b. AUDIT REPORTS

As previously stated the first warning, in a letter of acceptance of the work, as to the limitations of a balance sheet audit in respect to manipulation of the accounts and disclosure of defalcations was incorporated after the expansion of the organization in 1928 and 1929 when part of the records were kept at points away from the head office. With the recurring appointment of the auditors, however, it seems proper to consider the paragraph in each audit report [532] in respect to the scope of the audit as part of these annual renewals of the contract. A reference to scope appeared in the first report on Girard & Co., Inc. for the 9 months ended December 31, 1924 in the following language:

"Our examination was conducted along the lines of a balance sheet audit and was directed primarily to the verification of the financial position of the company as of December 31, 1924 and the results from operations for the nine months ending that date. It will therefore be understood that we have not attempted to check all the cash transactions during the period under review but have limited our examination in this respect to tests of periods selected at random and we are pleased to report that, so far as our examination extended, the accounts were found in order." [533]

This paragraph was used without important variation in the reports on Girard & Co., Inc., the Canadian Company, and on the Connecticut Company after the first quarter of 1927. A corresponding paragraph in the first (1929) and all subsequent reports on the Maryland Company and subsidiaries consolidated omitted the reference to the condition of the accounts.[534] In the report on the 1930 accounts of the Maryland Company the phrase "* * * nor did we circularize the debtors in verification of the receivables" appeared for the first time [535] and continued without other change until the report for 1934 when the language of the American Institute of Accountant's form of certificate, adopted after conferences with the New York Stock Exchange—

"In connection with our examinations, 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 * * *"

was used with the addition of the phrase "* * * nor did we circularize the debtors in verification of receivables." [536] This was expanded slightly in the 1935 report to cover the non-circularization

[532] The report referred to here is Price, Waterhouse & Co.'s report addressed to F. D. Coster and is to be distinguished from the certificate published in the Company's report to stockholders and from the annual reports filed with the Securities and Exchange Commission. See pages 344 ff. *infra.*

[533] Ex. 138.

[534] Ex. 139, 140, 141, 142, 143, 146, 147, 148, 149, 150, 151, 152.

[535] Ex. 153.

[536] Ex. 157.

of creditors in verification of payables.[537] This last form also was used for 1936 and 1937.[538]

c. GENERAL

It seems to have been understood from the beginning that the auditors would not make physical tests of inventories or supervise their taking, but would secure certificates from management as to quality, quantity, and condition. This fact was not mentioned in any of the letters of engagement except in the references to the work of R. G. Rankin & Co. in connection with the mergers.[539] The reports and the published balance sheets, however, contain statements to the effect that inventories were "* * * certified by responsible officials" [540] and the last letter enclosing the accounts of the Canadian Company stated "* * * The merchandise carried in the inventories of McKesson & Robbins, Limited at December 31, 1937 was confirmed to us by the vendors who held this merchandise at that date, but we have not attempted to otherwise verify the amount of merchandise so held." [541]

The statement that original bank deposit slips were not examined appeared in the letters of engagement for the 1931 audit and thereafter. Jaureguy had taken up the question with Coster during the 1930 engagement suggesting to him the desirability of making this test but after a few days consideration by the client, Price, Waterhouse & Co. were instructed not to do this.[542] Jaureguy's draft of the first report on the Maryland Company made no reference to the condition of the accounts, and in subsequent reports the statement that receivables had not been verified by circularization of debtors was included. That this was in recognition of the unsatisfactory conditions existing in the subsidiary companies of the organization[543] and consequently the increased difficulties encountered in making a satisfactory audit seems to be indicated by a letter written by him for transmission to Coster. Two paragraphs of this letter warrant quoting below in support of this observation.[544] And finally soon after the merger of

[537] Ex. 158.

[538] Ex. 159, 160.

[539] Footnote 518 *supra*.

[540] E. g. Ex. 128, 106.

[541] Ex. 100.

[542] Ex. 83.

[543] Representatives of Price, Waterhouse & Co. testified that all of their comments in this connection applied only to the wholesale houses and not to the Bridgeport companies.

[544] "In submitting the December 31, 1932 financial statements which we have sent you to date, we have called your attention, in the case of a number of companies, to the fact that there is not an adequate system of internal check to protect them against irregularities and misappropriations of funds. We believe that this condition exists in a majority of the subsidiary companies. It occurs to us, however, that since we have advised you in considerable detail in previous years regarding the situation in the various houses, you may perhaps consider it unnecessary for us to write you again this year regarding each individual company whose system of internal check is inadequate. Unless you advise us that you wish to have us report to you again

Girard & Co., Inc. and McKesson & Robbins, Incorporated of New York and McGloon's appointment as the first comptroller of the Company there was an increasing amount of pressure brought to bear on the auditors to reduce work and an attempt to exercise some influence over the kind of work to be done as evidenced by Coster's request for copies of Price, Waterhouse & Co.'s instructions to their representatives.[545]

The term "balance sheet audit" was used repeatedly in the correspondence and reports in defining the character of work to be done on this engagement. We have noted that Hartzell was introduced to Girard & Co., Inc. as the person who would "proceed with the audit" of the Company. The work was referred to as an "audit" in all of the letters accepting the engagement until that covering the work as of April 30, 1928 when the phrase "examination of the accounts" was used for the first time. The terms "audit" and "examination" were used indiscriminately thereafter with the McKesson letters requesting an "audit of our books and accounts" and Price, Waterhouse & Co. letters stating that "our examinations" would be "on the basis of balance sheet audits" and since 1932 "along the lines of a balance sheet examination," although even in these letters reference was made to the "audited" accounts or statements of minor subsidiaries and branches prepared by other accountants. The last letter of acceptance, December 17, 1937, was the only one to avoid the term "audit" entirely.[546] Somewhat similarly in the letters covering the audit for the year 1931 and prior thereto reference was made to a "verification of the assets and liabilities", for 1932 to an "examination of the assets and liabilities" and for 1933 and thereafter to an "examination of the balance sheet."

"Q. [By Mr. GALPEER.] And therefore you would say that the actual work you did at first in Bridgeport, and in later years was the same, and it was merely a change in description?

