

e. INTERNAL AUDIT—TRAVELING AUDITORS

One is entitled to ask what McKesson & Robbins did after 1928 by way of improving accounting methods in the wholesale houses to prevent such occurrences as the above. The answer must be—very little consistently¹¹⁷¹ other than to rely on their independent auditors, even though the engagement was not for a detailed audit such as might be expected to review sufficient transactions to uncover such minor defalcations as occurred repeatedly at one place or another in the organization.

It should be said, however, that McGloon undertook at the outset to bring order out of chaos by designing a uniform system of accounts for all the houses with uniform financial statements and reports to be supplied to the home office. This was to be made effective January 1, 1929. McGloon held meetings of the wholesale house accountants to instruct them in the new procedures.¹¹⁷² He also attempted from the beginning to establish a corps of travelling auditors. For a short period in 1929 he had four or five but these were discharged because the other officials thought they were too expensive. In 1932 he worked on a program for such auditors and invited Price, Waterhouse & Co. to prepare an outline of procedure for such a staff. This was submitted under date of September 22, 1932. A few years after that, one auditor was employed but was immediately assigned to divisional vice-presidents for special work and never carried out the duties of a travelling auditor under the jurisdiction of the comptroller's office. The point was raised repeatedly, and as recently as October 1938. At that time McGloon wrote a memorandum to Coster suggesting three travelling auditors. The result was a decision that the estimated cost of \$30,000 per year was too expensive, so the less costly procedure of increasing the fidelity insurance from \$100,000 to \$250,000 was adopted, although losses sustained in a case then pending in one branch house were in excess of the amount that could be proven to the satisfaction of the insurance company.¹¹⁷³

Not all of McGloon's difficulty in this regard can be charged to Coster's ideas. Some of the directors who were heads of wholesale houses had a mistaken idea of the duties and services that could be rendered by a permanent staff of travelling auditors. Bedsole of Mobile, for example, thought that after the auditors had aided in

¹¹⁷¹ R. 1596; Ex. 14 (p. 13).

¹¹⁷² R. 1570. 1573-1574.

¹¹⁷³ R. 1579-1583, 1674-1676; Ex. 91, 125.

establishing a good system, their services were no longer required.¹¹⁷⁴ Doerr, at one time chairman of the Sub-committee on Accounting, seemed to think that the travelling auditors were a crew of trouble shooters rather than a regular preventative measure. In his opinion the Bridgeport office control of accounting methods ended with letters from McGloon, after that it was the duty of the divisional vice-presidents to see that the houses complied with instructions.¹¹⁷⁵ Michaels, who succeeded Coster as president, was very vague on this subject.¹¹⁷⁶ Faxon, secretary of the Corporation as well as vice-president and director, testified that the methods in the 60 houses were different and that McGloon tried to control them by issuing bulletins from Bridgeport. He thought travelling auditors went around looking for trouble but were hired primarily to bring the accounting system into better shape.¹¹⁷⁷ Of the directors examined on this point, Murray seemed to have the best conception of the duty of travelling auditors. He agreed with McGloon that insurance was not an adequate substitute.¹¹⁷⁸

Rowbotham's appraisal of travelling auditors and fidelity insurance and their relation to the audit is appropriate here. He felt that in a situation such as this in which it was impossible to have adequate internal control in each house that both travelling auditors and fidelity insurance were necessary—the two were not mutually exclusive but as an accountant he thought that the travelling auditors should come first, although in his experience, their work was never as satisfactory in practice as it seemed to promise in theory. The reason for this weakness in most companies was that the travelling auditors felt that they had no opportunity to advance in such work. Rowbotham cited

¹¹⁷⁴ "Q. [By Mr. GALPEER] Now, Mr. Bedsole, was it customary for McKesson to employ travelling auditors of their own in addition to the annual audits?

A. They did, at times.

Q. But it was not a regular habit?

A. I think maybe they had some up until recently, but there have been no travelling auditors in our division for some years.

Q. What is your view on that, Mr. Bedsole? Do you think it is advisable, inadvisable? Why did you have it at one time, and why not at others?

A. Well, the committee voted at one time that we would have some travelling auditors, principally, as I remember it, to check the internal methods of operation, and to throw up certain safeguards, or throw out certain weaknesses. There was an auditor that came down in my division and worked all the houses, but that was the greatest good that I got from him—revealing certain weaknesses, maybe, and handling certain C. O. D. sales, and things of that kind—credit memoranda, for instance.

Q. Why was it abolished, then, if it did a certain amount of good?

A. You couldn't keep on, you know. If you have the thing going good, you have a good system set up, why change again?

Q. So that these men just came in principally to check the system, you might say, and then they would make their reports to you, would they?

A. Well, they made their reports to Mr. McGloon and to me. That is, the gentlemen who worked in my division did.

Q. Who put the reforms into operation?

A. I did." R. 2496-2497.

¹¹⁷⁵ R. 2555-2557.

¹¹⁷⁶ R. 4284-4288.

¹¹⁷⁷ R. 2526-2528.

¹¹⁷⁸ R. 2164-2166.

one example, however, where this difficulty was overcome by the president of a corporation who happened to be a certified public accountant. This man employed certified public accountants for his travelling auditors and promised them that promotion to comptrollers of the subsidiary companies would be made from their group.¹¹⁷⁹

The auditors' appraisal of conditions in respect to internal check and control in the wholesale houses as they affected the audit work in contrast with those in the crude drug operations at Bridgeport are significant. In the wholesale houses more extensive cash work was done because the transactions in the houses were large in number but relatively small in unit dollar values and involved the handling of numerous receipts in money rather than in checks. Furthermore, Thorn emphasized the division of control in the wholesale houses where he felt that there was no one executive with sufficient knowledge of all operations to serve as an effective check on the bookkeeper in the absence of an adequate mechanical system of internal check. At Bridgeport, however, although several operating functions were controlled by George E. Dietrich, less auditing work was believed necessary than in the other branches because very little cash was handled. It will be recalled that all receipts and disbursements arising from sales and purchases of foreign crude drug stocks were large in dollar value and relatively few in number of transactions and, since 1932, were cleared directly through what was considered to be a bank (Manning & Company) and were reported by it on debit and credit forms. In addition there was the fact that Coster was supposed to have had detailed knowledge of all of these operations and to have exercised close supervision over them.¹¹⁸⁰

McGlooin, the comptroller of the Corporation, had a somewhat different conception of the effect of the differences in organization at Bridgeport and the wholesale houses. He testified that the greater separation of duties in the houses would have required more widespread collusion among the Company's operating executives than was necessary at Bridgeport for concealment of a fraud such as was carried on by the Musica brothers disguised as: president, Coster; assistant treasurer, buying and sales manager, George E. Dietrich; and Robert J. Dietrich, head of the shipping, receiving and stock-keeping departments.¹¹⁸¹

As has been seen more auditing work was done in the branches on the cash program because of weaknesses in internal check and control

¹¹⁷⁹ R. 1963-1973.

¹¹⁸⁰ "Q. [By Mr. STEWART.] And is it also true that in the wholesale houses, for the most part, there was no one executive who had sufficient knowledge of the transactions to operate as a check upon the bookkeeper, in the absence of an adequate system of internal check on the bookkeeper?"

A. [By THORN] Yes, that is true. Even in the smaller wholesale houses there are usually three or four operating heads.

Q. As contrasted, for example, with the unity of operating head in the crude drug division at Bridgeport?

A. Yes, that's right." R. 4544.

¹¹⁸¹ R. 1653-1658.

than was considered necessary at Bridgeport¹¹⁸² even though in Rowbotham's opinion Coster exercised a very salutary influence on the divisional vice-presidents and the accounting in these units.¹¹⁸³ The additional work was done despite the fact that in the larger units of the wholesale houses there was a greater subdivision of functions among the executive staffs than in the crude drug operations.

K. REVIEW PROCEDURE

Review procedure and the mechanical preparation of the report are so inseparable that these phases must be considered together. However, the content of the finished product and the uses to which it was put are reserved for separate consideration in the next subsection. A very brief preview of the review procedure was obtained from Rowbotham on the first day of the hearings. The work of juniors as has been observed in foregoing sections was controlled and reviewed by the seniors. The managers of the various offices engaged on the audit reviewed the work of the seniors working out of their offices, and after this review, the papers with a covering memorandum and the accounts on each unit were mailed to New York (except on units handled directly by the New York office) where the manager of the entire engagement reviewed the papers preliminary to preparing the consolidated accounts. The partner in charge did not go over the individual working papers but kept himself posted generally during the progress of the job and finally reviewed all accounting points that arose.¹¹⁸⁴ Working in this way Rowbotham, the partner in charge of McKesson, handled at least 20 engagements during the year.¹¹⁸⁵

The first reports to be completed were those covering individual units of the Company. The manager in charge in New York (in recent years Thorn) wrote a letter to Coster on each one based on the memorandum accompanying the working papers when mailed in or brought in to the New York office.¹¹⁸⁶ The nature of these letters was discussed in some detail in the preceding subsection of this report. They were all read and signed by Rowbotham for the firm.¹¹⁸⁷ Two copies of the accounts were supplied, one for McGlooin's files and one for the head of each house in question, but these letters and accounts were not sent to the directors as such, except as they might head particular houses.

On work done under his direct supervision, Thorn sat down with the senior in charge who would have with him the working papers, a draft of the financial statements, and usually a brief memorandum on

¹¹⁸² Footnotes 679, 686 *supra*.

¹¹⁸³ R. 1836-1837; footnote 552 *supra*.

¹¹⁸⁴ R. 24-25, 74-75, 83-85, 879-880, 1915-1916.

¹¹⁸⁵ R. 33.

¹¹⁸⁶ R. 95, 880-881.

¹¹⁸⁷ R. 883, 1929-1931.

the accounts. Similar memoranda have been referred to repeatedly in telling the story of the work done at Bridgeport. The first step was to check the figures on the draft financial statements to the principal schedules in the working papers and from these to the underlying schedules. The papers then were reviewed in detail and any questions raised were discussed until the work was "pretty well covered." Such a review consumed several hours, after which the draft statements were approved for typing.¹¹⁸⁸ In most years Thorn made a preliminary review of the Bridgeport papers at the client's office.¹¹⁸⁹

Rowbotham's review of the work was a more or less continuous affair as the letters mentioned above were completed on each division but was most thorough when the accounts of the Connecticut Division, Canadian Company, and lastly the consolidated accounts for the entire organization were ready.¹¹⁹⁰ The accounts on the Bridgeport units were accompanied by memoranda referred to above but were submitted to Coster usually without comment, because any comment necessary was conveyed directly while the work was in progress; "* * * In other words we would be reporting to them on their own houses in that case."¹¹⁹¹ The consolidated accounts were part of a long form report the contents of which are described in the next subsection.

