

A. Well, that might be one way, although I am frank to say that I haven't quite seen the answer in my own thinking, merely to say first in, first out, last in, first out, base stock, does not necessarily answer the problem.

Mr. WERTZ. May we have a recess until 2 p. m.?

The EXAMINER. Yes; we will recess until 2 p. m.

(Whereupon at 12:30 p. m. a recess was taken until 2 p. m. of the same day.)

AFTERNOON SESSION

E. OTHER BALANCE SHEET ITEMS

Q. (By Mr. WERTZ.) Now, turning to some miscellaneous items in the balance sheet, Mr. Bailey, looking at item 4 on page 21 of the bulletin, what procedures do you follow to determine that amounts capitalized as additions to plant represent real additions or improvements?

A. Well, generally speaking, by examination of purchase invoices, contracts, work orders, minutes, and so forth.

We don't usually inspect the plant in that we can tell more about the details from the records than by inspection, but as to major plants we would expect our accountant to know those plants had been erected.

Q. Do you make any general inspection of the physical properties of the company?

A. Not in detail at all. We do expect our men to take advantage of being at the plants to have some knowledge of plant layout, some knowledge of the kind of equipment that they have and learn something about the plants, without having engineering knowledge of those plants.

Q. Now, at the bottom of page 34 for a moment, what procedures do you follow to determine that plant units have been abandoned and should therefore be removed from the asset account?

A. As to entire plants, there is usually some indication in the records such as inventory details or other items. As to items of individual equipment we have to rely on the records, on inquiry, and on the knowledge of the policies of the company, et cetera. The depreciation rates, too, have something to do with the importance of such abandonment, because if the rates are adequate to provide for abandonment on an over-all basis, we are not as much interested in individual item abandonments.

Q. If you find from the record that particular assets have been fully depreciated according to the rate applied to them, would you make any investigation to determine that they were in fact nearing the end of their useful life?

A. I don't think so. If they have been fully depreciated on the books, in accordance with the normal depreciation rates, the fact that there are some assets that are lasting longer than that indicated life wouldn't require any particular investigation.

Q. How about as compared to individual units, major units, such as a whole plant or something of that kind?

A. Well, the same thing holds: If I understand your question, would we make any effort to see that a fully depreciated plant had any determinable additional life. I do not think we would be suffi-

ciently concerned in it to want to know what that value was in order to set it up on the books, or anything of that kind.

Q. Would you take such facts into consideration in thinking about whether the depreciation rate was adequate or less than adequate or more than adequate?

A. Obviously, yes.

Q. You would use it to that extent?

A. Yes.

Q. What steps do you take in verifying the allocation of insurance charges?

A. Generally, by calculation of the premiums or a test of such calculations, if the insurance policies are very numerous and the company has worked out the allocation as to the proper year in which to place the charge.

Q. Would you examine the insurance policies?

A. In most companies we classify and list insurance for indication of adequacy and make some examination of the insurance policies, perhaps only to test the list which has been made by the company.

Q. At page 24 in the bulletin, item 2-C, it is suggested that a test examination be made of creditors' monthly statements which cover large balances. What practice do you follow in this connection, and what do you consider to be an adequate test?

A. Ordinarily we review the statements of major creditors and examine enough of the others to satisfy ourselves as to care in handling of the routine liabilities. I think we follow the procedure of intelligent sampling rather than getting large bulk. It usually includes requests for statements if important statements are not on hand.

Q. You leave instructions to retain statements?

A. Yes; we do.

Q. Do you examine statements that are going through at the time you are on the audit?

A. Well, we examine statements that are going through in order to see that the invoices were set up in the liabilities; yes.

Q. In the last paragraph on page 8 there is a statement that approval and entry of vouchers will be made by others than the disbursing officer. What significance does such a requirement have to you?

A. Well, one of the basic requirements of any system of internal control is that men who make the distribution and sign the checks have nothing to do with the authorization on which those disbursements are made.

Q. Turning to taxes for a minute, do you expect your staff to have a general knowledge of all the taxes which impinge upon a particular business?

