

F. D. Coster, J. H. McGloon, Geo. E. Dietrich, E. A. Johnson and,
as to quantities only, by Robert J. Dietrich.⁹⁸⁷

⁹⁸⁷ R. 795-796; Ex. 62:

"McKESSON & ROBBINS
Incorporated

Bridgeport, Conn., U. S. A.

CONNECTICUT DIVISION

MEMORANDUM TO PRICE, WATERHOUSE & CO., REGARDING INVENTORIES
AS AT DECEMBER 31, 1937

SUMMARY OF INVENTORIES
(Including Kobe, Japan—\$3,286.49)

Drums and containers	\$ 654.50
Raw materials	9,744,659.71
Finishing supplies	198,076.00
Merchandise in process	8,157.88
Finished stock	712,145.44
Miscellaneous	27,721.08
	<hr/>
	\$10,689,414.56
Less: General inventory reserve	91,500.00
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	<u>\$10,597,914.56</u>

1. QUANTITIES:

All quantities were ascertained by actual count, weight or measurement by an inventory crew of competent employees, and such quantities were independently checked throughout by a second inventory crew.

Certain sections of the inventory were taken from December 20, 1937 to December 31, 1937 and were adjusted to December 31, 1937 by giving effect to all changes between the time of stock taking and December 31, 1937, as shown by the sales, receiving and consignment records, etc.

All inventories stored in outside warehouses at December 31, 1937 were confirmed by certificates received direct from the custodians thereof.

All stocks of any substantial value belonging to the company were included in the inventories, including stocks on consignment with customers, agents, etc.

2. OWNERSHIP:

The foregoing inventories were the unpledged and unencumbered property of the branch and did not include:

Stocks on consignment from others or stored for others

Unshipped stocks billed to customers at or prior to the above date

Advance payments on account of purchase contracts for future delivery

The stocks on hand that were covered by postdated sales invoices were included in the inventories and excluded from sales.

3. VALUATION:

Each item in the inventories was priced at the lower of cost or market, explained as follows:

Cost is understood to exclude trade or quantity discounts and administrative, selling or financial expenses

Market is understood to mean either replacement cost or realizable value, but in no event, in excess of realizable value

Obsolete, defective, unsalable or slow moving items and items the manufacture of which has been discontinued, were not priced in excess of realizable values

The inventory was carefully compiled and checked in accordance with the procedure outlined in the company's closing instructions.

The inventories were valued on the same basis as the inventories as at December 31, 1936.

4. OTHER MATTERS:

The inventories included all substantial incoming shipments in transit at December 31, 1937 which were ordered F. O. B. shipping point.

Liabilities for all items included in the inventories were recorded in the general books of accounts as at or prior to December 31, 1937

The inventories did not include equipment, miscellaneous investments or other assets that were charged on the general books to other than inventory accounts as at or prior to December 31, 1937

The memoranda covering the work on the Canadian Company for 1931 and 1934 stated unequivocally that the Company's inventory was in Bridgeport but beginning in 1935 the memoranda stated positively that the goods were held by the Canadian suppliers.⁹⁸⁸ Although Ritts prepared both memoranda for 1935, that on the Connecticut Division does not mention the fact that inventories of foreign crude drugs at the end of that year were in Canada.⁹⁸⁹ The section on inventories was similar in form to that of 1933 and 1934 memoranda which do not state the location of the merchandise though Ritts testified that in those years they were held at the plant at Bridgeport.⁹⁹⁰ In 1936, however, Ritts adopted in the Connecticut Division memorandum the form he had used in the Canadian Company memorandum of 1935 and said that the goods were held by the various suppliers and although the confirmation did not state the location of the stocks, company officials assured him that the merchandise was shipped promptly from the vendors' warehouses upon advices submitted to them from the Bridgeport office. A similar comment was made at the close of the 1937 audit.⁹⁹¹

This situation raised some question in Ritts' mind as to whether the suppliers might not be dealing in futures. On the 1935 audit he questioned George Dietrich as to this matter. His approach was to ask for financial statements of the suppliers so that he could see if they were responsible people. Dietrich pointed out to him that he had evidence of shipment by the suppliers which Ritts agreed was proof that the goods were on hand. In this connection, also, Ritts inquired about the expenses of carrying the goods in Canada, warehousing charges, taxes, insurance, and so forth, which he was told were borne by the suppliers. The explanations he received satisfied

The branch's purchase commitments at December 31, 1937 were neither for quantities in excess of normal requirements nor at prices in excess of present current market prices.

Furthermore, at the time of signing this memorandum we have no knowledge of any other information relating to the inventories which would have a substantial effect on the branch's accounts that is not referred to herein or that was not fully disclosed in the general books of account of the branch as at or before December 21, 1937.

(s) F. D. COSTER

President

(s) J. H. MCGLOON

Comptroller

(s) GEO. E. DIETRICH

Assistant Treasurer

(s) E. A. JOHNSON

Office Manager

As to quantities: (s) ROBERT J. DIETRICH.

Date: February 23, 1938.

(s) A. B. RITTS,

Representative of Price, Waterhouse & Co."

⁹⁸⁸ Quoted at page 256 *supra*.

⁹⁸⁹ Ex. 73, 79. Cf. also footnote 991a *infra*.

⁹⁹⁰ R. 639, 4475; Ex. 80, 268, 57, 58, 59, 60.

⁹⁹¹ Ex. 49, 78; R. 593.

him for he referred to his discussion with Dietrich as a casual inquiry which he had no recollection of reporting to Thorn.^{991a} Thorn, however, testified that he probably had a telephone call from Ritts on the subject of futures and financial responsibility of the suppliers during which he pointed out that these drugs were sold in "bunches" and it was entirely unlikely that the suppliers could fill orders on short notice if they were short of the commodities since most of them came from long distances. Apparently Ritts also had considered the difficulty of filling orders on demand if the suppliers did not have the merchandise. In any event Thorn thought that Ritts undoubtedly agreed with him after that discussion and dropped the matter.⁹⁹² The fact remains, however, that Ritts agreed that he never knew the exact address of the vendors' warehouses, which he understood were in Canada, where approximately \$10,000,000 in inventories were supposedly held,⁹⁹³ and never asked for credit reports on the suppliers.

"Mr. STEWART. If you had thought it necessary to get any further credit reports on those companies, how would you have gone about it, Mr. Ritts?

The WITNESS. I presume I would have followed the same procedure we did with respect to W. W. Smith & Co. to obtain a credit report from Dun & Bradstreet had we thought it necessary.

^{991a} "A. [By RITTS.] I recall discussing the question of warehousing charges, insurance and other expenses in connection with these stocks stored in Canada.

Q. [By Mr. GALPEER.] But there is no notation in your papers, no physical evidence of anything of that sort?

A. Nothing at all.

Q. On this question of insurance, this conversation where you were told—have you any idea approximately what year that was?

A. No, sir, it may be 1935. I believe it was because I think 1935 was the first time that we found all of these stocks in Canada and in my 1935 working papers I did find a notation on the rough work sheet filed on top of the working papers to the effect that all stocks were stored in Canada, meaning that there is a point I must clear with some one.

Q. Whom did you clear it with?

A. When I say clear with someone I wanted to know more about it.

Q. What more did you find out?

A. Just what I told you, that in discussing the question of warehouse expenses and other expense incidental to the storing of these goods, we were informed that all such expenses were borne by the custodian of the stock.

Q. Did you make any inquiry if they did, do you think?

A. We may have, yes.

Q. Do you know whether in 1936, 1937 or any of the subsequent years you made any inquiry?

A. I don't recall at the moment any specific date. It seems that I questioned George Dietrich at one date with regard to these actual stocks in this respect; I think I asked him whether he had financial reports or a file of these reports of these various suppliers.

Q. And what did he say?

A. His answer as nearly as I can recall it is, 'No, what do you want with them, Mr. Ritts?' I said, 'I just wondered if you had them in the files, I was wondering if these people were really responsible.' He said, 'Well, that is quite evident from the shipments they have made.' I said, 'Yes, but I thought you may have had them in your files.' I said, 'I thought it might be a question of these people dealing in futures.' He said, 'That is quite evident to you, isn't it. that they are not. We are quite satisfied they have these stocks and are shipping them. You have seen evidence in our records to prove that.'

Q. Did you discuss that with Mr. Thorn subsequently?

A. I don't recall. I don't have any recollection of it in my mind.

Q. You just took his answer and were satisfied with it?

A. Yes, it was a casual inquiry with regard to financial statements and his question as to what I wanted with them and why I asked for them." R. 518-520.

⁹⁹² R. 605-606, 1059-1060.

⁹⁹³ R. 597-599.

