

4. Conclusion

To sum up, the annual confirmations and the record of transfers of funds during a large part of the period under review were strong support for accepting Manning & Company as real. However, it is equally clear that Manning & Company was not acting as a regular commercial bank and although the auditors made no claim of accepting it as such, this fact, when coupled with the idea that in apparent collection of cash from customers lies one of the best proofs of the authenticity of the entire set of transactions, might well have prompted further inquiry here especially in view of the direct dealing of both the vendors and the customers with that one fiscal agent, and in view of some of the other points mentioned above. This situation was further accentuated during the last three years of the engagement by the fact that the inventories were supposedly held by the vendors and shipped directly to the customers by the independent sales agency of W. W. Smith & Company, Inc. with the result that throughout this period neither the goods themselves nor the actual remittances from customers were available for anyone's inspection at the client's premises.

However, fictitious banks have been so rare that it must be conceded that in the presence of convincing evidence of a normal banking relationship, special inquiry as to the authenticity of the bank would not have been considered normal audit procedure. To us it appears that a most salutary lesson to be drawn from this case is that since transactions through a bank, as apparent collection and payment of cash, are regarded as evidence of the authenticity of the transactions underlying them, greater care should be exercised in determining the reality of such banking transactions both in establishing the authenticity of unknown banks and in establishing that the actual transactions going through a bank are what they purport to be; that is, for example, that the cash, although received by the bank, does emanate from the customers and in the manner as indicated by the client's records. But in any event it seems to us that the cash work even at its best cannot sustain the burden which it appears to us is placed upon it by most auditors as the keystone of the entire audit program and that other audit steps should be strengthened to share the load as will be more fully developed hereinafter.

E. ACCOUNTS RECEIVABLE

1. The Audit Program in General

Viewed as a whole the program on accounts receivable used by Price, Waterhouse & Co. followed generally accepted outlines for an examination of financial statements. Failure of that program to yield a warning to the auditors that the accounts of the foreign crude drug department were fictitious resulted from lack of proper observa-

tion and appreciation of the evidence in hand and the omission of direct confirmation, an audit step which at the time was generally considered optional except when there was cause for suspicion. The details as to receivables have been related in a preceding section and the principal points there raised will be appraised in the following paragraphs.

2. Character of the Accounts

The outstanding features of the customers' accounts of Girard & Co., Inc., the Canadian Company, Connecticut Company, and Connecticut Division of the Maryland Company were the concentration of the bulk of the business in a relatively small number of accounts with large balances on long credit terms and, since the merger of Girard with McKesson, with customers in foreign countries gradually restricted to addresses within units of the British Empire. The accounts were also unique in that they purportedly resulted from sales through first, Charles Manning & Company, Limited and then W. W. Smith & Company, Inc. under a contract by which the accounts were understood to be guaranteed against loss up to a certain amount and by which all expenses in connection with the sales were to have been paid by W. W. Smith & Company, Inc. and passed on to the customer. The latter, wherever he was, purportedly invariably paid when due, in full, in United States currency, through years of prosperity and depression and foreign exchange restrictions and depreciations, with no deductions for claims or adjustments. Business with these customers grew practically without interruption even in periods when other departments of the business were experiencing the difficulties of the depression years.

The phenomenal regularity of the transactions either was not noticed or was not appreciated by the auditors. The absence of claims for adjustments was thought explainable on the ground that Smith and/or the Canadian vendors might absorb them, although the auditors saw no evidence that there were any claims or that they were so absorbed. The complete absence of bad debt losses or claims therefor was attributed principally to the contract of guaranty with Smith although the interpretation thereof accepted by the auditors did not fully agree with its provisions.

While it seems incredible to us that these characteristics could have prevailed with respect to real accounts over such a long period, the accounts were accepted by the auditors as authentic because the documentary evidence seemed regular to them and the records indicated that the accounts were duly collected. On the first point it appears that Ritts and the men who worked under him never discovered the differences in the routine handling of the foreign crude drug transactions (which comprised over 65% of the business done at

Bridgeport) from other transactions nor really understood the purported flow of the documents involved. The second point was looked upon as one of the best evidences that the accounts were genuine and the business therefore real. Prior to 1931 this support for the accounts receivable rested upon actual cash receipts but the cash came from accounts controlled by Coster out of McKesson's own funds previously disbursed in purported payment of foreign crude drug purchases. Beginning in 1931, proof of collection rested on the acceptance of Manning & Company as a bank or at least as a legitimate collection and disbursement agency. Since in no event did the money really emanate from the customers as indicated on the books of McKesson, the appearance of collection proved to be a mirage.^{1344a}

3. Confirmation of Accounts

Price, Waterhouse & Co. maintain that the circularization of receivables proposed by them from time to time but not accepted by Coster was intended only for the wholesale drug and liquor divisions in which it was felt that the accounts were bad and internal control non-existent or poor.¹³⁴⁵ While this step was suggested for the benefit of the client, the risk was so distributed over the 84 units that it was not considered mandatory in order to express an opinion as to the accounts. Furthermore circularization of the foreign crude drug accounts was never considered necessary because of the guaranty of accounts, the apparent regularity of the transactions, the documentary evidence thereof, and the close supervision over the accounts by Coster and George Dietrich, and because a large portion of the accounts was always collected before the conclusion of the audit. The majority of authoritative opinion at the time of the hearings supported the view that circularization of receivables was not an essential in cases in which substantial collection of the accounts prior to the conclusion of the audit is proven. This appeared to Price, Waterhouse & Co. to have been the situation at Bridgeport. Judged by the practice in vogue when the audits were performed we believe that, under these circumstances, the failure to consider this step in connection with the foreign crude drug receivables or the failure to place any significance on Coster's rejection of this step for the wholesale houses can not be questioned.¹³⁴⁶ However, if circularization of receivables, even on a selective test basis, had been accepted practice under all conditions it is clear that such a test at any time in the life of the Canadian and Connecticut Companies and possibly as early as the first audit of Girard & Co., Inc. would have revealed the fictitious character of the receivables.

^{1344a} See footnote 407 *supra*.

¹³⁴⁵ Pages 316-317 *supra*.

¹³⁴⁶ P. 29, 142, 191, 241, 289, 400, 504, 557, 602. See also Bacas, Madden, and Rosenkamppf, p. 96; Kohler and Pettengill, p. 68.

The importance of this subject warrants its general discussion at this point. The bulletin, "Examination of Financial Statements by Independent Public Accountants", says in respect to this matter that

"the best verification of accounts receivable is to communicate directly with the debtor regarding the existence of the debt, and this course may be taken after arrangement with the client. While such confirmation is frequently considered unnecessary in the case of companies having an adequate system of internal check, it is one of the most effective means of disclosing irregularities. If it is to be undertaken, mail personally the requests for confirmation, after comparing them with the lists of outstanding accounts, in envelopes bearing the accountant's return address and enclose return envelopes addressed to the accountant."¹³⁴⁷

The expert witnesses understood that this language was a suggestion to confirm but not that confirmation of accounts was ordinary practice. The chairman of the committee which drafted the Bulletin testified that the sentence was intended to encourage confirmation but did not imply that accounts usually were confirmed.¹³⁴⁸ Despite their interpretation of the Bulletin, the majority of these witnesses stated that they confirmed accounts in a great many cases, especially when internal control was weak or when the nature or condition of the accounts indicated that such a test was desirable. Situations mentioned were large balances apparently in controversy, concentration of balances in a few accounts resulting from charges late in the year, and customers of stock brokers.

