity is discovered? After they report it to the seniors, what then do they do, take it up with the client?

A. The senior must use his own judgment in that case. It might be a very minor irregularity which would be brought up only to the people who were concerned with it, but if it was of any serious importance he would probably report either directly to the client or to the partner or manager, depending entirely upon the nature of the irregularity, whether it apparently was an intentional or merely an unintentional one, or whether it was a serious moment.

Q. Do you expect the senior to get as much information about the thing as he can before he takes it up with the client?

A. Yes.

#### IV. CONDUCT OF THE EXAMINATION

##### A. INTERNAL CHECK AND CONTROL

Q. Now, turning to the system of internal check and control, to what extent do you require the members of your staff assigned to a particular engagement to be familiar with the concern which is being audited, that is, the plant layout, the operating methods, nature of its products, method of doing business, its character of personnel?

A. Sufficient to facilitate the progress of the examination and to enable full assurance that we have covered the essential points.

Q. What would be sufficient in that respect?

A. There is no one answer.

Q. Could you characterize it any more fully than you have, or is it completely dependent upon the particular business?

A. It is so completely dependent upon it that I don't see how any one could give a very general rule with regard to that.

Q. Do you obtain or prepare an organization chart or its equivalent which indicates the employees or officers having accounting functions, lines of responsibility between them, etc.?

A. Occasionally, if it is a very complicated organization. Normally, no.

Q. Would you prepare any memorandum for, say, your permanent file on the company outlining these features?

A. To a certain extent, yes, if it was considered to be information which would facilitate the progress of the next audit.

Q. What do you understand the term internal check and control to mean, Mr. Couchman?

A. Well, it is a system whereby errors either of omission or of commission, either intentional or unintentional, should be detected within the organization; I mean by that, by the client's own organization staff. That is fundamentally what it is.

Q. What are the fundamental characteristics of such a system would you indicate any of those?

A. One of the basic features is that those having custody of removable or readily convertible assets such as cash must render an accounting which will agree with control records which have been built up independently by others of the organization staff.

Q. Is such a system always usable and can you always have one?

A. Well, of course, in that answer I just touched upon one point.

Q. I am thinking now of the general system.

A. No; you cannot, because sometimes the personnel isn't sufficiently numerous to allow of the diversification of responsibilities and of actual control of things.

Q. If there is sufficient personnel, should such a system be followed?

A. Yes.

Q. How would you distinguish a system of internal check and control from a system of internal audit?

A. Well, the system of internal check and control is intended to disclose any errors or irregularities at the time of the recording or immediately thereafter, as soon thereafter as the control becomes effective, and it is therefore intended to control it day by day, to control the recording of the transactions day by day.

The internal audit is usually a later investigation made by some one of the staff who will check as to the accuracy and the correctness of recorded transactions after a period of time has elapsed.

Q. Would you say that the system of internal audit might be a possible feature of a system of internal check and control in its broader sense?

A. Yes; it could be.

Q. I would like to read you a sentence from the instruction book to form 10-K under the Securities Exchange Act of 1934:

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

Do you understand that to refer to giving due weight to a system of internal check and control?

A. Unquestionably; that is my interpretation of it.

Q. Notwithstanding your interpretation of the system of audit here?

A. Right.

Q. On page 7 of the bulletin it is stated that the nature and extent of the examination depends upon the purpose of the examination, the amount of detail included in the statements to be covered by the report, the type of business the accounts of which are to be examined, and the system of internal check and control. Taking those factors one by one, what is the effect of them on the scope of examination, first, the purpose of it?

A. The purpose of the examination, of course, is a very broad determining factor in the scope of the examination which would have to be made to comply with that purpose.

Q. Could you illustrate that, perhaps, say between a purchase audit and an annual report?

A. I was going to say an audit of a business which is proposed to be purchased and you are investigating for the proposed purchaser, you might desire additional information and in more exact form and more specific than you would in the ordinary routine year by year auditing of an organization.

It might include such detail and data regarding sales and the various types of classifications of sales, the numbers of customers, the question of salaries and the question of the various sources of income

might be tabulated to a greater extent, and particular emphasis upon items of nonrecurring nature or which the new purchaser thinks he could limit or minimize.

Q. How about the amount of detail to be furnished in the statements or reports? How would that affect the scope of the audit, just directly?

A. The amount of detail that you are going to supply in your report does not of itself affect the audit, but usually the amount of detail is itself again dependent upon the purpose of the audit.

Q. Suppose the profit and loss statement is to be relatively condensed, would that require less audit work than if it is to be in great detail?

A. Generally speaking, I would say, no.

Q. How about the distinction between various classifications of expenses?

A. The same thing would be true if the profit and loss report as presented, the one to which our report applies, is within the purpose of the investigation.

Q. What I had in mind was this: Suppose you are going to group selling, general, and administrative expenses. Could you omit certain procedures you might have to employ if you were going to segregate and employ separately selling expenses, administrative expense, and general expenses?

A. In the general report most commonly put forward by accountants, they do not assume or even claim to assume any responsibility for all of the classifications.

They refer in the certificate to the operating results, but I think all accountants consider that it is necessary for them as far as is reasonable to determine that the major classifications have been properly made.

If the major classifications which is what I thought you referred to by a condensed statement, are broken down still further, that would involve a greater amount of work if the accountant attempted to pass upon all of these details and he might even face a problem there which was beyond his scope.

For instance, I believe you mentioned selling and administrative expenses. Suppose there were selling and advertising expenses shown separately. I do not know that the accountant could definitely draw a line between those two groups, or I would have to say that he might well reach a point where he was satisfied that the classification reasonably covered the items included, were reasonably in keeping with the heading.

Q. How about this third factor, the types of business the accounts of which are to be examined? How does that determine the scope of the audit?

A. The type of business is a determining factor. As an illustration, take a manufacturing business, on the one hand and stock brokerage on the other. The type of investigation of various items, the steps taken in the audit differ widely in those two.