A. [By ROWBOTHAM.] I would say it was merely a change in description, that the work we have done on this has been the same from beginning to end." [547]

We have referred to the series of bulletins prepared by the American Institute of Accountants and Price, Waterhouse & Co.'s participation in their preparation. Although the last two of the series refer in their titles to "verification" and "examination" of financial statements, both use the term "audit" and "auditors" as well as "verification" and "examination." The predecessor of the latest of these bulletins

this year regarding the individual houses which do not maintain an adequate system of internal check, we shall accordingly not write you concerning them.

"While a great many of the houses do not have a satisfactory check on collections from cash sales and C. O. D. sales, and this is one of the principal weaknesses among the subsidiary companies, there is also the possibility of misappropriation of funds through manipulation of the customers' accounts, which is serious, and we believe that you should give careful consideration to the advisability of having a surprise circularization some time in the future of the larger balances carried in the notes and accounts receivable." Ex. 88.

[545] See pages 167 ff. *infra*.

[546] Ex. 116.

[547] R. 1750. See also R. 1747-1751 and footnote 1293 *infra*.

was recommended reading for the Price, Waterhouse & Co. staff and we shall see that the firm also referred their clients to it as a source of information as to the work of public accountants.[548] Rowbotham was questioned as to the extent to which these bulletins were followed in his practice. He stated that the latest bulletin applied to small and moderate-sized companies but agreed that insofar as it was applicable his firm "* * * would follow something generally along those lines."[549] He felt that section three "Modifications of Program for Larger or Smaller Companies" was so general in nature that it would not be very helpful on a large job. Nevertheless this bulletin was given to all staff members as a general guide.[550]

However, as applied to McKesson, the size of the engagement insofar as the detailed work of the audit was concerned was dictated by the size of the individual branches which were treated as separate engagements until the consolidating stage was reached.[551] Another major difference between the affiliated group and separate corporations was in the degree of head office control. Rowbotham felt that Coster exercised some control over the branches but the audit was not relaxed at any point because of this.[552] After some discussion similar to that quoted below, the following question and answer were recorded:

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[548] Footnote 590, *infra*.

[549] R. 1766-1771.

[550] "Q. [By Mr. STEWART.] At pages 1904 and 1905, Mr. Galpeer asked you some questions about the office manual which has been introduced into evidence as Exhibit 121, and he followed that by asking: 'Is there any other booklet which more particularly describes the work on an actual job,' to which you answered: 'Why, that would be done, I think, from the working papers.' Now, did you mean by that, that there is no other booklet published by Price, Waterhouse & Co., or that there is no other booklet?

A. [By ROWBOTHAM.] Well, I don't understand what the answer in the record means, but there is no other booklet published by Price, Waterhouse & Co. beyond this blue booklet, whatever it is.

Q. Office manual?

A. Office manual, but we do, of course, hand out this pamphlet, 'Examination of Financial Statements' to our men and we do expect them to thoroughly master it and follow it in their general work.

Q. That is the pamphlet published by the American Institute of Accountants of which the most recent edition has been marked Exhibit 117. And would you say that that booklet is constantly used as a general guide book by Price, Waterhouse men conducting examinations?

A. Yes, undoubtedly." R. 2049-2050.

Cf. Ex. 118 in which Rowbotham on April 11, 1933 in a Price, Waterhouse & Co. letter to Coster said, "Our examination of your accounts for the year 1932 was, in our judgment as extensive as that contemplated in the bulletin, 'Verification of Financial Statements', issued by the Federal Reserve Board." See also footnote 590 and page 350 *infra*.

[551] See section III, A *supra* for a description of the McKesson organization and section IV, M *infra* for a discussion of the fee.

[552] "Q. [By Mr. GALPEER.] That is what I am trying to get at. Actually in the McKesson case, what sort of a control was there? I mean, wherein would that control make your work less arduous or less detailed, let us say, in the branch.

A. [By ROWBOTHAM.] The control that came in here, as I saw it, I cannot tell you so much about accounting, but as I saw it, Coster was continually on the necks of these divisional vice presidents trying to get their accounts in order, trying to get their receivables in order the whole way down the line and that seemed to me at the time to exercise a very salutary influence on those divisional vice presidents and on their accounting. Now, in an individual company, had the company been a—wait a minute—in the case of a separate company, they would not have that control and check from some, shall we say, outside source; it is not an outside source but some other source.

Q. Now, this influence of Mr. Coster, if we can call it that, referring to what you are speaking of, while that might have been salutary in your opinion, do you think that it was of such a nature that you could have legitimately relied thereon to do less detailed audit work in a branch than if that influence was not exerted?

A. No, I think we did quite as much detailed audit work in the branch. As I tried to express it on Friday, I am sorry that it is repetition, but cash is cash, and you verify cash in the branch as you would in an indi-

"Q. [By Mr. GALPEER.] In view of that, Mr. Rowbotham, wouldn't you say that except for the consolidating work that the actual auditing work on each of these branch houses would be the audit of a small or medium sized corporation as referred to in the bulletin.

A. I would say probably yes sir. It is very hard for me to divorce my mind from the fact that a branch; I think the answer is yes." [553]

Although the expression "these branch houses" used in this quotation refers to wholesale houses specifically, we will see later that the general audit program was uniform for all divisions of the company. As we have shown earlier in this report the records audited at Bridgeport included those of the home office (the Maryland Company) and likewise those of the Canadian Company and the Connecticut Division (prior to 1934 a separate subsidiary corporation). The Connecticut Division was the largest subsidiary unit of the Maryland Company and included in its books the records covering manufacturing of drugs for the wholesale houses and the resale operations in crude drugs. Rowbotham's testimony as a whole indicates that the American Institute of Accountants' Bulletin is a fair guide to the procedures followed in examining the books of all of the divisions.[554] Detailed comparison of procedures recommended in the Bulletin and procedures actually followed by Price, Waterhouse & Co. will be made hereinafter.[555]

3. Assignments of Price, Waterhouse & Co. Staff to the Engagement

The quality of the work done on an audit is governed necessarily by the ability of those assigned to the task. Therefore, before taking up a detailed study of the audit program and of the manner in which it was carried out by those assigned to the job, it seems appropriate to consider briefly the type of men employed, their training prior to the engagement, and the manner in which the firm of Price, Waterhouse & Co. made assignments to the work. The engagement falls naturally into two periods. Prior to the early part of 1928, when the audit was confined to a small business operating primarily at one location, the work required the services of only a small staff of auditors. With the formation of the Maryland Company and the acquisition of wholesale houses throughout the United States, the engagement required the attention of most, and at times, all of the branch offices of Price, Waterhouse & Co. For the purposes of this inquiry we limit our

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vidual company, but you do have a feeling, undoubtedly, that in a branch there are other checks than the one you are making yourself. In this case, I do not think we relaxed in our work anywhere along the line

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Q. Now, I meant actually as you went into your audit work of a branch, you would audit that branch as if it stood on its own feet.