There are three methods of carrying out the suggestion to confirm customers' accounts. A positive confirmation of all balances, by which all customers are asked to respond to an inquiry, is the most expensive and therefore practically prohibitive in some kinds of business. Seven witnesses considered this the best test but recognized its practical limitations. All of these witnesses recommended a judicious sampling of the accounts as a substitute and three other witnesses considered this to be the best approach to the problem. Two witnesses considered a negative confirmation to be the most satisfactory. By this latter method all customers are asked to respond directly to the auditors only if they find an error in the account as rendered.

Circularization of accounts has been recommended by writers for some years. Thornton, Cipriani, and Trouant of Price, Waterhouse & Co.'s staff, recommended the practice.¹³⁴⁹ Bacas, Madden, and Rosenkamppff state that:

"It is a basic principle of the work of the public accountant that if an item is of sufficient importance, wherever possible, its verification is made through in-

¹³⁴⁷ Ex. 117 (pp. 14-15).

¹³⁴⁸ Scovill, however, interpreted the language, since it was stronger than in the predecessor Bulletin of 1929, as indicating that the authors were recommending confirmation as normal procedure. P. 453-454.

¹³⁴⁹ Financial Examinations, p. 33; Cipriani, p. 71; Trouant, p. 45:

"A test circularization of larger and older accounts (and of some of the larger accounts written off) selected by the accountant may support the balances and has a psychological advantage with regard to internal check. It may also reduce the amount of checking of detailed transactions and trial balances usually considered necessary."

formation obtained from an outside source. Wherever such information may be obtained verbal explanations should not be accepted." ¹³⁵⁰

The opening and closing paragraphs of Montgomery's discussion of confirmation of customers' accounts constitute a good close for this consideration of the subject, as they are not only accurately prophetic in nature, but also give sound reasons for advocating the practice.¹³⁵¹

"Confirmations of Outstanding Accounts.—The auditor can best verify the balances of outstanding customers' accounts and detect defalcations arising out of the manipulation of such accounts by sending statements to all customers, requesting them to confirm the accuracy of the balance and other details such as due date, etc., preferably on a form inclosed for the purpose, which is to be returned directly to the auditor's office. This practice is followed by many leading auditors. The matter should be thoroughly discussed with the client and the advantages of the affirmative and negative methods pointed out. If all of the accounts cannot be confirmed, the auditor should suggest that a test be made by confirming all of one or more letters of the alphabet. If the client does not or will not consent to such a course, the responsibility for the integrity of the customers' balances is squarely up to him and such refusal should be mentioned in the auditor's report. The objections to this practice become fewer each year. No doubt within a few years the verification of customers' outstanding balances by correspondence with the auditor will be the rule rather than the exception.

* * * * *

"Value of Confirmations.—This independent check is of value not only in the disclosure of fraud, but also because of the information which it gives as to the condition of the accounts with respect to unadjusted items, allowances, etc. It is needless to say that some bookkeepers are careless and others lazy. When this is so, it is important for the auditor to find it out. In all classes of business various claims and errors crop out from time to time. When these affect customers' accounts, adjusting entries should be made at once, otherwise the outstanding balances do not reflect the true state of the accounts. If a bookkeeper is lazy or careless, it will soon develop in the replies from customers to the requests for confirmations. In several instances this inquiry has demonstrated a very unsatisfactory condition, the cause of which was carelessness rather than fraud. In many instances, however, carelessness leads to fraud. Whenever the auditor can check loose methods, he may really be preventing fraud. The auditor who prevents fraud is doing a greater service than in discovering it."

A judicious confirmation of customers' accounts, while it has not been considered mandatory in all cases, is good practice and in our opinion should be a normal audit procedure. We, therefore, commend the recent action of the American Institute of Accountants in requiring this procedure "* * * wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable

¹³⁵⁰ Bacas, Madden, and Rosenkampp, p. 90. For situations in which circularization of customers is inadvisable, see p. 90 ff.

¹³⁵¹ Montgomery, 5th Ed., pp. 153 and 156. For a dissenting vote see Kohler and Pettengill, p. 67 (following a discussion in which the negative method was favored):

"But the verification of accounts receivable through correspondence, or **circularization** as it is sometimes called, is not to be recommended for most balance sheet audits. Its only purpose lies in the detection and prevention of fraud by employees, though it serves occasionally to aid in the collection of old accounts. Other proof is available; besides, the method may be objectionable to the client. Generally speaking, it should be made use of only where other tests are unsatisfactory."

represents a significant proportion of the current assets or of the total assets of a concern * * *,"¹³⁵²

4. Reliance Upon Credit Reports

The record in this case reveals a reliance upon reports of credit agencies taken from the files of, or supplied by, the client. A number of these reports on the foreign accounts receivable were examined even though the accounts were understood to be guaranteed by W. W. Smith & Company, Inc. Also a special request was made of the client for a credit report on W. W. Smith & Co., the partnership which guaranteed the guaranty by W. W. Smith & Company, Inc. The reports covering the foreign customers were apparently authentic although the accounts receivable represented false entries. The reports on W. W. Smith & Co. were forgeries.

Reference to the use of credit reports in connection with an audit are meager in the literature of auditing that has come to our attention. In discussing the scrutiny of the accounts receivable for doubtful items, Kohler and Pettengill say:

"The financial stability of a debtor may be determined to a certain degree by reference to Dun's or Bradstreet's, but the experience within the business relating to its customers is, if available, the best test."¹³⁵³

This comment seems to refer to the credit-rating books rather than to special reports. Bacas, Madden, and Rosenkamppf in a general discussion of confirmations imply that some types of material may be obtained in the client's office.¹³⁵⁴ As a test of the nature of credit information secured by the client, a review of reports in the files, in the absence of any suspicion of irregularity, seems reasonable and proper.

However, when the accountants deem it necessary, as in this case, to make a special request for a credit report covering a major element in the situation under review, it would appear only prudent to apply the customary rules of obtaining independent confirmations by having the person requested therefor reply directly to the office of the auditors rather than to accept a report of this importance from the hands of the client.

F. INTERCOMPANY ACCOUNTS

Except for intercompany items, after 1932 all payments and collections on account of the purchase and sale transactions of the Canadian Company were recorded as passing through Manning & Company by means of the debit and credit memo device. Since Manning was not

¹³⁵² See Appendix A for the full text of "Extensions of Auditing Procedure" as approved at the Annual Meeting of the Institute, September 19, 1939.

¹³⁵³ Kohler and Pettengill, p. 67.

¹³⁵⁴ BacasMadden, and Rosenkamppf, p. 90: "* * * for instance, monthly statements from vendors." Perhaps the authors would include credit reports on vendees.

a checking account, dividends and other necessary actual cash disbursements were made by checks drawn on other bank accounts. Neither Ritts nor Thorn were certain as to how the cash was made available in these other bank accounts for such purposes. However, it has been shown that if the intercompany accounts had been analyzed, they would have revealed that while prior to 1937 funds were received and recorded as transferred by Manning & Company and as loans from the parent Company, in 1937 these funds were supplied to the Canadian Company by the Connecticut Division in payment for purported transfers of foreign crude drugs.¹³⁵⁵

A study of the comptroller's reports would also have shown that of the major divisions of the Corporation, the Connecticut Division, although the most uniformly profitable, was exceptional in that it did not contribute funds to the head office for the payment of interest and dividends and reduction of debt. Statements of application of funds, analyses of the branch control account, and schedules of accounts receivable and inventories prepared from year to year by the auditors revealed that profits of the Connecticut Division, formerly Company, were being plowed back into these two items, but Ritts testified that, even if he had noted that all the earnings were plowed back, this would have been an operating question for the Company rather than an accounting question. Thorn and Rowbotham testified that they were only concerned with whether the increases in accounts receivable and inventories reflected on the collectibility of the accounts and the salability of the merchandise. The plowing back of profits in a profitable business was considered commendable rather than cause for suspicion.

