

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., Tuesday, March 14, 1939.

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

PROCEEDINGS

The EXAMINER. Will you be sworn, sir?  
Whereupon:

CHARLES W. JONES

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

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

The WITNESS. Charles W. Jones, 135 South LaSalle Street, Chicago.

The EXAMINER. Mr. Jones, it is customary at hearings of the Commission 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. Jones, will you state your present firm affiliation?

A. I am a member of the firm of Arthur Andersen & Co.

Q. How long have you been a partner?

A. Fourteen years.

Q. What had been your accounting experience prior to that time?

A. I became associated with Arthur Andersen & Co. in 1914. Prior to that time I had worked in various capacities in a bank for 3 years.

Q. Had you had any educational training in accounting prior to coming with the firm?

A. I was a graduate of the University of Wisconsin, B. A. degree, course in commerce.

Q. Which included work in accounting?

A. Yes, sir.

Q. Are you a certified public accountant?

A. Yes, sir.

Q. In what states?

A. In Illinois, by examination, and some eight or nine other states by reciprocity.

Q. Could you indicate just roughly the general nature of the firm with which you are now connected, number of its partners, and so on?

A. We have 15 partners, 10 offices, several hundred employees. Anything else?

Q. Could you indicate roughly the variation between the low point and the peak temporary season?

A. Of our peak staff, roughly 35 percent, I would say, represents temporary employees.

Q. Could you characterize the principal types of clients you serve and the principal types of services you render?

A. We have the usual diversified type of client, manufacturing, mercantile companies, public utilities, oil companies, coal, investment trusts, and render the usual type of services.

Q. Are you a member of any of the professional societies or hold any offices in them?

A. I am a member of the American Institute of Accountants and the Illinois Society of Certified Public Accountants. I do not at present hold any offices.

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

A. I have in the Illinois society. I was president of that organization in 1934 and 1935.

Q. Have you published any works on accounting or edited any?

A. No, sir.

Q. Have you engaged in teaching accounting—

A. No, sir.

Q. (Continuing). Or similar work?

A. No, sir.

## II. SCOPE OF THE EXAMINATION OF FINANCIAL STATEMENTS

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

A. There is only one general type of accounting examination made by public accountants which leads to the certification of financial statements; the scope of the examination will vary depending upon circumstances, the system of internal check, and many other factors.

Q. Do you recognize any distinction that has been commonly called detailed audit on the one hand and examination on the other?

A. Yes; we do.

Q. How does that fit into what you are discussing there?

A. Well, you may have detailed auditing made for strictly internal purposes which has no relationship to the examination ordinarily made for purposes of certification.

Q. You can certify on the basis of a detailed audit, however?

A. Not necessarily. You might.

Q. If the detailed audit were sufficiently extensive; that is, covered enough of the business?

A. That is true.

Q. What type of services do you customarily render in preparing statements for certification under the Securities Act, the Securities Exchange Act, and the annual reports to stockholders?

A. We render the same type of service for statements rendered under the Securities Act and the Securities Exchange Act, as for statements used for stockholders' reports and other purposes, except that there are certain details required in the acts which are not normally gotten in other cases.

Q. And that would be this examination type to which you referred?

A. Yes.

Q. Are you familiar with Commission's Exhibit 117, which is the Examination of Financial Statements by Independent Public Accountants, a bulletin prepared and published by the American Institute of Accounts?

A. Yes.

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

A. Paul Knight, a member of our firm, was a member of the committee which prepared that bulletin.

Q. What was the purpose of preparing the bulletin?

A. My understanding of the purpose in preparing the bulletin was to record and make available to accountants, investors, and other businessmen a brief statement of the procedures followed by public accountants in making financial examinations which lead to their certificates. It further was intended to emphasize the importance of following accepted accounting principles and practices, and to further the importance of a consistent application of those principles. Also it was intended to emphasize the part that judgment plays in the preparation of financial statements.

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

A. I would classify it as an examination made for the purpose of certifying to financial statements.

Q. Would you say that the principles of the bulletin are of general application, irrespective of type or size of business?

A. Yes; I think the principles of the bulletin are of general application. The extent of their application, however, will depend upon circumstances of the individual case.

Q. In your own practice, do you use or follow this bulletin as a general guide in such examinations?

A. We furnish all members of the organization with a copy of the bulletin, but we have our own instructions and our own procedures, which are the principal basis of formulating audit programs.

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

A. We do.

Q. Now, speaking generally, do you regard the steps prescribed by the bulletin in the nature of a minimum or maximum requirement?

