

ous individuals, their duties, responsibilities, and who controls them, and so forth?

A. Oh, it is not absolutely necessary, but if an organization chart is in existence, it undoubtedly facilitates the accumulation of a picture of the organization of the business by the senior or by the men under him.

If there is not an organization chart in existence, then some one of the men on the engagement must obtain some of the facts, some of the relationships, that would be portrayed by an organization chart, not necessarily all of them, but enough to indicate responsibilities that are assigned to different people in the organization.

Q. What do you understand to be meant by the term "internal check and control" or "system of internal check and control?"

A. My own definition merely is this: A procedure used in a business in handling its transactions and the documents and accounting entries pertaining thereto, in such a way that more than one employee must be affected by each transaction, either as the one to approve or effect the transaction or to prepare the original documents or records, and post the resulting charges and credits.

Q. What are some of the common basic features of such a system? Can you give us an illustration?

A. The most common one, of course, is that which would decree that the same person should not handle the customer's ledgers and the cash. That is the most typical one. There are many deviations from that, such as collections and receivables, allowance authorizations in cash and relationships between shipping and sales and so forth.

Q. What is the purpose of such a system?

A. To make it necessary for more than one person to execute a transaction, sometime, somewhere, along the line so as to avoid, or make it very difficult to indulge in theft, defalcation, or embezzlement.

Q. Is one of the purposes also to insure accuracy so far as possible?

A. Oh, yes; accuracy in all cases.

Q. Now, can such a system always be used?

A. No; it cannot be used very well in small organizations. Some organizations are so small that one person in an office has to handle everything.

Q. Is such a system to be distinguished from a system of internal audit or is a system of internal audit a part of the system of internal control?

A. It is not the same. An internal check arrangement could exist without having internal audits, but an internal audit in a large organization does form a very important part in the internal check system.

Q. Now, looking at the bulletin on page 7. There is a statement that the nature and extent of the examination depends on the purpose of the examination, the amount of detail included in the statements to be covered by the report, the type of business, the accounts of which are to be examined and the system of internal check and control. Can you explain briefly the effect of each of these factors on

the scope of the examination? Take first the question of the purpose of the examination.

A. Where is that?

Q. On page 7, the first sentence under section 2—first paragraph.

A. I think all those are true statements. I believe the amount of detail included in the statements to be covered by the report is less important as a determining factor than the other three.

The nature and extent of the examination, of course, is determined very largely by the purpose of the examination and, undoubtedly, by the type of business.

Q. Could you indicate, for example, just how the scope would be affected by the purpose of the examination?

A. If an examination is being conducted for the purpose of determining some rights or infringements under a patent, the nature of the work would be materially different from what it would be if an engagement were for the purpose of effecting a merger or consolidation.

Q. Now, how would the type of business affect the scope of the audit?

A. The type of business would, undoubtedly, have an effect upon the relative weight given to the different portions of the audit.

For example, in a brokerage house, or financial institution, much more emphasis would be placed on cash than in a manufacturing establishment which handles very little currency, or cash.

Q. Would you say that the scope of the audit is so adjusted to give particular weight to those assets or transactions which are most important to the particular business?

A. Yes; that, in general, would be the case.

Q. Now, as to the system of internal control, how does that affect the scope of the audit?

A. That is very important, as implied all the way through in this pamphlet, and correctly so, I believe. If the internal organization of the client is such that there are many safeguards against inaccuracies and irregularities, then the auditor would modify his program to meet those conditions. He would not have to do as much in detail as he would in an organization that did not have such internal control.

Q. And would you say, generally, that the weaker the system of internal control, the more extensive the audit might have to be?

A. Yes; in general.

Q. And vice versa, of course?

A. Yes.

Q. Now, on pages 7 and 10 and elsewhere in the bulletin, it is indicated that section 2 is for small or moderate sized businesses and for large ones the modifications of section 3 should be made.

Now, would you indicate what, in your opinion, is the criteria, are the criteria, to distinguish between large and small businesses in this connection? Is it aggregate assets to the volume of sales, volume of transactions, capital employed? What is it?

A. It seems to me that the principal criterion there would be the volume of business, not the dollars in sales, but the number of transactions which, I think, has a very close relationship to the number

of people in the organization, in the office organization, and therefore to the internal check.

It seems to me that the dollar sales would not be a good criterion. A business might have a million dollars in sales and have many people in the office, or it might have \$10,000,000 in sales and have only a few people and have no good opportunity for internal check.

It seems to me a good criterion would be the volume, which is an indication of the number of people.

Q. Now, at page 9 in the bulletin, the last sentence of the first full paragraph on the page indicates that the extent of the examination is to be determined in part from the accountant's knowledge of the individual situation.

What is your understanding as to the extent of such knowledge of the individual situation which the accountant should have, at least before concluding his examination?

How far must he understand the particular situation?

That is on page 9, the last sentence in the first paragraph.

A. There are three conditions there, are there not? The experience and extent of internal check are two which I think should be woven in rather closely with the third one.

Q. Would you expand that thought just a bit?

A. Your question is what specific points there?

Q. The question of how far must the accountant know the individual situation in order to comply with those conditions.

A. My main point is this, that there are three items involved in that sentence, one of which relates to the auditor's experience, one to his knowledge of the individual situation, and the other to the extent of the internal check.

I think the knowledge of the individual situation is somewhat—ought to be somewhat submerged there, because the other two are so important, and it is difficult to enlarge very much on knowledge of an individual situation except to say, possibly, that the accountant before going on his engagement might know of some lawsuit that is pending and therefore might let that knowledge affect his work to some extent. He might know of some family connection that would cause him to look on things in a different way than he would otherwise, and a few things of that sort. I think the larger elements are experience and the extent of internal check so that the knowledge of the individual situation is just sort of a third-rate item.

Q. Do you feel that knowledge as to the system of internal check and control is comprehended within knowledge of the individual situation?

That is, that the sentence in question means that he must not only know the system of internal check but give weight to it?

A. Yes. But I thought possibly that knowledge of individual situation had some implication beyond the internal check, as I implied before, a knowledge of lawsuits pending or knowledge of some family relationship or knowledge he has obtained in some other audit that gave him an insight into something that existed in this concern.

Q. How would you say information as to the system of internal check and control of the client's accounting procedure should be developed by the accountant? How does he get that information? How do you advocate he should get it?

A. In general, I think the accountant would get that from the organization chart, if there is one, or from conferences with the one in charge of the whole accounting organization, say comptroller, if the organization has one, or someone corresponding to him, and I think he should supplement those sources with casual conversations with some of the people in the organization, merely by way of testing and checking up on the existence and adequacy of the internal check as described by the men in charge and as indicated by the organization chart.

Q. Should that information be kept up to date?

A. Yes; as far as possible the accountant should keep that up to date.

Q. Do you have any opinion as to the value of the use of the questionnaire as opposed to leaving the matter up to the senior or to some other person on an informal basis?

A. Well, a questionnaire has certain advantages. It probably makes it easier for the senior to think of all the things he wants to think of when he has a great many other things on his mind. On the other hand, he is likely to let it become mechanical and confine his attention only to the questions which are on the questionnaire, whereas, in some cases, if he is rather ingenious he might find in connection with certain situations that other questions are desirable and necessarily so; that while a questionnaire helps it should not be made all-inclusive.

Q. In finding out whether the system of internal control as related to the auditor by the administrative officer in charge is actually working, I think you have indicated that you would interview or talk to some of the employees who are actually performing various operations. Would it be possible to check up on your information by observation of the documents and initials, et cetera, and is that part of the auditor's work?

A. That is one of the reasons for determining the internal check in the first place and getting the organization before one, visually speaking, so that he can tell whether the initials are authentic and are the ones that should be on the documents which are to be examined, because in general he learns that certain people are given authority to approve certain types of documents and he gets that from his knowledge of the internal organization and to some extent the internal check, although those two do not necessarily correlate one with the other.

Q. Now, when the accountant has completed the study of the system of internal check and control; that is, his inquiries of the various officers and his observations of the procedures and his discussion with employees, would you say this should result in a thorough knowledge on the part of the auditor of the accounting system followed by a particular client including a knowledge as to what documents, vouchers, and other papers are used to support every step in the procedure?

A. Well, in general, I should say yes.

Q. Does that mean that each year the auditor should examine each of these documents?

A. No; if I understand the question it merely means that the auditor should know that as a result of this procedure and this organi-

zation certain documents are used and they go through certain channels and are approved by certain officials, employees, subordinates, et cetera.

