Wyman testified that he had secured credit reports from the client on other audits and that he had been told that Price, Waterhouse & Co. did not have a contract with Dun & Bradstreet. Ritts supported Wyman as to this practice and explained that there would be no point in getting a report on the New York firm when the Liverpool partnership would be the party ultimately responsible for any losses sustained under the contract. The report was obtained by Dietrich at Ritts' specific request but Ritts was not sure whether it was handed to him in the original envelope unopened, although he thought the usual practice would be to receive it without a cover.[788]

If the Dun & Bradstreet report in 1936 had been obtained direct from the agency in response to a request for information on W. W. Smith & Company, Inc., the report probably would at least have disclosed that the dummy New York firm, W. W. Smith & Company, Inc., such as it was, had been dissolved during that year (1936) [789] while the guaranty contract apparently still had 4 years to run. Ritts felt that in reality under these circumstances the partnership might still have been liable on their guaranty but that the situation would have been serious enough to warrant calling it to the attention of his superiors and possibly getting a legal opinion. All of this was speculation on Ritts' part for he had no knowledge that the corporation had been dissolved.[790] It should be noted here also that Ritts had never before heard of a forged Dun & Bradstreet report and he stated that he could not tell the difference between the forgery and a genuine report.[791]

Item 14 of the audit program, among other things, required the review of available credit information on accounts receivable. In complying with this requirement on the 1932 audit, the first year he was in charge, Ritts asked George Dietrich for credit reports on the customers as well as on W. W. Smith & Co. These reports indicated that the customers were all responsible people. He called for a great many of these reports in the earlier years, but not so many in recent years.[792] In addition to all this was the assurance from the president, Coster, that he looked into these matters himself—as Rowbotham put it—"Coster sat on the job."[793]

Further discussion of the audit of receivables was pursued with Ritts beginning with the matter of credit memoranda, item 6 on the program. This had to do with establishing that proper allowances for discounts, returns, and allowances had been made. Ritts noted none on the Canadian Company but stated that there was no segre-

[788] R. 566-576.
[789] R. 2074.
[790] R. 587-592.
[791] R. 832.
[792] R. 474; Ex. M-1.
[793] R. 1947.

gation on the books of the Connecticut Division that indicated whether there were any applicable to the foreign crude drug accounts. A schedule from the working papers introduced in evidence tabulated "Returns and Allowances", "Samples & Free Goods", "Discounts", and "Excise Tax" for 1937 by months but did not indicate the departments to which they were applicable.[794] Subsequently, however, other schedules prepared by the Company and accepted by Price, Waterhouse & Co. without verification were discovered in their work papers showing a tabulation of gross sales, returns and allowances, samples and free goods, cost of sales, and gross profit by departments for the Connecticut Division for the years 1932, 1934, 1935, 1936, 1937, and for the month of December 1937 in which "Special Resale Crude" (the foreign crude drug sales) did not reflect any "Returns and Allowances" or "Samples and Free Goods" charged against the Company's operations.[795]

Ritts testified that a junior with his eyes open during the checking of accounts receivable should notice any large credits for returns and allowances but stated that small credits might not be noticed nor would a complete absence of such credits be noticed. Ritts felt that if any claims for inferior or damaged merchandise had been made by the customers handled through W. W. Smith & Company, Inc., McKesson would recover such amounts from the suppliers and/or W. W. Smith & Company, Inc., the shipping agent, respectively. This was pure speculation for Ritts did not recall any such transactions and was sure that no notice would have been taken of them in his working papers. He agreed, however, that it would be impossible to run a business the size of the foreign crude drug division over a period of years without expecting some claims to arise.[796]

Ritts confirmed Wyman's reactions to the situation at all points. No reserve for bad debts was necessary for these accounts totaling some $9,000,000 because the record showed that all were collected promptly when due and there was the additional safeguard of the W. W. Smith & Co. guaranty. In the last 3 years, or the period covered by the last contract, foreign sales of crude drugs totaled approximately $50,000,000, $18,250,000 in the last year,[797] yet so far as the records examined under Ritts' direction were concerned no bad debts losses appeared. In fact, the memoranda on the accounts of both the Canadian and Connecticut Companies consistently stated that no losses were ever sustained on these accounts, nor were any of them ever charged back under the guaranty because of McKesson's failure to collect.[798] This did not appear unusual to Ritts for McKesson sold to a carefully selected class of customers. He was

[794] Ex. 36; R. 464.
[795] Ex. N, 124, 120. See also R. 1378-1379.
[796] R. 468-471.
[797] Individual orders averaged approximately $12,000 per customer. Ex. 30, 40.
[798] See footnotes 310, 318 *supra*.

told that not only did W. W. Smith & Co. verify the credit rating of these customers before guaranteeing the accounts, but McKesson made independent investigations of these people to decide if they were good credit risks, and as above stated, Ritts on the 1932 audit examined a great many credit reports on these customers which the Company had in its files.[799] Attempts made by the Commission and S. D. Leidesdorf & Co. (accountants for the Trustee) to confirm the accounts receivable established the existence of most of the customers as actual business firms but that none of them had done any business of this nature with McKesson.[800]

Ritts never questioned anyone as to why McKesson should pay a premium for a guaranty on accounts of this excellence, especially when they made their own investigation which as we have seen included the securing of Dun & Bradstreet reports. The language of paragraph six of the contract said that the premium was to be paid for the guaranty. When asked whether the premium was paid for a guaranty, Ritts said he thought so but that was a matter of legal definition. Yet without consulting counsel for a legal interpretation of the contract, he decided that the ¾ of 1% was not being paid specifically for the guaranty. He thought that the payment also covered the solicitation of the accounts.[801]

A similar confusion was revealed in the memoranda on the accounts of the Connecticut Company for 1931, 1932, and 1933 which linked the guaranty to the $18,000 fee provided in the contracts. The Smith contracts seem quite explicit as to the $18,000 fee for they say it is "* * * in full consideration of the services to be rendered by the New York Company [W. W. Smith & Company, Inc.] hereunder *(except the guaranty of accounts)* * * *" [802] [emphasis ours]. This and the section of the contract dealing with the guaranty[803] indicated that the premium of ¾ of 1% for the guaranty of accounts was not provided thereunder as a commission but solely for protection against bad debts that never materialized in 14 years.[803a]

Wyman, who read the Smith contract before going to Bridgeport, seemed unimpressed with the importance of correlating the terms of the contract with the recording of transactions under it. Purchase orders submitted by Smith to McKesson carried in the lower left hand corner the instruction "Please render invoice in Duplicate", below that, "Brokerage [blank] %", and still below that, "Guarantee

[799] R. 474, 579–582, 1650–1651; Ex. M-1. Page 219 *supra*.

[800] R. 4555; Ex. 255.

[801] R. 583–586.

[802] Page 59 *supra*. The confusion as to the interpretation of the $18,000 fee may have been due to the fact that a stated fee of $12,000 appears to have been the only payment required under the Charles Manning & Company, Limited contract of 1930 under which that company performed the services including the guaranty of accounts which W. W. Smith & Company, Inc. assumed as of August 1, 1931. Page 55 *supra*.

[803] Quoted in part at page 224 *infra*.