A. Speaking generally, I would say that the steps prescribed by the bulletin are a minimum. This should not be interpreted as meaning that all steps are carried out in every case. In practically all cases, depending on various factors, the nature of the business, the extent of the system of internal check, we add many steps and omit some.

Q. Would you say that if we omit the steps which are inapplicable because the conditions are not present, that the remainder is a minimum?

A. Yes.

Q. I think you mentioned your own examination, and in it you would often omit some of the steps and perhaps more frequently add a number of steps to the program outlined in the bulletin; is that correct?

A. Yes.

Q. Speaking historically, do you feel that the publication of this bulletin resulted in any changes in your own practice or in audit practice in general?

A. We considered the bulletin an important contribution, and at the time it came out we checked our own procedures with those prescribed in the bulletin and found that no modifications were required. I doubt if there was any material change in audit practice generally, but the bulletin undoubtedly provoked serious and thoughtful consideration of the whole question of auditing and, well, I cannot say what the effect was. It may have had some effect.

Q. You feel, then, the bulletin more or less codifies what was the best practice at the time, perhaps?

A. In a very general way.

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

Q. Now, in your answers to the remaining questions, Mr. Jones, I would like to have you distinguish, if you will, between practices or procedures that were current prior to the institution of the hearings in the McKesson case and those which may have been adopted since that time. Just indicate where that occurs.

When a client comes to you, Mr. Jones, do you make any independent investigation of his reputation or credit rating, say, before you complete the audit?

A. As a practical matter we rarely have any problem, as usually either we know the prospective client or he comes to us from some source that does have an intimate knowledge.

If that is not the case, we make whatever inquiries of banks or other sources that we consider necessary.

Q. Now, from your experience in auditing and accounting, Mr. Jones, who would you say exercises the prerogative of appointing auditors to certify to annual reports of corporations, the stock of which is publicly held?

A. I would say the prerogative of appointing the auditors is exercised by the officers, acting for the board of directors.

Q. Do you mean by "acting" directly acting at the direct request or acting through having been appointed by the directors?

A. Both, in different cases. It may be either.

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

A. I would say in our business dealings with a client the primary responsibility runs to the client. So far as the integrity of the statements is concerned, the responsibility extends to anyone who is entitled to rely upon the statements.

Q. When you say client, whom do you have in mind there?

A. The company, or it may be a partnership, etc.

Q. When accepting an engagement, what representative of your firm would determine the scope of the audit?

A. In most cases a partner either determines the scope of the audit or approves it after it is determined by a manager and a staff man—accountant in charge.

Q. Is it customary for you to reexamine the scope of the audit in the case of continuing engagements?

A. We do that annually.

Q. Do you start with that as a novel situation, or do you start with the audit program for the preceding year and make such modifications or changes as you think desirable?

A. We start with the record of it that is contained in the working papers of the year before.

Q. From your experience, who would you say determines such questions on the part of the client?

A. Normally the client determines the character of service he wants rendered and we determine the scope of the work to be done in connection with that service.

Q. How would that work out in the case of your being employed to certify statements for an annual report? Is that as far as the client's directions would go?

A. Normally, yes.

Q. Looking to the future, do you think there should be any changes in the method of appointing auditors or in fixing the scope of the audit?

A. I do not believe the method of the selection of auditors has any real bearing on the scope or the results of an examination.

I see considerable merit in having the board of directors or a committee, preferably of nonofficer directors, meeting with the auditors to get first-hand information as to the scope and as to any accounting problems that are involved.

Q. Would you think it desirable to have the auditors appointed at the beginning of the fiscal year in lieu of the end?

A. I believe that is desirable.

Q. What would be the advantage of that?

A. It gives the auditors an opportunity to plan the audit ahead, to do preliminary work.

Q. Now, turning to your own firm, do you classify your personnel, say, as between seniors, juniors, and so forth?

A. We classify the organization as between partners, managers, seniors, semiseniors, and juniors.

Q. How do you determine, when you accept an engagement, what personnel is to work on the audit?

A. Assignments are made to engagements on the basis of the qualifications of the available men; having in mind the particular type of

engagement that is involved, character of the business, the size, and other factors.

Q. Are the assignments permanent for successive audits?

A. They are not permanent. In the first place, the development and promotion of men through the various steps from a lower to a higher group automatically results in changes in assignments to the jobs.

Then, in addition to this, we make changes for the purpose of bringing a fresh point of view to particular jobs. We believe that knowledge of more than one type of business is very helpful in a particular audit.

The transfer of men on engagements probably does result in some increase in cost, but we feel that that is warranted by results.

