

c. TAXES

In the discussion of inventories, the relationship of their location to the problem of Canadian, Connecticut, and United States income taxes was discussed and it was also brought out that some concern was felt by Price, Waterhouse & Co. in the early thirties as to whether the Canadian Company was liable for United States income taxes.

Ritts explained that the client had a competent tax department which calculated the taxes due to various authorities and caused proper reserves to be provided. As a part of the audit Ritts testified that schedules prepared by this tax department were examined and checked to the books and for the calculation of the tax. After this check the tax problems of the client were reviewed in a general way by the tax department of Price, Waterhouse & Co., as indicated above. The audit working papers would include a reconciliation of the taxable income and the book profit for the year and in this connection the federal tax returns would be examined as would tax receipts for other payments.¹⁰⁹⁴

In a letter to Thorn in January 1933, while on the 1932 audit, Ritts raised an interesting point on the Canadian Company's tax payments. In 1931 and 1932 the books showed a profit on Canadian exchange in the payment of the income tax due Canada on income of the Canadian Company, since the books were kept and tax returns computed and filed in United States dollars (not indicated on the returns) but payment was then made in an equal number of, as distinguished from an equivalent amount of, Canadian dollars which were then cheaper than United States dollars.¹⁰⁹⁵ Miss Walsh's testimony brought out another occasion when settlement of Canadian liabilities raised an exchange question. Rent of \$1,000 per month was paid for some time on a leased warehouse in Montreal, usually by checks drawn on Canadian banks.¹⁰⁹⁶ These and other actual transactions previously mentioned may be contrasted to the transactions with Manning & Company all foreign, from purchase of the merchandise to collection from the customer, and all purported to have been conducted in United States currency.

d. CONTINGENT LIABILITIES

As a final step in the audit of liabilities, as in the case of receivables and inventories, a certificate was obtained from the Company's officials. This covered all liabilities of the Division and paid particular attention to possible losses, contingent liabilities, and various contractual obliga-

¹⁰⁹⁴ See pages 276-280, 286-287 *supra*.

¹⁰⁹⁵ Ex. M-29.

¹⁰⁹⁶ R. 4406-4407.

tions of the Company. Coster, McGloon, George Dietrich, and Johnson signed the certificate for 1937.¹⁰⁹⁷

I. PROFIT AND LOSS ACCOUNTS

1. Sales, Cost of Sales, and Gross Profit

Much of the audit work having a bearing on the profit and loss accounts is done in connection with the balance sheet accounts so that the operating accounts as such are given relatively much less attention than the asset and liability accounts in a balance sheet examination.

¹⁰⁹⁷ Ex. 66:

"MCKESSON & ROBBINS

Incorporated

Bridgeport, Conn., U. S. A.

CONNECTICUT DIVISION

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

(Including Kobe, Japan—\$4,313.13)

DIRECT LIABILITIES:

| | |
|--|-----------------------|
| Acceptances payable | \$ 542,883.41 |
| Accounts payable | 268,465.69 |
| Wages, taxes and other accrued liabilities | 394,477.91 |
| | <u>\$1,205,827.01</u> |

CONTINGENT LIABILITIES:

| | |
|--------------------------------|------------|
| Bankers acceptances discounted | 141,358.00 |
|--------------------------------|------------|

1. All liabilities (both known or established, and contingent) and all claims of any kind against the branch as at December 31, 1937 are included in the foregoing summary.

2. No extraordinary losses or contingent liabilities have been incurred during the period from December 31, 1937, to the time of signing this memorandum.

3. There are no law suits pending against the branch.

4. There were no contractual obligations as at December 31, 1937 for the purchase or extension of plant facilities, for the purchase of any other assets not required in the ordinary course of business or for the purchase or sale of any assets at prices involving substantial losses to the branch.

5. As at December 31, 1937 there were no contingent assets of the branch by reason of which the assets were understated, the liabilities or reserves overstated and the income account and surplus account understated on the general books of account.

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."