Mr. STEWART. And of whom would you have asked that?

The WITNESS. Mr. Dietrich." ⁹⁹⁴

As stated above, the auditors understood that since some time in 1935 the stock was supposed to have been in Canada. As of April 3, 1935, the Canadian Company qualified to do business in the State of Connecticut and filed a state tax return for the remainder of 1935. Taxable income allocable to Connecticut was determined on the average of three bases: average monthly fair value of tangible property in Connecticut; total salaries, wages, and other compensations paid in Connecticut; and gross receipts from business operations conducted in Connecticut. This return reported 5% of the first two items in Connecticut and 100% of the third. The return was supported in McKesson's tax files by letters from the five Canadian vendors (which Ritts testified Price, Waterhouse & Co. representatives had never seen) ⁹⁹⁵ in which they stated, under dates varying from the 3rd to the 10th of June 1936, that as of March 31, 1935 and December 31, 1935, the inventories were held by them in various warehouses in Jersey City, Perth Amboy, Hoboken, and in one case just New Jersey without naming a city. Two replies gave the warehouses' names, and three referred to "our warehouse." None of the replies gave a street location for the warehouses. ⁹⁹⁶

Connecticut State tax returns were also filed for the Maryland Company. A copy of the return for the year 1934 when all the foreign crude drugs amounting to over \$6,000,000 were supposed to be at Bridgeport stated that the fair cash value of real estate and tangible personal property in each town in Connecticut during the period was for Bridgeport and Fairfield \$566,343.02 and for New Haven \$123,354.66 and that which was located outside of Connecticut in "Various locations throughout the United States and in foreign countries" amounted to \$10,302,539.09. A schedule in McKesson's tax files indicated that \$8,719,073.28 of this latter total represented average value of inventories. Another schedule showed that this was the average at three dates, January 1, June 30, and December 31, 1934, with the amounts at the first two dates (being prior to the date the Maryland Company took over directly the business of its subsidiary companies) zero. ⁹⁹⁷ Supporting this were two further schedules (again, Ritts testified, not seen by Price, Waterhouse & Co. representatives) ⁹⁹⁸ giving the details of the portion arising from the Con-

⁹⁹⁴ R. 520-522A.

⁹⁹⁵ R. 4474.

⁹⁹⁶ Ex. 234.

⁹⁹⁷ Ex. 235: Inventories as at December 31, 1934, as shown on the schedule for various locations outside Connecticut, were \$26,157,219.83.

⁹⁹⁸ R. 4474.

necticut Division inventories. The first of these dated March 8, 1935 showed the location of all of this Division's inventories at December 31, 1934 to have been as follows:

Connecticut.....	\$ 666, 915. 17
Massachusetts.....	725. 02
New York.....	63, 317. 75
New Jersey.....	3, 191. 39
Pennsylvania.....	10, 036. 19
Missouri.....	364. 99
Montreal—Canada.....	427. 45
In Transit and Afloat.....	293, 418. 81
Kobe.....	853. 04
Miscellaneous—New Jersey ^a	6, 389, 125. 00
Total Connecticut.....	<u>\$7, 428, 374. 81</u>

^a "Miscellaneous" was in type—"New Jersey" was written in. Also written in but below the total was: "Cod Liver Oil Department (Merchandise inside Connecticut), \$26, \$73.86."

The item "Miscellaneous—New Jersey" was in turn supported by the second schedule set forth below which consisted of a list of 50 items of crude drugs and essential oils of the kind carried in connection with the Smith foreign crude drug business in this and later years, signed

by Robert J. Dietrich, stating that the merchandise as listed was held in the firm's New Jersey warehouse at December 31, 1934.⁹⁹⁹

⁹⁹⁹ Ex. 235:

"STATEMENT OF MERCHANDISE DECEMBER 31, 1934 IN WAREHOUSES
LOCATED IN NEW JERSEY"

This is to state that we are holding in our New Jersey Warehouse the following merchandise as of December 31, 1934.

<u>ITEM</u>	<u>PACKING</u>	<u>QUANTITY</u>	<u>EXTENSION</u>
Aloin U. S. P.	140 lbs. to a barrel	147,000 lbs.	\$132,300.00
Amidopyrine	50 lbs. net to a drum	60,500 lbs.	205,700.00
Antipyrine Crystals U. S. P.	100 lbs. net to a case	95,000 lbs.	161,500.00
Balsam of Fir Canada	2-40 lb. cans to a case	160,000 lbs.	115,200.00
Balsam of Peru	2-60 lb. cans to a case	156,000 lbs.	132,600.00
Benzoin Siam Large Tears	25 lbs. to a box	50,000 lbs.	70,000.00
Bismuth Metal	100 lbs. to a case	70,000 lbs.	73,500.00
Bismuth Subcarbonate	25 lbs. to a box	150,000 lbs.	187,500.00
Bismuth Subnitrate	50 lbs. to a box	125,000 lbs.	118,750.00
Gun Camphor, Slabs	100 lbs. to a case	200,000 lbs.	82,000.00
Carmine Powder #40	100 lbs. net to a keg	40,000 lbs.	106,000.00
Castor Fibre Powder	100-1 lb. tins to a case	6,000 lbs.	81,000.00
Coumarin	100 lbs. to a tin	58,000 lbs.	153,120.00
Dragon's Blood Powder Bright	25 lbs to a box	125,000 lbs.	68,750.00
Hexylresorcinol	50 lbs. to a can	10,000 lbs.	140,000.00
Crude Iodine	100 lbs. to a keg	50,000 lbs.	57,500.00
Iodine Resublimed	4-25 lb. jars to a case	50,000 lbs.	80,000.00
Iodoform U. S. P.	4-25 lb. jars to a case	40,000 lbs.	118,000.00
Menthol	60 lbs. to a case	66,000 lbs.	145,860.00
Artificial Ketone Musk	100-1 lb. tins to a case	15,000 lbs.	76,500.00
Musk Pods	20 ozs. net to a cady	11,500 ozs.	138,000.00
Virgin Mercury	Flasks	3,100 flasks	197,625.00
Oil of Cardamon	100-1 lb. bottles to a case	18,000 lbs.	198,000.00
Oil of Cinnamon Ceylon Pure	50-1 lb. bottles to a case	15,000 lbs.	75,000.00
Oil of Coriander Terpeneless	100-1 lb. bottles to a case	30,000 lbs.	210,000.00
Oil of Cumin	100-1 lb. bottles to a case	30,000 lbs.	191,400.00
Oil of Dill Seed	100-1 lb. bottles to a case	70,000 lbs.	210,000.00
Oil of Geranium Rose Algerian	25 lbs. net to a case	25,000 lbs.	122,250.00
Oil of Ginger Terpeneless	100-1 lb. bottles to a case	4,000 lbs.	112,000.00
Oil of Juniper Berries Terpeneless	100-1 lb. bottles to a case	10,500 lbs.	99,750.00
Oil of Lemon Sequiterpeneless	100-1 lb. bottles to a case	20,000 lbs.	160,000.00
Oil of Limes Distilled Terpeneless	10-1 lb. bottles to a case	3,000 lbs.	126,000.00
Oil of Limes Expressed Terpeneless	10-1 lb. bottles to a case	1,200 lbs.	162,000.00
Oil of Lovage	10-1 lb. bottles to a case	3,100 lbs.	139,500.00
Oil of Neroli Artificial	100-1 lb. bottles to a case	28,500 lbs.	213,750.00
Oil of Orange Sweet Terpeneless	10-1 lb. bottles to a case	2,810 lb.	174,220.00
Oil of Patchouli Finest	100-1 lb. bottles to a case	20,000 lbs.	58,000.00
Oil of Pepper Black	100-1 lb. bottles to a case	20,000 lbs.	132,000.00
Oil of Peppermint Natural	100-1 lb. bottles to a case	72,000 lbs.	151,200.00
Potassium Iodide	100 lbs. net to a case	60,000 lbs.	63,000.00
Procain	25-1 lb. tins to a case	5,750 lbs.	103,500.00
Pyrogallic Acid Resublimed Crystals	100 lbs. net to a tin	70,000 lbs.	113,400.00
Quindine Alkaloid Crystals	10-100 oz. tins to a case	185,000 ozs.	138,750.00
Quinine Sulphate	10-100 oz. tins to a case	320,000 ozs.	115,200.00
Sacharine Powder U. S. P.	4-25 lb. tins to a case	110,000 lbs.	148,500.00
Salel Powder U. S. P.	200 lbs. to a keg	180,000 lbs.	138,600.00
Santonine Crystals	17 lbs. to a case	5,610 lbs.	112,200.00
Spanish Saffron	50-1 lb. tins to a case	15,000 lbs.	121,500.00
Mexican Vanilla Beans	200 lbs. to a bag	40,000 lbs.	96,000.00
Pure White Vanillin	100 lbs. net to a case	20,000 lbs.	62,000.00
		TOTAL	\$6,389,125.00

(S) ROBERT J. DIETRICH.