This review by Rowbotham was confined to what he termed the points of the job and did not involve a review of the questionnaires on internal check and control or of the working papers except for occasional reference purposes. The internal check and control at Bridgeport, it will be recalled, Thorn, who was considered competent to judge, told him was good.¹¹⁹² The principal points of the job, however, were: the possibility of exchange restrictions on the foreign accounts; the increase in accounts receivable; the relationship of W. W. Smith & Co. to McKesson and the ability of Smith to make good on the guaranty; whether circularization of receivables was necessary; reserves for doubtful accounts; increase in inventories and their basis of valuation; the method of confirming inventories held by suppliers; purchase and sales commitments; the spice department; foreign exchange problems; and a comparison of the current accounts with the previous year. In addition, the manner of presenting the accounts was given a great deal of consideration and finally there was the question of whether exceptions should be taken in drafting the opinion on the accounts. In recent years the relationship of the accounts to the annual reports filed with the Securities and Exchange Commission was an added problem. This recital, it was testified, was

¹¹⁸⁸ R. 881-882.

¹¹⁸⁹ R. 878.

¹¹⁹⁰ R. 1921-1932.

¹¹⁹¹ Testimony of Thorn, R. 882.

¹¹⁹² R. 1921, 1932-1934.

illustrative of the kind of questions raised but neither Rowbotham nor Thorn had a formal list or review program.¹¹⁹³

To make this story complete as to mechanical details reference must be made to the firm's Office Manual and to the booklet written by Berger. This booklet states that only after the reports and statements have been reviewed by the partner and approved by him are they ready for typing.¹¹⁹⁴ The Office Manual required that the office copy of the typed report and accounts be submitted to one of the assistants who worked on the engagement for checking of all footings, cross footings, and references. Corrections made in the office copy must be called back to all the other copies as corrected, after which the partner, manager, or senior responsible for the work must initial the office copy before any of the other copies may be released. "The senior assistants in charge of the work must themselves read through * * *" the finished report before submitting it to the partner for final approval.¹¹⁹⁵

Advice on review procedure is also contained in Berger's dissertation on "Organization Ethics and Team Work."¹¹⁹⁶ He counsels all staff men to write the best report of which they are capable before submitting it to the principal with whom they should have had a preliminary discussion on exceptional points before starting to write. The extent of the principal's review will then depend upon the importance of the engagement, the accounting difficulties involved in the business, the ability of the staff man in charge, and the knowledge of the engagement possessed by the principal.

"Regardless of the extent of the review, the man in charge should be fully prepared to make all necessary explanations and to submit evidence therefor when called for and generally to show a complete mastery of the work, as nothing is so convincing in inspiring confidence as a ready and decisive answer to all pertinent questions regarding the work."¹¹⁹⁷

The paragraph following the above quotation is a fitting conclusion for this section:

"Similar to the requirement previously mentioned that the assistant should draw the attention of the man in charge to any important points developed, so likewise should the latter report to the principal any points of doubt affecting the integrity of the accounts or the sufficiency of the verification without waiting for this information to be elicited by questioning. The responsibilities of the profession are necessarily broad and it would be folly to add to those which are inherent in the work any further dangers resulting from a lack of coordination between the people involved in the various steps needed to submit the findings to the client. Above all the man in charge should not show a spirit of resenting changes or criticism by a principal or of impatience when the review is more extended than was expected."

¹¹⁹³ R. 2034-2040, 879.

¹¹⁹⁴ Ex. 168 (pp. 26-27.)

¹¹⁹⁵ Ex. 121 (p. 15).

¹¹⁹⁶ Ex. 168 (p. 23).

¹¹⁹⁷ Ex. 168 (p. 23).

L. THE REPORT AND CERTIFICATE

Berger wrote the paper from which we have quoted in the preceding subsection in the same year in which Girard & Co., Inc. was formed, and Price, Waterhouse & Co. published it privately for the benefit of their staff in the year in which their first report was rendered to F. D. Coster, president of Girard & Co., Inc. Since this booklet was adopted as an adjunct to the booklet of office rules, its doctrine, in respect to report writing, may be considered as controlling.¹¹⁹⁸ The following extract forms an excellent background for the discussion to follow:

"Where detailed reports are submitted for the use of the management little need be added to what has already been said except that there should be intelligent discussion of the figures and points of interest and of the basis upon which the accounts have been prepared, and attention should be drawn to any shortcomings in the company's accounting practices and questions affecting the integrity of the accounts. With such full comments, the accountant should be fully protected against a charge of making insufficient disclosure of material points.

"A much greater responsibility, however, attaches to the giving of certificates in condensed form wherein the accountant declares within a few words or sentences that in his opinion the accounts set forth the true financial position or the correct results from operation. Among the more important purposes for which such brief certificates are issued may be mentioned:

- Annual reports to stockholders,
- Submission to Banks and Note Brokers for credit purposes,
- Submission to Banks and Investment Houses contemplating the underwriting of securities,
- Submission to the public when inviting investment in such securities,
- Submission to Trustees of bond issues or other agent acting for the protection of security holders,
- Settlement of dispute between parties,
- Confirmation of figures called for under the provisions of a Contract.

"As a rule the recipients of such certificates are not furnished with the detailed report to the management and have not the time or inclination, or perhaps even the technical ability, to go into the details but form their judgment on the information contained in the bare certificates and the statements which accompany them. This makes it necessary to determine whether the accounts read in conjunction with the certificate make the facts sufficiently clear to set forth all material points, which immediately brings up the question whether the client is entitled to a 'clean' certificate or whether a qualification is necessary to put the stockholders, creditors, prospective investors or other interested party on guard as to any point of doubtful propriety.

"In considering the form of the certificate it is necessary to take a detached view and reason out carefully the rights and interests of all people involved and then reach a decision which is fair to the client and the public and yet protects the firm in its responsibilities to both. When a qualification seems desirable the client should be given the opportunity of stating his side of the case and where his information and views are not convincing as a rule he will be prepared to cure the defect so as to remove the qualification. On the other hand the principal in

¹¹⁹⁸ R. O. Berger signed the booklet in Chicago, May 1, 1923, and the cover carries the date 1925.

representing the firm should show a combination of reasonableness and firmness and have the courage to resist undue pressure and be prepared to withdraw from the work and give up the connection rather than submit a certificate more favorable than the client is entitled to."¹¹⁹⁹

The detailed or long-form reports to management during the entire history of the engagement were addressed to F. D. Coster, president of the successive corporations. Such long-form reports were rendered on Girard & Co., Inc., on the Connecticut and Canadian Companies through 1929 and thereafter only on the Maryland Company. The certificates, beginning with the first balance sheet for Girard & Co., Inc. at December 31, 1924, carried no salutation until the certificate on the Maryland Company accounts for 1930, which was addressed to the directors, setting a style to be followed thereafter. The Canadian Company certificates in the published reports were addressed to the shareholders in accordance with the requirements of the Dominion's Companies Act.

The content of the detailed reports to Coster on the Girard & Co., Inc. and Connecticut Company examinations through 1929 was uniform in style and followed this general outline:

1. Paragraph transmitting the report and listing exhibits included as follows:
 - I. Balance sheet.
 - II. Statement of profit and loss.
 - III. Statement of cost of sales (Girard & Co., Inc. only).
 - IV. Statement of factory burden (beginning with first quarter 1926).
 - V. Statement of administrative, selling, and general expenses.
 - VI. Statement of paid in surplus (Connecticut Company eight months ended December 31, 1928, only).
 - VII. Statement of earned surplus (1928 and 1929).
 - VIII. Intercompany accounts receivable December 31, 1929.
 - IX. Intercompany accounts payable December 31, 1929.
2. Paragraph on history (1924 and 1926 only).
3. Paragraph on scope of the audit.
4. Paragraph on results of operations (beginning in 1925).
5. Paragraphs discussing principal balance sheet accounts.
6. Section showing changes in financial position including a statement of sources and application of funds supplemented by a detailed comparative statement of current assets and liabilities.¹²⁰⁰

For the Canadian Company long-form reports were submitted to cover the audit of the last 8 months of 1928 and the year 1929. Each of these consisted of three pages of comments and three statements—balance sheet, statement of surplus, and statement of profit and loss for the period.¹²⁰¹ Thereafter only the statements accompanied by a certificate addressed to the shareholders was supplied on this unit.

The first full report on the Maryland Company was written by Jaureguy and set the pattern for those to follow. It included 22

¹¹⁹⁹ Ex. 168 (pp. 24—25).

¹²⁰⁰ Ex. 138-148, 151.

¹²⁰¹ Ex. 149, 150.

pages of text and 13 exhibits bound in a gold stamped leather cover. The exhibits included a consolidated balance sheet, consolidated profit and loss statements for 2 years; analyses of surplus; summaries for 2 years by companies of notes and accounts receivable, inventories, advances to customers and instalment notes and accounts receivable, miscellaneous investments and deposits; and analysis of mortgages payable and other long-term obligations. This list varied somewhat during the years. For 1930 and several years thereafter consolidating statements were included. The number of exhibits reached a maximum for 1932 and 1933 when 19 and 20 exhibits respectively were included. The list was reduced to 10 for the last 2 years 1936 and 1937. Throughout the period 2-year comparisons by divisions and companies of current notes and accounts receivable, inventories, non-current notes and accounts receivable, and trade and miscellaneous investments were presented. These schedules therefore gave totals for these categories for the Connecticut Division and for the Canadian Company, but no departmental analysis for either.¹²⁰²

The review of these long-form reports was an important part of Rowbotham's duties as partner in charge of the engagement. Their texts were devoted primarily to the financing of the Company and to the balance sheet accounts, closing with a statement regarding the legality of dividends. A brief statement of the scope of the audit followed the introductory statement and list of exhibits.¹²⁰³ No comments on operating accounts were included. The customary closing paragraph acknowledging the facilities extended, used for 1929 and 1930 only, stated "* * * that all information required by us for the purposes of the examination was readily obtained."¹²⁰⁴ The signature of Price, Waterhouse & Co. was by Rowbotham throughout the period of the Maryland Company. Six copies of these detailed reports were delivered to Coster each year but most of the directors who testified at the Commission's hearings said that they had never seen them before and had never asked to see them but did get the letters and accounts on their own houses and the published stockholders' report.¹²⁰⁵

There follows a consideration of the text of all of the long-form reports in which there were comments by the auditors dealing directly with the foreign crude drug operations and comments which might

¹²⁰² Ex. 152-160.