Q. Why would that be?

A. First, because of the nature of the information which is most pertinent to the company and which is most valuable to those who are interested in it. In a brokerage house, the emphasis must of

necessity be laid upon the customers' accounts and the securities as to their location and responsibility as to each class of security separately, which normally would not be done in other types of organizations.

Q. Would you say generally that the relative importance of the particular types of assets and liabilities to the business would cause adjustment in the steps of the audit to give particular emphasis to those which were most important?

A. Unquestionably. An organization might have a very small item of receivables as compared with another organization of the same total size, the receivables might be very large in volume, and might be complicated as to character.

Q. That is what I had in mind. And finally, this question: What system of internal check and control—how does that affect the scope of the audit generally?

A. The more completely the transactions are under a good system of internal check and control, the more readily the accountant can satisfy himself as to the general accuracy of the whole.

Q. Now, in several places in the bulletin, it is indicated that section 2 is for small or moderate sized businesses, whereas the modifications, section 3, are intended to apply if the audit covers a larger or smaller business. What is it that distinguishes a business as to size in this respect? Is it gross assets or volume of sales, volume of transactions, or what?

A. It is the general combination of all those features.

Q. There are none that you could point to specifically?

A. None generally, no.

Q. Would you say it was relatively as costly to audit a \$100 transaction as a \$10,000 individual transaction?

A. Frequently, it is.

Q. Now, at page 9 in the bulletin it is indicated that the extent of the examination is to be determined in part at least from the accountant's knowledge of the individual situation. What is your understanding as to the extent of such knowledge of the individual situation which an accountant should have before he completes his audit?

A. Well, the purpose of the examination, of course, is to satisfy the accountant as to the general truthfulness of the accounts as set forth in the financial statement upon which he reports.

His knowledge, of course, must be such as to accomplish that purpose. I don't think any exact measure for such knowledge could be indicated.

Q. Could you characterize it by saying he should be roughly familiar, reasonably familiar or anything of that sort? I do not want to press you.

A. Roughly familiar with what, may I ask?

Q. The individual situation? The scope of the examination is said there to depend upon the accountant's knowledge of the individual situation or is to be determined based on his own knowledge?

A. I am just wondering what is meant by that term, individual situation.

Q. It is in the bulletin. I am not coining it, I think—page 9.

A. That is why I do not think I could be any more specific than that.

Q. I will read the sentence again :

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

Would you say that he had to have some knowledge of the individual situation?

A. Unquestionably the individual situation in a broad scope would mean the general relationship of all of these things. The size of the business, the character of the business, the type of personnel, the type of transactions, the extent of the internal check and control would all, taken together, I think be perhaps what you call the general situation.

Q. Should he be reasonably familiar with those things or very familiar or general familiar?

A. He should be sufficiently familiar with them to satisfy himself that he had obtained a basic foundation for the judgment and opinion which he gave with regard to the statement.

Q. Now, Mr. Couchman, what methods do you employ for developing information in respect to a client's accounting procedure and system of internal control?

A. Of course, the senior in charge makes such a survey by consultation with the best informed employees and by observation.

Q. Do you employ a questionnaire or any sort of written document?

A. We do not; we use no fixed method for it.

Q. Do you retain in memorandum form the information the senior has gained on this point?

A. If he records it in memorandum form, yes, we do and we expect him to do that. We hope he does.

Q. Do you have any requirement that he should do that?

A. We have no specific requirement.

Q. Do you have what is sometimes called a permanent file with respect to a particular client?

A. Not as generally as perhaps we should, but we do retain a file which I think is what you refer to in that, which would have all comments, memoranda, and other data which the senior in charge has recorded as in his judgment being valuable for the future.

Q. How exactly would a senior develop that information? Would it be by inquiry, I think you said?

A. It would be by inquiry and by inspection, by observation.

Q. What do you mean by observation there? That is, how would he observe this; what would he do?

A. He has checks and proofs that can be applied to various sections or phases of the organization in order to determine that.

Q. What would some of them be?

A. That is rather a broad order. There is a case where a senior in charge would be a better witness for you than I.

It has been a number of years since I have done this.

Q. Can you give me any illustration of this, for example, the observance of initials on vouchers as indicating you performed certain functions?



A. Well, by inspection of the vouchers he could determine if it is considered pertinent and necessary in the course of his test to make sure that all of them did bear the initials in keeping with those which had been submitted to him as being the initials of the individual officers authorized to perform that work.

Q. Perhaps we are confusing things. How would it be determined that the system of internal check and control was actually being followed?

A. If it was necessary that certain vouchers should bear certain initials or signatures, an inspection of a section of those vouchers would disclose whether or not that had always been done and if it had not been done, and we have found such cases, it would be a proof that someone had not fully carried out instructions in that particular.

Q. I think you say "necessary": Do you mean that that was intended to be done?

A. Right.

(Thereupon, a short recess was taken.)

#### AFTER RECESS

Q. (By Mr. WERNTZ.) In making these inquiries, Mr. Couchman, from whom would they be made? Would they be from persons in all classifications, or would they be the persons who have general administrative supervision or direct supervision, or what, speaking now of the inquiries as to the system of internal control.

A. All information from employees of various grades would be supplemented by observation and test.

Q. If weaknesses are found in the accounting and control procedures, would these require, in your opinion, additional steps to be taken in the audit procedure?

A. Yes.

Q. Could you give any illustrations of that?

A. Well, if the cash and the ledger account, for instance, were handled by the same individual, or if there was no independent authorization for credit memoranda or other credits that passed through the customers' ledger other than the cash.

Q. Then you would go ahead and do further work?

A. Unquestionably we would be compelled to.

Q. Would that additional work be discussed with the company?

A. It should be, as a rule, because we would try to cause the client to understand that he should have a better system of internal control, but as far as discussing it as to the question of whether we should or should not do it, we would have to use our own judgment on that.

Q. If he objected to your doing the work when you discussed it, or found you were doing it, what would happen?

A. If the validity of the account were affected, we would be compelled to do the extra work.

Q. Would you say that the verification of the system of internal check and control should result in a thorough knowledge on the part of the auditor of the accounting system followed by the client,

including a knowledge of the supporting documents, vouchers and other papers supporting every step in the accounting procedure?

