

## Section IV

# DESCRIPTION OF THE AUDIT CONDUCTED BY PRICE, WATERHOUSE & CO.

## A. PRICE, WATERHOUSE & CO.

### 1. The Firm

Price, Waterhouse & Co. was founded in London, England, in 1865.<sup>468</sup> The firm was represented for the first time in the United States by two chartered accountants sent over in 1890 to act as agents of the firm. These men were not partners of Price, Waterhouse & Co. but formed the firm known as Jones, Caesar & Co. which practiced on its own account as well as in behalf of their London employers. When one of these men died and the other retired, the English firm of Price, Waterhouse & Co. took over the business. In 1901 a separate partnership under the same name of Price, Waterhouse & Co. was organized in the United States.<sup>469</sup>

On January 1, 1939, Price, Waterhouse & Co. was, in effect, a group of interrelated partnerships with offices in many of the principal cities of the world. The American (or United States) firm consisted of 24 partners and had 17 offices<sup>470</sup> in the United States and one in Havana, Cuba. The executive office of the firm was in New York and had 10 partners in residence. The other 14 partners were in residence singly at 5 offices, 2 in each of 3 offices and 3 at 1 office (Chicago).<sup>471</sup> The offices at which no partner was in residence were operated by managers.

The English firm was a separate partnership with 11 partners in London. Two partners of the United States firm were partners individually in the English firm but none of the London partners were members of the United States firm. Neither the American nor the English firm was a partner in the other, but both of these firms were partners in the continental firm of Price, Waterhouse & Co. which

<sup>468</sup> It is interesting to note in this connection that the first step toward the formation of a Society of Accountants was taken in Edinburgh, Scotland, January 17, 1853 and a Royal warrant was granted October 23, 1854. Similar societies were organized in Liverpool in January, and in London in November 1870. The London city directory listed 11 accountants in 1799 and 310 in 1860. See Richard Brown, Ed., *A History of Accounting and Accountants*, T. C. & E. C. Jack, Edinburgh, 1905.

<sup>469</sup> R. 14, supplemented by information supplied by Price, Waterhouse & Co.

<sup>470</sup> New York; Boston; Buffalo; Chicago; Cleveland; Detroit; Houston; Los Angeles; Milwaukee; Philadelphia; Pittsburgh; Portland, Oregon; Providence; St. Louis; San Francisco; Seattle; and Washington, D. C. R. 17.

<sup>471</sup> R. 18.

had its head office in Paris, France.<sup>472</sup> The South American firm of Price, Waterhouse & Co. had as partners the American and English firms of Price, Waterhouse & Co.; Peat, Marwick, Mitchell & Co.; and “\* \* \* perhaps five resident partners \* \* \*”<sup>473</sup>

There was also the Mexican firm of Price, Waterhouse & Co., in which the resident Mexican partner was joined by four partners, individually, from the New York office. And, finally, the American firm was a partner in the Canadian firm of Price, Waterhouse & Co., which had five offices in that country.

The loosely knit organization which we have described is perhaps the largest organization of public accountants in the world and the United States firm, the largest in this country. The next largest in this country, based on size of staff and scope of operations, would appear to be the firm of Haskins & Sells,<sup>474</sup> of American origin, with 28 offices here, 3 in Europe, 2 in the Far East. As a partner in Deloitte, Plender, Haskins & Sells, they also have offices in Canada, Cuba, Mexico, South America, and South Africa. The only other firms in the United States comparable to these two in size of organization are Ernst & Ernst,<sup>475</sup> with 45 offices here and 1 in Canada; and Lybrand, Ross Bros. & Montgomery,<sup>476</sup> which has 19 offices throughout the United States and 2 in Europe. While there are other accounting firms with foreign affiliations and many offices in this country, none appear to be comparable in size of organization with these four.

The number of employees on the staff of a large accounting firm varies widely during the year. Comparable figures for the peak staff, permanent staff, number of partners, and offices of the United States firm of Price, Waterhouse & Co. (which is the organization referred to hereinafter when the name is used) with those of other accounting firms whose partners were called as expert witnesses in this case are given below.<sup>477</sup>

<sup>472</sup> R. 15-16.

<sup>473</sup> R. 15.

<sup>474</sup> P. 172.

<sup>475</sup> P. 538.

<sup>476</sup> P. 222.

<sup>477</sup> P. 3, 64, 120, 172, 222, 272, 316, 378, 478, 538, 586.

## Size of Accounting Organizations Represented by Partners Called as Expert Witnesses, Compared with the Price, Waterhouse &amp; Co. Organization

[Arranged in order of appearance of partner as a witness]

Firm	Number of offices in the United States	Number of partners	Number of staff <sup>a</sup>	
			Peak	Permanent
Price, Waterhouse & Co.	17	24	1,465	750
Peat, Marwick, Mitchell & Co.	29	25	(b)	(b)
Scovell, Wellington & Co.	11	11	175	125
Touche, Niven & Co.	8	17	230	150
Haskins & Sells	28	57	1,120	720
Lybrand, Ross Bros. & Montgomery	19	32	<sup>c</sup> 815+	<sup>c</sup> 590
Mathieson, Aitken & Co.	1	4	40	40
Webster, Horne & Blanchard	2	4	25	25
Barrow, Wade, Guthrie & Co.	17	17	350	260
Klein, Hinds & Finke	1	6	100	50
Ernst & Ernst	45	27	950	650
Arthur Andersen & Co.	10	15	(d)	(d)

<sup>a</sup> Staff figures are for accountants only. In addition the four large firms reported corresponding figures for office employees as follows:

	Peak	Permanent
Price, Waterhouse & Co.	201	176
Haskins & Sells	240	240
Lybrand, Ross Bros. & Montgomery	<sup>c</sup> 185	<sup>c</sup> 160
Ernst & Ernst	250	200

<sup>b</sup> Several hundred employees, ratio of permanent to peak staff not given.