A. I don't think, sir, we made any change in our audit from the time those branches were separate corporations up to 1934, I think the date was, and then they merged and became branches and I do not think we relaxed our work in any way, because they ceased to be corporations and became branches." R. 1836-1838.

[553] R. 1839-1840.

[554] R. 1834-1840.

[555] Subsections C. ff. *infra.*

appraisal of the auditors' staff to the men assigned to the work at Mt. Vernon and Bridgeport, and to the control of the engagement by the New York office of the auditors.

C. R. Hartzell was the first man assigned to the work.[556] He enjoyed senior status with Price, Waterhouse & Co., having been in their employ since January 19, 1920. His experience prior to that time consisted of 2 years in business college and 1 year of university work coupled with 2 years in the army, 6 months with Standard Oil Co. and another half year of sundry business experience. He passed the New York State C. P. A. examinations several years after leaving Price, Waterhouse & Co. Hartzell did this first work for 1924 under the nominal supervision of J. C. Scobie, a partner, who charged 1 hour to the job and E. Christensen, manager, who charged 4 hours to the audit and 3½ hours to supervision of the other work done during the spring of 1925 as requested in Coster's letters. The assignment was practically a one-man job for the senior's time was 126 hours and the time of two juniors totaled 23 hours. The other work mentioned occupied Hartzell's time for 58 hours and led to his resignation from Price, Waterhouse & Co. to become the accountant for Girard & Co., Inc. His subsequent treatment is told in Coster's own words in his report to the stockholders and directors of Girard & Co., Inc. for 1925 in which he set forth certain expenses of 1925 which he anticipated would not recur in 1926.[557]

The work on the 1925 audit was performed under the direction of D. F. Morland, a manager who remained in a supervisory capacity for all of the audits of Girard & Co., Inc. and for the audits of McKesson & Robbins, Incorporated (Connecticut) through 1927 and who with one exception drafted all of the reports during this period. Morland had attended London University, is a chartered accountant (England) and had had 4 years of varied public accounting experience prior to January 8, 1913, when he joined Price, Waterhouse & Co., by whom he is still employed as a manager.[558] Partners Scobie, J. H. Bowman, and Rowbotham were in charge over Morland during his connection with the work. Partner's time chargeable to the work during this period was: 1 hour for 1925 (Scobie); ½ hour for first quarter 1926 (Bowman); 5 hours for second quarter 1926 (Rowbotham-McGloon drafted the report); 1 hour for third quarter 1926 (Scobie); 2 hours for October and

[556] Page 148 *supra*.

[557] "$2991.62 Represents officers salary paid to C. R. Hartzell. Mr. Hartzell was taken on from Price, Waterhouse & Co. at a salary of $6,000 per year believing that he would actually work himself and be useful in installing cost systems and generally improve our bookkeeping. Instead it worked out that he surrounded himself with an elaborate staff and his work became more of a supervising and consulting nature. After consultation with the partners of Price, Waterhouse & Co. an able local bookkeeper that was an assistant to Mr. Hartzell was placed in charge at a salary of $2400 a year, the staff cut down and the consulting and supervision placed in the hands of Price, Waterhouse & Co. at not over $1,000 per year. This change means a saving of at least $4,000 per year and more and this department is geared to handle three times over present volume if necessary." Ex. 176 (p. 5).

[558] Ex. 212.

November 1926, the merger period, (Scobie); 14½ hours for 1927, McKesson & Robbins, Incorporated (Connecticut), (Bowman).

The field work of the audit for 1925 was done by Morland with the assistance of a man classed as a junior and in the employ of the firm only on a temporary basis during that season and the preceding season (resigned end of second season). This junior had had over 11 years' experience as an internal bank auditor and clerk prior to this time. Morland spent 29 hours and his assistant 102 hours on the work.

We have referred to McGloon who served under Morland during 1926 and made a favorable impression on Coster. McGloon himself did practically all of the field work of the first quarter and about half of the chargeable time applicable to the next two quarters when he had the assistance of juniors for a substantial part of the work. McGloon had a high school education supplemented by a course at New York University (the record does not indicate that any degree was received), and had worked a half year with another accounting firm and a year and three-quarters as clerk and bookkeeper with sundry concerns prior to joining Price, Waterhouse & Co. on February 2, 1920. He had not acquired a C. P. A. certificate before he left the firm in May of 1928 after nearly 8½ years with them. When McGloon was loaned to Coster for special work incidental to the merger at the close of 1926, Anthony Jaureguy [559] took over the work and continued as senior in charge through the 1927 audit.

The personnel on the engagement from its inception to the close of the work for 1926 may be summed up briefly. Other than partners, 18 names are associated with the work: Christensen, the first manager, is now a partner in the Chicago office; Morland, the second manager, is still a manager in New York. Of the seniors in charge, Hartzell and McGloon resigned to work for the client, Jaureguy became a manager, and in 1934 a partner in charge of the Boston office. Of the remainder of the group, four are still with the firm, seven resigned, and two were temporary employees, one during nine seasons.[560] The educational and experience level of the group was relatively high, four having college degrees and all having had some college work or accounting school courses. Seven had passed their C. P. A. examinations or were chartered accountants at the time they were associated with this engagement and four others passed C. P. A. examinations later. Hartzell and McGloon of this group seem to have had the weakest record of progressive educational and business experience prior to their engagement by Price, Waterhouse & Co.