A. Yes; it should.

Q. You don't mean there that he should see each of these documents or vouchers each year, but that he should know what should be there, so to speak?

A. You said a knowledge of what, vouchers?

Q. Yes.

A. Right.

Q. Do you feel that an examination in accordance with this pamphlet should disclose fraud and in that connection I would like to have you keep in mind the sentence in the second full paragraph on page 10, the second sentence, which reads:

The procedure will not necessarily disclose defalcations or every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts.

A. An examination in accordance with this bulletin frequently does disclose fraud, but does not necessarily do so.

In other words, I think all accountants have had numerous cases where their procedure is somewhat like in this bulletin which they have followed and have disclosed frauds and, in fact, I do not recall any organization but what must have had many such experiences.

I know we have, but as a rule there is no publicity attached to that and the public do not become so much aware of it as they do in cases where it chances that a fraud is not detected.

Q. Would you say that before the auditor furnishes a certificate signed by him, that he should be satisfied as to the general integrity and accuracy of the records of the company?

A. The general integrity and accuracy, yes; he must be so satisfied.

Q. Referring to your statement as to the question of discovering fraud, would you say that within the scope of the examination outlined by this pamphlet the auditor should be alert to detect fraud and irregularities?

A. He must be alert, too, but of course this procedure would not necessarily detect fraud where it was not intended to be so sufficiently specific as to do that, and even if it were so intended, it would not necessarily detect fraud in the case of collusion.

For illustration, in brokerage work and other cases where one has to follow a more detailed inspection of types of things than this, it does not necessarily disclose fraud if there is collusion among sufficient numbers of people.

That is also true, of course, in all these internal checks, that the internal check, its whole value is based on the fundamental idea that the majority of people are honest and the purpose is to detect the few cases where they may not be or where an error may be unintentional or may have crept in the record, and if it so chances that out of the small percentage of dishonest people, two or more of them happen to work in such a manner that one checks the other, there is a question of collusion which your audit system does not detect and your internal control would not necessarily detect.

Q. Speaking generally now, is it your practice to make test examinations of records covering certain types of transactions such as sales, plant additions, cash disbursements or receipts?

A. Yes.

Q. That is, you sample the transactions from time to time?

A. Right.

Q. Do you feel that such tests, if the results are satisfactory, adequately verify the records as a whole? Would you take a sample and if that satisfies you, do you feel that it confirms the records as a whole?

A. You have used two different words. I think you used the word "verify" in your first question. I would say no, we do not. But if the test is sufficient to satisfy the accountants that it has been reasonable and that as far as it has gone shows that everything is correctly recorded, that naturally gives a further confidence in the fact that the untested items have been correspondingly correctly recorded.

Q. Would you say that it gives you sufficient confidence that you would not go ahead and examine all of the transactions?

A. Right.

Q. Of course, it would not conclusively establish the accuracy of the transactions you did not examine?

A. It would not.

Q. But you do feel that that sampling method is sufficient to be relied upon?

A. Yes; as far as it has gone.

Q. And assuming it is satisfactory?

A. Right.

#### B. CASH

Q. Now, turning to the detailed audit program, Mr. Couchman, in looking at the question of cash first, would you consider the cash program outlined on pages 11 and 12 of the bulletin to be a maximum or minimum procedure? And do you generally add additional steps or not, perform some that are mentioned there?

A. I would say that is a maximum procedure for the majority of cases.

Q. Would you customarily add or subtract any steps?

A. Right. Depending upon the nature of the cash accounts of the organization.

Q. I am not quite sure you understood my last question. Do you customarily make—do any additional work than is outlined there, or do you customarily omit any of it?

A. I do not think offhand of any one thing that we customarily omit or customarily add. My point merely was that there are times when we do more work than is specified here; in a few cases.

There are other times when—for instance, I notice one point: "A better confirmation may be provided by comparing the outstanding checks shown on the bank reconciliation with checks returned by the bank in a subsequent month."

I cannot say that we always do that, but generally speaking, this does measure the scope of work which one performs. It is a maximum rather than a minimum.

Q. Now, at page 33 of the bulletin, reference is made to the reconciliation of bank accounts by employees independent of the cashier's department.

How important do you consider that matter?

A. Well, its importance depends upon the relative importance of the total funds so reconciled.

Q. And that is, it would increase as the funds increased?

A. Proportionately; yes. For instance, if the total sum was only a thousand dollars in a corporation with several million dollars of cash, it would be relatively unimportant.

Q. And would your audit program be altered in any way if you found that the reconciliation was made by—was not made by an independent person and to increase your steps somewhat?

A. Yes; it would.

Q. Now, at page 12 in item 8, under what circumstances should a comparison of deposits be extended to include a check of original deposit slips or authenticated copies? The last sentence.

A. I would say that if irregularities such as kiting were suspected.

Q. Does your firm customarily employ that step?

A. I said only in cases where some such irregularity as I have mentioned is suspected.

Q. Now, in the third line of that same item there is a reference to the term, "bona fide receipts." Would you explain what your understanding of bona fide is; how one understands it?

A. Why, that they are actual receipts and not, for instance, company checks on outside banks which would be outstanding at the closing date.

To illustrate. If there was a shortage at the end of a year and an alleged receipt were recorded on, say the 29th of December, but in reality it was only a check drawn by some one, either of the company or some individual, on other funds which would be outstanding over the end of the year so they could be replaced by him by the time it was presented for payment, that would not be a bona fide receipt.

Q. Is it customary and proper, in your opinion, Mr. Couchman, to include in cash in banks amounts due from foreign banks and from private bankers?

A. Yes; unless there are restrictions on the cash in foreign banks.

Q. How would you determine whether any restrictions existed?

A. Well, I think one gradually acquires that information to a certain extent by their knowledge of dealings in foreign affairs.

Otherwise, by consultation with a bank or by foreign exchange authorities.

Q. Do you make a specific inquiry in a particular case if there are funds in a foreign country?

A. Yes; unless we know what restrictions are in that country.

Q. But you do consider the problem, and then if you do not know, you find out?

A. Because I think it has been coming up in our minds practically every day for the last month. It is one of the problems we have to consider.