The only profit and loss work program for the 1937 audit of the Connecticut Division was one for sales, prepared by Wyman as a handwritten copy of the previous year's program. Most of the work required by this program was designed to establish a proper sales cut-off in connection with the verification of inventories and accounts receivable. Consequently, the details involved and documents examined in this connection were discussed in connection with those topics. The program itself follows:

"WORK PROGRAM—SALES

Summarize totals of triplicate sales invoices on adding machine tape for each business day in Dec.

Trace totals for each day to sales register (and accounts receivable control).

Foot sales register to nearest \$100—and trace totals to general ledger controls for sales & accts. receivable.

Test check Dec. postings to customer's ledger.

Test-check all invoices billed in last five days of Dec. and first five days in Jan. to shipping advices to see that date of shipment corresponds with billing dates.

Obtain duplicate invoices and shipping advices for larger December shipments of crude drugs and essential oils per dates shown on accounts receivable trial balance and compare dates of shipments with dates of invoices. Trace such shipments to inventory cards to see that stock balances were reduced.

Test check larger shipments in last five days of Dec. to inventory stock cards to see that inventory balances were reduced.

Check shipments on which no stock cards are maintained to "N" book to see that shipment dates correspond with billing dates (**Cliff St. invt. cards.**)

Examine Jan. shipping records and trace orders that were registered in the Acctg Dept prior to Jan. to billing records to see that unshipped orders at Dec. 31 were not taken up." ¹⁰⁹⁸

There are other auditing tests involving the use of sales figures which are not brought out by this program, but which memoranda on the accounts, schedules in the working papers, and testimony of Ritts, Thorn, and Rowbotham indicated were made to some extent. These tests were directed primarily to establishing the general reliability of the operating accounts rather than of the related balance sheet accounts. The bulletin, "Examination of Financial Statements", for example, suggests that "Whenever the necessary statistics are available it is desirable to reconcile the quantities of the principal products sold with the production or purchases during the period, taking into consideration the inventories at the beginning and end of the period." The Bulletin also suggests that the profit and loss account should be

¹⁰⁹⁸ Ex. 46. A somewhat similar program except for the first item was prepared by Wyman for the Canadian Company:

"1. Prepare summary of sales by commodities and agree with ledger control.

"2. Trace duplicate invoices to December sales register.

"3. Foot sales register for Dec & trace to ledger control.

"4. Examine shipping advices on all Dec. shipments.

"5. Trace quantities shown on invoices & shipping advices in December to perpetual inventory cards.

"6. Examine all shipping advices for first ten days in January to see that charges have been made in proper period.

"7. Check postings for December for duplicate invoices to customer's ledger." Ex. 25.

analyzed in as much detail as is readily available and that comparable figures for prior years should be obtained as an aid in ascertaining and inquiring into unusual items during the year under review. In this work “* * * budgets adopted by the company and monthly financial statements, where available, should be obtained for comparison with the annual results.” The gross profit on sales should also be determined and marked variations from previous years investigated. The Bulletin further states that, among other things, the ledger accounts for selling, general, and administrative expenses should be examined to see that the accounts are properly classified; and suggests that a comparison of the net profit on sales with that of previous years is desirable.¹⁰⁹⁹

The memorandum on the Canadian Company's accounts for 1937 was almost an exact copy of the 2 previous years, all carrying a one-line reference to a commodity analysis of sales such as that suggested above and all stating that a profit had been made on all transactions throughout the year. A condensed summary of operating results disclosed that sales for 1937 were 10% greater than the year before but yielded a lower rate of gross profit. With the exception of intercompany sales to the Connecticut Division all the sales were of crude drugs and essential oils to customers abroad under the Smith contract.¹¹⁰⁰

While a commodity analysis was not attempted on the Connecticut Division, more detailed material for a part of the year was included in the working papers. These were sheets from a sales register for the latter part of December of the year of the audit and January and part of February for the following year used as an aid in price testing. The sheets involved applied only to sales through W. W. Smith & Company, Inc. and showed the customer's name, invoice number, commodity, quantity, selling price, amount of the invoice, unit cost price, cost of sales, and gross profit for each item. Each transaction listed on this section of the register from December 27, 1937 to February 7, 1938 resulted in a gross profit. Similar sheets were included in the inventory working papers for the prior year's audit. Ritts could not recall any sale in this department that was not made at a gross profit. However, he did not know whether records similar to that just described existed for the entire year of their engagement,¹¹⁰¹ so that this condition could have been determined as a fact.