[803a] See also section 7 "* * * New York Company * * * will charge no brokerage or commission to either of the McKesson Companies * * *." Page 58 *supra*.

¾ of 1 %%." [804] Wyman considered the premium of ¾ of 1 % to be a commission and not charged for the guaranty. Despite the notation on the purchase orders and despite the wording of the contract, when the latter was specifically called to his attention at the hearings, his conception of what W. W. Smith & Company, Inc. was being paid for was not altered.[805] He said he followed the Company's classification of the payment as a part of "selling salaries and commissions" [806] without questioning anyone about it. Whether for guaranty or commission, he felt the charge was selling expense, so the question never came up. His testimony seems to indicate that he did not give the contract particular attention because it seemed unnecessary for him to challenge what seemed to be a reasonable procedure established in prior years.[807]

To complete this topic of bad debts in relation to W. W. Smith & Company, Inc., Thorn was asked if he thought it possible for a firm to handle the business we have referred to with hundreds of customers in foreign trade from 1930 through 1937 without suffering a single bad debt loss. He thought it was possible and supported Ritts' position in the following answer:

"The WITNESS. These representatives of W. W. Smith were right on the ground and making this sale, and knew that their firm bore the risk of those sales, and naturally would be very sure of those credit risks before they made the sale. Then, when the sale was offered to Bridgeport, Mr. Coster has told me that he investigated the credit of each of those customers, that is to say, a new customer would be investigated so far as possible through their New York banking connections and their foreign correspondents, and they also received credit reports from outside agencies such as Dun & Bradstreets and it does not seem, it never has seemed unreasonable to me that under those circumstances, dealing in relatively large quantities with large concerns, that there should not be bad debt losses here." [808]

Thorn also supported Ritts on the question of allowances by saying that claims for defective merchandise would have been made against the supplier, clearing through McKesson's books if they appeared

[804] Ex. 8–B; R. 587.

[805] "A. [By WYMAN.] No, sir, the fact of the wording of the contract wouldn't alter my general conception of what W. W. Smith & Co. was being paid for.

Q. [By Mr. GALPEER.] Who gave you this general conception contradictory to the terms of the contract in your permanent file which you read?

A. Nobody.

Q. Did you raise this question, discuss it with any one?

A. No, sir.

Q. Do you think you can take it upon yourself after you read a written contract stating that the three-fourths of one percent is to be a guarantee charge, to just yourself take it and put it in the commission charge without talking to any one about it?

A. The nature of an item—the classification of an item is guided by its nature. The contract has nothing to do with it.

Q. The contract has nothing to do with it?

A. The contract could have called that anything." R. 369–370.

[806] Operating accounts for the Connecticut Division seem to include the payment in "Miscellaneous selling expense." Ex. 185.

[807] R. 371–375.

[808] R .921.

there at all. The claims for losses in transit, if any, he thought would have been made against W. W. Smith & Company, Inc. directly or cleared through McKesson's books. Thorn's views on this question may be expressed in his own words:

"* * * Now, I have thought, in dealing with commodities of this kind, that it may be possible to run for many years without having those claims, but I quite agree with you that over an extended time there would be bound to be differences. I think I ought also add that those things, in the course of a balance sheet examination, would not come to our attention, that is to say the claims and allowances. We are concerned, however, at the end of the year with whether there were any claims or allowances affecting those receivables at that date so that they would not be collected in full, but if there appears a claim last March, I don't think it would come to our attention or that we would be concerned with it." [809]

In such work as was done on these accounts, no bad debts or claims ever were called to Thorn's attention.[809]

Thorn discussed the operations of the crude drug sales with Coster in 1929. He testified that he probably did not have very extensive discussions with Coster or anyone else after that date. He was certain that no one in Price, Waterhouse & Co. was consulted as to the actual mechanics of carrying out the Smith contract. He testified that he did not consider it necessary to obtain a legal opinion thereon.[810] There was one note in the papers made on the 1933 audit in connection with an abstract of the extension of the agreement in that year. This note, made by an assistant under Ritts, was referred to as evidence that Ritts had knowledge of the obtaining of a legal opinion although Thorn did not have such knowledge. The note merely said, "No mention is made with respect to the flat fee of $18,000, but Mr. G. Dietrich advises that upon advice of counsel, they have continued to make same." [811]

Rowbotham was questioned as to his knowledge of the bad debts, allowances, and returns situation on the crude drug sales through Smith, and he supported Thorn at all points. The matter of allowances and returns he explained had never been discussed with him and would not have been in ordinary course. Rowbotham said that he would not have expected Thorn to bring such matters to his attention, for in a balance sheet examination he would not go into such matters except to see if returns and allowances were excessive in relation to sales.[812]

On the matter of bad debts, Rowbotham felt that this business was with a chosen group of large and responsible customers and hence it was quite reasonable that there would be no losses on bad accounts. In this connection, on referring to the Smith guaranty

[809] R. 923.
[810] R. 1134–1135, 1190.
[811] Ex. 56; R. 1196.
[812] R. 1936–1939.

of the accounts, Rowbotham supported Ritts in the thought that the guaranty was insurance against losses and in that way the premium was money well spent if it resulted in a high class of customers on which no losses developed.[813] Such an impression was supported by the practice of the client in paying the guaranty fee on all sales through W. W. Smith & Company, Inc.

A review of the exhibits and testimony indicates that while a correct interpretation of the W. W. Smith & Company, Inc. contract was academic in so far as its guaranty of collection features were concerned, since no claims were ever made under it; the amounts paid in premiums were considerable,[813a] and the emphasis placed upon the contract in its bearing on all aspects of the foreign crude drug business was so great that one would assume a careful consideration of the applicable clauses by the auditors.

Article 6 of the 1935 contract provided:

"In consideration of a premium of three-quarters of one percent (in addition to the service charge hereinafter provided for) of the total amount of any order placed under the provisions hereof, the New York Company will, if requested so to do in writing, unconditionally guaranty the full and prompt payment therefor by the purchaser in dollars, it being understood that the liability under this guaranty will become absolute thirty (30) days after written notice to the New York Company that such purchaser has defaulted payment in whole or in part, provided, however, that the total of accounts so guaranteed shall not at any time exceed the sum of $900,000. The liability of the New York Company hereunder shall not be affected by the fact that the guaranty premium shall not have been actually paid in advance, it being the intention of the parties that such premium items shall be billed monthly to the McKesson Companies * * *."[814]

The 1933 and 1931 contracts used similar language. An abstract of the prior Manning agreement dated March 12, 1930 from the files

[813] "Q. [By Mr. GALPEER.] * * * did it ever occur to you that it might be a useless expenditure of money to be paying this three-quarters of one percent, I mean where there was never one bad debt claim, did those two factors ever come together in your mind?

A. [By ROWBOTHAM.] Why, they did, sir, but I took exactly the opposite conclusion which you have, which apparently came to you, because it seemed to me this, that if these people could pay three-quarters of one percent to an international organization to look into their debt situation in such a way that they could have no bad debts, that that was an expenditure worth while having. In other words,—I am sorry, I cannot find the word, but the same words that you are using on the questionnaire, that it was a point of strength and not of weakness.

Q. [By Mr. STEWART.] Would another way of describing it be that you regarded it as cheap insurance against bad debts, Mr. Rowbotham?