Q. How do you go about to determine that a particular depository is, in fact, a bank or banker? What do you rely on there?

A. I do not recall that in my practice I have ever had occasion to make such a determination.

Q. Do you mean you just accept the account title, or what?

A. If you send a confirmation to a bank and it comes back upon a bank letterhead, generally you are familiar with those banks to a greater or less extent. If it is an unusual bank, I presume one could, I am not saying we do, I presume one could look it up in banking directories and so on. Normally, I do not think we do. Of course,

if we took it up with the company, if it appeared to be an unusual bank and if it was a corporation, for instance, we would already have found out from the inspection of the minute books when banks were authorized to receive deposits, and that would naturally be our basis of confirmation on that point.

Q. Do you place any reliance upon the flow of normal-looking bank transactions; that is, canceled checks, bank statements, bank letterheads, and so forth? I think you mentioned letterheads.

A. Naturally. They will have some weight in—say, in regard to that matter.

#### C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, turning to accounts and notes receivable. In several places in items 3, 5, and 6, for example, the pamphlet indicates the necessity of making inquiries from various persons to ascertain matters discussed there.

Could you describe briefly how you would go about obtaining such information; what persons you would consult?

It is on page 14.

A. Page 14?

Q. Page 14. Items 3, 5, and 6.

A. We would consult persons in the organization who were presumed to be best informed or had the best knowledge with regard to the specific items and those who had authority usually to pass upon such items.

Q. And would you inquire only of one person, or would you inquire of more than one person?

A. That would depend upon the nature of the organization. Under a large organization, presumably we would inquire of more than one.

Q. I mean as to a given transaction, or given subject.

A. That would depend upon whether or not we considered that we had received a sufficiently conclusive answer.

Q. What is meant, in your opinion, Mr. Couchman, by the first sentence of item 3:

Examine the composition of outstanding balances?

A. Well, one of the first thoughts that occurs to me is whether the outstanding balances represent customers' accounts or represent other classes which have been included therein; because we usually desire to make such a segregation showing accounts, for instance, from unusual sources separate from ordinary customers' accounts. Also, perhaps, on our working papers separating accounts due from officers and from employees and unquestionably accounts due from affiliated or subsidiary companies, in case the consolidation of accounts is affected.

I think in general that would be one of the things you would have to consider in discussing the composition of the outstanding balances and perhaps we might have to give some consideration also to the question of age and collectibility.

Q. How would you determine the nature of the miscellaneous accounts that you feel should not go in the general accounts receivable?

A. Tracing them to their source, if they are unusual.

Q. What do you mean by "tracing them to their source?"

A. Well, if it was a receivable, it must be a receivable as a result of some transaction, which transaction we would want to determine and analyze and see the reason for the receivable coming into existence, and whether it was a result, as I said, of some unusual transaction, aside from normal customers' sales.

Q. How would you go about determining whether it was from an affiliate, for example?

A. The record of the transaction would show that this was a sale to another company which we would already know—presumably we would already know would be an affiliate or subsidiary company.

Q. How would you acquire that information as to whether it was or was not an affiliate?

A. That is a difficult story. We usually know from stock ownership that a corporation is a subsidiary, whether wholly owned or partly owned. But as to the question of affiliate, they way the word is being used these days, it is beyond me to know how we are going to determine it.

Q. How would you determine a second degree subsidiary, for example? Whether the stock ownership is in a direct subsidiary?

A. If we are the auditors of a whole group, which we hope we are, our inspection of the subsidiary records would also disclose the ownership of the grandchild that you are referring to as the second degree—was that it? And perhaps of still further descendants or—

Q. (Interposing.) Would you say you rely on knowledge accumulated in the course of an audit program?

A. You would of necessity have to do that, perhaps supplemented in unusual cases by inquiries which—from the attorneys, for instance; of course, we are getting rather far afield there. We are getting into this question of affiliates and it is a long subject.

Q. Now, coming back to the question of aging the accounts receivable, is it customary for you to analyze the individual customers' accounts? That is, have your own men do that, or do you have the customer furnish you with schedules?

A. We prefer to have the customer furnish us with schedules which we check.

Q. That would be a test check or an individual check?

A. It depends upon the size of the receivables. In the ordinary small company we would make a complete check of it. If it was a very large company, we might not.

Again the question of ratio of importance has to be considered. I think throughout all of these, the chief emphasis, as far as we are concerned, is upon the question of judgment on the part of our staff and ourselves.

Q. How far back in the account would you go to determine the age of the balance?

A. In the normal classification I believe we list accounts that are not yet due, accounts that are 30 days old. That is, I mean past due 30 days and again 60 to 90 days; perhaps 120 days and then there would be some stopping point there, usually, either 6 months or 1 year, depending entirely upon the ordinary schedule of collections of the type of accounts which we were inspecting.

Q. Now, in the course of the examination for that purpose, would you expect the general condition of the individual accounts to be

noticed? For example, the concentration of charges in an unusual month, having in mind the business, the presence or absence of unusual credits such as write-offs, adjustments, claims, rebates, and the like?

A. I don't know. If they struck our accountant as being unusual, yes, they would be noted and perhaps followed through, but the mere question of variation in size is not a thing that would justify particular attention on the part of the accountant, ordinarily because there are so many accounts which would fluctuate in the relative charges month by month.

Q. Would you expect a concentration of sales in a particular month to be noted from your analysis of sales?

A. Yes.

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

While such confirmation—

Referring to the confirmation of accounts receivable—

is frequently considered unnecessary in the case of companies having an adequate system of internal check, it is one of the most effective means of disclosing irregularities.

Do you understand that to mean, or to imply that receivables ordinarily should be confirmed?

A. No, I do not so understand it.

Q. What is your understanding?

A. The statement is made here that confirmation may frequently be considered unnecessary and I agree with that part of it.

It further makes the statement that it is the best and most effective means of disclosing irregularities. Perhaps that is generally recognized as true, but in our experience you find some very remarkable things, sometimes, about confirmations and that's why I put a little qualifying thought on my approval of that.