<sup>c</sup> "In recent years the [total] number of employees has not gone below 750 and has exceeded a thousand at the peak." P. 222.

<sup>d</sup> Several hundred employees, 35% of peak staff being temporary.

Some measure of the professional work performed by firms of public accountants is gained from an analysis of registration statements and annual reports filed with this Commission under the Securities Act of 1933 and the Securities Exchange Act of 1934. The table below gives some indication of the activity of accountants in connection with security offerings under the Securities Act of 1933 during the 2½ year period from July 1, 1936 to December 31, 1938 in issues of one million dollars or over.<sup>478</sup>

<sup>478</sup> Material in this table was prepared in the Capital Market Subsection, Research and Statistics Section, Trading and Exchange Division of the Commission.

Employment of Accountants in the Flotation of Stock and Bond Issues of \$1,000,000 or Over Registered Under the Securities Act of 1933 and Offered for Sale From July 1, 1936, to December 31, 1938.

	Number of registrants by which expert was employed	Percent of total	Gross proceeds of issues in which expert was employed	
			(\$000)	Percent of total
Price, Waterhouse & Co.	54	16. 12	959, 984	20. 35
Arthur Andersen & Co.	53	15. 82	889, 207	18. 85
Haskins & Sells	47	14. 03	571, 158	12. 11
Lybrand, Ross Bros. & Montgomery	40	11. 94	871, 049	18. 46
<b>Total, 4 experts</b>	<b>194</b>	<b>57. 91</b>	<b>3, 291, 398</b>	<b>69. 77</b>
Arthur Young & Company	16	4. 77	171, 462	3. 63
Peat, Marwick, Mitchell & Co.	15	4. 48	55, 829	1. 18
Barrow, Wade, Guthrie & Co.	14	4. 18	87, 239	1. 85
<b>Total, 7 experts</b>	<b>239</b>	<b>71. 34</b>	<b>3, 605, 928</b>	<b>76. 43</b>
S. D. Leidesdorf & Co.	8	2. 39	24, 387	. 52
Touche, Niven & Co.	6	1. 79	63, 160	1. 34
Allen R. Smart & Co.	5	1. 49	30, 556	. 65
<b>Total, 10 experts</b>	<b>258</b>	<b>77. 01</b>	<b>3, 724, 031</b>	<b>78. 94</b>
2 experts, 4 each	8	2. 39	310, 985	6. 60
2 experts, 3 each	6	1. 79	151, 761	3. 21
7 experts, 2 each	14	4. 18	248, 515	5. 27
49 experts, 1 each	49	14. 63	282, 214	5. 98
<b>Total, 70 experts</b>	<b>335</b>	<b>100. 00</b>	<b>4, 717, 506</b>	<b>100. 00</b>

This table should be compared with the one which follows which shows the number of firms of accountants which certified to financial statements contained in annual reports for 1937 filed with the Commission in accordance with the provisions of the Securities Exchange Act of 1934. While the preceding table may be irregular in amount and incidence both in time and as to accountants involved the following table may be some indication of regularly recurring auditing work.<sup>479</sup>

<sup>479</sup> Material in this table was taken from the records of The Survey of American Listed Corporations, a Works Progress Administration project sponsored by the Securities and Exchange Commission. The limitations of the table are expressed in the following paragraphs from Report No. 1 of the survey:

"The study as now constituted, therefore, includes about 2,100 companies which is about 79% of the 2,651 companies fully or provisionally registered or exempt from registration under the Securities Exchange Act of 1934 at June 30, 1938. The total number of companies with securities admitted to listed and unlisted trading on national securities exchanges at June 30, 1938 was 3,356, of which total the present study covers about 63%.

"Registration is not required of companies with securities admitted to unlisted trading privileges or of companies with securities traded on exempt exchanges, and these were not included in the study. Other types of enterprises with securities traded on stock exchanges but which were not covered are: Railroads and other carriers reporting to the Interstate Commerce Commission; communication companies reporting to the Federal Communications Commission; insurance companies; banks and trust companies; bank holding companies; bondholders' protective committees; and foreign issuers other than Canadian and Cuban."

Statements Filed for the Fiscal Year 1937  
Under the Securities Exchange Act of 1934

<u>Accountants certifying</u>	<u>Number of statements</u>	<u>Percent of total</u>	
		<u>Firms</u>	<u>Statements</u>
Price, Waterhouse & Co.	238	. 25—	11. 91
Ernst & Ernst	204	. 25—	10. 21
2 firms	442	. 49—	22. 12
Lybrand, Ross Bros. & Montgomery	162	. 25—	8. 11
Haskins & Sells	157	. 25—	7. 86
Arthur Andersen & Co.	127	. 25—	6. 36
Peat, Marwick, Mitchell & Co.	103	. 25—	5. 15
Arthur Young & Company	67	. 25—	3. 35
7 firms	1, 058	1. 72	52. 95
S. D. Leidesdorf & Co.	39	. 25—	1. 96
Touche, Niven & Co.	36	. 25—	1. 80
Barrow, Wade, Guthrie & Co.	35	. 25—	1. 75
10 firms	1, 168	2. 46—	58. 46
5 firms, 13, 15, 18, 21, 29 respectively	96	1. 23—	4. 80
10 firms, 10-13 each	116	2. 46—	5. 81
25 firms	1, 380	6. 14	69. 07
18 firms, 5-9 each	122	4. 42	6. 11
12 firms, 4 each	48	2. 95	2. 40
55 firms	1, 550	13. 51	77. 58
19 firms, 3 each	57	4. 67	2. 85
58 firms, 2 each	116	14. 25	5. 81
132 firms	1, 723	32. 43	86. 24
275 firms, 1 each	275	67. 57	13. 76
<u>407 firms</u>	<u>1, 998</u>	<u>100. 00</u>	<u>100. 00</u>

It is interesting to note that there is only one difference in the names of the first 10 accountants in the two tables set forth above: Ernst & Ernst, with the second largest number of annual reports, does not appear in the first 10 accountants employed by registrants of new security offerings during the period shown, whereas Allen R. Smart & Co., with the tenth largest number of registrants of new security offerings, does not come in the first 10 for annual reports.<sup>480</sup>

<sup>480</sup> Ernst & Ernst certified registration statements for 4 registrants in the period covered, while Allen R. Smart & Co. certified 6 annual reports for 1937.