A. Yes; I expect our staff to have a general knowledge of taxes as they affect the audit procedure.

Q. Do you make a special point of considering the tax problem in connection with each audit?

A. Yes. The tax problem particularly comes in, of course, with respect to income and Federal taxes and to see that provision has been made for the taxes that we know about.

As to foreign taxes, we do not expect quite the same knowledge. With foreign audits we customarily will rely, where an audit has been made by a foreign auditor, on his knowledge of those foreign taxes.

Where we have to have a knowledge ourselves and have no foreign auditor to rely on, we probably will have to go to experts in our own organization to give us the answer on foreign taxes.

Q. Now, turning to contingent liabilities. What responsibility do you feel an auditor has in that connection, and what procedures do you follow to determine the existence and amount of contingent liabilities?

A. I think the auditor assumes the responsibility of checking through the ordinary sources and making inquiries and being alert to business practices that lead to contingent liabilities.

As for ordinary sources, I would say bank confirmations, legal procedures, contracts, sales policies, minutes of meetings, and so on. Also we get a definite signed statement from a responsible official on this point in order that our questions to the management may be answered more carefully.

The accountant cannot be held responsible, it seems to me, for contingent liabilities that are not disclosed or discoverable by the reasonable investigation that is made.

Q. Would you consult counsel for the company with respect to pending litigation?

A. We do.

Q. Would you read the—would you examine the contracts which may be in the company's files?

A. Well, we try to examine the important contracts. We may not examine in detail all the purchase and sales contracts, but we make inquiries and ask to have presented to us the important contracts.

Q. Would you consult counsel as to the interpretation of contracts?

A. It depends on the contracts and what information we want to get out of them. In many contracts we can answer the problem ourselves, and in some others we may have to consult counsel. For instance, such things as contingent liabilities.

Q. You mentioned, I believe, reference to minutes. What type of minutes do you have in mind there?

A. I have in mind directors' minutes and important subcommittees of that board. It depends to a little extent on the practice of the company, whether it is to have the board of directors approve the minutes of the underlying committees or whether they reenact the important things from the underlying committees.

I do not think we would ordinarily go to such committees as operating committee minutes that take up for discussion all of the many operating problems the company has. We would probably restrict ourselves to directors and finance committee and executive committee.

Q. Did you include stockholders' meetings?

A. I did not. Of course, we do examine the minutes of the stockholders' meetings, but it is very rare that they would disclose any such thing as contingent liabilities. As a matter of fact, it is very rare when they disclose any information.

Q. Are there any purposes served by this survey other than your work in connection with contingent liabilities?

A. Well, you go through for the determination of any kind of liabilities or any other information that affects your audit.

I think the principle is that certain highly important things have to be covered by the board of directors and you cannot overlook that source of information.

Q. Such as authority for dividends and the like?

A. Quite so.

F. PROFIT AND LOSS ITEMS

Q. Now, turning to the question of the profit-and-loss statement for a moment, item 1 on page 30 suggests that a working profit-and-loss statement be obtained or prepared in as much detail as is readily available. For this purpose, to what extent do you obtain and utilize financial statements and analyses that the company has prepared?

A. Well, we get any information in the way of statements the company prepares to help us in our background, to help give us the picture of the operation of the business and help us in our understanding. We use them, too, as a check against independent statements which we may be preparing ourselves.

Q. Do you make specific inquiry to determine what statements the company customarily prepares?

A. Yes.

Q. Do you check their statements against the records in any way to see whether you should use them?

A. Well, I think that we use them more to give us background, to guide us in our investigation, rather than to use them as reliable data.

Q. In item 2 there is a reference to obtaining budgets, previous annual statements, and monthly statements. What is the purpose of that?

A. Again it is purely a purpose of improving the background and knowledge of the company's business. Data of that kind, if it is reliable, helps you on quite a number of things. It points out leads perhaps as for concentration of the business in a given period, and so forth.

Q. Do you make comparative studies of monthly statements with previous monthly statements?

A. I think as a general rule we study over the monthly statements and get such information as the statements give.

I think it does carry with it some comparison of one month with another.