Q. For example, would you expect the accountant to know all of the typical papers that would be included in the ordinary voucher jacket or in connection with a particular voucher?

A. I should think that would be one of the things that the senior would ordinarily expect to learn about the organization and he might not always know it the first year. That would be one of the advantages to be derived by continuing the senior on the same engagement; but in general the fundamentals are there and although the balance-sheet audit does not imply that he is going to look at all these documents, yet he ought to know enough about the general procedure to know that the vouchers should be supported by the receiving records, requisitions, purchase orders, et cetera, which ordinarily enter into the picture.

Q. Should an examination of the scope we are discussing, ordinarily detect fraud or disclose fraud?

A. You mean the scope in this pamphlet [indicating].

Q. Yes; you might wish to refer to it there—to page 10—the second full paragraph, and the second sentence which reads:

The procedure will not necessarily disclose defalcations nor every understatement of assets concealed in the records of operating transactions or by manipulation of the accounts.

A. That same phrase was used in the 1929 publication so it must be a good one. That is one that was carried over verbatim from the 1929 publication and I still don't understand why they emphasize understatement of assets so much instead of putting along with it overstatement of assets and maybe some understatement of liabilities; but nevertheless I would say that this procedure would not necessarily disclose all defalcations. I don't think that it is primarily intended that it would disclose all of them.

Q. Would you say that before the auditor completes an investigation and signs the certificate he should be satisfied as to the general accuracy and integrity of the records?

A. Yes; whatever that may mean. That is a pretty hard thing to define, the general accuracy and integrity.

Q. Would you say the auditor should not sign a certificate if he has any substantial doubt as to the accuracy or integrity of the records?

A. I think that would be a safe statement, yes.

Q. Now, within the scope of the examination contemplated by this bulletin, would you say that an auditor should be alert to detect fraud and other irregularities?

A. If I understand the question I would say yes; that the auditor ought always to be alert to detect irregularities.

Q. What I have in mind is: If a simple test of sales, accounts receivable, or cash transactions is made, should the auditor in his work on those records be alert to discover any irregularity therein?

A. Oh, yes; you mean while he is making the test?

Q. Yes.

A. Yes; well, of course, there is where the experience and intelligence of the auditor has a great part to play and if he knows how

to select his tests and what tests to make and he gets what some people might call the right hunches based on experience, intelligence and resourcefulness, then he undoubtedly can get many more clues than another auditor who has not had experience and who is not as resourceful and who cannot play his hunches quite so well.

Q. Speaking generally of this type of examination, should test examinations of records covering certain types of transactions such as sales, plant additions, cash disbursements, expenses, be made?

A. Yes; I think so.

Q. Do you feel that such tests, if the results are satisfactory, adequately verify the records as a whole, although you have only examined certain portions of them?

A. Well, they do in a sense. The law of averages, of course, comes in there very largely. It is one of those cases in which the accountant, if he is not authorized to do everything in detail, must at times take a chance until the public and those who use accountant's services are educated to the fact that an accountant cannot do everything that is absolutely necessary to prove everything to his utmost satisfaction.

Q. I have in mind a case of this sort: Let us assume you have a reasonably satisfactory system of internal check and control. You test the sales, we will say, for 1 month to examine them in some detail. If the results of that examination are satisfactory do you feel that that is adequate test to verify or establish the sales for the entire period? I don't wish to pin you down as to 1 month out of 12, but any portion less than all of them.

A. I will say that it seems to have been the custom for a number of years to recognize that sort of a test as one which the reasonable careful accountant would indulge in and consider it satisfactory.

I am not sure that I would say that this is the type of test that is ideal, but it seems to be the prevalent one and until it is changed by custom or public opinion or otherwise, I suppose the best thing to say is that if nothing appears in that test, that the accountant is justified in saying that a further continuation of the work along that line—further testing—would not pay for itself.

Q. Of course, I think your answer clearly indicates that such a test does not, at least not conclusively, verify the records not examined?

A. It is not conclusive, no. It is not by any means conclusive.

Q. What is your thought as to whether such tests should be relied upon or not, having in mind the cost and time consuming nature of a complete verification?

A. I think I could say, if I am looking to the future, that such tests to be relied upon should be made on a larger scale than has been customary in the past because of the fact that so many employees these days are learning more about auditing and auditor's customs and they are much more likely to be able to counteract the effect of tests, no matter how wisely the auditor might choose his periods for tests.

Q. Could you indicate how much further such tests should go? Have you any thoughts there?

A. The limit, of course, would be a detailed audit which I am not ready to advocate for all purposes as yet. As between the detailed

audit and a test of 1 month there are many possibilities. That is where accountants naturally must differ. It is where the readers of balance sheets must differ. I don't know what I would suggest as a happy medium or the next stopping point, whether we should say he should test 6 months at random or 7 or 5 months.

Q. But substantially more than, say, 1 month, for example?

A. According to the law of averages, several months would be much better than one.

Q. Did you say that more sampling should be done than was perhaps customary at the present time, in your opinion?

A. That is the idea and I would say yes to your question, if we can educate the public, the bankers, and others that have to help the accountants in a sense to get public confirmation. If the accountants had this support, and if these people mentioned would enable them—the accountants—to get the fees commensurate with the time spent, I think it would be worth while.

B. CASH

Q. Turning to some of the details of the audit program and considering first of all cash, in the procedure set out on pages 11 and 12 of the bulletin, do you consider the cash program there outlined as a minimum or maximum procedure and could you indicate any steps therein which you think might be omitted ordinarily or any steps which you think ought generally to be added?

A. Well, I consider this a minimum for those concerns handling large amounts of currency and for those without adequate internal checks; for those with a fine internal check and an internal audit it probably is a maximum.

Q. Do you have any particular steps in mind that could be added or deleted from this program under the circumstances you have mentioned?

A. Sometimes I would check more than 1 month in detail, depending upon conditions; sometimes I would examine endorsements on all checks. I have found conditions in which that seemed to be absolutely necessary. Sometimes I would verify more additions of discount columns and cash, et cetera, than are implied here. There is very little verification of additions which I think would be necessary in some cases. Those are the principal modifications I think of.

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

A. I consider that rather an important procedure, one which could be indulged in in large but not so much in small organizations.

Q. Would your opinion differ if the funds involved were small working funds as compared to a situation in which they were the large general balances of the company? Would it be more important in the latter case?

A. Well, it would seem to be. Of course, defalcations and errors can arise in smaller as well as in larger funds. The only difference is in the degree of defalcations, I presume.

Q. Back to page 12 again in item 8, the last sentence of that item reads:

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

Under what circumstances should that comparison be made?

A. That would be made, I believe, in case it seems that there is any belief or clue that lapping has been indulged in.

Q. But not as a general rule?

A. Not as a general rule, that is not in detail. Of course, you could test something, but not throughout the whole year, if that is what you mean.

Q. Well, let us take them separately first as to testing: Would you think that testing always should be made?

A. Testing ordinarily during the beginning and end of the year to detect lapping.

Q. But a complete comparison only under circumstances which warranted some suspicion?

A. Yes.

Q. In the third line of item 8 on page 12, what is meant there by the term "bona fide receipts" and how are those bona fides established?

A. Bona fide means good faith.

Q. I believe so.

A. Originally.

Q. What are meant by bona fide receipts?

A. I suppose that means the ones that are really adding something to the cash balance of the company and are not merely transfers or not merely entries that are made as part of a kiting scheme.

I think a kiting scheme would probably be brought out in this sort of a picture.

Q. Now, Mr. Scovill, turning from general questions as to accounts with cash; is it customary and proper in your opinion to include in cash amounts due from foreign banks and private bankers?

A. I think so.

Q. Do you have in mind any conditions under which it would not be proper?

A. Well, I suppose in the case of foreign banks you might have the question of availability of the cash. I presume the accountant would not be justified in counting something as cash which he knew could not be made available for paying the bills of the company in the near future; if there was some way in which that cash is tied up, I mean. Some countries, I believe, do tie it up at the present time, and then the accountant should not call it cash.

Q. How could the existence or absence of those be determined, would it be special inquiry as to foreign balances?

A. I presume most accounting firms have information available in their offices and if not they could readily obtain it from the bank where the foreign exchange department could tell them whether there is any restriction.