[559] Partner in the Boston office, B. S. University of Oregon, 1915; 1 year accounting department, Western Electric Co.; 1¼ years U. S. Army; 2½ years High School instructor; M. B. A., Harvard Graduate School of Business Administration; employed by Price, Waterhouse & Co., October 3, 1921. Ex. 212.

[560] Ex. 212. Exhibit does not include information for men employed on audits of the Connecticut Company as at March 31, 1927, December 31, 1927 and April 30, 1928 being the period between the merger of Girard & Co., Inc. with McKesson & Robbins, Incorporated (New York) when the Connecticut Company was formed, and the formation of the Maryland Company. See pages 26 ff. *supra*.

The year 1928 was the turning point in McKesson & Robbins, Incorporated and likewise, on that account, in the character of Price, Waterhouse & Co.'s engagement to audit the books of the Company. With this year the engagement developed into an audit of wholesale houses under contract to join the expanding McKesson & Robbins organization and the regular annual engagement was broadened from a two-man audit at one location to a nationwide engagement requiring the services of nearly every office of the firm with the directing and consolidating work being done in New York under the supervision of Geoffrey G. Rowbotham [561] whose assignment to the work at this juncture we have noted.[562]

At the hearings Rowbotham explained the procedure for organizing a staff for a job of this magnitude. As in this case, where the client dealt with the New York office, a manager in that office directed the work. Below him managers in key positions throughout the country were assigned from branch offices of the firm. Each of these managers then organized a unit, consisting of a senior, possibly a manager on difficult work, and as many first and second assistants (semi-seniors and juniors) as were necessary to conduct the audit in the allotted time. In addition, the New York manager organized similar units for the divisions examined directly by the New York office.

To sum up, on the 1937 examination conducted by the Price, Waterhouse & Co. staff in the United States, 15 offices participated and in the respective offices there were employed from one to five managers for a total of 24 managers; from no seniors to eleven, totaling 48; and from one to 39 assistants, 145 in total; making a grand total engaged for that audit of 217 staff men in addition to the partner in charge. Of the total of 21,620 hours spent on the entire engagement, 86 represented partners' time, 1,769 managers', 3,714 seniors' and 16,051 assistants'.

We do not have the personnel records of each of the 217 staff men mentioned above and the many other engaged on all of the annual audits for the 10 years 1928 to 1937, inclusive, but an appraisal of the staff engaged on the work at Bridgeport where the fraudulent transactions were recorded may be of interest. Six or seven men were used each year, 37 different names appearing on the roster throughout the period. Of the 37 men in this group eight were, at the time of the hearings, still on the permanent staff and one was employed annually on a temporary basis. Two resigned after serving for some time on a permanent basis. Twenty-six were only employed for temporary periods during the peak seasons, seven resigning after

[561] Rowbotham secured his training during 5 years' apprenticeship with chartered accountants in Glasgow, Scotland, passed the several examinations required and was elected a member of the Institute of Accountants and Actuaries in Glasgow. He came to the United States in 1908 and joined Price, Waterhouse & Co. as a junior and, after promotion through the ranks, was made a partner in 1926.

[562] Page 150 *supra*.

such employment and the remaining nineteen being released although four of these had previously enjoyed continuous employment for several years.

Of the group of 37, 13 possessed college degrees (three held master's degrees). Of the rest, 13 had done some accredited college work, seven had attended business colleges or night school, three possessed only a high school education, and for one, Price, Waterhouse & Co.'s record in this regard was blank. Except for two college graduates (still on the staff), all of the 37 men had had some accounting or business experience, ranging from 5 months (in the case of another college graduate) to 23 years, prior to their employment by Price, Waterhouse & Co. Of the eight survivors on the permanent staff, four were from those holding college degrees, three had had some college work and one was from the high school group. All of these men who were retained on a permament basis passed C. P. A. examinations after joining the firm.

Of the group of 37 men employed on the engagement at Bridgeport under Rowbotham's direction for the annual examinations of 1928 through 1937, Jaureguy served as manager for 5 years; Thorn served as a senior 4 years and as manager 5 years; and Ritts, who served as a semi-senior for his first 2 years, continued as senior in charge at Bridgeport the last 6 years. Three of the other five permanent staff men served on the McKesson work as juniors in the first year of their employment, one going back once after missing a year. The other two permanent men were seniors, each serving 1 year only at Bridgeport but several years at other locations. Of the remaining 29 men, 28 may be described as temporary juniors and one a permanent senior when they were assigned to Bridgeport for the first time. One was assigned 4 years, one 3 years, and two 2 years in succession as juniors, and one returned after an interval of a year as a senior assistant. Seventeen of the entire group of 37 were assigned to Bridgeport as juniors in the first or only year of their employment by Price, Waterhouse & Co.[563]

Of these 37 men who, from 1928 through 1937, at various times worked on the engagement at Bridgeport, there was one certified public accountant (Jaureguy) and one chartered accountant (of Scotland) on the 1928 audit, and thereafter, except for the New York manager in charge of the entire engagement, no certified public accountants or chartered accountants were employed at Bridgeport until the audit for 1937 (the last) when Ritts had his certificate. In addition, it should be mentioned that Thorn, Ritts, and three others received their certificates after a particular year's engagement at Bridge-

[563] The educational and business records of six of the 37 men indicate that they came to the United States from Great Britain, Ireland, and Canada. Of these, two served one season; three several seasons on a term porary basis (two resigning); and the sixth, a chartered accountant of Scotland, resigned after 5 years.

port, based on examinations taken (each in a different year—1928, 1931, 1935, 1936, 1937) before such engagement. In only one case (1928), however, would it appear that the results of the examination were known at the time of the assignment to the engagement.[564]

With the exception of Thorn (junior 1 year), Jaureguy appears to be the only one of those employed prior to the 1928 audit who was included in the 37 men who carried on after that time. Jaureguy continued as manager through the 1932 audit after which he was transferred to Boston in anticipation of his promotion to partner.[565] Ralph E. Thorn was then made manager in charge of the work on the entire audit and Albert B. Ritts retained the senior assignment at the Bridgeport office of the client.