Q. To what classification of your employees does this policy apply, leaving out promotions, of course?

A. All classes, except that the transfers are more infrequent in the case of managers and partners.

Q. But even with managers and partners there is a policy of change at intervals?

A. That policy is not as well defined; we do make frequent changes.

Q. That relates mostly to seniors, would you say? I mean, your policy in this respect?

A. I would say to the staff from the senior rank down.

Q. I see. What is your procedure in recruiting juniors for your permanent staff; how do you go about that?

A. We get practically all of our juniors from universities and colleges that offer major courses in accounting.

Q. How about your temporary staff?

A. A considerable number of our temporary staff represents men who come back year after year for the peak season. Others we get from agencies that specialize in men of this type, others represent men who call at our offices to seek employment.

Q. Do you have any policy of retaining men that you have employed on your temporary staff as members of the permanent staff?

A. Yes; we do.

Q. Do you do that to any great extent, or is that rare?

A. No; it frequently happens that a temporary man will prove to have the qualities that we are looking for, and we keep him.

Q. I think you said that you mostly get your juniors from colleges where there has been a course in accounting. Do you have any other requirements for those men?

A. Well, we require that they shall have completed their college courses with distinction, including the courses in auditing and accounting, and in addition they must be recommended by department heads, and by their instructors, as to ability, general fitness for general accounting work, and character.

Q. Do you have any further requirements as to training or self-education after they join your staff?

A. Yes. The new juniors are given considerable attention during the fall months after they join the organization, familiarizing themselves with our routine, procedures, and methods. In addition all members of the staff during the fall months are required to attend a series of lectures that are given by partners and managers on auditing and accounting procedures.

Q. Do you have any requirements as to the possession of a C. P. A. for promotion?

A. No; we do not require that. We do urge all of our men to take the C. P. A. examination.

Q. Are there any limits to which a man can rise if he has no C. P. A. at the present time?

A. He cannot be a partner.

Q. In the rank of partner, a C. P. A. is a prerequisite.

A. Yes.

Q. Could you characterize, or describe briefly, the type of duties which you customarily assign to juniors?

A. Work assigned to juniors customarily consists of the routine detailed work that can be effectively controlled and supervised by an experienced accountant.

Q. Would you say that that work requires a knowledge of accounting or auditing?

A. It does.

Q. Speaking generally, from what sources do you obtain your seniors?

A. It has been our policy to promote our staff men through the various grades and we get very few permanent seniors from outside sources. We have found that our policy of development and promotion from within has been sufficient to meet our requirements.

Q. What characteristic or qualification do you look for in men to promote to the rank of senior?

A. He must have a thorough technical knowledge of accounting and auditing, several years experience in public accounting, covering all phases of ordinary auditing, and he should have demonstrated his ability to handle medium-sized jobs under the supervision of a manager or partner. He should have an analytical mind, an aptitude for investigation; he should be alert, he should have a reasonably forceful personality, and some ability to organize work and to direct and supervise others.

Q. Could you characterize briefly the type of duties that a senior will be assigned to?

A. These duties depend upon the size of the engagement. In the ordinary engagement the senior is actively in charge of the work and does much of the field work personally. He directs it. He is personally responsible for any work that he may assign to assistants. Without going into detail as to how an audit is made, a senior usually works on a prearranged program which has been thoroughly discussed with the manager in charge and approved by the partner in charge. He is directly responsible to the manager for the proper performance of the work and he is required to check currently and keep the manager informed on the progress and on any problems that may arise from time to time.

He is also responsible for the initial preparation of the audit report, if one is written.

Q. Is he limited by this prescribed audit program?

A. He is not. He is expected to make or recommend changes in this program as conditions newly discovered may dictate.

Q. Would he make those changes on his own initiative or merely bring them up to the manager and get his approval before going ahead?

A. That depends upon the relative materiality of the changes. Minor changes he would make. Important changes he would discuss with the manager or partner.

Q. Do you feel it is part of the senior's duty to train the men assigned to him or under him?

A. Yes; very definitely.

Q. How would that be done?

A. That is done in two ways I should say: The first and most effective way is by close supervision of the work of his assistants and alertness to point out reasons for doing particular types of work, emphasizing the type of information that is being developed by the work that he is instructed to do, the most logical and effective approach, and particularly how the work fits into the general plan of the examination.

In the second place, he trains the men under him by discussing thoroughly the problems that arise from day to day on the engagements and in these discussions he may also cover accounting problems in general.

Q. How do you satisfy yourselves that the juniors have been satisfactorily performing the work assigned to them?

A. The work done by the juniors is currently supervised and reviewed by the staff man in charge of the engagement. All working papers incident to the engagement, including those prepared both by juniors and seniors, are further reviewed by the manager in charge and possibly by a partner.