It depends to a large extent upon the character of the customer whom you are going to circularize. If you are going to make a complete audit.

If these customers are business men, thoroughly used to receiving confirmations, you will probably get a reasonable percentage of replies. But, on the other hand, if they are housewives or farmers, or perhaps workmen, you may not get a very satisfactory number of replies and you may get some very startling replies in those that you do get.

I can speak from our own experience on that; I recall one time sending out a complete confirmation on the accounts of a department store which had just gone into receivership that preceding afternoon.

We got quite a percentage of replies and they indicated many irregularities, all of which, of course, had to be traced down. Very few of them were found to be correct. I mean by that, very few of which were found to be as indicated in the confirmation.

The records were far more correct than the confirmations which we received.

I recall one lady who thought she had been rather cheated at one time in some sheeting that she had bought, so she deducted that from her confirmation, said she didn't owe them that much. And others, of course, get highly incensed and insulted, "they dealt with the store for many, many years and it is the first time they ever received such

a notice and if the store doesn't like their business, they'll go elsewhere."

But more particularly in the cases that I have in mind, it frequently happens in such cases that a certain type of customer will sometimes try to take advantage of this confirmation to indicate a reduction in the amount which they owe.

The illustration I am giving is an extreme one, I admit, but I only want to mention it to illustrate the fact that confirmations are not always what they are alleged to be as to the authenticity of their results.

Q. Do you distinguish there what you might call are—what you have spoken of as housewives and so forth from businessmen?

A. Right.

Q. Do you find difficulty from businessmen in that respect?

A. No, from businessmen you get a different reply. Although, take it in brokerage work, where we have to confirm all accounts and naturally customers are sufficiently experienced in business to have an account with the company—most of them. The first reply usually is not as satisfactory as we would like. Frequently a second confirmation is sent out and if we get an 80 or 85 percent reply, that's frequently—we have to be content with that for it is about the best that can be obtained.

We have even at times sent a third request, registered receipt—I mean, registered and return receipt requested and, of course, you get the return receipt card showing delivery and still no confirmation from the client.

There are certain customers, even businessmen, who just will not sign a confirmation. Certain banks will not.

Q. Would there be any circumstances under which you feel that confirmation was particularly desirable, such as, for example, where a relatively large percentage in amount of accounts receivable was concentrated in a few accounts?

A. Yes; frequently that might be done. We frequently do confirm accounts by test and frequently send out complete confirmations such as in brokerages and perhaps in certain types of other audits, and then again if a company is passing into receivership and we have to prepare a statement for the receiver or for the trustee.

Of course, at that time we have to confirm accounts.

Q. How does the credit and adjustment record of a particular account affect your decision as to whether confirmation is desirable or not, or the collection subsequent to the date of the balance sheet, but prior to the audit?

A. Yes. The record of collections prior to the completion of the audit affects to some extent our judgment for, I believe, that a majority of the corporations are better—feel better in having the cash receipts than they do to have merely the confirmation that it is owing.

Q. Do you make any check to see whether those receipts were, in fact, received, or do you rely completely on the book records for that?

A. Usually we have to see that they go into the bank, unquestionably. In other words, we must be not merely content with the credit records on the customers' accounts, but we have to see that that also is recorded in the proper side of the cash books and finds its way to the depository or into the cash drawer.



Q. If you find that, then your judgment may be affected?

A. Very much.

Q. Now, taking these different methods of confirmations; positive confirmation of all accounts, test confirmation, including large balances, and negative confirmation of all. Having in mind both the value of the results and the cost of obtaining them, which would you say was most satisfactory, or which do you prefer?

A. If you consider the cost of obtaining it in comparison with the value of the result, the test check would probably be the more satisfactory. For the positive confirmation of all accounts is, of course, expensive and yet presumably produces the best results subject to such limitations as I indicated before, depending upon the type of personnel that you circularize.

The negative confirmation of all accounts is probably the most economical and does give to a certain extent a negative proof, if you could use that term, of the authenticity of the accounts, since it has given an opportunity on the part of the customer to question anything that they do not approve of.

Q. Do you prefer the positive confirmation of the sample as to the negative?

A. Yes.

Q. Now, at page 8 and again at page 34 of the bulletin under accounts receivable, reference is made to safeguards surrounding the handling of the incoming mail and remittances and the mailing of monthly statements to customers.

What tests or inquiries do you make regarding the existence of such safeguards?

A. Well, the type of inquiry or test depends upon the collateral circumstances, but we prefer to see and to obtain definite information—I mean to the effect that the handling of incoming cash and remittances is under the control of someone other than the one who has to be responsible for the cash. That is, the custodian, the final custodian of the cash or the one who gives credits to the various accounts.

Q. How, as to the latter items, about the mailing of statements to customers?

A. Well, the mailing of statements to customers is one of those forms of negative tests we referred to before, except it is not very authoritative nor very conclusive.

Q. It does, perhaps, give some assurance?

A. It adds somewhat to your confidence in the situation.

Q. Do you follow any procedures to assure yourselves that statements are being mailed to customers monthly?

A. No.

Q. What kind of an examination, Mr. Couchman, do you understand is meant by the expression "relatively limited test" as it is used on page 34 under Accounts Receivable in respect to individual customers' accounts?

A. Well, any test that is—I mean any examination that is not complete is, of course, limited.

How far the term "relatively" applies as used in your question, it is difficult to answer. I think that it would—we would at least do—we would prove the total of all balances on the accounts to the

controlling account. We would check periodic summaries, possibly, from subsidiary records against the control accounts. We would scrutinize accounts as to activity and recent transactions.

I do not know as I could indicate specifically what other points we generally do on that except to say that we—the test should be such as again will satisfy the accountant that he can pass that item on the balance sheet.

Q. Now, if you determine in a particular case that it is unnecessary to make confirmation of receivables would that control your decision as to confirming notes receivable growing out of the open accounts?

A. It would.

Q. At the bottom of page 33 in the bulletin under notes receivable, there appears this sentence:

Large installment companies may have thousands of notes receivable which are controlled by a satisfactory system of internal checks.