R. J. DIETRICH"

Prior to the time these tax returns were introduced, Thorn had testified:

"* * * if some merchandise was stored in New York and some was stored in Connecticut, that made a difference in their Connecticut State tax return and their New York State tax return which had given us some interest in where these goods were located * * *." 1000

and Ritts had testified:

"Q. [By Mr. GALPEER.] Now, Mr. Ritts, just to illustrate what you have in mind, what would you do in reference to, let us say, the various state taxes that might have to be paid, or reserves set up for? What sort of schedule would you prepare, and what sort of check would you make?

A. Well, the company, in the last number of years, prepared an over-all tax schedule, setting forth the particulars of the various taxes, the nature of the tax, and the period covered, the amount chargeable to the current period, the amount deferred, the amount accrued; and that summary schedule would be supported by schedules—say, as an illustration, Connecticut State income tax: There would be a supporting schedule covering that item, setting forth the computations of the tax itself, based upon the book figures. There would be similar supporting schedules to the various other taxes where it would be necessary.

Q. And you would examine those supporting schedules?

A. Yes sir. I should have mentioned that tax payments, the tax receipts were examined by us for the payments they made.

Q. Did you ever look at the tax returns themselves?

A. Yes, we would look at the tax returns for the preceding period particularly those which were still open * * *." 1001

When these tax returns were introduced the following record was made:

"Q. [By Mr. STEWART.] Mr. Ritts, you have examined the schedules and letters attached to the last two exhibits which have just been introduced; that is, you did examine them just now, since they have been introduced.

A. Yes, I have.

Q. Did you ever see them before?

A. I haven't any recollection of seeing the State returns. If we did, we would have a transcript of it, or summary, which would be in our working papers. I think I stated previously that we did examine tax returns.

Well, I had in mind specifically the United States Federal tax returns which we would examine, and I think I said at the time that the State taxes that we would look into would be set forth on the schedule showing the computation of the tax; so I haven't any recollection of seeing that—I haven't any present recollection of seeing a return, and I know definitely we never saw the supporting papers or letters to the returns.

Q. Did you ever ask any questions of anybody at McKesson & Robbins as to where the merchandise confirmed by the Canadian suppliers was stored?

A. Yes, frequently.

Q. And were you ever told that any of it was stored in New Jersey?

A. No, sir, we were not. * * *"

Ritts concluded by stating that he thought of one exception in 1932 when McKesson "* * * had a certain amount of merchandise

¹⁰⁰⁰ R. 941.

¹⁰⁰¹ R. 4445-4446.

stored in British American Storage Warehouse * * * in Jersey City but that thereafter and through December 31, 1934, the merchandise was located at Bridgeport and from 1935 it was always represented as being in Canada.¹⁰⁰²

The foregoing tax papers should be compared with the inventory situation, as Price, Waterhouse & Co.'s representatives understood it, at December 31, 1934, the last year end that the inventories in question were believed to have been at the Bridgeport plant.¹⁰⁰³ Documentary evidence relied upon for this belief began with the inventory books, in which in book 7 at pages 6, 7, and 8 were listed the items covered by the certificate attached to the 1934 Connecticut tax return set forth in a previous footnote. Each of the three pages expressly stated the location of the inventory to be on the first floor of building No. 2, which is a unit of the plant at Fairfield (Bridgeport).¹⁰⁰⁴

The original materials from which the inventory book was prepared were count sheets of which a set of six copies were made, two retained in the office for checking purposes and four sent to the plant. Of these, three were used for independent counts and the fourth was used as a control sheet by the supervisor.¹⁰⁰⁵ Count sheets for 1934 indicated that this system was applied in counting merchandise actually on hand in the plant at December 31, 1934.¹⁰⁰⁶ Three sheets covering counts of the same stock, each bearing different pairs of names and written in different handwriting, were accompanied by a fourth, the control sheet, which listed the three pairs of names but no figures indicating the count. The names as written by the supervisor, John White, were Hackett, Millar, Perry, Coccozza, Mull, and Takacs, each succeeding pair being a count team. The original sheet in each group was kept by the supervisor and did not show quantities, while the carbons were used by the counters.¹⁰⁰⁷ Each sheet under the caption crude drug inventory carried the location, as: "BLDG #2—1st FLOOR CENTER LEFT," "BUILDING #2—FIRST FLOOR—RIGHT CENTER," "BUILDING #2—1st FLOOR FRONT," "BLDG. #2—1st FLOOR—RIGHT SECTION," "BUILDING #2—FIRST FLOOR—LEFT."¹⁰⁰⁸

Countsheets prepared in the foregoing manner were available except for the foreign crude drug stock. The two sets of count sheets covering these false items which were listed on pages 6, 7, and 8 of book 7 were supposed to have been in Bridgeport at this time showed counts on the original sheets and two carbons of each set with the remaining four carbons of each set blank except for the typed description of items and sizes and top captions common to all in the set. None of

¹⁰⁰² R. 4473-4475. Cf. R. 598-599.

¹⁰⁰³ R. 204, 639.

¹⁰⁰⁴ Ex. 59; footnote 999 *supra*.

¹⁰⁰⁵ Ex. 42, "Notes on Inventory" from Price, Waterhouse & Co. 1934 work papers.

¹⁰⁰⁶ However, an original and six carbons were found in each set of count sheets. Ex. 57, 58, 60.

¹⁰⁰⁷ R. 1495-1497; Ex. 57.

¹⁰⁰⁸ Ex. 57.

these count sheets carried the counters' names or initials nor did the fourth sheet list names of crews. As in the case of the Canadian Company count sheets previously described, the location of the stock appeared in original typewriting on all the carbon sheets and read "BUILDING #2—1st FLOOR" without giving the location on the floor as was done on the sheets for stock actually on hand.¹⁰⁰⁹

Ritts testified that he had never done a complete inventory examination on this engagement and that "* * * It has been my practice to take the man who is going to work on the inventories to the office manager and the various people that you come in contact with and discuss with those people, at that time, the method of taking the inventory, who all was involved in actually counting the stock and particularly the people that supervised this job." He testified that Robert J. Dietrich would have been the supervisor in charge of the inventory in book 7.¹⁰¹⁰ Dietrich's name appeared on the general certificate covering the entire inventory.

The inventory certificate signed by the officers of McKesson & Robbins at the request of Price, Waterhouse & Co. was in the same general form as the one for 1937 reproduced above¹⁰¹¹ and, therefore, was not conclusive support for any statements in respect to location of the stock for it covered without segregation both goods in the plant and in outside warehouses. This earlier certificate carried the same signatures as the later ones except for George Dietrich's name which was added when the change in location of the merchandise was made in 1935.¹⁰¹²

As stated above, Hill, the last junior in charge of inventory work, gained his knowledge of the McKesson inventory procedures from Johnson, Geiger, and Osterhout, all of the accounting office, and there is no testimony that John White, who directed the actual count in 1934 and subsequent years under Robert Dietrich's supervision, was consulted about crude drugs. Referring to the 1934 count when the goods in question were supposed to have been in Bridgeport, White testified that since he supervised the stock taking on the first floor of building number two (his count sheets showed all the goods that in fact were there) and the floor was full with that alone, it appeared impossible to him that approximately 1300 tons of the foreign crude drugs also could have been in the same place.¹⁰¹³ White also testified that original copies of the count sheets supposed to support pages 6, 7, and 8 of book 7, the fictitious merchandise in question, were given to him by Robert Dietrich, who asked him to make up the sheets from the inventory cards kept in Dietrich's office. The number of

¹⁰⁰⁹ Ex. 58.

¹⁰¹⁰ R. 660-662.

¹⁰¹¹ Ex. 62; footnote 987 *supra*.

¹⁰¹² Ex. 63; R. 795, 658-665.