Q. How does the senior know whether the junior, let us say, is doing a good job on getting the information from the records that he is supposed to?

A. By questioning, by observing what he is doing, by carefully noting his written comment on his audit steps.

Q. Do the partners in your firm participate to any extent in the field work of the audit?

A. As to any engagements of any size, they do. They take part in the development of the audit program and exercise a reasonable amount of supervision over the field work.

Q. Do they visit the client, or the place where the audit is being conducted, during the course of the audit?

A. They do.

Q. Is that an inflexible rule?

A. No; it is not an inflexible rule. It is a practice that we have that I should say on engagements of any size is followed very generally.

Q. Is it customary for the partners to visit the clients during any other part of the year?

A. Yes; a partner may visit a substantial number of clients at other times during the year.

Q. Now, when he visits the client during the course of the audit, what would his program be, generally speaking; what would he do?

A. He would spend considerable time with the accountants working on the engagement, would observe their work, discuss various phases of it thoroughly.

He may examine many records personally. He would also discuss the work with accounting officers, financial officers of the company, possibly with other executives.



Q. Now, on a new engagement, Mr. Jones, do you expect the staff assigned to become generally familiar with the trade or industry either before or during the course of the audit?

A. We do.

Q. Do you expect your juniors to be sufficiently familiar with the type of records and documents with which they are apt to come in contact so as to be able to recognize significant irregularities. I have in mind there such things as the absence of an endorsement on a check, the absence of appropriate initials on vouchers, and the like.

A. Yes; we do expect our juniors to be sufficiently familiar with the type of records and documents with which they are normally concerned, to recognize any significant irregularities.

Q. How would that training or knowledge be acquired?

A. That training comes from constant instruction and supervision from men in charge of the examination, and from experience.

Q. Do you expect them to be alert to detect and report such irregularities?

A. Yes.

Q. What instructions do you give your staff to follow in case irregularities are discovered? When would they take it up with the clients, for example?

A. The course which would be pursued depends of course upon the nature and materiality of the irregularity. In case of defalcations, members of the staff are instructed to take the matter up immediately with the manager in charge of the engagement, and assuming that we are certain as to our facts, the matter would immediately be discussed with the proper officer of the client.

Q. Is it your custom to go as far as you can in ascertaining the facts before taking it up with the client?

A. Within practical limits; yes.

#### IV. CONDUCT OF THE EXAMINATION

##### A. INTERNAL CHECK AND CONTROL

Q. I would like to turn now to the question of the system of internal check and control. You mentioned a moment ago that you expected your staff to be generally familiar with the trade or industry in which the client finds itself. To what extent do you require the staff to become familiar with the particular concern being audited; that is, its plant lay-out, its operating methods, its method of doing business, the nature of its products, the character of the personnel, and things of that type?

A. We expect the staff assigned to an engagement to become generally familiar with the business of the client, including a general knowledge of its operations, the nature of its products, its sales methods, its source of raw materials, and things of that type.

Q. The degree would vary with the rank of the member of the staff?

A. Yes.

Q. In connection with this, would you obtain or prepare an organization chart or its equivalent which would indicate as to the accounting personnel, their duties, the lines of control, et cetera?

A. We prepare what I consider the equivalent of an organization chart in connection with our review of the system of internal control. That includes a survey of the segregation of duties in the accounting and financial departments.

Q. Is that placed in a permanent file?

A. It is.

Q. Is it brought up to date from year to year?

A. Each year.

Q. What do you understand the term "internal check and control" to mean? In that connection you might indicate briefly some of the more common basic features and the purpose of such a system.

A. The term "internal check and control" means the planned allocation of the duties among personnel so as to bring about a system of checks and balances for the purpose of safeguarding the assets of the company and insuring the general accuracy of its accounts. Some of the basic features of a system of internal control are, first, that employees having custody of cash and securities and other negotiable assets should not keep or have access to the records which establish accounting control over such assets.

Similarly, those having control or custody of materials and manufactured products should not have access to the record control over those assets.

The approval and authentication of invoices for payment should be made by officers or employees who do not actually disburse the funds.

Q. Can such a system always be used?

A. Theoretically, I suppose, you can have a system of internal check if you have more than one employee. Actually, where you have a small number of employees, it is extremely difficult to have an effective system of internal check.

Q. How would you distinguish this from a system of internal audit?

A. A system of internal check is primarily concerned with the original handling and recording of transactions, whereas a system of internal audit embraces a subsequent review, or a check, of the recorded transactions coupled with periodic verifications of assets and liabilities by other company employees.

