

**BEFORE THE SECURITIES AND EXCHANGE
COMMISSION**

In the Matter of MCKESSON & ROBBINS, INC.

OFFICES OF THE SECURITIES AND EXCHANGE COMMISSION,
120 Broadway, New York, N. Y., Monday, March 13, 1939.

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

PROCEEDINGS

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

GEORGE D. BAILEY

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

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

The WITNESS. George D. Bailey, 2000 Buhl Building, Detroit, Mich.

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

I. AFFILIATIONS AND BACKGROUND

Q. (By Mr. WERNTZ.) Mr. Bailey, will you state your present firm affiliation?

A. I am a partner of the firm of Ernst & Ernst.

Q. How long have you been a partner?

A. I have been a partner for 17 years.

Q. How long have you been in accounting work?

A. I have been in accounting work for 26 years.

Q. All with Ernst & Ernst?

A. All with Ernst & Ernst. I had a few months of private practice after graduating from college, but only a few months.

Q. Had you had any training in accounting before going with Ernst & Ernst?

A. I graduated from a 4-year course in commerce at the University of Wisconsin, majoring in accounting, and had general bookkeeping and clerical work during summers between high school and college.

Q. Are you a certified public accountant?

A. I am; Michigan and several other Middle Western States, Ohio, Indiana, and so forth.

Q. Could you indicate, roughly, the size of your present firm and the nature of its organization?

A. The firm has 45 offices in the United States, 1 in Canada. Of these offices, 13 are suboffices which operate as part of the office to which they are attached.

The firm has 27 partners and the organization varies from a typical low in June from about 850 to a typical high in January of about 1,200. Of this the typing and office and clerical staff run around 200 to 250.

Q. Would you characterize briefly the principal type of client served or business you perform?

A. The firm has a broad list of clients of all kinds—industrial, commercial, financial, utility, nonprofit institutions, and so forth—and there are large companies, medium and small.

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

A. I am a member of the American Institute of Accountants, Michigan Society of Certified Public Accountants, and American Accounting Association.

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

A. I hold no office in any of them at the time.

Q. Have you been active in the committee work in furtherance of professional interests?

A. At the present time, I am a member of the special committee on accounting procedure and of the special committee on certificates of the American Institute of Accountants.

Q. Have you published any works on accounting or done any editorial work of that nature?

A. I have not. My work of that kind has been limited to addresses of various kinds.

Q. Have you engaged in teaching or related activities?

A. No; I have not, since I graduated from college.

II. SCOPE OF EXAMINATION OF FINANCIAL STATEMENTS

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

A. Of course, there is the broad division as between certification of financial statements and the special services, such as tax services, costs, budgets, organization work, etc.

Leading up to the certification of financial statement, the difference is largely in degree. The most usual is the examination of the balance sheet and a review of the operating accounts with variations for an increasing amount of detail checking approaching sometimes to a detailed audit.

In other cases, the examination may be only of the balance sheet.

Q. In which case you would not certify the profit-and-loss statement?

A. In which case we would not certify the profit-and-loss statement.

Q. Would you have to do any work on the operating accounts in order to certify the balance sheet?

A. You would have to do work in connection with the authenticity of the records. I should say that that type of examination does not run to companies with a public interest or with substantial credit problems, but only runs to closely held companies.

Q. You could certify, of course, based on a detailed audit, could you not?

A. Oh, yes.

Q. What type of these services do you customarily render in preparing statements for certification under the 1933 and 1934 Acts or for annual reports?

A. What I referred to as an examination of the balance sheet and a review of the operating and income account; the detailed checking in that case is to such an extent, in view of the accounting methods, as we believe necessary to pass on the fairness of the statements, of the propriety of the accounting principles, and the consistency thereof.

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

A. I am.

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

A. I don't think so. I did not, and I know of none who did.

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

A. It seemed to me that the purpose was to furnish for the profession and the public an up-to-date outline of accepted procedures being followed by independent auditors, certifying to statements and presenting reports, and also to outline the function of auditors and the limitations inherent in their work.

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

A. The type that I referred to as used for S. E. C. purposes and credit purposes.

Q. In such examinations, do you feel that the principles of this bulletin are applicable irrespective of the size or type of business?

A. The principles of the bulletin which recognize variations for size are generally applicable except possibly where the internal control is so weak that the principle of test may have to be abandoned in favor of a more detailed audit.

Q. Do you use or follow this bulletin as a general guide in your practice?

A. Not as such. We have our own adaptation growing out of this and preceding booklets of the same kind.

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

A. We expect them to be; yes.

Q. Speaking generally, do you regard the examination outlined by this bulletin in the nature of a maximum or a minimum procedure?

A. I think in its general philosophy it sets forth a minimum procedure. There are a number of specific procedures within the general philosophy that represent maximums, of course.

Q. Suppose you eliminate from consideration those steps outlined in the bulletin which are not applicable because the conditions are not present, would you say then that the remainder constitutes a minimum, ordinarily?

A. Well, I think the best answer is to say that I believe the philosophy to be a minimum philosophy. That may mean that under certain circumstances some minor phase that would be included in the minimum would be changed for some other procedure perhaps not covered in the bulletin at all, but in its philosophy I think it is a minimum procedure.

Q. How would you compare, generally speaking, the scope of the examination ordinarily performed by your firm with that contemplated by this bulletin?

A. I think, generally speaking, it may be a trifle more extensive. That's particularly true, I think, on a detailed check on the internal control and emphasis on inventories.

Q. Of course, you include within the phrase "scope of the examination contemplated by this bulletin," I take it, those cases where, because of a weak system of internal control you have to extend the detail?

A. Oh, yes. I think the answer to the question has got to be considered as applicable to typical cases.

Q. That's what I had in mind. Now, historically speaking, did the publication of this bulletin result in any change in your own practices?

A. It didn't result in any change in our own practice, no.

Q. You haven't any opinion as to whether, speaking generally in auditing, it resulted in changes?

A. My opinion would not be worth very much on that, but my inclination would be to say that it did not particularly change the audit practice.

III. OFFICE METHODS AND STAFF ORGANIZATION AND TRAINING

Q. Now, in these next questions, Mr. Bailey, I would like to ask you to distinguish, if you will, between practices which were in general use prior to the present proceedings of the McKesson case and between any practices that have been adopted in the meantime as the result of these, if you will just indicate.

When a client comes to you, Mr. Bailey, do you make any independent investigation of his credit rating or reputation?

A. Well, it is so seldom a client comes without some background. It is very rare that we would find a client that we cannot easily form an opinion about as to whether we want to serve him or whether we do not.

As a matter of routine, we get credit listings on all new clients.

As to further investigation, if we find it a border-line case where we have difficulty in making up our minds, we would check with banks or other sources that occur to us at the moment or we would go in, in some cases where there is no reason to doubt the character of the business, and withhold final decision for a little while until we can see what the character of the business is.

Q. Did I understand you correctly to say that as a matter of routine you obtain credit reports?

A. As a matter of routine we get the credit ratings, but do not ask for detailed credit reports, unless there is some reason to do so.

Q. You get that from one of the common services?

A. Yes; from Dun & Bradstreet.

Q. From your experience as an auditor, Mr. Bailey, who would you say exercises the prerogative of appointing auditors to certify annual reports of corporations, the stock of which is publicly held?

A. I think today the great bulk of practice puts the employment of auditors with the board of directors. I think that should be modified, however, to state that the officers have a tendency to reemploy auditors from year to year without reference to the board, but I think it could rather definitely be said that changes in auditors today for that kind of companies would be quite likely to be referred to the board of directors.

Q. That is, you feel that in the first instance, or when a new firm of auditors is being selected, the matter is treated by the board of directors?

A. It has been my experience for the last several years, yes.

Q. And to whom would you say your primary responsibility runs, as an auditor?

A. I think the primary responsibility runs to the board of directors as a whole.

In answering it that way, we must take into consideration that the report is rendered to the board of directors for the purpose of being sent to the stockholders and that the auditor must constantly bear in mind the necessity for fair presentation of the accounts to the stockholders.

Q. Now, when you accept an engagement, what representative of your firm is charged with determining the scope of the audit work to be done?

A. Well, the final analyses would be that of the—the decision would be made by a partner or a manager. We have some offices in which we do not have partners.

