

AFTERNOON SESSION

E. OTHER BALANCE SHEET ITEMS

Q. (By Mr. WERNITZ.) I would like to turn now to some of the miscellaneous items on the balance sheet. First, referring to item 4 on page 21 in regard to fixed properties; plant and equipment, how is it that you determine that amounts capitalized as additions to plant represent real additions or improvements? What procedure do you follow?

A. We usually inspect authorizations for additions, perhaps the minutes of the board of directors with regard to them, appropriation amounts, or accounts, reports of contractors or of architects supervising the construction; that is, if there are such, or other informed people.

Q. You inspect—

A. (Continuing.) Work orders—we do. Work orders if it is a case of construction by the corporation itself.

Q. Do you inspect the physical property itself?

A. We do not necessarily. Here is what I mean: If they are building a new plant it is entirely possible that out of curiosity we are going to look it over with the idea of how it might be adapted to their uses and so on but not as an essential part of the accountant's work.

Q. Would you look for corroborative information in the increased production or turn-over or what have you?

A. Well, that would follow later, after the construction.

Q. I mean after the construction when you come in and audit at the end of the year.

A. Right.

Q. Now, at the bottom of page 34, how do you ascertain that plant units have been abandoned and should be removed from the asset account?

A. I do not consider that it is the function of the accountant to determine such factors. If the company records disclose the facts, of course, we pay attention to those records.

Generally speaking, of course, the account shows the investment of the company in its plants, according to records, less such reductions as may have taken place.

Q. Do you make any inquiries?

A. After all, to a large extent the accounts must show, with regard to such items as that, what the corporation has done with the funds that have been entrusted to it and the managerial officers, or the corporation, is responsible for that. In other words, the usefulness of the plant lies with the management.

Q. Do you make inquiries as to whether there have been abandoned any assets that therefore should be removed from the fixed property?

A. If that is brought to our attention, yes, and we might at times make such inquiries.

Q. In connection with utilities do you make any segregation as to the useful and nonuseful equipment?

A. Only to the extent that the segregation has been made on the records and we may have such proofs to determine its propriety.

Q. Do you make any physical verification of the useful items which may be nearing the end of their useful life or estimated life?

A. No, I think the answer to the previous question applies there.

Q. Do you confirm your depreciation schedule or rates to check their accuracy?

A. We do that in order to determine that when the plant is fully depreciated, that no further depreciation shall be taken upon it, but the item may remain in both asset and reserve accounts for depreciation for some time after that.

Q. But do you make any attempt to verify the accuracy of the depreciation rate by comparison with the life of the asset, that is to see whether they are working out?

A. So far as that may be done by accountants, for we make no pretension to be engineers and we do not pretend to qualify in determining the useful life of a plant.

Q. I have in mind the depreciation on an office building, let us say. If you get it down completely depreciated and are still working in it, would you take that into consideration?

A. Unquestionably, although the depreciation might then nearly equal the book value of the asset because they would have a right to let it stand on their books at a very nominal amount.

Q. As to insurance, what steps do you take to verify the allocation of insurance charges to the appropriate years?

A. By analysis of the policies which will show the amount of the premium and the period of time covered.

Q. Do you utilize the information obtained in that analysis in any other respect?

A. Well, in detailed reports we may and we usually do mention the total amount of insurance coverage by classification but that is only as incidental information.

Q. Now, page 24 in item 2-C it is suggested that a test examination be made of creditors' monthly statement covering large balances. What do you consider to be an adequate test in that respect?

A. The investigation should be sufficient to satisfy the accountant.

Q. Do you customarily make such an examination?

A. I cannot say that it always is done; no.

Q. Do you ordinarily confirm accounts payable in any respect?

A. Frequently, particularly in confirmations to banks we always make as part of the questionnaire which we send to the banks a request for tabulation of any payables owing to them and of any other items such as notes that they have discounted, et cetera.

Q. Now, in the last paragraph on page 8, what is the significance of the requirement that the approval and entry of vouchers will be made by others than the disbursing officer? I think you have mentioned that before?

A. I would say that that is one of the steps that are taken to prevent a disbursing officer from covering any defalcation or shortage through the medium of reducing the recorded liability as determined by the vouchers.

Q. Would you say that it is an important step or feature of a system of internal control or one of the less important ones?

A. Yes; it is. Like every phase of internal control, it loses its effectiveness if it is not independently checked on that point and of course loses its effectiveness if there is collusion between the parties who are concerned.

Q. Would you say it was one of the more important features of such a system or one of the less important? Is it one of the ones less commonly or more commonly found?

A. It is quite commonly found but I do not know as I could answer as to its relative importance. One would have to give some thought to the various items in order to determine relative importance.

Q. Now, turning to taxes for a moment. Do you expect your auditing staff to be familiar with the various types of taxes which impinge upon a particular business?

A. Well, in our organization it chances that we have an entirely separate tax department. By separate, I mean that the men in that department devote their whole time to taxes the year around and are not concerned in audit work. And that department includes specialists in all frequently found forms of taxes, and it is a requirement that all tax questions must be referred to this department by the auditor in charge; that is, by a senior in charge of the account.

Q. Does the senior in charge develop that there is a tax question or does he submit all the information about the company to the tax department and let them determine whether there is any question?

A. He usually does both in this sense that nearly all seniors are of course familiar with the most commonly found forms of taxes and therefore try to ascertain the information which will be needed to indicate whether or not a particular type of tax applies and that information is of course passed on to the tax department in addition to the special information which that department requests.

Q. Now, as to contingent liabilities, Mr. Couchman, what procedures do you follow to determine their existence and amount?

A. I referred a moment ago to the requests to banks as to contingent liabilities. In addition, of course, we examine the minutes, contracts, indentures, and similar documents. Then we inquire from counsel of the company with regard to any possible suits that may be in process or undetermined. If the corporation's taxes are handled entirely by their own tax department, then, of course, they advise us with regard to contingent liabilities in the way of additional assessments and if we do not handle taxes of the corporation, then we inquire from their tax counsel as to such matters.

Q. When you spoke of contracts did you mean you examined all of the contracts, that is, the evidence of contracts, that is, the written instruments which the company may have?

A. We do, so far as we can determine that any of those contracts may have an effect upon the financial statement either present or contingent, and in that I do not mean we attempt to make a legal analysis but only an analysis to determine what effect these contracts may have upon the present financial statements, whether or not proper effect has been given to that in the financial statement and also as to what contingent obligations or liabilities may accrue because of those contracts.

Q. Would you turn to counsel in that respect for difficult contracts?

A. Yes, always; we usually, in addition, request a letter from the counsel of the corporation with regard to such matters.

Q. You spoke also of minutes. What minutes do you have in mind—stockholders, directors, operating committees, or what?

A. Stockholders' and directors' minutes in all cases. In the case of operating committees all those that might be pertinent to that effect.

Q. And the same for financial committees?

A. Especially financial committees and even sometimes if they have special committees with regard to promotion campaigns it would have to be inspected with the same end in view.

Q. Is it your practice always to examine the minutes of this sort?

A. Always, and to make a digest of them for our working papers.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to the profit and loss statement, item 1, page 30 suggests that a working profit and loss statement be retained or prepared in as much detail as is available for this purpose. To what extent would you utilize statements gotten up by the company? And to what extent would you prepare your own?

A. Whenever the statements prepared by the company give you reliable information with regard to the work we want to utilize them. There is no necessity for duplicating work if the work has been done satisfactorily for our purpose.

Q. Would you trace those statements back to the records?

A. Yes.

Q. Would you make inquiries to determine what statements were available?

A. Yes.

Q. Now, in item 2 under that same heading, what is the purpose of obtaining budgets, previous annual statements, monthly statements, and other analyses prepared by the company?

A. For our information and to disclose any unusual variations I should say it is primarily the purpose.

Q. When you find these variations, what do you do?

A. We try to satisfy ourselves that any significant changes are proper and do not conceal irregularities.

Q. Item 3, under sales and cost of sales, outlines a procedure for testing allowances to customers for returned merchandise, for claims, rebates, and so on. What is the importance of such an analysis?

A. Well, it is information that is valuable in the determining of the propriety of reserves.

Q. For any other purpose?

A. Not within itself, except to determine that the allowances, claims, and rebates are legitimate and have been properly approved by the officials concerned, so far as that is reasonable.