Prior to his employment by Price, Waterhouse & Co. on January 9, 1928, Thorn had had over 10 years experience in banking, broken by a period of 2¼ years in the army.[566] He worked through various positions in the Clarinda National Bank in Iowa, leaving that bank as assistant cashier to become cashier of the Commercial Savings Bank of Farragut, Iowa. This work in the country banks required him to supplement his high school education and 2 years at the University of Chicago with a LaSalle Correspondence Course in accounting and law so that he could advise depositors of the bank on accounting, income taxes, insurance and other matters.

When his health failed during this work, he was advised to leave banking. He moved to New York and took a position as auditor in the stock transfer department of the Bankers Trust Company. There he stayed for 2 years until he was successful in getting a position in public accounting, which had been his intention on moving to New York.[567]

Thorn's first experience in public accounting was as a junior in January 1928 under Jaureguy on the McKesson audit for 1927 at Bridgeport. During most of 1928 and a substantial part of 1929, he assisted Jaureguy in New York on the work in connection with the acquisition of the Group One and Group Two companies [568] which launched McKesson as a nationwide wholesale distributor of drugs. At the end of 1928, he made the examination of the Bronx Drug Company, one of the Group Two companies, and at the end of 1929 he examined subsidiary companies in New Haven, Conn. and Scranton, Pa. Early in 1930 after 2 years experience in public accounting a majority of which was gained on the McKesson work, he went to Bridgeport as the senior nominally in charge of the 1929 audit under Jaureguy. On the audits for 1930 and 1931, Thorn was in full charge

[564] Foregoing two paragraphs based on Ex. 212. Price, Waterhouse & Co.'s records also indicate that six (juniors) passed the examination after the elapse of various periods following their work at Bridgeport (two after leaving Price, Waterhouse & Co.) but do not indicate the subsequent history of the remaining 24.

[565] R. 2053.

[566] Ex. 212; R. 90-91.

[567] R. 857-861.

[568] See pages 33-34 *supra*.

at Bridgeport. On the examination for 1932, Thorn worked with Jaureguy in New York, as it was known that Jaureguy was to go to Boston and that Thorn, having impressed Rowbotham with his work, was to be in charge of the entire job throughout the country. Thorn thereupon was given a contract as manager at the end of 5½ years [569] with Price, Waterhouse & Co., as contrasted with the average of 9.4 years service of men appointed from 1930 to 1938, inclusive, and remained in charge of the McKesson work from 1933 on, in recent years devoting about half of his time to it. In addition to McKesson, Thorn had a varied experience as a senior and was regularly in charge, as manager, of examinations of a fertilizer company, a corset and box manufacturing company, an electrical specialty company, and banks.[570] He became a New York certified public accountant in the spring of 1932 after passing the examination given in the fall of 1931.[571]

Albert B. Ritts became a New York certified public accountant in the spring of 1937 after passing the examination given the preceding October. He started work for National Biscuit Company in Altoona, Pa. during summers while still in high school. From Altoona he was transferred to the Pittsburgh sales office of the company, where he was bookkeeper and then in charge of accounts. He left this company in August 1928, after 9½ years employment, to do accounting work on his own in Altoona. This he abandoned in December of that year when he went to New York and was employed by Price, Waterhouse & Co.[572]

Ritts had never taken a course of instruction in accounting or auditing until he joined Price, Waterhouse & Co., when he took the required staff training, which consisted of classes and required reading. When questioned by counsel for Price, Waterhouse & Co. as to his study of standard textbooks and authorities on audit procedure, Ritts testified:[573]

"Q. [By Mr. STEWART.] And you have made studies of the books that would customarily be studied by anybody taking a regular accounting course in college?

A. I think I have read and studied every recognized book on accounting and audit procedure, yes, sir."

Ritts' first contact with the McKesson work was as a semi-senior when he made an examination of the New Haven subsidiary for 1930 (2 years after he came with Price, Waterhouse & Co.) and then assisted Thorn in the work at the Bridgeport office. He was Thorn's first assistant on the work at Bridgeport for 1931 and took charge for 1932 when Thorn, preparatory to taking over the entire engagement

[569] R. 2053-2054.
[570] R. 891.
[571] Ex. 212; R. 102.
[572] Ex. 212; R. 828-829.
[573] R. 851.

the following year, was kept in New York to assist in the consolidating work. Ritts continued in charge at Bridgeport through the 1937 audit and in recent years also assisted Thorn on the consolidating work in New York. On the 1937 work particularly he was not on duty at Bridgeport for the entire audit as George F. Wyman, who had had experience on audits for 1932 through 1936 at various branches of McKesson, had been assigned to Bridgeport that year as his understudy,[574] Ritts having been promoted to a manager's status.[575]

As he had for Thorn, Rowbotham, the partner in charge, also had a high regard for Ritts, an opinion which he stated he reached after a period of close association on a difficult consolidation assignment in Chile where Ritts was given one of three posts of considerable responsibility on one of the most troublesome points in the engagement.[576]

B. BEGINNING THE EXAMINATION

To carry out a balance sheet examination requires a mutual understanding between the client and the auditors of the scope of the work to be performed and a definite agreement as to the place and time of doing the work and the preparations that must be made by the client to insure that the books are ready so that no delays or needless work will fall on the auditors.

The first step in organizing an audit of this magnitude was for the manager in charge to arrange with the client for a uniform method of closing the books of all of the associated companies or divisions involved in the audit. In the interests of economy to the client, these plans included specifications for sundry schedules and analyses to be prepared by the client's clerical staff for the use of the auditors. Having made these arrangements with the client, the next step was to draft a uniform set of instructions for each examination which were sent to the cooperating managers in other offices. These general instructions were supplemented by each manager with an audit program going into considerable detail on the major points in the examination. The firm's "Office Manual" covers this point quite clearly under the caption "Responsibility for Work," at page 14:

"4. On all regular audits, programs should be made up and periodically revised, notations being made explaining any deviation therefrom.