It seems reasonable to suppose that this sort of information for the Connecticut Company could have been obtained at least for the period since 1930 for Johnson, office manager, in investigating the background of the false transactions, prepared from records regularly kept in the accounting department a table showing by months in 1931 the sales, cost of sales, and gross profit for two classes of merchandise of the

¹⁰⁹⁹ Ex. 117 (pp. 30-33, 35-36).

¹¹⁰⁰ R. 376-380, 800-804. Ex. 25, 26, 71, 72, 73. Page 255 *supra*.

¹¹⁰¹ R. 814-820, 798-800. Ex. 84, 40 (D 15, D 16, D 17). See pages 261-263 *supra*.

Special Sales Department: resale stock and finished stock. The former was fictitious foreign crude drugs and the latter included hand lotion and a product known as Dandrofuge, which also appear to have been fictitious for the sales at this time at least were recorded as "* * * made to the same customers and in the same manner as crude drugs sold by Mr. Coster."¹¹⁰² Johnson also identified the more recent sales register as a record kept continuously in his department to record only foreign sales of crude drugs in which he never saw a transaction that was not concluded at a gross profit.¹¹⁰³

Thorn's attention was directed to sales as reported in 1930. In the memorandum on the Connecticut Company for that year, a table showing foreign sales separate from other sales for each of the last 4 months of the year was presented, in which foreign sales during October, November, and December were more than one-third greater than September. The memorandum also noted that because of a change in account classification, it was difficult to tell what the foreign sales amounted to for the year. Thorn testified that while he thought the December sales were out of line and therefore had the December sales invoices totaled on an adding machine, the only purpose of this work was to make sure that the books were supported by the underlying records for that month. The thought had occurred to him that some January sales might have been included in December and, in addition, the running of the total satisfied him that the transactions as recorded were authentic, because they agreed in total with the duplicate invoices on file.¹¹⁰⁴

Thorn also explained that he usually compared sales in the aggregate, but not by commodities, month by month through the year to pick up any extraordinary changes. His papers for the next year 1931 included a notation of work to be done at Bridgeport which carried the question "Why are December sales higher?" Opposite this question was a mark which indicated that the point had been disposed of to his satisfaction. He had no recollection of anything unusual and found no other reference to the matter in the papers.¹¹⁰⁵ He had also noted that the foreign business ran in bunches but made no further inquiry as to the cause.¹¹⁰⁶

Thorn's conclusions may be judged by examining the following table which reproduces in part the table prepared by Johnson (referred to above) showing the sales, cost of sales, and gross profits by months for 1931 of the Special Sales Department, listing separately the "Finished Stock" (hand lotion and Dandrofuge) and "Resale Stock" (foreign crude drugs).¹¹⁰⁷

¹¹⁰² R. 1075. Testimony of Thorn.

¹¹⁰³ R. 1372-1376; Ex. 105.

¹¹⁰⁴ R. 911-916.

¹¹⁰⁵ R. 1118-1119, 1087-1070.

¹¹⁰⁶ R. 1061.

¹¹⁰⁷ Ex. 105.

STATEMENT OF SALES, COST OF SALES & GROSS PROFIT—SPECIAL SALES DEPT. 1931

| Month | Finished Stock | | | Resale Stock | | |
|-----------|----------------|---------------|----------------|----------------|----------------|--------------|
| | Sales | Cost of Sales | Gross Profit | Sales | Cost of Sales | Gross Profit |
| January | \$ 139,000.00 | \$ 21,625.00 | \$ 117,375.00 | \$ 53,000.50 | \$ 48,000.00 | \$ 5,000.50 |
| February | 139,000.00 | 21,625.00 | 117,375.00 | 53,000.00 | 48,000.00 | 5,000.00 |
| March | 139,000.00 | 21,625.00 | 117,375.00 | — | — | — |
| April | 139,000.00 | 21,625.00 | 117,375.00 | 28,125.00 | 24,375.00 | 3,750.00 |
| May | 139,000.00 | 21,625.00 | 117,375.00 | — | — | — |
| June | 139,000.00 | 21,625.00 | 117,375.00 | — | — | — |
| July | 139,000.00 | 21,625.00 | 117,375.00 | 29,988.00 | 29,682.00 | 306.00 |
| August | 139,000.00 | 21,625.00 | 117,375.00 | 7,546.00 | 7,469.00 | 77.00 |
| September | 69,500.00 | 10,812.50 | 58,687.50 | 54,035.60 | 52,615.80 | 1,419.80 |
| October | 139,000.00 | 21,625.00 | 117,375.00 | 49,135.60 | 47,765.80 | 1,369.80 |
| November | 41,300.00 | 5,412.50 | 35,887.50 | 966,770.40 | 872,532.67 | 94,237.73 |
| December | — | — | — | 1,253,915.92 | 1,081,009.38 | 172,906.54 |
| | \$1,361,800.00 | \$210,850.00 | \$1,150,950.00 | \$2,495,517.02 | \$2,211,449.65 | \$284,067.37 |