Q. Do you always make such a test—sampling test?

A. I cannot say that we always do; no.

Q. Do you always consider it a question?

A. Yes.

Q. Now, speaking generally of profit and loss statements, what in your opinion, is the responsibility of the accountant for the proper

classification of expenses and income? I think we discussed this briefly this morning, but we might repeat it here.

A. I think that the accountant usually undertakes to see that the principal items are properly classified and, of course, in special cases he may go further, depending upon the purpose of the special investigation.

Q. Does he do that by a sampling process or how?

A. Sampling process?

Q. That is—

A. The more important items, frequently analyzing these as to their purport.

Q. Would he make, also, a sample study of all of the transactions for a limited period?

A. Yes; to a certain extent. He frequently does in order to make sure that items of expense are included in expense and are not buried some place else.

V. REVIEW OF THE ENGAGEMENT

Q. Now, turning to the review of the working papers and the preparation of statements, in your practice, Mr. Couchman, who is responsible for drawing together the results of the audit work and preparing the preliminary drafts of the statements?

A. The senior in charge of the particular examination.

Q. Are those statements reviewed in detail by any person other than the one who is actually supervising the audit?

A. The financial statements are; yes.

Q. Would you describe briefly, or would you describe in some detail, rather, the steps which you have in your own reviewing process; not merely yours, but all of the review steps beyond the preparation of the financial statements by the senior?

A. In the first place, those statements are submitted to the manager or the partner, as the case may be, who will study the statements to confirm the general propriety and efficiency of display of essential information and to see to what extent—I mean, to see whether or not they conform to sound accounting principles. That is one of the principal steps.

With regard to detail, I believe I have already mentioned this morning the fact that there is a further recomparison of all essential items such as a complete recalculation of all the amounts that may be recalculated, a complete refooting of all things in the statements, a rechecking of all things mentioned in the statement that refers to previous reports or cross reference from one department to another or any other way.

Then, of course, the accounts are carefully scrutinized with regard to the proper description that may have been used, the wording in the accounts, the sufficiency of the footnote explanations and if there is a detailed narrative that, of course, is read from the standpoint of trying to see that it is in good English and that it says exactly what it is intended to say and no more.

I believe those cover the general steps.

Q. May I ask you a few questions there. Taking the seniors' statements. Does anyone check those statements back to the work papers, item by item, to see that they are integrated and agree properly?

A. In the first place, if it is a job which has on it a number of men of senior rank, although one is directly in charge, the majority of the papers may be prepared by the assistants. The senior in charge will do that checking to the extent that he considers it necessary, which, in most cases, means a detailed checking back to the analyses of the various accounts to see that there is supporting evidence for each item that is on the financial statements.

Q. Do these seniors review in detail the working papers that have been prepared under their direction?

A. I should say to a very large extent; yes. And in addition if there is a supervisor over a number of jobs he does the work I have just indicated a senior will do in that engagement.

Q. Taking it up as far as the supervisor, would you say that each man's work is reviewed by some other person?

A. That is correct.

Q. That is, the senior would review the junior's and the supervisor the senior's, or something of that kind?

A. That, of course, is a general rule. Naturally, there are exceptions. For instance, we might have a very small examination and the man in charge is such a thoroughly experienced senior, or a man of long experience with us, so that we have full confidence in him, it may be that there is no supervisor or even a partner who will go back into the detail of the working papers; they will accept his work.

Q. I believe you have mentioned, and also stated this afternoon, that there is a more or less arithmetical survey of the papers by these juniors—subjuniors, if you will, to see that all the amounts tie in. Is that correct?

A. That is correct, with this modification, if I may add this: That all calculations such as footings and recalculations are done by comptometer operators.

Q. Now, when you come to the partner, how does he make his review? Does he take in the working papers and the statements as prepared for him and prepare his own list of questions from them, or things he wants to talk about and then call in the senior, or supervisor, or whoever is in charge, or does he make his review with the person present?

A. There is practically no general rule we can give to that. It varies with the circumstances. In many cases the senior will come in with his working papers and the partner will ask him what particular items occur to him there to deserve consideration or special consideration or if he has any problem and having none he may leave the papers with the supervisor, or partner, for further consideration, subject to call upon the senior as soon as they determine some item that they want further information upon.

There is no set practice in our firm as regards that.

Q. When questions are raised in the course of that review with the partner, is that also discussed with other members of the firm, or does each partner handle his own work?

A. To a certain extent the partner handles his own work, but if the question is unusual or if it calls—if there is any uncertainty in his mind as to the best method, he might call in another partner.

I can recall many cases, particularly in registration statements, where sometimes three or four or five are called in and discuss

the matter. Perhaps no two of them agree but out of it we try to arrive at what seem to be the best steps to follow.

Q. Do you have any partner whose particular duty it is to review or study from an objective point of view the various statements, who is not connected with the audit, is not personally in charge of the particular job?

A. We have for a number of years had a procedure whereby what we term the blue copies, which chances to be our designation of one of the office copies which we retain of all reports, being reviewed later by another partner wholly distinct from the one who has handled the work. That applies not only to our own reports at the New York office but reports coming in from all branches.

Q. That is after the report has gone out, however?

A. After the report has gone out. That is the post-audit, as it were.

Q. What would you say is the purpose—not this last step of review, but the general reviewing process?

A. To assure ourselves that the report is one which we desire to sign our name to.

VI. THE REPORT OR CERTIFICATE

Q. Now, turning to accountant's certificate or report, what person or persons in your firm are authorized to sign a certificate?

A. Partners and managers of offices where there are no partners.

Q. Who drafts it?

A. It is usually drafted by the senior in charge of the job, subject to review.

Q. By the partner or the person signing it?

A. Right.

Q. Is it your practice to use a certificate along the lines set forth on page 41 of the bulletin?

A. Yes.

Q. What do you understand to be the function of that—of the accountant's certificate? What is it intended to do?

A. Usually it is a brief expression of the scope of the examination followed with the resulting opinion of the accountant and in some cases it may include a statement of pertinent information or may state qualifications.

Q. When you use a certificate along the lines of this one, what impression do you mean to convey? What are you trying to say to the reader?

A. Just what the certificate says.

Q. Could you explain that a little more?

A. In what respect?

Q. I have in mind—are you trying to say that these accounts are correct?

A. Well, I think if that is what we are trying to say, that is the way we would word our report.

Q. Now, looking at the certificate in some detail, take the second sentence of the first paragraph, is it your understanding that that is supposed to be a reasonably comprehensive statement as to the scope of the examination in conformity with the bulletin?

A. Yes; in general terms.

Q. Would you believe that any material omissions from the program indicated in the bulletin should also be indicated in the certificate? I say material omissions here.

A. Well, generally speaking there should be no material omissions from the general—in a general examination. If by the word “material” we mean one that has a serious bearing upon the validity of the financial statements as expressed.

Q. Would you say that if some material step has been omitted, it is not proper merely to qualify—to include a statement of it in the certificate but rather that you should not give a certificate? Is that what you had in mind?

A. It might be that extreme. Rather, I have in mind this, that there may be special examinations where there is, by the very nature of the examination, a limitation or, rather, omissions, I should say, of certain steps which would apply in the general examination. In those cases, a special certificate would be drawn to cover that.

Q. I am thinking of an audit, or an examination, which is intended to lead up to a certificate to a company, or an annual report or statement filed with us. How would you feel there?

A. The question there is one of materiality, Mr. Werntz. In every examination there, of necessity, must be room for judgment as to what emphasis is to be placed on the various points covered by the examination so that a detailed report could deal intelligently with the major factors requiring comment.

Q. Is it your practice to have any sort of written understanding with the client as to the engagement?

A. That is one of those questions I suppose I should answer yes and no to, both. In other words, in many cases we do have, in a great many cases we do not have.

Q. Is that written understanding in the form of a formal contract or letters or what is it?

A. In most cases it is in the form of correspondence. In some specific cases it must be in the form of a contract such as we undertake to do work for the trustees under a court, for instance, we very much prefer to have it in very definite contract form.

Q. Irrespective of whether the audit engagement has been reduced to writing in that form, would you prepare an internal memorandum for the use of your staff as to the examination?

A. Yes; we do.

Q. Is that carried forward from year to year or do you have a new one each year?

A. Again the question varies. In some clients it is merely carried forward as a matter of routine. In a few cases there is a renewed understanding year by year.

Q. Now, thinking of examinations leading up to the certification of statements for annual reports or to the Commission, is it customary to have limitations on the scope of the audit included in this agreement that is agreed upon between you and the client?