Q. Would you say that the system of audit might be an optional feature of a system of internal control or is it something completely separate?

A. I would say that it is separate.

(Discussion off the record.)

Q. The instruction book for Form 10-K under accountant's certificate contains the following sentence:

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

Do you feel that as to the term "internal system of audit," as used there, it gives the accountant the right to rely on the system of internal control or is the right to rely on such a system implicit in the preparation of financial statements?

A. My opinion is that that particular sentence refers only to the system of internal audit without, however, detracting from the right of the auditors to rely on the system of internal check.

Q. Now, the bulletin which we have referred to, at page 7, states:

That the nature and extent of the examination depends on the purposes of the examination, the amount of detail included in the statements covered by the report, the type of business the accounts of which are to be examined, and the system of internal check and control.

Can you explain briefly the effect of each of these upon the scope of the examination? Let us take first the question of purpose.

A. The examination may be made for the purpose of prospective financing, which ordinarily requires investigating for a number of years or for a prospective purchaser who might require specific information on certain phases of the operating results in which he is particularly interested.

It might be for purposes of a receiver who would be interested only in assets and liabilities. It might be made as a check on the honesty of employees which might require detailed auditing.

Q. How about the second one—that is, the amount of detail to be included in the statements?

A. The amount of detail to be included in the report would be dependent upon the nature of the client's requirements.

For example, one client might require the auditor's certificate to cover a segregation of operations by departments. Another client might require statements of sinking funds, maintenance funds, statements of fundable construction in the case of utilities.

A receiver might be interested in detailed schedules of assets and liabilities.

Q. Would you say, as a general rule, that increasing the amount of detail to be included in the statements would result in the necessary increase in the scope of the audit?

A. It frequently does.

Q. I mean, as to the way the amount of detail is related to the scope?

A. Right.

Q. Now, how as to the type of business?

A. I can illustrate that by comparing a public utility with a manufacturing company. In case of a public utility the property account may be of relatively great importance, while in the case of a manufacturing company the inventory is ordinarily the important thing.

Q. Would you say that the scope of the audit is adjusted to give particular attention to those assets or revenues or expenses which are particularly important in the business?

A. Always.

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

A. Well, if the company being examined has an effective system of internal check and control, the examination in many respects can be restricted to broad test checks, whereas if the system is not effective, much more detailed work must be done.

Q. And would you say that the correlation runs the whole gamut from the condition where one person keeps all the books to the con-

dition when you have a perfect, or semi-perfect system of internal control?

A. It does.

Q. At pages 7 and 10 of the bulletin, it is indicated that section 2 is designed for moderate-sized corporations and that modifications of section 3 are for larger ones or in some cases smaller ones. Can you explain what the criteria are which should be used to distinguish business for this purpose between large and small?

A. In general, size might be determined by combination of many factors, assets, liabilities, sales, volume of transactions, number of employees. It is difficult to say.

Two companies, otherwise similar, might; oh, one might sell its entire product to one customer, the other might sell to thousands of customers. A company may be small in one respect and large in another.

Q. Would you say that roughly it costs about as much to audit a small dollar transaction, say \$500 as it would to audit a considerably larger one, say \$10,000?

A. It frequently does.

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

A. You mean by that when he is practically finished?

Q. Well, if you care to say what he knows before he starts and what he should know before he finished?

A. Well, at the beginning of the examination the accountant must have a basis for judgment as to the effectiveness of the system of internal check and control, sufficient general knowledge of the extent and character of the operation of the business to permit him to formulate a program.

Following that, the program may be changed in many respects, depending on new information that is developed through conditions that arise.

Q. Could you characterize the knowledge between relatively thorough—could you characterize it in any such way?

A. I don't know that I can.

Q. I think you said he has to have a sufficient knowledge to be able to do some things, and I was wondering what you had in mind by "sufficient"?

A. That's hard to define in specific terms. He does have a thorough knowledge of many things, but taking the aggregate, I can't say.

Q. Can you say a pretty thorough knowledge of those parts of the business which would appear to be directly affecting the scope of the work he should do?

A. He should have, yes.

Q. What methods do you employ for developing information in respect to client's accounting procedures and system of control?

A. We furnish our staff men with an outline which is used as a basis of their investigation of the system of internal control. The points in the outline are not intended to be all-inclusive, but are intended to be suggestive of the type of things regarding which inquiry must be made.

Q. Is that in the form of a questionnaire or instructional outline, or what?

A. It is more of an instructional outline, I would say.

Q. Now, how do you determine that the accounting procedures and system of check and control are, in fact, being followed? How do you go about doing that?