¹²⁰³ See pages 153-154 *supra*.

¹²⁰⁴ Ex. 152, 153.

¹²⁰⁵ Thompson (treasurer and director) read the full report each year but did not think it ever was submitted to a board meeting, R. 2111; Pettingill (lawyer) saw one of these about 2 weeks prior to December 5, 1938, R. 222B; Phillips (investment banker) did not remember seeing anything but the published report, R. 2352 and 2368; Weinberg (investment banker) had seen the published report only, R. 2399-2401; Cummings (lawyer) had seen the private report recently, R. 2448; Michaels, Murray, Bedsole, and Faxon (wholesalers) had not seen the leather-bound report, R. 4294, 2177, 2498-2499, 2528; but Doerr had seen one several years ago, R. 2588-2589.

have suggested such a business or which might have provoked an inquiry thereon.

Comments on the cash work, from time to time through the reports, mentioned that bank acceptances of varying but substantial amounts arose from export sales of bulk stock, the first such comment being in the report on the Connecticut Company for the 4 months ended March 31, 1927.¹²⁰⁶ Similar references appeared in reports on the Canadian Company for 1928,¹²⁰⁷ in the last separate report on the Connecticut Company (1929)¹²⁰⁸ and in the 1929 report on the Maryland Company in which the item was referred to as arising from export sales by the Connecticut Company and its Canadian subsidiary.¹²⁰⁹ In connection with these comments it may be recalled that, beginning in 1931, the collections from foreign crude drug customers were supposed to have been made through Manning & Company but neither this fact nor the name Manning & Company was mentioned in any of the reports.

The excellent condition of the foreign accounts receivable was the subject of frequent comment in the reports as was noted in the discussion of the receivables phase of the audit program. That the fictitious foreign business was a development from the Girard & Co., Inc. business is suggested, not only by the fact that the accounts receivable at December 31, 1924 seemed to be remarkably good,¹²¹⁰ the outstanding characteristic of the fictitious accounts, but also by the gradual evolution in the descriptions used in the classification of the receivables in succeeding reports. The second report on the Connecticut Company classified customers' accounts as "Domestic" and "Foreign" and aged each group. "Domestic" was subdivided in another table to show "Retailers, wholesalers and jobbers" separate from "Distributors".¹²¹¹ The third report showed the classes of accounts as:

- "Wholesalers, distributors, etc:
 - Wholesalers and jobbers.
 - Distributors.
 - Girard division—foreign and domestic.
- Export department:
 - Spanish.
 - Foreign.
 - City Export."¹²¹²

But following this was an aging schedule in which "Wholesalers, jobbers and distributors" were grouped and agreed with the sum of

¹²⁰⁶ Ex. 145.

¹²⁰⁷ Ex. 149.

¹²⁰⁸ Ex. 151.

¹²⁰⁹ Ex. 152.

¹²¹⁰ "Customers' accounts aggregating \$34,692.40 had all been paid at the date of examination with the exception of two accounts amounting to \$2,625.18, which were considered good and collectible." Ex. 138, dated March 9, 1925. Reference is also made in a later report to " * * * the insurance company which has insured their collectibility." Ex. 140. Coster, in his President's Report for 1925, says, "We have had no bad debts in 1925." Ex. 176.

¹²¹¹ Ex. 145 (p. 4).

¹²¹² Ex. 146 (p. 5).

the two groups so named above, as did a separate aging for "Export department", but the amounts under "Special foreign (Girard division)" agreed in total with the amounts shown under "Girard division—foreign and domestic" in the previous list.¹²¹³ The next report for the first 4 months of 1928 used the terms "Distributors", "General" and "Export department" with the amounts involved indicating that "General"¹²¹⁴ referred to the business previously described as "Special foreign (Girard division)". The term "General" was retained in the final reports submitted for the Connecticut Company¹²¹⁵ but included some accounts other than those arising from foreign sales of crude drugs. The last report on the Connecticut Company (for the year 1929) contained the following paragraph which is a typical comment as to the collectibility of the Connecticut and Canadian Company foreign accounts receivable:

"The trade accounts receivable have increased \$2,107,191.35 during the year largely as the result of larger balances arising through the export sales of crude drugs. Despite this increase in the balances, no proportionate increase in the reserve for doubtful accounts was considered necessary because past experience has shown these foreign accounts to be safe and liquid. No credit losses have been sustained by the company thus far in this department of the business."¹²¹⁶

The increase referred to resulted in over three times the balances due at the close of the preceding year.

Although the Maryland Company reports beginning with 1929 did not present analyses of the customers' accounts receivable, in 1930 the report referred to increased sales of crude drugs and raw materials in the Connecticut and Canadian Companies and in 1932 the report in commenting on a reduction in receivables of approximately \$1,900,000 during the year stated: "* * * This reduction is net, the receivables of McKesson & Robbins, Incorporated (Connecticut) and McKesson & Robbins, Limited, principally due from foreign customers, having increased approximately \$1,100,000 while the balance of the receivables were reduced by approximately \$3,000,000."¹²¹⁷ Thereafter comparative figures for 2 years were presented in each report showing total accounts receivable for each company or division of the McKesson organization so that such over-all changes as were formerly commented upon in the text could have been observed by scanning the schedules.¹²¹⁸

An interesting account of the changes in the inventories may be traced through the audit reports. Figures of some significance appeared in successive reports on Girard & Co., Inc. through 1926, the last rendered on this company. No comment was offered in the reports, however, on the large quantities of raw material in proportion to the other

¹²¹³ Ex. 146 (pp. 5-6).

¹²¹⁴ Ex. 147 (p. 4).

¹²¹⁵ Ex. 148 (pp. 7-8), 151 (pp. 2-3)

¹²¹⁶ Ex. 151 (p. 3).

¹²¹⁷ Ex. 153 (p. 20), 155 (p. 17).

¹²¹⁸ Ex. 156-160.

items or on the doubling of the amount in 2 months as revealed in the following table:¹²¹⁹

Inventories of Girard & Co., Inc., as at Sept. 30, 1926 and Nov. 30, 1926

Raw materials.....	\$244, 144. 56	\$558, 731. 59
Containers and supplies.....	19, 376. 49	22, 334. 02
Manufactured products.....	30, 590. 77	25, 699. 86
	<hr/>	<hr/>
Total.....	\$294, 111. 82	\$606, 765. 47
	<hr/> <hr/>	<hr/> <hr/>

The report on the Connecticut Company for the 4 months ended March 31, 1927 gave more detail than the above as to inventories, the largest category being described as "Raw materials and crude stock", referred to in subsequent reports as "* * * on hand, in transit and in public warehouses."¹²²⁰ Advantage was taken of the simplicity of the crude drug transactions beginning in 1928 to present in the Connecticut Company report an analysis by commodities of changes in the inventory of this class of merchandise. For example at April 30, 1928, an increase in raw materials and crude stock of over two-thirds over the value of raw materials and crude stock on hand at December 31, 1927 is accounted for by the following increases:¹²²¹

<i>"Commodity:</i>	<i>Approximate increase during period</i>
Crude iodine.....	\$230, 000. 00
Santonine crystals.....	149, 000. 00
Camphor.....	52, 000. 00
Cod liver oil.....	28, 000. 00
	<hr/>
	\$459, 000. 00"
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And at the close of the same year, 1928, a further net increase of \$330,310.04 in all inventories was accounted for in the Connecticut Company report as follows, but as previously, and in the year to follow, without further comment in the report:¹²²²

"It will be noted that the inventory of raw materials and crude stock increased approximately \$350,000.00 during the period. In examining the inventories we found increases and decreases in the quantities of certain commodities in approximately the following amounts:

¹²¹⁹ Ex. 142-143.

¹²²⁰ Ex. 145-148, 151.

¹²²¹ Ex. 147 (p. 7).

¹²²² Ex. 148 (p. 11).

	<u>Increase</u>	<u>Decrease</u>
Menthol	\$233, 000. 00	
Mercury	75, 000. 00	
Senega root	52, 000. 00	
Cod liver oil	49, 000. 00	
Potassium iodide	167, 000. 00	
Crude iodine		\$192, 000. 00
Camphor		81, 000. 00
Santonine crystals		24, 000. 00
Miscellaneous raw materials	71, 000. 00	
	<hr/>	
	\$647, 000. 00	\$297, 000. 00
	297, 000. 00	
	<hr/>	
Approximate net increase, as above	<u>\$350, 000. 00</u> '	

By December 31, 1929, the inventories of the Connecticut Company had increased \$1,345,193.07 over the previous year end, principally in "Raw material and crude stock", \$472,242.54; "China wood oil," \$348,263.01; "Containers and packing supplies", \$154,379.23; and "manufactured products" \$385,735.98.¹²²³

"The larger items making up the increase of approximately \$472,000.00 in the amount of raw materials and crude stock are:

	<u>Increase</u>	<u>Decrease</u>
Menthol		\$27, 000. 00
Mercury	\$146, 000. 00	
Cod liver oil		30, 000. 00
Potassium iodide		27, 000. 00
Crude iodine	122, 000. 00	
Camphor	58, 000. 00	
Santonine crystals	18, 000. 00	
Quinine sulphate	134, 000. 00	
Pyrethrum flowers	29, 000. 00	
Antimony	20, 000. 00	
Miscellaneous raw materials	29, 000. 00	
	<hr/>	
	\$556, 000. 00	\$84, 000. 00
	84, 000. 00	
	<hr/>	
	<u>\$472, 000. 00</u> '	

Comments in the Canadian Company reports for 1928 and 1929 were very brief—merely noting that the merchandise was all in a public warehouse from which the auditors had received a certificate as to quantities which agreed with the books. In 1928 the inventory amounting to \$456,112.95 was reported to have consisted solely of mercury and senega root.¹²²⁴

¹²²³ Ex. 151 (p. 6).

¹²²⁴ Ex. 149, 150.