I should say that the line of demarcation between the managers of those offices and some of the younger partners in other offices is a very fine line indeed, the experience being quite comparable in the two classes.

The decision as to scope is made by the partner or manager in all important cases. In other cases it may be made in the first instance by a supervisor and discussed in detail with the partner.

Q. If you have a continuing auditing engagement, do you reexamine the scope of the audit at intervals?

A. It is our practice to reexamine the scope of the audit every year.

Q. Do you do that as a novel situation, or do you start from the old audit and make changes therein?

A. Well, in actual practice it works both ways. The typical case would be the partner most interested and supervisor and the senior, perhaps with an additional partner sitting down to rechallenge the work.

Once in a while a senior will decide, or the partner will decide that a new scope can profitably be written from the very beginning. At other times modifications are made of the old scope and in some cases, of course, the decision is to continue on exactly the same program.

Q. When you continue on exactly the same program, does that mean you do exactly the same work?

A. No, it does not. And, of course, it is subject to challenge each year on the job. The senior is supposed to, or supervisor, or whoever may be in charge, is supposed to rechallenge that again as the work progresses. One year the emphasis may be on one phase and another year on another phase.

Q. Depending on circumstances?

A. Depending on circumstances.

Q. Now, from your experience, who would you say determines the question as to the scope of the audit on the client's part?

A. I think to such an extent as the client has a participation in determining the scope it probably is in the hands of the senior executive officer or the chief financial officer. Maybe in some cases it depends on the comptroller, but in that case it is usually as an agent for, or representative of, the chief executive officer.

The client's participation in scope, of course, can only run to procedures beyond the necessary minimum that the auditor thinks has to be followed such as to whether the cash checking shall be carried out further or perhaps as to whether the inventories shall be checked as to quantities.

As to minimum procedures, that remains in the hands of the outside auditor.

Q. Now, looking to the future, Mr. Bailey. Do you think, or can you recommend, any changes to be made in the method of selecting auditors or fixing the scope of the audit?

A. I think the responsibility for the independent auditing should be fixed with the board, both in the employment of auditors and the discussion of scope as well as in reviewing the work.

I do not believe the election by stockholders serves any real purpose and may even have disadvantages. In my opinion it is advisable to have general recognition of the desirability of closer contact between the board or a committee of the board and the auditors.

I know of a number of situations of large companies with a large public interest where that relationship exists and it has proved to be very satisfactory to both sides.

Q. When you say the board or a committee of the board, do you make any distinction between members of the board who are also officers and members who are not officers?

A. Well, obviously the purpose of referring the matter to the board is to take it out of the hands of the executive personnel, and if you are dealing with a committee it should be a committee with a majority, at least, of nonexecutive members. I don't say it should be completely free from executive representation, but it should have a majority of nonexecutive members.

When you are dealing with the board as a whole, the mere presence of outside nonexecutive members serves that purpose. The dis-

inction between a board and a committee, it seems to me, is largely in the size of the board of directors. If the board is small, I have found it to be very satisfactory to deal with the board as a whole, even more satisfactory than with a committee. If the board is large, the committee procedure is better.

Q. Would your opinion be the same in this connection if the board had a majority of executive members; that is, members who are also officers?

A. Well, as a matter of public interest, I think it is better to have a board of directors with a majority not executives.

I have found that the ideal board is one which has a representation of both sides but with a majority of nonexecutives.

Now, I do not think that is vital, though it is preferable. I have found that even where a minority membership of the board is non-executive that the mere presence thereon results in an entirely different approach to the discussion of the auditor's problems.

As a matter of fact, I found the formality of reporting to boards of small companies without any public interest and without any outside representation at all to be such as to give the auditor an entirely different consideration.

Q. Would you say that the appointment of the auditors should be made at the beginning of the year or toward the close, as is quite customary now?

A. I think it is highly advantageous to make it at the beginning of the year. I think in most cases that is done now.

Q. Now, turning to the composition of your own organization, Mr. Bailey, do you classify your staff? For example, between seniors and juniors?

A. Yes; we do. Our classification runs juniors, seniors, supervisors, managers of offices, and partners.

Q. When an engagement is accepted, how do you determine what people in each of these categories will serve on the audit work?

A. Well, as to partners, the decision rests on availability, particular experience, kind of problems involved, and so forth.

The same is true with respect to supervisors, if the work is large enough to have both the supervisor and the partner.

As to seniors, I think more attention would be paid to applicability of experience, knowledge of the particular business, and so forth.

Juniors are, of course, determined largely from the standpoint of availability, though preference would be given for any knowledge of the business.

Q. You left out managers in your statement.

A. Well, managers and partners are used rather interchangeably, because offices with partner and manager classification do not exist.

Q. You would not have on one job a partner and then, say, a manager?

A. We have had.

Q. But not as a general rule?

A. We have had two partners on some jobs. I think the answer to that is that—yes, there are a substantial number of cases where in an important or complicated matter we do have a partner get into the work in addition to the manager of the office.

Q. I think you said that where the engagement was large enough you would have a supervisor in addition to the partner; is that a correct statement?

A. That is correct.

Q. So that, in a smaller engagement, the line-up would be a partner down to a senior, or would it be a supervisor and senior?

A. I did not mean to apply that too definitely, and I did intend to cover it later. There are, of course, engagements where there are supervisors and the partner does not get into the actual field work.

In those cases it is mostly engagements in which the partner has had in the past rather intimate contact with the engagement and knows it rather definitely.

Q. When you have made the assignment of men to the particular audit, are those assignments rotated from year to year or at any interval?

A. Well, we have no fixed program on that. The assignments are not intended to be permanent. The situation is challenged each year. There is, however, a tendency to permanence on the partner's individual attention and on supervisors, and to a certain extent on seniors.

But what we try to do is keep a balance between a desirable detailed knowledge of the business and some new challenge of auditing procedure. There is a natural flow of seniors and juniors; and if that natural flow does not occasionally result in new assignments, we probably would make a deliberate change.

I say probably, because in cases requiring a high degree of specialized knowledge we might not do that. I believe that familiarity with a client's affairs and business makes for audits that are better, but I couple with that belief a necessity for an annual rechallenge of the audit procedure by partners, supervisors, and seniors.

In my opinion the rotating of seniors has to be considered in line with the specific problems and the other attention that that job is getting.

Q. Now, turning to your own staff for a moment: How do you go about recruiting juniors on your permanent staff and for your temporary staff?

A. The permanent staff is recruited from the temporary staff. Each year we take a number of men directly from the colleges with a major in accounting, with the understanding that they will be reasonably permanent, but otherwise additions to the permanent staff come from that group of men who were taken on with no understanding of permanency.

Q. Do you have any particular training or experience that you look for as a general matter?

A. Aside from the men taken from the colleges where we have the opportunity of studying their marks and grades and discussing them with the professors, we try to get a combination of practical experience and college training or other courses in accounting.

The men are selected from applications and are given an examination designed to tell what accounting knowledge and clerical aptitudes they have. I made an analysis, or had one made of the Detroit office with which I am connected, in answer to this question

for the men that were taken on this year, and I found that one-third of the men had been with us before, that two-thirds of the men, including those that had been with us before, had majors in accounting at a college or university, and that the other one-third had all had courses in accounting of one kind or another.

Of the college men, over two-thirds had had commercial experience in addition to their college work.

Q. When you say commercial experience, do you mean public accounting experience or business?

A. I mean bookkeeping, clerical work, working for companies, but not in public accounting work.

Q. Now, when you get these men on your staff, do you have any requirements as to further self-education or training of any sort?

A. Well, we give all the encouragement we can to that but advancement, of course, depends on the way they do improve so that I think I can say that we do have requirements that they must develop.

What we do is try to help these men in any way we can to improve their own accounting knowledge. Most of them, as I pointed out, do have a background of definite training in theoretical accounting. Throughout every fall we conduct meetings for juniors on auditing procedure, trying to go into it more from a practical standpoint. We give the juniors specific reading to do, and help them to familiarize themselves with our methods.

In addition, we have a series of meetings for older staff members on various accounting subjects as well as auditing, all of which the juniors attend.

We have been trying out dividing the staff into research groups, seminars, or round table discussion. The men are expected to take the C. P. A. examination as soon as the time requirements of practices are met and there is consistent studying to that end.