¹⁰¹³ R. 1521; Ex. 108 and testimony quoted at pages 110-111 *supra*.

containers was determined by dividing the quantity on the inventory card by the size of the container as typed on the count sheet.¹⁰¹⁴ This procedure was followed in exactly the same way in prior years.¹⁰¹⁵ White, who was first employed as a shipping clerk by McKesson in December 1926, and hence had worked under Robert Dietrich for almost the entire life of the business since Coster merged Girard & Co., Inc. with it, first learned of the export business about 1928 to 1930 when he happened to notice some orders on Robert Dietrich's desk. He was told that this covered direct shipments of merchandise which did not have to be handled physically by McKesson. Soon after this he was given the job of preparing the inventory count sheets and continued to do so in the manner described.¹⁰¹⁶ He testified " * * * that it has always been driven in to us that all transactions had to conform to the same procedure irrespective of whether it was direct shipping or not."¹⁰¹⁷ White could not recall that he ever had any occasion to tell the accounting department how these count sheets were made up and never told any representative of Price, Waterhouse & Co. because he was never questioned by them as to the methods used in taking inventory.¹⁰¹⁸ He said he never suspected anything wrong in what he was instructed to do or in what he did.¹⁰¹⁹

McGlooin testified that he thought the crude drug inventories in question had been in Bridgeport and that he had seen inventory sheets initialed by White and another shipping clerk, Howard Cone, showing that the merchandise had been counted by the first and recounted by the second and that these sheets indicated that the merchandise was in the Company's Bridgeport warehouse. It was his understanding that the inventories were carried in the warehouse in Bridgeport until 1935, and his department relied on the inventory sheets to that effect.¹⁰²⁰ The inventory sheets to which McGlooin referred were the inventory book sheets for December 31, 1931. The pages, introduced in evidence, are 51 and 52 of book 7, which total \$4,982,898.95 for items similar to those of the 1934 inventory. The sheets are labelled "Warehouse Crude Drugs."¹⁰²¹ White explained the presence of his initials on such sheets by the fact that he and another employee were instructed by Robert Dietrich to initial them before they were sent in to the main office.¹⁰²²

It has been noted earlier that Ritts had never inspected the plant at Bridgeport, but that in leaving the building after closing time he

¹⁰¹⁴ R. 1478-1480, quoted at pages 108-110 *supra*.

¹⁰¹⁵ R. 1501.

¹⁰¹⁶ R. 1500-1501, 1523.

¹⁰¹⁷ R. 1561.

¹⁰¹⁸ R. 1518-1519.

¹⁰¹⁹ R. 1541-1542.

¹⁰²⁰ R. 1677-1682.

¹⁰²¹ Ex. E.

¹⁰²² R. 1512-1514; quoted in part at page 112 *supra*.

and his staff left by the employees' exit which required walking through part of one floor of the plant. Ritts testified that he did not know the identity of this building but that he did see merchandise stored in it, although in the audit work neither he nor his staff would go into the plant for the purpose of identifying or counting any of the merchandise. Since he did not know that the building he had passed through on floor one was building No. 2, the purported location of the foreign crude drug stocks, he could not say whether the stock he saw was that merchandise or whether the approximately 1,300 tons of it could have been stored there.¹⁰²³

The auditors' verification was limited to an inquiry as to the methods employed in taking the physical inventory (the "Notes on Inventory" in the 1934 work papers clearly sets forth the method supposed to have been followed by the company and apparently actually followed for the real goods)¹⁰²⁴ and accounting tests to see that the results corresponded to the book records. Occasionally adjustments in quantities between the physical count and the inventory cards were necessary in some of the stock but no discrepancies of this kind were ever found in the foreign crude drugs, and adjustments to reduce from cost to market were rare on this class of merchandise.¹⁰²⁵ The only occasion Ritts remembered when the latter problem arose was in 1932 when he had some difficulty in convincing the two Dietrichs, Johnson, Geiger, Osterhout, and McGloon that a reserve of \$18,000 to \$20,000 was necessary on two items.¹⁰²⁶

Ritts testified that he was convinced that in this case if he had attempted a physical examination or a test count of inventories he would have been delayed in one way or another until some kind of merchandise could have been produced with the proper labels to represent the crude stocks. Furthermore, he did not consider himself qualified to

¹⁰²³ R. 640, 646-649.

¹⁰²⁴ Ex. 42, M-21.

¹⁰²⁵ Compare testimony of E. A. Johnson, Jr. at R. 1418-1421 and that of Ritts at R. 651-652 and R. 726-729. Ex. 42 (D 35).

¹⁰²⁶ "The inventory of crude stocks are all carried at cost and in the case of two specific items, viz., iodine resublimed and potassium iodide, specific reserves were provided to reduce them to market. These were the only items which appeared to be carried above the market quotations as shown by the Journal of Commerce and the Oil, Paint & Drug Reporter, but it appears from a review of these journals for the periods at which time these stocks were purchased that the prices quoted are invariably above the company's costs and are not entirely satisfactory for our purposes, but they are the only sources available from which published quotations may be obtained. We requested the company to have W. W. Smith & Co. (from whom the bulk of their crude stocks are purchased) furnish us with market quotations at December 31, 1932 of the principal items appearing in the inventory but they (the company) preferred to have the prices confirmed through several outside brokers. The quotations they obtained by letter from these brokers conformed with the prices quoted in the above named journals but we are inclined to be somewhat skeptical of their reliability. We feel that a possible loss, due to a market decline, may have existed in these stocks at December 31, 1932 but we are at a disadvantage in trying to show that any of the prices, apart from the two specific items mentioned above, are wrong, due to the fact that there are several grades of most raw materials and due to the limited trading done in these commodities. It was noted, however, that approximately 50% of the company's December 31, 1932 inventory of crude stocks had been sold prior to the date of completion of our examination at a small margin of profit." Ex. 81 (Ritts' memorandum on the 1932 accounts of the Connecticut Company); R. 520-521. See also footnote 942 *supra*.

identify any of the stock and did not consider it an accountant's duty to employ chemists to make tests.¹⁰²⁷ As an example of the problem on this audit Mr. Stewart asked Ritts:

"Q. Do you think it is a part of the duties of an independent accountant to be able to recognize Aloin when he sees it?

A. I think any accountant that attempts to say he does is only trying to kid the public."¹⁰²⁸

Prior to carrying inventories supposedly at vendors' warehouses, receiving tickets were prepared indicating delivery of the merchandise at the Bridgeport plant by "Our Truck." Afterward the same form was used but with it a rubber stamp stating "Held at Suppliers, No other Charges." The line reading "Received at McK. & R. Receiving Department at" was filled in by crossing out "at" and adding "as Bpt. Plant." The next line "Received by" carried an initial and "at their Warehouse."¹⁰²⁹ Ritts was unable to account for the use of such a ticket after 1934¹⁰³⁰ except to venture an opinion after one was introduced in evidence that it indicated that the goods had been set aside at the suppliers for McKesson. This was a conjectural explanation by Ritts for he said he did not recall that he had ever seen such tickets. These tickets, Ritts thought, would not have been examined by the auditors because the goods were not received at the Company's own plant and the invoices from the suppliers, together with the year-end confirmations from the same source, were ample support for the purchases and remaining balances.¹⁰³¹

Another possible test of the presence of inventories among the real assets of the Company was suggested for Ritts' opinion. The Maryland Company carried two blanket insurance policies, one for \$21,000,000 and the other for \$3,300,000 but Ritts did not know whether these covered the Canadian Company assets or not.¹⁰³² In fact he had been informed that the foreign crude drug stocks in the hands of vendors were insured by them.¹⁰³³ Even if this had not been the case he felt that if the client had a competent insurance man it would not be customary for the auditors to make any test of the ade-

¹⁰²⁷ R. 775-776, 835-837, 841-843.

¹⁰²⁸ R. 836.

¹⁰²⁹ Ex. F, 20; page 76 *supra*; R. 1709-1711.

¹⁰³⁰ "Q. [By Mr. GALPEER.] Is it likely that there would be documents in the plant such as that receiving ticket that you would not examine as part of your audit, as part of your check of the internal control or otherwise?

A. [By RITTS.] We would examine receiving tickets for merchandise actually received at the plant, yes, particularly that copy that was attached to the invoice, but if the company was buying merchandise and storing it in Canada, certainly we would not be foolish enough to ask for a receiving ticket on something that had never been received by the company at their own plant.

Q. Well, now, if I told you that such receiving tickets were prepared, wouldn't that seem foolish to you, as you state?

A. Yes, certainly." R. 284.

¹⁰³¹ R. 709-712, 283-287.

¹⁰³² R. 549-550. See also Ex. M-28.