There is no question but that a reconciliation of year-end balances of all intercompany accounts and of intercompany sales and services is necessary if the accounts of the affiliated branches and companies are to be eliminated properly in preparing the consolidated financial statements. The real question here is as to whether an analysis of the interim transactions sufficient to reveal the movement of funds between the affiliates is a necessary part of an examination of financial statements.

The authorities vary in their opinion as to the amount of work that should be done in connection with these accounts. Montgomery and Bacas, Madden, and Rosenkampff emphasize the reconciliation problem. Kohler and Pettengill go a little further and suggest an analysis to disclose the reason for advances. Thornton says that:

"Intercompany advances and other transactions between parent and subsidiary and between subsidiaries should be reviewed * * *,"

while Trouant says that:

"A review of the entries in accounts with affiliated companies is of assistance in determining intercompany transactions which may have resulted in unrealized

¹³⁵⁵ Also in 1938 subsequent to the last Price, Waterhouse & Co. audit and to some extent in 1935.

profits or losses or which may require special authorizations because of the relationship between the parties.”¹³⁵⁶

Three of these five books suggest a review of the intercompany accounts more extensive than would be necessary to reconcile differences between affiliated companies which would seem to have been the limit of examination of the transactions between the Canadian Company and the Connecticut Division in this case.

In our opinion a general review of the intercompany accounts is a necessary procedure. Such a review in the case of the Canadian Company transactions with its affiliates during the last year audited by Price, Waterhouse & Co. would have revealed that the cash it used for payment of expenses and dividends did not come from its own trading with customers which was consistently recorded as profitable but from transfers of merchandise to its parent. Likewise, a less complacent acceptance of the observed plowing back of profits in the Connecticut Division might well have instigated some examination by the auditors for, as we have seen, it was this very point which led to Thompson's activities that resulted in the exposure of the fraud.

G. INVENTORIES

1. The Audit Program in General

“1. The accountant's examination of inventories falls naturally into three main divisions:

“(a) Accuracy of computations, footings and recapitulations.

“(b) Basis of pricing.

“(c) Quantities, quality and condition.

“2. The responsibility of the accountant in the first two cases is clear; check the inventories sufficiently to be satisfied as to the substantial accuracy of the clerical work performed and that the goods are valued in accordance with the usual commercial practice—that is, at cost or market, whichever is lower or on some other reasonable basis which is accepted as sound accounting practice in the particular trade or business.

“3. The duties and responsibilities of the accountant in the case of quantities, quality and condition of stock vary with the circumstances; but he must rely principally for information as to quantities, quality and condition upon the responsible officers and employees of the company. In the case of a business which does not call for technical knowledge and presents no substantial difficulties, the accountant, by special arrangement with his client, may be justified in assuming a greater degree of responsibility than in cases where expert knowledge is essential. Make reasonable inquiries and tests to ascertain that quantities have been carefully determined and that quality and condition have received due consideration.”¹³⁵⁷

The material above quoted from the Institute's Bulletin introduces an audit program essentially the same as that followed by Price, Waterhouse & Co. and which the testimony of all expert witnesses

¹³⁵⁶ Montgomery, p. 593; Bacas, Madden, and Rosenkamppf, p. 409; Kohler and Pettengill, p. 71; Financial Examinations, p. 86; Trouant, p. 104.

¹³⁵⁷ Ex. 117 (pp. 17-18).

and published material indicates is generally accepted auditing practice today. However, in one important particular—the extent of the auditor's duties and responsibilities in connection with physical verification of quantities, quality, and condition—there has been a sharp difference of opinion for many years. This point will be discussed more fully after disposing of the other two in order.

2. Accuracy of Computations, Footings, and Recapitulations

The time spent on the mathematical features of inventory checking was cause for complaint from time to time by various officers of McKesson & Robbins and at one time led to a suggestion from the client that Price, Waterhouse & Co. have the work done by comptometer operators. This suggestion, however, was not accepted by Price, Waterhouse & Co. The expert witnesses testified that when the engagement required a substantial amount of such checking they employed machine operators to do this work.¹³⁵⁸ With proper control it would appear that machine operators can do this work more quickly and cheaply than the average junior accountant.¹³⁵⁹ If this is done, however, the inventories must still be carefully scrutinized by an experienced accountant to detect evidence of deliberate irregularity, a task on which the auditor must be alert to pick up various devices used by the unscrupulous to accomplish an overstatement in inventories, or even an understatement, as part of a manipulation of accounts to conceal fraud. The employment of comptometer operators on a large engagement to do the purely mechanical parts of the work rather than lessening the opportunities for such observation, should, by relieving the accountant of the pressure of himself completing this purely mathematical work, provide more time for intelligent scrutiny and consideration of the accounts.

3. Pricing

This is not the place to debate the propriety of methods of inventory valuation. All accountants recognize their duty to determine that the pricing has been done in accordance with generally accepted principles, consistently maintained. The question which arises in this case is whether the Price, Waterhouse & Co. staff determined in a competent manner that the inventories were priced at cost or market whichever was lower, which, for inventories such as McKesson's, was a generally accepted method.

¹³⁵⁸ It may be that McKesson's suggestion was to have calculating bureaus take over and certify the work themselves. R. 1713-1714. Cf. Ex. 112. This procedure would probably not have been acceptable to the experts who testified that they hired the operators directly and assumed responsibility for the work. See also item "b", page 169 *supra*.

¹³⁵⁹ " * * * I think it is a waste of money to have a junior accountant, who doesn't know how to add anyway, most of them, spend their time on adding up inventory sheets and multiplying them." Testimony of Bell, p. 197.

In making their tests Price, Waterhouse & Co. compared inventory prices with the previous year's inventory prices, with the current year's purchase prices, with the client's sales prices for a period subsequent to the inventory date, and also with quoted market prices. All of these tests have authoritative support.

A blending of phrases from Trouant and Thornton provides a fair summary of opinion on market prices not only for Price, Waterhouse & Co. but also for other accountants.

"Market" is susceptible to many interpretations. In using published quotations for purposes of application to inventory amounts it is necessary to employ quoted prices for quantities comparable with those usually bought at one time by the client; if there be no such market, prices in the company's sales market may be used after making proper deductions for selling and other expenses and for normal profit.¹³⁶⁰

In this case, however, the comparison of the foreign crude drug prices with quoted prices revealed that some items could not be properly matched with quoted prices as to quality and method of packing and that wide discrepancies appeared between the quoted prices and both purchase and sale prices, quoted prices with rare exceptions being higher but much more so in some cases than others. The auditors accepted the explanation offered at the plant that this was due to the quantity traded but made no attempt to verify the quantities to which the quoted prices applied. The Price, Waterhouse & Co. staff responsible for this work assumed instead that the quoted prices were not satisfactory and that prices of sales after the inventory date but while the audit was still in progress (not, however, covering all of the items carried) were their best reliance. By relying principally upon sales and purchase invoices in connection with price testing, the auditors must necessarily have depended upon the authenticity of the cycle of business transactions ending with apparent collection from the customer, which it will be remembered they deemed the best evidence of the reality of the cycle. Thus in effect, as previously mentioned, they again relied upon the cash work, instead of making independent inquiry concerning the business in which Coster was supposedly engaged. Knowledge gained from such an inquiry might well have led to the disclosure of the falsity of the entire cycle.

We do not mean by this to say that sales and purchase invoices should not be examined. Such work is important not only for a check of prices contained thereon, but if alertly considered may disclose evidences of fraud. In the instant case, for example, the price test schedules over several years revealed no transaction that was not concluded at a gross profit, no uneven quantities, and an unnatural

¹³⁶⁰ Trouant, p. 66; Financial Examinations, p. 66.

regularity of transactions as more fully summarized in the table on page 105 *supra*.