Q. Do the partners participate in this internal education?

A. The partners do participate in this internal training. For instance, this past year I conducted several general staff meetings myself and I conducted one round table group, as well as reviewing the research group work with many of the subchairmen among the men.

Q. Could you describe briefly or characterize the type of duty that you generally assign to people in the junior class?

A. Well, first, of course, the work is purely clerical and checking, working under the instructions of a senior, and doing what is pointed out and given to him to do by that senior. As he gets more experience and develops more background, he will do more analytical work and perhaps more research into problems beyond the instructions given by the senior.

Q. Would you say that in those preliminary stages any knowledge of accounting is necessary?

A. We feel that it is, and as I say, one of our requirements, the examination, is to show that he does have some knowledge of accounting.

Q. Now, speaking generally, from what sources do you obtain your seniors, what qualifications do you look for in them?

A. The senior, as I said, is taken from the junior staff.

Q. Is that always true?

A. That is always true. I cannot think of a case in which we have hired a senior as such. I will amend that by saying I can think of a case in which we hired a man who had a practice of his own to fit into our organization and we spent quite a little time fitting him into our organization before he moved on to operate more alone than a junior would. However, I suppose occasionally there may be an exception to prove the rule.

The qualifications I would say are accounting knowledge, aptitude, character, industry, personality, capacity, et cetera.

Q. What kind of duties do you customarily assign to seniors?

A. Except in large engagements where a supervisor is more or less in constant attendance, the senior is in direct charge of the field work, of the supervision of the juniors and is responsible for the preliminary preparation or report, all under the partner or manager or supervisor.

Q. When you say supervise the junior, does that include any general duty to train them?

A. Well, not as such completely. We expect the senior to explain to the men why they are doing things and take advantage of every occasion to improve the junior's knowledge, but the direct responsibility for training the men is left in the office rather than the individual senior.

Q. Is he supposed to see to it that the juniors are equipped to handle the particular work he assigns to them?

A. Yes.

Q. Fit them into the work that they are supposed to do?

A. Yes; that is one of his duties. And part of his duty is to see that they understand what he gives them to do, to see that they are carrying it out in the way he wants it carried out.

Q. How do you satisfy yourself that your juniors are actually doing the work that they are given and doing it satisfactorily?

A. In the first instance, that responsibility rests on the senior. In the second phase it rests on the supervisor or partner. The probability is that the partner or supervisor would not go into the junior's work to the same degree as he goes into the senior's controlling work but he does have occasion and takes occasion to look over the junior's work in connection with all of the special points that he is investigating himself, so that there is a certain amount of review by the supervisor and partner of the junior's work.

Q. How would the senior discharge his responsibility in this case? How would he see that they are actually taking from certain documents or handling documents in a satisfactory manner?

A. Of course, the senior is supposed to start out the work with the junior until he is satisfied that the junior does know how it is getting along. Most of them, I notice, check in on the junior's work as it is progressing to see that it is going along the way it was started and then review it when it is completed.

Q. Now, turning to two higher grades which, maybe, we can call the supervisors and partners, to what extent do they participate in the field work?

A. That varies, of course. I think I can say as a general rule that supervisors and partners, one or the other, do participate in the field work. Certainly that is true on all important engagements. They will be there to see that the work is being done, to check into it, to question the scope, to question findings; on important engagements, probably both the supervisor and partner, and on new engagements it would undoubtedly be that way, but sometimes the partner's experience with that work is such that he may not participate in the field work but rely on his past experience and the supervisor's review.

Q. Would you say that in all cases a partner is in general charge or supervisory charge of each audit?

A. Yes; if you add partner or office manager.

Q. If he does not participate in the actual work of the audit, would he visit the client during the course of the work or how would he keep up his contact with him?

A. His contact would be kept up by visits during the year when there is anything to be brought up and if there should be a year in which nothing has come up to cause him to go there, he would make a special effort to go under any conditions the following year. We try to see that the partners do not get very far away from an intimate knowledge of the engagement.

Q. When the partner visits the client, say, during the course of the audit, what is the nature of his visit? Does he go on specific matters to be taken up and limit himself to that or does he do other things?

A. In general, his visit during the course of the audit is to see that things are moving along the way he would like to have them and probably also are occasioned by some specific problems.

His work at that time would probably be a combination of reviewing problems and discussing work with our own people, with the supervisor or senior, and taking up problems with the management.

Q. When a new engagement is accepted, do you expect the staff assigned to become generally familiar with the trade or industry, say, prior to completing the audit?

A. On a new engagement we expect the staff to obtain a general knowledge of the business and its problems but as an accountant or business man and not as an operating specialist in that particular business.

Q. As distinguished from the particular business, do you require any knowledge of trade conditions in that industry, for example?

A. Well, we expect him to have a working knowledge of the trade conditions before he finishes the work.

Q. And I think you said that, in part at least, your selection of a staff is based on familiarity with particular industries?

A. That is right.

Q. Do you expect your juniors to be sufficiently familiar with the type of records or documents which they will have to examine or come in contact with in the course of their work to be able to recognize what might be termed significant irregularities, let us say, the absence of a date or monetary amount on a check or the absence of an endorsement or initialing on a voucher?

A. We expect them to be generally familiar with the type of records and documents that they come in contact with and we would expect

them to notice the absence of a counter signature on a check or initialing of supporting documents when the document needs support. That is more a question of alertness than it is knowledge.

Q. Where do they get the knowledge of what would be an irregularity, for example?

A. When a senior lays out the work for a junior that has had no background of that kind, it is up to the senior to see that he knows the significant things to look for. Of course, we try to add to that some general background of the knowledge of various documents and data in our own office discussions and we expect them to have had some of that in their training that they have had in colleges and other courses.

Q. You have said that this is, in part, at least, a matter of alertness. Do you expect your staff to be alert to report such items?

A. We expect them to be alert to report any irregularities of that kind.

Q. What instructions do you give them as to the course to be followed when irregularities are uncovered?

A. We expect them to take it up with their particular superior. What happens then depends on the irregularity. It may be checked further through on the suggestion of the senior; it may be brought into the office immediately for further discussion.

Q. At what point would you go to the client?

A. That depends entirely on the irregularity, the division of responsibility within the client's affairs. The problem, of course, is not to take up an irregularity with a man who could remotely have been connected with an irregularity.

Q. Would you satisfy yourself, so far as is possible, as to what the underlying facts in the situation were before you took it up with the client or would you take it up with him first?

A. I think so. That, again, depends upon the irregularity. If we are finding some checks aren't coming through, perhaps, with endorsements, we might follow it through by discussing it with some of the people further down among the client's organization. On the whole I think we would satisfy ourselves pretty definitely that the irregularity existed before we took it up with the client.

IV. CONDUCT OF THE EXAMINATION

A. INTERNAL CHECK AND CONTROL

Q. Now, turning to the system of internal check and control—you may have answered this in part already—to what extent do you require the members of a staff assigned to an engagement to become familiar with the concern which is being audited; that is, the plant layout, the method of conducting business, the office personnel, et cetera?

A. Well, we expect our seniors, at least, to have a general knowledge of the plant and methods, but we do not expect them to have a critical knowledge of either plant or method.

As to the nature of the product and personnel, particularly that personnel with which we may want contact as to points of our work, we expect more than the knowledge that they have on the plant layout. What we are after is a good working knowledge of the business and a background for our work as accountants.

Q. Do you obtain or have prepared any sort of organization chart or its equivalent which would show the personnel engaged in the accounting routines, lines of control, et cetera?

A. Usually that is limited to a listing of the divisions of authority and the staff underneath those divisions and the work assigned to it. Once in a while it takes on the formality of a chart, but we don't insist on it.

Q. Would you have some sort of memorandum on those points?

A. There would be a memorandum of the personnel and the work that they handle.

Q. Do you carry that forward from year to year, or what happens to it?

A. That, of course, is part of the permanent record as to the background of internal control.

Q. And is consulted each year for changes, or how do you keep it up to date?

A. It is rechallenged each year. I am trying to bring out the fact that it is not a permanent thing that is pulled out and looked at and put back. Each year the division of duties has to be looked at all over again.