A. Yes, sir. I thought it was an excellent arrangement." R. 1952.

The insuring of receivables was a practice adopted by Coster as early as 1925. Price, Waterhouse & Co. reports on the audits of Girard & Co., Inc. for the first three quarters of 1926 in referring to the status of accounts receivable said " * * * these were all considered good and collectible either from the customer or from the insurance company which has insured their collectibility." Ex. 140, 141, 142. Coster in his President's Report for 1925 listed a number of items of expense in that year which should not recur. One of these he commented upon as follows:

"$475.25. This amount represents premium for Credit Insurance. The policy does not expire until September 1926. On account of the terms and conditions of such insurance I do not recommend continuance of this form of insurance since in order to collect we must first suffer initial losses of $5,000. This added to $475 premium means that we are out $5475 before we start to collect. The class and character of the trade we sell is such that we would not incur such losses as warrant this insurance. We have had no bad debts in 1925." Ex. 176 (p. 6).

[813a] See pages 47-48 *supra*.

[814] Ex 50.

of Price, Waterhouse & Co.[815] interpreted that contract in the same way as the client and Price, Waterhouse & Co. interpreted the subsequent Smith contracts above mentioned to the effect that the premium was payable on total sales and that for these payments all outstanding accounts (which at all times were considerably in excess of the maximum sums mentioned in the applicable contracts) were guaranteed, provided, however, that W. W. Smith & Company, Inc.'s maximum liability for losses on the accounts in any one year would not exceed the amounts specified in the respective contracts. All of the memoranda written on the audits at Bridgeport assumed this interpretation. The language in the 1931 memoranda on the Connecticut and Canadian Companies stated that the combined accounts of the Companies were guaranteed by Smith against losses up to $350,000 in any one year, which in effect amounted to a reserve of $350,000 on these accounts.[816] Subsequent memoranda were similar except that commencing with the memoranda for 1933, the reference to the reserve was dropped.

The possible inconsistency between this interpretation and practice which treated all the accounts guaranteed, the amount specified in the contract being the limit of the guarantor's liability *during any one year*, and the express language of the 5-year contract which seems to restrict the amount of outstanding accounts that could be guaranteed *at any one time* to the amount specified in the contract, does not seem to have occurred to anyone on the auditors' staff at any time in the life of the engagement. Since the contract was never tested in practice by claims for losses, its ambiguous character in this respect is only interesting in that such ambiguity did not trouble the auditors despite the great reliance by them upon this and other provisions of the contract in explaining the many unusual features of the foreign crude drug business.

Another point in the contract which is not entirely clear when considered in the light of other facts in the record is the precise relationship existing between McKesson and Smith in regard to these foreign accounts. Article 2 of the 1931 contract under which this business was done stated that all purchase inquiries for drugs, chemicals, or any other commodities dealt in by McKesson would be submitted to McKesson for quotations. If such quotations were as favorable as others obtained by Smith in the open market, the business would be placed with McKesson.[817] According to the Price, Waterhouse & Co. memoranda of accounts, during 1932 and 1933 most of the crude drugs were reported to have been purchased from W. W. Smith & Co. which also served as McKesson's sales agent for the same merchandise much

[815] R. 956.
[816] Ex. 76, 82.
[817] Page 58 *supra*.

of which had its origin in foreign countries and was sold to customers in other foreign countries.[818] W. W. Smith & Co. was supposed to have had financial resources of several millions of dollars.[818a]

But, in the auditor's opinion, the real proof of the genuine character of the foreign crude drug accounts receivable was that the accounts were collected. If the sale was charged to the customer and there was evidence of the money having been received in payment of the goods, they felt that no question needed to be raised in regard to the genuineness of the transactions in the absence of suspicion.

The validity of this position is, of course, vitiated if the money was not received from the customer or his authorized agent. As to the situation prior to the use of Manning & Company as a bank Ritts testified, "* * * but I do know that prior to 1931, before Manning & Company were the fiscal agents of McKesson and Robbins, that actual cash was received in the various banks of the company, such as the Guaranty Trust Company, the New York Trust Company, the Manufacturers Trust Company and other banks that we knew did exist, so when you ask me whether I know that the actual money was received, I say, yes, definitely, we did know." [819] But there was no proof other than book entries that the money credited by the various banks came from the customers, which events have shown was not the case. After the transactions were concentrated in Manning & Company there was no investigation of that firm to establish that it was a bank, which, in fact, it was not. Reliance was placed on credit advices and monthly statements from Manning that collections had been received by Manning from the customers to whom shipments supposedly had been made through W. W. Smith & Company, Inc., thus supporting the authenticity of the accounts.

"Q. [By Mr. GALPEER.] Now, Mr. Thorn, on the McKesson sales side, when you say that you saw the cash for the payments, what you have reference to is the credit advice coming in from Manning & Company?

A. That is true during the period we examined.

Q. That is what I am speaking of now.

A. Yes, sir.

Q. And when you say you saw evidences of shipment, the only evidences you saw were again the letterheads of W. W. Smith & Company, containing advice of shipment.

A. Well, I think that is true, technically. Now, I may be making the same point Mr. Stewart just tried to, but thefact was, of course that seeing the collections in these receivables was also a support to that evidence of shipment, that is, when you see that the goods were paid for it would be the best possible evidence that they had been shipped." [820]

In the discussion of cash procedure it will be recalled that Thorn did not know how the customers were advised to pay Manning and did not consider it important to find out.[821] Rowbotham indicated his reliance on collection when questioned about this part of Thorn's testimony. He was asked if he agreed with Thorn's conclusions as to

[818] Ex. 75, 81. [818a] Page 81 *supra*. [819] R. 216-217. [820] R. 1123-1129. [821] Footnote 737 *supra*.

the non-necessity of being familiar with the forms used in handling transactions. His answer was, "Yes, sir, I do. If I were looking at this job and the money was being collected, I would not care whether they put a sticker on the bill or not." [822]

But there was one aspect of collection of these foreign accounts which did cause some concern, at least to Jaureguy, for he sent Thorn back to Bridgeport on the 1930 audit, after he had brought the papers to New York, to make an analysis of the foreign accounts, especially to determine the amount due from customers in Australia and New Zealand. The results of this analysis showed that of $4,180,000 customers' receivables on the Connecticut Company's books at December 31, 1930, probably $3,200,000 covered foreign sales, of which $2,433,103.70 were Australian balances and $400,000 New Zealand. The Canadian Company at the same date had accounts totaling $795,660.25 outstanding in Australia and $303,718.75 in New Zealand out of a total of $1,316,623.50.[823] The investigation revealed that all of these accounts were current at the year end, none having been billed prior to August 1930. Besides, practically all the accounts due prior to the date of the inquiry, February 25, 1931, had been collected, proving that the foreign exchange situation in Australia whose pound was at a discount had not affected the collectibility of the accounts which were payable in U. S. dollars.[824]

During 1931 the accounts were still largely in Australia. Beginning with the 1932 memorandum on the accounts of the Canadian Company and with the 1933 memorandum on the accounts of the Connecticut Company, detailed geographical analyses were shown for the foreign accounts. The Canadian Company in 1932, for example, in addition to accounts in the British Empire, listed customers in France, Belgium,

[822] R. 1846.