Reports of the Maryland Company beginning with that for 1929 contained schedules showing the inventories by companies or divisions of McKesson compared with the preceding year. The first of these comparisons included 3 years, December 31, 1927, 1928, and 1929. The text of the 1929 report merely noted a total increase of approximately \$2,400,000.¹²²⁵

The reports for 1930, 1931, and 1932 included comments stating the increase or decrease in the Connecticut and Canadian Company inventories combined compared with the change for the Maryland Company as a whole consolidated. The approximate changes reported, closing with total inventories at December 31, 1932 of approximately \$23,850,000, were:¹²²⁶

	<u>1930</u>	<u>1931</u>	<u>1932</u>
Net increase (decrease) in total inventories	(\$ 970, 000)	\$ 700, 000	(\$4, 500, 000)
(Decrease) in wholesale house inventories	(2, 910, 000)	(2, 900, 000)	(2, 900, 000)
Increase (decrease) in Canadian and Connecticut Companies' combined inventories	1, 940, 000	3, 600, 000	(1, 600, 000)

The increases in Canadian and Connecticut Companies were attributed largely to the purchase of crude drugs and raw materials in the primary markets in 1930 and 1931, and to the carrying of somewhat larger stocks of finished products in 1930, with the sales of crude drugs and raw materials in that year in excess of 1929 sales.¹²²⁷

In addition to the separate treatment given to the principal current assets discussed above, all of the reports rendered on quarterly and annual audits of Girard & Co., Inc. and the Connecticut Company included a summary of the Company's change in financial position during the period under review. These statements were prepared in a manner which emphasized the increases and decreases in the accounts covered in the above discussion and related the net change in working capital to the profit for the period. As an example of the form in which these statements appeared each year the one from the report on the Connecticut Company for 1929 is reproduced here:¹²²⁸

¹²²⁵ Ex. 152 (p. 12).

¹²²⁶ Ex. 153 (p. 20); 154 (p. 19); 155 (pp. 20-21).

¹²²⁷ Ex. 153 (p. 20), 154 (p. 19).

¹²²⁸ Ex. 151 (p. 15), used because it is the last included in a report to the client, although, as noted at pages 244-245 *supra*, the auditors prepared such statements subsequently for their own use.

“Disposition of Profits and
Change in Financial Position”

The change in financial position of the company during the period under review is summarized in the following statement:

Net profit for the year ending December 31, 1929 (per exhibit C)	\$1, 271, 647. 75
Provision for depreciation not representing cash outlay, less charges thereto	68, 889. 06
Increase in reserve for contingencies	4, 833. 07
	\$1, 345, 369. 88
Investments and notes receivable of affiliated com- panies disposed of, etc.	1, 359, 686. 79
	\$2, 705, 056. 67
Deduct:	
Additions to properties (net)	\$592, 577. 90
Reduction of mortgage on property	10, 000. 00
Reduction of liability for sprinkler system	3, 942. 00
Reduction of liability for manufacturing rights	6, 666. 66
Cash dividends paid	733, 125. 00
	1, 346, 311. 56
Balance of funds retained in the business as addi- tional working capital as shown in the following comparative statement	\$1, 358, 745. 11

	<u>As at December 31,</u>		<u>Increase or Decrease* in funds</u>
	<u>1928</u>	<u>1929</u>	
Cash in banks and on hand	\$ 368, 744. 31	\$ 267, 416. 17	\$ 101, 328. 14*
Bankers' acceptances	282, 950. 00	280, 110. 18	2, 839. 82*
Notes and accounts receivable, less reserves	1, 475, 072. 34	3, 325, 554. 55	1, 850, 482. 21
Inventories, less reserves	1, 936, 756. 98	3, 270, 950. 05	1, 334, 193. 07
	\$4, 063, 523. 63	\$7, 144, 030. 95	\$3, 080, 507. 32
Current liabilities	1, 953, 102. 45	4, 302, 278. 08	2, 349, 175. 63
	\$2, 110, 421. 18	\$2, 841, 752. 87	\$ 731, 331. 69
Intercompany accounts re- ceivable (net)	732, 400. 00	1, 204, 275. 08	471, 875. 08
Prepaid expenses and sundry supplies	73, 178. 74	228, 717. 08	155, 538. 34
Net totals	\$2, 915, 999. 92	\$4, 274, 745. 03	\$1, 358, 745. 11**

It was noted above that these long-form reports dealt with financing and the propriety of dividend payments and Thorn testified that one of the copies of the report was for the use of the trustee of the “indenture” issue.¹²²⁹ The 1930 report referred to the issuance of \$22,000,000 of debentures in April of that year and stated:

¹²²⁹ R. 887. Article Two, Section 11 of the indenture dated as of May 1, 1930 covering \$25,000,000 20-year

"The indenture relating to the issue contains certain restrictions: among other things the Maryland Company has agreed not to borrow money, or permit the subsidiary companies to borrow money, unless a consolidated current ratio of $2\frac{1}{2}$ to 1 can be maintained; and has also consented to the following restrictions on the payment of dividends or the investment of current assets in fixed assets:

"(a) Consolidated net current assets to be equivalent to $1\frac{3}{4}$ times the sum of the outstanding debentures plus mortgages and other long-term obligations.

"(b) Consolidated current assets not to be reduced to less than $3\frac{1}{2}$ times the consolidated current liabilities.

"(c) Consolidated current assets not to be reduced to less than $1\frac{1}{4}$ times the sum of the consolidated current liabilities plus the sum of the outstanding debentures, mortgages and other long-term obligations.

"The disposition of the proceeds received from the sale of subsidiary companies is also restricted under the indenture."¹²³⁰

Reports for 1931, 1932, and 1933 referred to the 1930 report for the details quoted above, concluding a one paragraph summary with the phrase "* * *" and it would appear that these terms have been complied with as at December 31 * * *,"¹²³¹ In reports for the succeeding 4 years, 1934-1937, a shortened paragraph was used concluding with the sentence "* * * The terms of the indenture in respect of such ratios were complied with as at December 31, * * *,"¹²³²

Section 14 of Article Two of the indenture provides that for the purposes mentioned above "Consolidated current assets" shall be defined to include among other things the following:

"Inventories of merchandise, materials and supplies taken at cost or market value, whichever shall be lower *exclusive of goods purchased abroad which are either in foreign warehouses or in transit at the date of such determination and exclusive of plants and equipment.*" [Italics supplied.]¹²³³

If, at December 31, 1936 and 1937, the foreign crude drug inventories, which the representatives of Price, Waterhouse & Co. testified they believed were purchased from the Canadian vendors and were at that time stored in warehouses located in Canada, had been ex-

$5\frac{1}{2}$ % convertible debentures provides that:

"At all times the Company will, and it will cause each subsidiary company at all times to, keep proper books of record and account, in which full, true and correct entry will be made of all dealings, business and affairs of the Company and its subsidiary companies, all in accordance with good accounting practice. The Company further agrees to deliver to the Trustee, as soon as available after the close of each fiscal half-year, Consolidated Balance Sheets and Combined Earnings Statements certified to by the Treasurer or an Assistant Treasurer of the Company, setting forth in reasonable detail the condition and operation of the business of the Company and its subsidiary companies, for and as of the close of such fiscal half-year, and as soon as available after the close of each fiscal year, it will deliver to the Trustee, Consolidated Balance Sheets and Combined Earnings Statements certified to by public accountants satisfactory to the Trustee, setting forth in reasonable detail the condition and operation of the business of the Company and its subsidiary companies for and as of the close of such fiscal year." McKesson & Robbins, Incorporated, Securities Registration, Form 10, File No. 1-1435, Exhibit B (p. 37).

¹²³⁰ Ex. 153 (pp. 3-4).

¹²³¹ Ex. 154, 155, 156.

¹²³² 157, 158, 159, 160.

¹²³³ McKesson & Robbins, Incorporated, Securities Registration, Form 10, File No. 1-1435, Exhibit B (p. 41).

cluded from consolidated current assets, the ratio specified in "(b)" above would not have been complied with as at December 31 of those years, although the Price, Waterhouse & Co. reports stated that the terms of the indenture in respect to the ratios had been complied with at the year ends.¹²³⁴

The portion of the indenture italicized above was inserted after Jaureguy of Price, Waterhouse & Co. had read the draft and suggested that provision be made to cover the practice which McKesson then followed of not including in their asset *or liability* totals on the balance sheet "Goods purchased abroad, in foreign warehouses or in transit * * *." ¹²³⁵ Despite the language of the indenture, the auditors' position is that the provision was not meant to apply to inventories such as the Canadian merchandise in question which had been paid for or for which a liability had been set up. And in any event the auditors claim that Canada, where the goods were purchased and warehoused, is not "abroad."

The purpose and content of the reports we have reviewed were discussed at the hearings with some of the Price, Waterhouse & Co. representatives responsible for their preparation. The problem was

¹²³⁴ McGlooin in his comptroller's report for 1937 noted that "The balance sheet ratios of current assets to current liabilities * * *" were 3.56 and 3.46 respectively at December 31, 1936 and 1937 and commented as follows, Ex. 266 (pp. 17-18):

"RATIOS REQUIRED UNDER INDENTURE:

All of the ratio requirements under the indenture governing our debentures were met at December 31, 1937, with the exception of the ratio of current assets to current liabilities governing the declaration of dividends, etc. (which ratio has since been corrected in 1933 to meet with terms of our indenture) as is shown in the following summary. It might again be mentioned that various adjustments are made to the balance sheet figures when computing the ratios required under the indenture.

Otherwise, the fulfillment of the terms of our indenture relating to our debentures was observed, and no notice from the Trustees of any default during the year 1937 on the part of the Company has been received.

	Re- quired Ratio	Actual Ratios as at		
		December 31, 1937	June 30, 1937	December 31, 1936
Governing the declaration of dividends and the conversion of current into fixed assets:				
1. Net current assets to debentures, plus other non-current indebtedness and mortgages not assumed	1.75	3.02	3.02	2.89
2. Current assets to current liabilities	3.50	3.49	3.61	3.56
3. Current assets to current liabilities, plus debentures and other non-current indebtedness, including mortgages not assumed	1.25	1.91	1.04	1.83
Governing the borrowing of money:				
Current assets to current liabilities	2.50	3.49	3.61	3.55 ¹²³⁷

A comparison of the balance sheet current ratios and the adjusted ratios as presented by McGlooin indicates that such adjustments as were made at December 31, 1937 strengthened the ratio slightly while those at December 31, 1936 (if any), made no difference in the result. If, however, the inventories understood to have been in warehouses in Canada on those dates had been eliminated from current assets, the balance sheet current ratios would have been less than 3.2 at December 31, 1936, and less than 3.1 at December 31, 1937.