Q. Which may start from the preparation of the memorandum?

A. Which may well start from the preparation of the memorandum; yes.

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

A. To me, the term internal check and control means the division of work among various members of the personnel so that each handles only a section of the record keeping and the work of one man is subject to a check by the work of others.

It contemplates separate individuals or groups in charge of the major record-keeping functions such as the purchasing records, receiving records, production and cost records, cashier's records, general ledger accounting, credit and collections, authorization of disbursements, et cetera.

It may or may not be accompanied by some internal audit where personnel not responsible for original entries may be checking the work of others.

Systems of internal audit mean to me a set-up where there is a separate checking of the work of others but originating nothing in the way of record keeping. Or it means a system of internal auditors having certain specific duties, such as checks of the branches, and so forth.

The internal audit would be a part of the internal check, but there could be internal check without internal audit.

Q. Can this system of internal check always be used or are there limitations on its use?

A. Of course, the limitations on it are how well it works.

Q. Could you employ it in a small as well as a large business?

A. Well, you have to have a number of employees in order to have any internal check. As to factors affecting internal control, you have to see that the work is divided so as to see that one man can

check the others. In other words, if these requirements I have just given exist, then it is applicable to one business as well as another.

Q. But you do have to have at least enough personnel so as to be able to make a division of the work?

A. That is fundamental in the question of internal check.

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 statement to be reported, the type of business, the accounts of which are to be examined, and the system of internal control. Taking this one by one, could you indicate the effect of each of these factors on the scope of the examination:

First, the purpose of the work?

A. As to the purpose of the examination, the client may wish an extensive check of cash transactions or a special study of some phase.

Q. That would include also all these special audits, I take it?

A. Yes; but the purpose of those special items would extend to work beyond the acceptable minimum. We are discussing now, I assume, about companies with a public interest?

Q. Yes.

A. So that there is always the acceptable minimum that the accountant requires for reports to stockholders.

Now, beyond that, the client may want any number of things especially investigated which would require variations or extensions of the scope.

Q. How about the amount of detail to be included in the statement?

A. Well, I don't think that makes any particular difference in balance-sheet items; but as to income and expense items or operating statements, the amount of detail given does have a bearing on the amount of checking of the internal control that is done.

For instance, if a detailed statement of the selling expenses, let us say, is included, the amount of checking that would have to be done with respect to satisfying the accountant as to the propriety of distribution of expense items would be extended beyond that required where selling, administrative, and general expenses were lumped as one item, let us say.

Q. That would be to some extent true of the balance sheet, for example, if you had the single caption for plant and good will, it might be less difficult to separate the two?

A. Well, I don't know that it runs quite the same with respect to balance-sheet items.

Q. I wanted to press that a little further. Now, how about the question of the type of business the accounts of which are to be examined? How does that affect the scope of the audit?

A. Well, of course, some businesses you have got to check in much more detail than you do others.

For investment trusts you customarily check out to far greater detail, even to the extent with some of them of going through a detailed audit.

The kind of business does have a bearing on your emphasis. In some cases the emphasis will be in one place and in others it will be in other places.

Q. Would you say that the importance of particular assets or sources of revenue, for example, would result in the scope of the audit being adjusted to give particular attention relative to their importance?

A. I would; yes.

Q. Now, as to the system of internal check and control. I think you have already indicated that, perhaps.

A. I think I have covered that. It will not hurt to repeat it. The completeness of the internal check does affect the amount of detailed checking that has to be done to satisfy one's self as to the authenticity of the records.

The failure to have a good system of internal control might extend the audit almost to the point of a detailed audit. The greater the internal control the more the auditor is justified in relying on intelligent tests.

Q. That is, you might say, running the whole gamut from a single person keeping all the books to a multitude of persons engaged in the internal control?

A. That is correct.

Q. Now, at pages 7 and 10 of this bulletin, it is indicated that section 2 was designed for small or moderate sized businesses and that for larger ones than that, or smaller ones than that, the modifications of section 3 should be made.

What in your opinion, is the criterion to distinguish between those sizes?

A. Well, principally I usually test the system of internal control or the adequacy of it—usually in direct ratio to the number of transactions.

In considering variations in procedure for size, such variations are influenced by the extent of the internal control followed. Reductions of tests along the lines outlined in the bulletin are, in my opinion, justified only if the increased control exists.

Q. Do you have in mind there that it perhaps costs just as much to audit a hundred-dollar transaction as a 10-thousand-dollar one?

A. The size of the transaction has no bearing on it. It is only volume that gives you an opportunity to have broader division of work and better check of one person or another.

Q. I see.

A. Dollar volume has nothing to do with it.

Q. Dollar volume has nothing to do with it?

A. In my opinion; no.

Q. Now, on page 9 of the bulletin it is indicated that the extent of the examination is to be determined in part, at least, from the accountant's knowledge of the individual situation. What is your feeling as to the extent of the knowledge of the individual situation which the accountant should have, say, before completing his first examination?

A. Well, he should know definitely the extent to which the internal control is functioning. He should know what are the important phases of the business and where emphasis can properly be placed, and a general knowledge of the business personnel, and so forth.

Q. And from that he can then adjust his audit as you outlined a minute ago?

A. He should take those factors into consideration in carrying out his program.

Q. What methods do you employ in your firm, Mr. Bailey, for developing information in respect to the accounting procedure of a company and its system of control?

A. Well, we expect our staff to investigate the handling of cash receipts, disbursements, petty cash, cash audits, pay rolls, accounts receivable, securities, purchases, inventory controls, and so on.

From that study we expect a presentation in such detail as would permit the development of a proper audit procedure for that engagement.

In the first instance, for the first audit, facts are developed by conversation and observance subject to further check to determine that the system is, in fact, being followed.

Q. Do you employ a questionnaire in that connection?

A. We very generally have given up questionnaires. We found that questionnaires do not serve their purpose. We have general guides on audit procedures, but have gone more to the use of more definite and formal procedures for each engagement which are determined based on consideration of the internal controls and considered by the principals as well as by the seniors.

The problem, of course, is to give the staff guidance without removing initiative and at the same time to provide for review and thorough consideration by the principals.

Q. Is this information as to the system of internal control kept up to date from year to year?

A. That is checked every year. That is one of the first things to be done the next year—that is to see that the internal control is functioning as in the preceding year.

Q. I believe you said this, but I want to make sure. Do you keep some sort of written memoranda which is included in the file for that company that outlines this, or is it retained orally—I mean, retained mentally by the people in charge?

A. You mean the program?

Q. No; what the findings are as to the system of internal control?

A. Well, that is supposed to be written into the record, of course.

Q. That is what I had in mind.

I think you said that it is necessary to determine whether the system of internal control is actually being observed. How would you go about finding that out?

A. Well, generally I would say that we determine that the procedures are being followed by actual checking of some transactions and other test examinations and by actual observation. To the extent that we rely on any information that information is supposed to be from those who are actually doing the work.

Q. Rather than the supervisors?

A. Rather than the higher-ups, where we might get a theoretical outline of what is supposed to be done rather than a picture of what is actually being done.

Q. Now, if your study of the system of internal control indicates what you believe to be weaknesses, am I correct in believing that that would require additional steps in the audit program in many cases?

A. If the proposed system of internal control is not functioning, then the full program has to be rechallengeed.

For instance, if we found that the counter signature on the checks required to give an independent approval of disbursements was being so carelessly made as to provide no real check, we would undoubtedly extend our check for support of the disbursements.

Q. And would you discuss any additional work that became necessary because of these findings, with the company?

A. I think as a matter of general practice that we would quite likely tell the client that we thought an extension of our original program had to be carried out, but it would depend a little bit on the amount of time involved. But, at the same time, if you find weaknesses of that kind you do report them to the client so, I presume, we would take it up with the client but not generally to ask his permission.

Q. Suppose he does not want you to do the additional work?

A. Of course, he has always got the right to let us stay in his program or throw us out. If he does not want us to do it we have our choice of retiring.

Q. Suppose he just does not want to pay you for it?

A. Unfortunately we do find that occasionally. We have to go ahead and make the kind of examination we require in order to satisfy ourselves.

Q. Would you say that when you have completed your work on the system of internal check and control, the study of it and such of your other work as gives evidence as to the system, the auditor should have a thorough knowledge of the accounting system which the client follows, and including there a knowledge of the supporting papers or documents which are intended to evidence the various steps?