The situation revealed in the above table was not recognized in any way in the audit working papers except by the question quoted above concerning December sales which Thorn testified must have been answered to his satisfaction.

A somewhat similar heavy concentration of sales toward the end of accounting periods also existed in the records covering the short life of Girard & Co., Inc. A schedule of accounts receivable was prepared from Price, Waterhouse & Co.'s working papers listing accounts with balances at the date of the audits of Girard & Co., Inc., December 31, 1924; December 31, 1925; and March 31, June 30, September 30, and November 30, 1926. At the earliest date, six of 11 accounts (billing date not known) totaled \$34,415.88 (\$9,305.05 due from W. W. Smith & Co.), while the other five totaled \$276.52. Net sales for the 9 months ended December 31, 1924, totaled \$251,977.06. The next year end, six accounts all billed from December 17 to 31 (including J. P. Meyer & Co. billed December 30 for \$17,250 and W. W. Smith & Co. billed on December 21 and 23 for a total of \$22,750) totaled \$155,972.00, while 212 others totaled only \$14,145.56. Sales for 1925 were \$1,129,302.38. The four reports in 1926 show still larger balances due from a very small proportion of the accounts, which included the names of Chas. Manning Chem. Co., J. P. Meyer & Co., W. W. Smith & Co., and Geo. Vernard & Co. indicating the same concentration of billing (as compared with prior sales) in the last 15 days before the audit date.¹¹⁰⁸

Another instance of heavy concentration of sales in a short period was noted in Ritts' memorandum (dated February 18, 1933) on the Connecticut accounts for 1932. In connection with difficulties of establishing inventory prices, Ritts called attention to the fact " * * * that approximately 50% of the company's December 31, 1932, inventory of crude drug stocks had been sold prior to the date of completion of our examination at a small margin of profit."¹¹⁰⁹ The inventory corresponding to the sales referred to here was turned 1.67 times in 1932 and 2.38 times in 1933,¹¹¹⁰ whereas the indicated annual rate for 1933 based on the period to February 18 was approximately 4 times.

Returning to the 1931 memorandum on the Connecticut Company accounts, Jaureguy, on information supplied by Thorn who was in charge at Bridgeport, stated "The net sales during 1931, which include \$2,000,000 from the new spice department, amounted to \$14,007,607.94 compared to \$13,890,246.55 for 1930."¹¹¹¹ There followed a full page explanation of the spice department which, on the

¹¹⁰⁸ Ex. 170.

¹¹⁰⁹ Ex. 81. See footnote 1026 *supra*.

¹¹¹⁰ Based upon Ex. 43 which for the periods involved included figures relating to crude drug transactions other than those of the fictitious foreign crude drug business. The figures based upon the fictitious foreign crude drug business alone were 1.21 times in 1932 and 2.12 times in 1933. Ex. Q, 267.