Q. They should make inquiry regarding foreign balances?

A. It seems so easy to do that, it seems it should be something that the auditor should spend a few minutes on.

Q. What, in your opinion, should an auditor do in order to satisfy himself that a particular depository is in fact a bank or bankers. What evidence is he entitled to rely upon?

A. I think he is entitled to rely on the evidence that comes before him in the ordinary course of the audit, such as bank statements. Of course, in canceled checks, if he does anything with them at all, or he examines them, he will have evidence there, such as that obtained by examining the perforation stamp. Of course, in all banks of the Federal Reserve System he would have the Federal Reserve number on the checks and the cancellation. Those would enable him, I think, to determine whether or not a bank is a bona fide bank. That would at least show him whether the bank in question is bona fide; as to whether or not it is a member of the Federal Reserve, again, is another thing; I am not familiar with private banks. We don't have them in Illinois any more, but even in private banks there are cancellations and endorsements on the checks, and there would be endorsements from other banks, and if the other banks deal with them, they evidently are recognized as banks or their checks and drafts couldn't go through the clearing house, as in the central cities.

Q. And if it did not go through any of those?

A. If it did not go through any of those, I think the auditor, if he had any suspicion at all, would be justified in taking additional steps. The auditor hardly thinks of some of these details arising in the ordinary course of business. He gets so used to the cancellation marks and bank endorsements that he probably does not give them a second thought.

Q. You think, generally speaking, the ordinary appearance of ordinary transactions with the bank, bank statements, bank letterheads, papers, canceled checks, is satisfactory evidence on which the accountant is entitled to rely for this purpose?

A. Yes.

C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, turning to accounts and notes receivable and looking at item 3 on page 14, the first sentence there reads:

Examine the composition of outstanding balances.

What is meant at the present time by that instruction, in your opinion?

A. In view of what follows, I think that means to find out whether the accounts are good or bad. You see, all this deals, as I observe, with customers' balances only, beginning with that phase, paragraph 1 is customers' balances, so I think composition in this case refers to only the good or bad accounts and not to any differentiations between employees, officers, and so on.

Q. Would the accountant have to follow some procedure to distinguish, let us say, between trade accounts and other accounts such as with affiliates, officers, and employees?

A. Yes, that is ordinarily considered part of the accountant's job to segregate the trade customers' balances from the other types.

Q. Now, back to the original question: What should be done in connection with that sentence?

A. I think the most common practice in connection with that is that of aging the accounts to determine how many are 6 months old

a year old, 2 years old, whatever number of months might appear to be desirable or customary for the type of business to be considered.

Q. Does that mean analysis, account by account, individual accounts?

A. Yes.

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

A. Well, you go back as far as the credit side of the account would seem to indicate you should go.

Q. Whatever is necessary, you have in mind there?

A. Yes, if the total credits to the account in the last 5 years do not equal the charges made 5 years ago, you might have to go over the 5-year period.

Q. What else might you do, just mark it as more than 2 years old?

A. Yes.

Q. In such examination or otherwise, should not the general condition of accounts receivable be noted, or would you expect to be noted such items as a concentration of charges at or near the end of the year, or at some nonseasonal months, the presence or absence of write-offs, credits for various things?

A. Yes, in other words, that would be a scrutiny that should be given the accounts receivable by the one that is looking them over and attempting to age the accounts.

Q. If the aging is done by the client and the accountant checks it back to the records through a test check, your answer would refer only to the test checking done?

A. Well, the test check and a scrutiny are not the same thing.

Q. I mean, you would only scrutinize certain accounts out of the whole group?

A. Yes, an intelligent scrutiny, in my opinion, is better than a blind or careless test check.

Q. I have in mind a case where a client prepares a schedule of accounts receivable for aging and the auditor sufficiently checks them back to see that the work has been well done.

A. Yes, that is right.

Q. In such cases he would examine only the ones he has checked back and not all of them?

A. Well, I think if that is the scrutiny of all the accounts receivable, would not take so long, but what I mean is, one would be justified in scrutinizing many more accounts than he would test on a test check.

Q. Now, the sentence at the top of page 15 reads as follows:

While such confirmation—

Speaking of confirmation of receivables—

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

Is it your understanding that this sentence implies that receivables could ordinarily be confirmed?

A. Yes, that is the way I interpret that. I looked up the 1929 pamphlet on that and it says it is best to verify open balances by confirmation from customers. That is the statement made in 1929, and I feel at the trend since that time has been more toward confirmation than has been away from it. If that seemed to be the prevailing idea at

that time, I have a feeling that at the time the 1936 pamphlet was prepared, those who were responsible for it felt probably more inclined to recommend something approaching complete confirmation than they did before.

That is the reason I interpret it in that way.

Q. Would the past credit and adjustment record of the individual accounts affect the desirability of confirming accounts receivable? Include in that, if you will, collection of some or all of the accounts subsequent to the balance sheet prior to the end of the audit.

A. Well, the general condition might affect them somewhat. I think there are a number of surrounding circumstances which might cause a senior or partner planning the audit to recommend that confirmation be not indulged in, but by that last part you imply, that if collection of an account has been made since the balance sheet date, but before the completion of the audit?

Q. Yes.

A. That confirmation with respect to those customers whose accounts show such collections since the date of the balance sheet might not be undertaken?

Q. Yes.

A. That is assuming that everything is in order and has been taken care of accurately and without fraud since the date of the balance sheet.

For example, there might be some lapping there and the credit that should have been recorded to the credit of the customer's account as a result of a sale made since January 1, we will say, might have been made to the credit of a customer whose account was open on December 31, and therefore erroneously closed. In that case I think the auditor would be careless if in examining account receivable he would say: "Here is a customer's account which shows a credit since December 31, closing the account, therefore I won't have to have that account confirmed." It might be a lapping.

Q. You would have to trace those into cash and look into the accounts receivable sufficiently to assure yourself.

A. You would have to go as far as necessary to detect lapping especially near the end of the year. Of course, I think most auditors try to do that to the date of the audit. Even that would not detect this lapping because that involves posting to the ledger and, of course, it depends originally in the first place, upon the amount of internal check involved.

Of course, what I am saying about this would not be possible in some concerns with an adequate internal check, but I say an account shown as collected since the date of the balance sheet would require a confirmation for the entire account balance as of the balance sheet date in my opinion.

Q. Now, looking generally at this question of confirming accounts receivable, having in mind the relative cost of several methods, the usefulness, what is your opinion as to these methods, that is, first, the positive confirmation of as many accounts receivable as is possible; second, the sampling of the accounts or possibly the confirmation of all large accounts and a sample of the small ones; and third,

the negative confirmation of all accounts? How do you feel as to the relative value of those tests?

A. I probably have not had enough experience with the negative one to condemn it, but as I think it through from time to time and discuss it casually, it seems to me that I would prefer the first one you mentioned, the positive one with respect to the accounts insofar as seemed desirable.

The second best one I believe would be the one in which you take all the larger ones and a very good sample of the other ones. I would say that I don't exactly condemn the negative one; I haven't had much experience with it, but I have discussed it and thought over it and my opinion is it is not ordinarily as good as the others.

Q. On page 8, I mean line 8, page 34, under accounts receivable, reference is made to safeguards relative to the handling of incoming mail and remittances and the mailing of monthly statements to customers.

To what extent must the accountant go in satisfying himself that these safeguards exist?

A. I think the best would be to inquire into the procedure and see that the internal check exists and find out that the one who is responsible for mailing the statements is not the ledger keeper or cashier at least. It seems to me at least you should do those things.

Q. Would you take any steps to see that the statements are actually mailed to customers?

A. I don't believe I would if I was satisfied with the internal check, that it was complete and I saw the office was large enough so that there would be a complete separation of individuals involved in the routine.

Q. Would you consider that the mailing of statements to customers is a partial assurance that the accounts are authentic?

A. I think that would be the natural supposition, yes. I can say that there could be occasions in which that would not be an absolute proof that the accounts existed or that statements were mailed to all the customers.

Q. If you checked up on the preparation of the monthly statements and then saw that they were mailed, would that increase your reliance on the procedure?

A. Oh, yes, that would come more nearly to the procedure in getting confirmations where you were sure that the statements covered everything that was in the customer's ledger at least, and that no one had access to them after you had completed your check.

Q. Looking at page 34 under "Accounts receivable," what kind of an examination do you understand is meant by the expression "relatively limited tests," in respect to individual customer's accounts? This refers to part 3 in the bulletin.