Price, Waterhouse & Co. occupies a closely contested first place in both lists.

A less tangible way of appraising the position of Price, Waterhouse & Co. in the accounting world, but basically more important than mere size of staff or volume of business to a professional organization, is the reputation it enjoys. The importance of this factor alone is significant in the history of this case. It is well expressed in Julian F. Thompson's report on Girard & Co., Inc., which he submitted to Horace B. Merwin of The Bridgeport Trust Company in the spring of 1925. Thompson in speaking of Coster's management policies said, "When he decided to have an audit, he inquired as to who the finest in the country were and finally chose Price, Waterhouse & Company. \* \* \*"<sup>481</sup> Anthony Jaureguy (now partner of Price, Waterhouse & Co.) agreed that the first audit report by his firm referred to here was the start of Girard & Co., Inc. on the Price, Waterhouse & Co. name.<sup>482</sup> That Coster secured the audit report for credit purposes is evident from the fact that the report was submitted to The Bridgeport Trust Company when a loan of \$80,000 was secured in May 1925.<sup>483</sup> At the same time three officers of that bank bought stock in the Company, while two of them later became and continued to be directors in Coster's Companies.

That this reliance on the Price, Waterhouse & Co. name was generally recognized practice in financial circles is well demonstrated by the colorful language in which it is expressed by other directors of McKesson & Robbins, Incorporated. Henry D. Faxon, for example, when asked what he considered to be the purpose of having an audit, answered:

"You know I never considered that. I just took it that when you put Price, Waterhouse on the bottom of the statement, it was Sterling Silver, and every thing went."<sup>484</sup>

Other directors<sup>485</sup> referred to the auditors as "the Blue Ribbon firm

<sup>481</sup> R. 2243, 2252; Ex. 177. It should be noted that this report was written before Thompson became connected with Coster's Company. The engagement to which we refer is the first audit of Girard & Co., Inc. by Price, Waterhouse & Co. which covered the audit of the last 9 months of 1924 and a report to include a summary of sales contracts entered into in 1924 but applicable to 1925.

<sup>482</sup> R. 55; pages 24-25 *supra*.

<sup>483</sup> R. 2241-2242; footnote 35 *supra*.

<sup>484</sup> R. 2529.

<sup>485</sup> The following testimony of Rowley W. Phillips illustrates the unquestioned public reliance on the mere fact that statements have been audited:

"\* \* \* In 99 cases out of 100, I never see the certificate of it. I look in Moody's Manual. I am not the investment banker of more than a very few corporations. If you, as an individual, asked me to tell you the condition, say of du Pont and asked me for my advice as to whether it is a good stock for you to buy or sell, I would look in, say, Moody's Manual; that is the first thing I will do. We will look together to see who audited it. There is no qualifying statement of any nature, it gives those figures. The balance sheet and earning statement, I assume, and I have assumed, and will continue to assume that those are all right because there is no possible way that I can check up on the thing. I have no intention of making a personal investigation of du Pont, nor can I very well ask you to wait for a couple of weeks while I send for a statement and see whether the audit was complete or merely a verification of columns of figures, or what it was." R. 2354-2355

of America", "they were tops", "one of the outstanding firms in America; if not the most outstanding firm",<sup>486</sup> and Wilbur L. Cummings, a partner in one of New York City's leading law firms specializing in corporation law, in his testimony as a director of McKesson summed up his opinion of the auditors in two sentences:

"I have had implicit faith in Price, Waterhouse, and I still have. Absolutely nothing that has occurred here changes my faith in Price, Waterhouse."<sup>487</sup>

The firm of Price, Waterhouse & Co. has not been insensitive to the prominent place it holds in the ranks of the profession. The influence of members of the firm and staff on accounting thought in the last 25 years has been outstanding. Perhaps no one has been more prominent in this regard than the senior partner, George O. May, whose extensive writings were collected by his associates a few years ago and published under the title, "Twenty-Five Years of Accounting Responsibility."<sup>488</sup> May's influence has been felt also in his capacity as lecturer in accounting on the A. Lowes Dickinson Foundation<sup>489</sup> at the Harvard Graduate School of Business Administration and in his participation in the affairs of the American Institute of Accountants and of the New York Stock Exchange over a long period.

Members of the firm have taken part in the preparation of the widely accepted and authoritative series of bulletins, which was initiated in 1917 by the publication under the auspices of the Federal Reserve Board of the pamphlet, entitled, "Approved Methods for the Preparation of Balance Sheet Statements." This pamphlet was revised by the American Institute of Accountants and reissued in 1929 by the Federal Reserve Board under the title, "Verification of Financial Statements", and was addressed to bankers, merchants, manufacturers, auditors, and accountants. The most recent revision of this document was prepared by a committee, of which P. F. Brundage, of Price, Waterhouse & Co., was a member, and was published by the American Institute of Accountants in January 1936 under the name, "Examination of Financial Statements by Independent Public Accountants."<sup>490</sup> As we shall show later, this Bulletin has been considered to be an authoritative statement of present day auditing procedures.

Members of the staff, also, have written widely accepted books dealing with auditing practice and procedure. F. W. Thornton, for many years on the staff of Price, Waterhouse & Co., wrote by request of the publishers, American Institute Publishing Co., Inc., "Financial

<sup>486</sup> R. 2210, 2403. See also R. 4269-4270.

<sup>487</sup> R. 2450.

<sup>488</sup> May, George Oliver, *Twenty-five Years of Accounting Responsibility—1911-1936*; American Institute Publishing Co., Inc. New York, 1936.