[823] Ex. 83, 77; R. 916.

[824] "Q. [By Mr. GALPEER.] Was there a question there of exchange restrictions, or was it merely a question of the Australian pound going below par?

A. [By THORN.] I only remember the decline in the quotation of the Australian pound and through these years there have been questions of exchange restrictions, but I don't remember whether they apply here or not.

Q. The fact that you had this concern about the Australian balances, which totaled about two and a half million dollars, and I think you mentioned later on in this report that nevertheless the collections remained good and that there was no loss of any items; had that occurred to you as in any way strange or suspicious? Do you see my question, what I mean?

A. Yes. No, it did not. If there were restrictions there—we see cases right along of so-called bootleg exchange coming out and of course we verified the actual receipt of enough of this cash to know that it really was coming in.

Q. I understand that that was coming in to Manning & Company the same as we have described?

A. That was coming in to the Guaranty Trust Company mostly and possibly some to the Bridgeport City Trust Company.

Q. So the fact that there was this concern, but that despite this concern all these balances were paid in full did not strike you as unusual in any way?

A. No, not when they were actually being paid. We felt that the balances were collectible. We were not,—we were only concerned with how much they could realize on those accounts, that was our concern and we reached the conclusion that the fact that we actually saw this cash coming in that the balances were good and collectible." R. 916-918.

See also memorandum on accounts of Canadian Company for 1932: "The officials certified to us that the accounts are all payable in U. S. dollars and, although we believe some of the countries involved have exchange embargoes, Mr. Coster informed us that the debtors are able to 'bootleg' the exchange." Ex. 205.

Japan, Sweden, Norway, Denmark, and Rumania. New countries in 1933 were Italy, Holland, China, Spain, Germany, and Switzerland. By 1937 the only countries outside the British Empire were Holland and Sweden. These analyses were made to determine the balances due from customers in countries having exchange restrictions, but Thorn testified that he did not recall that any check was made as to depreciation in currency in the several countries.[825]

The history of these accounts reveals that sales were curtailed to customers in countries in which exchange restrictions were set up and that McKesson gradually worked out of such restricted countries. All of the accounts, however, were collected promptly in full as was also the case for accounts with customers in countries having depreciated currencies to which sales were not curtailed.

The withdrawal from restricted countries seemed to Thorn a reasonable thing to do and the fact that it was 100% successful did not disturb him in the least for he had heard that there were ways of "bootlegging" exchange "* * * and [he] saw that cash actually coming in".[826] Each year the situation in respect to exchange restrictions was checked by one of Thorn's assistants and on at least one occasion Thorn discussed the matter with either George Dietrich or Coster, who he says gave him a satisfactory explanation.[827]

[825] R. 1095.

[826] R. 1096–1098. "Q. [By Mr. GALPEER.] * * * I read you certain amounts owing from customers in Japan, Spain and Italy, and those amounts were owing, those sales have been undertaken at times when the restrictions were already in effect. My question is whether it didn't strike you, I know that you can get most of your money out despite restrictions, but didn't it strike you surprising that there was 100 percent compliance here again?

A. [By THORN.] No, it did not, because in the first instance we actually saw the cash coming in and we knew that it was perfectly possible for that situation to exist and we also knew that they were working out of those countries.

It might have appeared strange if there had been no change in the location of their business, but we noted from about, I think, about 1930 or 1931, along in there is when we first began to watch that, and we noted that their business worked out of those countries where there were restrictions, and it seemed perfectly natural to us." R. 1097–1098.

[827] "Q. [By Examiner HUMPHREYS.] Did you consider the difficulty with which McKesson & Robbins might get their money out of these countries?

A. [By THORN.] Yes, I did. I remember of talking to either George Dietrich or Mr. Coster personally about that once. It was probably when I was in Bridgeport reviewing the papers because I think it was after the period when I was senior on the work.

Q. Did you go into the question as to whether they might have to get their money out by barter?

A. Yes, I believe I did because I was just as a matter of human curiosity wondering how they did get their money out and as I recall that certain of these foreign customers, they said that these foreign customers being fairly large business men, with a large acquaintance among similar people would find someone in their country who had dollars, that is dollar balances here, that they would be able to make the exchange.

Q. Did you consider the question of expense in making such conversion?

A. That is, that it might be a very expensive process for the customer to have to get his dollars that way?

Q. Or McKesson & Robbins might have to take a discount in receivable, in cash, to get it out of the country?

A. No, that point seemed to be clear that they had to have their money in dollars. Every sale was made in dollars and the customer, of course, when he made this purchase, knew undoubtedly how he was going to be able to secure these dollars and how much this purchase was going to cost him in his own money which was naturally all that concerned him." R. 1101–1103.

See also R. 918–919. Likewise see Ex. 82 (Memorandum on 1931 Accounts) for a discussion of foreign exchange transactions in which the risk of foreign exchange fluctuations was borne by McKesson in connection with pepper transactions (Sterling) and in codliver oil (a loss of $28,000 incurred in the devaluation of the Norwegian Kroner).

The letters of engagement beginning with the 1931 audit, it will be recalled, specified that, in accordance with Coster's request, the customers' accounts would not be circularized. Circularization was again suggested to McKesson by the auditors in connection with the wholesale houses following the audit of 1932,[828] but Price, Waterhouse & Co. never considered it necessary in connection with the work at Bridgeport, although Thorn stated that they would have welcomed the opportunity to make this form of verification in either case. The relatively small accounts in the wholesale houses totaled approximately 90,000 divided over 80 to 85 different units of the Company while the foreign crude drug accounts numbered a little over 700. The reason given for suggesting the circularization of receivables in the wholesale houses was that there was less internal control there than at Bridgeport and collections were slower but in view of the distribution of the risk, this audit step was not considered necessary in order to express an opinion on the accounts.[829] It may be noted that when McKesson acquired the wholehouse houses in 1928 and in some cases in 1929 the accounts receivable taken over were guaranteed by the owners of those houses so that no independent confirmation was necessary in those cases in connection with the merger.[830] Thorn in reporting on the work at Bridgeport for 1933 wrote in his memorandum on the Canadian Company:

"We have not confirmed any of the receivables with the debtors but, during the course of the examination, we did everything we could think of to satisfy ourselves that the accounts are authentic and that the balances outstanding at December 31, 1932 had been liquidated in cash when due." [831]

Similar notations to the effect that the receivables had not been confirmed but that comprehensive tests to establish the authenticity of these accounts had been made and liquidations in cash had been noted appear in all subsequent memoranda on the Canadian Company [832] and also since 1933 in all memoranda on the Connecticut Company, later Division.[833]

The omission of circularization was covered specifically in a certificate obtained at the close of the 1937 engagement (as well as in similar certificates obtained in connection with the 1934, 1935, and 1936 examinations). The 1937 certificate is reproduced in the footnote.[834]

[828] Ex. 88 quoted in part in footnote 544 *supra;* R. 934.
[829] R. 935–936.
[830] R. 876; Ex. 152 (pp. 14–16).
[831] Ex. 75.
[832] Ex. 74, 73, 72, 26.
[833] Ex. 80, 268, 79, 78, 49.
[834] Ex. 67.