A. I would say, yes, he should have certainly on all the important documents, the first line underlying documents in support of the system.

Q. Would you say that an examination, in accordance with the procedure outlined in this bulletin, should disclose fraud? In this connection I think you might consider the sentence on page 10 in paragraph 2, the second sentence there. That sentence reads:

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

A. Of course, the examination is a test examination. It isn't carried through to such a detailed extent that it is certain to disclose fraud if carried out, but I do feel, and it has been my experience, that this type of test or examination is ordinarily sufficient to disclose ordinary recurring fraud, that is particularly true of items that rest finally in the balance sheet.

The examination is a test examination that may not pick it up one year but may pick it up the second year.

However, on those items of fraud that have to do with minor defalcations, let's say, that go through the expense accounts where the internal control just isn't functioning the way it seems to be, this kind of a test examination might not disclose those minor things resting in the income and expense accounts.

Of course, you always have to exclude widespread collusion.

Q. Do you feel that the auditor should satisfy himself as to the general accuracy and integrity of the records, having in mind your

statement as to minor fraud and defalcations to the expense accounts?

A. Yes, I think he should. I think that is what the purpose of the examination contemplates.

Q. Now, within the limits of this type of examination, should the auditor be alert to detect fraud?

A. Oh, I think he should.

Q. In the records he examines?

A. He should be alert at all times.

Q. Now, speaking generally, what is your practice as to making test examinations of records covering certain types of transactions, such as, for example, sales, plant additions, cash receipts?

A. Well, we do make tests. In most cases, ordinarily, we prefer to rely not only on observation of how the system is working but by actually making tests of the transactions to see that it is working, such as cash disbursements and tracing cash to bank deposits and so forth.

Q. If the results of those tests are satisfactory, do you feel that they adequately verify or establish the records as a whole?

A. Well, I kind of stutter on the word "verify" but if the results are satisfactory, I think they give reasonable grounds upon which to rely upon the authenticity of the record.

Q. Of course, they don't conclusively verify the others?

A. They don't conclusively verify assets or conclusively prove anything that would be established, perhaps, by detailed check, but they give reasonable grounds upon which to rely on the authenticity of the records.

Mr. WERTZ. I think maybe we can take a recess.

The EXAMINER. We will take a 5-minute recess.

(Thereupon a short recess was taken.)

AFTER RECESS

B. CASH

Q. (By Mr. WERTZ.) Now, Mr. Bailey, I would like to turn to some of the points in a detailed audit program; first, taking cash.

Do you consider the cash program which is outlined on pages 11 and 12 of the bulletin a minimum or maximum procedure? In connection with that, you might indicate any steps that you customarily add or any that you customarily omit.

A. Well, I think the procedure might be considered as a minimum for a medium-sized company. I put emphasis on the "medium-sized company."

I do not usually put emphasis on seeing original deposit tickets, depending rather on second proof of bank accounts, direct receipt of subsequent statements from the bank, direct confirmation of unclosed transfers between banks and similar points, nor with good cash control do we always inspect investments at the same time.

On the other hand, we customarily trace some receipts to the daily deposits as shown by bank statements, and duplicate deposit slips; we give attention to the supporting data for some disbursements to establish the policies of such support, and usually inde-

pendently confirm bank balances a second time, or directly receive a subsequent bank statement and the canceled checks, and make some test of footings and postings.

Q. At page 33 in the bulletin, reference is made to reconciliation of bank accounts by employees who are independent of the cashier's department. How important do you consider this matter in considering this question of internal control?

A. Well, I think it a good thing to have, but as to affecting the auditor's work, I think the working funds would have to be very small and very numerous so the outside auditor would not at least make one reconciliation of those accounts.

Q. In case of larger bank accounts?

A. Of course, while the procedure mentioned might in many cases add to the internal control, it doesn't relieve the auditor of doing the reconciling himself.

Q. Looking at it solely from the point of view of internal control, what is your feeling?

A. Well, it is easy to say that theoretically it is a good addition to have.

Actually, I know of many situations where it isn't done that way and I wouldn't recommend it being changed because the other elements of control are such that the cashier is so independent by himself that he can properly carry out those reconciliements.

Q. Now, at page 12 of the bulletin in item 8. Under what circumstances do you feel a comparison of deposits should be extended to include a check of original deposit slips? You mentioned that briefly.

A. I think I covered it briefly a moment ago. I don't insist on it where the other procedure permits examination of subsequent transactions. Put it this way: There might something come up during the course of the examination that would indicate the advisability of going to the bank and seeing the original deposit slips, but as I say, we generally do not do that if other points of control are satisfactory.

Q. In the third line of item 8 on page 12, what do you understand to be meant by the term "bona fide receipts"? How do you establish that?

Oh, I think bona fide receipts—I have thought it meant that they were regular receipts in the flow of business and not checks from insiders to correct irregularities. To establish bona fides is one reason for checking receipts to deposits for the last days of the year, but our various other checks do help to establish that fact.

Q. Now, turning to the commonly found caption on balance sheets of cash and cash items. Do you feel that it is customary and proper to include in cash amounts due from foreign banks and private bankers?

A. I do, provided they are subject to withdrawal and as to foreign balances, they are not subject to exchange restrictions.

Q. Do you have any procedure to establish those conditions?

A. Well, as to foreign situations, if the senior on the job isn't thoroughly familiar with the exchange restrictions of a particular country, he is supposed to inquire from others in the office, and if

we do not find out about it that way we check with banks and other sources.

As to private bankers our test is whether they are deposits subject to immediate withdrawal. We don't find that very much in the United States.

Q. Do you have any procedures to follow to determine that particular depositaries are, in fact, banks or bankers?

A. I think we would be more inclined to rely on the statements that are returned and all the evidence of authenticity such as the canceled bank checks and the statements and the returned checks and endorsements and things of that kind. Also, I think we have a right to rely on directors' resolutions. They are usually available with respect to the bank accounts.

Mr. WERNTZ. Off the record.

(Discussion off the record.)

C. ACCOUNTS AND NOTES RECEIVABLE

Q. (By Mr. WERNTZ.) Now looking at accounts and notes receivable, Mr. Bailey, at item 3 in the bulletin. What is meant by "instruction to examine the composition of outstanding balances"?

A. Well, I have understood it to mean what makes up the account, such as old or new balances, the apparent regularity of the items. Also, as to whether it is a regular customers' account or special account.

Q. Do you include in that aging the accounts?

A. Yes.

Q. What procedures do you follow there?

A. Well, we try to identify open items as to the entry in the account showing when the item originated.

Q. How far back would you go?

A. Well, we usually classify them in detail by months for the more recent months and then block them by quarters back of that and, depending upon the industry, we probably would stop at the end of the year and lump together those over a year old as one item.

Q. What procedures do you follow to determine whether accounts are—the accounts are due from regular customers or from others?

A. Well, the general analysis of the accounts, as to the aging, shows something in the flow, the title and name of the company shows something about it. Your other tests indicate whether consignment accounts are included or personal accounts are included.

Q. How about questions of amounts due from affiliates? How would you recognize those?

A. Well, you are supposed to have a knowledge of the affiliated companies in one way or another disclosed by various documents or tests that you made; information that you get from various sources.

If there were a deliberate attempt to keep a remote affiliation from notice of the auditors, it might, in some cases, be possible, but if the account was handled at all irregularly or it showed up in irregular balances, it would be questioned from that standpoint.

Q. Now, in the course of examining accounts with these purposes in mind, do you expect the general conditions of the individual ac-

counts to be noted such as concentration of charges in particular periods, off-season periods, let's say, the presence or absence of special credits for returns, discounts, damage claims, and so forth?

A. I don't think concentration of accounts in particular months would show up from the composition of the balances unless there were a large number of unpaid balances and the total were out of line with a proper comparison with sales. But you would get that concentration matter through other tests and other investigations.

I don't think it would necessarily show up from the accounts. The failure to put through credit memoranda and things of that kind wouldn't be quite so likely to be disclosed from the accounts as would the actual putting through of entries. The credit memoranda which actually are put through would show up in the analysis of the accounts. And the examination subsequent to the balance sheet date when the accounts are examined for subsequent disposition would give some information on credit memoranda and special data.