A. Well, I think that would refer in this case to the larger concerns in which the internal check exists and in which we would do little except to age the accounts, test the run-off of the ledger with the control account, and a few of those things which would ordinarily be done.

Q. What is meant by the phrase "relatively limited test of individual customer's accounts"?

A. I am not sure what they have in mind in that. What the authors of this pamphlet might have had in mind is a limited confirmation of balances in addition to some routine checking in the records themselves.

Q. Is it possible that it would mean that the accountant would have to scrutinize only a few of the accounts or a test sample of the actual individual customer's accounts?

A. Well, it might mean that, although I think in the other part of the pamphlet there is no indication that the auditor would be expected to indulge in very much detailed checking of papers, say, postings, et cetera, outside of the general adjustments, so that it makes me feel that they have in mind more the confirmation in this limited test, but I am not sure.

Q. Now, if you deem it unnecessary in a particular instance to make confirmation of open accounts, would this control your decision in respect to confirming notes receivable arising out of open accounts?

A. Yes, I believe that would take care of that.

Q. Then you consider it desirable to confirm notes receivable under the conditions outlined on the bottom of page 33, that is, in the case of a large installment company having a large number of notes receivable controlled satisfactorily by a system of internal check?

A. I don't believe that that would be necessary in that case if the internal check is of such a character that the ones who make entries for the notes do not have access to the notes themselves so that they could modify or remove them or something of that sort.

Q. That, in your mind, would be a satisfactory system?

A. Yes, I think that would be satisfactory.

D. INVENTORIES

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

A. I think he is responsible for a reasonable verification of prices.

Q. That is, seeing to it that they have been priced in accordance with such principles.

A. Yes.

Q. Now, if the principle is employed, such as cost or market, whichever is lower, which requires the determination of a market price, what is your understanding as to what market price is meant and how should the accountant go about it to satisfy himself that the market price is in fact applicable?

A. First, it would be the buying market price and not the selling market price and that market price would be obtained in some commodities from quotations, newspaper quotations; in some it might have to be obtained from catalogs for the more stable commodities.

Q. How about the more recent purchase invoices of the company?

A. The more recent purchase invoices of the company, if they are sure that they are bona fide invoices, would serve the purpose very well.

Q. If market quotations are used, is it necessary for the accountant to assure himself that such quotations are in fact applicable to quantity, quality, and condition of goods such as are in the inventory?

A. I think so; yes.

Q. What procedure should be followed, Mr. Scovill, to determine that goods held or shipped by the company on consignment are properly treated in inventory? That is, consignments in or out?

A. If they are shipped in to the client, of course, they should not be included in the inventory, and then in order that the auditor might find out whether or not they are in the inventory, he could do several things. He could inquire from those who took the inventory; he could examine the nature of the goods and probably if there is some attempt to put something over on him, he might determine from the general nature of the goods on consignment whether they are the type that this concern ordinarily produces or handles. That might give him a clue. He could examine the receiving records and compare them with the freight bills sometimes, as independent of the receiving records, or I had better say supplementary to the receiving records of the concern itself. Those are the ordinary orthodox procedures.

Q. How about consignments out?

A. Oh, in handling consignments out, the same problem exists except in about reverse order, the main object being, of course, always not to have the items included in both receivables and inventory.

Q. Would you expect him to make confirmations with the consignors and consignees which according to their records the goods were held by the company or for the company?

A. From ordinary correspondence, one might get enough information but I think it would be most desirable for one to try to get independent confirmation with regard to consignments in the hands of consignees just about as one might get confirmation from a trust company with respect to certain securities, et cetera, without any special arrangement.

Q. Under such circumstances would you think it desirable to send confirmations to any person with whom the company had been in the habit of dealing on this basis irrespective of whether the record shows that the goods were held on consignment or not?

A. I think that would be a very good safeguard; yes. That is often, I think, overlooked by accountants not only in connection with merchandise but in some other things.

Q. Do you think that any more tests or any other tests should be made to determine whether the company in fact owns the inventory which is known to be on hand?

A. You say which is known to be on hand?

Q. Let us assume that there is an inventory in the factory or plant. Should the accountant make any test to determine that the company actually owns that inventory?

A. Yes; the ownership is a very important part of it. It is interesting to note that fact in this pamphlet, as I use it sometimes, to supplement auditing texts for instructional purposes. I have run through it and marked the various paragraphs in this bulletin which deal with the three phases of quantity, ownership, and valuation.

There are several of these paragraphs which deal with ownership and in general I think they cover the subject pretty well.

Q. You feel then that if an auditor follows the procedure outlined in that pamphlet he has done enough along the lines of determining who owns the goods which he has included in inventory?

A. Yes; with respect to ownership.

Q. And as to ownership, you think those were satisfactory?

A. As to ownership I think those are fairly satisfactory; yes. They seem to cover the points pretty well.

Q. What is the desirable procedure to be followed in determining that there have not been included in sales, goods which were shipped during a subsequent period?

A. That is about the same type of an idea we have in connection with consignments, to be sure that we don't show the goods in two places as a receivable and also inventory. In order to protect himself on that, one should examine the records that have to do with changes from inventory to receivables such as sales invoices, shipping records, sometimes freight invoices, on freight bills, bills of lading, and other evidence which would assist one in knowing whether or not the goods which are in the inventory have been recorded as sales also.

Q. And the converse in the case of purchases?

A. And just about the opposite would be true in the case of purchases. The purchase records, receiving records, and in either case you might have stock records depending on how they control their merchandise.

Q. Now, if the procedure outlined in this bulletin as to inventories has been satisfactorily completed by the auditor, do you think there should be included in the accountant's report or the statements a qualification as to his responsibility as to the quantity, quality, and condition of the inventory, assuming he has satisfactorily completed the steps contemplated?

A. If all steps mentioned in the bulletin are carried out intelligently and conscientiously, considering all surrounding circumstances, I believe there isn't much necessity for qualification of the certificate or report. I should like to see one other step included in the bulletin, that is, a supervision by the accountant of the taking of the inventory and a general statement as to the reasonableness of the quantities considering space, volume of manufacturers, sales, et cetera.

Q. Now, looking at the last sentence of item 3 on page 18, which reads:

Make reasonable inquiries and tests to ascertain that quantities have been carefully determined and that quality and condition have received due consideration. In your opinion, what tests and inquiries are required by this sentence?

A. Well, I think that refers to a test of perpetual inventory records with the physical inventories and inquiry directed to those who have taken the inventory or who have assisted in taking it.

Q. You said, directed to those who have taken it. Do you mean the actual persons taking the inventory or their supervisors?

A. I mean some of both. The one who supervised inventory and then some of the others that the accountant might know had some part in the detail work of taking the inventory.

Q. Do you feel that this sentence contemplates any tests as to physical quantities?

A. I don't believe it does.

Q. Now, if the accountant's report or statements indicate that the auditor has relied upon responsible officials for information as to quantity, quality, and condition, do you feel that this avoids the necessity

of making such tests as are contemplated by the sentence we have been discussing? If I qualify it in that respect, does that avoid the necessity of making these tests?

A. There are certain tests of reasonableness considering space and a few other things that an auditor can check up on. It seems he would not be relieved of that responsibility.

Q. Do you advocate the review of the methods followed by a client in taking inventory?

A. Yes.

Q. What would you say were some of the important points in a satisfactory method of taking inventory?

A. One of the most important points is proper supervision by somebody who knows what it is all about and knows the relationship between inventory—physical inventory and accounting records.

Then, the next important element, it seems to me, is an organization and procedure; procedure might be one involving single tag or double tag; I think probably single tag is ordinarily considered sufficient.

Q. Will you explain what is mean by single- and double-tag systems?

A. Well, the single tag is one in which they merely put on one tag as the first crew goes around, tag the inventories, and another one comes along and makes a note of the items that are recorded on the tags and counts them. Some of them have a coupon to tear off which is checked up at the end. Other systems have a double tag which involves two tags in which the second crew follows through and takes one of the tags and they get them all assembled and make sure everything is accounted for.

Q. In order to appraise the integrity and accuracy of inventory quantities, quality, and condition, is it necessary or desirable to ascertain and give weight to the shipping, receiving, and stock-keeping records and methods?

A. Those words I did not quite get.

Mr. WERTZ. Will you reread it?

(Question read.)

A. Well, I think, if I understand it correctly, that the verification of the physical inventory should be tied in with the perpetual inventory records, if one is in existence.