<sup>489</sup> Named after Sir A. Lowes Dickinson who died February 28, 1935, having been a partner in the English firm of Price, Waterhouse & Co. from 1913 until he retired in 1932 and previously senior partner in the New York office from 1901 to 1913.

<sup>490</sup> Ex. 117; R. 1766-1767.

Examinations", as an interpretation of the bulletin "Verification of Financial Statements." He also wrote, "Duties of a Senior Accountant." "Duties of the Junior Accountant" was written originally by Thornton and W. B. Reynolds, also with Price, Waterhouse & Co., and was revised by A. B. Cipriani, with the Price, Waterhouse & Co. Pittsburgh office.<sup>491</sup> D. L. Trouant, with the firm's Philadelphia office, wrote "Financial Audits",<sup>492</sup> an interpretation of the last of the series of bulletins referred to above. These books and "Audit Working Papers", by J. Hugh Jackson,<sup>493</sup> now of Stanford University, formerly of Harvard University Graduate School of Business, and for a time on the staff of Price, Waterhouse & Co., have made known in a very effective manner what may be assumed to be methods advocated by that firm. Except for the last mentioned book, however, the firm connection of the authors is not given in the books themselves.

The importance of maintaining a high code of ethics within the profession, and more especially in his own firm, could not be told in a more convincing manner than is done by R. O. Berger, a partner in the firm's Chicago office, in a booklet "Organization Ethics and Team Work"<sup>494</sup> written by him for the benefit of the staff and privately published in 1925. While now out of print, it is the first of five items listed in the firm's "Office Manual" as recommended reading,<sup>495</sup> and is available in the firm's library, although in the last few years classroom training has largely replaced this less direct method of instruction for new members of the staff. Berger, at page 5 of his booklet concludes a list of six points to be covered with the following:

" \* \* \* the cultivation and retention of the Goodwill of our clientele is practically the only means we have for development. Advertising is not looked upon with favor in the profession and we must leave the spreading of our name and reputation into new channels, first, to those having had experience with us who were well satisfied and, second, to the cumulative prestige following the successful carrying out of our practice and obligations as a whole and the Goodwill inherent in such prestige."

This leads him to conclude that:

"We have been in business in this country for a number of decades and cherish

<sup>491</sup> R. 1761-1765.

<sup>492</sup> R. 1771.

<sup>493</sup> The first important book on the subject. Published by The American Institute of Accountants Foundation in 1923.

<sup>494</sup> Ex. 168; R. 2030-2031.

<sup>495</sup> The "Office Manual" which was published in 1931 is somewhat out of date, and no doubt would include additional or different references if revised. See footnote 550 *infra*. However, it is interesting to note that in addition to Berger's booklet, four books are recommended as sources from which the principles and standards upheld by the firm may be obtained. These four are:

"The Duties of a Junior Accountant," by W. B. Reynolds and F. W. Thornton; "Verification of Financial Statements" (Federal Reserve Bulletin); "Audit Working Papers," by J. Hugh Jackson; and "Accounting Practice and Procedure," by A. Lowes Dickinson.

W. B. Reynolds, F. W. Thornton, and J. Hugh Jackson were associated with Price, Waterhouse & Co. when their books were written; Sir A. Lowes Dickinson was a partner. See footnote 489 *supra*.

the hope and belief that we shall continue indefinitely to be important factors in the profession and in the financial structure so that our policy should be that once we establish a new connection we should endeavor to make it a permanent one."

The general tenor of the 32 pages of the pamphlet is indicated in the second from the last paragraph, where reference is made to the staff's responsibility to the firm and the firm's responsibility directly, as well as indirectly through the professional societies, to the client and the public.

"But greater than the responsibility to any such institutions or individuals is the moral responsibility that every one should do his full share according to the best of his ability and knowledge of the requirements in placing the profession on a higher footing so that it may in fact as well as in theory be entitled to the fullest respect from the financial and business public. Likewise, it is the duty of each of us to seize any opportunities to correct unfavorable impressions which may exist in the minds of the public as to the profession or any individual or firm in practice when we know that the charge on which such impression is based is a false one."<sup>496</sup>

In the foregoing paragraphs, we have given some indication of the size, prestige, and attitude of the firm of Price, Waterhouse & Co. in their professional work. In anticipation of a detailed review of their methods of procedure, it seems desirable to consider the composition of the firm's staff and the training methods employed.

For the fiscal year ended June 30, 1938, the staff ranged from a low of 940 members in July 1937 to a peak of 1,666 in January 1938 and back to a low of 926 in June 1938.<sup>497</sup> Minor additions to the staff were made in October and November of 1937, while an increase of approximately 20% was made in December over the November figures, and in January 1938 a 25% increase was made over December's roster. Unimportant losses took place in February; while approximately one-fifth and one-fourth of the declining numbers were dismissed in March and April, respectively; one-tenth in May; and half as many in June to reach the low point for the period. In short, eliminating minor additions and dismissals, the increased staff was carried only from December through March with the bulk of these only in January and February.

On July 1, 1938, the staff, in addition to the 24 partners mentioned above, consisted of 112 contract managers,<sup>498</sup> 227 seniors, 207 first assistants, 173 second assistants, and 176 on the office staff for a total of 895 persons.<sup>499</sup> In expanding this basic staff to meet the demands of the busy season, most of the additions are made in the junior ranks,

<sup>496</sup> Ex. 168; R. 2030-2031.

<sup>497</sup> Ex. 122.

<sup>498</sup> Contract managers correspond to managing accountants or supervisors as the terms are used in other offices. In Price, Waterhouse & Co. the title recognizes the terms of employment whereby the members of this group are given a contract for a definite term and specifying a given number of shares in the bonus fund, whereas the seniors do not have a contract. "Seniors" is a universal term. First assistants and second assistants may be better known as semi-seniors and juniors respectively. R. 22, 30.

<sup>499</sup> R. 30.

although some experienced applicants are employed as seniors.<sup>500</sup> Rating above juniors, however, is attained generally by promotion.