"Programs in general are for guidance of seniors in charge of audits, and omission of work called for by a program (except on the approval of a partner) will be regarded as evidence of neglect on the part of the senior; omission from the program of work which should be done will not, however, be regarded as relieving the

[574] R. 306–308; footnote 690 *infra*.

[575] R. 105.

[576] "One of these was the man who is now the manager in our Valparaiso office. One of the others was Ritts. For weeks he worked in the next room to me, and I had a personal chance of seeing his work from personal and direct observation and I formed then a very high opinion of his ability, intelligence, and energy which I have not lost since." R. 2056.

senior of responsibility for the failure to perform such work. Seniors should bear in mind the importance of eliminating any unnecessary work and take up with a partner any requirements in a program which seem to them superfluous or ineffective." [577]

In carrying out the engagement in this case, the arrangements were worked out through McGloon, who became comptroller in 1928. One of his first duties was to secure some uniformity in accounting procedure in the branch houses. He issued accounting instructions in 1928 and a chart of accounts effective as of January 1, 1929.[578] In preparation for the annual audit, mimeographed instructions for closing the books were prepared by the company after consultation with the auditors as to their requirements. Price, Waterhouse & Co., in turn, prepared "Private and Confidential" instructions to their representatives in charge of the several audits, which for 1937 totaled 84 different examinations.[579]

The practice of regularly submitting to McKesson in advance of the audit, copies of Price, Waterhouse & Co.'s instructions to their representatives was started by the auditors with the preparations being made for the 1930 audit, and was continued to the end, the draft copy of instructions for the 1938 audit bearing a date of November 22, 1938, having been submitted to McGloon for review. These instructions opened with a brief statement as to the scope of the audit and a warning that "The extent of the work should be kept on a practical basis consistent with sound procedure for a balance sheet examination of a branch office." [580] There followed advice to study the client's closing instructions as they contained an outline of work to be done in anticipation of the audit such as detailed descriptions of schedules to be prepared in advance.

The next section listed statements and papers to be sent to the New York office and the character of the report to be made on the branch. One paragraph at this point warrants quotation in view of the stress to be laid on the subject later in this report:

"In view of the importance of the system of internal check, the questionnaire on this subject included in your working papers should be brought up to date and your memorandum to us should state your opinion of the effectiveness of the system and specify the particulars of any points of weakness." [581]

Succeeding paragraphs dealt with general procedures to be followed in respect to the various accounts and outlined in a broad way the amount of work to be done. In those cases in which arrangements with the client had resulted in an understanding that certain audit steps would not be used, these were called to the attention of the staff. Two items of this character appeared in appropriate places in the following lan-

[577] Ex. 121.
[578] R. 1736.
[579] R. 92-96.
[580] Identical in 1937 and 1938 instructions, Ex. 13, 92.
[581] Ex. 13 (p. 3), 92 (p. 4).

guage: "At the request of the company, we have agreed not to ask the banks for copies of deposit tickets for deposits made near the end of the year", and "We have been requested by the company not to circularize customers for confirmations of the receivables, but you should obtain confirmations of the balances due from officers, directors and employees." [582]

The text of the instructions closed with this paragraph:

"Everything possible, consistent with the scope of a branch examination, should be done to reduce to a minimum the time required for the work. As previously mentioned, the head office has instructed the branches to assist you in every way possible and you should avail yourself of their help in preparing schedules or with any other work that will save your time."

The McKesson & Robbins closing instructions for December 31, 1937, consisted of a mimeographed pamphlet of 68 pages, of which 24 pages were descriptive text of instructions and the remainder model forms of schedules and exhibits and lists which were to be prepared for the Bridgeport office and for the auditors. The text constituted a head office order to the branches to be ready for the auditors by not later than January 20, not to close the books until the auditors had finished their work, and to make sure that their figures were in agreement with those of the auditors before mailing them to Bridgeport.

The body of the instructions followed in general the same order as the Price, Waterhouse & Co. instructions to their representatives with a similar detailed treatment of the major balance sheet items. One of the most troublesome points, for example, was covered by seven pages of instructions for preparing trial balances of notes and accounts receivable and the analysis of these accounts and the treatment of related reserves.

One of McKesson's two concluding paragraphs may be compared with Price, Waterhouse & Co.'s concluding paragraph quoted above:

"It is obviously to our own interest to cooperate with the auditors in every way possible in order to keep down the time spent on the audit to a minimum. Should you feel that your audit is not being conducted properly, please advise us so that we can discuss all such matters with the New York office of Price, Waterhouse & Co., for we are anxious to have the audits of all our houses conducted as efficiently as possible and with the minimum of friction. This request to be advised does not, of course, mean that you, yourself, should not, at the same time, endeavor to clear up any points of contention or complaints as to the conduct of the audit directly with the senior in charge." [583]

Whether because of, or in spite of, the fact that McGloon was a Price, Waterhouse & Co. man, the history of the engagement since he took office as comptroller of the client in 1928 was not one of complete harmony. Some of the early differences of opinion and the origin of the practice of consultation on, and exchange of, instructions are re-

[582] Ex. 13, 92.
[583] Ex. 15.

vealed, from McGloon's point of view, in a memorandum prepared in his office in anticipation of a conference with the auditors in regard to the 1930 audit. Reproduction of that document gives at least an indication of the atmosphere in which the audit was conducted from this period down through the last year.[584]

"MEMORANDUM OF POINTS TO BE DISCUSSED WITH MR. CAMPBELL AND MR. JAUREGUY IN CONNECTION WITH THE ANNUAL AUDIT OF DECEMBER 31, 1930.

"Heretofore we have been denied the privilege of reviewing instructions to representatives of Price, Waterhouse & Co. We did, however, examine the instructions covering the audit of December 31, 1929, but not until June 4th, 1930, the date Mr. Coster requested the information.

"The following items, in my opinion, should be discussed in detail with the partners of Price, Waterhouse & Co.

"1. Their remarks regarding the re-organization of wholesale houses. On Page 30 in their closing instructions, they mention the fact that our houses were incorporated under the State of Delaware and other States having lenient laws.