Of course, that could be done by complete verification or comparison at the end of the year, or may be done by comparing a group of items now and then with the perpetual inventory during the year and making adjustments.

Q. In that work, do you have to ascertain and give weight to the nature of the methods of receiving stock, holding it, and shipping it?

A. Yes. It involves the receiving and shipping also, because those must be very carefully correlated in order to be sure that the stores, stock, perpetual inventory records reflect the condition as it actually exists.

Q. What significance has the independence of the people performing the various accounting functions of the departments?

A. It is rather important there. The one who controls the perpetual record, merchandise inventories, finished goods, raw material, and so on should not be the receiving or shipping clerk. I think that would be a fair statement in respect to internal check in that aspect of the work.

Q. Now, in your opinion, should an auditor be reasonably familiar with the nature of the products manufactured or dealt in by the company?

A. I think he should.

Q. More important products?

A. In a general way, he should, probably to the extent that he would know what processes are necessary in manufacturing establishments, say, in carrying the raw materials through to completion as finished goods.

He ought to know something about the general nature of the raw materials and general nature of the finished products.

I do not mean by that he ought to know all the various degrees and grades of steel or lumber or something of that sort. He should know that there is such a thing as different grades, probably, but I doubt if he should be expected to know a great deal about the different grades, just for that purpose.

Q. What is your opinion as to the feasibility or desirability of making spot tests of any portion of the inventory by actual count or inspection? Do you think that is a desirable or feasible step?

A. Well, I think it is a feasible and desirable step if the records are satisfactory against which he checks the inventory.

That sort of implies a spot test with a running inventory under ordinary conditions as in a concern with proper internal check and certainly one with internal audit that is pretty well taken care of.

Q. Now, do you think it is possible or feasible to spot-check the physically taken inventories in the absence of a perpetual inventory?

A. Well, that is possible; yes.

The auditor would not be safe in doing it if he did not attempt to do it immediately after the inventory was taken, however. If he waits very long after the inventory is taken, a spot test might not mean so much.

Q. He would have to work back to the records?

A. He would have to work back.

Q. To presupposed quantities?

A. Yes.

Q. Do you advocate any over-all tests as to reasonableness of the over-all quantities such as comparison with insurance, tax payments, warehouse capacities, and the like?

A. Yes; I think that an auditor should attempt to use a reasonable amount of ingenuity and care in assuring himself that the inventory is a possible and reasonable volume and quantity. Of course, insurance tests are inadequate for that purpose as far as I have observed. There are certain cases in which the auditor, to a very great benefit to himself and his client, can test the reasonableness of certain quantities. In that connection, probably I am somewhat more biased than I would have been if I had not had an experience as a semisenior accountant which has impressed me greatly and which I believe was rather valuable.

It happened that my superior had audited a concern; it happened to be a brewery. He audited it a couple of years. I think he completed the balance sheet as of September 30 of a given year and got the certificate of inventory from the manager of the bottling department to the effect that the inventory was correct as to quantity,

prices, quality, and so on. Of course, we did not test the quality, but the senior took his word for that.

Well, it happened that a couple of months later there seemed to be something wrong with the bottling department, financially. They sent me out, a semisenior, to find out what was wrong. I checked everything through from the product in the brewery, through the bottling department, into the bottles, and out to the customers, through the drivers and back again, returns, and net receivables in cash, and carried all through the necessary routine to determine that all the product was reflected in good cash, ready to use for something else.

When I got through I found that the present inventory records had been kept very meticulously, were correct in every detail as to drivers' sheets, production records, and so on.

Then I still thought there was something wrong, so I went out to the warehouse, spent about 15 minutes in measuring up cubical capacity, roughly by pacing off, estimating the height which I thought would be fairly accurate. I also measured the size of a case, cubically speaking, and by a little computation found out that the warehouse, in order to hold the stock that was shown on the perpetual inventory records, would have had to be larger than it was.

As a matter of fact, it was only about a tenth full.

Well, that immediately uncovered the defalcation. If I had not taken pains to do as I did, I would have done exactly the same as my superior had done. I would have taken the certificate, would not have found any defalcations which did amount to thousands of dollars, and, as I say, that experience has impressed itself upon me and made me feel that the 15 minutes' time was well spent.

Now, that is not saying that that should be done under all conditions; I am not implying that, but I am implying that there are conditions under which that sort of thing can be done. That was a very simple case, otherwise I probably would not have been able to handle it.

Q. Among these tests of general reasonableness, do you advocate the use of the gross-profits test?

A. Yes; I think the gross-profits test is helpful.

Q. For what purposes can it be used?

A. It can be used more in merchandising concerns, I think, than it can in manufacturing where there are so many problems involved, carrying through process and finished goods and raw materials.

Gross profit does not mean as much there as it does in merchandising concerns, though it can be utilized.

Q. Is it desirable to use that on a departmentalized basis as compared to an aggregate or over-all basis?

A. Yes. In order to be most effective in a well regulated department store, it has to be carried by departments, because gross profit varies so much with departments.

Q. What have you advocated should be relied upon to verify the quantities of merchandise held in independent warehouses, or vendor's warehouses? What evidence?

A. Well, I think ordinarily if there is nothing in the picture that seems to justify extreme caution, that a certificate from the independent warehouse man would be sufficient.

Q. Or the vendor's warehouse—vendor, I mean?

A. Yes.

Q. Would you advocate the use of any tests as to the financial condition of these people who furnish the certificates?

A. Well, I don't know that that would be material, ordinarily. The general purpose is to find out that the goods are there that are shown as being there on the balance sheet.

The only reason for inquiring into the financial integrity of a person whose warehouse is used is to find out—to be reasonably sure whether the goods can be made available at the proper time.

Q. Do you think any investigation should be made of the credibility of the persons who furnish the certificates?

A. Well, it does not seem as though it would ordinarily be done in a routine business, routine auditing, I had better say. It is a warehouse and it seems to be an independent warehouse; I think that ordinarily would be accepted as sufficient.

Q. Would the procedure you have just outlined disclose whether the vendor, for example, had misappropriated merchandise he claims to hold? That is, would the obtaining of a certificate do that?

A. Oh, no. If you obtain a certificate, of course, it is subject to the same conditions as obtaining certificates from any one for any other purpose.

Q. That is what I had in mind. Do you advocate the making of any other tests; that is, other than those we have mentioned as to quantity, quality, or condition of this inventory?

A. No, I do not think of any now. We covered, I think, the ones that are in the pamphlet.

Q. Yes.

A. I assume we have covered those, quality, ownership, and valuation and so on are covered there.

I think the only one that is not covered as fully as I would like to have it covered is the quantity. I should like to see a little more included there and like to see a little more become common practice.

Q. Now, looking toward the future, Mr. Scovill. What procedures do you think auditors should use for verifying the quantity, quality, and condition of inventory?

A. Well, I think—

Q. You may have answered that in your last answer.

A. I think that has been answered, yes, sir. I think the pamphlet, as I have gone through and studied the various paragraphs (not only in the 1936 issue but the 1929 issue, I have that one marked up similarly for teaching purposes) I think it covers those procedures pretty well, considering the point of view of the public in respect to auditors' duties.

Q. Do you think that auditors should participate in, or supervise, the process of taking inventory on the part of the client?

A. I think it would be well if the auditors could supervise the taking of the inventory, lay out the general plan, see that the assistants assigned to him are ones that know enough about the business and have enough integrity and there is enough internal check involved in the group so he can be reasonably sure they carry out his instructions, and if his staff can be assigned to observe the taking, and may participate to some extent in it, I think that would be a very desirable

procedure. I think it is one that would not necessarily imply that the auditor should know a great amount about the product. He can inquire enough about it and learn enough about it to supervise, I believe, without really being an expert on the commodities that are being handled.

Mr. WERTZ. I wonder if we might recess now until a quarter past two.

The EXAMINER. We will recess until 2:15.

(Whereupon, at 12:45 p. m., a recess was taken until 2:15 p. m.).

AFTERNOON SESSION

E. OTHER BALANCE SHEET ITEMS

Q. (By Mr. WERTZ.) Now, Mr. Scovill, turning to some of the miscellaneous items on the balance sheet, referring first to item 4 on page 21, which deals with properties, plant, and equipment, how would you determine that amounts capitalized as additions to plant represent real additions or improvements? Would you inspect the plant in this connection, or what?

A. Usually, I think, an inspection of that sort would begin with the vouchers that are passed through the organization for such additions after they had been brought to one's attention by the analysis of the capital account. The verification of the authenticity of those as capital expenditures should be done in one of several ways, probably all of them together.