"McKESSON & ROBBINS

Incorporated

Bridgeport, Conn., U. S. A.

CONNECTICUT DIVISION

MEMORANDUM TO PRICE, WATERHOUSE & CO. REGARDING NOTES AND ACCOUNTS RECEIVABLE AND RESERVES AS AT DECEMBER 31, 1937

SUMMARY OF RECEIVABLES AND RESERVES

DESCRIPTION:	AMOUNT		RESERVES
Current notes and accounts receivable:			
Bankers acceptances	$		
Other notes receivable	660.00		
Customers' accounts	7,800,287.87		68,202.20
Officers and employees	2,426.59		
Miscellaneous	35,849.35		
		$7,839,223.81	$ 68,202.20
Non-current notes and accounts receivable:			
Other notes			
Accounts	142,587.62		36,934.87
Total		$7,981,811.43	$105,137.07

1. The above receivables were all unencumbered assets of the branch at the above date and all receivables, other than interbranch and intercompany receivables, resulting from transactions of any kind entered into on or before December 31, 1937 are included, except such as have been written off as uncollectible.

2. No amounts are included in respect of sales made after December 31, 1937 of representing unsold goods shipped to others on consignment.

3. All receivables resulting from transactions outside the usual course of the branch's business are separately classified.

4. Segregation of receivables as between current and non-current has been made in accordance with the procedure set forth in the company's closing instructions.

5. In the light of our present information, the above-stated reserves are neither excessive nor deficient to cover:

Losses that may be sustained with respect to the above receivables

All rebates, allowances or other deductions that may be granted to the debtors

Any rebates and allowances that may be payable to customers as quantity discounts or otherwise, whether in respect of uncollected items or not.

Losses that may be sustained in collection of any receivables that have been discounted or sold with the branch's endorsement.

6. The debtors were not circularized, in accordance with our instructions, for confirmation of the unpaid balances at December 31, 1937.

7. The valuations of the collateral held against notes receivable as shown in the trial balances of the notes, in our opinion, represent the realizable value of the collateral.

Furthermore at the time of signing this memorandum we have no knowledge of any other information relating to the above, which would have any substantial effect on the branch's accounts, that is not referred to herein or that was not clearly disclosed in the branch's general books of account as at or before December 31, 1937.

(s) F. D. COSTER
President
(s) J. H. McGLOON
Comptroller
(s) GEO. E. DIETRICH
Assistant Treasurer
(s) E. A. JOHNSON
Office Manager

Date: February 23, 1938

(s) A. B. RITTS
Representative of Price, Waterhouse & Co."

It bears a notation in Thorn's handwriting, "Note for 12/31/38—Say payable in U. S. dollars."

In summing up the audit procedures followed in verifying accounts receivable, Rowbotham's comparison of the Price, Waterhouse & Co. program with that outlined in the Bulletin of the American Institute of Accountants revealed that these programs were substantially the same save for the important omission of the optional step of circularization of accounts and for the inclusion by Price, Waterhouse & Co. of some additional steps. The added steps were items 11, 16, and 17 of the work program quoted above.[835]

The Bulletin in referring to circularization says:

"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."[836]

Rowbotham approved the omission of this step because in his judgment it was not necessary. He continued in his testimony:

"* * * In this case this seemed to me about the last type of case where a circularization would be applicable. You have, of course, as I have already testified, I think—no circularization is commenced nowadays until you get the consent of your client. You have to convince him that circularization is necessary. Now, in this case those receivables——

Q. [By Mr. STEWART.] Referring now to the crude drug department?

A. Yes, sir, these receivables were obtained by sales agents, W. W. Smith & Company, who made an extensive check or were supposed to have made an extensive check of their credit before submitting the bids to Coster. Smith also guaranteed these receivables to the extent of $900,000; they were supposed to be carefully checked up here and when I say here, I mean with a Dun & Bradstreet's report. Coster himself sat right on top of this thing and looked at those credits himself. On top of that there was an excellent record of collections and there was no reason at all that I could see, that I could ever see here for circularizing these receivables and I did not at any time raise the question and I did not think at any time that they should be circularized, and in the absence of suspicion, which I never did have, it would never have occurred to me that this was one place where circularization was necessary." [837]

Collection of the accounts coupled with what was considered to be good internal control was the auditors' basis for believing that the customers' accounts were authentic and were worth 100 cents on the dollar. Therefore a more detailed inquiry into internal control as it affected this question would appear to be appropriate at this point. Recording of sales is so closely associated with control of billing to and collection from customers that the two must be considered together.

In the review of the questionnaires it was found that on the 1937 audit a junior was sent to get answers to several questions on receiv-

[835] Page 216 *supra*.

[836] Ex. 117 (pp. 14-15).

[837] R. 1860-1861. See also R 2008-2009.

ables, and that he refused a detailed explanation which Johnson, the office manager, offered to give him requesting instead brief accurate answers for he "just wanted to get the answers down." [838] The first question called for a brief description of—

"safeguards in use to insure that (a) an invoice or record of charge to the customer is prepared for every shipment of merchandise leaving the warehouse; (b) every invoice, or record of charge to the customer, is entered in the accounts; (c) there is a charge to the customer for every direct shipment from supplier to customer."

The junior's answer was:

"(a–b) Shipping orders are controlled by billing dept.; invoicing is controlled thru separate invoice register independent of both billing & shipping dept. (c) Accounts Payable Register controls invoicing of customer thru billing dept."

Wyman's answer to the same question in respect to the Canadian Company was:

"All direct shipments from whse. to customer (a) [blank]; (b) shipping advices checked to sales reg.; (c) agreement whse. cerf. & stk. card."

Since Wyman's answer was correct for the Canadian Company, all of whose business since some time in 1935 was supposedly done through W. W. Smith & Company, Inc. by direct shipment from vendors' Canadian warehouses, it would appear that the junior failed to distinguish this type of business, which was handled in the same way in the Connecticut Division as in the Canadian Company, from the other business of the Connecticut Division.[839]

The junior's answer to question seven,

"(a) Who is responsible for the granting of credits? (b) Are credit limits established and followed?"

also revealed his failure to secure complete and accurate information for he wrote:

"(a) Mr. Titus, credit mgr., is responsible for granting credits. (b) Yes, as established by Mr. Titus."

This again applied to the real business which the junior apparently learned about but which was much the smaller part of the total business, although his superiors knew that Coster and George Dietrich performed these functions on what has been found to have been the larger fictitious business.[840] Wyman did not answer this question.[841]

In addition to his questionnaire on the Canadian Company and the work program on accounts receivable, Wyman prepared a sheet showing the work done on sales. Some of the items on this program

[838] Pages 178 *supra*.

[839] The junior's answer to "c" seems to apply to a small class of direct shipments for which McKesson received the vendor's invoice coincident with McKesson's billing to its customer. This latter type of direct shipment constituted an infinitesimal portion of total sales of the Connecticut Division, whereas the foreign crude drug sales supposedly shipped direct from vendors' warehouses some time after purchase was the major part of the Division's business.

[840] Ex. 19; R. 1112.