Q. And do you look through those for changes in various items comparative with previous years or previous months?

A. Well, when you are dealing with the year as a whole, of course you look through them for indications of changes for the preceding year. To a very much lesser extent is that true with months. I do not think the monthly comparison detail would be carried out the way it would be on the annual detail.

Q. If you discovered significant differences, what do you do to make any determination—to determine the reason for the differences?

A. The whole purpose of it is to discover any significant differences, if there are any significant differences. It does carry with it the obligation to investigate those differences further.

Q. How far do you go?

A. Generally speaking, we go far enough to satisfy ourselves as to what caused those things.

Q. Item 3, under sales and cost of sales outlines a procedure for testing allowances to customers for returned merchandise, for claims,

rebates, et cetera. What, in your mind, is the importance of such an analysis?

A. You want to get an idea of whether or not the balances at the close of the year or the close of the period were so fictitious as to require substantial adjustment. It is a guide on the bona fides of the account.

Q. Do you always make such a test?

A. Yes.

Q. Now, speaking of the profit and loss statement generally, what in your mind is the responsibility of the accountant for verifying the classification of income and expenses?

A. The responsibility as to checking and classification differs a little bit with respect to the statements that are rendered. I think his responsibility goes to being reasonably satisfied that the classification of expenses as submitted in the statement which he approved is reasonably accurate.

If the statement which he approves is quite condensed, his responsibility runs to the reasonable division between those disclosed classifications. If the statements are detailed, he has to do more work to satisfy himself as to the general reasonableness of the allocation in the more detailed statement.

Q. Would you make samples, let us say, for all in a particular period and scanning for the more important transactions in all periods?

A. It would depend a little bit upon the individual situation, but I think the procedure might quite properly be examination of a sufficient number of disbursements or distribution of charges so that we are satisfied that the company's system of distribution and policy of distribution is accurate.

Q. Would you examine, for example, their own chart of accounts and instructions as to classification?

A. Yes; we would.

Q. Would you follow any procedures to determine if the people who are in charge of charging things to the various types of accounts understood those instructions?

A. Again I come back to some tests and supporting data in the distribution, but if, for any reason it was not done by actual examination of the distribution, it would have to be done through other means to satisfy one's self that they were making proper distribution.

V. REVIEW OF THE ENGAGEMENT

Q. Now, turning away from the detailed audit program and looking to the preparation of the statements, in your practice, who is responsible for drawing together the detailed audit work and drawing up the preliminary financial statements?

A. Well, generally speaking, the top senior on the work, or if it is a large job, the supervisor giving almost his entire time to it. The responsibility would be in the first instance upon the supervisor.

Q. Is it customary to have the statements and working papers reviewed by any one other than the person actually supervising the field work of the audit program?

A. We try to see that it is always done.

Q. What is the purpose of such a review?

A. It is just an added check that the work is being performed in accordance with the program, that it is being performed intelligently, and that things are not being overlooked.

Q. Would you say perhaps it is an example of a system of internal control?

A. I think perhaps we have the same problem of testing our own procedure that we have of testing the other fellow's.

Q. I wonder if you would describe in some detail your policies in respect of the review program and the actual steps that it goes through, indicating who does it, et cetera?

A. The steps vary a little bit in the different sized offices: In the larger offices the senior's work is reviewed on the job by a supervisor or by a partner or by both if the supervisor is responsible for bringing the job together. I am talking now about jobs of reasonable importance or complication.

When it comes into the office, it will be reviewed with the partner interested though this may be done on the job and then gone over by an independent review department.

In suboffices, the reports are reviewed in the first instance by the manager of the office and then sent in with all papers for review by the review department, inspected by a partner in the main office, or perhaps brought in by the senior or manager if it is a special problem.

In some other offices all reports are cleared through a central office where there are partners and reports released on advice from that office.

In a number of other offices, reports are released by managers without the partner's approval, but even here partners get in on the special and more complicated and more important jobs. Those offices are the ones I referred to awhile ago in the statement that the line between a partner and a manager was pretty finely drawn.

Where there is no partner's review it is because of the manager's long experience and when his technical ability makes review seem unnecessary except on a special job.