A. Generally speaking, the methods of internal control are determined by conferences with responsible officers and executives and subsequently are checked by actual observation of procedures as they are carried out by employees.

Q. When you say observation, does that include discussion with the people who are performing the duties?

A. It does; yes, sir.

Q. Now, if you find any weaknesses in the system of internal control as you develop it, would you say that these would require, or might require, additional steps in the program; additional work?

A. Yes.

Q. Could you give us some illustration there?

A. Well, it depends upon the nature, seriousness of the weakness, etc. For instance, if we find that a cashier or his assistants perform work on records other than the cash books, we probably would conclude that we should enlarge the scope of our work in reconciling the cash accounts.

Among other things, we might determine that we should make a second reconciliation following the date of the balance sheet.

Q. Now, would that additional work be discussed with the company, or how would you handle it?

A. It would be discussed with the company if it involved a major change, or material amount of work.

Q. What would you do if they disapproved or asked you not to do it?

A. Well, I cannot recall any cases where that has happened. If it should happen and the work that we wished to do played a vital part in the examination, I think we probably would withdraw from the engagement.

Q. If you were not permitted to go ahead?

A. Yes.

Q. Suppose the company just would not pay for it, what would you do?

A. We would go ahead and do it.

Q. When you have completed your verification of the system of internal control, do you think that should result in pretty thorough knowledge on the part of the auditor, both of the accounting system followed by the client and the knowledge as to what documents, vouchers, papers, and so forth are supposed to support the various steps in the accounting procedure?

A. I would say that the examination of the system of internal control should result in a reasonable knowledge on the part of the auditor of the accounting system, documents, vouchers, and so forth, that they are of relative importance in the various steps.

Q. You do not mean to imply that he should examine all of those documents each year?

A. No.

Q. But that he should know what documents are supposed to be the basis for making accounting entries?

A. That is correct.

Q. Do you feel that an examination in accordance with this bulletin should detect fraud?

A. In my opinion, this examination should disclose fraud of a material character, except in cases involving extensive collusion.

Q. What is your understanding of the meaning of this sentence on page 10 in the second paragraph, second sentence, which reads:

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

A. I think that sentence means that the procedure will not necessarily disclose irregularities or understatements of the assets that are not substantial in relation to financial statements.

Q. Do you have any feeling as to why the word understatement was used and the contrary, overstatement, not used? Is there any difference there?

A. Yes; I think there is a difference. Understatements might relate to defalcations of a relatively unimportant amount; that is, in relation to the statement.

Q. Do you feel that overstatement was meant to be included in the sentence, or excluded? I am just trying to find out what you feel.

A. Overstatements of a material amount, I think, were intended to be excluded.

Q. Do you feel that the auditor should be satisfied as to the general accuracy and integrity of the records before he signs the certificate?

A. He should satisfy himself as to the general accuracy and integrity of the record.

Q. Now, speaking as to the minor defalcations, would you feel that within the scope of the examination; that is, looking to the records you do examine by the sampling process, that this examination should detect fraud of that character?

A. As to transactions examined, yes.

Q. Speaking generally, is it your practice to make sampling tests of such transactions as sales, plant additions, cash receipts, disbursements, and the like?

A. Generally speaking, we do make test examinations of that kind.

Q. Rather than detailed examinations?

A. Yes.

Q. And do you feel that such tests, if you are satisfied in their results, are adequate to verify the records as a whole?

A. I do not think that we can say that those tests verify anything except the particular transactions that are examined.

Q. They do not verify the rest of them?

A. They do not. But, to the extent that these tests and other procedures followed indicate the substantial integrity of the accounts, they may properly be relied upon.

Q. Do you feel that it might be desirable to extend such sampling to cover a great percentage or great proportion of the transactions?

A. In what case?

Q. Let me restate that.

How would you determine what sampling shall be done? Is that a set program, or do you adapt it to the particular case?

A. It depends entirely upon the conditions of the particular case.

Q. And if it gives results which you are not satisfied with, what do you do?

A. Then we would have to go much further.

Q. And the ultimate limit would be a detailed audit of at least that type of transaction?

A. That is right.

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

The EXAMINER. Yes.

(Thereupon, a short recess was taken.)

#### AFTER RECESS

#### B. CASH

Q. (By Mr. WERTZ.) Mr. Jones, I would like to turn now to some of the detailed procedures in the customary audit program. Taking first the question of cash: Do you consider the cash program outlined on pages 11 and 12 of the bulletin as a maximum or minimum procedure, and I would like to have you there indicate, if you will, any steps which you customarily omit and any steps that you add?