A. Not usually, not if they are material limitations; no.

Q. If any such limitations are reached as a matter of agreement, should those be indicated in the certificate?

A. Not necessarily, unless they are sufficiently material to justify a qualification in the certificate.

Q. Do you feel that if they do justify a qualification, then you would have to put them in on those grounds?

A. Yes; both from the standpoint of information and, second, from the standpoint of qualification.

Q. Earlier in the day we were discussing the question of what might be termed optional steps in this procedure and the basic minimum or required steps. Would your concept of materiality differ between the required and the optional steps?

A. Yes.

Q. That is as to a required step, you would feel, perhaps, that its omission was a material factor?

A. It would quite evidently be more material than those which were wholly optional.

Q. Would you indicate the language on the certificate on page 41 which indicates there has been no material change either in accounting principles followed or in the manner of their application as compared with the preceding period?

A. The phrase, "consistently maintained during the period under review," was intended to do that. I happened to be a member of the committee who spent many weary hours trying to formulate the proper wording for this certificate, and it was quite necessary, we felt, to bring in some language which would indicate the point you have raised.

There was a great deal of difference of opinion and almost every suggestion that was offered had some objection definitely applicable to it. Finally, we hit upon the word "maintained" which we ascertained from the dictionary definition seemed to imply what we had in mind, the general significance of it being to keep in the same condition as formerly.

For instance, we refer to a man maintaining his position on a matter. We refer to maintenance with regard to the upkeep of a physical asset, so after much consideration we felt that the words consistently maintained during this period meant that during this period it followed the procedure that had been followed in the preceding year.

Q. Do you feel that that meaning has been transmitted to the reader as a result of your experience with this certificate?

A. It is a question, I think, as to what emphasis is laid by the reader upon the real meaning of the word "maintained" as we intended it to mean when the certificate was drawn originally. I very much feel that it is not understood as well as it should be.

Q. Is it possible that a modification of it or some other language might be clearer to bring out this question of consistency with the preceding year?

A. Yes, it is. In fact, I think accountants as a whole would appreciate any one who would devise a shorter statement to cover what we hoped to cover by that phraseology and which will not be susceptible to even worse misinterpretation.

Q. Now, looking at the introduction to the accountant's certificate at the bottom of page 40, it is stated there that matter may be included in the statement of the accountant's report or certificate for the purpose of being merely informative, or to state limitations on the scope of the accountant's work, or to indicate dissent from particular practices of the company.

How is the reader to distinguish between the various purposes of particular language? Is it a question of choice of words or what?

A. I think the accountants try in their reports to make those matters clear as to which they do intend. In other words, I do think if the accountant dissents from a particular practice of the company, his report should indicate such dissent.

Q. Where? Any particular place?

A. It might be in a paragraph between the one indicating scope and the one indicating an opinion, and if it were one which caused him to feel that he had to qualify his certificate, it would of course have to be repeated in the opinion or in the opinion words would have to be used to refer back to the paragraph where it is described.

Q. If it does not qualify his opinion, would you say it is merely informative?

A. Yes.

Q. Even though it is a dissent?

A. Yes.

Q. Now, take a phrase that is quite frequently found such as that inventories have been certified as to quantity, quality and condition by responsible officials of the company. If that is included in the statements themselves, in the face of the statements, or in the footnotes, which of the functions is it performing of these three, in your practice?

A. Merely informative,

Q. Suppose it appears in the scope?

A. It is still informative only.

Q. And then suppose finally it appears in the opinion paragraph?

A. That would indicate a qualification.

Q. Now, assuming that it appears in the scope paragraph and you say that the phrase in the opinion paragraph based upon the above examination is intended to qualify your opinion to the extent that the scope has been limited by this disclosure as to the method of looking at inventories?

A. No, it would not qualify it for the reason that based on our examination is a broad term indicating that as a result of everything we have done it is now our opinion that the financial statements fairly present what we say in our certificate they do present.

Evidently there is no qualification there unless we specifically express it in the opinion.

Q. But taking no responsibility with respect to things you said you have not done?

A. Right.

Q. Now, you brought out the question that you could express a dissent in an intervening paragraph. What, in your mind, is the difference between a dissent to a company's practice and a qualification to your certificate?

A. I cannot at the moment think of any dissent which would not of itself be necessarily referred to as a qualification, with this possible exception: It may be that an organization has followed a procedure which you do not believe is the better of several procedures it might have followed, and you think that it is desirable that you should make a comment to that effect, and yet you recognize that as a whole they have not used a procedure which was contrary to sound

practice and therefore the financial statements as finally presented, you are still willing to put your certificate to.

Q. To indicate that, would you include the dissent in a paragraph prior to the opinion paragraph, but with the qualification in the opinion paragraph?

A. Yes; if that were the circumstance.

Q. If, in addition to that, you felt you could not give an unqualified opinion, would you incorporate it in the last opinion paragraph either directly or by reference?

A. Yes; we would so record it in the opinion paragraph.

VII. GENERAL SUGGESTIONS AND COMMENT

Q. The suggestion has been made, Mr. Couchman, that corporations should rotate auditors at frequent intervals, I mean firms of auditors. Have you any opinion as to this matter?

A. Well, I feel that if a corporation has a proper firm of auditors to begin with, I see no reason why they should rotate them. That would depend to a large extent on the type of auditors they had prior to such proposed rotation.

Q. You see no reason why there should be rotation?

A. It might possibly be that some advantages would accrue in some cases. I rather doubt its wisdom as a general matter.

Q. You feel the value of maintaining the auditors outweighs what benefit might be obtained by rotating them?

A. That is exactly it. I appreciate there are certain advantages, but there are also disadvantages and I am inclined to think the disadvantages normally outweigh the advantages in most cases.

Q. Those advantages would be the familiarity with the business, etc.?

A. Yes.

Q. And the disadvantages?

A. The additional time required for the new firm to learn what the old firm had already learned.

Q. And a duplication of effort in that respect?

A. That is right.

Q. Is it customary, Mr. Couchman, for a representative of your firm to appear at directors' or stockholders' meetings at which the auditors' reports are presented?

A. Not customarily. It sometimes has been done, seldom, however.

Q. Have you any opinion as to the desirability of such a practice?

A. It might be desirable if the directors want to question the accountants with regard to any matter and under certain circumstances the accountant may desire to discuss with the directors the future of the company as to finance or possible reorganization or elements of that kind.

Q. As a general matter, do you think it would be desirable to have auditors present?

A. I can see no objection to it.

Q. Can you see any advantages?

A. There might be.

Q. Would you as an auditor feel more free to bring things up, that you would have some responsibility because you were there to bring things up?

A. I don't know that I would feel any increased responsibility, but I might feel I had an increased opportunity.

Q. From the point of view of the directors, would you feel that the nonmanagement directors might have a better chance of discussing accounting or financial problems with the auditors if that were done?

A. That is true.

Q. Is it your practice or the practice of your firm to send copies of the audited reports to directors in advance of the meeting at which they are to be considered?

A. Only in cases where we are so instructed. In the general routine we have instructions as to the person to whom our copies are to be mailed, and frequently we make enough copies for all directors, and it is our understanding that the person who does receive our reports does distribute them to the directors.

Q. You say frequently. Do you mean that you don't always do that? You don't always make enough copies?

A. We don't always. It depends again on our instructions with regard to the number of reports desired.

Q. In those cases where you don't make enough copies, to furnish to all the directors, do you know whether the company duplicates them and sends them in that way?

A. Very frequently in those cases the reports are printed and distributed to all stockholders, and of course that naturally includes all directors.

Q. Would you distinguish there what we might call a long form of a report as distinguished from a short annual report made out to stockholders?

A. It is usually the short form that is printed and distributed, and it is usually the short form for which additional copies are requested for purposes other than that of information to the management, although there are some of our clients where the complete detailed report or long form of report is submitted in sufficient numbers to enable the company to pass one to each of the directors.

Q. Do you know whether it is customary for the company to duplicate the long form report in sufficient quantity to give to directors?

A. I do not know.

Q. Do you think it would be desirable to have the auditors send the long form reports directly to the directors?

A. It depends on the content. Frequently there is a great deal of comment in there which is of interest or of value only to the managerial officers.

On the other hand, there are times when there is information in that which might be of great interest to certain directors other than the managing directors or directors who are also officers.

Q. Do you feel that auditors should point out in their report or in their statement significant developments or changes during the audited period in addition to furnishing the customary statements, I mean?

A. Well, I think that it might be perhaps a very good thing if that were done, although I do not believe it is the general practice.