¹⁰³³ R. 429.

quacy of the insurance coverage, except perhaps in a general way.¹⁰³⁴

Thorn's testimony on inventories supported Ritts in most particulars. Points in common were that he never made any count or other physical test of inventory quantities¹⁰³⁵ and never estimated warehouse capacity in respect to inventory quantities.¹⁰³⁶ He also considered the McKesson selling prices the best test of market in judging the correctness of the inventory prices because of the difficulty of identification and large volume handled by McKesson, although he never made any independent inquiry to establish this fact.¹⁰³⁷ If he had considered it desirable to establish the financial stability of the Canadian vendors he would have asked Dietrich for Dun & Bradstreet reports, and also would have asked him to get financial statements from the suppliers themselves.¹⁰³⁸ Thorn could not throw any new light on the purpose or manner of preparation of receiving tickets after the change in location of inventories in 1935.¹⁰³⁹ Thorn was also in agreement with Ritts that at least two independent counts of the inventory of merchandise actually on hand were taken, as White explained was the case—three counts in some instances. It may be noted, however, that the procedure laid down in McGloon's printed instructions for taking the inventory merely provided for signatures of two counters on the same count tag or sheet, so that the second crew would have knowledge of the first count. In this case, therefore, the practice was stronger than the instructions.¹⁰⁴⁰

On two occasions major changes were made in the supposed location of the foreign crude drug stocks. In the Canadian Company the stocks were supposed to have been in Montreal until 1931. From 1931 to 1935 they supposedly were held in Bridgeport. Thereafter the five Canadian suppliers were supposed to have retained them in their control. In the Connecticut Division substantial stocks were supposed to have been kept in the warehouse of the British-American Stores, Inc. in Jersey City, N. J., until sometime in 1933, after which all the stock was supposed to have been in Bridgeport until sometime in 1935. After that time vendors were supposed to have retained possession of the goods in Canada. Thorn says it would not be part of the audit to trace these changes to the extent of discovering whether the merchandise in fact was moved, or, as he assumed, that the goods were sold out at the one location and built up again in the next.¹⁰⁴¹

¹⁰³⁴ R. 839.

¹⁰³⁵ R. 865.

¹⁰³⁶ R. 870, 1225-1226.

¹⁰³⁷ R. 1009-1012, 1027-1038.

¹⁰³⁸ R. 1062-1063.

¹⁰³⁹ R. 1241.

¹⁰⁴⁰ R. 1006-1007, 475-478; Ex. 16.

¹⁰⁴¹ R. 1222-1225; Ex. 104A, 104B; R. 938-940.

"Q. [By GALPEER.] And do you know in what year those inventories were supposedly shifted from Bridgeport to Canada, that is, foreign crude drug inventories we are speaking of?

A. [By THORN.] At December 31, 1934, the inventories were all held in Bridgeport, that is, say, Fairfield. At December 31, 1935, they were all held in Canada." R. 938-939.

The question of the location of the merchandise was important for the Canadian Company in connection with taxes. Prior to April 3, 1935, as a Canadian corporation, taxes on income were paid to the Canadian government. During part of the period from organization in 1928 to April 3, 1935, inventories were supposed to have been in Bridgeport and during all of the period the books and records were kept in Bridgeport. This situation led Thorn in 1930 to refer the matter to Price, Waterhouse & Co.'s tax department, whose representative, Ashbaugh, advised Coster that as long as the Canadian " * * * Company was operating in the United States, or maintained inventories in the United States, it was probably liable for Federal income taxes." Thorn commented on this opinion in strong language in his memoranda on the 1931 and 1932 audits,¹⁰⁴² but no reserve was provided and no tax returns were filed except in Canada. In 1933 a two-page memorandum of Ashbaugh's addressed to Rowbotham emphasized the same point again, and the fact that the bulk of the transactions of the company seemed to be handled through Bridgeport. This resulted in a provision of a \$50,000 reserve from surplus but no United States tax return.¹⁰⁴³

There was no change in the situation in 1934.¹⁰⁴⁴ As previously stated, in 1935 the inventories were supposedly shifted from Bridgeport to Canada. Beginning with April 3, 1935, the company filed United States tax returns and also filed in Connecticut as a foreign corporation, and according to the memorandum of accounts intended to claim exemption from Canadian income taxes " * * * under Section 4K, Part II, of the Dominion Income War Tax Act on all profits arising since the latter date * * *." Memoranda for 1936 and 1937 reported the settlement of all claims with both the United States and Canada, but with no United States tax due for periods prior to 1935 and no Canadian tax due after that date.¹⁰⁴⁵ The only change in the supposed physical operations of the business which took place during the year 1935 was the shifting of the inventories from Bridgeport to Canada. Cummings of Sullivan & Cromwell, a director and counsel for McKesson, testified:

" * * * I thought probably if they were kept in Canada, it was more likely liable to double taxation." ¹⁰⁴⁶

And Section 4 (k) of the Canadian Income War Tax Act referred to in the Price, Waterhouse & Co. 1935 memorandum on the Canadian Company, as quoted above, in fact provided exemption for:

"(k) the income of incorporated companies (except personal corporations), whose business is not only carried on but *whose assets, also, are situate entirely outside of*

¹⁰⁴² Ex. 76, 205.

¹⁰⁴³ Ex. 75.

¹⁰⁴⁴ Ex. 74.

¹⁰⁴⁵ Ex. 72, 73, 26.

¹⁰⁴⁶ R. 2444.

Canada, provided that such companies file annually a fully completed return, on the form prescribed, and pay a filing fee of one hundred dollars, in each case within four months from the close of their fiscal period. * * *¹⁰⁴⁷ [Italics supplied.]

Thorn, it appears, relied on the fact that Ritts had discussed these questions with the Canadian tax authorities when they were in Bridgeport, as Thorn was unable to say how the decision had been reached and was not familiar with the Canadian law.¹⁰⁴⁸

As partner in charge of the engagement, Rowbotham's opinion was sought in the hearings on the various matters dealt with in the testimony of his staff. As in the case of cash and accounts receivable, he found by detailed comparison that his firm's work program on inventories was substantially in accord with the suggested procedure of the American Institute of Accountant's Bulletin—no material differences were noted.¹⁰⁴⁹

More specifically, following the Bulletin's suggestion to "Make reasonable inquiries and tests to ascertain that quantities have been carefully determined and that quality and condition have received due consideration", Rowbotham stated that he would get the Company's inventory instructions and talk to the actual supervisors on the job. On quality and condition he would make a study of the perpetual inventory cards to determine rapidity of movement. The supervisors in this case he would assume to be Robert Dietrich and possibly Johnson and McGloon. He would not talk to those who had actually done the counting.¹⁰⁵⁰

The tests referred to, Rowbotham thought, would be accounting tests of the records and not actual physical sampling or counting. Nor would it include estimates of warehouse capacities or reference to public sources of statistical information on trade and manufacturers.¹⁰⁵¹ In one instance in connection with the McKesson work, Price, Waterhouse & Co. representatives served as umpire between McKesson and the sellers of a wholesale house in taking the inventory. This was merely a matter of acting as arbitrator between a willing buyer and a willing seller for the purpose of settling differences at once. Let Rowbotham explain further:

"Now, in those circumstances, our partner who looked at this thing while I was away did not see any objection to handling that and I should not have seen any objection, either, had I been there, but I do not think it has any bearing on the question of taking stock as between, let us say, ourselves and the public, in an opinion that we would sign on an annual balance sheet. A lot of this was package

¹⁰⁴⁷ As amended by 24 & 25 Geo. V, c. 55, §2 (1934). Also amended by 1 Edw. VIII, c. 38, §4 (1936).

¹⁰⁴⁸ R. 946-948.

¹⁰⁴⁹ R. 1858, 1863-1864.

¹⁰⁵⁰ "I think you would speak to Dietrich himself, you might talk to Johnson or McGloon—I don't know how far down the line you would go on this thing. I don't think you want me to answer what I think is the specific question in your mind—I don't think you would go out and talk to the men who had actually done the counting." R. 1869-1870.

¹⁰⁵¹ R. 187.

goods, of course, and if one side was willing to accept a package without opening it and the other side was willing too, it made little difference." ¹⁰⁵²

In Rowbotham's opinion the client practically never requested the auditor to supervise the inventory taking and he was convinced that in many lines of business, such as textiles, lumber, hides, furs, crude drugs, and steel such supervision would not be worth anything if undertaken. However, although he felt that in these cases the books were often more reliable than the physical inventory, he was not ready to say that the future might not bring auditor participation in inventory taking. ¹⁰⁵³

This, he said, might have a good moral effect but at the same time create an illusory safeguard. ¹⁰⁵⁴ In the case of McKesson he estimated that to supervise the inventory at December 31 would have required 300 men a week's time on the job. In Rowbotham's opinion this would be an impossible task on a calendar year closing in view of the number of companies which keep their books on a calendar year basis. ¹⁰⁵⁵

¹⁰⁵² R. 1872-1873; Ex. 101-A.

¹⁰⁵³ "Q. [By the EXAMINER.] You do actually supervise taking inventories, don't you, in other audits if the client requests it?