You expect many of those things to come through other tests rather than account analysis.

Q. Now, at the top of page 15 of the bulletin in connection with the confirmation of receivables, the following sentence appears:

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

Do you understand that this sentence implies the necessity of making confirmation, and what is your practice in that regard?

A. I have interpreted that to mean that confirmation was not mandatory, depending on internal check and so forth, but to be an encouragement to such confirmation.

Of course, there are circumstances where confirmation is particularly desirable, but I think it depends on many circumstances. Concentration may not be one of the controlling factors as to accounts.

I do think there is an increasing feeling that some independent confirmation of accounts is desirable unless other tests are particularly conclusive or unless the accounts are small and very voluminous so that a reasonable confirmation would be impractical.

As a general rule, except for such situations, I have felt that some confirmation is advisable and believe that reasonable tests can be conducted without materially increasing the cost, and that has been our practice.

Q. Would your decision as to the desirability of confirming receivables be affected by the credit and adjustment records of the individual accounts, particularly by evidence of collections subsequent to the date of the balance sheet?

A. Well, the decision might be more affected by a record of collections subsequent to the balance sheet date than it would be by previous history. Of course, if you are relying on data from a subsequent date—or if you are relying on subsequent collections, you have to take steps to see that they are collections and not just book entries.

Q. What is your feeling as to the relative value of the various tests, such as a negative confirmation of all receivables, a positive confirmation of a sample and a positive confirmation of as many as can reasonably be made?

A. Relatively I think they would rate. Positive confirmation of all, positive confirmation of an intelligent sampling and negative confirmation of all, or a large part.

In any case, reliance is placed on the belief that in case of errors, replies are more likely to be returned than with correct statements. I don't—personally, I don't think there is really very much difference between the three methods which I have indicated.

The negative confirmation of a great many, with care in mailing and return of undelivered envelopes to the auditor, seems to me to be quite satisfactory and less expensive.

Also, intelligent sampling of the accounts is better than mere dollar bulk. You get both the large and the small and the old and the new and the charged-off and so forth.

Q. From the point of view of expense, would that rule out the first of those; that is, positive confirmation of all of them or as many as possible?

A. Of course, in many cases where there aren't very many accounts, the difference in expense isn't material but the first method is the most expensive because it carries with it, too, some possibility that the auditor might have to send out some second requests. We work, on the whole, on the theory of getting replies where accounts are wrong, and in my experience it has been a perfectly satisfactory reliance.

Q. Now, at page 8 and again at page 34 under Accounts Receivable, reference is made to safeguards surrounding the handling of incoming mail and remittances and to the mailing of monthly statements to customers. In this connection, what inquiries or tests do you make?

A. Well, I would say actual observation and inspection and inquiries.

Q. Of all three stages?

A. Yes.

Q. What steps do you take to assure yourself that customers are being mailed statements at the usual intervals?

A. Well, a general examination of the mailing methods and habits of the company, knowledge of the fact that they do at least have a theory of sending out statements to all their customers.

Now, unless you are present at the actual times they are sent out, it is a little difficult to know whether some are being abstracted or not, but again that requires some examination of the general internal mailing methods and so on.

Q. Is it customary for you to be present in the course of the audit at a mailing date?

A. Well, that depends. Let me answer it this way: We do not definitely plan our work so that we can be there at the time statements are mailed out, but if for any reason we are particularly anxious to find out whether the company is mailing out statements we would plan to be there at that time. Where we do any independent checking of our own, we prove the mailing of statements in that way rather than by observation of what they do.

Q. If you don't plan to be there but happened to be there at the mailing date, would it be customary for you to observe, or not, or would that be up to the situation?

A. I think that would be a customary thing. I can go further and say one of the things we want to know about in an internal audit is that statements are being mailed out.

Q. Do you consider that the actual mailing of statements is some assurance that the accounts are authentic?

A. As distinguished from the policy of not mailing out statements, the policy of mailing out statements does give you increased assurance.

Q. Now, looking again at page 34 in the bulletin. What kind of examination do you understand is meant by the expression "relatively limited test," as it is used there under accounts receivable in relation to individual accounts?

A. Well, that phrase applies to situations where there are very large numbers of accounts. I illustrate it in my own thinking by reference to a large department store which does a large credit business where there will be tens of thousands of accounts, all reasonably small in amount. The internal control in such a situation is quite likely to be very good. The volume of work is such that it has to be divided and spread around and one checks against the other.

So that in those cases I feel that it is satisfactory to take a portion of the accounts instead of all of them as respecting—as it runs to the examination of the individual balances.

Q. Then, with those selected accounts, you would make the same examination, or more or less examination?

A. Well, I think on the whole with the illustration that I have given, you might make even less because the accounts are all small and the amount of work required to carry them back in detail ourselves might be quite voluminous, but we do expect and demand that the company make analyses that we can check so that we have definite knowledge of the composition of the balances.

Q. And you say you do test check those?

A. Yes; we do.

Q. Now, if you have determined in a particular case that it is unnecessary to confirm accounts receivable, would the same consideration make your decision as to whether notes receivable should be confirmed if they arose out of open accounts?

A. I think, speaking generally, that would be true because the notes receivable is just one more evidence of authenticity than the accounts.

On the other hand, there might be some indication that the notes were taken only for doubtful accounts or bad accounts and there might be occasions where you want to confirm notes, where you would not accounts. But generally speaking I think the two would run together.

Q. Now, looking at the bottom of page 33 in the bulletin. The statement under notes receivable there is that:

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

Do you think it desirable to confirm notes in such situations?

A. Well, that depends on the individual situation and internal check and whether or not the company itself is doing independent confirmation. In the very large companies, it is quite customary for the company to have an independent internal audit department that

conducts independent investigations of the authenticity of those accounts, and in many cases you could be satisfied that that is being carried on with sufficient accuracy to make it unnecessary for the auditor to do confirmation himself.

On the other hand there are many situations where some independent confirmation is highly advisable, and I think the question comes as to how well satisfied the auditor is as to underlying records, how much work is done on various things, and whether or not a modest test of that large number of receivables is apt to give replies that would mean anything.

Q. Would these conditions relieve you in any way of examining the notes?

A. Well, you come in the same situation there as you do in a large number of accounts receivable which we discussed a moment ago. Certainly it is necessary to make sufficient examination of the notes to be satisfied that there are notes there in support of the records but that is a test examination in most cases rather than complete, where there are large numbers of those notes.

Q. What features of the accounting procedure would indicate to you that notes receivable were subject to satisfactory internal check.

A. Well, the way the work is divided, the way the underlying documents are taken care of as separate from the accounting records themselves, the way collections are handled independently of the underlying records, and the origination of the accounts, and so forth.

Q. And including this question of independent confirmation?

A. Yes; including that. That, of course, has a very distinct bearing on it.

D. INVENTORIES

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

A. Well, he is responsible for it; yes. I think I should say—I mean he is responsible for seeing that it has been done rather than for having done it in the first instance himself.

Q. If the determination of market price is necessary in connection with some method of inventory valuation, such as cost or market, what is meant by market price?

A. Well, market price, in my opinion, means the cost of replacement limited by the sales price, reduced for distribution costs, with possibly exception to confirm sales contracts which may not need to be written down. This applies to manufactured goods as well as raw materials.

I have found there is some substantial body of thinking that the market-value test does not need to be applied to manufactured goods as long as the selling-price test shows a margin.

My own feeling, however, is that this is not cost or market but is a reason for not applying the cost or market theory throughout.

Q. Now, when you are employing cost of replacement as market, what sort of a market is meant there?

A. That is the client's market.

Q. Purchasing market?

A. The first test, which is replacement cost, is his purchase market. When you apply the test of the limit of the selling price reduced by the cost of distribution it is, of course, his selling market.

Q. What procedures do you follow to assure yourself that the replacement market price is applicable as to quantity of purchase?

A. First, you go to invoices and other data. You have references to data in the trade papers and other places for quoted market prices. You then have to take into consideration variations from the quoted conditions as may be customarily made for the grade and quantity that your customer has been buying.

You can get a line on that by past history of his invoice prices in relation to the market prices.

