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American Institute of Accountants (1939)

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Confidential—Not for Publication

To Members and Associates of
The American Institute of Accountants

Gentlemen:

The Institute has received numerous requests from members for a statement of facts in relation to the McKesson & Robbins case. Up to now it has been impossible to present any such statement since no public record of the facts was available. Hearings of the Securities and Exchange Commission, which began January 5th, and are still continuing, have now developed such a record. The undersigned special committee has been appointed by the executive committee to prepare a brief summary and send it to the entire membership.

The testimony has already run to more than three thousand pages, and it is obviously difficult to select from the mass those statements which appear to be particularly significant without sacrificing any of the meaning which they might carry if read in the context of the testimony.

However, the committee believes it highly important that the membership of the Institute be in possession of sufficient information to permit a general understanding of the accounting and auditing questions involved in the case.

In the following paragraphs we endeavor to present salient facts which we believe to be undisputed. We do not wish this statement to be taken as implying any opinion on our part as to whether the auditors did or did not do everything which they should have done in the circumstances, or whether they did or did not exercise all the care or diligence which might reasonably have been expected.

1. The balance-sheet of McKesson & Robbins, Inc., as of December 31, 1937, showed among other assets customers' accounts receivable of $25,791,604.19, and inventories of $44,254,735.70, which now appear to have been overstated in total by about $19,000,000. Apparently about $10,000,000 of inventories, and about $9,000,000 of accounts receivable were nonexistent. It appears that inflation of these assets had been gradually increasing for a number of years.

2. It is alleged that the president of the corporation and the assistant treasurer (who under the president had charge of the purchase of crude drugs), and the head of the production and stock department, three brothers, with another brother on the outside, all under assumed names, were acting in collusion and deliberately planned the overstatement of assets and the procedures by which it was concealed in the accounts.

3. The records of the fictitious assets related to dealings in crude drugs by the Connecticut division, and the transactions in these commodities were recorded in the same general accounting records of the company as other transactions of the Connecticut division which were wholly legitimate.

4. Most, if not all, the fictitious sales of crude drugs appear to have been reported as foreign sales of crude drugs made through a sales agency, W. W. Smith & Co., under a contract with McKesson & Robbins. W. W. Smith & Co., guaranteed McKesson & Robbins against losses on accounts receivable up to $900,000 and the parent company of W. W. Smith & Co. (supposedly located

in Liverpool, England), in turn guaranteed performance of the contract by its subsidiary. The auditors have testified that they were shown the agency contract and the guarantee of the parent company, as well as a Dun & Bradstreet report indicating that the parent company guarantor was financially responsible. It now appears that the contract, the guarantee, and the credit report lacked substance or were forgeries.

5. Collections arising from the foreign sale of crude drugs were purportedly deposited in a private financial organization, Manning & Company, Canada, as fiscal agent and depository for McKesson & Robbins. The auditors have testified that they were shown the minutes of the board of directors authorizing the use of Manning & Company as a depository. Monthly statements (which now appear to have been forgeries) were received by McKesson & Robbins from Manning & Company, showing the funds received and paid, and balances to the credit of the company. Debit and credit advices (without supporting documents attached) were furnished currently in respect to individual payments and collections.

6. The crude drugs in question were purportedly purchased from five suppliers, also in Canada, and were supposed (subsequent to 1934) to be held by the suppliers until sold. The auditors have testified that they received by mail direct to their own offices, confirmations from these suppliers showing the amount of inventory held by them owned by McKesson & Robbins at the year end. These confirmations now appear to have been forged. The auditors testified that they understood that payment for purchases of crude drugs from these suppliers was made by Manning & Co., against drafts drawn by the suppliers on McKesson & Robbins.

7. The testimony indicates that the transactions were further supported by such documents as purchase orders, invoices and shipping advices (all of which now appear to have been false or forged). W. W. Smith & Company, Manning & Company, and the five suppliers, have now been revealed as dummy organizations administered by an outside person or persons in collusion with the officials of the company to whom reference is made above. The false transactions were recorded in the company's accounts and records by the regular accounting and stock-record departments which also handled legitimate transactions.

8. The auditors have testified that prior to 1935 (when crude drugs were supposedly stored in Bridgeport rather than being held by the Canadian suppliers), they were furnished with inventory sheets signed or initialed by employees of the company; that they test-checked the items to the perpetual inventory record and checked the inventory sheets as to clerical accuracy. After 1934, as stated above, they have testified that they obtained direct from the suppliers confirmations as to quantities supposed to be held by them, but that otherwise the audit procedure was the same. In addition, the auditors have testified that they checked the prices shown in the inventory sheets by reference to purchase invoices covering a substantial portion of the quantities of each item. As a supplementary check, prices were also compared, according to the testimony, with published quotations in trade journals, and with selling prices indicated by duplicate sales invoices subsequent to the end of the year under examination. The auditors also testified that they obtained certificates signed by two or more responsible officials of the company, covering quantity and condition of inventories as reflected in the balance-sheet. The balance-sheets indicated on their face, in parentheses against the item of inventories, that quantity and condition had been certified by responsible officials.