Additions to the staff in the junior ranks in recent years were from two classes. These were college men who wanted to go into accounting work and applicants who had had experience of a clerical or accounting nature. All applicants were interviewed by one man, who is a contract manager, and who estimated their adaptability to the work and gave them a practical examination (no theory questions) to test their capabilities. Three references were required in each case.<sup>501</sup>

Berger said that "After engaging men one of the important responsibilities of the firm and of the profession is to provide adequate facilities for the **training of the staff** in order to equip the members thereof for meeting the demands of accountancy work."<sup>502</sup> Price, Waterhouse & Co. attempted to meet their responsibility in this regard by means of classes during the fall months and by encouraging the staff to keep abreast of current literature in the field and to attend meetings of the professional societies. In the practical application of accounting knowledge, supervision while on the engagement was considered perhaps the most essential phase of the training. Berger, for example, after outlining a course for personal advancement, said:

"In the preceding remarks I have dealt with what may be termed the Educational side of the training of the staff, but, important as this may be, substantial development rests more particularly on the practical work on assignments, as after all experience is the best teacher. Therefore, anyone wishing to attain the maximum progress should make the most of his opportunities daily throughout the year while engaged on the work for the firm. He should endeavor to understand fully the objects of the work which he is requested to take up and to avoid carrying out instructions in a purely mechanical way. When in doubt he should ask those in charge, who will gladly extend a helping hand such as they received when they were in a similar position."<sup>503</sup>

Geoffrey G. Rowbotham, the partner in charge of the McKesson audit since 1928, in speaking of the manager in charge under him, said that Thorn received—

"\* \* \* from Jaureguy a very thorough training in a personal way in which it always seems to me an accountant should be trained.

"I am, perhaps, a product of the apprenticeship system myself and am impressed with personal training more than classroom training. That is merely a personal prejudice on my part."<sup>504</sup>

Success in the training program was measured by results obtained in the field. Contract managers and seniors reported currently on the qualifications and personality of the men working under them. These reports were analyzed to form the basis for a periodical review of the

<sup>500</sup> R. 31.

<sup>501</sup> R. 19-20; Ex. 212.

<sup>502</sup> Ex. 168 (pp. 7-8).

<sup>503</sup> *Idem* (p. 10).

<sup>504</sup> R. 2053.

status and salary of each member of the organization.<sup>505</sup> To reach the status of contract manager, substantial experience with the firm was required.<sup>506</sup>

Of the 112 contract managers as of July 1, 1938, 66 entered the group since 1930 and 46 prior to that date. Their average age in February 1939 was 41.6 years, and average period of service with Price, Waterhouse & Co. was 16.1 years. Their average service when first awarded a contract was 8.4 years. The 66 managers appointed since 1930 remain from a group of 71 (five resigned) who were offered contracts after an average of 9.4 years of service at an average age of 33.8 years. Of this group, only four were under 30, while 17 were over 35.

The average compensation, including overtime and bonus in the several ranks for the year ended June 30, 1938 was as follows:<sup>507</sup>

Contract managers.....	\$10, 106. 00
Seniors.....	3, 924. 00
First assistants.....	2, 493. 00
Second assistants.....	1, 837. 00

Junior assistants and office staff (in general, employees paid less than \$200 per month<sup>508</sup>) are paid overtime

"\* \* \* at the equivalent hourly rate for all overtime worked after 6 P. M., but no overtime is expected to be charged if the time worked does not exceed one hour. \* \* \* In any one month in which available time, holidays or sickness are charged as well as overtime, the latter, if not considerable, should in most cases be offset against the non-chargeable time as shown. Payment for overtime will be made annually at June 30, or at the time of release or resignation.

\* \* \* \* \*

"Supper allowances of \$1.50 per night will be made when overtime is worked, provided it is necessary to return to the office, or when the time so worked exceeds two hours."<sup>509</sup>

Employees at a salary of \$200 per month or more are paid a bonus, which is at least equal to overtime.<sup>510</sup>

## 2. The Origin and Terms of the Engagement

### a. LETTERS OF ENGAGEMENT

#### (1) Girard & Co., Inc.

In the preceding section we have sketched very briefly a picture of the firm of Price, Waterhouse & Co. and indicated that it would appear that they were sought out by Girard & Co., Inc. because of their outstanding position in the profession. In this section it is important

<sup>505</sup> Ex. 168 (pp. 6-7).

<sup>506</sup> R. 2054-2055.

<sup>507</sup> R. 31-32.

<sup>508</sup> R. 29.

<sup>509</sup> Ex. 121 (pp. 2-3).

<sup>510</sup> R. 29.

that we show the manner in which F. D. Coster's new enterprise was accepted as a client by the firm of Price, Waterhouse & Co. and the development of the contract or understanding between the parties as expressed in annual exchanges of letters preceding each engagement.

Geoffrey G. Rowbotham testified that an official of First National Pictures met their W. B. Reynolds one day and said an acquaintance of his, named Coster, in Mount Vernon, wanted some accounting work done and that he, Harwood, had given Coster the name of Price, Waterhouse & Co. and Harwood thought the firm might hear from him in a few days. This single personal contact seems to have been the only information obtained by Price, Waterhouse & Co. about the prospective client except what came to them in the correspondence with the client which we will review. Entire reliance for information about the client was placed upon an examination of the books after taking the engagement.<sup>511</sup> Whether independent inquiry in other quarters would have cast any doubts on Coster's reputation seems impossible to say at this late date.<sup>512</sup> In any event the negotiations proceeded as we will recite and the audit was carried out apparently without any suspicions arising as to the reliability of the client.

The outstanding features of the negotiations for the first engagement was a conflict between Coster's insistence for service from a large accounting firm in the midst of a busy season and that firm's attempt to postpone the work until a more convenient time. Correspondence in respect to the engagement opened with a letter from

<sup>511</sup> R. 35-37, especially the following passage:

"Q. [By Mr. GALPEER.] What examination did you make of Mr. Coster, or what examination did you make of this account to determine whether you would take it and sign your name to it on its certification?