"2. In my opinion Price, Waterhouse should not convey to their assistants that we are likely to do a little 'window dressing' at December 31st of each year.

"3. Price, Waterhouse & Co. have warned their assistants to see to it that manipulations as between accounts and notes receivables are not resorted to in order to have old accounts appear to be of current dating. We should explain our views in detail to Price, Waterhouse & Co.

"LISTS OF NOTES RECEIVABLE

"A. If the date of the original transaction is not easily ascertained, Price, Waterhouse & Co. should not demand the information or spend time ascertaining the information.

"B. Price, Waterhouse & Co. should be instructed to accept our schedules on notes receivable.

"C. Trade Notes, Contract Notes, and Acceptances should be classified in the Balance Sheet as follows:

"Current Assets

"a. Trade notes falling due in 1931.

"b. Trade notes past due at December 31, 1930.

"c. Instalment notes falling due in Dec. 1931.

"d. Instalment notes past due at Dec. 31, 1930.

"e. Serial notes falling due in 1931.

"f. Serial notes past due at December 31, 1930.

"g. All other notes including past due time loans and demand loans which are likely to be paid prior to December 31, 1931.

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[584] Ex. 111; R 1714-1727.

"The EXAMINER. Do you know whether or not it was prepared under your direction?

The WITNESS [MCGLOON]. If I didn't prepare it, it was prepared under my direction.

Mr. GALPEER. Well, Mr. Examiner, I would like to state now, perhaps we can end it this way, that this document is being offered with the entire understanding that this was an internal memorandum of McKesson's, there is no claim here that any facts appearing in this document were communicated to Price, Waterhouse & Co. It was merely offered for what it is, namely, an inter-office memorandum taken out of McKesson's files.

Mr. STEWART. On the understanding that it is not to be taken as an indication that any of the statements therein were communicated to Price, Waterhouse, or that Price, Waterhouse & Co. knew anything about the statements therein made, I have no objection to it." R. 1726-1727.

"Non-Current Assets

"a. Trade notes falling due subsequent to Dec. 31, 1931.

"b. Instalment notes falling due subsequent to December 31, 1931.

"c. Serial notes falling due subsequent to December 31, 1931.

"d. All other notes including time loans and demand loans which are not likely to be paid prior to December 31, 1931.

"e. Price, Waterhouse & Co. should be instructed not to age notes receivables.

"f. If we prepare detailed schedules of all notes receivable, Price, Waterhouse & Co. should not trace individual notes to both our schedules and the notes receivable ledger.

"ACCOUNTS RECEIVABLE

"A. Heretofore, Price, Waterhouse & Co. have prepared detail lists of accounts receivable showing the following information:

"1. Customer's name.

"2. Amount owing on the date of their examination.

"3. Balances classified under four general headings. Our executives are of the opinion that Price, Waterhouse & Co. should be satisfied with an adding-machine tape of all open accounts, together with a schedule of past due accounts.

"4. Past due accounts are to be aged and classified as follows:

"a. Amounts resulting from sales made during October and November 1930.

"b. Amounts resulting from sales made during July, August and September 1930.

"c. Amounts resulting from sales made prior to July 1, 1930.

"In addition, our accountants will furnish Price, Waterhouse & Co. with a summary sheet which will show one amount for sales made during December 1930 and sales made prior to that date if the amount is not due at December 31, 1930. This schedule will also show a total for columns a, b, and c mentioned above.

"Last year Price, Waterhouse & Co. devoted a great deal of unnecessary time summarizing amounts due from customers for sales made prior to December 31, 1929, the amount of which was not due at December 31, 1929.

"According to Price, Waterhouse & Co. closing instructions of December 31, 1929, we could not close our books and prepare our financial statements until we were advised what figure we should provide for doubtful accounts.

"We should either adopt Price, Waterhouse & Co.'s formula for providing reserves for doubtful account, or have them adopt our formula.

"Our formula calls for less detail work and we believe the final results are about the same.

"Our method of satisfying ourselves that the reserve for doubtful accounts is adequate is briefly outlined hereunder:

"1. All notes and accounts on which there is no hope of recovery should be written off to the reserve for doubtful accounts.

"2. Provide a reserve in whole or in part for the remaining notes and accounts.

"3. A sum added, equal to a blank percentage of the net sales for the four months ending December 31, 1930. This provision is for the portion of the receivables which, by reason of their recent dating, appear at the date of the audit to be good and collectible, but which will become uncollectible at a later date.

"4. Ascertain the amount of detail posting Price, Waterhouse & Co. intend to do December 31, 1930.

"5. Under ordinary circumstances, the reserve for cash discounts should not exceed the average monthly allowance. The practice of analyzing each customer's account in order to ascertain the amount of discount which will be taken, should be discontinued. The Chief Executive of each house will, at our request, furnish the representatives of Price, Waterhouse & Co. with a list of customers who are entitled to special discount rates.

"6. The reserve for allowances should be based upon the gross profit on the amount of merchandise returned. In a few instances we have been compelled to provide a reserve equal to an average month's charge for allowances.

"7. All open accounts should be classified under Current Assets, unless the item represents an advance of a more or less permanent nature which is not likely to be paid prior to December 31st.

"8. Amounts due from officers and employees for merchandise sales should be treated as 'Amounts Due from Customers.'

"INVENTORIES

"a. Price, Waterhouse & Co. should use standard price books in verifying prices. According to our accountants, Price, Waterhouse & Co. are required to spend hours tracing small items from such suppliers as Eli Lilly, Merck, McKesson & Robbins, Conn., etc.

"b. Arrange for outside machine operators to verify footings of inventory sheets.

"c. Owing to the fact that Price, Waterhouse & Co.'s closing instructions refer to the matter of slow-moving and obsolete merchandise, their representatives are likely to spend a great deal of time on this phase of work unless we work out a satisfactory arrangement with Mr. Campbell.

"d. Intercompany profits on merchandise will, as heretofore, be eliminated from the records in the Bridgeport office. It should be understood, however, that we will not be required to eliminate intercompany profit on the sale of general and bulk items sold thru the Maryland Company on which there is a small profit.