Q. You mentioned a review department. What exactly is the function of that?

A. Well, the function of the review department is to see that the mechanics of the program have been carried out, that matters requiring judgment have been challenged and are fully covered in the papers or are taken up independently to be rechallenged. Generally, it is intended to be a completely independent review of that work.

Q. Does the review department see to it that the original work papers tie into the final financial statements?

A. That is one of the purposes; yes.

Q. Speaking generally of this, would you say that with the exception of work done by partners, perhaps the work done by anybody else is reviewed by someone not connected with him?

A. Even with the work done by the partner, we turn in the report to the review department.

Q. So that always at least two people are passing on these steps?

A. We try invariably to do that.

Q. How do you determine whether the job is important; you made some distinction there?

A. I think the answer to that is that some jobs are quite small and the problems that they have are practically nonexistent, except from a mechanical standpoint, and the public interest is not involved, et cetera.

Q. When you refer to size, you mean the size of the business being audited?

A. Well, in this particular use of the term "size" I do refer to the size of the business being audited, rather than the other basis of the extent of the internal check.

VI. THE REPORT OR CERTIFICATE

Q. That is what I had in mind. Now, turning to the question of the accountant's certificate or report, Mr. Bailey, what class of persons in your firm are authorized to sign the report?

A. In offices with a partner or the suboffices by a partner. In others by the manager of the office, but in some of these only on release by the respective major office after some review. In some offices the manager can sign reports without partner approval.

Q. Would those be to the larger or more important jobs?

A. Well, on the larger and more important jobs it is pretty usual that there is a partner connected with those jobs.

Q. Who would draft the form of the report?

A. I think in the first instance probably it is drafted by the top man on the job, the senior or the supervisor.

Q. And then reviewed by the person——

A. Yes; someone farther up.

Q. Is it your practice to use a certificate as set forth on page 41 in indicating an examination such as described in this bulletin?

A. We use a somewhat different certificate, the difference being in the opinion paragraph.

We thought the standard certificate was not definite enough as to consistency and was unwieldy if exceptions were required. Accordingly, we use two sentences for our opinion and state definitely, that the statements are on a basis consistent with the preceding year. We have left out the phrase "maintained by the company" because it seems unnecessary with our wording as to consistency. I personally, and some of my associates, have a preference for adding additional data as to the scope of our work or specific expressions of opinion on certain points, but that is purely a matter of taste in certain cases.

Q. What do you understand to be the functions of an accountant's certificate?

A. I think we have come to regard the functions of the accountant's certificate to not only give the accountant's opinion of fair presentation in accordance with accounting conventions and as to the principles and practices followed and their consistency, but also to give some information as to the extent of the examination upon which that opinion is based.

Q. In using the certificates in the form you do, what impression do you intend to convey? This may involve simply a rewording perhaps of the certificate?

A. I mean to convey that we have made an examination in accordance with accepted procedure and that we are satisfied to express our opinion.

Q. Based on that examination?

A. Based on that examination, of course.

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

A. I don't think it is particularly comprehensive or definite. I think it is a conventional wording intended to be used for such an examination as is contemplated by the bulletin, but before the wording can be really useful I think there must be a wider appreciation of that particular convention.

I think we accountants may find that the difficulty of a common understanding on that sentence is great, so great that we may find it advisable to make the scope paragraph more definite.

Q. Do you believe that any material omissions from the program outlined in the bulletin should be indicated in the certificate?

A. Any material omissions not within the philosophy of the variations indicated by the bulletin should be indicated clearly in the certificate. Of course, if the omission restricts opinion on a highly important item or items, then there is a serious question as to whether any certificate should be issued.

Q. Do you ordinarily reduce the audit contract of the client to a written form?

A. Not as a matter of ordinary practice; no.

Q. Do you prepare any memorandum for internal use?

A. We have an office memorandum on it; yes.

Q. Would that go into the permanent file?

A. We prepare a new memorandum each year.

Q. Would it be in a file which would be consulted with respect to the next audit?

A. Well, I think probably yes, of course, because a new memorandum would be made up having consideration of the old one.

Q. That is what I have in mind. You have a device for bringing these more permanent papers to your attention?

A. We have what we call a permanent file; yes.

Q. Now, if that agreement with the client, whether it is in writing or oral, contains any limitations on the scope of the audit, do you feel that those should be indicated in the certificate?