A. [By ROWBOTHAM.] The only examination we make is the actual examination of the company's accounts themselves. I mean, we don't make a preliminary examination of a president of a company in order to see whether he is a desirable man.

Q. You don't make any examination of your clients at all to determine whether they are desirable so that you would handle their account?

A. That is not quite so. Most of them, of course, we have known for years, 30 years' time, but if a man comes in who is president of an apparently reputable company, and we go in and look at his accounts and he seems to be a reputable man, we don't have anything, I don't know how to describe it, any detective service. We don't have any.

Q. You don't make any independent check?

A. We don't make any independent check. Usually he comes to us with some kind of a recommendation.

Mr. STEWART: As in this case, Mr. Coster came to you from Mr. Harwood?

The WITNESS: Yes.

Q. [By Mr. GALPEER.] Would you say that Mr. Harwood recommended Mr. Coster or merely said that he had recommended you to Mr. Coster?

A. I think the facts are that he had recommended us to Coster and I think it was assumed at the time that had he known anything detrimental to Coster he wouldn't have sent him on to us.

Q. But yet in summary, it is not your practice to make any independent check of people or firms whose work you undertake?

A. No, if a man comes in and he is president of the company, we go around to his company. He is president, he has a treasurer, he has a plant, we don't go into his past history.

Q. Did anyone in your firm meet the man who represented himself to be P. Horace Girard, who sent you the first letter?

A. I can't answer that." R. 36-37.

<sup>512</sup> Cf. Ex. 177.

Girard & Co., Inc., dated December 17, 1924, signed by P. Horace Girard, vice-president.<sup>513</sup> This first letter was a two-sentence inquiry as to charges for auditing the books for 1 year and advice on the installation of a new bookkeeping system. It carried no information as to the size of the company except to say that they expected to branch out into a different field and for that reason felt that their present bookkeeping could be greatly improved.<sup>514</sup> As this inquiry came in at the start of the busy season, it was acknowledged by stating that the regular charges would be \$30 per day for a senior accountant, \$20 per day for an assistant, and \$50 per day for such time as might be required of a manager. The letter closed by stating that the firm was extremely busy and would be glad to have as much notice as possible if the work was to be entrusted to them.<sup>515</sup>

This exchange of letters was followed by one from the prospective client, this time signed by F. D. Coster, President, and dated December 26, 1924, in which the writer said that they were in no particular hurry—sometime in January would do very well if the auditors would not be so busy at that time. The letter asked how much notice would be required but this point was avoided in the acknowledgment on December 30, wherein the responsibility for further negotiations was placed on Coster.

Two weeks later, Coster wrote again to the attention of Reynolds, with whom he had had some conversations over the telephone. This letter gives a brief description of the business and plans for the future. The last paragraph is so full of significance in giving Coster's conception of the functions of auditors in checking employees as distinguished from officers that we quote it in full:

"Our book entries up to December 31st while running into fairly large figures are comparatively few on account of the character of our business, and as there is no particular investigation that we have in mind to be pursued for the reason that stocks and merchandise, cash, etc. have been under the constant scrutiny of one of our officers; the work to be done in that respect, is comparatively light as our trial balances agree to date; but what we are extremely anxious to have accomplished at the earliest possible date, is to plan and install the most economical and efficient system that you can plan for us in our new operations and thereafter arrange with you to check up on the system on a monthly or quarterly basis, whichever you prefer, in other words, make some arrangement whereby we can rest assured that we have someone in our confidence who can check up and control the operations of our employees so that the officers who have been devoting part

<sup>513</sup> P. Horace Girard seems to be another alias of Philip Musica—Frank D. Coster. Footnote 27 *supra*. The examiner asked Jauregui if he had ever met the man. The reply was that he had never met Girard, who had died before he came on the audit for the first time soon after November 30, 1926. His recollection was that he was told that Girard's widow lived in the country near Bridgeport. He had never heard of any family relationship existing between Girard and Coster. R. 46, 66-67. In the early part of 1925 P. Horace Girard was represented to Thompson (subsequently treasurer of McKesson & Robbins) as being in charge of production. Ex. 177.

<sup>514</sup> Ex. 116.

<sup>515</sup> Ex. 116. Letter dated December 18, 1924.

of their time in the keeping of our records, will be able to devote their entire time to more important matters.”<sup>516</sup>

Girard & Co., Inc., soon became impatient for action as the next letter, signed P. Horace Girard, was dated January 19, 1925 and pleaded for at least one man to get them started as they had made no entries since January 1, which was rather “confusing” to them. Receiving no answer, Coster wrote 1 week later, asking for immediate attention to the system installation. This letter also was not answered. On February 3, Coster wrote again, asking for at least “one or two ordinary checkers” to get the audit out of the way if it was impossible to send one of “your best experts to plan our new books.” Letters of February 6 and 11 followed which referred to ineffectual efforts to reach Reynolds by telephone, the last letter raising a new problem—the necessity of filing a tax report. Finally, this persistence was rewarded by a letter, dated February 13, 1925, saying “This letter will introduce our representative, Mr. C. R. Hartzell, who will proceed with the audit of your company if you will furnish him the necessary facilities.”

The engagement was renewed the following year with much less difficulty than was encountered in getting under way the first year. A conversation confirmed by an exchange of letters dated December 28 and 29, 1925 in which Coster expressed his satisfaction with the report on the previous year’s work and asked that the same procedure be followed again, the details to be discussed with the auditor’s representative on the work, was all that was necessary.