A. [By ROWBOTHAM.] Well, the client practically, sir, never requests it nowadays. What he is going to request in the future I don't know, but right now the client is usually content with his own method, and when he gets out his own inventory instructions he takes the inventory in a way he thinks is satisfactory and he does not ask us to supervise that inventory, I should say, in almost every case that we have. What might happen in the future, I don't know.

Q. [By Mr. STEWART.] Let me just ask one question on that point, if I may. Regardless of whatever supervision you might be able to make on the count of merchandise, recognition of which involves a technical or specialized knowledge, Mr. Rowbotham, do you think it would be possible by reason of such supervision to give an unqualified certificate as to the quantity, quality and condition of inventories without placing substantially the same reliance on the client in your statement which you now place and have placed in the McKesson & Robbins certificate?

A. No, sir, I do not, because you can take quite a lot of commodities almost without thinking. I mean, you can—stuff like textiles and lumber and hides and furs and crude drugs here, I mean, the client—an accountant can go out and supervise that and I do not think his supervision would be worth anything. Take carpets, for instance, what does he know about carpets? I mean, there are quite a lot of things that the accountant simply cannot supervise on. Now, then, take the case of—the obvious case of an ore pile in a steel company. I have gone out to steel companies and looked at ore piles and it looked to me like a huge mountain of earth; he has to rely, in a case like that, on his book records and it has been pretty well proved, I think, in the steel companies that the book records are more reliable than the physical counts. There have been steel companies who have gotten a sudden rush to the head of what they thought were modern methods and they sent out an engineer to look at those things and the books have been right and the engineer has ultimately been wrong.

Q. [By Mr. GALPEER.] Do you think, then, that your participation in inventory taking would not add significantly to the value or the correctness or the accuracy, or authenticity of that inventory?

A. I do not go as far as that, sir. I think, perhaps, our present inventory practice may be extended to go further and do what you call supervising. I mean, I think that is a step that perhaps might come; it has not been done so far, but it might come, but all I am trying to say is this, sir, that even if you did supervise, even if the accountant does supervise, if I went out and saw a huge yard filled with lumber covered with a tarpaulin and was told it was hardwood and was supervising the taking of that hardwood, I am sure I would still end up by relying on the book figures and the representations of the company's officials." R. 1873-1876. Cf. footnote 1369 *infra*.

¹⁰⁵⁴ "Q. [By the EXAMINER.] Have you formed any conclusions as to the possible psychological or moral effect on such supervision?

A. [By ROWBOTHAM.] I have, sir. It may have some psychological or moral effect for the good, but I am deadly afraid, to be quite frank about it, that you would be creating a safeguard or having people rely on it that would not really represent it. I am giving you my personal opinion now and not the opinion of the American Institute or anybody else." R. 1876.

¹⁰⁵⁵ R. 1876-1881.

Rowbotham was positive about the inefficacy of an attempt by accountants to spot test inventories physically. His views are stated best in his own words:

“Q. [By MR. GALFEER.] Well, under the system as you have described it, what would be the purposes of having what I have referred to as test checks of inventory or spot tests or something to that effect?

A. Well, if by test checks or spot checks you mean the accountant going out and taking hold of a physical part of the inventory and looking at it himself, frankly I am talking personally now, I don't think they are any good at all. I just can't see them, because you could go into this plant here and they could show you a barrel of something or a bottle of something and you could even take samples and they could palm the samples upon you. I think it just gives a false impression of security if you take test checks.

Q. Now, take the comparison of a building. Assuming a building is carried on the books of a corporation, assuming an accountant cannot determine the exact value of that building, in an appraiser's sense, he could nevertheless by seeing the building know that at least such a building existed. Don't you think that is so, and I am just trying to establish the thought here—don't you think that by at least looking at the inventory he could establish whether such inventory existed.

A. To take your example of the building, he might see a building was there but if it was part of a steel plant, he wouldn't know if it was modern, if the machinery was up to date, whether it was fit for what it was supposed to be fit for, and looking at the building I don't think would tell the accountant anything except the very bare fact which I don't think has any meaning, that there is a building there; now, if you look at the material out here, you might see that something is there but what that something is I think is practically meaningless.

Q. Well, take the situation here: Don't you think that to have determined the bare fact as to whether the inventory existed would have been helpful?

A. I don't regard it so. You are talking about the goods in Bridgeport or in Canada or both.

Q. I am talking about the crude drugs. Let us speak of the time they were supposed to be in Bridgeport.

A. If we had gone there, I am certain, and I am sorry to say this is hindsight, I am certain if we had gone to Coster and said, 'We want to look at this stuff,' they would have shown us something, and then we would be in a worse position than today because we would have had to say that we had test checked that inventory and I am quite certain it wouldn't have been what we probably thought it was.

* * * * *

Q. [By the EXAMINER.] Do you feel that the extent of your inventory investigation will be identical in a detailed audit as with a balance sheet examination?

A. Yes, I don't think in a detailed audit we would go into the quantities, quality or condition of the inventories at all. I don't think the accountant has any concern with it.

Q. Whether the McKesson & Robbins audit or any other audit was a detailed audit or balance sheet examination you would treat the inventory question identical in both circumstances?

A. Yes, in my opinion they should be so treated."¹⁰⁵⁶

Rowbotham's opinions were asked on sundry other matters which were raised during the testimony of his staff. For example, he could

not recall any occasion in his experience when he had called upon another office of his firm to make an inquiry as to the existence of merchandise or warehouses in another city unless a subsidiary of the client being audited was involved.¹⁰⁵⁷

If insurance policies had been requested on the crude drug stocks, Rowbotham agreed with Ritts that Coster would have produced something that looked authentic. With a competent insurance department it was his judgment that a study of insurance coverage was unnecessary.¹⁰⁵⁸

The arrangement by which the vendors of crude drugs held the inventories in Canada and shipped on Coster's orders seemed entirely reliable to Rowbotham because the same vendors had seemed to establish themselves as responsible people through several years' business relations while the inventories were supposed to have been in Bridgeport. The idea that Ritts brought to Thorn's attention that the vendors might have been dealing in futures did not come to Rowbotham's attention until recently and for reasons just stated he thought that independent credit reports on the companies were unnecessary.¹⁰⁵⁹ If doubt had arisen as to the inventories, Rowbotham thought that Price, Waterhouse & Co. would have consulted Coster who would have sent Robert Dietrich to take an inventory with which Rowbotham would have been thoroughly satisfied.¹⁰⁶⁰

Rowbotham's testimony on prices was largely a reiteration of the points brought out with Ritts and Thorn, leading to the conclusion that the client's records of purchases and sales were more reliable than published quotations.¹⁰⁶¹

To summarize very briefly at this point, the Price, Waterhouse & Co. verification of inventories in the Connecticut Division and Canadian Company was confined to an accounting test of the records supported by what appeared to be authentic confirmations of a substantial part of the stock in the warehouses of vendors whose financial standing was never questioned due to years of satisfactory business relations prior to the time when they became responsible for warehousing of the

¹⁰⁵⁷ "Q. [By Mr. GALPEER.] Mr. Rowbotham, not referring to this McKesson situation, but speaking generally has the occasion ever arisen wherein doing any examination work you make independent inquiry through one of your other offices to establish certain facts? In other words, to be specific, would the occasion ever arise where you would want to check the existence of merchandise or the validity of a warehouse, or anything like that, where you would write to some one of your other offices near that spot to check it for you?

A. No, I can't recall any occasion of that kind where we would call in another office unless there was an actual subcompany in that town as there was, of course, in many of these towns covered by this McKesson set-up.

Q. [By Mr. STEWART.] And when you said subcompany, you mean a subsidiary of the company under examination and not merely a company with which it was doing business?

A. Yes, I mean what we call nowadays divisions." R. 1980-1981.

¹⁰⁴⁸ R. 1881-1885.

¹⁰⁵⁹ R. 1885-1888.

¹⁰⁶⁰ R. 1888-1890.