[841] Ex. 19.

referred to records dealing with shipments, which he examined. Item 2 stated that he traced duplicate invoices to December sales register and item 4 called for examining shipping advices on all December shipments. Item 5 required the tracing of quantities shown on invoices and shipping advices in December to perpetual inventory cards. Item 6 read "Examine all shipping advices for first ten days in January to see that charges have been made in proper period", and item 7 was, "Check postings for December from duplicate invoices to customer's ledger." Items 1 and 3 dealt only with sales and will be discussed later.[842]

Having done all of the above, the proof relied upon by the auditors for the authenticity of purchase and sale transactions throughout the rest of the year was the exact agreement of the inventory certificate quantities as reported by the vendors with the balances on the stock cards at the beginning and end of each year. Prior to 1935, the proof was the correspondence of the physical inventory count as certified by responsible officials with the book records. As for the internal paper work in the Canadian Company, there is nothing in the documents in evidence or in Wyman's testimony to show that he realized that all such documents supporting these transactions either originated in or came from George or Robert Dietrich's offices to the Canadian Company's one bookkeeper, Miss Walsh, who acted under George Dietrich's direct supervision.[843]

Wyman, although he checked the W. W. Smith & Co. notices of shipment, saw no evidence on them to indicate from which vendor's warehouse the order was filled nor did he ask the source of the merchandise. He did not see any bills of lading, consular invoices, invoices, or insurance certificates which were check-marked on the notices, as accompanying them. He did not ask to see any of these. The advice of shipment was on the letterhead of W. W. Smith & Co., of Liverpool, 3, England, but he did not notice that. He never inspected the copy of the McKesson factory order to which was attached copies 1, 3, and 4 of the McKesson uniform straight bill of lading form.[844] The work one junior did on the Connecticut Company did not require the examination of any shipping documents that he could recall, although he did examine sales invoices in connection with some inventory work.[845]

Wyman and this junior were on the McKesson audit only 1 year, but Ritts went on at Bridgeport as a junior on the 1930 examination and stayed with it through 1937, the last 6 years in charge of the work there. This is longer at Bridgeport than any other man as-

[842] Ex. 25; R. 376-378. See pages 300 ff. *infra*.
[843] R. 4382.
[844] R. 378-380.
[845] R. 1113-1114.

signed to the work and for this reason his understanding of the accounting procedures of McKesson is particularly significant.

A typical set of documents purportedly arising from a sale of crude drugs under the contract with W. W. Smith & Company, Inc. has been described and reproduced in an earlier section. Ritts in his first appearance at the present hearings testified that the sales procedure started on the receipt of a purchase order from "W. W. Smith & Company." These orders he said were sent to McKesson's billing department, where they would be transcribed onto their own forms, which he thought were of the fanfold type with the invoice on top, with several duplicates, and under them several order forms. When he was shown a copy of the factory order, however, he could not say where it was prepared, but he thought it went to the shipping department. He could not say whether the order was prepared before or after the invoice.[846]

Ritts continued his explanation by stating that one copy of the invoice went to the mailing department in George Dietrich's office, one copy to the clerks in charge of the sales records, one to the customers' ledger bookkeeper, and one to the department which kept the perpetual inventory. On the due date the customers paid through Manning & Company but Ritts had never seen any instructions for them to do so. He thought that possibly W. W. Smith & Co. told them.[847]

On the second day of the hearings, Ritts testified that when McKesson received an order from W. W. Smith & Co. to ship to certain customers, in recent years the Company prepared shipping instructions to the supplier holding the stock advising them to ship to designated customers. In due time, the supplier or custodian of the goods

"* * * would advise McKesson by formal advice that this shipment had been made in accordance with their instructions and they would spell out all the details of the shipment, who the shipment was made to, and also accompanied these advices by bills of lading indicating actual shipments had been made to the various customers. From there on, McKesson and Robbins would use these advices as the basis of making the charge to the customer in their own account."

Continuing the discussion, Ritts said he had seen these advices from the suppliers and also bills of lading indicating that beginning in 1935 the shipments were made from Canada.[848]

At this point, Ritts was shown a W. W. Smith & Co. "Notice of Shipment." On seeing this document, Ritts changed his version of the system, for the documents indicated that notice of shipment reached McKesson through W. W. Smith & Co. rather than direct from the supplier. It now appeared to him that on receipt of the

[846] R. 134–138.
[847] R. 143. Cf. Thorn's version, footnote 737 *supra*.
[848] R. 162–164.

W. W. Smith & Co. purchase order, McKesson must have issued an order to the supplier to deliver to W. W. Smith & Co. When that order was carried out, W. W. Smith & Co. would use the "Notice of Shipment" to advise McKesson that they, in turn, had made the shipment to the customer. He reiterated that McKesson issued orders to the suppliers to ship, although he could not say whether they went direct to the supplier or through Smith. He thought he had seen such orders, although employees of McKesson's accounting department testified that they had not seen them and none have been discovered.[849]

The samples of the two Smith documents reproduced, the "Purchase Order" dated January 28, 1938 and the corresponding "Notice of Shipment" dated January 31, 1938,[850] give only one address—Liverpool. Within the indicated three day interval it was necessary that the order be received, accepted, credit passed, a Canadian supplier be advised by McKesson, delivery made by the supplier to Smith, consular invoices and so forth be obtained, and actual shipment to the customer made by Smith. Ritts explained the Liverpool heading by saying it was not unusual that an affiliated company, in this case W. W. Smith & Company, Inc. of New York, would use stationery of the other affiliate.[851]

After an interval of ten days during which time Ritts made a careful study of all of the types of documents which had been produced in connection with the foreign crude drug sales he testified that these documents, the purchase order and shipping advice from W. W. Smith & Co. and the McKesson bill of lading form, indicated that W. W. Smith & Co. obtained the merchandise from the Canadian vendors by their truck and handled all the details in connection with the shipment to the customers. The advice of shipment, under this interpretation of the procedure by Ritts, was the only evidence of shipment necessary for the auditors as the bill of lading form was only an internal memorandum prepared in the McKesson shipping department and would not represent an outside proof of the transactions' authenticity. These so-called bills of lading were attached to the shipping department's duplicate invoice whereas the juniors under Ritts, in accordance with the audit program, used in their work the accounting department copy of the invoice to which the W. W. Smith & Co. purchase order and shipping advice were attached.[852]

In his first testimony concerning the documents used in connection with these transactions which are reproduced and described earlier in this report,[853] Ritts was positive that the auditors had seen bills of

[849] R. 165-169, 1355-1356.

[850] Ex. 11-C, 11-B. See pages 78-79 *supra*.

[851] R. 169-173, 195. Cf. Thompson's testimony at page 133 *supra* to the effect that Coster told him that the Smith advices were mailed from Liverpool.

[852] R. 716-717, 177-180.