9. With respect to accounts receivable, the auditors testified that they were furnished with detailed trial balances of customers' accounts receivable, which they checked to the accounts-receivable ledgers, and that the total of all outstanding balances was agreed by them with the general ledger control account. The auditors checked the aging of the accounts receivable, according to their testimony. In support of balances shown on the accounts-receivable ledgers from the sale of crude drugs, more than 700 in number at December 31, 1937, the auditors testified that they test-checked charges to individual customers' accounts. Among the documents and records which the testimony indicates were examined in support of the accounts receivable were perpetual-inventory records, copies of invoices sent to customers and shipping advices from shipping agents, all of which now appear to have been false or forged. In addition, credits to individual customers' accounts for the same period, subsequent to the year-end, the auditors testified, showed substantial collections received on outstanding year-end balances. The auditors checked these credits to the cash records and to statements or credit advices from Manning & Company (now believed to be forgeries). The testimony indicated that there were no bad-debt losses or allowances to customers in connection with the foreign crude-drug business.

The accounts receivable were not confirmed by direct correspondence with debtors in this or any other department. The auditors testified that they discussed the question of circularization with the president and the president requested that circularization be not undertaken. According to the testimony, the auditors considered circularization unnecessary because in their view the foreign crude-drug accounts in particular were in excellent condition and showed large collections subsequent to the close of the year; and because these accounts were all foreign, and they were guaranteed by W. W. Smith & Co. against losses up to $900,000.

The record shows that the entire 1937 audit, including branches, resulted in expenditure of 21,000 hours of chargeable time by the auditors.

The line of questioning by S.E.C. counsel throughout the hearings has indicated an interest on the part of the Commission in a number of broad questions related to auditing and accounting, typical of which are the following:

Should it be the duty of auditors to make at least some spot checks of inventory, and some test by direct confirmation of accounts receivable?

Should auditors take independent steps to ascertain whether companies with whom their clients do business actually exist, or are in a position to discharge their obligations to the client?

To what extent should accountants go behind original documents which support the accounts, such as invoices, to prove their authenticity?

What is the accountant's responsibility with respect to fire insurance coverage on assets owned by his client?

To what extent should accountants investigate the operation of the client's system of internal check to assure themselves not only that the system is adequate but that it is actually being followed?

What is the difference between a balance-sheet examination and an audit, and should auditors disclose more fully in their certificates or otherwise the scope of their examination, or any variations from what may be considered a standard examination?

What reliance should the public be entitled to place on auditors' reports—

for example, may they properly expect that the assets actually exist or that fraud will have been disclosed?

How closely should partners supervise the work of staff accountants; to what extent, if any, does the employment of temporary men in the busy season reduce the effectiveness of auditing; to what extent does the pressure of time under which all staff men work in the busy season reduce the effectiveness of auditing?

To what extent should directors participate in the engagement of auditors, and discuss with them the scope of their work?

When acting as directors, do company officers consider themselves as employers or employees of the president?

Directors of McKesson & Robbins, Inc., have testified at the hearings that they had no doubt of the integrity of the president until his fraudulent actions had been disclosed. The controller testified that in his opinion, in view of the system of handling the records, it would have been impossible for the fraud to have been carried out without collusion between the president of the corporation, its assistant treasurer, and the head of the stock department, and somebody on the outside to take care of sending in invoices from suppliers and the various other papers. The auditors have testified to the same effect.

It is not practicable to describe in detail all the audit procedures employed or the devices by means of which the false transactions were given the appearance of reality so as to be recorded by the accounting department and not be brought to light by the auditors. Numerous questions on these points will arise in the minds of many members of the Institute which can be answered only by a reading of the testimony as a whole. It is hoped, however, that this brief factual outline will provide members with a general understanding of the nature of the case and the audit problems involved.

The announced purpose of the hearing at present being conducted by the Securities and Exchange Commission is to determine:

(1) the character, detail and scope of the audit procedure followed by the auditors in the preparation of the financial statements included in the registration statement and reports of McKesson & Robbins;
(2) the extent to which prevailing and generally accepted standards and requirements of audit procedure were adhered to and applied by the auditors in the preparation of the said financial statements; and
(3) the adequacy of the safeguards inhering in the said generally accepted practices and principles of audit procedure to assure reliability and accuracy of financial statements.

We wish to emphasize again that nothing in this statement is intended to be, or should be interpreted as, an expression of opinion on any of these questions. They are questions requiring extensive study of the record by the Securities and Exchange Commission and by committees of the Institute charged with that responsibility. At the present time, it seems possible for us to present only a sketch of the background.

Yours truly,

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CHARLES F. COATES
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Special Committee