On April 14, 1926, Price, Waterhouse & Co. wrote a letter to Girard & Co., Inc., introducing their representative, J. H. McGlooin, who was to be the senior in charge of a first quarterly audit for 1926 under D. F. Morland, who had been in charge for the annual audit for 1925, and was now manager. The audit for the second quarter was requested in a letter dated June 25, 1926 in which Coster stated that he preferred “\* \* \* if possible, someone that has had previous experience on our accounts \* \* \*” In accordance with this request McGlooin returned for this and the audit for the third quarter of 1926.<sup>517</sup>

(2) Merger of Girard & Co., Inc. and McKesson & Robbins, Incorporated (New York)

Events moved rapidly during the latter part of 1926 for at the close of October the merger of Girard & Co., Inc. and McKesson & Robbins, Incorporated (New York) to form the new McKesson & Robbins, Incorporated (Connecticut) required extra work by the auditors, who were instructed to do this in a long letter from Coster, addressed to

<sup>516</sup> Ex. 116. Letter dated January 14, 1925. Plans for expansion contemplated transactions ranging from \$10 to \$500 with fifteen hundred to five thousand accounts. The system to be installed was to provide for control over district managers, receipts of merchandise, conversions of manufactured products, and aid in reducing cost of production and overhead.

<sup>517</sup> Ex. 116.

the attention of Morland. This letter covered the final closing of Girard's books and an audit of McKesson & Robbins, Incorporated (New York) since the date of the last audit which had been done by Price, Waterhouse & Co. as of December 31, 1925.

The letter instructs Price, Waterhouse & Co. to coordinate the accounting departments of the two companies at Bridgeport and to make the audit, even though other auditors had done certain work for the bankers in connection with the financing. The audit instructions are very briefly summarized in this paragraph from the letter:

"4. The books and records of McKesson & Robbins of New York have been very thoroughly investigated by Messrs. R. G. Rankin & Co., who have acted for the bankers, who are effecting the financing of the transaction. In the course of said investigation, we have had members of our staff co-operate with Messrs. R. G. Rankin & Co., and we have satisfied ourselves on the matters of inventories and accounts receivable, both foreign and domestic; therefore, it will be unnecessary to take up any physical inventories or verification of accounts receivable, and your investigation may be confined to the usual verification of these assets, and you may proceed in the same manner that you have done for Girard & Co., Inc."<sup>518</sup>

On effecting the merger, resignations were accepted from certain employees of McKesson & Robbins, Incorporated (New York) and J. H. McGloon of Price, Waterhouse & Co., in a letter dated November 10, 1926, was instructed to take charge of all books of account and complete records of the Company at 1:00 o'clock, p. m. of that day " \* \* \* and assume full supervision and direction of all accounting or record keeping of any nature and description."<sup>519</sup> The work apparently kept McGloon busy until August of the following year. Under this arrangement McGloon's salary was billed to McKesson monthly but Price, Waterhouse & Co. had no other connection with the work.<sup>520</sup>

(3) McKesson & Robbins, Incorporated (Connecticut)

Instructions for the 1927 audit were issued by Coster under date of November 28, 1927. The auditors were requested to pursue the same procedure as in the past, to supply 10 signed copies of the report, 10 copies of signed certified balance sheets, and under separate cover for his personal information certain schedules of expenses in connection with the merger and moving and so forth. The letter requested that the report be ready as soon after January 10 as possible as plans were under consideration for the absorption of other companies about the middle of January. A perfunctory acknowledgment to the effect that these instructions would receive attention in due course completed the formal arrangements. It may be noted that the resulting report is dated January 31, 1928.<sup>521</sup>

<sup>518</sup> Ex. 116. Letter of October 30, 1926.

<sup>519</sup> Ex. 116.

<sup>520</sup> R. 60-65.

<sup>521</sup> Ex. 146.

## (4) McKesson &amp; Robbins, Incorporated (Maryland) and Subsidiaries

The year 1928 saw the formation of McKesson & Robbins, Incorporated (Maryland) and opened with a request dated April 14, 1928 for balance sheet audits, similar to those conducted for McKesson & Robbins, of drug houses at 17 locations. These audits were to include the years 1925, 1926, and 1927 and the first 4 months of 1928 and special reports as required by the bankers in connection with their acquisition. Fixed assets were to be appraised by the American Appraisal Company and inventories were to be taken under the supervision of R. G. Rankin & Co. with responsibility for proper pricing on Price, Waterhouse & Co., but for quantities and quality on Rankin. Coster requested of Morland, manager in charge, that Jaureguy, Harvey, and McGloon be assigned to the work with a special request that McGloon be intrusted with the investigation of receivables of the retail druggists as he had done an especially good job during the preceding year in connection with the accounts of McKesson & Robbins, Incorporated (New York).<sup>522</sup>

This letter was acknowledged by Geoffrey G. Rowbotham, a partner of the firm, who about this time had made a specialty of re-financing work. This special work on McKesson was assigned to him and led to his permanent assignment on all of their work. The acknowledgment was longer than those of other years which we have noted in that it recognized the various points made in Coster's letter and in addition suggested that the management of the various companies to be examined be instructed to prepare aging schedules of accounts, notes, and acceptances receivable in accordance with a classification indicated. This suggestion was accepted by Coster in an acknowledgment which contained instructions to be prepared to make a similar audit of a number of additional companies on the same basis. This letter also asked Price, Waterhouse & Co. to disregard the work that R. G. Rankin & Co. and McKesson's own staff would do on inventories and to get the customary certificates from the managements of the several wholesale houses covering the correctness of their inventories. Beyond this no specific instructions were given to Price, Waterhouse & Co. on this subject.<sup>523</sup> Concurrent with these audits of wholesale houses destined to become parts of the McKesson organization, Price, Waterhouse & Co. also made an examination of the Connecticut Company which " \* \* \* consisted principally of a verification of the assets and liabilities of the company as at April 30, 1928 and of a general review of the profit and loss account for the four months ending April 30, 1928. \* \* \*"<sup>523a</sup>

<sup>522</sup> Ex. 116.<sup>523</sup> Ex. 116. Letter of April 27, 1928.<sup>523a</sup> Ex. 147.