If there was a very substantial addition, undoubtedly there would be plans and drawings, if the auditor thought it was necessary to go that far to supplement his physical inspection which, of course, would be very superficial.

He would examine the architect's certificates or anything that might be comparable to them.

Q. How about the—are you finished?

A. I think that is sufficient on that.

Q. Continue if you wish to, I did not mean to interrupt you.

A. That is about all on that point.

Q. How about the converse cases in determining that all amounts properly to be added to plant have been treated as plant additions?

A. That would be much more difficult. To take the opposite point of view it is much more difficult to determine whether something has been charged to expense that should have been capitalized because you would not know which nominal account might have been affected.

It might have affected the ordinary one such as repairs. If they want to cover something up they might put it in some extraordinary account that could not be analyzed very readily.

Q. Are there any procedures to follow to detect that thing?

A. If one were not suspicious of it one might overlook such items, unless one went through the comparison of the nominal accounts over a series of years and accounted for any large difference.

Q. It would be customary to examine, at least superficially, the aggregate balances of various nominal accounts such as maintenance and repairs?

A. As I said, inspection of nominal accounts is an important part of the balance-sheet audit.

Q. Now, referring to the bottom of page 34, how would you ascertain that plant units have been abandoned and should be removed from the asset account? How is that done?

A. Well, the starting point for that usually would be the accounts. The practice there would be, I think, to examine the ledger accounts and the plant accounts for depreciation, see which ones had been theoretically retired, and if theoretically retired, then the next question would be, are they actually retired? The inspection then could verify that. It could be a very casual inspection, and might require a consultation with the works manager or chief engineer. If the ledger accounts or plant accounts under newer methods of depreciation of the last several years did not reveal units theoretically retired, then it would be rather difficult for the accountant to determine whether part of the plant was really retired or not.

Q. Now, turning to the question of insurance charges, for a moment. What procedures do you advocate for the verification of the amounts chargeable as insurance in a particular year as compared with the deferred items?

A. The insurance policies, I think, would serve as a base for that, merely going through the routine procedure of taking the amount of unexpired insurance on different policies where calculation of unexpired portions is possible; of course, not liability insurance and so on, but the normal fire and other types of policies.

Q. Would the information gained from that analysis of the insurance policies be useful for any other purpose?

A. Well, not very useful. I have seen it used in other cases to test the adequacy of protection in various ways. It is something an auditor should give some attention to, but it is rather an elusive item.

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

A. Well, the test there, I believe, would consist largely in examining the items affecting a given creditor over several months. It would indicate then whether or not there is a complete absence of items in this month, the last month of the fiscal year, we will say, while all the preceding months show a considerable number of items for this creditor. Such a condition would indicate a withholding of liabilities, a possibility, I should say, which could be then followed up by the auditor.

Q. Now, on the last paragraph on page 8 there is a statement that approval and entry of vouchers will be made by others than the disbursing officer. What is the particular significance of that phrase?

A. Well, that is merely to bring out again the importance of internal check. If a disbursing officer is one that has to approve a transaction for its authenticity there is a lack of internal check which the auditor should recognize and therefore do more in connection with the audit of that phase of the work.

Q. Now, turning to the question of contingent liabilities, what procedures do you advocate to determine the existence and amount of contingent liabilities and what responsibility do you feel the auditor should take in this connection?

A. That is about the hardest part, I think, of the auditor's duty, to tell what ought to be on the books that is not there and to tell what liabilities might possibly arise in the future that are now in status quo.

The usual procedure, I think, consists in consulting the company's attorneys to see if there are any suits pending; in covering the point when asking the banks for confirmation of balances by asking them to indicate whether or not there are any contingent liabilities on notes on the part of the client at the bank.

Of course, it cannot always be covered adequately because there might be contingent liabilities in banks where there are no open balances. These are more difficult to verify by confirmation, and the auditor would have to use his judgment in asking that question of banks wherein the client does not seem to have current balances.

Oh, there are other contingent liabilities, most of which would be reflected in some legal aspect of the case, patent infringements and those things that are likely to arise—damages.

Q. Do you think an auditor should examine contracts, written contracts, available to him in the files of the company with this purpose in mind?

A. Well, yes. I think any contract that seems to be of importance, that comes to the attention of the auditor through the reading of the minutes or through any other contact that he might have as a result of his regular audit procedure, should be examined, inquired into.

Q. Would he make that examination himself, or should he consult counsel on it?

A. Well, I think he ought not to try to be a lawyer at the same time he is an accountant.

Q. Now, what responsibility do you feel the auditor assumes in regard to contingent liabilities when he certifies a statement?

A. I think he is merely implying by a certificate that he has done what the ordinary prudent accountant would be expected to do under the same conditions, and that means in accordance with the custom as it has developed without very much modification in the last 50 years.

Q. And the results of his study are incorporated in the opinion of the statement?

A. I think there has been very little progress in auditing for contingent liabilities in the last 50 years. I have carried it through, not all that time, but 35 years, possibly.

Q. What consideration should be given to such corporate matters as minutes of stockholders' meetings, directors' meetings, finance committee meetings, corporate charters and—

A. All those you mentioned should be examined by the auditor in order that he may be informed of their provisions and of actions of directors and committees. His examination of capital stock outstanding, capital structure, and so on might be governed by some of those items and his action in respect to many other items might be affected by his examination.

Q. You have in mind there the examination of these corporate instruments might indicate further lines of inquiry or particular things to be incorporated in the statements?

A. Yes.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to the profit and loss statement, Mr. Scovill. Item 1 on page 30 suggests that a working profit and loss statement be obtained in as much detail as is readily available. For this purpose, to what extent do you advocate that the accountant prepare the statements and to what extent obtain statements prepared by the company?

A. Well, I think in general the accountant should merely take the profit and loss statement prepared by the company. That would be especially true in an organization that had a good internal control, auditor, chief accountant, and so on.

I think the accountant would probably not have to modify that much.

Q. And should he check it back to the books?

A. Well, if he did not check it up with the books, setting up proper comparative statements, analyzing key accounts, those which seemed to be large and in some cases padded, he could not get a reasonable idea of the accuracy of the items.

Q. Now, looking again at item 2 in that connection, what is the purpose of obtaining budgets, previous annual statements, monthly statements, and so forth in connection with the survey or examination of the profit and loss statements?

A. I think those are merely to be used as correlative evidence because, after all, this whole question of auditing is a matter of evidence, and anything that the accountant can get which might help him draw conclusions would be helpful.

For example, budgets would help him in gaging the reasonableness of the expense accounts, and help him to some extent in the income accounts. Not that they would agree at all, but there might be certain places where he might find questions that should be raised, a point of departure, a starting point. If he finds a place where the budget is far off from the actual conditions, that would be a starting point, a place where he would begin to inquire and get the additional evidence.

Q. You would say, would you, that comparison of these statements, or if the comparison developed significant differences, it would then be up to him to make such inquiries as he felt were necessary to satisfy himself as to the differences?

A. Yes; that's the idea.

Q. Now, item 3 under sales and cost of sales in this connection outlines a procedure for testing or analyzing allowances to customers for returned merchandise, claims, and rebates. What is the significance of such an analysis?

A. Principally for the purpose of determining whether or not some customers have been credited with allowances when there were really no bona fide allowances. Such entries would, therefore, take the place of cash credits which might permit some one to abscond, appropriate cash, and cover it up by these allowances.

Q. Speaking generally of the profit and loss statement, what is your opinion as to the responsibility of the accountant for proper classification of income items and expense items? And what procedure do you use to verify these?

A. Well, I believe in a balance sheet audit that the accountant would not be expected to waste very much time in trying to find

whether something is in selling expense accounts that should be in office-expense accounts or vice versa, or some other situation.

I think he should, by the ordinary test and comparison, and by scrutiny, which I emphasize a great deal, be able to detect unusual marked differences.

As I have said earlier, there is such a close relationship between some of the nominal accounts and some of the real accounts that by the time the auditor gets through testing those, such as insurance and insurance unexpired; bad debts and receivables; securities and interest on bonds; and receivables and interest income and so on, there are not so many major nominal accounts left but what he might go through some analysis and comparison of those.

I might have mentioned also repairs and fixed property as closely allied which he should test, in his own way. He will then have a few that are left on which he can spend his time analyzing and scrutinizing for the purpose you just implied.