4. Quantities, Quality, and Condition

a. TESTS BASED ON RECORDS

Accounting tests of quantity of the inventory that may be made from the records include examination of documents covering the purchasing and receiving and the selling and shipping of merchandise, primarily at the close of one accounting period and the opening of the next, to make certain that goods taken into inventory and the liabilities therefor are recorded in the same accounting period and that the inventory does not include merchandise for which a charge has been made to a customer. Expert witnesses, accounting texts, and Price, Waterhouse & Co. are in agreement as to the general auditing procedures to be followed. In their application to the McKesson work the principal question raised was as to whether the W. W. Smith & Co. orders and advices of shipment and subsequent receipt of payment through Manning & Company were sufficient evidence of shipment or whether the auditors should have seen other evidence covering these shipments such as duplicates of bills of lading. The texts consulted and some of the expert witnesses used the ambiguous term "shipping records" to cover the documents which should be examined in support of the sales cut-off. Several of the witnesses, however, mentioned bills of lading as the documents that would be referred to in proof of shipment. While events have shown that a careful examination of the so-called McKesson bills of lading should have aroused suspicion, the Price, Waterhouse & Co. view, that the examination of the notice of shipment from the shipping agent, W. W. Smith & Company, Inc., if regular in itself, was sufficient, seems to have support.¹³⁶¹ However, as previously pointed out, there were several features of these notices which if observed might well have called forth further inquiry.

Another phase of the accounting check of inventories requires the investigation of the methods of inventory taking and the examination of the perpetual inventory records. The general conception of the requirements of this work was met by Price, Waterhouse & Co. except in one important respect. The testimony and the results obtained show that inquiries made of the client's employees as to the inventory procedure were not extended to the employees who

¹³⁶¹ But see Kohler and Pettengill, pp. 67-68:

"A comparison of the sales invoices and shipping records should be made for the last few weeks of the fiscal year for the purpose of determining that all accounts are actual receivables rather than finished stock inventory. This will eliminate the possibility of the predating of invoices and serve as a test check to a certain extent in ascertaining that the billing has been made to bona fide customers rather than fictitious ones. This latter check can, of course, be carried out quite extensively as the various freight bills, packing records, and so forth, may be checked."

did, or had direct supervision of, the work under Robert Dietrich. Several of the expert witnesses testified that a proper inquiry of the client's inventory methods must extend to the men who actually did the work to make certain that prescribed methods were followed.¹³⁶² If inquiry had been made of White, the McKesson & Robbins employee, who, on the 1934 examination for example, filled in the original count sheets on the foreign crude drugs and supervised the taking of the inventory that was actually in the space at the Fairfield plant designated on the count sheets for the foreign crude drug stocks, his testimony is conclusive that he could not have even pointed out the latter merchandise.

Of the various book tests of reasonableness of the inventory quantities, none would have revealed the fantastic character of the foreign crude drug inventories unless in this connection comparisons had been made with independent sources of information, since the rates of turnover and gross profit as shown by McKesson's books varied slightly from year to year so that it is not surprising that no suspicion was aroused. This general statement is subject to one exception in the years 1931 and 1932 when the Dandrofuge line which produced approximately 85% gross profit on sales was dropped and the foreign crude drug operations which yielded only approximately 10% gross profit on sales were expanded enormously to take the former's place in total gross profit produced. Thorn's conception of the gross profit test as merely an over-all test of inventory valuation is erroneous for variations in the rate of gross profit may also indicate errors or manipulations in purchases and sales. Moreover, as he applied it to a combination of lines the results were quite uninformative even as a check on inventories.¹³⁶³ There was general agreement among the expert witnesses that the gross profits test was of very little value unless departmental figures were available. This seems so fundamental that it requires no further discussion.

In a previous section it was brought out that an independent inquiry of anyone familiar with the trade or a reference to applicable trade statistics would have revealed the improbability of accumulating and storing such large stocks in the normal course of business or of disposing of them in regular channels of trade. When the goods were supposed to have been in Bridgeport, an inquiry of persons who were supposed to have actually handled the merchandise or a test of the designated storage space would have revealed that the goods were not at the location designated on the inventory sheets.¹³⁶⁴ Most of the expert witnesses testified that such over-all tests as they made were confined to the client's own records, the most common test

¹³⁶² P. 93, 249, 297, 349, 407, 563, 607; see also Kohler and Pettengill, p. 78.

¹³⁶³ Pages 307-309 *supra*.

¹³⁶⁴ See also discussion in respect to the location of inventories under taxes at pages 417-418 *infra*.

being the one employed by Price, Waterhouse & Co. for the Canadian Company of proving the ending inventory by accounting for purchases and sales since the opening of the fiscal year. Here again the value of this test has been shown to depend basically on the validity of the assumption that if the cash records are proved to be reliable other accounts related to those records may be relied upon.

The same witnesses testified that they would expect their top men to be generally familiar with the trade of the client under examination. It would seem unfair, therefore, to conclude from their answers to the question on over-all tests that no accountant would have a basis for testing the reasonableness of inventory quantities except by the records of the client. Two of the twelve witnesses cited examples in their experience where a quick calculation of storage capacity revealed the falsity of the inventories,¹³⁶⁵ and one witness said that trade statistics of production and consumption would be used to some extent.¹³⁶⁶ While such procedures have not been regular practice in the past, the situations in which their use would have disclosed fraud have not been uncommon¹³⁶⁷ and we believe they may with profit be judiciously employed in the future.

b. PHYSICAL TESTS

One of the important and controversial subjects in auditing practice has been the extent to which accountants should make physical tests of clients' inventories and whether such tests should lead the accountant to accept responsibility for inventory quantities, quality, and condition. While resolutions similar to that adopted by the New York State Society of Certified Public Accountants have attempted to limit the auditors' responsibility,¹³⁶⁸ opinion and practice,

¹³⁶⁵ Lenhart, P. 251; Scovill, P. 461.

¹³⁶⁶ Jones, P. 608.

¹³⁶⁷ See P. 514-515.

¹³⁶⁸ Monthly Bulletin, New York State Society of Certified Public Accountants, June 1934, p. 5:

"Resolved: That it is the sense of The New York State Society of Certified Public Accountants that, if a certified public accountant reports on a balance sheet of a concern over his signature without qualification or special explanation as to the item of merchandise inventories contained therein, it shall imply that he has exercised care in his examination by making accounting tests and checks of the concern's books of account and other available records pertaining to merchandise inventories, that he has received all information and explanations he has required from the officers and employees responsible for the taking and valuation of the merchandise inventories, and so far as accounting methods permit, has satisfied himself as to their substantial correctness, but that, as regards the information and explanations he has required and as to ownership, physical quantities, description, quality, condition, marketability and valuation of the merchandise, he has relied upon the representations of the concern's management, subject to such checks as may have been obtainable from the records in respect thereto; and be it

"Further Resolved: That it is the sense of this Society, that while the certified public accountant, through his experience in various lines of industry, may be of value in assisting and cooperating with the management of a concern in the supervision of a physical inventory taking, it should be clearly understood that in undertaking this work the certified public accountant does so only in his capacity as an accountant and does not assume responsibility as an appraiser or valuer for the physical quantities, description, quality, condition, marketability and valuation of the merchandise."

See also the New York State Society of Certified Public Accountants, Report of the Committee on Co-

as revealed by auditing texts and the testimony of expert witnesses, have been sharply divided on this question during the period of the Girard-McKesson engagement.