In May 1928, J. H. McGloon resigned from Price, Waterhouse & Co. to become comptroller of McKesson. Instructions for the regular annual audit for 1928 were sent to Price, Waterhouse & Co. over McGloon's signature as comptroller. The examination for this year was to be along the lines of a balance sheet audit with the following reports:

- "(1) Report and accounts for each Company.
- (2) Certified balance sheet and profit and loss for each Company.
- (3) Consolidated certified balance sheet and profit and loss statement.
- (4) Consolidated Federal Income Tax Return."<sup>524</sup>

The letter listed 16 subsidiaries of the Maryland Company and a supplementary letter listed McKesson & Robbins, Incorporated, of Connecticut, and McKesson & Robbins, Limited, of Canada. Neither letter nor Rowbotham's acceptance of the work for Price, Waterhouse & Co. mentioned any details of the auditing work other than the general requirements above.

McGloon's letter of the following year was in much the same form but reduced the requirements to "a. Reports and Accounts; b. Certified Balance Sheet" with instructions "\* \* \* that the Balance Sheet and the Profit and Loss Statement be prepared in accordance with our usual forms, copies of which will be mailed to you within the next few days."<sup>525</sup>

The Price, Waterhouse & Co. acceptance this year dated December 19, 1929 (the file copy is initialed by Rowbotham and Jaureguy) closed with a paragraph explaining that the examination would be along the lines of a balance sheet audit and would not include a detailed check of all transactions for the year.<sup>526</sup> The engagement for the following year consisted of a written acceptance of oral instructions, the acceptance opening with a new wording of the preceding year's description of the scope of the work stating that the detailed checking would not be "\* \* \* such as might disclose a misappropriation of funds or manipulation of the accounts."<sup>527</sup> For 1931 the letter of acceptance followed a conversation covering the work to be done and was couched in language similar to the preceding year with the addition of two

<sup>524</sup> Ex. 116. Letter of November 3, 1928.

<sup>525</sup> Ex. 116. Letter dated December 14, 1929.

<sup>526</sup> "In accordance with your instructions our examinations will be made along the lines of balance sheet audits and, in that connection, you will of course understand that we will not attempt to check all the cash and other detailed transactions during the year under review but that our work will be restricted principally to the verification of the assets and liabilities as at December 31, 1929 and to incidental tests. As requested, we will prepare reports and accounts and certified accounts and will submit either two or three copies of each to Mr. Coster and one copy to the presidents of the respective subsidiary companies." Ex. 116. Letter dated December 19, 1929.

<sup>527</sup> "We thank you for your oral instructions to audit the books and accounts of McKesson & Robbins, Incorporated (Maryland) and subsidiary companies for the year ending December 31, 1930. We confirm our understanding that our audits are to be conducted, as heretofore, along the lines of our usual balance sheet or financial audit which would consist of a verification of the assets and liabilities as at December 31, 1930 and a general review of the profit and loss accounts for the year ending on that date, but would not include a detailed check of the cash and other bookkeeping transactions such as might disclose a misappropriation of funds or manipulation of the accounts." Ex. 116. Letter dated September 9, 1930.

significant sentences. This is the first year that the letter accepting the engagement stated that "As requested, our audits will not include an examination of bank deposit slips or any circularization of receivables." It also stated that separate certified accounts would not be furnished for "\* \* \* the very small subsidiary companies which maintain an inadequate system of internal accounting check \* \* \*." 528

The next year similar references to deposit slips and circularization of receivables were retained in the letter. No mention was made, however, as to supplying certified accounts on the subsidiaries. In compliance with an oral request two copies of the Price, Waterhouse & Co.'s mimeographed memorandum of instructions prepared for the guidance of their representatives in connection with the examination of the McKesson subsidiaries<sup>529</sup> were enclosed with the letter.

Subsequent letters accepting the work through the 1937 audit were substantially the same, varying slightly in the description of the engagement.<sup>530</sup> The statement respecting examination of bank deposit slips and the circularization of receivables referred to above was retained. From 1934 on the circularization of payables was also included in the statement of work not to be done. The letter of December 5, 1934 closed with the reminder that the regulations of the Securities and Exchange Commission must be observed by the Company in preparing the accounts.<sup>531</sup> The former policy of furnishing separate certified reports on the subsidiaries was changed to one of supplying unsigned statements with a covering letter including comments on the audits and calling attention to deficiencies in internal check and control. The policy of supplying copies of the instructions was continued and was accompanied by conferences between Ralph E. Thorn, manager in charge of the work for Price, Waterhouse & Co. and McGloon, McKesson's comptroller, in order to coordinate the Company's closing instructions to the divisions and the Price, Waterhouse & Co. instructions to their representatives.

<sup>528</sup> Ex. 116. Letter dated October 14, 1931.

<sup>529</sup> The character of these instructions are explained at pages 165-166 *infra*.

<sup>530</sup> E. g. "In accordance with your instructions, our work will be conducted, as heretofore, along the lines of a financial or balance sheet examination consisting of an examination of the balance sheets of McKesson & Robbins, Incorporated and its subsidiary companies as at December 31, 1937 and a general review of the profit and loss accounts for the year ending on that date, but will not include a detailed check of the cash and other bookkeeping transactions such as might disclose a misappropriation of funds or manipulation of the accounts, should any exist. It is our understanding that the examination will not include an inspection of bank deposit slips or any circularization of debtors or creditors in verification of receivables and payables." Ex. 116. Letter dated December 17, 1937. See also Ex. 100.

<sup>531</sup> "As you know, the accounts of your company as at December 31, 1934 will have to be presented in accordance with the accounting regulations of the new Securities and Exchange Commission. These regulations have not yet been issued, but we do not anticipate that they will require any substantial changes in the scope of the examinations of your companies. It is, however, we think, fairly certain that the responsibilities which the Act and Regulations will place on directors and officers will be considerable and we believe that it would be inadvisable for you to issue your accounts without thorough consideration on your part and, possibly, after consultation with your counsel. It seems to us, therefore, that it will not be feasible to issue your accounts so promptly as you have done in past years and we suggest this to your consideration." Ex. 116.