A. Well, again to come back to the question of minimum procedure upon which the accountant is willing to undertake the work, any omissions of minimum procedure not thoroughly justified by the peculiar conditions of that work should be brought out definitely in the certificate and perhaps going back to the other question, perhaps there should be no certificate issued.

Q. If they are important enough?

A. If they are important enough.

Q. Perhaps I am just paraphrasing something you said just a few moments ago, if the steps omitted are what might be termed "optional steps," according to this bulletin, your opinion is that perhaps they need not be mentioned whereas if they are what we might call

prescribed steps as a minimum in any case and the omission would fall in this class that you have indicated—

A. Any prescribed steps that are generally recognized as necessary should be certainly mentioned if they have any importance to the engagement.

Q. Mr. Bailey, in the instruction book for Form 10-K, as to the accountant's certificate, the following sentence appears:

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

In your work do you interpret that as permitting reliance on a system of internal check and control or is that confined to an internal system of audit in your opinion?

A. I thought that particular thing meant having what I call internal auditors; I made the distinction sometime ago, but I think that I have felt that it went equally to any system of internal check. I have never quite understood the importance of that term, because obviously the accountant had a right to rely on the internal-control methods of the client in laying out his work and he had no right to rely upon procedures where the internal check or audit control wasn't being carried out.

Q. And you feel that this paragraph, if this sentence be confined to a system of audit as you have defined it by implication, permits reliance on a system of internal control?

A. Oh, yes; because the greater always includes the lesser.

Q. That's what I had in mind. I think you brought this point up a few moments ago, but I would like to have you restate it if you will.

What language in the certificate indicates there has been, or is intended to indicate there has been, no material change either in accounting principles followed or in the manner of their application as compared with the preceding period?

A. Of course, the standard certificate meaning, as explained by the footnote, is that the statements are on a basis consistent with the preceding year. We use the language of the footnote to convey that idea.

Q. That is, you put it into the certificate?

A. It is in our certificate except where the S. E. C. requires us to say "maintained by the company" in addition.

Q. And do you feel that the language as used by the certificate is not fully clear, if I am not mistaken?

A. I have felt that; yes. I think it is another one of those conventional wordings that is so difficult to get over to the reading public and to the profession because it is ambiguous; that we might well shift our emphasis from trying to give a widespread, common meaning to an ambiguous phrase to emphasizing the change of phrase.

Q. According to the introduction of the accountant's report in the bulletin at the bottom of page 40, matters may be included in the certificate for two or three purposes, namely, the purpose of being merely informative, to state limitations on the scope of the work, or to indicate the sense of the particular practice of the company.

In your practice, how do you include language for one or the other of these purposes? How would you expect a reader to determine the purpose?

A. Well, we try to use the English language with sufficient definiteness so there cannot be any doubt about it.

Generally speaking, I think where we mean to take exceptions, those exceptions are taken in the specific wording of the opinion paragraph. The complete details of the exceptions may have to be set forth in the preceding paragraph and referred thereto, but we try to have our exceptions clearly set forth in the opinion paragraph.

As to information, it can either be in the balance sheet or as a footnote or can be in the certificate itself. I do not object to the inclusion of informative data in the certificate as long as it is not confusing to data intended for exceptions.

There was a third classification there?

Q. Limitations on the scope of the work done.

A. The same thing is true on limitations. The wording should be rather clear that it is what we consider a limitation.

Q. Let us take an example that is found quite frequently, or has been, and that is this phrase: "Inventories have been certified as to quantity, quality, and condition by responsible officials of the company." Would it have any different meaning to you if that phrase were included in the balance sheet as compared with inclusion in the scope paragraph or in the opinion paragraph?

A. Well, to me it has not had that; but I think the phrase has two meanings, both informative and to state limitations on the scope of the work. It has been used to indicate scope of work in those cases where the accountant feels reasonably satisfied, but by its very wording does imply qualification.