¹²³⁷ The Annual Report for 1929, the one current at the time the indenture was drawn, carried the following note under inventories:

"NOTE.—Goods purchased abroad, in foreign warehouses or in transit at December 31, 1929, not included above, amounted to approximately \$1,085,000." Ex. 130.

first raised and discussed with Thorn who explained that the details covered in the letters on the audits of the wholesale houses and discussions he may have had with Coster in respect to the Connecticut Division and Canadian Company were not covered in the consolidated long-form report “* * * because that is for the use of the directors and the trustee of the indenture issue [and certain banks which extend credit] and they were not concerned with those minor matters we would mention of an individual house.”¹²³⁶ Coster and the divisional vice-presidents, Thorn felt, would be more concerned with the operating details included in the individual letters than they would be in the accounting problems covered in the overall report which also described the scope of the examination and what was or was not done in respect to important accounts.¹²³⁷ Thorn felt that he would have been presumptuous if he had suggested breaking up the Connecticut Division accounts to show crude drugs and manufacturing separately so that the separate operations could be seen and commented on in the auditors’ report as the purpose of the annual examination was to enable the auditors to give an opinion as to whether “accounts * * * prepared * * * by the company * * * do or do not fairly present the financial position and results of the operations for the year and whether accepted accounting practices have been consistently followed.”¹²³⁸ There was no place in any of the Price, Waterhouse & Co. reports where the results of the crude drug transactions standing separately could be seen.¹²³⁹

Thorn’s testimony referred to above, used language stating that the accounts were “prepared by the Company.” He testified, however, that it was his practice to draft a report and send it to McGloon so that all statements of fact could be checked before completion in final form. Thorn also understood that Coster read the report as well as McGloon. Drafts of the 1935, 1936, and 1937 reports obtained from McKesson’s files carry notes by McGloon to the effect that Coster had reviewed the report.¹²⁴⁰ In this connection it may be noted that Thorn stated that the financial statements and attached footnotes included in McKesson’s annual reports to the Securities and Exchange Commission were typed in the office of Price, Waterhouse & Co.¹²⁴¹

Rowbotham, who signed the report for Price, Waterhouse & Co., stated that although negotiations in respect to the engagement were

¹²³⁶ R. 887.

¹²³⁷ R. 894, 897.

¹²³⁸ R. 903, see also R. 900.

“Q. [By MR. GALPERR.] And it is not your duty to comment upon such operating conclusions as might be drawn from the figures or to point out various conclusions that might be drawn by a study or breaking up of the figures just from an operating point of view?

A. [By THORN.] No, sir, I personally should, as I said a while ago, I would feel presumptuous if I attempted to get very far into the operating end of the business.” R. 903.

¹²³⁹ R. 909.

¹²⁴⁰ Ex. 93, 94, 95; R. 991-995.

¹²⁴¹ R. 1026.

conducted by Coster—at times through McGlooin—he thought he was reporting to the Corporation through Coster, its president. The crude drug department was not reported upon because he thought it was the best run department of the business, conditions were satisfactory and required no comment.¹²⁴² He understood that the letters on the wholesale houses were used by Coster and McGlooin to prod the heads of those houses into corrective measures where conditions were criticized but he did not suppose that they would be referred to in directors' meetings, although the directors would have a right to see them. This last opinion was qualified to some extent for Rowbotham thought that if a director who was head of one of the wholesale houses called upon him for permission to see a letter covering another house, he would probably not have released the letter if the contents were a serious matter or if the director's inquiry was based on suspicion. Rowbotham thought that the inquirer should be refused the information and directed to seek it of Coster, the executive head of the corporation.¹²⁴³ This seems to be along the same line as the idea expressed by Ritts, in response to a question based on a statement that the check on operations effected by the president himself was an important element of internal control in this case:

"Well, our first duty, of course, is to the president or the Board of Directors, the people that hire us. I assume we do have a responsibility, though, to the stockholders in certifying accounts that we know are going to be published."¹²⁴⁴

This responsibility to stockholders was called upon in several ways from 1924 through 1937 for the client's financial statements carrying Price, Waterhouse & Co.'s certificate were used in reports submitted to stockholders, to prospective stockholders in prospectuses issued in connection with the sale of securities, and in listing applications filed with the New York Stock Exchange; and, more recently, in reports filed with the Securities and Exchange Commission.

The form and content of the published stockholders' reports have shown a gradual change through the years in conformity with pre-

¹²⁴² R. 1981-1983.

¹²⁴³ "Q. [By Mr. STEWART.] Perhaps you misunderstood Mr. Galpeer and me both—I didn't mean we were talking about working papers. I am talking about letters sent to Coster and then to the divisional vice president in charge of a particular company, commenting on weaknesses in that company. Now, if another director should come in and ask for a copy of such a letter, and give you an explanation that he was suspicious about something in that company, is that a letter which you would release to him?—it has nothing to do with the working papers now.

A. [By ROWBOTHAM.] Probably not, because it wouldn't seem to me that that was any of his business. If he had suspicions in that connection, I think his job in that case would be to take it up with Coster, who is the executive head of the corporation. I am assuming that his suspicions related to the divisional point and not to Coster himself.

Q. Suppose he expressed some suspicions as to Coster himself, then what would your reaction be?

A. Then the question would have been what his suspicions were, and I really can't answer that question any better than this, that I would have given it the most serious consideration and probably, I think, if it was sufficiently serious, we would have taken it up with our attorneys and simply wanted to know what we should do next.

Q. That occasion never arose.

A. That occasion never did arise." R. 1987-1988.

¹²⁴⁴ R. 667.

vailing accounting practice, the most marked change being in the increase in information given in the profit and loss statement. Rowbotham was asked whether this tendency should be carried further by reporting profit and loss accounts for major lines of business conducted by large corporations such as McKesson & Robbins, Incorporated, had grown to be. His opinion was that “* * * the simpler and more compact you can make the documents you offer to the public, the more likely they are to understand them.” He pointed out that corporations were required to report sales in many cases against their will and he thought that they would have good reasons for not wanting to split up this figure in published reports.¹²⁴⁵

It seems unnecessary to discuss in detail the changes in reporting through the years but a brief comparison of the material in the long-form reports addressed to Coster with the reports to the stockholders and to the Securities and Exchange Commission may be of interest. With the exception of the balance sheets and surplus accounts the statements in the long-form report are in comparative form for 2 years with the current year outside. In the stockholders' report the consolidated balance sheet and surplus accounts are reproduced without change but the consolidated profit and loss statement condenses some detail (opening with “net sales” instead of gross sales for example) and the current year's figures are brought inside the prior year's (a suggestion marked by McGloon on the draft report submitted to him). None of the supporting schedules were published, nor financial statements for the parent company only. The only notes that appear on the stockholders' reports are those on the face of the balance sheet as parenthetical expressions, and statements as to contingent liabilities, and some detail in respect to preferred stock which are reported at the foot of the right-hand side. The annual report filed with the Commission substitutes required schedules for those in the long-form report and makes certain changes in the profit and loss statement as required by the form. The balance sheets refer to three pages of footnotes for each and the profit and loss statements to one.¹²⁴⁶

¹²⁴⁵ R. 1977-1980.

“Q. [By Mr. GALPEER.] Do you think that any distinction might be made in your answer between a company, let us say, as an oil company, where you refer to their having one product and take it through various stages and a firm like McKesson & Robbins, where in addition to their own products, as I understand it, they job and wholesale the products of others as well?

A. [By ROWBOTHAM.] I don't think so, in any case where you believe as we believed here, that this business was genuine and that those profits were genuine. If you believed that this business, as we did and as I did, was a genuine business and those profits were made, I don't think that you would want to make the split-up. I think you would meet some objections from the company which I think would have seemed to you or would have seemed to me reasonable from the directors, that they didn't want to disclose the amount of profit in this specialty business to possible competitors. We have had that objection on other companies.” R. 1979-80.

¹²⁴⁶ Ex. 160, 106, and McKesson & Robbins, Incorporated, Securities Registration and Annual Reports, Forms 10 and 10-K, File No. 1-1435.

It was noted earlier in this account that the financial statements for the annual report to the Commission were typed by Price, Waterhouse & Co. It may be noted here that Thorn wrote the footnotes. This point was established in connection with the note in regard to inventories. The following quotation will make the accountant's position clear in this regard:

"Q. [By Mr. STEWART.] Now, as I understand it, this footnote with regard to the quantities of goods on hand being counted was not a part of your certificate, but a footnote to the company's balance sheet?

A. [By THORN.] That is correct. I wrote that note.

Q. You wrote it for the company?

A. For the company.

Q. And expressed an opinion with regard to it?

A. I am writing what I think the company should say. Then, of course, this is sent to the company and they change it any way they want. This is their statement, you understand (indicating [Form 10-K])."¹²⁴⁷

A statement of Rowbotham's is also in point here on the subject as to whether the financial statements are the accountants' or the clients'. He said that on an earlier balance sheet he put a note on himself in the most conspicuous place he could find to draw "* * * to the stockholders' attention that as to quantity, quality and condition of the inventories we relied on responsible officials * * *."¹²⁴⁸ A note "* * * as certified by responsible officials" or "* * * certified as to quantity and condition by responsible officials * * *"¹²⁴⁹ appeared on every certified balance sheet prepared for McKesson by Price, Waterhouse & Co. except the first one for Girard & Co., Inc., for December 31, 1924.¹²⁴⁰

The certificate attached to the statements rendered throughout the engagement were the usual short form without qualifications and conformed to the changing manner of expression of the period. All of the certificates supplied to Girard & Co., Inc., were substantially the same as the first which stated:

¹²⁴⁷ R. 1046-1047, see also R. 1014. The testimony quoted in the text arose in connection with a discussion of the footnote to inventories on the balance sheet filed with this Commission as part of the Annual Reports for 1935 and 1936, which, after listing the entire inventories in four commodity groupings, stated "The quantities of goods on hand at December 31 * * * were determined by actual count, weight or measurement by officers and employees of the companies, and were priced on the basis of cost or market, whichever was lower." The corresponding footnote for 1937 added: "* * * and the quantities of goods stored in outside warehouses were confirmed by the warehouses. * * *" Although there was no mention in this connection in the 1935 and 1936 reports of the goods not in McKesson's own warehouses, Thorn testified that, like "cash on hand" as distinguished from "in banks", only goods held in the Company's warehouses were "on hand" and that such statements, therefore, did not apply to goods held in outside warehouses. R. 995-1000, 1046-1057.

¹²⁴⁸ R. 2005. See also:

"Q. [By Mr. STEWART.] It is simply designed for the purpose of making it clear to anybody who reads the balance sheet that on that point they must accept the word of the company officials rather than the word of the accountants?

A. [By ROWBOTHAM.] Yes, sir." R. 2043.

¹²⁴⁹ R. 1992; Ex. 128-137, 161-167, 106.