One extreme view is that held by Rowbotham that the accountant has no concern with physical quantities, quality, or condition of the inventories.¹³⁶⁹ Representations of management are accepted and that fact reported on the balance sheet. The opposite view is that accountants are obliged to do such work as they consider necessary to establish to their own satisfaction that the inventories are as represented.¹³⁷⁰ The former group maintain that the latter cannot do enough work to assure themselves, and representation that they can is misleading and likely to have more disastrous consequences than reliance upon management. Those who rely upon management and refuse to make physical tests apparently follow the opinion in the English case of *In re Kingston Cotton Mill Company*¹³⁷¹ as ample defense for their position if it should develop that their reliance on certificates by management proved to have been misplaced. Those who uphold the opposite view maintain that an accountant should not avoid his responsibility in so important a matter even though there is some legal precedent for so doing. In the Kingston case the court held that the auditors were not negligent in relying on a manager's certificate even though a bookkeeping calculation such as Price, Waterhouse & Co. employed in the McKesson work would have revealed that the inventory quantities could not have been correct. Montgomery's comment on this case, in which a mathematical test would have disclosed the fraud, is, "* * * Most prominent American auditors would now, however, probably agree that such failure to discover the true state of affairs when the means for doing so were available would be inexcusable."¹³⁷²

operation with Bankers and Other Credit Grantors on Results of Meetings Held with Officials and Members of the New York Credit Men's Association, dated October 31, 1938, which stated that:

"Before giving the results of the discussions * * * it may be well to call attention to the fact that the members of the credit fraternity attending the annual meetings referred to were largely those serving the textile and related industries in the mid-town area of the City" and after repeating the resolutions quoted above continued:

"The credit men present at the meetings expressed their full satisfaction with the provisions of the foregoing resolution. It was recognized that the inventory resolution adopted by the Society represented a rule or guide for the membership of the Society and that any member going beyond its scope and intent did so at his own risk and could not look to the Society for support in the event that he becomes embarrassed by reason of the adoption by him of a different or extended procedure." The New York Certified Public Accountant, December 1938, pp. 109-113.

¹³⁶⁹ See Audit Procedure in America, Journal of Accountancy, LXVIII (August 1939), 101-103, reprinted from "The Accountant, London" in support of Rowbotham's position; but see Correspondence, idem 103-104.

¹³⁷⁰ Bacas, Madden, and Rosenkampff, p. 246:

"There are certain types of merchandise where it is inadvisable or practically impossible for the public accountant to endeavor to make a physical count of the items. . . .

"However, there are other types of merchandise where the public accountant can easily make verification. If such an item was in question and it was found at a later date that the quantities had been overstated, it would be difficult for the public accountant to justify his omission to make the count."

¹³⁷¹ 2 Ch. Div. 279 (Court of Appeal, May 19, 1896).

¹³⁷² Montgomery, 5th Ed., p. 184.

The question may now be raised as to what extent a physical inspection of inventory quantities is also one of the means available to auditors which, if omitted, would be inexcusable. Even in a case such as this in which there was no assumption of responsibility for quantities, quality, and condition of inventory, some actual inspection was made, as for example, at the wholesale houses where inspection of slow moving items of large quantity and test counts when the inventory as taken was suspected of being inaccurate apparently were deemed by the seniors there in charge to be reasonable steps for a prudent auditor to take.¹³⁷³ Thus, tests of the physical existence of inventories are clearly not forbidden in the Price, Waterhouse & Co. organization. Thornton says:

“* * * If, however, the auditor cannot satisfy himself that the inventory has been properly taken or that the permanent inventory records are correct, it may be necessary to have substantial tests made of the physical quantities.

* * *”¹³⁷⁴

and Trouant in 1937 wrote:

“Usually the accountant accepts as his starting point the original count records signed by the employees taking the inventory. Counting bales of cotton or wool, bags of cement, flour or fertilizer, rolls of cloth or paper, or other relatively large units may serve to satisfy the accountant that the total recorded quantities are actually on hand, and such tests are occasionally made.”¹³⁷⁵

Professional curiosity as to the business being audited might well have prompted a request to see merchandise of the character supposedly carried in the McKesson foreign crude drug inventories when it was recorded as on hand in Bridgeport. A wide awake tour through the plant with the preposterous foreign crude drug quantities in mind (for example 5,000 25-pound boxes of Dragon's Blood Powder Bright, 500 100-pound kegs of Crude Iodine, 3,100 flasks of Virgin Mercury, 2,000 100-pound cases of Gum Camphor slabs, and 200 200-pound bags of perishable Vanilla Beans) would have been quite sufficient to have revealed the fraud that was being perpetrated. Such a trip might well have been suggested by the following paragraph from Thornton:

“If the auditor have not been consulted in advance he should ascertain how the quantities were determined, the nature of the goods, their location and the way in which they are handled, physically and on the books. If he is dissatisfied with the method of stocktaking he must consider the advisability and practicability of again taking the stock in whole or in part.”¹³⁷⁶

¹³⁷³ Page 318 *supra*.

¹³⁷⁴ Financial Examinations, p. 53.

¹³⁷⁵ Trouant, p. 59. See also Duties of a Senior Accountant, pp. 20-21:

“It is quite permissible for the senior to consult with the client as to methods of taking and valuing inventory. On proper instructions he may even supervise the actual work of taking inventory, provided that he does not take responsibility for either quantities or values, except as to their agreement with the records.”

¹³⁷⁶ Financial Examinations, p. 51. See also p. 50 referring to procedure recommended when the auditor is consulted prior to inventory taking, quoted in part in footnote 1321 *supra*.

In our opinion the complete omission of any attempt at physical contact with the inventory while it was supposed to have been at Bridgeport cannot be justified even on the theory of nonassumption of responsibility by the auditors for inventory quantities. While in view of the size of this fraud such inquiry, if boldly attempted, might well have disclosed the inflation, a mere cursory inspection cannot, of course, be relied upon in place of a regular test of and assumption of reasonable responsibility for inventory quantities.

There are two generally recognized methods for making such tests. The auditor may arrange with the client to be present as an observer while the inventory is being taken and make or supervise such test counts as he deems necessary during the course of the work. Or the auditor may go in at some other date and make sample counts (spot-tests) of stock for comparison with permanent inventory records or for reconciliation with the physical inventory by taking purchases and sales in the interim into account.

All of the expert witnesses testified that spot testing of inventories was feasible in many lines of business and that such testing or observation of inventory taking was by no means an uncommon procedure, although none of the witnesses required that either be done as an invariable rule in their auditing procedure. There is considerable difference in manner of expression among the witnesses but a general summary of the opinions expressed must recognize the following points:

1. The accountant in undertaking inventory tests should have a general knowledge of the client's products but does not profess to have a technical knowledge of all items in the inventory or to exercise the functions of an appraiser as to quality and condition.

2. The tests are considered to be based upon ordinary business judgment and are collateral and circumstantial support for the primary accounting tests based upon the records.

3. Reliance may be placed upon the manner in which the business is conducted in judging whether packages contain material described on the labels.

4. There are occasional industries and lines of business in which the nature of the product or character of the merchandise makes physical testing practically impossible in which case spot testing would not be a reasonable or practicable requirement.

Those who oppose physical tests of the inventory fear that if such testing is considered good and generally accepted practice, the uninformed will consider auditors to be guarantors or insurers of the inventories. Even the possibility of this erroneous impression by laymen, if it does exist, does not seem to us to be an adequate excuse for refusal to make such reasonable and practical tests as are within the four points stated above. The importance of this subject warrants

quotations from three of the witnesses who in their opinions indicate various views on the question. George D. Bailey of Ernst & Ernst testified:

"Q. [By Mr. WERTZ.] * * * looking to the future, what procedures do you think auditors should use in verifying quantity, quality, and condition of inventory?