[853] Pages 77 ff. *supra*.

lading covering a large number of these shipments [854] although in recent years, since he assumed senior status, he had delegated that examination to juniors under him.[855] At first he was sure that bill of lading forms similar to the ones shown to him and placed in evidence were examined as supporting these transactions [856] but then stated that it would not be such an examination as would disclose whether it was a genuine bill of lading—merely a cursory examination,[857] "Bills of lading were examined incidental to other documents that we examined. Our primary purpose is not directed to the genuineness of this bill of lading." After examining the bill of lading more carefully Ritts granted that it was not in order, but repeated that it was only one of many documents, which in the absence of suspicion would not be examined in detail for he relied primarily upon the other documents in support of the shipment.[858] Although Ritts stated that it would be part of his duty as senior on the job to know how and from where the goods were shipped,[859] he could not recall that he had examined any bills of lading since the goods had been stored in Canada.[860] He felt, however, that he had satisfied himself "* * * in a general way that there was a sufficient control to preclude any major defalcations in the accounts in the absence of any collusion or fraud."[861]

The development of Ritts' conception of the way these foreign crude drug sales were handled from his original ideas expressed on the second day of the hearings in this proceeding to his final version developed in testimony 10 days later throws some light on the extent of his familiarity with the client's accounting procedures.[862] Five days after his first testimony on the subject at the present hearings, Ritts testified that his recollection of the facts had not been too clear in his mind before but now that he had had time to examine all the documents, he believed the correct version could be given. The bill of lading, consular invoice, and insurance certificate checked as

[854] R. 174, 176-177.

[855] R. 177.

[856] R. 181-182.

[857] R. 185-190.

[858] R. 190-200. Ritts testified:

"I will grant that subject to a scrutiny like we are giving it, it will be evident that this copy of the bill of lading is not in order, but if I may repeat myself, the bill of lading was only one of many documents. All work we did in this respect was merely a cursory examination. Unless we had some specific reason to believe that there was something wrong with this shipment, that we had reasons to believe that this shipment was not made, we wouldn't examine it in detail, we would rely principally on the other documents supporting the charge to the customer." R. 200.

[859] R. 214-215.

[860] R. 211.

[861] R. 209.

[862] In his testimony before the Attorney General of the State of New York on December 10, 1938, about a month before his testimony at the present hearings, Ritts gave still another version of that part of the procedure which concerned the warehousing of the goods after purchase. "The contract with Smith & Co. provided that they would store and insure and bear all necessary expenses applicable to these stocks of McKesson bought from Smith or Smith's agents." R. 514. At the present hearings Ritts stated that in giving the foregoing testimony he was the first witness to be questioned in connection with the McKesson case and spoke beyond his actual knowledge from memory without having the advantage of reviewing the working papers or collecting his thoughts. R. 515.

accompanying the W. W. Smith & Co. "Notice of Shipment", he thought would of necessity be forwarded to the customer with the sales invoice. That meant that the bill of lading in evidence did not purport to be the original bill of lading covering shipment to the customer. He assumed that the bill of lading, covering shipment by W. W. Smith & Company, Inc. as McKesson's forwarding agent, would have been made up in triplicate, one copy retained by the carrier, one by the shipping agent, and one sent to McKesson & Robbins to be forwarded to the customer so he could claim the goods. Under this interpretation no bill of lading would be in McKesson's files although it would appear that they should have been flowing through the office on current transactions while the audit was in progress. Ritts could not recall that he had ever seen any of these bills of lading, nor could he say definitely that his present version was correct.[863]

In further testimony another 5 days later, Ritts amplified the second explanation referred to briefly above. He now stated that he had no recollection of how bills of lading had been made out when he had last seen them 4 years before, except that they carried such identifying words on their face. During 1935, 1936, and 1937, there would have been no occasion for examining them, for during this period, the audit programs required an examination of shipping advices from W. W. Smith & Co. instead. If by chance one of his men had come across a bill of lading during the last 3 years, he would have looked at it only long enough "* * * to see that it was a document he was not interested in examining." Why this document was in the files may best be explained by the following extract from Mr. Stewart's examination of Ritts:

"Q. [By Mr. STEWART.] Since your original examination by Mr. Galpeer, concerning bills of lading, have you for the first time had an opportunity to examine the document which you have there marked Commission's Exhibit 9 [Reproduced at page 88 *supra*] for the purpose of attempting to determine what it means and what its function was in the system of records of McKesson & Robbins?

A. Yes, I have.

Q. Now, from your knowledge of the way the McKesson & Robbins crude drug transactions were handled during the past three years, and your knowledge of the documents which were examined by you and your subordinates during that period, what is your present opinion as to the meaning of that document, Commission's Exhibit 9, and as to the function it performed in the records of McKesson & Robbins?

A. I think it is clearly evident that it is intended to serve only as an office memorandum to indicate that this shipment was made, not by McKesson & Robbins, but by W. W. Smith & Co. as shipping agent.

* * * * * * *

Q. * * * Would you say that it is usual or unusual for printed forms to be used by a corporation or corporations for the purpose of keeping internal records and to be used for a purpose different from the purpose for which they were apparently used in the first place?

[863] R. 624–626.

A. There would be nothing unusual about it so long as it would serve the purpose it was intended for.

Q. Now, assuming that the document marked Commission's Exhibit 9 was intended to be merely an internal memorandum of the shipping department of McKesson & Robbins, will you point out what language in the document indicates to you the date of shipment that it intended to record?

A. Well, it is stamped on the face of it, "Shipped January 31, 1938, by R. J. D.," which is Robert J. Dietrich, which indicates that——

* * * * * * *

He merely noted on here that shipment had been made per the advice of the shipping agent.

Q. In other words, that he was willing to accept the responsibility for saying that he was satisfied that the shipment had been made?

A. Well, it is also stamped—this is on the copy of the bill of lading "Received W. W. Smith & Co., Inc., forwarding department."

Q. What do you understand that language to mean?

A. Well, I think that the purpose of this bill of lading—the stamps indicate thereon—merely mean this, that W. W. Smith & Co., has stated that it got the merchandise by their truck, from the supplier and made the shipment to the customer.

* * * * * * *

Q. And it was simply intended to be an internal memorandum of the corporation to record the disposition of the merchandise?

A. Yes, sir, that is my opinion after studying those documents.

Q. Is it your present understanding that that document, Commission's Exhibit 9, was intended to be a bill of lading or a copy of a bill of lading at any time?

A. No, I don't think so.

Q. Now, look at Exhibit 8–C, which you also have in your hand, that is the shipping advice from W. W. Smith & Co., and tell me whether it is your present understanding that the document which has been marked Commission's Exhibit 9 was intended to be the bill of lading referred to on the bottom of Commission's Exhibit 8–C?

A. No, I think not, as the bill of lading——

Q. Now, what do you understand that reference to the bill of lading on Commission's Exhibit 8–C to refer to?

A. Well, it would be a copy of the original bill of lading prepared by W. W. Smith & Co., I believe, who were acting as shipping agents. They would have to furnish McKesson with a copy of this bill of lading so that in billing the customer for this merchandise—they would also have to send the customer a copy of the bill of lading to enable him to receive the merchandise at the other end. In other words, when the shipment arrived, the customer would receive notice from the carrier that they held such and such merchandise there for his account. Now to enable him to claim that merchandise, the customer would have to present a copy of the original bill of lading.

Q. Would that copy of the original bill of lading sent by Smith & Co. to McKesson & Robbins and sent by McKesson & Robbins to the consignee of the merchandise be a paper you would expect to find in the files of McKesson & Robbins?

A. Certainly not.

Q. Why not?

A. Not unless they receive more than one copy of the bill of lading because if they received one it would have to be sent to the customer, otherwise the customer could not claim the merchandise at the other end." [804]

[804] R. 704–708.