Would you feel that confirmation is necessary under those conditions?

A. No. Your question refers to the second portion of that, Mr. Werntz? That is, if the company is small and has been accustomed to discount its notes?

Q. No. It refers to the first part.

A. I wonder if I can have the question repeated?

Q. Surely. At the bottom of page 33 there is a statement under notes receivable that large installment companies may have thousands of notes receivable which are controlled by a satisfactory system of internal check.

Would you feel that confirmation was necessary under such circumstances?

A. Not if the internal check is satisfactory.

Q. What would you consider to be a satisfactory system?

A. That they maintain sufficient proof upon all the steps; that is, all the transactions or all the steps through which the notes had to pass so that there would be no possibility, reasonable possibility, of any irregularity taking place in them in the absence of collusion without it being brought forth.

Q. Is it customary in such cases, do you know, for the company to make confirmations by an independent staff?

A. Usually it is. I was just trying to think in that question as to what experience I have had in that. In such companies as we have had, where the circumstances are such as indicated, usually there is not only a good system of internal control, but also a further system of internal audit upon which we have to rely in the main but even in those cases we make sufficient tests to assure us that the system is complete and that it is properly handled.

#### D. INVENTORIES

Q. Now, turning to inventories. In your opinion is an accountant responsible for the pricing of inventory in accordance with accepted accounting principles?

A. He is not necessarily responsible for the pricing but rather for the checking of the pricing that may have been used. Is that what you mean?

Q. I will put it this way: Is it up to him to see that the inventory is priced in accordance with generally accepted accounting principles?

A. Yes; I consider that it is.

Q. Now, if the determination of market price is necessary, such as in cost or market, whichever is lower, what is meant by market?

A. Generally speaking, from my viewpoint, replacement cost, so far as purchasable items are concerned.

To illustrate: If it is a factory, the raw material, the merchandise upon which the factory has not yet performed any operations, the market price there would be the current cost of replacement of that item.

Q. Where would you find out what that current cost of replacement is? What would you examine?

A. Two methods. First, the recent inventories of purchase, or invoices of purchase, I mean, and, second, the market quotations as far as one could determine them.

Q. Would those market quotations have to be applicable to this particular business in the sense of proper quantity, quality, and size of items?

A. That is what I meant, so far as one could determine them.

Q. You would have to determine that before you could utilize them?

A. Has to be, because you could find a market quotation for some particular items in carload lots and your customer might only buy it in very small quantities so that quotation might not be valid.

Q. Or vice versa?

A. Or vice versa.

Q. What position do you follow in determining that goods held or shipped by the company on consignment are properly treated in inventory; both consignments in and out?

A. The procedure has to vary with the size and character of the company. That seems to be the reply that I am giving to every question but it is so completely true that I have to. Chiefly by an examination of the various records connected with the receipt or the sending out of the merchandise supplemented, perhaps, by confirmations either way.

Q. Is it customary to make such confirmations if the items in question are significant?

A. If they are significant.

Q. If the amounts involved are significant?

A. Yes; I would say it is if they are significant.

Q. Where you find a business that is normally dealing in consigned merchandise, or sending merchandise out on consignment, and particular consignors are shown by the record not to have any goods out with them, or not to have any goods with the company, would you, nevertheless, confirm with them?

A. No; not necessarily. For this reason: When I said a moment ago significant, very material or unusual.

Where it is a company's policy to continually receive goods on consignment and continually ship goods on consignment, it becomes a part of their regular procedure, then it doesn't require any further investigation than any other form of receivable.

In other words, the records maintained and the internal check and control should establish quite definitely on the records the validity

of the accounts as being consigned in or consigned out. The accountant makes such tests of these as would satisfy him on those points.

Q. What you meant by significant was that the transaction was unusual to the business and of large amounts?

A. Right.

Q. Would not it be possible for there to be large consignments, even in the ordinary course of business, important ones, so that you would have the same question as you would have in the case of confirming receivables, that it might be desirable to confirm anyhow?

A. I would say that probably the same rules would govern one as the other in that respect.

Q. Now, if you determine to confirm, would you confirm only those that the records showed had goods or would you confirm the ordinary people that the company shipped goods to, whether the records showed they had or had not goods on hand?

A. If one were to make a complete confirmation, you would follow the latter policy but it is very seldom done in our organization.

Q. Is it customary to make any other tests to determine who owns the inventory that is on hand?

A. Well, I think that if we are present at the inventory taking, or even if we are not—I mean we establish certain procedures that the company has followed at what is called the cut-off date. Any tests that are made at that time would tend to establish the fact of whether the company had in its inventory items for which no liability had been set up and therefore that would be a question of ownership, whether the company in fact owns.

I presume that you mean by that that we have received—have it on hand and have set up the liability for it.

Q. Or perhaps they are holding it for someone else. Do you make any other tests to determine who owns the inventory that you see there?

A. None except those that are pertinent to the inventory cut-off date.

Q. You make no further examination?

A. That's right.

Q. Now, in this cut-off date, do you determine that there have not been included in sales goods which were shipped in a subsequent period or that there have been delayed certain sales of goods which already have been shipped and the converse situation in regard to purchases? What sort of procedure do you follow to establish that there is appropriate cut-off? What is done there?

A. The question, the answer, I mean, goes back again to the question of type of client and how long we may have served him and what experience we have accumulated regarding their methods.

Generally speaking, if we have had a good many years experience with a client and find their records have been just as accurately kept and checked internally as perhaps we could give in the way of an audit check, we make very little investigation at that date with regard to those points, on the assumption that the records themselves are true, having been proved so year after year for past periods.

Q. Do you mean by the records what you might also call the secondary records such as journals, or the original records such as shipping invoices and what not?

A. I was referring there to the amounts as shown by the financial records.

Q. That is what I wanted to clear up.

Do you alter your procedure where the goods are not in the control of the company? That is, they are in an outside warehouse?

A. If they are in an outside warehouse we may establish that by confirmation with the warehouse.

Q. How would you establish the cut-off?

A. The date of the confirmation with regard to the warehouse would indicate the date at which we expect that warehouse to reply and that would be an indication which we could check with the records as to date.