A. In most cases I consider it a minimum. The exact procedure in each case depends upon the individual situation. Assuming an adequate system of internal control, it would not be necessary to count cash where the amount of undeposited receipts is relatively small. Some additional steps that we might include and frequently do, are examination, for example, of bank cancellation dates on checks, to make certain that the checks were actually paid by the bank during the period examined.

We obtain authenticated deposit slips covering deposits in transit, at the balance sheet date, and for cash on hand at the balance sheet date, deposited subsequently and check them item by item to the cash book.

We make special investigation of checks payable to affiliated companies, for example, or officers.

We frequently obtain directly from the bank statements and canceled checks as of a subsequent date, usually at least a week subsequent to the date of the balance sheet, and then we make a complete second verification or reconciliation of bank accounts.

Q. At page 33 in the bulletin, reference is made to reconciliation of bank accounts by employees independent of the cashier's department. What significance or importance do you attach to this matter?

A. From the standpoint of a satisfactory system of internal check, it is very important that such reconciliation be made by some one independent of the cashier's department.

Q. How would it affect your work if that were not done?

A. If it were not done we would have to make a more detailed verification of cash.

Q. Now, at page 12, item 8, there is a reference to a comparison of deposits extending the comparison of deposits to include a check

of original deposit slips or authenticated copies. You mentioned that a moment ago. I wonder if you could indicate under what circumstance you customarily do it?

A. We do it where we have undeposited receipts at the year-end and we may extend it, if we find that there are weaknesses in the system of internal check, to include deposits for several days prior to the end of the period and a few days subsequent to the end of the period.

Q. Now, looking at the third line of item 8, there is a reference to "bona fide receipts." What is your understanding of that term, and how do you establish the fact that they are bona fide?

A. I should say that bona fide receipts are receipts that in fact are what they purport to be. For example, receipts from a customer are actually receipts from a customer.

Q. As compared to what, for example?

A. As compared to money that a cashier, for example, has put into the company's funds to cover customer's payments that he may have taken.

Q. Do you feel that the term customer requires verification in that connection, that is, to see that these are customers whose names are attached to the checks or receipts?

A. Well, not all cases. I don't know that I understand the question.

Q. You say receipts from a customer actually are receipts from a customer.

A. Well, yes; that is what is—

Q. How would you go about determining whether they are actually receipts from a customer, what evidence would you rely on?

A. Well, we would trace the receipt to the customer's account and that, in cases of confirmation, would be established if the account were confirmed.

Q. Now, looking at the cash situation in general, is it customary and proper in your opinion to include in cash or cash items amounts which are due from foreign banks and private bankers?

A. It is customary to include cash in foreign banks with other cash. Frequently, if it is of relatively material amount, it is shown separately.

Q. Do you have in mind any conditions under which that would be improper?

A. Yes; if you had amounts in foreign banks which were subject to governmental exchange restrictions and you didn't have in the current liabilities amounts that were payable from those funds, I think a different treatment would be followed.

Q. What procedure would you follow to determine whether there were restrictions?

A. That is ascertained by inquiries of bankers or others who are in constant touch with exchange situations. In many cases it is common knowledge.

Q. Do your remarks apply also to private bankers as well as foreign banks?

A. Well, with respect to private bankers, we rarely have any problem. We have very little contact with that question. There are relatively so few that we feel we cover it satisfactorily by inquiries where we run into them.



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

A. It is ordinarily a matter of common knowledge and in cases where there is a doubt we make inquiries to satisfy ourselves on that point.

#### C. ACCOUNTS AND NOTES RECEIVABLE

Q. Now, turning to the question of accounts and notes receivable: What do you understand to be meant by the instruction in item 3, the first sentence:

To examine the composition of outstanding balances.

A. This, I think, means to examine the items making up the outstanding balances, commonly called aging an account.

Q. How would that be done? What procedure do you follow there?

A. You analyze the account to determine which items among the charges have been paid or cleared and which remain.

Q. How far back would you go?

A. You might go back a year, depending on the—

Q. Do you utilize schedules prepared by the client, or do you do that work yourself?

A. Where we can, we have the client prepare those schedules and then check them.

Q. Does that examination have any other purpose in mind such as examination of receivables due from officers, affiliates, credit balances in receivables not being offset against debit balances, etc.?

A. That is included in the general examination of the receivables; yes.

Q. How would you determine whether a company is an affiliate or not? What do you rely on?

A. Well, on a number of things. Normally, we know what the affiliated companies are and if we find that there are numerous transactions with a particular company and there is any question as to being affiliated, then we find out from officers just what the relationship is.