It is customary to get a certificate on inventory in all cases, regardless of the work done. That is the use of the term "certify."

The trouble with that phrase, either "certified by management," or "quality and condition determined by the management," is there is no common understanding of its real meaning.

I think, as accountants, we must move forward there to a clearer statement of our inventory scope and its meaning.

Q. How do you feel, generally, as to the purpose that is served by including a statement that there has been a certificate given by the management, say, as to plant condition or the presence of abandoned assets? What assistance is rendered by including a statement to that effect?

A. It seems to me when it is included, it is included in an effort to emphasize the auditor's limitations, but again none of them give any clear-cut meaning as to why that phrase is included.

If we could clear it so that each thought was pointed at emphasis on accountant's limitations, natural and inherent, it would have more usefulness, of course, but I do not think we have got to that stage.

Q. We have been discussing the meaning intended to be conveyed by the accountant's certificate. Do you have any thoughts as to the meaning that you feel the public has gotten from the customary form of accountant's certificate as to what his work is or what his functions are?

A. Well, I do think the change in certificate in 1933 helped the public understanding of the fact that the accountant's examination was largely based on the test examination rather than detailed checking, but, again, I think the phrasing we use conveys no adequate information to the public, and I am beginning to despair of educating the public to read the bulletin "Examination of Financial Statements."

Q. Have you any substitute to offer?

A. The only substitute I have is some little more definiteness as to the important points in the scope and I am not at all sure we may not have to change the wording of that scope sentence so that we do point out that there are legitimate variations in scope between large companies with very large volume and smaller companies where we have to do more than to merely test in brief.

VII. GENERAL SUGGESTIONS AND COMMENTS

Q. Now, we have had a suggestion made that corporations should rotate the firm of auditors employed at frequent intervals. Have you any opinion as to such a practice?

A. I do not approve of it.

Q. Will you expand on that a little, perhaps?

A. The only excuse I can see is that the accountant might grow stale and that does not seem to me to be a controlling factor.

The accountant touches so many phases of corporate activities today that his familiarity with the problems and records and history is of invaluable assistance to the company.

In large corporations the company can afford to have a permanent organization to take care of some of the points on which the accountant specializes, but the moderate-sized company cannot expect to have an organization to cover those points and must depend upon consultation with his accountants.

Familiarity with the affairs of the company is important at that stage. Much of the accountant's time is given to consulting service of various kinds where his knowledge of accounting and his contacts are particularly helpful.

I do not think it places the accountant in a dual capacity.

It has been my experience that a more intimate knowledge of the client's business makes for better audits and helps to move forward to improve policies in accordance with changing accounting thoughts.

If, as a matter of public policy, it is desired to strengthen the accountant's hand, a policy of rotating accountants would not be helpful.

Q. Do you think it would be possible that rotation would bring a fresh point of view to bear; I mean, a completely different point of view?

A. It is possible, of course. Whether that completely new point of view would be helpful is always open to question. The average accounting firm is constantly striving to have a rechallenge of its work with the client and I think they are succeeding rather definitely.

Q. Is it your practice, as a member of the firm, or representative of the firm, to appear at directors' meetings at which the audited accounts are presented?

A. I do not know as it can be so extensive as to be called a practice; we do favor it. I have done it quite a bit myself and have found it very helpful. Some of the very best relationships I have are those where we appear before the board of directors and spend some time in discussing the company's accounting and the auditing, and so forth.

As a matter of fact, I carry this to quite a substantial number of companies and many of my partners do also. It may start out rather casually and coldly and not make much progress, but it has a way of becoming increasingly useful year by year.

Q. How about stockholders' meetings?

A. I haven't had very good luck with stockholders' meetings. I think I can give an illustration which is rather typical, I think. One of my particular clients that I follow has a substantial number of stockholders, made money a year ago, and at the stockholders' meeting there were a dozen or 15 outsiders, I was told.

This year the company lost money and it was thought advisable for the auditor to present the accounts to the stockholders' meeting. Instead of being twice as many stockholders, there were two this time as compared to the number the previous year. There were no questions asked.