It depends partly upon what you mean by significant developments or changes. If they are such that are already brought out by the

financial statement, it may not require further comment, but if there is anything supplementary to that upon which the accountant has a definite opinion, it might be well to include that in such report.

Q. Let us take, for example, a statement of application of funds which would bring out significant changes in a little different manner than a single balance sheet or comparative balance sheet would. Do you customarily prepare one of those for your own use in connection with an audit?

A. We do in a long form of report customarily, but do not include it in the short form report.

Q. In the case of the short form report, do you make up one for your own use?

A. I can't say we always do. I think I can recall quite a number of cases where we do, but I wouldn't begin to say that it was our universal custom.

Q. Turning to the question of the natural business year, do you feel that the adoption of that would be of assistance involving auditing problems and procedures?

A. Yes; I do.

Q. Would you indicate your reasons for that?

A. There is a tendency which has been present for a great number of years for corporations to use December 31 as the end of their fiscal year to such an extent that it concentrates within a very few months a tremendous portion of the work which the public accountant has to do with regard to all of his clients.

If that should be diversified throughout the year, that would have a number of advantages. First, it would enable the maintenance of a larger permanent staff or, should we say, a more permanent staff on the part of the accountant. It would give the accountants an opportunity to render certain help in the way of advice and aid to a client wholly outside of the purport of his report.

Q. Would you feel that the spreading of the work through the adoption of the natural business year would be a benefit to the auditor in his professional capacity, and if so, what would the benefits be?

A. He would not be laboring under such terrific strain during certain months of the year. He would have time to give a little further thought and consideration to some matters additional to what he now does, although I hope that it would not mean he would do any more real work because I trust our work is still thorough under present conditions, but at some times is quite a physical strain.

Q. Do you see any disadvantages in the adoption of the natural business year?

A. None.

Q. Now, going back for a moment to the question of the auditors making reports to the directors, do you feel that the auditor could be in a position to exercise his own judgment as to whether a long or a short form report should be sent to the directors in particular cases?

A. Yes; he might.

Q. Do you think that that would be a desirable responsibility for him to have?

A. I can see no disadvantage to that. If he felt that the additional information given in the long form of report was such as would be valuable to the directors who might not otherwise receive it.

Q. Now, looking generally at present-day auditing practices, would you say that at the present time auditing procedure is mostly concerned with determining that generally accepted accounting principles and conventions have been followed in the accounting records of the company?

A. In the accounting records of the company, do you mean prior to the advent of the public accountant upon the scene?

Q. Prior to and during, I mean, of the account he is reviewing?

A. No; I do not think so. I think there are a number of cases where the client, the corporation, its officers, have followed what they consider reasonable and proper methods of recording facts and yet have not concerned themselves seriously with or may not even be aware of the finer points of accounting principles which the public accountant has to consider.

As a result, the public accountant reaching those records has to make such adjustments as seem to him right or proper or, rather, recommends to the client such adjustments which are made by the client usually, and at that time the reports presented to the public, the financial statements, are supported by the detailed accounts in the client's books after these adjustments.

Q. Would you say that that is the principal purpose of present-day auditing procedures, the function you have just described?

A. When you say principal, you mean most important?

Q. I mean mostly concerned with that.

A. I think perhaps it is.

Q. As distinguished from a determination that the financial condition is in accordance with the facts?

A. Well, the two are involved so closely together that I don't think you could quite separate them, because the whole purpose of the accounting principles so-called, or procedures, if you prefer that word, that are generally accepted are for the purpose of bringing the financial reports into such a condition that they will as nearly as it is possible present the facts of the situation.

Q. I had in mind the sentence on page 1 of the bulletin which reads as follows:

This pamphlet deals with the accountant's examination of the balance sheet of a business enterprise at a specified date and of the profit and loss and surplus accounts for the period under review, and also with his review of the accounting procedures for the purpose of ascertaining the accounting principles followed and the adequacy of the system of internal check and control, as opposed to determining objectively that the assets were there and the liabilities were as stated?

A. That purpose of ascertaining that accounting principles have been followed implies to my meaning that they have been followed up to and including the presentation as set forth in the financial statement, not that they all necessarily have been followed by the client on his own initiative.

There is a distinction there, as I see it.

Q. I think we are perhaps a little confused. What I am trying to get is this: Is auditing concerned principally in seeing to it that generally accepted accounting principles have been followed as distinguished from seeing to it that the transactions and assets of the business are authentic and in accordance with the actual

facts? That is, that the records are in accordance with accepted accounting principles without examining whether the facts underlying the records are in existence, would you say that?

A. Of course you are undertaking to make a distinction which is rather difficult to make, because there is such an interlocking of those things, but if I grasp your question as now worded, I would say that both are essential in the accountant's work.

Q. Could you indicate briefly the items in the balance sheet and income statement which your auditing procedure verifies to your own satisfaction, or establishes to your own satisfaction by tests independent of the accounting records of the company and the information furnished by its officers and employees?

A. Well, assets in the hands of custodians such as cash, securities, and so forth, mortgages and other contractual obligations, bond issues, accounts affected by contracts and indentures, and so forth, where the outside verification or test or confirmation is supplementary to that within the records, contingent liabilities, provisions for taxes, appraisals by independent appraisers in case they have been the subject matter of a recording of amounts on the books of the client, capital stock outstanding, prepaid insurance, interest receivable or payable, royalties, and other items which are the result of contractual obligations, numerous other items of that type.

Q. How about inventories when you spot check them and otherwise?

A. That would also be supplementary to the record unless they had a very sufficient internal control.

Q. Even there where you make a test of the records, it would be supplementary?

A. Yes.

Q. Would you say that one of the duties of the public accountants is to check up on the management as well as the employees? That is, you have indicated throughout that you rely upon the management to a certain extent for various things for inquiry, etc. Is it part of the inquiry system to determine so far as possible the reliance that you should place upon the management's responses?

A. I think that in any investigation you naturally acquire a certain opinion more or less dependable as to the integrity of the management, and in fact that is a very vital thing, I think, in the accountant's work because if you doubt the integrity of the client it is quite a question as to whether or not you should retain him as a client.

So that, unquestionably, that element of integrity does prevail throughout all of your work to the extent that you know that all of your work hinges upon the fact that you must rely upon honesty of many people in the organization from the management clear down, of necessity because all auditing is based on that underlying principle of dependence upon integrity and upon the fact that the great majority of people in business are honest and that there is sufficient internal control to detect any variations from that on the part of the organization so far as that may be done.

Q. To what extent would you rely on information obtained by inquiry that could be verified by observation or independent tests, when the facts which you are seeking to ascertain could be verified directly?

For example, will you rely on a statement, as to how much cash was in the bank, from an officer?

A. We would rely, and of necessity rely upon the integrity of the individuals with regard to those elements which were not otherwise ascertainable and to a certain extent must rely upon that as supplemental information with regard to other items that we do check or determine to the extent that the element may be one that we cannot determine with complete accuracy.

Q. Or without undue expense?

A. Or without undue expense.

Q. Now, the second paragraph of the certificate on page 41, Mr. Couchman, states that in the auditor's opinion, based upon his examination, the statement fairly presents the position of the company and the results of its operations.

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

A. No; I don't think we do. I think we mean exactly what we said. If we had meant something else, I believe we would have been inclined to have said something else.

Q. Does that certificate imply that you have made such an examination as you, as an expert, feel was necessary to enable you to give an informed opinion as to the financial condition?

A. So far as accounting matters are concerned; yes.

Q. And based upon such an examination, this is your opinion?

A. It is.

Q. Have you anything to add?

A. Yes.

Q. We would like to have you do so.

A. I would like first to emphasize one element that has some bearing upon the scope of the public accountant's examination, and that is the time limitation set by those over whom the accounting profession has no control.

The major portion of the great majority of examinations must be performed between the period of the closing of the books of the commercial organizations and the date when reports should be sent to directors or stockholders before stockholders' meetings. These two dates are beyond the control of the accounting profession.

Usually they are set for a particular corporation by its charter and bylaws, frequently at the suggestion of the company's attorneys.

This pressure is further accentuated by the time limitation set by various practicing authorities and by other governmental bodies, such as the S. E. C., requiring reports to be rendered within a specified period after the closing of such fiscal year.

In fairness to the accounting profession, it must be recognized that to a large extent and wholly aside from other factors, the scope of its work is limited from the time standpoint by authorities wholly outside the control of the profession. The fact that the great majority of corporations have set December 31 as the close of their fiscal year puts a tremendous burden of time pressure on the public accountant.