¹¹¹¹ Ex. 82.

volume quoted above, made approximately \$10,000 on what was claimed to be a virtual corner in pepper. The memorandum set forth the following summary of gross profit on the several classes of sales:

| | | |
|--|-------------------|----------|
| "Manufactured products (the McKesson line) | \$1, 485, 530. 12 | 35. 41% |
| Resale departments—crude drugs, China wood oil, spices, etc. | 379, 761. 80 | 6. 16 |
| Export sales of crude drugs and finished stock through W. W. Smith & Co. | 1, 413, 889. 25 | 37. 20 |
| Essential oil department ¹¹¹³ | 13, 774. 58 | 5. 47 |
| | <hr/> | |
| | \$3, 292, 955. 75 | |
| Less—Cash discounts, transportation on sales and adjustments | 438, 726. 68 | |
| | <hr/> | |
| Total gross profit on sales | \$2, 854, 229. 07 | 20. 52'' |
| | <hr/> <hr/> | |

But there was no mention in connection with the export sales of crude drugs and finished stock through W. W. Smith & Company, Inc. of the cutting down of the "Finished Stock" line and the sudden expansion of the "Resale Stock" sales in November and December of 1931 as indicated on Johnson's table previously set forth.¹¹¹³ Specifically, there was no indication that in 1931, the Dandrofuge and hand lotion line (finished stock) produced 84.5% gross profit on sales; or that sales of crude drugs (resale stock) also sold through W. W. Smith & Company, Inc. surged up in November and December to replace it in dollars of gross profit although producing only 11.4% gross profit on sales. A combination of approximately one-third Dandrofuge and hand lotion sales and two-thirds crude drug sales accounted for the 37.2% rate of gross profit on combined sales for the year of \$3,857,317.02.

The memorandum for the following year 1932 also contained a summary of gross profits on the several classes of sales in which comparative figures were shown for the preceding year but without including the percentages of profit.¹¹¹⁴ Again much space was devoted to a discussion of the troubles of the spice department (in which a loss of \$250,438.93 was suffered in pepper) but no explanation was given for the drop from \$1,413,889.25 to \$996,319.27 in the gross profit in the export sales of crude drugs and finished stock through "W. W. Smith & Co."¹¹¹⁵ The sales figures were not reported in this memorandum for either year, so it was impossible to discover from a comparison of the figures or from the text of the 1932 memorandum that the change in profit was due principally to a reduction in the rate of profit resulting from the elimination of the hand lotion and Dandrofuge line.

¹¹¹² Real and not to be confused with the essential oils included with crude drugs as part of the fictitious foreign business supposedly conducted through W. W. Smith & Company, Inc.

¹¹¹³ Page 303 *supra*.

¹¹¹⁴ The real essential oil department was included with the other resale departments.

¹¹¹⁵ Ex. 81.

A reconciliation of the gross profit of \$996,319.27 from "Export sales of crude drugs and finished stock through W. W. Smith & Co." reported in the 1932 memorandum with a schedule of sales, cost of sales, and gross profits for 1932 included in Price, Waterhouse & Co.'s working papers discloses that in addition to the two items supposed to have been handled in that manner, seven other items were also included in the gross profit figure on transactions through Smith. The sales of the two fictitious items supposed to have been handled through Smith were "Special Finished Stock" (hand lotion and Dandofuge) \$438,000.00 and "Special Resale Stock" (foreign crude drugs) \$6,508,510.53. Profits of \$368,305.00 (84.1% of sales) were recorded on the former and \$576,238.78 (8.9% of sales) on the latter. The principal items incorrectly classified with the Smith transactions in the 1932 memorandum were from Hermann's domestic department, "General Crude" sales of \$1,035,266.29 and "General Camphor" sales of \$122,785.87, and from Stebe's export sales of \$229,603.43. Total net sales of the items incorrectly included were \$1,436,715.12 and gross profits incorrectly included as applicable to sales through Smith amounted to \$51,775.49. The profit reported in the memorandum therefore applied to \$8,383,225.65 of sales or at the rate of 11.9%.¹¹¹⁶

In 1933 the spice department loss was separately reported and commented upon in the memorandum for that year but the profit from all other Bridgeport operations was reported in one figure.¹¹¹⁷ The memorandum on the Connecticut Division for 1934 included, in addition to a brief analysis of the increase in net profit, a comparative summary of the Division's gross profit for 1933 and 1934, showing the results for the spice department, four classes of manufactured products, general-export and import (included real items mentioned above in connection with the 1932 memorandum as well as the fictitious foreign business), and miscellaneous (sundry small categories of sales and unallocated adjustments). The spice department was again the only one commented upon separately. Neither sales nor rates of gross profit were given for any department.¹¹¹⁸

Beginning in 1935 the division in the statement of gross profits was made between all crude drugs on the one hand and sales of manufactured products on the other. In that year Thorn in his memorandum noted the interesting fact that approximately \$15,000,000 of the former produced 10% gross profit while "only \$3,800,000" of the latter produced 35% gross profit.¹¹¹⁹ Sales of manufactured products gradually increased in proportion to crude sales but the

¹¹¹⁶ Ex. 81, N, Q.