Q. Now, turning for a moment to goods on consignment, what procedures do you follow in determining that goods held or shipped by the company on consignment have been properly treated in the inventory?

A. Existence of the practice of consignment would be almost certain to show up through other tests which are customarily made. Once such a practice is discovered, the procedure would be indicated by the system of internal control, and the extent of investigation would somewhat parallel the investigation of other items of inventory.

In addition, we ask for a formal and specific signed statement from the client on this point. Important consignment situations would be confirmed by correspondence.

Q. How about customers or suppliers with whom there had been a regular course of consignment but which the records show were zero at the present time?

A. You are talking now about consignments in, whereas the previous question was consignments out, as I understood it.

Q. Take both of them.

A. Well, to follow the previous question, then, as to consignments in. Again the problem is to determine from some evidence that there is such a practice likely to be in existence. A formal statement is relied on to some extent in addition to all the other statements.

Q. Would you indicate what some of those other tests are that you have in mind there?

A. Well, you have your unpaid purchase invoices, let us say. You have statements from suppliers which you look into. You have various inventory controls that vary with different companies but which, if properly run, would show up the consignment feature.

Occasional consignments entirely extraneous to the usual procedure might be difficult to turn up from your ordinary practice.

When you do find a situation such as that, of course, you follow it through from such angles as are indicated. If you have knowledge of a practice of consignment and find no goods on consignment from that source today, or no goods shipped out to any such source today, I would not think that it necessarily followed that one would confirm those to see whether the practice was being followed and not recorded.

I think you might base your decision on that as to whether there was any suspicion that suddenly the company had ceased recording that kind of entries that it had been its practice to record.

Q. Do you examine the course of the business with the particular people in mind?

A. Yes; I think depending on importance.

Q. Is it customary for you to make any other tests to determine whether the company in fact owns the goods which are known to be on hand?

A. Well, you make the ordinary tests that you can from the knowledge of the way the records are being kept, the inventory controls are functioning, and you make inquiries from individuals having to do with the inventory itself. I think the answer to it is to make such tests as you think are indicated by the circumstances.

Q. What is your customary procedure to determine that there have not been included in sales, goods shipped during the subsequent period?

A. It is an examination of what we call the cut-off which runs to the shipping records and the sales records a few days before and after the closing date. We examine the procedure to see how duplication for that period is guarded against, because that is something which has to be looked for in all companies, and most companies do develop a very definite procedure for getting accuracy on that cut-off.

Generally speaking, the shipping records, if independent, are satisfactory; but if it is a small company and the shipping records are really under the same control as are the sales invoices, et cetera, other tests might be indicated.

Q. Would you indicate what tests you have in mind there?

A. I think that would depend so thoroughly upon the records that the company had and the kind of business, that it would be difficult to generalize.

Q. When you referred to shipping records a moment ago what had you in mind there?

A. I had in mind the shipping records of the shipping department of a company of the goods which go out of the shipping door.

Q. Would you make any difference in your procedure if the goods were shipped from a warehouse or point not under the control of the company?

A. Well, in order to get one side of the entry which is the sales, you would have to have reports from that warehouse and the minute there was a check on the sales end of it, there would be authentic information as to the other side of that question. Where you know of a practice of independent warehouses with shipments from those warehouses on orders, there practically always is a report in the office from that independent warehouse that is available for investigation.

Q. Now, as to purchases, how do you establish similar facts with respect to purchases, that is, that they have not been included in the wrong period?

A. Well, it runs to the receiving records and the purchase invoices. Again the question of dates as to a few days before and after, you examine the disbursements and the vouchers put through for the period after the close of the year until you are reasonably along with your work to get delayed entry of invoices. I think only if there was some indication of the lack of reliability in those two situations,

receiving records and receiving slips and purchase invoices would you necessarily follow it through to other tests that the situation might indicate.

Q. After the procedure as to inventories which is outlined in the bulletin has been satisfactorily completed, is it your practice to include in the accountant's report or statement any qualification as to the quality, quantity and condition of the inventory?

A. We have not been making a practice of stating inventory certified by management. For several years we have been getting away from it. We felt it was not sufficiently descriptive to have any particular weight as a qualification. As a general rule, we have not felt it necessary to comment on the absence of physical inspection of inventory where we were reasonably satisfied and if we were not satisfied an exception would have to be taken in definite terms.

There has been a growing tendency in some of our offices to make a definite statement of the general extent of our inventory work, particularly in industrial companies where inventories are important.

Q. 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.

What tests and inquiries do you feel that sentence contemplates?

A. I do not think that sentence contemplates tests of physical quantities. I think it means tests of the records, because that is the only philosophy that is tenable with what has gone before with respect to that particular question.

Limiting it to tests of the record has to do with examination of the procedure and investigation into underlying records such as cards and tags and original inventory sheets, discussions with those actually charged with the inventory taking, evidence that quality and condition is being reported by those who actually took the inventory, determination of procedure used in determining the cut-off, and a broad use of the various inventory controls which most companies have, including perpetual inventory records, if any.

Q. Now, if the accountant's report or statements indicate that the auditor has relied upon responsible officials for quantity, quality, and condition, do you feel that this avoids the necessity of making any of the tests which are contemplated by this sentence?

A. No; I think those tests have to be made under any circumstances.

Q. Subject, of course, to an express qualification.

A. Of course, subject to express qualification in terms which can leave no doubt as to what is meant.

Q. I think you stated a moment ago that it was customary for you to review the method followed by your client in taking its inventory. How do you obtain knowledge as to what is actually done?

A. Well, as to the review of the methods, we get it by actual tests, by talking with the people.

Q. Whom have you in mind there?

A. I have in mind those who actually took the inventory. We rely on getting in the procedure—we investigate into the underlying records such as cards, tags, and original inventory sheets, and have

our discussions with those who were actually charged with the responsibility of taking the inventory and sometimes those who actually did the counting.

We get into the determination of what the procedure actually was in making the cut-off and our test as to whether that was carried through gives some indication of the fact that it was actually carried out and we use any other controls that the company might have.

Q. What do you do if you feel the methods are unsatisfactory or that the inventory has not been carefully taken?

A. If we feel that the inventory has not been carefully taken, we have three choices, I think: One is to ask for a new inventory and to work that back.

Q. Has that ever been done?

A. Yes, we have done that; and second, to qualify our report in such a way that it is perfectly clear that we have not been quite satisfied; and third is to withdraw from the engagement because the inventory is so unsatisfactory that it cannot be used in giving a fair presentation of the whole picture.

Q. How would you distinguish between those last two as to just not being satisfied or being so dissatisfied that you cannot give any certificate?

A. There is not any rule of thumb that you apply. You have to have your own pretty definite feelings on it.

Q. In appraising the integrity and accuracy of inventory quantities, quality, and condition, is it necessary in your opinion to ascertain and give weight to the nature of the shipping, receiving, and stock-keeping records?

A. Yes; I think so.

Q. What significance has the independence of the various people charged with these responsibilities?

A. I think it has the same general significance as the internal control in the other office records having to do with cash and receivables for example.

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

A. I think he should.

Q. Is it your practice to make any spot tests of any portion of the inventory by actual count or inspection?

A. With respect to industrial companies, we have tested inventory quantities in a substantial number of cases. Inventories are so important in an industrial territory such as Detroit, for instance, that we have advocated quantity tests for many years and the effect of such tests for accurate inventories has proved worth while to our clients.

Perhaps I can state it this way: I believe that the client has a right to determine whether we shall test quantities provided we are reasonably satisfied otherwise, but that quantity tests do make for better audits and better accounting.

Of course, the procedure of testing quantities does cost more but I have not found it to be exorbitant.

Another feature in connection with that is the reliability of the underlying cost and inventory control. This is so important in an

industrial territory that companies are quite likely to have good cost control and we have done quite a lot along that line.

In recent years there has been an increasing tendency to be present at the time of taking inventory and making a general inspection where we do not make extensive tests. On the other hand there are other situations such as department stores, wholesale groceries, chain drug stores, and others of that kind where we have not favored actual test of quantities as the multiplicity of units or departments, the small size of items and particularly with the department stores, the control records and analysis of inventory make possible records that are much more indicative of the accuracy of the inventory than tests that can be practicably made of the quantity when there is such large volume.