"We have examined the books and accounts of Girard & Co., Inc. as of December 31, 1924 and we certify that, in our opinion, the above balance sheet fairly sets forth the financial position of the company at that date."¹²⁵⁰

The style adopted for the first published report for McKesson & Robbins, Incorporated, of Connecticut, served without substantial change for the Maryland Company as well through 1932. To avoid minor variations arising from special circumstances existing through the formative period of the Maryland Company, the certificate from the report for that company for 1929 is used as an example:

"We have examined the books and accounts of McKesson & Robbins, Incorporated (Maryland), and subsidiary companies for the year ending December 31, 1929, and we certify that the attached consolidated balance sheet and relative statements of profit and loss and earned surplus have been correctly prepared from the books and, in our opinion, set forth the financial position of the combined companies as at December 31, 1929, and the result of operations for the year ending on that date."¹²⁵¹

Reference to correct preparation from the books was omitted for 1932.¹²⁵² With the 1933 report the form recommended by the American Institute of Accountants, in cooperation with the New York Stock Exchange, became standard. To complete the series, the last certificate is reproduced:

"PRICE, WATERHOUSE & CO.

56 Pine Street
New York March 7, 1938

"To the Board of Directors of
McKesson & Robbins, Incorporated

"We have made an examination of the consolidated balance sheet of McKesson & Robbins, Incorporated and subsidiary companies as at December 31, 1937, and of the consolidated statements of profit and loss and surplus for the year 1937. In connection therewith, we examined or tested accounting records of the companies and other supporting evidence and obtained information and explanations from officers and employees of the companies; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

"In our opinion, based upon such examination, the accompanying consolidated balance sheet and related statements of profit and loss and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the companies during the year under review, the position of the combined companies at December 31, 1937, and the result of their operations for the year.

PRICE, WATERHOUSE & CO."¹²⁵³

The certificate filed with this Commission was altered only to include a reference to the index to financial statements and to the footnotes. It was signed for the firm by Rowbotham.¹²⁵⁴

¹²⁵⁰ Ex. 2.

¹²⁵¹ Ex. 130.

¹²⁵² Ex. 133.

¹²⁵³ Ex. 106.

¹²⁵⁴ R. 2014-2015, 2058-2059. See pages 358-359 *infra*.

The certificates for the Canadian Company revealed a similar transition with a blending in recent years of the requirements of the Canadian Companies Act and the style of the United States form of report. The differences in form in the two countries may be observed by comparing the last certificate for the Maryland Company quoted above with the last for the Canadian Company which is shown below:

“PRICE, WATERHOUSE & CO.

56 Pine Street
New York
February 11, 1938.

“To the Shareholders of
McKesson & Robbins, Limited

“We have made an examination of the consolidated balance sheet of McKesson & Robbins, Limited and its subsidiary company in England as at December 31, 1937, and of the consolidated statement of profit and loss and surplus for the year 1937. In connection therewith, we examined or tested accounting records of the companies and other supporting evidence and we have obtained from officers and employees of the companies all the information and explanations we have required; we have also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

“In our opinion, based upon such examination, the accompanying consolidated balance sheet and related statement of profit and loss and surplus are properly drawn up so as to exhibit a true and correct view of the state of the companies' affairs according to the best of our information and the explanations given to us, and as shown by the books of the companies.

PRICE, WATERHOUSE & CO.’’¹²⁵⁵

Rowbotham explained that all of these certificates covered the same type of work and that therefore the language used could be interpreted merely as a changing preference in the manner of reporting. Rowbotham thought the earlier style was too laconic so the changes were made in an effort to give more explanation to the stockholder of what an accountant does when he examines accounts.¹²⁵⁶

Rowbotham's interpretation of the last American certificate and a reconciliation of it with the requirements of the “Instruction Book for Form 10-K for Corporations, Annual Report”, was requested. The second sentence of the certificate he understood to be compliance with the requirement that the certificate should be reasonably comprehensive as to the scope of the audit made.¹²⁵⁷ The certificate was not as informative as to scope as the long-form report for in the latter a statement was made that debtors and creditors were not circular-

¹²⁵⁵ Ex. 167.

¹²⁵⁶ R. 1994-1997, 2014.

¹²⁵⁷ R. 1998.

ized.¹²⁵⁸ Rowbotham thought that this information should not go in the report to stockholders or in a footnote on the balance sheet because it is the accountants' duty to decide whether circularization is necessary and, if it is not, a statement that it was not done would give the stockholders the impression that there was something wrong with the debtors. He felt that if the auditor thinks circularization is necessary he should insist upon it—a sentence in the report would not be a substitute.¹²⁵⁹ This situation Rowbotham thought was different from the note in respect to inventories because it was common practice for ac-

¹²⁵⁸ The comparison here is between the certificate and the paragraph in the long-form report entitled "Scope of Examination." It should be observed, however, that in the discussion of the principal balance sheet accounts the long-form report commented briefly on the audit procedures followed in verifying certain of the items. The following excerpts from the report on the 1937 examination illustrate this practice:

"The cash in banks as at December 31, 1937 was reconciled with certificates received direct from the banks, and the cash on hand was counted at the time of our examination. In accordance with instructions, we did not request the banks to confirm the details of deposits made near the end of the year.

* * * * *

"The notes receivable as at December 31, 1937 which were on hand at the time of our examination were inspected by us and those held by others were confirmed by correspondence. Trial balances of the accounts receivable were checked to the detailed ledger accounts and the totals were agreed with the general ledger controlling accounts. In accordance with instructions, we did not circularize the debtors for confirmations of their balances.

* * * * *

"The amounts of the reserves for doubtful notes and accounts and for sales discounts, returns and allowances as at December 31, 1937 were adequate, in our opinion. In considering the collectibility of the receivables, we reviewed such credit information as was available relating to balances that were past due or relatively large in amount, and discussed such balances with local officials. Because retail druggists, in general, appear to be unable or unwilling to furnish satisfactory financial statements, our conclusions as to the adequacy of the reserves were necessarily based, to a large extent, on the discussions with local officials and the paying records of the respective debtors. In the case of each house, consideration was also given to the bad debt experience of that particular house during recent years.

* * * * *

"The quantities of merchandise, materials and supplies on hand at December 31, 1937 were determined by actual count, weight or measurement by employees of the companies and the quantities stored in outside warehouses were confirmed direct to us.

"We made a comprehensive check of the arithmetical accuracy and of the prices used which indicated that the inventories were carefully compiled and properly priced on the basis of cost or market, whichever was lower, and that sufficient allowance had been made for slow-moving and unsalable stock.

* * * * *

"Responsible officials of the companies have certified to the quantities, condition and ownership of the goods included in the inventories, as well as to the prices used and the adequacy of the allowances for obsolete, damaged and slow-moving stock.

* * * * *

"So far as our examination extended, it appeared that all known liabilities as of December 31, 1937 had been taken up on the books of the respective companies as at that date, and we secured certificates from responsible officials stating that, to the best of their knowledge and belief, all liabilities had been taken up.

* * * * *

"We received a certificate from the Manufacturers Trust Company, successor trustee under the indenture, confirming the amount of twenty-year 5½% convertible debentures outstanding at December 31, 1937.

* * * * *

"With reference to the capital stock of McKessou & Robbins, Incorporated, we received certificates from the transfer agent and from the registrar confirming the number of shares of preference stock and common stock outstanding at December 31, 1937. * * * Ex. 160.

¹²⁵⁹ "In other words, it seems to me that if an accountant wishes to say in his report that he has not circularized the debtors, that he is implying that there is something wrong with those debtors and I think then the point is for him having that idea not to try to get away with it by simply making a sentence in his report but by going and having a row with the company." R. 2004.

countants to refer to certificates of officials in respect to inventories but that was not true of circularization of accounts.¹²⁶⁰ Reliance on the books he considered was feasible for receivables because collection subsequent to the balance sheet date and prior to completion of the audit was proof of their authenticity but in the case of inventories collections on receivables arising from sales of stocks on hand at the balance sheet date, because of the long credit terms, would not be made until after the audit was concluded and hence collections during the audit would not be satisfactory proof of the existence of such inventories. Matters such as these were descriptive of the work done on the audit and in Rowbotham's opinion were beyond the intent of the term "* * * comprehensive * * * description of the scope of the audit."¹²⁶¹

Continuing a study of the certificate, Rowbotham explained that a general review of the operating and income accounts, referred to therein, contemplated a search for extraordinary or non-recurring items rather than a criticism of the client's classification of accounts provided the classification seemed reasonable. The certificate was signed with the requirements of the American Institute Bulletin in mind that the form should be modified, if necessary, to embody any qualifications, reservations, or supplementary explanations and in the belief that the examination made was adequate and in conformity with the principles outlined in the Bulletin.¹²⁶²

In respect to the permissive sentence in the Commission's instructions to the effect that independent accountants "* * * may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff",¹²⁶³ Rowbotham said that he had always interpreted internal audit to mean internal control and the meaning of the entire sentence to be that in the case of large companies where a detailed audit is practically humanly impossible the accountants should "* * * review the internal control and satisfy themselves that proper accounting procedures are being followed" which does not mean that internal auditors are a necessary part of the procedure.¹²⁶⁴ The certificate, as used by accountants, in Rowbotham's opinion means that the accounts are honestly and consistently presented in accordance with accepted principles

¹²⁶⁰ R. 2005-2006.

¹²⁶¹ R. 2007-2011, 2044-2045.

¹²⁶² R. 2015. Assurance of compliance with the requirements of the predecessor Federal Reserve Bulletin was given to Coster for transmission to the New York Stock Exchange in a letter dated April 11, 1933.

Ex. 118. See also footnotes 550, 590 *supra*.

¹²⁶³ Instruction Book for Form 10-K (pp. 11-12).

¹²⁶⁴ R. 2026-2028.

of accounting and that there are documents to prove that they represent an actual business.¹²⁶⁵

M. THE FEE

The professional services rendered by Price, Waterhouse & Co. to McKesson & Robbins, Incorporated, of Maryland, and affiliated and predecessor companies controlled by F. D. Coster from the early part of 1925 to the latter part of 1938 comprised balance sheet audits throughout the period, purchase audits of wholesale drug houses during 1928 and 1929, tax work during part of the earlier years, work in connection with statements filed with the Securities and Exchange Commission since its creation, special examinations, and other special services from time to time during the period. The following table

¹²⁶⁵ "Q. [By Mr. GALPEER] Summing up, Mr. Rowbotham, can you tell me specifically what impression you mean to give the shareholders through your certificate on the McKesson & Robbins consolidated report, for example, which I understand is a standard form—what reliance are they entitled to place upon the authenticity and accuracy of the report to which the certificate has been attached?

The EXAMINER. Do you refer specifically to any one, for example, the 1937 report for example?

Mr. GALPEER. No, I just mean what that certificate form intends to convey in general.