A. Well, I think the tests that they have been using in the past do not need to be changed except as to degree. My experience with quantity tests has led me to believe that auditors in the future can more frequently supervise or oversee the process of inventory taking or that they can more frequently test the inventory quantities.

However, I think we will need to be careful not to be too dogmatic about the whole question of inventory tests, because, as I said once before, there are some situations where a satisfactory physical test may not be practicable.

I think perhaps there may be something to be said for an acceptance of greater participation in inventory with a definite statement as to the extent of that participation and not just a negative statement when such participation does not exist.

Certainly we should strive for greater clarification as to whether we are reasonably satisfied with our test. And I think we should strive also to bring out more clearly that our examination as to grade, quality, and things of that kind has to be made largely from the evidence that is available from the records, because the number of cases in which inspection might show the error in grade or classification is not very large.

Q. You mention in the first part of that statement that in some situations verification of quantity was not practicable. Would you characterize that more fully?

A. I am thinking again of department stores, chain stores, and things of that kind where the number of items is so large and the total of each individual item so small that the tests of quantities would not be practically satisfactory. We could move forward on those, of course, to be present at the inventory, when it was taken, but we rely in that kind of situation upon checking the departments against one another and against prior years and against turn-over figures and many other things, so that I hesitate to be so definite as to say we should in all cases participate in inventory.

I personally have a feeling that if we say flatly what we do and have it understood what we mean by that wording, that we will find we work out to a pretty definite position for the accountant in connection with the accuracy of the inventory item."¹³⁷⁷

William H. Bell of Haskins & Sells answered Mr. Wertz' first question:

"A. * * * I don't see why accountants should not serve the useful purpose of making an independent, reasonable, physical substantiation of inventory quantities.

In any case, where quality and condition may be a matter of unusually great importance, it may be desirable to have an expert in the particular industry make an investigation.

Q. * * * again looking to the future, what do you think of the auditor participating in the taking of inventory, in a supervisory capacity?

A. The ideal method of substantiating inventory quantities is to supervise, or observe the process of inventory taking by the company.

¹³⁷⁷ P. 567.

As I have previously stated, I think this is entirely practical.

It is subject, however, as far as general observance is concerned, to lessening the congestion of auditing work at the end of the year by the wider adoption of the natural business year for corporations.

In this connection, the case of companies which maintain well kept and controlled perpetual inventory records, and which take annual physical inventories at the time when their business activities have reached the lowest point of their business cycle, that is the close of the natural business date, or at other dates not coinciding with the balance sheet, physical tests could be made by accountants at such other dates supplemented by such review of the records of intervening transactions to the balance sheet date and such supplementary physical tests as they consider appropriate." 1378

Charles W. Jones of Arthur Andersen & Co. gave the following opinion on the same subject:

"A. The complete verification of the quantity, quality, and condition of inventory, in my mind, by auditors, is wholly impractical. The procedure of observing the taking of physical inventory and spot-testing quantities, I think, might be applied to a greater extent than it has been in the past, but I am not prepared to say to what extent such procedure should be extended because I am not convinced that from a practical point of view any material or substantial extension of those procedures would, in the last analysis, be worth their cost to industry.

Q. How do you feel about participation in and supervision of the inventory taking?

A. I think that is important.

Q. And would be a desirable thing?

A. Not so much from a point of view of supervision as to observe the steps in the procedure.

Also it is important, I think, to ascertain in advance of the inventory, just what a company plans to do in connection with taking inventory." 1379

Perhaps the reluctance of some accountants to assume greater responsibility for inventories is based upon the common knowledge that this asset is easy to falsify and is frequently used in manipulations of accounts intended to distort profits, one of the principal bases for valuing securities. To us these two facts make it all the more necessary that accountants should do all that their training and experience qualifies them to do in ascertaining that the inventories are fairly stated. Many of the tests of the records, generally considered mandatory, aid materially in determining that quantities, quality, and condition are as represented, and, as has been noted, some accountants consider these tests more reliable than inspection under certain circumstances. However, it seems consistent and desirable to us for the accountant, in addition, to make any reasonable and practicable test that will reassure him of the actual existence of an inventory.

Montgomery in twenty-two pages discusses the problems of inventory verification and presents a twenty-two point program for the

1378 P. 202, see also longer discussion at P. 200.

1379 P. 609.

purpose. He supports the proposition, in no uncertain terms, that auditors can assume a reasonable degree of responsibility for most inventories and should make physical tests in the process of verifying them.

"The author is of the opinion that in the majority of cases the auditor can make, at reasonable cost to his client, such an examination as will enable him to certify to the balance sheet without qualification and to accept a reasonable degree of responsibility with respect to the inventory. To what extent this may involve independent verification of quantities and other factors will depend upon the kind and size of the business, the adequacy of the perpetual inventory records, the opportunities for proving quantities by independent checks, and the efficiency of the organization that is responsible for the custody and inventorying of the merchandise and materials."¹³⁸⁰

The following excerpts from Montgomery's rules for verifying inventories indicate his positive views on physical tests and require no further comment:

"The rules suggested below rest upon the assumption that, as an auditor is not a valuer, he is not charged with a special or technical knowledge of the elements constituting stock in trade. If he exercises due care and skill, he may feel that he has conscientiously discharged the duties imposed upon him.

* * * * *

"2. * * * If the inventory has not been taken under supervision by the auditor, he should look over the stock before dealing with the inventory sheets.

"There are such things as 'bonds' representing debts, and 'bonds' which are used in track construction. Familiarity with terms in use is most rapidly gained by object lessons.

* * * * *

"8. * * * Physical tests should then be made of a sufficient number of items to test the accuracy of the records. [Refers to perpetual inventory records.]

* * * * *

"Large thefts of goods have been discovered by tests.

* * * * *

"21. When the audit is being made, during the taking of the inventory or immediately thereafter, select some items from the inventory sheets and verify by inspection of the goods on hand.

* * * * *

"22. In the case of inventories stored in the client's plant or own warehouses the auditor must make a good physical test even when book quantities have not substantially changed, as fraud has been concealed by overstating the quantity of stored goods."¹³⁸¹

In our opinion, the time has come when auditors must, as part of their examination whenever reasonable and practicable, make physical contact with the inventory and assume reasonable responsibility therefor as had already become the practice in many cases before the

¹³⁸⁰ Montgomery, 5th Ed., p. 180.

¹³⁸¹ Idem. pp 181-187.

present hearings.¹³⁸² By this we do not mean that auditors should be, or by making such tests become, the guarantors of inventories any more than of any of the other items in the financial statements but we do mean that they should make all reasonable tests and inquiries, and not merely those limited to the books, in order to state their professional opinion, as auditors, as to the truthfulness of that item in the same way as they do for the other items in the statements. As in the case of confirmation of receivables we approve the action of the American Institute of Accountants in prescribing the use of physical tests of inventories or observation of the inventory taking by independent public accountants as regular audit procedure.¹³⁸³

5. Ownership

a. MERCHANDISE ON THE CLIENT'S PREMISES

The difficulty of assuring himself that the merchandise he sees is the client's is one of the strongest arguments brought to bear by auditors against the proposition that inventories should be tested by physical count. The accounting tests, however, that are relied upon for pricing and for quantity supply substantial evidence of ownership if they are reliable for the first two purposes. And if, under the tests suggested above, these records are supported by actual possession and there appears a proper relationship between observed quantity and payment, the test would appear fairly reliable and certainly is stronger than if the records only are relied upon for evidence of ownership.