I suggest that there are two steps which might be taken by corporations which would relieve this pressure to some extent.

One is that the public accountants be notified of their election as early as possible in the year and be allowed access to the records at any time during the year. This would enable some portion of the work to be performed before the close of the fiscal year.

The second is the adoption by corporations of a fiscal year which is natural to each individual business; that is, a fiscal year which will close at that month-end which has been shown by experience over the years to be the one at which there is the lowest ebb of activity.

I suggest that the Securities and Exchange Commission may be of great assistance to public accountants in aiding in the adoption of these two recommendations.

Going back to your question, "Have you anything further to say?" The difficulty presented to an accountant to answer this question properly is somewhat like that faced by an attorney, of whom one has asked 128 questions regarding the practice of the law, and then asked: "Have you any questions or suggestions to offer regarding legal questions which have not been developed?"

Regarding the questions which have been asked in this hearing, it occurs to me that there is a danger that the questionnaire may be considered by the public as a broad cross section of what public accounting work is and as implying that the practice of accountancy is little more than the following of a more or less rigid code of auditing steps.

Much of the accountant's work covers many other phases that have not been emphasized by this questionnaire but which may have a greater effect on stockholders' interests than do the matters which have been stressed.

Among these are such matters as questions of general conservatism or otherwise of the company's treatment of items affecting its balance sheet and its operating statements, proper treatment of transactions creating surplus of various types and the propriety of charges made against each, problems of reorganization and of refinancing, with proper presentation of the resulting effect.

This is all supplementary information to be set forth as footnotes or otherwise in the financial statement.

Analyses of all types of contractual obligations and of governing laws to determine and measure the effect upon various elements in the balance sheets and in the income statement, analyzing availability of surplus for a variety of usage under the terms of various laws and of indentures, problems concerned with the preservation of and impairment of a corpus of a legal entity, the reasonableness of a variety of items which are not within the scope of definite accounting determination, the consolidation of accounts and treatment of intercompany items of corporations and subsidiaries.

These are only a few of the multitude of problems forming the duty, from day to day, of the public accountant, but scarcely touched upon at this hearing, such matters as these are an integral and an important part of the accountant's examination.

Throughout the commercial world these matters and their effects are of infinitely more importance to stockholders and to creditors

and to the continued existence of the corporation than are the irregularities that occasionally may be found in inventories and in customers' accounts.

The questions today have centered on the pamphlet of some 40 pages. There are thousands of pages of text concerning accounting and auditing with the subject matter of which the public accountant must be familiar in the practice of his profession.

It must be kept in mind that accountancy is not an exact science and therefore the detailed method employed in its practice cannot be exactly tabulated.

In the type of examination performed in connection with the rendering of a report upon financial statements to be issued to stockholders or for credit purposes, the primary service is to establish a reasonable ground for the belief, or opinion, that is set forth in the accountant's report.

Sound opinion cannot always be determined by set formula.

Since a primary purpose of the examination is to enable the accountant to satisfy himself as to the general truthfulness of the financial records, it is evident that the process is subject to the same variations as to methods that apply in any attempt to determine truthfulness of individuals or of alleged facts or other circumstances such as the attempt of the law to determine truth in legal cases.

The procedure must vary as the circumstances warrant.

As to the general scope of the usual examination, the public accounting profession has had to be practical and to attempt to determine the greatest common denominator of need.

At one extreme there may be such a thing as an audit so incomplete as to be of little value to the commercial world; at the other extreme the complete detailed audit which would be so expensive that very few corporations could undertake it except under most unusual conditions. Generally speaking, its cost would be prohibitive.

Between these two extremes, the profession has for many years endeavored to determine what scope of examination, or that scope of examination which broadly speaking will be of the greatest value to the business community in proportion to its cost. The trends of thought or of demand from time to time may vary the scope. It may prove insufficient in a particular instance but consideration must be given as to how well it meets the needs in all other instances.

In all cases of test check there is the possibility that an error may lie in some untested section. That is true, however, in all activities of business or professional work or human relationship or politics or of life itself, in cases where complete and perfect knowledge of a matter is unattainable.

In all preventative lines of endeavor, whether directed against fraud or disease or accidents or crime or property loss, or loss of faith, perfect prevention is an idealistic goal rather than a practical accomplishment.

The accountant in his work can only do his best and exercise his best judgment based upon his experience, his knowledge of the experience of others, his ability, natural or acquired, any sixth sense he may have developed for smelling out irregularity and the following of such procedures as have proven effective.

Accountants are human; we do not seriously mind increased business but we are interested in knowing whether an increased value will result to the people we serve. We want to render as valuable a service as possible and I think we will continue to strive to improve and will welcome any intelligent aid toward that answer.

That is all.

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

The EXAMINER. Mr. Henderson, have you any questions?

Mr. HENDERSON. No, sir.

The EXAMINER. Mr. Couchman, have you any opinion as to what concept the public has of the scope of your certificate?

The WITNESS. They probably have a very unjustified concept, Mr. Examiner. Probably have a broader concept than is justified. I think that is quite probably the case.

The EXAMINER. Have you any suggestions as to modification of that certificate that would, shall we say, apprise the public of just what the accountant does and what he is intending to say to them he has done when he makes that certificate?

The WITNESS. I think to do that would be a very difficult thing and a very long and involved matter to try to put into a certificate. I feel that the profession has made available to the public, and particularly to those people who are sufficiently interested in business that they have made investments either in securities, stock or bonds, they have made available to them, I say, a great deal of information as to the scope of accounting work, as to what an accountant does and I do not know that we can compel all such people to study that information and to avail themselves of the opportunity that has been given to them to find out what this thing is about, even though it is something that they feel very seriously affects them.

If they feel that this is an important thing, and yet do not go out of their way to find out exactly what is meant by the statements they receive, it is very difficult for us as accountants to know what we can do to change that.

The EXAMINER. Thank you.

Anything else, Mr. Wertz?

Mr. WERTZ. I have nothing else.

May we recess until 10 o'clock Monday morning at which time we will have Prof. Hiram T. Scovill of the University of Illinois.

The EXAMINER. We will now adjourn until 10 o'clock Monday at which time we will have as the witness Prof. Hiram T. Scovill of the University of Illinois.

(Whereupon the hearing was adjourned until 10 o'clock a. m., March 6, 1939.)

BEFORE THE SECURITIES AND EXCHANGE COMMISSION

In the Matter of MCKESSON & ROBBINS, INC.

OFFICES OF THE SECURITIES AND EXCHANGE COMMISSION,
120 Broadway, New York, N. Y., Monday, March 6, 1939.

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

PROCEEDINGS

The EXAMINER. Will you be sworn, sir?

Whereupon:

HIRAM T. SCOVILL

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, Mr. Scovill?

The WITNESS. Hiram T. Scovill.

The EXAMINER. Mr. Scovill, 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. Scovill, will you state your present occupation?

A. I am professor of accountancy and head of the department of business organization and operation, University of Illinois.

Q. How long have you been in that position or in teaching in general?

A. Twenty-five years.

Q. And in your present position as head of the department?

A. Twenty-two years.

Q. Would you indicate your experience in accounting work?

A. My experience in accounting work dates back to 1908, when I became identified with McGregor, Chase & Co., a firm of C. P. A.'s in Chicago.

About 1910 or 1911 Mr. McGregor of that firm became the Chicago partner or resident manager of DeLoitte, Plender, Griffiths & Co., and I continued with that organization until 1913. Since that time I have indulged only in intermittent practice in summers and consulting work of different types, etc.

Q. Had you had educational training in accounting prior to entering accounting?

A. I graduated from the University of Illinois.

Q. Did you include accounting courses?

A. Yes.

Q. Are you a certified public accountant?

A. Yes.

Q. In what state?

A. Illinois.

Q. Could you indicate whether you are a member of any of the professional societies and indicate the offices held, if any?

A. I am a member of the Illinois Society of Certified Public Accountants. In that organization I was director for several years, 1930 to 1936; from September 1936 to September 1937, vice president; and September 1937 to September 1938, president.

Q. Are you a member of any other professional accounting society?

A. American Institute of Accountants, National Association of Cost Accountants, American Accounting Association, American Economics Association.

Q. Have you held any offices in the other associations?

A. In the American Accounting Association I was president, not of that organization, but of its predecessor, the American Association of University Instructors in Accounting, in the year 1920. I have not held any office in the American Institute of Accountants nor the National Association of Cost Accountants, but have served on committees of the institute.