There are, of course, cases where the records and the kind of inventory are such that we would not feel that we could make an intelligent test of the inventory.

Q. Do you make any general tests or over-all tests as to the reasonableness of quantity?

A. Of course, we use such over-all tests as are indicated, any common sense over-all tests that can be made and the various challenges that can be applied. One of the tests, of course, is the test in relation to sales; the gross profits test comes into that, of course.

Q. Do you make any over-all tests or any that you particularly favor?

A. If you are referring to checking imports, national consumption, and warehouse capacities and things of that sort, I do not think we would necessarily unless there was some particular reason to.

As to tax payments, probably not, because the tax valuations have not been indicative. As to insurance coverage on the smaller companies probably yes, some comparison at least between the two although we have not found them particularly instructive.

As to large companies with an independent, adequate insurance department, I am inclined to feel that we would rely upon that department for the expert knowledge of getting coverage. As a general thing, however, as you get more familiar with the business there are over-all tests that you develop and which occur to you and work out rather satisfactorily.

Q. More or less peculiar to individual businesses?

A. Peculiar to individual businesses and have a relationship with the previous year and a knowledge of what constitutes the normal for that particular business.

Q. Now, I think you referred to the gross-profit test a moment ago. Would you indicate the purpose you have in mind when you use that test and also whether it should be applied on a departmental basis or to the aggregate over-all figures?

A. Well, I have not found a gross-profit test very satisfactory on an over-all basis. Applied to departments there are occasions when they are quite satisfactory. Where there are departments that cannot be compared with one another and only have to be compared with the preceding year, again they have not proved very satisfactory.

There are so many factors that enter into the variation of the percentage of gross profit, that it is usually quite easy to find a satisfactory explanation for such variance but where there are a mul-

tiplicity of departments more or less related, where the gross profits can be compared with departments or units and also compared with the preceding year, gross-profits tests are quite satisfactory, quite indicative.

Q. What evidence do you customarily rely on for establishing the existence of a quantity of merchandise held in independent warehouses?

A. Well, this again depends upon the internal check and the extent of the other inventory checks. Generally inventory in independent warehouses is proved by examination of warehouse receipts and by correspondence; only occasionally would there be quantity tests for items so held.

Q. How about vendor's warehouses?

A. Well, if held by the vendor the same question of internal check and extent of inventory check arises.

Q. Would that be this company's internal check or the vendor's internal check?

A. The clients. If you feel that the internal check is quite satisfactory so that you would not have to check physical quantity in his own warehouse, you might not feel it necessary to check physical quantity with the supplier but in those cases correspondence is quite customary and quite satisfactory.

Q. Do you make any tests of financial responsibility?

A. I don't think that financial responsibility is quite as important as the knowledge that the goods are not being intermingled but are segregated as belonging to our client.

Q. How would you determine that?

A. Well, there are various ways of determining it. We have in some cases gone out to make certain that the supplier was making segregation. It is not customary to do it frequently and having once established the fact that the supplier was trying to segregate that, we might not feel it necessary to do it every year depending on whether we were testing quantities or whether we could thoroughly rely on the supplier.

If the vendor has undisputed financial strength and large reserves of material on hand, actual earmarking or inspection is not necessary as in borderline cases. I think generally only in the unusual case would we be inclined to inspect. Otherwise, we would rely on correspondence.

Q. If you do rely on correspondence, would that procedure or any procedure which might accompany it disclose whether or not the vendor has misappropriated the merchandise?

A. No; it would not. There is where your knowledge of what the procedure is has to enter into it and the financial strength, et cetera.

Q. Do you make any tests we have not mentioned as to quality, quantity, and condition of inventory?

A. Well, of course, we try to get such evidence from the records of the quality and condition as our experience with the company's affairs may indicate and it varies with every different kind of company. These have to be determined for each company in each case and general rules cannot be laid down except that the test must be within the range of our ability as accountants, with our familiarity with the records.

We usually investigate for obsolescence, slow-moving items, et cetera, but this has to be from the record inquiries, et cetera. This is in particular one of the places where experience with and intimate knowledge of the company's affairs is very helpful in helping us determine such problems as obsolescence, slow-moving items, et cetera.

Q. Have you ever employed experts to assist you in that?

A. Very rarely, because we do not like to take engagements in which we have to pass on something that is beyond our knowledge. We find in many of these cases though that the records of the company are so complete that test checks of the record give pretty satisfactory information.

Q. Now, Mr. Bailey, looking to the future, what procedures do you think auditors should use in verifying quantity, quality, and condition of inventory?

A. Well, I think the tests that they have been using in the past do not need to be changed except as to degree. My experience with quantity tests has led me to believe that auditors in the future can more frequently supervise or oversee the process of inventory taking or that they can more frequently test the inventory quantities.

However, I think we will need to be careful not to be too dogmatic about the whole question of inventory tests, because, as I said once before, there are some situations where a satisfactory physical test may not be practicable.

I think perhaps there may be something to be said for an acceptance of greater participation in inventory with a definite statement as to the extent of that participation and not just a negative statement when such participation does not exist.

Certainly we should strive for greater clarification as to whether we are reasonably satisfied with our test. And I think we should strive also to bring out more clearly that our examination as to grade, quality, and things of that kind has to be made largely from the evidence that is available from the records, because the number of cases in which inspection might show the error in grade or classification is not very large.

Q. You mentioned in the first part of that statement that in some situations verification of quantity was not practicable. Would you characterize that more fully?

A. I am thinking again of department stores, chain stores, and things of that kind where the number of items is so large and the total of each individual item so small that the tests of quantities would not be practically satisfactory. We could move forward on those, of course, to be present at the inventory, when it was taken, but we rely in that kind of situation upon checking the departments against one another and against prior years and against turn-over figures and many other things, so that I hesitate to be so definite as to say we should in all cases participate in inventory.

I personally have a feeling that if we say flatly what we do and have it understood what we mean by that wording, that we will find we work out to a pretty definite position for the accountant in connection with the accuracy of the inventory item.

Q. To what extent do you think that testing physical quantities might be used as a portion of your check-up on the system of internal

control as distinguished from counting to determine directly the quantity of inventory on hand—that is, sampling in the same way that you use sampling of so many sales or so many sales returns?

A. Of course, in any inventory check, either as to quantities or condition, or anything else, we rely upon test examinations of the records. Your tests do go to inventories the same as they go to anything else, and if those tests are satisfactory and the records are reliable and you can use the two, you can come to some rather satisfactory conclusion on the inventory, either that you are satisfied or that you are not.

The accuracy of the records, the way the manufacturing control is kept up, all of those things have a bearing. Where there is production control and goods are made in accordance with production schedules and there are semimanufactured goods on the floor ready for assembly, and the production department is counting on using those for manufacturing, it is a reasonable presumption that those are of a grade and quality necessary for that production.

Q. Now, in our forms we have a requirement that the basis of stating the amount of inventory be given. You have indicated that there is a definition of market, for example, in which you indicated that there might be two which would be applicable to any case. Are there similar different methods in determining costs?

A. There are about as many different methods in computing costs as there are in market. I had an occasion of addressing a group of accountants in Indianapolis on inventories. In the discussion which followed, I asked each man who stood up to express the basis on which his company took inventory and they were all different. Most of them said that they were following cost or market basis.

I have a feeling that we, as accountants, must challenge our general acceptance of the idea that it did not make much difference what inventory basis was followed as long as it was consistently followed.

I think we can find that there are preferred methods of pricing inventory at cost for respective inventories, methods that will come more nearly to reflecting the true income as against pure bookkeeping income which follows from some of the methods now in vogue. I think that is one of the problems that accountants have before them right now.

Q. That would perhaps be by industries or types of business?

A. My thinking is not crystallized to its final conclusion, but I think that what we should look forward to is an improved method for individual industries.

Q. Now, in view of your comment as to possible ambiguity of the term "cost," do you think it might be desirable to go a little bit further in describing what is meant by cost?

A. Well, I think you have a problem as to whether or not you are disclosing information that one would know what to do with in the report. As to the condensed stockholders' reports, I am not quite as clear on that point as I am on more detailed reports for others. I do think that we should move forward to more clearly defining what particular method of cost or market is being followed.

Q. Would it possibly be that you could group these methods under relatively widely spread categories and then describe the category?