All of the authorities are in agreement that, in addition to the usual tests, inquiries must also be made to establish that goods on hand and included in the inventory are the property of the client. It is also

¹³⁸² That this is far from impossible is clearly illustrated by the following certificate dated after the disclosure of the fraud in the present case:

"OPINION OF INDEPENDENT PUBLIC ACCOUNTANTS

To the BOARD OF DIRECTORS OF
EMSCO DERRICK & EQUIPMENT COMPANY,
Los Angeles, California.

We have made an examination of the financial statements and schedules of Emsco Derrick & Equipment Company that are listed on the accompanying index. In connection therewith we examined or tested accounting records of the company and other supporting evidence and obtained information and explanations from officers and employees of the company; we made extensive tests of the inventory quantities by inspection of the physical stocks, in which we were assisted by persons who were not employees of the company but who were qualified to identify its products to us; 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 financial statements with the notes appended thereto fairly present, in accordance with accepted principles of accounting consistently maintained by the company during the year under review, its position at December 31 1933 and the results of its operations for the year ending on that date.

[S] PRICE, WATERHOUSE & Co.
(Price, Waterhouse & Co.)

LOS ANGELES, CALIFORNIA,
April 25 1939."

¹³⁸³ Appendix A contains the full text of "Extensions of Auditing Procedure" as approved at the Annual Meeting of the American Institute of Accountants, September 19, 1939.

general practice, as was done in this case, to request the client to sign a certificate covering this and all other phases of the inventory question.

The purpose of the certificate is clearly stated by Montgomery:

"An inventory certificate is not to be regarded as a substitute for, but merely as a complement to, a proper examination of the inventory by the auditor, and it is important for several reasons. Banks and others interested in financial statements often raise a question regarding the confidence expressed by the management in inventory quantities and valuations. Furthermore, it often occurs that there is not an exact meeting of minds between the auditor and the management as to the general basis of inventory count and value. The signing of an inventory certificate on the part of the management brings clearly to the latter's attention the general basis used in arriving at inventory count and valuation. A request for an inventory certificate is, in no sense, any reflection upon the integrity of the management, but the obtaining of such a certificate does satisfy the auditor of the management's own conviction with respect to the inventory."¹³⁸⁴

All of the expert witnesses agree with Montgomery that the inventory certificate from responsible officials does not relieve them of making the usual tests and inquiries in regard to inventories.

b. MERCHANDISE NOT ON THE CLIENT'S PREMISES

A novel question raised by this case is whether an auditor should investigate custodians of the client's merchandise. The storing of merchandise in public warehouses is a common practice and the holding of customers' merchandise by vendors was not unknown before this case. Price, Waterhouse & Co. confirmed merchandise held off the client's premises in both public and vendors' warehouses by direct correspondence which in the case of the foreign crude drugs resulted in receipt of documents from the five dummy Canadian vendors.

All of the authorities examined are in substantial agreement that goods stored off the premises should be confirmed by correspondence if material in amount. All of the expert witnesses are in agreement that confirmations would not disclose a misappropriation of the merchandise by the holder, but only one testified that he had ever required evidence of financial responsibility of the holder. In this case the witness had had an experience which indicated the desirability for this precaution where goods had been paid for and left in the vendor's warehouse.¹³⁸⁵ This witness and another stated that a situation in which vendors held goods that had been paid for, as was pretended in the instant case, was rare in their experience.

It should be recalled at this point that Ritts suggested securing financial statements on the five Canadian vendors, who at that time supposedly held McKesson inventories valued in excess of \$7,000,000, because of the possibility that they might not have all of the goods,

¹³⁸⁴ Montgomery, 5th Ed., pp. 188-190.

¹³⁸⁵ P. 39.

but that George Dietrich convinced him that since the goods came from distant countries their prompt shipment of sales orders was evidence that the goods must be on hand. Thorn testified that he thought he had approved Ritts' acceptance of Dietrich's explanation. Here again reliance was placed on the cycle of transactions which ended with apparent cash collection.

If Ritts had insisted upon securing financial reports from Dietrich, it is not unlikely that falsified ones would have been produced. If it had occurred to any of the auditors' representatives to question or investigate independently the legitimacy of these concerns by requesting the Canadian firm of Price, Waterhouse & Co. to make an inquiry on the scene, or otherwise, it is hardly conceivable that an exposure would not have resulted. The situation here was so unique that it is difficult to say exactly what established practice was in this respect, but it is probable that for some time to come public accountants will be more cautious in a situation of this kind. In any event we believe that supplementary independent inquiry should be added as a normal audit procedure if the amounts of inventory represented as being held in outside warehouses are significant, particularly if the purchase price for such goods has been paid.¹³⁸⁶

H. OTHER BALANCE SHEET ACCOUNTS

I. Unexpired Insurance

The discussion of insurance brings out more clearly than any other topic in this report the differences in practice due to the size of the business under examination. It will be recalled that Ritts, with Rowbotham endorsing the idea, testified that the examination of insurance policies was limited to a verification of the unexpired portion of the premiums thereby determining the amount of the remaining asset and the amount chargeable to expense. It was not considered necessary to review coverage, for the client had an insurance expert in its employ in charge of the insurance department.¹³⁸⁷

The expert witnesses were in substantial accord with the position taken by Price, Waterhouse & Co. The point was made by some of the witnesses, however; that the question of coverage was considered in the audit of small and medium-sized businesses and one witness testified that the policies should be examined in order to detect liens against property.¹³⁸⁸ This latter point is made in some of the textbooks.

¹³⁸⁶ The American Institute of Accountants' "Extensions of Auditing Procedure" adopted September 19, 1939 recommends this procedure. See Appendix A.

¹³⁸⁷ As previously pointed out the fact that the blanket insurance policies were reduced a substantial amount in 1935 was deemed confirmation of the auditors' understanding that the merchandise was insured by the custodians who commenced storing the goods in that year. But see footnote 1065 *supra*.

¹³⁸⁸ Klein, P. 519.

All of the texts examined state that the auditor at least should know the amount of insurance coverage in relation to the book value of the assets of the client and, under certain circumstances, should comment upon it in his report. The character of the discussion in some of the books indicates that the small or medium-sized business without an insurance department is in the minds of the authors. However, it is clear that all deem it necessary for the auditor to be reassured in one way or another that the client has made proper provision for the various kinds of business risks which may be insured against.¹³⁸⁹ The most clear-cut statement of the reasons for this position is found in Bacas, Madden, and Rosenkamppff, who sum up their conclusions as to the auditor's duty in this regard as follows:

"It would seem, however, that the public accountant should have the responsibility to see that, at the very least, the client is fully protected as to the risks incidental to fire, workmen's compensation, public liability and automobile insurance."

2. Fixed Assets

Fixed assets were a minor factor in the McKesson examination and warrant discussion here only because of the additional light that is thrown on Rowbotham's philosophy of complete reliance upon book records without reference to the physical properties represented. It will be recalled that he stated that the accountant did not actually see or touch the plant and that if he did do so, he would be no wiser.

All of the expert witnesses support this position, to some extent, on the grounds that the records are adequate and better evidence of detailed changes in plant assets than a superficial inspection. However, seven of the twelve witnesses stated that the plant was sometimes inspected for major additions. One of these stated that such an inspection would be quite detailed under these conditions.¹³⁹⁰

The prevailing opinion is clearly and briefly stated by Montgomery:

"The duty of the auditor with reference to fixed assets differs from his duty relative to current assets. He must verify, upon his own responsibility, both existence and value of current assets or specify in his certificate the extent to which he has relied on the statements of others. It is good practice to depend largely on the information to be obtained from others with respect to fixed assets."¹³⁹¹

That Montgomery does not intend that the auditor should stay out of the plant is clear from his advice that "* * * The auditor should personally inspect the plant and note whether it appears to be in good condition or not," and in connection with discovery of undisclosed liabilities, "Inspection of the plant may disclose the

¹³⁸⁹ Montgomery, 5th Ed., pp. 292, 353, 521-523; Kohler and Pettengill, pp. 91-93; Trouant, pp. 92-93; Financial Examinations, p. 127; Cipriani, p. 121; Bacas, Madden, and Rosenkamppff, pp. 358-359; Bell and Powelson, pp. 251-252; and Jackson, pp. 106-108.