"e. Price, Waterhouse & Co. should not attempt to verify quantities of merchandise listed in the physical inventory.

"f. Price, Waterhouse & Co. should not attempt to ascertain the amount of rebates due each subsidiary. This information will be handled in Bridgeport.

"FIXED ASSETS

"1. Price, Waterhouse & Co. have gone on record that all additions to fixed property in excess of $50.00 are to be vouched. If practical, the amount should be changed to $100.00.

"2. During the year 1930 our houses did not follow a standard method of adjusting depreciation on fixed assets. In the majority of the cases, the provision for depreciation was based upon the balance in the property account at the close of business each month, but several of our houses followed the practice of adjusting depreciation at the end of each three months and others at the end of each six months. Price, Waterhouse & Co. should accept the method used in each house.

"ACCOUNTS PAYABLE

"1. Price, Waterhouse & Co. should agree to accept an adding machine tape for the open items at December 31, 1930. Heretofore, we have been compelled to furnish them with a detailed list of the items which were open, showing the names and amounts due.

"INTERCOMPANY ACCOUNTS

"1. Price, Waterhouse & Co. should be asked to confirm intercompany balances by correspondence. Telegrams and telephone calls are too expensive and should not be restored to except in emergency cases.

"GENERAL NOTES

"1. Ascertain how many nominal accounts Price, Waterhouse & Co. intend to analyze.

"2. Price, Waterhouse & Co. should be asked to use our classification for nominal accounts or inform us where our Chart of Accounts are wrong.

"3. The method of handling the following accounts should be discussed with Mr. Campbell:

"a. Cash discounts allowed customers

"b. Provision for doubtful accounts

"4. According to our accountants, Price, Waterhouse & Co. frequently send Junior accountants on the job who are not qualified to conduct an audit and in the opinion of our men, a great deal of time is wasted by the Junior accountants until the Senior accountant arrives. Our accountants have also notified us that in many cases the Senior Accountant is dissatisfied with the schedules prepared by the Junior accountant and it is necessary for the Senior to verify the account for the second time.

"5. In several instances according to our own accountants, Price, Waterhouse & Co.'s, representatives have had many important and elaborate schedules prepared for them but have refused to use the schedules as part of their working papers. In other words, they have prepared their own schedules. According to our Chief Executives and Accountants, Price, Waterhouse & Co. are in the habit of adjusting our books and accounts without discussing the items with our Manager.

"6. Our accountants have been instructed not to release their December financial reports until after Price, Waterhouse & Co. have completed their examination and all adjustments taken up on the books. This practice was followed last year except in a few cases where Price, Waterhouse & Co. made adjustments without discussing the item with our accountant. Last year it was also noted that several adjustments effective the net profits were adjusted by the partners and no notice was given to our executives and accountants.

"7. Instructions should be issued to Price, Waterhouse & Co. that they are not to verify the collections of guaranteed receivables.

"8. Price, Waterhouse & Co. have agreed to employ outside auditors to audit the books of the following companies:

"McKesson-Kelly & Pollard Co.

"McKesson-Midwest Drug Co.

"Arrangements should be made to have outside auditors verify the records of McKesson-Langley-Michaels Co. Ltd. Honolulu. Discuss with Mr. Campbell accounts of Doster-Northington and secure their permission to re-value the accounts as of the date of acquisition and charge all adjustments to 'Paid-in-Surplus.'

"9. Unless special arrangements are made with regard to the treatment of laboratory equipment of our wholesale houses, Price, Waterhouse & Co. will insist upon adjusting the accounts to give effect to the loss on machinery which is no longer actively engaged in the manufacturing of merchandise.

"10. Inasmuch as Price, Waterhouse & Co. are not to furnish us with a report or prepare the Federal Tax Return, they should refer to these points in their closing instructions and inform their own auditors that the work should be governed accordingly. If the assistants on the job will follow this suggestion it will be possible for them to eliminate several unimportant schedules.

"11. The Federal Income Tax Return is to be prepared in the Bridgeport office but we will be greatly indebted to Price, Waterhouse & Co. if they will request their branches to forward the working papers on each audit to the New York office where they can be held after we complete the consolidated Federal Tax Return.

"12. Price, Waterhouse & Co. should be requested to accept the audit with the view of reducing the fee 50% or more. 10/27/30"

McGloon was questioned at some length about this memorandum. He explained that it was prepared as a guide for a conference in which the parties were to try to get together and reach a clear understanding as to the work to be performed and what the client could do to expedite it and thus reduce the expense.[585] His memory was inadequate to the task of recalling the results of the conference or the significance of many of the points in the memorandum. He was quite clear on the point of manipulation of notes and accounts receivable, however, for he explained that he was trying to convince the auditors that it was not necessary to know the date of the original transaction with the customer where a note had taken the place of an account. His memory was fresh on this point because the auditors insisted upon getting the information and as late as the 1937 audit the client had prepared it as regular routine preliminary to the audit.

Other conferences resulted in an agreement as to the method of checking prices on inventory items purchased from certain suppliers with price lists rather than by the laborious process of tracing many small items to invoices.[586]

Much of the friction on the work developed in the wholesale houses which were in many cases being subjected to an audit for the first time. McKesson files examined in the preparation of this case revealed a number of letters from heads of the various branch houses complaining about the methods employed by the auditors and the time consumed in various phases of the work. For example, the San Francisco branch wrote a memorandum following the 1932 audit. The gist of this was that the auditors' instructions to their representatives were not specific enough. Too much latitude as to the checking on inventory work was left to the senior on the job. This memorandum also suggested that expense could be reduced by employing a calculating agency to check all inventory computations.[587] A similar complaint was registered with McGloon by G. V. Doerr, executive vice president, in respect to audits of the Akron and Cleveland units, where he felt that excessive checking was done on inventories. Price, Waterhouse & Co.'s reply to McGloon indicated that Doerr was not accurately informed as to what was done on the audit and gave an analysis of the time in support of their opinion.[588]

[585] R. 1722.
[586] R. 1733.
[587] Ex. 112.
[588] Ex. 186, 187.