I have attended another company's stockholders' meeting for 10 years and have never had a stockholder ask a question on the accounting.

Now, I have had such poor luck with appearance before stockholders' meetings that I don't put much weight in that appearance.

Q. Turning back to directors' meetings, would you expect the auditor to have the right to speak if he wished to?

A. Well, of course, if he appears before the board of directors he has got to be prepared to answer any questions put to him.

Q. I mean to speak on his own initiative.

A. Of course, he shall have the right to speak on his own initiative.

Q. And not in response to questions?

A. Well, it is hardly conceivable that once a relationship gets established, that some director will not say, "Well, have not you got anything else to say?"

Q. That is all you need?

A. That is all we need, of course. Again, the auditor has to be careful that he is not passing on the company's operating policies or criticizing the management on things with which he has no adequate background.

Q. Is it customary for your firm to send copies of the report you prepared to the directors?

A. No; I do not think it is. There are two kinds of reports. The reports that go to stockholders are rather condensed and it is trouble enough to get them ready for the directors' meetings themselves. At the same time those condensed reports can be reviewed by the auditor at the meeting as satisfactorily as if they are sent to the directors in advance.

As to a detailed report, which usually with us follows the stockholders' report by some period of time, I don't think that's usually sent to the directors, either by us. I think usually it is presented to the members of the board at the board meetings.

Q. Do you think the directors might be inclined to give more thought to the reports if they were available to them in advance of the meetings?

A. Well, as to the condensed reports for stockholders; no, I do not think so. As respects to detailed reports they follow the issuance of the statements to the stockholders and whether they can look at them in advance of the meeting in which they are presented or whether they take them away from that meeting for further study, I don't think it makes so much difference.

Q. Do you know whether individual copies of the report are customarily furnished to each director?

A. Well, I think we have to answer that by saying sometimes they are and sometimes they are not.

Q. Do you think that might be desirable?

A. I think it might be desirable; yes.

Q. Do you feel that auditors in their reports should point out significant developments or changes during the period?

A. Well, in the detailed reports it is quite customary to make such comparisons and disclosures of financial data as will give a background for intelligent comparison.

I think the answer is "Yes"; it is advisable to give such financial comparisons and figure comparisons as will be helpful.

Q. What do you think of the statement of application of funds in that connection?

A. I think as a matter of common practice in the detailed report it is extremely useful. I want to point out the difference of including data of that kind and the auditor's setting himself up to say whether or not the management is running this business from an operating standpoint the way it ought to be done. That is expecting a great deal of the auditor in the present stage of his development.

Q. Within the field that the auditor is qualified, would you expect him to make comments and give suggestions or recommendations?

A. Well, I would like to limit that. Within the matters of accounting, yes; within the realm of general advice in passing on operating situations, I wouldn't expect him to include those in the ordinary report.

Q. On matters of internal accounting policy and procedure?

A. Matters of general accounting policy and matters of definite conclusion.

Q. In what group would they fall?

A. They would fall in the matters to be included in the detailed report.

What I am trying to bring out is this: I don't think that the auditor should be expected in an audit report to say how the business ought to be operated, whether the products that are being handled are proper, whether the prices that are being charged are enough or whether the president is giving enough attention to the business or not.

When it comes—he may be perfectly competent in certain cases to give advice on that kind of things and should be prepared to do so if it is put up to him by the board of directors.

As a matter of common inclusion in the report, I don't think he can generally be expected to do that.

Q. Turning to another question for a moment. What is your feeling as to the desirability of the adoption of a natural business year?

A. I am for it in spite of the fact that I know I will be charged with having a selfish interest. It isn't entirely a question of self-interest. There are too many other people and institutions that profit by it. Accountants have been working on it over the past several years and have made substantial progress in that direction, but the accountant has so obvious a self-interest that his recommendations are discounted and some outside help or important examples are going to be needed if the inertia is to be overcome and it is mostly inertia that is stopping the shift. If we could make a change in our territory in Detroit where there is a predominance of the automotive industry, it would be very helpful.