¹⁰⁶¹ R. 1955-1956.

merchandise. The Price, Waterhouse & Co. procedure at Bridgeport did not include physical contact of any kind with the inventory.¹⁰⁶²

H. OTHER BALANCE SHEET ACCOUNTS

1. Unexpired Insurance

Unexpired insurance as an asset on the balance sheet was, by comparison, a trifling amount, being only a part of \$554,245.36 which included taxes and other prepaid expenses, out of the total of \$87,182,-765.74 assets on the consolidated balance sheet at December 31, 1937. At that date only \$2,627.76 of unexpired premiums applied to policies on the books of the Connecticut Division, as most of the insurance was taken up on the books of what was known as the Central Division of the Maryland Company.¹⁰⁶³ As previously stated in connection with the discussion of inventories, the auditors did not consider it to be a part of their duty to check on the adequacy of insurance coverage under the circumstances of this case because the client had an expert insurance man (Robinson) in its employ.¹⁰⁶⁴ Furthermore, the fact that the blanket insurance policies were reduced a substantial amount in 1935 was deemed confirmation of the explanation received that the custodians who commenced storing the goods in that year assumed such responsibility.¹⁰⁶⁵ Insurance protection Ritts thought was an operating problem while the accountants' primary purpose in examining insurance policies was to compute the prepaid insurance or to establish the premium liability that should appear on the Company's books.¹⁰⁶⁶ Rowbotham summarized this idea completely in answer to a question by Mr. Galpeer:

"Q. Would you say, then, sir, that as far as your work had to do with insurance, it was for the purpose of analyzing premiums to determine which of them were paid in advance and to be sure that all premiums paid were included as operating expense?

A. And to see that a proper charge had gone into the income account for insurance."¹⁰⁶⁷

2. Fixed Assets

Fixed assets, less reserves, constituted less than 8 percent of total consolidated assets of McKesson & Robbins, Incorporated, at December 31, 1937, and have only small place in this inquiry for that reason, as well as because there is no evidence that these accounts were

¹⁰⁶² For variations in inventory practice in other divisions of the Company see page 318 *infra*.

¹⁰⁶³ Ex. 48; R. 547-549.

¹⁰⁶⁴ Pages 284-285 and 290 *supra*.

¹⁰⁶⁵ The record on this subject is found as follows: Ritts, R. 417-429, 547-549, 838-839, 843-844; Thorn, R. 1207-1208; Rowbotham, R. 1881-1885. See also Thompson, R. 2096-2098, quoted in part at pages 127-128 *supra*. The record does not indicate, however, whether the date of the reduction in insurance coincided with the time of change in the location of the inventory.

¹⁰⁶⁶ R. 420.

¹⁰⁶⁷ R. 1882. Cf. Ex. M-28 for the auditors' comments on the adequacy of the Company's insurance records.

involved in the fraud. However, to complete the record there is included the brief audit work program on this topic for the Connecticut Division in 1937 as carried out by a junior (item 6 by Ritts):

"FIXED ASSETS AND RESERVES

- 1 Obtain summary from Co. of changes; check from ledger & foot.
- 2 Vouch additions of \$75, or over on list of additions prepared for us by Company.
- 3 Check larger deductions into detail property records to see that asset & reserve have been relieved in the proper amounts.
- 4 Schedule profit & loss on the disposal of fixed assets. Check the consideration received on the larger items.
- 5 Test check calculation of 1937 depreciation provided against individual items & calculate effective depreciation rate by classification for year.
- 6 Trace transfers to and from other divisions and companies to see that they will eliminate in consolidation.
- 7 Obtain list of depreciation rates applicable to purchases since date of appraisal. Test check large items for monthly depreciation set up on books. Should take same life as similar assets shown in American Appraisal Co. report."¹⁰⁶

As in the case of the inventories this program was confined to an examination of the records and as has been pointed out previously no inspection of the plant was included as a step in the audit program. "The accountant does not go out and actually touch or see the plant."¹⁰⁶⁹ Rowbotham has explained why in his opinion this comment of his must be so:

"* * * the accountant is not an engineer. He very often does not know the actual existence, to be quite blunt about it, of the capital assets. He may know that there are buildings there. He does not know the buildings are suitable for the purpose. He does not know the machinery is suitable to the purpose. He is not a lawyer. He does not know that the titles rest in the company."¹⁰⁷

However, in relying on the books, the auditors seem to have had some trouble in getting at the facts from the accounts, as extracts from successive years' working papers indicate. A note by Ritts on Schedule K-3, Connecticut Company papers for 1933 stated:

"The company has capitalized a number of items during 1933 which appear questionable but due to the small amounts involved we have not attempted to adjust their accounts. We have, however, discussed the matter with Mr. Cairns¹⁰⁷¹ and he informed us that it was not their intentions to capitalize any expenditures under \$50 but because of certain changes in the personnel these additions were made without his knowledge. Mr. Shoemaker is now handling the property ledger and he has been given definite instructions regarding these matters. We have prepared skeleton schedules for his use during the coming year and it is expected that the property accounts will be handled more satisfactory in the future."¹⁰⁷²

¹⁰⁶⁸ Ex. 44; R. 538.

¹⁰⁶⁹ R. 1749.

¹⁰⁷⁰ R. 2019. See also R. 1894.

¹⁰⁷¹ Assistant to McGlooin—also formerly with Price, Waterhouse & Co.

¹⁰⁷² Ex. M-14.

Ritts was too optimistic for on the 1934 audit a junior wrote as follows in regard to his work on fixed assets:

"The summary schedules were in such form that we were unable to use them and drew up schedules of our own. The supporting schedules were likewise very unintelligible and practically useless. However, we tried to salvage them as well as possible. Mr. McGlooin and Mr. Johnson have been informed of the deplorable state of the property accounts. They have informed us that this situation will be rectified and that adequate plant ledgers will be kept in the future."¹⁰⁷³

The poor condition of the Company's books reported above is given added interest when it is realized that the properties had been appraised by the American Appraisal Company as at October 31, 1934, and the asset and reserve accounts adjusted to conform as at that date.¹⁰⁷⁴

3. Liabilities

a. ACCOUNTS PAYABLE

The following work program on accounts payable used on the 1937 audit at Bridgeport for the Connecticut Division and Canadian Company was the same form of mimeographed work program used on all divisions handled out of the New York office of Price, Waterhouse & Co.:

"ACCOUNTS PAYABLE—WORK PROGRAM

- (1) Obtain a trial balance of accounts payable at December 31st and make arrangements with client to withhold invoices paid subsequent to the period under review from the files until they are examined.
- (2) Verify footings and agree total with general ledger control.
- (3) Check accounts payable ledger, or open items in voucher register, to trial balance.
- (4) Test check larger items to ascertain (1) nature of liability, (2) whether invoices were properly approved, (3) whether particulars, i. e., price, extension, and footings, were verified, (4) whether merchandise receipts, etc. were verified by reference to receiving tickets, and (5) whether vouchers or invoices were properly recorded.
- (5) Test check open balances at December 31st by reference to creditors' monthly statements.
- (6) Transfer debit balances in accounts payable to miscellaneous accounts receivable, and inquire into collectibility.
- (7) Scrutinize liabilities for intercompany or interdivision payables.
- (8) Examine all invoices and statements entered subsequent to December 31st and those not yet entered, for liabilities applicable to the period under review.
- (9) Examine cash disbursements record, journal entries, and all other records of original entry subsequent to December 31st for liabilities applicable to the period under review.
- (10) Examine receiving records for the last five days of the period to see that corresponding liabilities were properly recorded.
- (11) Examine cash-book to see if disbursements are charged to any accounts other than accounts payable.

¹⁰⁷³ Ex. M-20.

¹⁰⁷⁴ Ex. 160 (p. 14).

(12) Ascertain whether any differences existed between the accounts payable records and the general ledger control during the period; state what disposition was made of these differences, if any, and whether they were brought to the attention of the client.

(13) Prepare liability certificate, exercising due precaution to see that all points are covered, and obtain the signatures of responsible officials.

(14) The foregoing is a general program outlining the minimum work to be done on accounts payable. This program should, of course, be modified and added to in order to meet the requirements of each particular examination. The additional work done should be described below."¹⁰⁷⁵

Accounts payable of the Canadian Company at December 31, 1937 consisted of two invoices, one of \$750 for the December installment of the "W. W. Smith & Company" service charge and the other for \$2,221.42 being $\frac{3}{4}$ of 1% on December sales of \$296,189. There were no liabilities on the same date for merchandise purchased of the five vendors. The only work required in connection with these two items was to verify the calculations and since it was his first work at Bridgeport, Wyman said he related these items to the contract which, as previously pointed out, was thought to be with W. W. Smith & Company, Inc., guaranteed by W. W. Smith & Co. The accounts payable work sheet in the Price, Waterhouse & Co. papers listed only the two Smith items, above referred to, both of which were tick-marked "Invoice seen."¹⁰⁷⁶

These two items for December were included when paid with vouchers covering similar charges for January and February 1938. All six invoices were on stationery labelled "Branch Account Statement", of "W. W. Smith & Co. Commission Merchants, Purchasing, Forwarding & Shipping Agents, Liverpool, 3, England", to be paid at "* * * our *New York* [stamped] office in *U. S.* [typed] currency. Address all inquiries there." The six vouchers involved were made out to "W. W. Smith & Co." and "Selling Expense" was charged. They were paid by two checks dated March 14, 1938 drawn on The Bridgeport-City Trust Company to the order of W. W. Smith & Co., Ltd. The first of these two checks covered 3 months' service charge (\$2,250) and was endorsed

"FOR DEPOSIT ONLY IN
THE ROYAL BANK OF CANADA
GREENE AVE. BRANCH
TO THE CREDIT OF
W. W. SMITH & CO. LTD."