Q. If the goods are physically capable of identification, such as machinery by lot number, or serial number, or something, would you make any physical tests to see that the goods are, or are not, in inventory in accordance with the records?

A. I don't know that it is necessarily a part of our responsibility to do so. I know as a practical matter we frequently do.

Q. In verifying the accuracy of inventory footings and extensions prepared by your clients, do you employ comptometer operators?

A. Yes.

Q. Do you feel there is anything undesirable about that practice?

A. No. They are about as accurate as anyone and certainly are more speedy than most accountants.

Q. Now, speaking generally as to inventory, if you complete the steps which this bulletin outlines and in a satisfactory manner, is it customary for you to include in your accountant's report, or certificate, any qualification as to your responsibility for the quantity, quality, or condition of inventories?

A. No qualification.

Q. If you satisfactorily complete the tests?

A. Right.

Q. What tests do you feel are implied by the sentence, the last sentence of item 3 on page 18, which reads:

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

A. Well, to check the original inventory sheets with the office copy of inventory, to discuss the individual items with informed employees, to make sufficient test checks to satisfy yourself that quantities listed are reasonably correct. From this as a basis I think we can go on in particular circumstances as much farther as seems to be desirable.

Q. When you say original inventory sheets, what have you in mind?

A. The original sheets or count sheets are recorded by the individual who does the actual counting before they are assembled on the final.

Q. If the system of inventory tags is used, do you refer to the inventory tags there?

A. Yes; I don't mean that in the normal procedure we would inspect them all. I said tests of them. Not inspect them complete but only test them.

Q. Now, you referred to tests of quantities. What did you have in mind there? Actual count or inspection?

A. If the organization has a continuous inventory system we might actually count certain items and compare it with the inventory count.

Q. If it does not?

A. If it does not, there is not much we could do at the time we are in there to verify the quantity at some previous time unless we wanted to follow the long procedure of counting some items and tracing all incoming and outgoing items of that class.

Q. Do you do that?

A. Very seldom.

Q. When you do not make that physical test, do you qualify your certificate?

A. We do not.

Q. If the accountant's report indicates that he has relied upon certificates from the management for information as to the quantity, quality, and condition of inventories, do you feel that this avoids the necessity of making any of the tests or inquiries which are indicated by this sentence we have referred to?

A. No.

Q. That is, those tests would have to be made anyway?

A. Yes.

Q. To clear up one other point. You said that you make certain tests as to quantities. Do you feel that that test is implied by this sentence if it is practicable?

A. It may be implied by the sentence, but we feel that it is desirable although we do not feel that the accountant has any responsibility there by the very nature of his training, cannot be expected to have a full responsibility for the various types of knowledge that are necessary in order to determine a count or a computation or a measurement.

Q. Would you say that the test of quantities you make there is in the same sampling nature and with the same purpose in mind as the sampling of transactions, say, to see that this system of internal control, the records are accurate?

A. Yes.

Q. Without taking the responsibility for the entire quantity or the quality and condition of the inventory?

A. Right.

Q. Do you review the method followed by the client in taking those inventories?

A. With new ones?

Q. With old clients.

A. We make an occasional review of the method. We usually know pretty well how they follow it.

Q. Could you indicate briefly what you think some of the important points to be observed are in taking an inventory?

A. Physical inventory?

Q. Yes.

A. Well, the responsible character of employees, the procedure being well planned in advance with careful detailed instructions as to steps to be followed, independent control of count or measurement so far as is possible.

Q. What do you mean by independent control?

- A. In other words a count or measurement by others than those custodians of the particular items so far as practicable.
- Q. Would there be any duplicate counting?
- A. Usually there is.
- Q. With the previous count before the second counter?
- A. Yes.
- Q. How do you establish that those points have been observed by the client?
- A. By questioning and by test, if in doubt.
- Q. Whom would you question in that connection?
- A. The employees who have had a part in the taking of the inventory, from the lowest class or grade up, depending on how far we felt it necessary to get into that.
- Q. This was all supplemented by your other work of testing the inventory records, count sheets, and what-not?
- A. Right; and I might say that what I referred to there must be emphasized with regard to the organizations where we are not reasonably sure of how all these things are carried on and perhaps we relax considerably in the case of year-by-year clients where we have had sufficient experience to know that they are just as anxious as we to make sure that everything is correct.
- Q. Now, if you find that the client's inventory methods are unsatisfactory, Mr. Couchman, what position do you take? What do you do?
- A. Call it to their attention and endeavor to have the condition improved.
- Q. If you are coming into a first audit?
- A. We naturally have to go much further in the determination of the inventory than we would if the conditions were satisfactory.
- Q. In what direction would you go further?
- A. In establishing the reasonableness, if I may use that term, of the recorded amounts.
- Q. Now, in appraising the integrity and accuracy of the inventory records kept by the company and the inventory quality, quantity, and condition, would it be your practice to ascertain and give weight to the shipping, receiving, and stock taking methods and records?
- A. Yes; usually.
- Q. What significance does the independence of the persons responsible for these things have?
- A. The more complete the independence, the better the control.
- Q. In your opinion, should an auditor be reasonably familiar with the products of the company, manufactured or dealt in?
- A. Well, yes; with the general nature of the important products, yes.
- Q. I think you have already said, but is it your practice to make spot tests of any portion of the inventory by actual count or inspection customarily?
- A. Yes; we do.
- Q. Now, coming to the reasonableness of the inventory, is it your practice to make any over-all tests of this by comparison with, say, warehouse quantities, insurance payments, average production or consumption of the company, trade statistics and the like?

A. I cannot see that any such comparisons would be of any value. Certainly they would be of very little value so far as any clients that I have been concerned with go.

Q. You spoke a moment ago of going further in determining the reasonableness. What would you do there? How would you determine that reasonableness?