Q. To say the least?

A. To say the least. Incidentally, it works toward the accuracy of statements, too, because inventories are taken as at the close of the natural year and if one wants to test physical quantities, that is the time to do it.

Obviously, you get more accuracy when the year closes coincident with the natural business year. When you have a flow of business extending over the fiscal period, because your natural business year ends at a different time, there are always more estimates to be taken into consideration.

It also could be minimized by having the fiscal closing correspond with the natural year.

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

A. Well, I think the emphasis is still on the authenticity of the accounts and the fairness of the presentation, but certainly there is increasing emphasis on the accounting principles or practices and conventions.

Q. Taking the balance sheet and profit-and-loss statement, will you indicate, item by item, those items which your auditing procedure verifies to your satisfaction by tests which are independent of the accounting records of the company and of information furnished you by the officers and employees?

A. Well, the basis of that question is outside of the records?

Q. Yes.

A. I interpret it to mean in what place do we get sufficient independent confirmation or inspection so that we can disregard the records. There is very little. Cash on deposit is confirmed, but it also has to be considered in the light of outstanding checks and other data shown by the records. Receivables that are confirmed by correspondence are verified with respect to those receivables. But you use that as a test to prove the authenticity of the records on the balance of the accounts so that your proof of the accounts receivable independent of the records is limited to those that are actually confirmed.

Inventories to the extent of inspection or to the extent of general knowledge without detailed knowledge as a matter of visual verification. But again that runs only to the knowledge that a certain substantial amount of inventory is present.

Notes payable can be confirmed by correspondence but one is dependent upon the records in order to know where to confirm notes payable. You might prove those that you do confirm, but that doesn't prove that you have the total of the notes payable. The same thing is true with respect to the accounts payable.

Funded debt is quite usually proved by correspondence with the trustee and capital stock, too, if there is a registrar and transfer agent. I don't mean to imply that there are no substantial independent confirmations, but in many of those cases authenticity of the records has to be considered in conjunction with that confirmation.

Q. You might say, then, that it is a combination of the independent sources with the records?

A. That is correct.

Q. That gives you the answer that you can give a certificate to?

A. I think so.

Q. To what extent in making your audit, or outlining your audit procedure or following out the audit procedure, is it desirable to rely on the statements given you, or information given you, by employees?

A. Well, as a rough general test, I take the position that you have a right to take into consideration information given to you by the employees in helping to form your background and get data and that you have a right to give reliance on that to things that are not susceptible of other confirmations.

Generally speaking, I think the reliance should be on employees only when that is the only source.

Q. By "only," you mean only practical?

A. Only practical, of course.

Q. The second paragraph of the certificate states that in the auditor's opinion, based upon his examination, the statements fairly present the condition of the company and the results of its operations.

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

A. Well, again I'd stutter on the use of the word "verify," as I did before.

Q. Suppose we supplant that with "establish to your own satisfaction."

A. Suppose we say, rather, "to give the accountant reasonable grounds to believe in the authenticity of the assets and liabilities and the authenticity of the operations." The answer is "yes."

Q. Unless you were satisfied to that—or had those reasonable grounds as an expert, you feel that a certificate should not be given?

A. That's correct, or that the exceptions should be taken so definitely that it cannot be misunderstood.

Q. And, finally, that in giving such a certificate, you are also saying that the examination has been such that you, as an expert, feel able to give this opinion?

A. We give that certificate only when we feel satisfied from our examination and feel that we have made enough of an examination to give us reasonable grounds upon which to express an opinion.

Q. That's what I had in mind. Have you any suggestions?

A. Nothing further. Thank you.

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

Mr. HENDERSON. No, sir.

The EXAMINER. Thank you, Mr. Bailey.

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

(Witness excused.)

Mr. WERTZ. Mr. Charles Jones, of Arthur Andersen, will be the witness tomorrow.

The EXAMINER. Charles Jones, of Arthur Andersen & Co., will be the witness tomorrow.

We will adjourn until 10 a. m. tomorrow morning.

(Whereupon the hearing was adjourned until 10 o'clock a. m., March 14, 1939.)