The other check for the guaranty fee of $\frac{3}{4}$ of 1% for the 3 months amounted to \$6,171.26 and was endorsed

¹⁰⁷⁵ Ex. 47, 24.

¹⁰⁷⁶ R. 364-368; Ex. L.

"PAY TO THE ORDER OF
THE CHASE NATIONAL BANK
OF THE CITY OF NEW YORK
HAMILTON TRUST BRANCH
W. W. SMITH & Co., LTD.,
MONTREAL
CANADA" ¹⁰⁷⁷

Although the foregoing checks were issued after the audit and therefore might not have come to the attention of the auditors, Wyman, who did the work on the Canadian Company for 1937 would at least have seen the checks dated December 31, 1937, covering November 1937 charges, which were similarly drawn to W. W. Smith & Co., Ltd., and so endorsed, ¹⁰⁷⁸ since they appeared as outstanding checks on the December 31, 1937 cash reconciliation.¹⁰⁷⁹ Item 13 of the cash work program previously referred to required that sometime in January checks paid to date should be secured from the bank and that all paid checks dated December 31 or prior thereto should be traced to the checks outstanding on the reconciliation.¹⁰⁸⁰ According to endorsements thereon the checks in question cleared through the banks during the first 10 days in January and therefore must have been included in this step which, although not initialed, Wyman testified was done.¹⁰⁸¹

Here is the situation to which reference was made earlier in this report. The contract was thought to be with W. W. Smith & Company, Inc., a New York corporation, and was guaranteed by W. W. Smith & Co., a copartnership of Liverpool, but the checks drawn in settlement of invoices rendered on the partnership stationery were drawn to W. W. Smith & Co., Ltd. and so endorsed.

At December 31, 1936, accounts payable of the Canadian Company consisted of two items, \$300 due to Brown, Montgomery & McMichael, lawyers of Montreal; and \$1,655.70 listed as payable to "W. W. Smith & Company."¹⁰⁸² The latter item was paid by a check dated April 15, 1937 drawn for \$3,239.58 (this included the January 1937 guaranty fee of \$1,583.88) on the Canadian Bank of Commerce, New York, N. Y. to the order of "W. W. Smith & Company Ltd." The invoices supporting the voucher were on the stationery of W. W. Smith & Co. Ltd., 1405 Bishop Street, Montreal, Canada, terms "Net U. S. Cy."¹⁰⁸³ The invoices preceding these last, covered September, October, and November 1936 charges and were on the

¹⁰⁷⁷ Ex. 226, 227. Similar W. W. Smith & Co. statements and checks in payment are reproduced at page 101 *supra*.

¹⁰⁷⁸ Ex. 86A, 86B, 224, 225.

¹⁰⁷⁹ Ex. K.

¹⁰⁸⁰ Ex. 21, 29; quoted at pages 250-261 *supra*.

¹⁰⁸¹ R. 329-330.

¹⁰⁸² Ex. J.

¹⁰⁸³ Ex. 223.

same statement form, but the check dated December 31, 1936 covering them was drawn to "W. W. Smith & Co." The check, however, was endorsed like those above by "W. W. Smith & Co., Ltd."¹⁰⁸⁴

Although, as above indicated, it was not followed meticulously, particularly as to lists or papers prepared for office use or given to the auditors,¹⁰⁸⁵ Miss Walsh, bookkeeper for the Canadian Company, testified that in recent years "Ltd." was always added on the checks on instructions from George Dietrich. She could not remember precisely when these instructions were given. Similar checks to the order of W. W. Smith & Co., Ltd. for payments under the contract thought to be with W. W. Smith & Company, Inc., guaranteed by W. W. Smith & Co. were also issued by the Connecticut Division.¹⁰⁸⁵

Ritts was asked about these discrepancies between the parties to the contract, and the payee on the checks but he seemed to think the subject was of no significance.¹⁰⁸⁷

"Q. [By Mr. GALPEER.] Would you say W. W. Smith & Company, Limited was W. W. Smith, Incorporated or W. W. Smith and Company?

A. I don't know as I would make a distinction.

Q. Would you consider those checks proper payment under the contract referred to?

A. I think so. I do not think it is significant that a check is not made out in the exact name.

Q. That is, you do not think it is significant that under a contract with W. W. Smith & Company, Incorporated, guaranteed by W. W. Smith & Company, the co-partnership, if the checks are made out to W. W. Smith & Company, Limited?

A. I don't think that is significant."¹⁰⁸⁸

He had no recollection of having seen the vouchers or the invoices from Smith as he stated he relied on a calculation of the fee in accordance with the terms of the contract in checking the liability.¹⁰⁸⁹ Prior to being questioned in the instant hearings he had never heard of Smith as a limited company¹⁰⁹⁰ and did not consider the distinction in names of any more importance than between "McKesson & Robbins, Inc.," as used in the order for this hearing, and "McKesson

¹⁰⁸⁴ Ex. 222.

¹⁰⁸⁵ R. 4433-4434; Ex. 222, 223, 224, 225, 226, 227, I, J, K, L.

¹⁰⁸⁶ Ex. 86C, 86D.

¹⁰⁸⁷ R. 822-824.

¹⁰⁸⁸ R. 823.

¹⁰⁸⁹ R. 4467-4468.

¹⁰⁹⁰ "Q. [By the EXAMINER.] Mr. Galpeer mentioned a moment ago W. W. Smith & Co., Ltd. I believe this is the first time that a Limited Company by the name of W. W. Smith & Co. has come into this hearing—

A. [By RITTS.] Yes, sir.

Q. Is that the first time you heard of it?

A. Yes, sir, this is the first time that I recall ever seeing or even hearing of Smith being referred to as a Limited Company.

Q. We have already discussed W. W. Smith, Inc. and W. W. Smith & Co. of Liverpool. You do not know whether this W. W. Smith & Co. Ltd. is a third company or not?

A. No, sir, I do not; I have no knowledge as to that." R. 844.

& Robbins, Incorporated" which he pointed out was the correct legal title.¹⁰⁹¹

Item 5 of the work program on accounts payable: "Test check open balances at December 31st by reference to creditors' monthly statements" provoked some discussion at the hearings. In carrying out this test Ritts stated that it would be his practice to call for all available statements if he got to this step before the statements had been destroyed, but he would not make a request in advance nor ask for confirmations from creditors if the statements were missing. In doing this work he could not recall having seen statements from the five Canadian vendors. He did not think it unusual that no amounts were owing at the year end to this source of all of the Canadian Company's and most of the Connecticut Division's purchases.¹⁰⁹² The balance of the program was initialed as completed without amendments or additions.

b. ACCEPTANCES PAYABLE

The largest single class of liabilities of the Connecticut Division at December 31, 1937 was acceptances payable although as previously stated, since 1932, these did not include any items relating to the foreign crude drug transactions. The work on this was done by Wyman, who wrote out an audit program describing what he had accomplished. The points covered are listed below:

"WORK PROGRAM—ACCEPTANCES & DRAFTS PAYABLE

Also: Currency engagements,
Unused balances under letters of credit.

1. Obtain company schedule of direct liabilities for trade acceptances and for acceptances under letters of credit issued by bank.
2. Agree items as above scheduled with items in acceptance register shown as not due until 1938.
3. Agree items on schedules or schedule in total with amounts of direct liabilities reported by banks.
4. Further identify the open items by tracing from cashbook. The payment in 1937 of all items showing on register as due from 9/1/37 to 12/31/37.
5. Check on conversion of items stated by cash in sterling or francs by noting that they are restated by company in dollars as covered by future currency engagements or that they are converted at closing cable rates.
6. Re currency engagement a/c commitment. All sterling acceptances covered by engagements to purchase sterling before due date. Currency engagements in excess of direct liability at 12/31/37 as per notation on A-11, Head office papers. Rate of engagement lower than closing cable.
7. Check clerical accuracy of company schedule.
8. Agree company schedule of unused balances under letter of credit with letter of credit register and bank confirmation."¹⁰⁹³

¹⁰⁹¹ R. 571. See also R. 172-173.

¹⁰⁹² R. 540-545. See also Ex. M-10, M-15.

¹⁰⁹³ Ex. 45.