Q. Would you indicate your committee work in these various organizations?

A. I was a member of the Special Committee on Technical Information of the Institute in 1937 and 1938; chairman of the Natural Business Year Committee of the American Institute of Accountants 2 years, October 1928 to October 1930; member of the Committee on State Corporation Laws, American Institute, 1934 to 1937.

I have also been a member of a number of other committees in the Illinois Society of C. P. A.'s, which I presume it is not necessary to mention.

Q. Will you indicate some of those, please?

A. I was a member of the committee on investigations and complaints, 1922 and 1923; member of the committee on membership, 1923 and 1924; committee on education and library, 1924 and 1925; committee on education, again, 1925 and 1926; natural business year committee, 1928 and 1929; and I was chairman of the natural business year committee of the Illinois Society 1930 to 1936, inclusive.

I have held a number of committee assignments in the American Society of C. P. A.'s, which has in the last few years merged with the American Institute. I am not sure that is material.

Q. I should like to have you indicate those, if you would.

A. Well, I was state representative for Illinois in the American Society for 7 years, 1930 to 1937; member of the committee on technical affairs, 1932 to 1935; member of the committee on accounting practice, 1933; and member of the committee on natural fiscal year in 1935.

I think those are the major ones.

Q. Have you published any accounting books or assisted in their publication?

A. Well, yes. I think it would be unnecessary, probably, to name books; I have written a number of books on accounting, probably one a little more unique than some of the others, what might be called a pamphlet that I prepared for the Illinois Public Utility Commission a number of years ago when it was regulating the utilities in about the same way as it is now; the pamphlet on uniform accounting for gas companies as a result of an assignment given to me after I passed a civil-service examination.

Since then, and before that, I have written books, mostly textbooks.

Q. Have you edited any books?

A. At the present time I am editor of the Wiley Accounting Series published by John Wiley & Sons in New York, publishers. I have held that position as editor from 1923 or 1924 up to the present time.

Q. And does that accounting series include accounting books on all types of accounting topics?

A. Yes. There are books of a great many varieties in that series—theory, auditing, fundamentals, systems, cost accounting, and so on.

Q. Have you published articles, in addition to these books, in professional magazines?

A. Yes. I have written a great many articles. I believe it would be unnecessary to name all those. It would probably aggregate 100,000 words or more in a period of 20 or 25 years.

II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

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

A. I think what are ordinarily called balance-sheet audit and detailed audit, I do not exactly like those terms, but those are the ones you see used most often, so I probably should use them.

Q. Would you characterize those two terms?

A. The balance-sheet audit is one that is considered the ordinary, more common, type of audit or examination for ordinary purposes, for refinancing, general control.

The detailed audit is one that is indulged in more often when something is expected in the way of irregularities which might be hard to uncover by the ordinary balance-sheet audit and without going into detail much more than the balance-sheet audit implies.

Q. And when you say "balance-sheet audit," does that include any work on the profit-and-loss statement?

A. Yes. In my opinion, a balance-sheet audit cannot be conducted by verifying merely the assets and liabilities in the balance sheet. Such a procedure merely enables one to say within reasonable bounds that the assets that are shown in the balance sheet are there.

It does not give any indication whatever that the assets that should be on hand are there.

One can hardly verify, accurately, the existence, authenticity, and value of an asset or a liability without referring to considerable extent to the nominal accounts; expense and income accounts.

I think that any accountant would realize that no entry affects the nominal accounts without affecting the real accounts.

There is such a close relationship that one can hardly state that he is sure an asset is correct without doing a considerable amount of work in connection with the relative expense or income accounts.

In other words, it helps one to find—to detect the accuracy or determine the accuracy of a balance-sheet item if he does more or less with the nominal accounts, such as expense and income.

Q. Are you familiar, Mr. Scovill, with the Commission's exhibit 117:

Examination of Financial Statements by Independent Public Accountants?

A. Yes, sir.

Q. Which is prepared and published by the American Institute of Accountants?

A. Yes; I am.

Q. Did you participate in the preparation of that pamphlet?

A. No, sir.

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

A. I believe it was an attempt to bring before the accountants, and the investment bankers, commercial bankers, and others who use balance sheets and read them with some degree of intelligence, the procedure that is recommended as a result of generally accepted practice by accountants.

Q. Among the types of services you mentioned a moment ago, how would you classify the examination contemplated by this bulletin?

A. That would be contemplated as a balance-sheet audit rather than as a detailed audit except insofar as the bulletin in certain places seems to indicate that in case of lack of internal check, then more things should be done which might border on a detailed audit, but in general I think it contemplates a balance-sheet audit.

Q. In such examinations would you say the principles of the bulletin are of general application to all types and sizes of business?

A. Yes; I think the general principles would be.

I might say, if you are asking me if I am familiar with this, I do expect all members of our instructional staff, about 25 in number, to procure a pamphlet of this sort, become familiar with the general contents, and each year we urge our senior students and graduate students to acquire a copy. That amounts to about a hundred copies a year we order of those for the benefit and use of our students, not that we use it as a textbook, it is not a textbook. It might form a good basis for lectures. One would have to elaborate much more than the pamphlet does in order to tell why and how; and give ideas as to procedure involved in a given case, but it does form a good outline for lectures. We feel that students and members of the staff should keep informed and up to date on what is, as is represented by this pamphlet, considered fairly good accepted practice, you might say.

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

A. Well, I would say that—off the record.

(Discussion off the record.)

A. (Continued.) Auditors that do their work by rule rather than reason are likely to consider the steps prescribed as a maximum; which they can check off as work is performed.

Those who have the brain capacity that I believe should be possessed by accountants, doubtless treat the bulletin as a point of departure, more of a guide than a complete measuring stick.

Q. How would you compare, generally speaking, the scope of the examination as set forth in this bulletin with the scope of the examination which you recommend in your courses for this type of examination?

A. The scope is along the lines that we teach, but as I said a few minutes ago, the steps are so briefly stated they can hardly be compared with a presentation in the classroom where we naturally spend a great deal of time discussing the reason for each step, and some of the procedures and digressions permitted or required by unusual circumstances which might arise.

In other words, this pamphlet could not be used as a textbook.

Q. Historically speaking, did the publication of this pamphlet result in any changes in the teaching of auditing or in audit practice in general, as you know of it?

A. I believe it did not. If those who were teaching auditing had kept pace with the general trend of the times and had modified their teaching to conform to what I think was represented by good practice up to that time when the bulletin in 1917 was put out and later the bulletin of 1929; and had modified their teaching to keep pace with what I think was representative in those bulletins, then the procedure I think would not be materially modified. There was a marked difference between the 1929 and 1936 bulletins. I think the 1936 bulletin is better in most respects, at least the first part of it shows a very good trend, I believe, in emphasizing the consistent practice to be followed by concerns in handling their accounts.

III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. From your experience, who would you say exercises the prerogative of appointing auditors to certify annual reports of corporations whose stock is publicly held?

A. Either the president or the directors. There seems to be no set rule or custom on that, because I know of a great many in which the president does and some in which the directors do. Sometimes the board appoints and sometimes a small group of the board. I could not make any general statement as to that.

Q. To whom would you say the accountant's primary responsibility runs? Is it to the people who employ him in that capacity?

A. At the present time I believe it runs to the board of directors.

Q. As individuals?

A. As individuals in the sense that I think the auditor should feel that each one should be informed. If he can assume that each director will be informed on the audit through the board meetings, then that probably should be sufficient.

Q. Is there any responsibility to stockholders, creditors, investors?

A. Yes; I feel that the auditor is generally looked upon, and more so in the last 10 or 15 years than ever before, as one who can be relied upon to give the public the unbiased information which they seek.

By public, I mean more the stockholders who probably could not be called public in one respect, at least with respect to a given corporation.

Q. In your opinion, is there apt to be a conflict between the responsibility you have indicated to the board and the responsibility you have indicated as to the stockholders and the public?

A. If I understand what you mean, I think that there should be no conflict in general, but undoubtedly there are cases in which there is a conflict.

Q. And in such cases what is your thought that the accountants should do, where there is a conflict?

A. You mean where there seems to be a conflict of authority and where it seems that the president or the board is trying to withhold information from the stockholders?

Q. Withhold or color information.

A. I believe the accountant should do all he can to advise the stockholders of the situation.

Q. When an accounting firm accepts an engagement, Mr. Scovill, by what representative of the firm in your opinion should the scope of an audit be determined?