A. Well, I think that we accountants try to embody that in this opinion itself. For instance, in the first paragraph here we state that we examined or tested accounting records of the company and have obtained information and explanation from officers and employees of the company; in other words, that we have made an examination of books and had interviews with individuals, that we have made a general review of the accounting methods.

In other words, that we have there a definite set of records of what has every appearance of being genuine and full business. Now, in our opinion section here we state that as a result of having made this examination in the first paragraph that the accounts are presented in accordance with accepted principles of accounting, in other words, the accounts are fairly presented in accordance with the accepted principles of accounting; in other words, that there is no, to our belief, no misleading of the public in the manner in which these accounts are shown. I think I testified, I don't know whether it was yesterday or on Friday that most of our quarrels with clients and most of the rows we have with them come on what we call purely accounting points as to whether or not accounts should be stated this way or that and this statement here of accepted principles is three-fold: That we believe this is a fair presentation, that it is in accordance with accepted principles and that they have been consistently maintained by the company during the period. I think I said in answer to some question you asked yesterday perhaps, that 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. And when the S. E. C. started out, I don't know that you remember it, we accountants tried to put all these things in our certificates—I mean to state much more bluntly and much more compactly than this what our position was and what our position was not.

In short, that we were accountants here trying to present accounts fairly and honestly. Now, the S. E. C. came along and told us, which was true, that we accountants were trying to get lawyers to write our certificates for us. That happened to be said by Mr. Commissioner Landis to one of my partners and it happened to be true at the time and we swung away, perhaps, from explaining these things in certificates as to the things we do not do, but forgetting for the moment these negative things what I do want to say is this: That as a result of our work on the accounts and our interviews with the officials, that this is a statement of our opinion that these accounts are honestly presented.

Q. [By Mr. GALPEER.] * * * what would you summarize as being your position in regard to the authenticity of the account?

A. The authenticity of the account. If the accounts exist, if there are documents to prove them, if there is every evidence shown to the accountant that such accounts are the accounts of an actual business, I mean, I think, that is the proof of the authenticity that you speak of.

Q. And just one more question, Mr. Rowbotham. You state here in the opinion: 'We examined or tested accounting records of the company and other supporting evidence'. What is meant by the words 'and other supporting evidence'?

A. I would say, sir, that my understanding here was that the accounting records had more direct reference to the books themselves and other supporting evidence would refer, let us say, to the invoices and vouchers and various other documents that you would naturally see in the course of your work." R. 2017-2021.

gives a fair conception of the growth of the McKesson organization and of its importance as a fee-producing client for Price, Waterhouse & Co. The fees and out-of-pocket expenses are charges for annual audits, except as noted, performed by United States offices of Price, Waterhouse & Co. Fees for other services are excluded as they are not directly related to the audit work which is the subject of this investigation.

McKesson & Robbins, Incorporated
(and Predecessor Companies)

Year	Charges of Price, Waterhouse & Co.			Consolidated Accounts	
	Fee	Expenses	Total	Total Assets at December 31	Sales for Year
1924 ^a	\$ 550.00	\$ —	\$ 550.00	\$ 295	\$ ^a 252
1925 ^b	2,137.50	316.06	2,453.56	584	1,134
1926 ^c	3,900.00	247.04	4,147.04	^c 1,306	^c 2,227
1927 ^d	5,350.00	767.46	6,117.46	4,134	^d 6,250
1928 ^e	43,250.00	5,767.01	49,017.01	43,090	88,721
1929	118,300.00	20,068.11	138,368.11	77,071	140,635
1930	80,147.41	12,824.37	93,071.78	82,048	143,908
1931	70,000.00	11,998.73	81,998.73	79,967	127,963
1932	62,500.00	10,800.67	73,300.67	65,422	111,241
1933	62,500.00	11,197.68	73,697.68	65,801	111,608
1934	70,000.00	11,295.68	81,295.68	69,251	131,778
1935	70,000.00	11,408.15	81,408.15	71,410	140,163
1936	70,000.00	11,545.14	81,545.14	82,672	162,960
1937	72,500.00	11,351.95	83,851.95	87,183	184,981

^a Girard & Co., Inc., 9 months ended Dec. 31, 1924.

^b Girard & Co., Inc., 4 quarterly audits.

^c Girard & Co., Inc., sales for 11 months ended Nov. 30, assets at Nov. 30, 1926.

^d McKesson & Robbins, Incorporated (Connecticut), sales for 13 months ended Dec. 31, 1927, audits for 4 months to Mar. 31, 1927, and 9 months to Dec. 31, 1927.

^e McKesson & Robbins, Incorporated (Maryland), consolidated, beginning with this date.

^f \$2,387.50 reported in Ex. 169 less \$250.00 described by Jaureguy as for special work. R. 58. The rest of the table is based on Ex. 1, 169.

In addition to the regular audit fees listed above, the English and Continental firms of Price, Waterhouse & Co. made examinations of the London subsidiary of McKesson & Robbins, Limited, and Isdahl & Co., A/S, respectively, since 1931 for the former, and since 1928 for the latter. It may be observed that the total of fees and expenses charged by Price, Waterhouse & Co., of London, for the London subsidiary have averaged more than double the fee for its parent, the Canadian Company (no expenses were allotted to the parent from the total expenses incurred at Bridgeport).¹²⁶⁶ Four of the smaller

¹²⁶⁶ It should be noted in this connection in respect to the Canadian Company that its London subsidiary is comparable to the wholesale houses in character of business, and that it was examined quarterly in 1931, 1932, first 2 quarters of 1933, and semi-annually thereafter, whereas the parent was examined annually. Ex. 1.

divisions have been audited regularly by other accountants whose reports have been accepted by Price, Waterhouse & Co. for consolidation purposes.¹²⁶⁷

To judge the adequacy of the fees charged by the United States firm, two methods of calculation must be known. One calculation is based upon per diem charges for time employed on the engagement. For this purpose partners' time is charged for at the rate of \$100 per day, managers' \$50 to \$75 per day, seniors' \$30 to \$35, and juniors' \$20 to \$25. A supplementary calculation is then made by doubling the *actual* direct salary cost on the engagement and adding 35%. This formula may be stated another way as 50 parts direct cost based on time spent, 50 parts to cover overhead and the 35 parts for profit. The results based on the per diem charges and the formula are compared and a proper fee reached after discussion with the client.¹²⁶⁸

The following tables give pertinent information for an appraisal of the fee in relation to time charged to the client in the last 5 years.

¹²⁶⁷ Billings, El Paso, and Honolulu wholesale houses, and Hollister Drug Co., Ltd. in all years and, in addition, the Kansas City wholesale house in 1933.

¹²⁶⁸ R. 26-28, 81. In recent years a staff man has averaged 1600 hours chargeable time and seven hours has been considered a day's work for billing purposes. In applying the formula, overhead or burden is not computed on partners' time.

McKESSON & ROBBINS, INCORPORATED

Comparative Statement of Annual Audit Fees and Expenses of United States^s Offices of Price, Waterhouse & Co.—for the Years 1933 to 1937, Inclusive, and Corresponding Time Charges of Price, Waterhouse & Co. Staff

<u>Fees:</u>	<u>1933</u>	<u>1934</u>	<u>1935</u>	<u>1936</u>	<u>1937</u>
Wholesale houses	\$48,725	\$57,800	\$54,775	\$56,425	\$58,800
(Number of houses)	(50)	(57)	(59)	(64)	(64)
Connecticut Division	1,750	1,675	1,650	1,575	1,625
McKesson & Robbins, Limited (Canada)	250	250	225	250	275
Liquor production divisions	1,300	975	3,650	4,100	3,800
All other units, including home office	1,875	1,800	2,725	1,800	1,600
Consolidation and miscellaneous services	8,600	7,500	6,975	5,850	6,400
Total as per Ex. 1 (de- tails from Ex. 220)	\$62,500	\$70,000	\$70,000	\$70,000	\$72,500
<u>Hours by Classes of Staff:</u>					
Partners	180	131	105	71	86
Managers	1,453	1,032	1,241	1,244	1,769
Seniors	4,579	4,556	5,130	3,813	3,714
Assistants	16,333	16,267	15,068	16,812	16,051
Total as per Ex. 123A	22,545	21,986	21,544	21,940	21,620
<u>Expenses:</u>					
Wholesale houses	\$ 9,914	\$10,187	\$10,279	\$10,512	\$10,130
(Number of houses to which charges were made)	(50)	(54)	(54)	(55)	(60)
Connecticut Division	444	424	422	511	504
Liquor production divisions	34	—	113	212	306
All other units, including home office	260	227	235	5	7
Consolidation and miscellaneous services	545	458	360	309	385
Total as per Ex. 1 (de- tails from Ex. 220)	\$11,198	\$11,296	\$11,408	\$11,545	\$11,352

A test calculation of the fee may be made in the following manner, using 1937 for the experiment:

Class of Staff	Hours Charged	Days at 7 Hours Per Day	Rate Per Day	Total Charge
Partners	86	12. 3	\$100	\$ 1, 230
Managers	1, 769	252. 7	" 50	12, 635
Seniors	3, 714	530. 6	" 30	15, 918
Assistants	16, 051	2, 293. 0	" 20	45, 860
Total	21, 620	3, 088. 6	—	\$75, 643

^a Minimum rates stated by Rowbotham. These are the same as rates quoted Girard & Co., Inc. in letter dated Dec. 18, 1924. Ex. 116.

The following figures are supplied for comparison with the above tables:

Assets at December 31:	1933	1934	1935	1936	1937
			(000's omitted)		
McKesson & Robbins, Limited (Canada) ^a	\$ 2, 817	\$ 2, 852	\$ 2, 925	\$ 3, 027	\$ 3, 067
Connecticut Division ^b	15, 481	16, 466	17, 531	19, 379	21, 686
McKesson & Robbins, Incorporated, and subsidiary companies consolidated	65, 801	69, 251	71, 410	82, 672	87, 183
Sales For the Year:					
McKesson & Robbins, Limited (Canada) ^a	\$ 2, 885	\$ 3, 187	\$ 3, 207	\$ 3, 345	\$ 3, 811
Connecticut Division ^b	19, 576	19, 019	20, 153	22, 820	25, 326
McKesson & Robbins, Incorporated, and subsidiary companies consolidated	111, 608	131, 778	140, 163	162, 960	184, 981

^a Amounts as in annual reports for McKesson & Robbins, Limited and London, England branch consolidated. Ex. 163-167. The London branch adds less than \$50,000 to the asset totals at the dates shown, and approximately \$300,000 to sales in the several years. The Canadian Company assets include Goodwill, Trade Names, Franchises, etc., as valued by directors, \$420,000. Sales in 1937 include approximately \$245,000 to the Connecticut Division. Ex. 255.