¹¹¹⁷ Ex. 80.

¹¹¹⁸ Ex. 268.

¹¹¹⁹ Ex. 79.

relationship in rate of profit remained about the same. Sales of non-manufactured items increased until in 1937 the total was approximately \$18,000,000 in the Connecticut Division. Combining this Division and the Canadian Company, the sales increased from about \$12,000,000 in 1932 to \$21,365,000 in 1937. The increase in the Connecticut Division was attended by a fairly uniform rate of gross profit—9% in 1934, 10% in 1935, 10.18% in 1936, with a drop to 8.89% in 1937.¹¹²⁰ Ritts explained the drop in the crude sales gross profit percentage in 1937 as being due to a change in proportion of sales of crude drugs and essential oils.¹¹²¹ The rate of gross profit in the Canadian Company was 13.05% of net sales in 1928, 12.97% in 1929 and from 1932 to 1937 fluctuated from approximately 8½% to 9%.¹¹²² These figures for non-manufactured products since 1932 included in addition to the fictitious Smith business, real business amounting to approximately 10% and 15% of the total sales in the Canadian Company and Connecticut Division respectively.

The figures quoted from the memoranda were not developed by Price, Waterhouse & Co. during the audit but were taken by them from schedules similar to the one for 1932 referred to above, which were supplied to them by the Company. Such schedules in Price, Waterhouse & Co.'s papers for 1934 through 1937 show 10 to 13 classes of manufactured goods; five items under general sales, including "Special Resale Crude" (the fictitious business),¹¹²³ "General Crude," and "General Camphor" as the principal ones; and two other minor categories of sales. In 1934 and 1935 Stebe's exports were included under general sales but in 1936 and 1937 were shown separately. Gross profit and rate of gross profit were developed for each item and for the total.¹¹²⁴

Although the results of the foreign crude drug business were thus separately set forth, both Ritts and Thorn at the hearings stated that there was no record by which they could separately state the gross profits for the various years. The contradiction apparently arises from the fact that they never treated this business as being departmentalized and never checked the various detailed classifications to determine what they included.¹¹²⁵

A rather extended discussion was had with Thorn over the study the accountant should make of these departmental sales and gross profit figures. He explained that the memoranda were written for internal office use and were designed to save the time of the partner.

¹¹²⁰ Ex. 79, 78, 49.

¹¹²¹ Ex. 49.

¹¹²² Ex. 150, 162, 163, 164, 73, 72, 26.

¹¹²³ Exact correspondence of the amount of sales shown for "Special Resale Crude" for 1936 on the schedule in Price, Waterhouse & Co.'s working papers with the amount reported by S. D. Leidesdorf & Co. as fictitious sales for the same year indicates this to be the false department. Ex. 120, 255.

¹¹²⁴ R. 1072-1073; Ex. 120, 124, N.

¹¹²⁵ R. 526-533, 1072-1073, 1081-1082, 1901-1902. Cf. Ex. 43 and Q.

He agreed that a change in rate of gross profit on Smith transactions from 37.2% to approximately 10% was a very large one and due to the elimination of the Dandrofuge line but that this fact could not be discovered from the memoranda of 1931 and 1932, even if compared, for no percentages were given in the latter nor were the base figures of sales readily available. Thorn said that if the partner happened to ask for the figures, the man who prepared the memorandum could make the calculation.¹¹²⁶