A. I think the scope of it ought to be determined by the auditor.

Q. And specifically, in the case of a firm, would it be the—

A. In the case of a firm the one to advise with the auditor and who probably determines the scope to a considerable extent also, in many cases would be the president or the—

Q. No; I am referring to whom in the accounting firm—would it be a junior?

A. I thought you meant the comptroller or president of the corporation.

Q. We will come to that in just a minute.

A. Oh, in the accounting firm, one of the partners should be in most cases, I think, and is, unless it is a very minor audit in which a partner would not care to bother or would permit some senior to carry out in full, but I think that would be more an exception than a rule.

Q. Should the scope of the audit be reexamined in the case of a continuing engagement?

A. Oh, yes. You mean, an engagement that a firm of accountants has year after year; yes.

Q. Yes; should it be reexamined, say, annually?

A. Yes.

Q. Coming to the client, from your experience, who would decide questions as to the scope of the audit on the part of the client?

A. That would usually be the president, either directly or through the chief finance officer, the accounting officer, the comptroller ordinarily in the larger concerns.

Q. Looking to the future, do you think there should be a change in the method of appointing auditors or determining the scope of the audit?

A. The only change I would recommend is that the auditor himself be given more power to define the scope of the audit. If that could be accomplished, I think it would be a great step forward, but I believe it could not be accomplished without a considerable amount of

education of, and cooperation with, commercial bankers, investment bankers, bodies such as the Securities and Exchange Commission and others who could assist the accountants in educating the public to the fact that a more complete program, which I think accountants ought to demand, would cost more and therefore would have to demand a higher fee.

Those two things work in together, but they are very important. That is, the scope is important and the fee, of course, incidentally is important.

Q. Now, looking at the assignment of people by the firm to a particular audit; do you have any opinion as to whether staff assignments should be permanent for successive audits? Would you indicate reasons for your belief?

A. You mean should the accounting firm send out about the same individuals on the audit? I suppose you mean more the ones in charge who are responsible for the outlining and planning, carrying out the audit?

Q. More so than the juniors.

A. Yes; I think it would be most desirable to continue the same people in the audit year after year because they become familiar with the business and routine, products, the organization; they can save time and make it more economical for the client in the last analysis and I think accomplish much better results.

I would be in favor of continuing the same responsible individuals on the audit year after year.

Q. Are there any disadvantages to such a practice?

A. The principal disadvantages would be that one who is inclined to be careless and not check up on himself frequently might get into a rut and might get to know the personnel of the client's staff so well that he would begin to feel that everyone is doing his job well and would not take the opportunity or the time to dig into things the way he might if he were new on the job or if a new person came on the job.

Q. If the same people are returned year after year to an engagement, is there any way by which that disadvantage you mentioned can be overcome or is it purely a personal factor?

A. Well, I think it could be overcome if seniors on an engagement, sometimes there are more than one, sometimes there are several—seniors and semiseniors—of the one, two, or three responsible for the engagement would get together oftener and spend more time thinking about the audit and discussing phases of it and discussing the program and do some of that real thinking instead of spending some of the time that they now spend on more or less routine matters.

Of course, I am not implying that the seniors waste any time on routine matters but probably I should say in addition to the time they spend on other matters. That matter of thinking things through is very important and I think is an item often overlooked that cannot be even covered in a pamphlet such as we are discussing.

Q. Have you any knowledge as to how juniors are recruited for accounting firms, speaking generally?

A. I think I have. At least I have assisted a number of firms in procuring juniors for their staffs. I have discussed the matter with a number of other firms whom I have not helped so much

directly except to suggest that we might help them. Is that all there is in the scope of that question?

Q. How are juniors recruited, from your knowledge? What procedure do the firms follow?

A. I believe I would divide the firms of accountants by and large into about two classes on that point: One class still holds the idea that prevailed in Great Britain for a number of years, and which is carried over in this country in many cases, that the accountant should be brought up through the apprenticeship system.

There is another school, another class of accountants, that has come to believe more in the procuring of their staff members through the retaining of college graduates who have had proper academic training in accounting and allied subjects.

The ones who procure their accountants and junior accountants through the ranks of the university graduates are the ones that I come in contact with most naturally, but I do find, occasionally, that I come in contact in that respect with some of those who believe more in the apprenticeship system because occasionally they do discuss the advisability, at least, of having a college graduate on the staff.

Q. Need I ask you to indicate which of those methods you believe is preferable from the point of view of the accounting field?

A. You hardly need ask but I am willing to answer it.

Q. I would be glad to have you indicate the reason for that answer.

A. The main reason I have for that answer, which is implied, I believe, by my position and statements previously made, is that I think that the accounting and auditing work with the vast modifications, enlargements, and complexities in business that have arisen in the last 20 years should demand the highest type of intelligence.

Now, that does not imply that intelligence does not come from anywhere except universities and colleges. It does imply that if one can complete an academic career in an institution which maintains high standards, he undoubtedly must have a high degree of intelligence. It does not say that no one else does, but at least it says that he does have, and it gives a firm of accountants an opportunity to select men of intelligence and personality.

I have never overlooked the matter of personality, resourcefulness, tact, and judgment in selecting an employee for a staff of accountants. Those elements are very important.

Q. Do you know what training or experience accounting firms in general look for in men applying for positions of this character?

A. As juniors?

Q. Yes.

A. I think they look for some of those I mentioned last. I should have mentioned character along with those. Character is one of the very important ones, probably the most important: Character, technical training, resourcefulness, tact, judgment, personality.

Q. Do you know whether they have any special requirements as to having taken accounting work in their college courses? Is that a prerequisite?

A. I think it is in those who hire college students in general. There are a few I know, as I have talked with accounting partners in this city and other cities, who say that they would employ and do employ bright young men out of college who have not had any accountin

work. I think those cases are the exceptions and I think they will grow less and less in the coming years.

Q. Have you found, generally speaking, that the accounting firms have any requirement for further self-education or further education applicable to juniors whom they employ?

A. Yes; I know some of the firms do take considerable interest in the training of their junior staff and try to give them opportunities for learning, either in some organized way through formal lectures by older staff members, or by opening the library to them and urging the use of the library to do special study. Most of the firms encourage their juniors to go to night school or probably I might say to take correspondence school work, so as not to be partial in that respect.

Q. Do you know whether the partners or seniors of the firms participate in this training in any cases? Do they have a series of lectures?

A. I don't know that I could say just who it is in the firm who ordinarily indulges in this. My feeling is that the partners do not. I have discussed it with several but I can't think of any cases in which the partners do much of that. My feeling is that the partners do not do much of that. Some of the more responsible other members of the staff do it.

Q. Do you know whether a C. P. A. certificate is a prerequisite for advancement, as a general matter?

A. No; I wouldn't believe it is a prerequisite. In many firms it is a help to men to advance from a junior to a senior.

Q. Yes; or further?

A. Of course, I suppose most of the firms, and here again it is more or less not hearsay exactly, but a result of my having talked with a great many different accountants and also with a great many alumni from whom I pick up facts of that type (I never pick up any confidential facts, but just facts of a general character). It is my feeling that in order to become a partner one does ordinarily need the C. P. A. certificate and is expected to have it before he becomes a partner. I am not sure that that is universal but my feeling is that that is strongly the trend.

Q. Will you describe briefly the types of duties which are assigned to juniors?

A. Juniors are ordinarily assigned to the routine tasks, so-called, including verification of what additions might be required in books of entry and documents here and there. They often are assigned to the reconciliation of the bank, if there is nothing extremely complicated in the situation, and verification of petty cash funds. Some of them I know are assigned to aging accounts receivable and some to the verification of extensions and additions in inventories. There is a certain amount of help they can give seniors, of course, in many other lines such as getting out confirmations for accounts receivable, analyzing accounts; some things are done in connection with seniors in which the juniors merely assist without taking any great responsibility themselves.

Q. Speaking generally, have you any information as to the sources from which accounting firms get their senior accountants? Are they ordinarily promotions from within?

A. From my knowledge of the firms, the senior accountants are obtained from two general sources: They are developed within the organization from juniors, from the men who show the most promise or if the concern happens to have misjudged its juniors or didn't get enough in to develop seniors, then it is necessary to go outside and bring in other seniors or if the firm is growing rapidly and therefore does not have enough good men coming along, it must expect to get seniors from outside. I am not sure that there is any proselyting in that but I have a feeling sometimes there might be.