Q. In connection with that sort of an examination, would you say that he should, if possible, break down sales to months or other periods for comparative purposes?

A. That is done, I think—conditions would tend to govern that to a considerable extent. It is a desirable procedure, sometimes very helpful. In other words, any analysis that an accountant can take time to procure is helpful. If it isn't too much of a waste of time, it is a good thing to have some of those analyses.

Q. In listing the various income and expense accounts, would you say that he should examine some period in detail and scrutinize the rest for unusual items? Would that be the type of examination you had in mind?

A. Yes. In some cases I doubt if an examination in detail would be necessary, scrutiny, in a comparative sense might be sufficient.

Q. When you mention balance-sheet audit in this connection, do you have in mind the type of examination that would lead up to the certified profit and loss statement as well as the certified balance sheet?

A. Yes. Under my interpretation of a balance-sheet audit and the interrelationship that should be recognized between the nominal and real accounts, I think it would include that.

V. REVIEW OF THE ENGAGEMENT

Q. Now, turning to the review of the working papers and the preparation of financial statements based thereon, who do you believe should be responsible for drawing together the results of the detailed audit work and for preparing the financial statements in the first instance, the preliminary statements?

A. I think the senior in charge of the engagement is the one that is ordinarily in the best position to do that.

Q. Would you outline in some detail your views as to the steps which you think should be followed in reviewing statements and working papers—general reviewing program?

A. Of course, the senior should review the work of the junior and then the work of the senior (if the senior is the one who is permitted, allowed, required, or expected to make up the report of the audit) should be reviewed by one of his superiors.

That double check is rather important and an opportunity to discuss and support the results of the work is highly desirable.

Q. Would you say that, in general, any original work done by one person should be checked by at least one other person?

A. That would be a pretty broad statement.

Q. I had in mind here—you said the senior should check the work of the juniors and then somebody should check what the senior does.

A. I didn't mean check in that sense. I mean, he should go over the work and ask enough questions to satisfy himself that the junior has done certain things and has or has not recognized certain principles. Anyone above the senior, whatever his title may be, in a given organization, should do the same with a senior and make him justify his work and support it in view of questions that might be asked by someone who has taken an over-all picture and not been so close to the work as a senior has.

Q. In general, do you think it would be desirable for someone other than the senior who has been in charge of the field work, so to speak, to take the statements and integrate them back into the working papers to see that there has been no slip-up there?

A. Will you read that question again, please?

(Question read.)

Q. That is, that the working papers substantiate everything that appears in the balance sheet?

A. I doubt if it would be desirable for anyone to check the work back to see that every item has been correctly transcribed or adjusted.

I think the superior, in this case the one above the senior, would examine key items and might observe memoranda on the working sheets, comments, as to what had been done with respect to peculiar conditions.

If the one in authority should do that, I think that would be sufficient, he would not need to compare every item on the working sheets.

Q. Does your thought there contemplate that a senior, or junior, should incorporate in the form of a written memorandum, or otherwise, the important things which he has uncovered in the course of his work?

A. Oh, yes; that is generally accepted; I believe that the one in charge of the audit should make ample notations, sometimes on the face of the analysis sheet, the work sheet, sometimes on separate sheets, where there are unusual conditions or circumstances.

Q. Which is then available to the partner or supervisor or who goes over the work?

A. Yes.

VI. THE REPORT OR CERTIFICATE

Q. I would like to turn now to the question of the accountant's report or certificate. What do you understand to be the function of an accountant's certificate or report?

Mr. WERTZ. Off the record.

(Discussion off the record.)

A. My opinion is, it is merely to convey to those who read the balance sheet the opinion of the auditor that the statement presents the financial condition of the business subject to such reservations as he might make at that time or in the report.

Q. Is that the impression that you feel is meant to be conveyed by this form of certificate used on page 41 of the bulletin?

A. I believe it is. I think that's what they had in mind in framing it.

Q. Have you any thoughts, or have you any knowledge, as to whether that impression is generally correctly conveyed to the readers of the balance sheet?

A. I am sorry to say I think it is not. As I have followed through a number of cases that have been before the public in the last 30 years, I think we find numerous instances in which the public, even good bankers, investment bankers, commercial bankers, have taken the certificate to mean that everything is all right, that the audit has been completed, everything is satisfactory.

They have not taken time to consider the qualifications in many cases, nor to read the report in which there might be some very pertinent comments, even in the form of exceptions.

Q. Is it your understanding that the second sentence of this form of certificate is intended to be a reasonably comprehensive statement as to the scope of an examination in conformity with the bulletin?

A. Yes, I think that is what is intended.

Q. And do you believe any material omissions from the program indicated in the bulletin should be indicated also in the certificate or report?

A. Yes; subject to what I said previously about inventories and the supposition that the auditor has used the utmost intelligence and resourcefulness in applying the principles laid down in the bulletin.

Q. And would you say, forgetting for the moment any procedures outlined by the bulletin which are not applicable to the particular instance because the conditions are not present, leaving those out, do you believe that any further material omissions from the program indicated in the bulletin should be indicated also in the certificate?

A. I think so, but I would like to say in the same sentence that I think it would be very unfortunate if accountants' certificates had to become encumbered with a lot of exceptions.

I really think that the time ought to come when accountants can have a very brief certificate and it can mean that they have been permitted, through adequate fees and other things, to do a sufficiently thorough audit so that they will not have to encumber the certificate with a lot of exceptions.

Q. Would you add to that, this:

If they could not give an unqualified certificate, no certificate should be given?

A. Not in the present-day practice.

Q. I am looking to the future, in the way you had anticipated.

A. That may be an idealistic point of view, but I think that is what we ought to have in view. I mentioned a while ago the fact

that so many people think that is what an accountant's name means on a certificate.

Q. Do you believe that the certificate should indicate any limitations which were agreed upon between the accountant and the auditor in the audit engagement?

A. If those limitations are of such a nature that the auditor as a result thereof would not do some of these things that an ordinary prudent auditor would ordinarily be expected to do.

Q. Looking again at the certificate in the form set forth on page 41, what language therein, in your opinion, indicates that 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. Well, it has always been my opinion "in accordance with accepted principles of accounting consistently maintained by the X Y Z company during the year under review" means just that.

Q. Means that they were maintained during this year in conformity with what was maintained last year?

A. Yes. That is what it means to me. It does not say that, but it seems to me that is what it means.

Q. Do you think it may be clarified, let me use your words, to what you think it means?

A. I think it means that the principles of accounting used this year have been of the acceptable type and that they have been the same general principles that were applied in the preceding year. The reason is that the necessity for uniformity is not necessarily from month to month, it is from year to year, because the statements referred to are annual, not monthly, statements and the comparison is with last year and not with December, November, or October of this fiscal year.

Q. Now, looking at the introduction of the accountant's report at the bottom of page 40, that introduction states that matters may be introduced in the accountant's report or in the statements 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 a reader to determine as to a particular matter which of these purposes is intended? You might illustrate that, if you will, by the phrase that is quite commonly found such as, "inventories have been certified as to quantity, quality, and condition by responsible officials of the company"?

A. That is at the bottom of page 40?

Q. Yes. Particularly the sentence beginning, "Distinction should be made between—" fourth sentence.

A. I think that the accountant should specifically state if he has any dissent from the practices of the company, otherwise the exception would be merely informative.

Q. Do you know whether there is any customary way of distinguishing between those various types of information?

A. Not unless the accountant indicates which.

Q. Let us take the phrase I cited as to inventories. If that language were found in the footnotes to the financial statements or in

the face of the financial statements, how would you interpret that, as a qualification, as a limitation on the scope of his work, or as merely informative?

A. Will you read that again, please?

(Whereupon, the reporter read the last question.)

A. I think it would be more informative than anything else, in view of the fact that the present practice requirement does not seem to require that complete verification of quantities should be indulged in.

Q. It would be merely informative, you say?

A. Yes; would be merely informative.

Q. If that same language were to appear in connection with the scope of the audit in the accountant's certificate, what would be your feeling?

A. Well, I think it would be informative there also.

Q. Now, if it appeared in the last paragraph which begins, "In our opinion—" and goes on in the customary manner. If this language appeared in that paragraph, what would be your thought?

A. I still think it would be informative.

Q. It would not be a qualification?

A. No.

VII. GENERAL SUGGESTIONS AND COMMENT

Q. The suggestion has been made, Mr. Scovill, that corporations should rotate firms of auditors at frequent intervals. Have you any opinion as to the desirability of such a practice?