^b Amounts are combined totals from Ex. 169 less Canadian Company consolidated. Assets include investment in Canadian Company stated at \$420,000.

It can be seen from the above figures that after the Maryland Company had more or less shaken down into an operating organization the time required for the work and consequently the cost and the fee became fairly stable figures. The most difficulty was experienced in 1929 when 34,086 hours of staff time (including 295 hours for partners) were required for the engagement. The following year the time dropped to 22,303 hours and remained fairly uniform thereafter.¹²⁶⁹ The individual fees for each wholesale house during the last 5 years averaged less than \$1,000 per year except in 1934, when the average

¹²⁶⁹ Ex. 123A.

slightly exceeded this figure. Out-of-pocket expenses chargeable to the client averaged approximately \$200 per house per year during the same period. The Connecticut Division and Canadian Company combined,¹²⁷⁰ representing as they do about 30% of consolidated assets and approximately one-sixth of sales for the entire organization, were handled at a cost of an average fee of \$1,900 and average out-of-pocket expenses of \$450 during the same period. The range in fees for the wholesale houses in these recent years has been from \$25 for Sioux Falls to \$3,375 at Los Angeles, both for 1937. Expenses charged to the houses have ranged from nothing to amounts in excess of \$700.¹²⁷¹

In our discussion of arrangements for conducting the audits reference was made to objections of various directors and wholesale house heads to the expense and scope of the work.¹²⁷² This was a continuous problem with the expense apparently the outstanding factor in the minds of many of the directors. McGloon explained that the executive vice-presidents required him to prepare and submit to them comparative tables of fees and expenses in connection with the audit. The most recent of these¹²⁷³ is the basis of the foregoing discussion. Five years earlier, following the 1932 audit, he was instructed to advise Price, Waterhouse & Co. that some of their charges for the wholesale houses seemed “* * * out of line and inconsistent with the volume of business * * * .” He found this to be the case in 14 houses and desired to know if the cause was inefficiency on the part of McKesson’s staff in the houses or that too much work was being done by the auditors. His letter closed:

“Please do not construe this letter as criticism on the part of the Management. We are of the opinion that if we can find ways and means of reducing the audit fee that it will tend to make us both happy. Moreover, on the basis of efficiency I think we are both interested in keeping the annual audit charge down to a minimum.”¹²⁷⁴

Price, Waterhouse & Co.’s reply pointed out the error in the McKesson argument, in a two-page letter in which one paragraph stated their case:

“The principal reason why the fees charged to your various companies do not vary in proportion to the net sales is that in a balance sheet examination, such as we have made of your subsidiary companies, the volume of sales has very little direct effect on the amount of work required, although in many cases the amount of the sales do give some indication of the size of the balance sheet items. As you know, the major portion of our work on your companies has been devoted to the current assets and the non-current notes and accounts receivable. It follows

¹²⁷⁰ Financial statements in the record do not show a separate consolidation of the Connecticut and Canadian Companies. As the comparison used here is only a rough approximation it was not considered necessary to make the consolidation. The principal factors are indicated, however, in notes (a) and (b) in the table on the preceding page.

¹²⁷¹ Ex. 220.

¹²⁷² See Ex. 112, 119, 186, 187; pages 171-172 *supra*.

¹²⁷³ Ex. 220.

¹²⁷⁴ R. 1583-1584; Ex. 109A, 109B.

therefore, that the amount of work required for the examination and, consequently, the size of the fee, depends much more on the amount of these assets than on the volume of sales, which require a relatively small amount of our time."¹²⁷⁵

Testimony of three of the directors who were questioned about the expense of the audit was uniformly in support of their primary object—a reduction of the expense. Murray, for example, stated that the scope of the audit “* * * was usually decided by Mr. Coster in Bridgeport” while discussions of the audit in meetings of the Board of Directors, or of the Operating or Executive Committees were devoted to the expense of the work.¹²⁷⁶ Bedsole had nothing to say as to the scope but was impressed by the fact that he had to pay the auditors.¹²⁷⁷ One of Doerr’s objectives, as a member of the Sub-Committee on Accounting was to improve conditions so that the auditing would require less time.¹²⁷⁸ Faxon, however, thought the satisfaction arising from an audit was worth what it cost.¹²⁷⁹ Michaels and Cummings expressed the opinion that the audit program must be a compromise between thoroughness in detail, the results to be accomplished, and the expense involved.¹²⁸⁰

George O. May, senior partner of Price, Waterhouse & Co., expressed the same ideas, at about the time the Girard & Co., Inc. engagement was accepted by his firm, in the following language:

“In any such work we must be practical; it is no use laying down counsels of perfection or attempting to extend the scope of the audit unduly. An audit is a safeguard; the maintenance of this safeguard entails an expense; and this expense can be justified only if the value of the safeguard is found to be fully commensurate with its cost. The cost of an audit so extensive as to be a complete safeguard would be enormous and far beyond any value to be derived from it. A superficial audit is dangerous because of the sense of false security which it creates. Between the two extremes there lies a mean, at which the audit abundantly justifies its cost.”¹²⁸¹

N. PRICE, WATERHOUSE & CO.’S APPRAISAL OF THEIR AUDIT

A general appraisal of the work that has been described in considerable detail in the foregoing pages was made by the two representatives

¹²⁷⁵ R. 1583-1584; Ex. 109A, 109B. But compare the relation of the Connecticut Division fee to total fees with the proportion of that Division’s assets to the total. A factor not specifically mentioned in either letter, but important in a proper comparison of audit fees, is the character of the business as reflected in the number of transactions involved in a given volume of business.

¹²⁷⁶ R. 2167-2168.

¹²⁷⁷ R. 2501.

¹²⁷⁸ R. 2565-2572.

¹²⁷⁹ “Well, we got in my houses in the middle west what I considered a most careful checking and overhauling, so that if I had qualms about the way things were going, they were eased off after the annual audit. That is what I got out of it, and I think it is well worth the money.” R. 2531-2532.

¹²⁸⁰ R. 2453, 4296.

¹²⁸¹ An address delivered to the Society of Certified Public Accountants of the State of New Jersey, Newark, N. J., October 19, 1926; reprinted in May, George Oliver, *Twenty-five Years of Accounting Responsibility, 1911-1936*; American Institute Publishing Co., Inc., New York, 1936. Quoted in Ex. 118.

of Price, Waterhouse & Co. who were primarily responsible for its direction during the last 5 years of the engagement.

Ralph E. Thorn, manager of the engagement, stated his opinion in the following passage of testimony:

"Q. [By Mr. STEWART.] From what you know of the jobs that were done for McKesson & Robbins during the period that you were connected with them and considering them in the light of all the things that Mr. Galpeer has called to your attention and to Mr. Ritts' attention during the course of this hearing, are you or are you not satisfied that the jobs done by Price, Waterhouse & Company were conducted in accordance with good audit procedure?

A. I am satisfied that we have made a good balance sheet examination in accordance with accepted accounting procedures.

Q. [By Mr. GALPEER.] Would you say that what you did followed the outline set forth in the booklet entitled 'Examination of Financial Statements' published by the Institute?

A. Yes, I would say that generally speaking. As I have tried to bring out once or twice, this work is entirely on a professional basis. By the time a man becomes a senior he has to use his own judgment and his own experience in exactly how to proceed with a particular examination. I think I hardly need to elaborate on that, we all understand that. There is no such thing as taking a pamphlet like the one you mentioned and starting out and making an examination on a set of accounts than there is in a doctor going out on a sick call with a fixed list of what he is going to do when he reaches the patient. It is entirely on a professional basis, and I may be elaborating too much, but I just want to make it clear that that is, I think, a fair statement of a balance sheet examination. The work which we have done is a balance sheet examination and—

Q. In other words, you would fit the particular undertaking to the needs of what you discovered on the particular job but in general the procedure you would follow is the outline as set forth in the pamphlet I have stated; in other words, you would start off with a generalization and then fit the job to the particular need?

A. I think it is a fair outline of a balance sheet examination, yes sir."¹²⁵²

Geoffrey G. Rowbotham, partner in charge of the engagement, closed his testimony in the hearings as follows:

"Q. [By Mr. STEWART.] Mr. Rowbotham, in the light of what you know about the system of internal control which existed at McKesson & Robbins during the period under examination by Price, Waterhouse, and in the light of the testimony brought out in this proceeding, is it, in your opinion, fair to say that under that system it would have been impossible for the fraud now indicated in this situation to have been carried out without collusion between the president of the corporation, the assistant treasurer of the corporation, the head of the stock department of the corporation, and somebody on the outside to take care of sending in invoices from suppliers, bank statements, bank debit advices and other papers?

A. No, sir, it had to be carried out with the collusion of these men.

Q. And when you say that, am I correct in understanding you to mean that even if there had been collusion between the assistant treasurer and the head of the stock department and somebody on the outside, to take care of sending in papers, the fraud would necessarily have been discovered in short order by the president, had the president not been also in collusion?

A. Yes, sir. You have to know Coster. He was a man of ability. And he worked extremely hard. He attended to his business. This thing could not have happened if Coster had not been in it himself. If either George Dietrich

¹²⁵² R. 1252-1254.

or Robert Dietrich had tried to do anything and Coster had been honest, they couldn't have gotten away with it for 30 days.

Q. And did you, prior to the disclosure of December 5th and subsequently, have any suspicion or any suggestion to you by anybody that there was a possibility of the nonexistence of the crude drug department?

A. No, sir, I certainly did not. This thing broke in my face like a bombshell on the night of December 5th.

Q. Now, Mr. Galpeer has called to your attention specifically notes No. 1 and No. 6 on page 41 of Commission's Exhibit 117, which is the bulletin on examination of financial statements. Those notes read, 'It is contemplated that before signing a report of the type suggested, the accountant will be satisfied that his examination has been adequate and in conformity with the principles outlined in this bulletin.'

And note 6 reads: 'It is contemplated that the form of report would be modified when and as necessary to embody any qualifications, reservations or supplementary explanations.' With those notes in front of you now and with what you know about the manner in which the examination of the McKesson & Robbins accounts was conducted by Price, Waterhouse & Co., and in the light of all the points which have been raised during the course of the testimony in this proceeding, do you still think that you were justified in signing the accounts?

A. Yes, sir, I certainly do. I signed those accounts in good faith in the belief that those accounts were thoroughly true. I thoroughly think I was justified in signing them." 1283

¹²⁸³ R. 2056-2059.