¹³⁹⁰ Jones, P. 610.

¹³⁹¹ Montgomery, 5th Ed., p. 247.

existence of major items of equipment not identified on the books. * * *¹³⁹² Reference has already been made to Trouant's advice that a tour of the plant aids in the audit of additions and abandonments.¹³⁹³ Kohler and Pettengill suggest that if the equipment records are in good shape " * * * and good accounting practice has been followed, the auditor's examination may be limited to a test check of some of the individual cards against the machines themselves."¹³⁹⁴

While reliance must be placed on the records for the precise details of fixed asset changes, it may be observed that in those cases where the auditors do their work, or some of it, at the client's plant, the staff on the engagement must become aware of the principal physical changes that take place from year to year and that whether consciously or not this must lend reality to the work done on the records. As previously stated in the case of inventories we believe that whatever physical inspection of fixed assets can reasonably be made should be undertaken as a supplement to the examination of the book records and that this can only enhance the value of such examination.

3. Liabilities

a. THE AUDIT PROGRAM IN GENERAL

The work done by Price, Waterhouse & Co. on liabilities was substantially in accord with the suggestions of the bulletin "Examination of Financial Statements by Independent Public Accountants" and with those of other publications examined. Some special points raised in connection with the McKesson work will be reviewed in the following paragraphs.

b. ACCOUNTS PAYABLE

Price, Waterhouse & Co.'s appraisal of McKesson's internal check on purchasing procedure may be responsible for the failure of the audit of accounts payable to reveal a clue to the fraud. George Dietrich it will be recalled authorized all purchase orders and approved the vouchers authorizing payments for foreign crude drugs and at the same time occupied the office of assistant treasurer which controlled the daily cash routine including the Manning & Company account through which payment was supposed to have been made. Prior to the Manning period Dietrich signed the checks without countersignature. Every expert called to testify stated that such a combination of duties was prohibited by sound principles of internal check and control, yet Ritts and Thorn were not disturbed by this for in their opinion Coster

¹³⁹² *Idem.*, pp. 260 and 352.

¹³⁹³ Page 380 *supra*.

¹³⁹⁴ Kohler and Pettengill, p. 108. The same authors state that horses may be counted. It is even possible that some auditors could judge of their condition.

was supposed to have exercised complete and detailed supervision over Dietrich's handling of the purchase orders; and the accounting department, relying on what appeared to be genuine documents from outside sources, exercised proper control over disbursements. It seems clear to us that even if the vendors had been real the accounting department would not have been an adequate check on Dietrich for he approved the vouchers and signed the checks to cover purchases which he had authorized.¹³⁹⁵ With the acceptance of this situation, it seems improbable that Price, Waterhouse & Co.'s suspicions would have been aroused in carrying out the mechanics of this phase of the audit.

The conclusion stated in the foregoing paragraph is supported by the same result growing out of another step of this program—the examination of creditors' statements. The authorities vary as to the extent of this test and as to whether balances should be confirmed.¹³⁹⁶ Some maintain that large balances on creditors' accounts should be confirmed but if not confirmed, the statements should be examined.¹³⁹⁷ As previously discussed in connection with accounts receivable, it was stated in the letters of engagement that such confirmations would not be made in this case. However, examination of available statements was part of the Price, Waterhouse & Co. program. This step, however, would not have involved an examination of statements from the five Canadian vendors because no amounts were owing to them at the audit dates, all purchases prior to that time having purportedly been regularly paid through Manning & Company. Here again, therefore, reliance goes back to the cash work.

If confirmation of these accounts payable had been attempted as of any date, it is certain that the auditors would have received documents which confirmed the book records as they did on the inventories supposed to have been in the possession of these dummy concerns. These two situations are of course distinguishable from the accounts receivable of the McKesson Companies in which the customers were real and would not have confirmed that they owed the sums indicated on the

¹³⁹⁵ The importance of this point is clearly brought out in the following paragraph from Trouant, p. 101:

"Accounts Payable

"Probably no other single account presents so great an opportunity for latitude in the accountant's examination as does 'accounts payable.' From the balance-sheet point of view, the book amount may sometimes be accepted as a fact and the review limited to a search for liabilities not included. On the other hand, the details relative to accounts payable may be of the greatest importance from the point of view of internal check. Disbursements of cash may follow almost automatically upon the presentation of invoices for payment, and, hence, the control over the approval and entry of the invoices may be the crux of the whole system. Not only the propriety of the amounts is important, but the distribution of the charges directly affects the accuracy of the records and particularly the classification of expenses. Since the accountant ordinarily analyzes relatively few of the expense accounts in detail, it is essential that he should satisfy himself by other means that the book classification is sufficiently accurate for purposes of determining production costs and for the review of statements of profit and loss."

¹³⁹⁶ Montgomery, 5th Ed., p. 336; Cipriani, p. 136; Financial Examinations, p. 135; Bacas, Madden, and Rosenkamppf, pp. 285-287; Trouant, p. 102.

¹³⁹⁷ Kohler and Pettengill, p. 119.

books. In the former situation five concerns purportedly held more than \$10,000,000 worth of merchandise. In the latter case over \$9,000,000 worth of receivables were divided among approximately 750 customers.¹³⁹⁸ The facts here illustrate that where accounts are particularly large and the risk is not divided, mail confirmations cannot be solely relied upon to establish the reality of the account but other independent knowledge or investigation is necessary.¹³⁹⁹

c. TAX LIABILITIES

A situation very similar to that discussed in connection with insurance prevailed in respect to taxes, for McKesson & Robbins was assumed to have a competent tax department. The problems surrounding the United States taxation of the Canadian Company, however, were reviewed quite thoroughly by the auditors and referred to their own tax department. That senior accountants should be able to recognize these problems is expected. The record raises a serious question however as to the adequacy of the investigation of the Canadian tax law under which it was thought that since 1935 the Canadian Company was exempt from the Dominion income tax. As we read the section of the law referred to by Ritts in his memorandum of the accounts such exemption was in conflict with Price, Waterhouse & Co.'s belief that after 1934 the foreign crude drug inventories were held in Canada for the law states that the exemption is granted if the business is carried on, and the *assets are also situated*, entirely outside of Canada.¹⁴⁰⁰

Another important question of procedure, which arises in this case, is whether it was proper for Ritts to accept schedules prepared by the client's tax department showing the computation of all state taxes, or whether he should have examined the tax returns themselves in his verification of the computation of the tax liability. All of the authorities examined require a review of the tax situation of the client, but of those examined only the three Price, Waterhouse & Co. authors answer the specific question here involved.

The comment of these three authors in order of publication follows: Cipriani, January 1933:

"Vouchers and tax returns must be examined to substantiate all payments that have been made. The accountant must see that all taxes have been paid or otherwise are recorded as liabilities."¹⁴⁰¹

¹³⁹⁸ The five concerns purportedly sold McKesson over \$16,000,000 worth of merchandise during 1937 while McKesson's sales of over \$18,000,000 went to more than 750 customers.

¹³⁹⁹ Ritts testified that independent credit reports on W. W. Smith & Co. and the five Canadian vendors would have exposed the fraud. R. 774. Thorn agreed but said ". . . I never heard of any accountant doing that, however." R. 1245-1246.

¹⁴⁰⁰ See pages 286-287 *supra*.

¹⁴⁰¹ Cipriani, p. 125.