Q. Can you characterize the type of duty you have found ordinarily assigned to seniors?

A. The seniors would ordinarily be assigned to the general supervision under the direction of some partner or manager in charge of other type of accountant, whatever the firm calls him, but a senior would be in charge of the general work on the scene of action in the client's office, and as such would supervise the verification of inventory pricing; and do what is necessary in connection with quantities and cost; would supervise the verification of accounts receivable notes, securities and all the fixed assets, also verifications of bond payable and the other liabilities, checking up on contingent liabilities and all those ordinary things the auditor must do.

In other words, the senior supervises those and delegates to junior or semiseniors the parts of the work that he feels they can perform and which would to him be clearly detail and therefore on which he should not take too much of his time.

Q. Do you consider it one of the senior's duties to train the men under him? If so, in what way?

A. Well, I feel that it is the duty of a senior, probably not to train those under him while they are on the scene of action, engagement because that might imply the waste of too much time. The training probably should be done back in the office during the slack season of the year but I think the senior should train the junior under him to the extent of being willing to tell him why he is doing everything that he is asked to do.

If a person is merely told to do something and is not given surrounding circumstances, background, and the reason, then that person does not have an opportunity to use his ordinary intelligence in doing the work. If he is given to understand the reason for the performance of the task, then if some little unusual thing arises, he can use his intelligence and proceed in a much better way than if he didn't know all the surrounding circumstances and was not advised of the whys and wherefores of the procedure.

I think the senior can do a great deal to instruct the junior in the way and to give him advice and to answer his questions politely and intelligently and make the junior feel that the senior is willing to help him out in all reasonable cases to become a valuable member of the firm.

Q. Would you say it is part of the senior's duty to be sure that the junior is aware of what he is supposed to do in a particular assignment and if necessary to instruct him as to how to do it?

A. Oh, yes. I think I included that in my comments.

Q. Do you know in what manner a firm satisfies itself, or should satisfy itself, as to whether the juniors are satisfactorily performing their duties?

A. You say how a firm does, or should it?

Q. Both, should it and how should it; or have you found it does?

A. It should satisfy itself as to the work of the junior; yes.

I believe, ordinarily, such satisfaction is obtained through reports rendered by the senior accountants who have had the juniors on their staff in various audits.

Q. Do you know whether partners, ordinarily, participate in the field work of the audit or whether they in any way come in contact with the client during the course of the audit or at other times during the year?

A. That depends quite largely, I think, on the size of the accounting firm.

I know some very small firms in which the partners do a great deal of work in the client's office. In some of the larger firms I know of, the partners do very little, if any, work in the client's office. They get around to the client's office and make contacts, ask questions, breed good will, maintain the esprit de corps of the employees on their staff, and in general make it appear that the audit is being done by the firm rather than by merely some hired employees.

Q. To summarize your ideas on this general question—I wonder if you could give us a statement of your views as to this general problem?

A. You mean the assignment of duties?

Q. The whole problem.

Mr. WERTZ. Off the record.

(Discussion off the record.)

A. Well, of course, all these answers, as you have observed, are not the result of my having operated a big office or a small office, but as the result of having been in one as an employee and as a result of having conferred with a great many accountants and employees, alumni, and so on, so that I feel I have a pretty good idea of the organization and how it operates.

Of course, first you have the partners who are the real important men in the organization, and should be. I am not going to describe the scope of their activities, the methods they follow, that is beyond the scope of this, I presume.

The next, of course, would be the men to whom they give a great amount of responsibility without their yet being partners. The title given to those men just below the partners differs in the different firms.

Then, there are men just below them who are senior accountants, of course, but who also often have some other title in the firm, indicating that they have charge over several seniors at one time in the different audit engagements.

A title is given to some of these men in the second or third brackets, so-called, manager, supervisor, in-charge men and so on.

Then the senior accountant is next in line and the semisenior and the junior.

I think that is about the type of organization you will find in the more representative firms, whether they be large or small. Of course, in the small organizations you would not find some of those classes or groups.

Q. In undertaking, or before undertaking a new engagement, do you have any opinion as to whether the staff assigned should become

generally familiar with the trade or industry prior to the—at least prior to the completion of the first audit?

A. It is my opinion that they should become more or less familiar with the general nature of the business of the client, not before the completion of the audit, but before the beginning of the audit.

It seems to me that it would be very possible, and not highly theoretical, for a staff member—senior, semisenior, junior, in-charge man, or supervisor—to know in advance that he is to be assigned to a certain audit, the business of which he knows very little. In view of the fact that he does know for a considerable length of time in advance that he is to be assigned to an engagement of that sort, he could, undoubtedly, spend some time learning about the general nature of the business, its products and processes, nature of its markets, type of raw materials, and some of those things so that he would know whether it is necessary to become familiar with imports and exports and foreign exchange, or a number of other subjects that might enter into the specific organization.

With all the bulletins that are now put out by the National Association of Cost Accountants, some of which are good and some not so good, and the numerous articles put out by the Journal of Accountancy and other publications, it is possible these days, from those sources, as well as others, to find out some of the general broad fundamentals of any one of a variety of businesses.

I feel that an accountant going on an engagement for the first time should inform himself on some of those fundamentals before he audits the organization, not wait until he gets on the engagement.

Q. Now, returning to the duties assigned to juniors, which I take it from your description would involve the examination of the records and various documents in connection therewith:

Do you think that juniors should be sufficiently familiar with the type of records and documents with which they are apt to come in contact so as to be able to recognize what we might call significant irregularities, such as the absence of an endorsement on a check, or absence of approving initials on a voucher? Where would this training be obtained and how?

A. I think the intelligent junior, the better grade of junior, would be informed enough on such matters to know enough about the different types of records and forms so that he could use a considerable amount of resourcefulness in carrying out his work.

The average or mediocre junior, I think, might have considerable difficulty in orienting himself or in realizing that what he has before him is really that which he has seen before in principle, if not in detail.

There is a great deal of difference among people, in general, and among junior accountants, on that one point.

Some people can correlate ideas and can relate one thing to another in such a way that the thing before them is perfectly clear, even though it is not exactly like anything they have seen before. Some other people are so constituted that if something is before them they are not accustomed to, they do not see the relationship with known factors. That is the reason I emphasize all the time the importance of good thinking men, either as junior accountants or senior accountants; those who can correlate and think.

Q. Do you think the juniors and other people on the staff should be alert to note and report such irregularities which you have been describing?

A. You mean other men on the accountant's staff as well as juniors?

Q. Juniors and anybody else who would happen to see an irregularity.

A. Oh, yes. All should be alert and on the lookout.

Q. Have you any thought as to how—as to the course to be followed when irregularities are disclosed in the course of an audit?

A. Yes. If a junior finds an irregularity, I would say that he should report it to his immediate superior.

If a senior finds something, of course—seniors work through the seniors, but if the senior finds something irregular that is beyond just ordinary routine, that he cannot adjust, he should take it up with his immediate superior, whatever title that person might have; not necessarily a partner in a big organization, but his superior in charge.

Q. At what point should he go to the client with his information?

A. I think he should go to the client after he has discussed it fully within his own organization. It would depend upon the nature of the irregularity, whether it should go clear up to the partners in some of the bigger firms. But if it does seem to be of such a nature that the one who receives it, as it comes up to him, feels that he can act on it without referring to a partner, then he should think it over and discuss it with those below him, as to details, and then take it up with the client. If it seems to be of such a nature that he, by the general scope of his authority, should not take it up with the client, then he should refer it to a partner and discuss it with him and let the partner take it up.

Q. Do you think the accountant should ascertain as nearly as possible the facts before taking it up with the client?

A. Oh, yes. I think that would be very necessary. If not, it might put him in a bad hole sometimes.

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

The EXAMINER. Yes.

(Whereupon a short recess was taken.)

AFTER RECESS

IV. CONDUCT OF THE EXAMINATION

A. INTERNAL CHECK AND CONTROL

Q. (By Mr. WERNTZ.) Mr. Scovill, coming to the question of internal check and control, to what extent, as a matter of sound accounting practice, do you feel the members of the staff assigned to an engagement should become familiar with the particular concern being audited; that is, the plant layout, its operating methods, its method of doing business, major products, and so forth—character of personnel?

A. I think it is very desirable for the one in charge of the audit to become familiar with those things in the general organization and other things you have mentioned.

Q. Is it necessary, or desirable, to obtain an organization chart, at least of the accounting department of the business, showing the vari-