Q. Would you make any independent test or inquiry other than inquiry from officers?

A. Yes; we might.

Q. Would you consult registration statements and things of that kind in appropriate cases?

A. Yes.

Q. In this examination of the balances of accounts receivable, do you expect the general condition of the individual accounts to be noted, for example, concentration of charges at the year-end or other off-seasonal periods, the presence or absence of special credits for returns, allowances, write-off claims and the like?

A. Yes; as to material accounts and material amounts.

Q. At the top of page 15, there is a sentence which reads as follows:

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

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

A. It is my understanding that the sentence quoted implies that a test confirmation of receivables is a desirable procedure unless the particular circumstances of the client seems to make such procedure unnecessary.

For example, if the client through its own auditing department confirms receivables at regular intervals, it would appear that the auditors could satisfy themselves by a review of the company's confirmation.

Q. Would you feel that particular circumstances such as concentration of large amounts in a few accounts would have any effect upon the question of confirmation?

A. Yes; it frequently does.

Q. How does the past credit and adjustment record of the account affect your decision, including there, if you will, the collection subsequent to the balance sheet date but prior to the completion of the audit?

A. If a test circularization were being made I would feel that it would normally be more desirable to include those accounts which have an unfavorable collection and adjustment record.

Q. How would collection subsequent to the date of the balance sheet affect your judgment?

A. It wouldn't necessarily affect the procedure although if we were satisfied that an account actually had been paid we would be more apt to exclude it from the test confirmation.

Q. Now, as to the relative methods of testing or confirming accounts receivable, what do you feel as to their relative value, having in mind both the cost and the probative effect of the confirmation, taking the three types:

Positive confirmation of as many as you can, the test confirmation of a fair sample, the negative confirmation of all accounts?

A. I consider positive circularization of as many accounts as is reasonably possible to be most valuable. As a practical matter, positive confirmation of either a fair sample or of all large accounts and a sample of all others is ordinarily satisfactory.

I consider the negative confirmation as to all accounts the least valuable of the three.

Q. And your decision between the positive confirmation of all and the sampling process would rest in part on the relative expense, would it?

A. No; I think it would rest more on our judgment as to what would constitute a fair confirmation under the circumstances.

Q. I see. At pages 8 and 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. What inquiries and tests do you make in this connection?

A. We make careful inquiries as to the procedure followed in receiving mail and remittances and in checking and mailing monthly statements to customers and observe the actual operation of these procedures.

It is sometimes difficult to determine whether proper statements are actually being mailed to customers, and about all that we can do is to ascertain that the prescribed procedures are such as to give reasonable assurance that that is done.

Q. If you are present at a monthly date when statements are being sent out, do you observe the mailing at that time?

A. We do.

Q. And do you consider that such mailing is some assurance that the accounts are authentic?

A. I think that it does afford some assurance as to the accounts.

Q. Now, looking at page 34 under accounts receivable in respect to individual customers' accounts, what kind of examination do you understand is meant by the term "relatively limited test"?

A. Well, I would say that this expression refers to the examination of companies in which there are a large number of customers and that have a satisfactory system of internal check and control. In which case the auditor is justified in relying on his examination of procedures followed, his review of the aging, comparison with sales volume in light of credit terms, and upon examination of only a portion of the individual accounts.

This latter might involve confirmations, checking customers' accounts to the ledgers to ascertain that the totals are in agreement with controls, discussion of delinquent accounts with the credit department.

I can't give a minimum percentage that the auditor would examine in this connection. It might be 20 percent, it might be more or less, depending on circumstances.

Q. If in a particular case you deem it unnecessary to make confirmation of open accounts, would that control your decision as to the question of confirming notes that have grown out of the open accounts?

A. Not necessarily. If the notes were past due, for example, we would want to confirm them.

Q. If the notes themselves are not past due, would that change your opinion?

A. Not necessarily, if they were taken under special circumstances we still might wish to confirm them irrespective of the conditions with respect to the accounts.

Q. Do you consider it desirable to confirm notes receivable under the conditions that are outlined on the bottom of page 33? That has reference to large installment companies having a great many notes receivable controlled by a satisfactory system of internal check.

A. That depends upon the system of internal check. I think it would be desirable to confirm a portion of the notes if an effective system of internal check were not in operation.

If the system were satisfactory we might not consider it important to send out verification letters.

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

A. Well, going back to our original discussion of internal check, there should be, of course, a complete segregation of duties of those who handle notes and those who establish the record.

Another feature that I consider essential is that delinquencies be handled by some one separate from the cashier's department or those handling cash and those having control of the notes.

Another important feature is that when the notes are taken they are confirmed independently of the person who handles the transaction.