As to the manner in which the billing was handled, Ritts now testified that when an order came in from Smith that it was sent to the billing department which prepared a factory order, or a combination order and bill. This was registered and given an order number and then sent to the shipping department which issued shipping instructions to Smith. In due course the Smith notice of shipment, together with the documents indicated thereon, would come back and be sent to Robert Dietrich. The factory order would then be stamped "Shipped such and such a date R. J. Dietrich" and accompanied by the notice of shipment and various underlying documents went back to the accounting office. Then it would be charged to the customer. The original invoice together with the documents that would accompany the notice of shipment would be sent through the mail to the customer. The copies of the invoice would be used internally.[865] On this point, Mrs. Freer, assistant to Bonsby—head of the billing department for most of the period under review, testified that while the regular orders were handled substantially in the manner as described by Ritts, on the foreign crude drug sales or "pet" orders, as they were called, her department received the factory orders from George Dietrich, one typed copy only, with no shipping stamps or documents attached, from which the invoice was prepared and sent back to George Dietrich for mailing, the factory order going to the shipping department after the invoice had been thus prepared.[866]

Thorn started his association with the McKesson audit under Jaureguy on the work for 1927 and naturally had only a vague recollection of detailed instructions given him at that time in respect to what was expected of him in connection with his examination of documents. He stated that as a general thing he was expected to be on the alert to notice anything that might be of interest to his superior. While the following passage refers to purchase invoices rather than sales invoices, it sums up the situation rather well:

"Q. [By Mr. GALPEER.] Let me ask you the question this way: When you were told to do a particular job which would, let us say, entail checking invoices against another sheet, as to amounts and dates and so forth, were you expected to do that or were you expected to spend a little time and perhaps analyze the process generally, examine the papers in more detail than perhaps was absolutely essential for the particular checking job you might have to do?

A. [By THORN.] No, I should say not in the absence of any irregularity in the work which I was told to do, but, of course, there would be no restrictions on me if I saw anything that I thought I should look a little deeper into, why I was perfectly free to do that.

* * * * * * *

Q. What I mean was, when you went out to look at the invoices that you were to examine, would you look at the items of cost or would you look at other things, for example, the address of the vendor, the terms of sale and things like that which

[865] R. 766–767.

[866] R. 4352–4360, 4375–4377. Quoted in part at pages 80–85 *supra*.

were not immediately pertinent to the particular test check that you were told to do?

A. No, sir, I would say generally not, no." [867]

For the 1929 examination, Thorn served as senior in charge at Bridgeport. At this time shipments of foreign crude drugs were supposed to have been made from inventories carried there. The practice of keeping all of these inventories in Canada began in 1935 after Thorn assumed control of the entire audit and spent most of his time in New York. From this time on he had no first-hand knowledge of the procedure in Bridgeport but assumed from Ritts' explanations that the system provided good internal control. Although he assumed there were such, he had never seen a shipping instruction from McKesson to the supplier or to W. W. Smith & Co. and did not know what form they took or who received them.[868] It was his understanding, however, that the orders were signed by George Dietrich on instructions by Coster, so that insofar as the internal system at McKesson was concerned the signature of Dietrich would have been accepted as valid authority for the release of the merchandise.[869] Thorn testified that the only evidence, other than collection of the account, which his men saw relating to the shipment were the advices from W. W. Smith & Co.[870]

On examining the Smith advices, however, Thorn could find no indication from which of the five Canadian vendors the merchandise was supposed to have originated and furthermore was sure that he had never before seen documents like them. His testimony indicates clearly that he relied on collection rather than upon any

[867] R. 868-869.

[868] R. 1124 ff.

[869] "Q. [By Mr. GALPEER.] Did you yourself review any of these documents? They must have changed somewhat in form, or did you ask Mr. Ritts to review them in connection with this change in 1935?

A. [By THORN.] You mean the shipping advices particularly?

Q. That is right.

A. No. As far as I know, I have never seen a shipping advice on those items. I, of course, was familiar with the Manning account, having been there after the account was opened.

Q. Now, you made some mention, I believe, before, of the shipping instructions sent by McKesson—you don't remember whether it was the supplier or W. W. Smith & Company?

A. Yes.

Q. Do you know what form they took?

A. No, I don't know.

Q. Who was supposed to have approved those shipping advices?

A. You mean the company, who sent those out?

Q. Who was responsible for their issuance?

Mr. STEWART. You mean shipping instructions. You say shipping advices.

Mr. GALPEER. Yes.

A. Mr. Coster handled the operations of that department and any sales, it is my understanding, would be approved by him. You want the man who made the decisions, I presume.

Q. The actual signatures on the orders, would that be Mr. Coster's, or someone else's?

A. The actual signatures on the orders, I think, would always be George Dietrich's, because he was Mr. Coster's handyman and did the clerical work, but Mr. Coster made the decision, told George what to do, and George did it.

Q. That is right. As far as the internal system of McKesson they would have recognized George's signatures as validating that document?

A. I should think so, absolutely." R. 1132-1133.

[870] R. 1129.

documentary evidence surrounding the sale in support of the reality of the transactions. His attitude toward the mechanics of the procedure is revealed in the following passage from his testimony:

"Q. [By Mr. GALPEER.] Let me put it this way: In referring to the documents that would have satisfied you that these shipments had been made, would you have accepted a set of this sort which didn't indicate the particular supply house or would you have insisted upon some evidence in these notices of shipment that the source or the supply from which the shipment had been made be indicated?

A. I should have accepted those documents because I would not have been concerned with those operating details. I might have gone on, as a matter of curiosity to see how they were doing it but from an auditing standpoint I have no concern with the exact mechanics down to the last particular with which they are able to do it.

The main thing with me, after all, is that it works.

Q. I was thinking perhaps you used the word auditing in that connection, but I was thinking in connection with your check of the internal control, would this have satisfied you?

A. That is the reason I used the word auditing, yes. No, I don't think that is an element of internal control." [871]

Rowbotham supported his staff's point of view as to forms by drawing a distinction between forms as forms (which would not require a meticulous study) and the method of procedure which he felt could be determined without checking the details of the forms used in carrying out that procedure.[872]

F. INTERCOMPANY ACCOUNTS

There are two aspects of the intercompany accounting which require attention. The first is the sale of foreign crude drugs by the Canadian Company to the Connecticut Division, which is definitely a working capital position question. The second, the plowing back of profits, on its face would appear to be an investment question rather than one of current position, but as will be shown later, this too is basically a matter of the allocation of working capital between the Maryland Company and the Connecticut Company (later Division) and wholesale houses.

The intercompany relations of the Canadian Company with the Connecticut Division were referred to by Wyman in his memorandum covering his work on the Canadian Company audit for 1937. In this memorandum he stated that:

"With the exception of intercompany sales amounting to $244,875, the operations of McKesson & Robbins, Limited, have been confined, as in the past, to the sale abroad of crude drugs and essential oils. These sales have been made under a sales agreement with W. W. Smith & Company, Inc., New York, a firm having its head office in Liverpool, England, and conducting an international business as traders and guaranty brokers in general merchandise." [873]

[871] R. 1148–1149.
[872] R. 1846–1849.
[873] Ex. 26.