A. I think it is not very desirable, for about the same reasons mentioned before for not changing seniors. There is a great deal a firm of auditors can do to assist a business in various ways, if the firm of accountants, auditors, are more or less familiar with the operation of the business through its auditing procedure.

Q. Are you aware of any advantages that such a rotation might have?

A. There are some that might be stated as advantages, such as getting new blood into the organization so that they might not overlook something as a result of performing their operation in too perfunctory a manner or in getting too well acquainted with the management so that they might be influenced to assume too much in the way of honesty and integrity of the management and employees.

Q. Do you have any opinion as to the desirability of having representatives of an auditing firm appear at directors' meetings at which the audited statements are presented?

A. Yes; I think that would be a good plan.

Q. Would you expect the auditor to have the right to speak as well as the duty to answer questions?

A. Yes; I think so.

Q. How about stockholders' meetings?

A. Well, theoretically I think they ought not. Practically a stockholders' meeting is a directors' meeting, anyway.

Q. Do you think it would be desirable to have the auditors send copies of their reports to the directors individually, in advance of the particular directors' meeting?

A. I think it would be nice if that would become more of a custom. I think it would be rather helpful.

Q. In what way?

A. It would enable the auditor to put the results of his audits more directly before directors who, in many cases, at present, never hear about the audit directly. Frequently now it is announced at the directors' meeting that an audit has been made and the reports turned over to the comptroller for inspection, and so on.

Q. Do you think a long-form report or short-form report should be prepared by the auditors for the directors?

A. For the directors, I think, the long-form report would be desirable.

Q. Would you say at least the auditor should be allowed or have the power to decide which form of report should go to the directors if he prepares both?

A. Yes; I think he should. I think the auditor, if he were really interested in the organization, would usually recommend the long report.

Q. That is what I had in mind. Coming back to the stockholders' meeting for a moment, the auditor appearing at the directors' meeting, I think you said that would be a desirable practice. What did you have in mind there as its advantages?

A. Will you say again what you think I said?

Q. I think you said you think it would be desirable for the auditors to attend the directors' meeting when the audit statements are considered?

A. Oh, yes.

Q. What would be the advantages in that?

A. It would give the directors an opportunity to inquire more intimately into the audit if any of them had something about which they would like to inquire.

Q. And would it give the auditors an opportunity to bring to the attention of the directors other matters which they thought were of particular importance?

A. Well, yes. Of course, that would be implied if they let him read the report, but he might have some things he would like to comment on orally which sometimes might not be just the best things to put into a report.

Q. Do you feel that auditors in their reports, at least to the directors, and possibly to the stockholders, should point out any significant developments, or changes, during the period covered by the audit?

A. A great deal depends upon what is meant by the word "significant" there. I think they would have to be very important.

Q. To have special comments?

A. To have special comments; yes.

Q. Do you think it is desirable to—would it be desirable for business to adopt a natural business year?

A. I think that would help a great deal.

Q. In what ways would it assist in a better audit program and completion of better auditing work?

A. It would undoubtedly enable the auditing staff to approach their work with greater care, probably their minds would be in better working order if they were not doing the audit during the rush

season, which is a heavy strain on the nervous and muscular energy of an auditor.

It would permit a more accurate verification, I believe, of many of the items in the balance sheet, because they would not be as large, especially inventories and receivables, which are very important factors, time-consuming factors, in an audit. It would, doubtless, give the client's staff an opportunity to do a better job of taking inventory and pricing it, because the client's staff in a natural business year-end would not be as busy as they are, in some cases, now, on December 31. I could go on and enumerate many other reasons because I have studied that subject to some extent.

Q. I will be glad to have you enumerate any further ones that come to your mind at this time.

A. Of course, there are advantages to the credit departments of banks who, in large banks, might have men assigned to specific industries, and by adopting a natural business year in a given industry, the concerns in that industry will have their balance sheets drawn up as of the same date, to enable the specialists in the larger banks to make a little better comparison; probably they could spend more time in such comparisons, also, if they did not receive so many of those reports at the end of the year.

The Internal Revenue Department, of course, has been mentioned. Some people think the Internal Revenue Department really wonders whether there are advantages or not; but I think there are.

Q. Have you made any analyses, or had any analyses made by industries to determine whether a substantial reduction in the peak load of auditors might be accomplished in this way?

A. Oh, yes; several analyses have been made. I, personally, have helped in some of them in the preparation of one of the bulletins of the University of Illinois. I did not do that myself. The man was here a few minutes ago who really did that work. I directed and suggested that he do it. But that was only one study. There have been a number of other studies since that time and probably a few before; many suggestions before but very few, if any, studies of the matter by industries.

Q. These studies indicate what might be determined the preferable date for closing for various types of industries?

A. Yes; that is right.

Q. Would you say, Mr. Scovill, that present-day auditing procedure is concerned mostly with determining that generally accepted accounting principles and conventions have been followed in the accounting records of the company?

A. Well, I am not sure of that. It would appear that that is the case if one were to confine attention solely to the surface statements, statements that appear on the surface in the bulletin because many of them do seem to deal with accounting principles rather than auditing procedure and obtaining of evidence. In my opinion the obtaining of evidence is one of the very important items in auditing, also the selecting of evidence and the judging of evidence.

Q. Now, taking the balance sheet and profit-and-loss statements by individual items appearing thereon, which of those items does present-day auditing procedure verify by tests which are independent of the accounting records of the company or information obtained from officers and employees?

A. Undoubtedly cash is one of the best illustrations. Accounts receivable to a large extent, subject to confirmation with credit officials, depreciation of fixed assets if no appraisal is to accompany the audit.

Q. Excuse me. Are you outlining here the items which are verified independently of the records?

A. Yes. Wasn't that the way your question was asked?

Q. Yes. I wasn't clear when you referred to fixed assets, independent of the accounting records or of information obtained from officers or directors.

A. I would not include fixed assets if your question includes accounting records, because they would require reference to accounting records to a very large extent. And, of course, the deferred items, securities, would ordinarily come under a class with those that are verified very largely independently.

Q. How about liabilities and capital stock?

A. Well, capital stock would be verified independently, if it is issued—handled through a trustee or agent. That would be an independent verification, not relying on the management for information. Contingent liability is another one.

Q. Similarly as to bonds? I mean, similarly as respects capital stock?

A. Yes. Of course, bonds would be handled much the same way as capital stock, through trustees.

Q. Now, looking again at the certificate which appears on page 41 of the bulletin. The second paragraph states that in the auditor's opinion, based upon his examination, the statements fairly present the position of the company and the results of its operation. When this form of certificate is used, does it mean in your opinion—or rather, is it your understanding that it means that in the opinion of the accountant, as a public accountant, the examination made has been sufficient to verify the existence of the assets and liabilities and the authenticity of the transactions?

A. Yes; I think so.

Q. And to what extent would you say, as a general matter, Mr. Scovill, that the accountant in the course of his audit is entitled to rely on information furnished by the management in order to ascertain facts or conditions of which independent verification may be obtained?

A. Well, I think he is entitled to do as much of that as he thinks desirable. It is desirable to do a great deal of it, but not to the exclusion of taking necessary independent checks along with it. I think it is the same question again of getting as much evidence as possible. Sometimes a conference with the management can bring up a number of good points that might assist in interpreting evidence that the auditor can get independently but he cannot rely too much on the statements of the management. He should use them as corollaries or starting points, possibly, for inspection of other evidence or origination of other evidence or analysis from other points of view. I think those two things work in together very nicely.

Q. Would you say that that point of reliance is in part determined by the relative difficulty, or time-consuming nature, or expense of getting independent verification of the facts and conditions?

A. Yes. That is one of the determining factors. I cannot help but feel that the public is not permitting the accountants to get the fees they ought to get to do the work they ought to do and that is back of a great many things that have arisen in the last 30 years.

Q. Have you any further suggestions or comments to add at this point?

A. No; I think I have covered most of the things.

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

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

Mr. HENDERSON. No, sir.

The EXAMINER. Thank you very much.

Mr. WERTZ. Joseph J. Klein, of Klein, Hinds & Finke, will appear tomorrow morning at 10 o'clock.

The EXAMINER. We will adjourn then until 10 o'clock tomorrow morning.

Dr. Klein, of Klein, Hinds & Finke, will be the witness.

(Whereupon the hearing was adjourned until 10 o'clock a. m., March 7, 1939.)