A. It is rather a broad question but if they indicate a certain quantity of merchandise or of this or that, I think that one has to exercise merely his common sense; the accountant must, in seeing that there is something there which is apparently reasonably explained. I do not think that the accountant has a responsibility for the physical inventory but I think he just naturally wants to satisfy himself as far as he can that there has been no misstatement. He must use whatever appeals to him as giving him confidence that the records are what they purport to be when they finally reach the form of financial statements.

Q. Would you indicate that this type of test would not be among those things, the type of test I indicated a minute ago, such as warehouse capacities and the like?

A. I cannot recall any instance where warehouse capacity would have any particular thing to do with the inventory. I do not recall any instance where any of those items you have mentioned here would be taken into consideration by us.

Q. Would there be any other item you have in mind?

A. No.

Q. Do you employ the gross profits test, Mr. Couchman?

A. Frequently.

Q. With what purpose in mind?

A. Again it is a question of confirming the reasonableness of results shown by comparison with preceding years or periods.

Q. Should that test be applied on the aggregate figures or on departmentalized figures if obtainable?

A. Practically valueless unless it is applied on departmental figures or figures where the various elements are comparable as well as the gross profit.

What evidence do you customarily rely upon to verify the quantity of merchandise held in independent warehouses or in vendors' warehouses?

A. Well, in independent warehouses by direct acknowledgment from the warehouse.

Q. And vendors' warehouses, or do you mean by independent, independent of the particular company?

A. That is what I did mean. By vendors' warehouse reports, I should say, from the warehouse manager.

Q. Of that company?

A. Of that company.

Q. Would you obtain any evidence of financial responsibility of these people?

A. Of the vendors?

Q. Yes.

A. Presumably you already have that if you are engaged on the work. You certainly wouldn't go farther merely because they had goods in a warehouse, I believe.



Mr. HENDERSON. I think Mr. Couchman is misinterpreting "vendors."

Q. (By Mr. WERTZ.) I am speaking of a person selling goods to you.

A. No; we would not.

Q. Would the procedure followed disclose whether the person selling goods to the company had misappropriated the merchandise; that is, that it was dealing in futures, if you will?

A. No; I don't know that it would disclose it.

Q. Do you make any test as to quality, quantity, and condition that we haven't discussed, customarily?

A. Not customarily. In specific cases, yes; but not ordinarily.

Q. Have you any examples of those specific cases in mind?

A. Only in cases where we—and that is only occasional—where we try to make some test as to the obsolete nature of things which have been carried so long in inventory.

Q. You might age the inventory, so to speak, and make some special test of the older parts of it?

A. Yes; it would be a test in a sense. I have in mind merely cases where something may have been carried in inventory for many years and apparently without any decrease or any activity in it; I think then that we would of course want information as to whether or not that had not decreased in value also.

Q. Looking to the future, Mr. Couchman, would you think it desirable for auditors to participate in or supervise or observe the process of taking inventories?

A. Well, I think that corporate managements should not depend entirely upon public accountants for such control. I think the management is responsible for the custodianship of the company's assets, including inventory.

Q. Well, from the point of view of the accountant who will certify it?

A. Now, the accountant has to a certain extent dependence upon that honesty and integrity. I am not sure that I feel we should go further than we have been doing. Certainly I do not believe that the accountant should undertake to do something that he isn't qualified by training and experience to do. I think that would be disastrous to him and perhaps misleading to the public, if I understand your question.

Q. Would the accountant not be qualified to, let us say, set up the procedure to be followed in taking inventory and then to observe the company in taking it?

A. Yes; he could do that so far as participating and supervising that.

Q. Would you think that is desirable?

A. Yes; provided that it is physically possible to be done, when there is such a tremendously popular use of December 31 as a date for closing fiscal years there would be quite a burden put upon the accountants who undertake it at that time.

Q. If there were perpetual inventories, could you spread that over the year rather than necessarily take it December 31?

A. Right.

Q. In our forms under inventories we ask for the basis of determining the amount. I think you have already indicated that there

are at least two concepts of markets. Are there similar differences as to what cost means or how cost should be computed?

A. Yes; there are.

Q. Would those differences make a significant difference on the balance sheet as to the amount of inventory, the use of, say, first in, first out, as compared to average purchases or average cost?

A. If the total market during the period when the inventory was accumulated was rising or was falling, you would get contrary effects by the use of one method as compared with the other.

Q. You would get significant differences in dollar value?

A. Yes.

Q. Do you think in view of that situation and the ambiguity perhaps of the word "cost," it is insufficient to say simply cost or market, but that you should indicate the type of cost or market you mean?

A. You only indicated one or two. If one wanted to be very specific there might be a dozen different types of costs, that is, cost according to normal value, cost according to a certain type of cost system, a cost determined according to such a cost system with adjustments for unabsorbed burden, and so forth, all of them would give different figures known as cost.

Q. Would you use more than one of those in a given instance?

A. The main thing is to make sure that the same system is used at the beginning and at the end of accounting periods. Otherwise they equalize themselves pretty well.

Q. On the profit and loss statement, you mean?

A. Right.

Q. Except for the fact that if you use first in, first out as compared with last in, first out, your profit would be thrown into different periods?

A. It might be.

Q. Do you think it would be desirable to explain a little more fully in a statement the basis of the type of cost, what type of cost is meant and what type of market?

A. You mean for the accountants to, in general?

Q. On statements filed with us.

A. That would be very desirable were it not for the fact that our experience is that the more we say about it the more questions are asked by the S. E. C. as to what we mean by it.

Q. Well; if you use a clearly unambiguous designation of the type of cost, do you feel that that would be more satisfactory?

A. I recall in one case of an oil company where we struggled very assiduously to the best of our limited ability and finally it resulted in a paragraph of about 30 lines and it brought a hurried call to Washington almost immediately.

Q. Is it possible that a given company would utilize more than one method of determining cost; in respect to different types of inventory?

A. Yes; quite frequently.

Q. And that would make it perhaps more confusing?

A. Yes; that is where the trouble usually lies.

Mr. WERNTZ. May we take a recess at this time?

The EXAMINER. Yes. We will take a recess until 2:15 p. m.

(Whereupon at 12:45 o'clock p. m., an adjournment was taken to 2:15 o'clock p. m. of the same day.)