On another phase of this question, Thorn explained that the only purpose of making the gross profit percentage calculation was to indicate any possible errors in the basis of valuation of the inventories and for this purpose he would approach the question from the standpoint of the Company as a whole.¹¹²⁷ Thorn explained that the only departmental analysis he would want would be to separate McKesson products from their other business. Dandrofuge, he thought, was an exception to that rule because, while it was supposed to have been made in Bridgeport, it was not a part of the McKesson line sold to the subsidiary houses but instead was sold largely in Australia to the same customers as the crude drugs and through the same agency, "W. W. Smith & Co.", and hence was more properly grouped with foreign sales, even though this did merge lines of business with widely different profit characteristics. He explained further that a change in rate of gross profit would indicate, perhaps, that inventories at the end of the year had been valued on a different basis than at the beginning, or that some stock had not been properly accounted for, but he did not think a change might suggest the possibility of fictitious transactions. The review of the profit and loss account, Thorn thought, was only incidental to determining the financial position of

¹¹²⁶ R. 1077-1078, 1086-1094, especially:

"Q. [By Mr. GALPEER.] There is nothing in the memoranda, exhibit 81, itself, on which the partner could make any calculation of gross profit for that year, is there?

A. [By THORN.] No, sir. The partner, I might say, would not make any calculations of gross profit in any case, he would ask the man that was taking the accounts up with him to do that.

Q. Let me ask you one more thing; why wasn't this change shown in the exhibit 81 in the first instance?

A. That is on the 1932 memoranda?

Q. Right.

A. I can't answer that, I don't know.

Q. Let me ask you just one more thing. What was there in the 1932 memorandum which would have focused the partner's eye to the fact that there might be some question here, or might be some reason for considering the percentage of gross profit which may have been far out of line and instead of 37 percent is 10 percent?

A. I don't think there is anything in the memorandum calling particular attention to that. It is a matter of his general review of the accounts that would cover that." R. 1092-1093.

¹¹²⁷ "Q. [By Mr. GALPEER.] Do you know, as a matter of fact, in this gross percentage figure of 37.2 how much represented Dandrofuge and how much of their resales, not based upon facts which happened subsequently?

A. No, sir, I do not, and I doubt if I can tell from our papers. We would approach that question, really, from the standpoint of the company as a whole and we always, of course, have the gross profit test there, and if there is any substantial change we require an explanation because of the fact that it may mean there is a difference in the basis of valuation of the inventories from the beginning of the year to the end of the year; that is the only value of the so-called gross profit test." R. 1076-1077.

the Company so the auditor would not be concerned with departmental operations.¹¹²⁸

However, the partial analyses of profits referred to in the foregoing discussion indicate that *over-all* gross profit percentages were inadequate to disclose important changes in the business. And the record also shows that the changes in rate of profit resulting from irregularities were not the reflection of changes in method or errors in taking the year-end inventories as Thorn suggested would be a principal reason for examining a change in rate.

Rowbotham was asked for his opinion on the foregoing subjects discussed with Ritts and Thorn. On the first point concerning the consistent realization of gross profit on foreign crude drug sales and record of every sale at a gross profit, Rowbotham was not disturbed for Coster was supposed to have been the leading crude drug expert of this country and was in a position to wait for his market.¹¹²⁹

Although, as previously stated, the memoranda on their face gave no clew to the hand lotion and Dandrofuge line with their high rate of gross profit, as compared to the crude drugs purportedly sold through W. W. Smith & Company, Inc. and although the questionnaire filled out for 1932 carried the answer "No" after "Has the company abandoned any line of manufacture, and if so, for what reason?";¹¹³⁰ Rowbotham testified that he thought that the drop in over-all gross profits was noted at the time and that it was explained by the fact that these products were abandoned.¹¹³¹

On the question of analyzing sales by departments, Rowbotham stated that the purpose of the examination was to express an opinion on the annual accounts of the Company which did not require going into departmental or operating questions. He cited the bulletin, "Examination of Financial Statements," as authority (because no ref-

¹¹²⁸ R. 1077-1082:

" * * * Could I add a little information here which I have been thinking might be pertinent in connection with these questions. As you know, we are making a balance sheet examination with only a review of the profit-and-loss accounts, that is, we don't make an examination of all their various departments as such separately. We are not particularly concerned with the gross profit that one department might have made or might not have made.

We are concerned with the financial position at a certain moment and all of these things which you have mentioned probably have been discussed when these accounts were taken up with the partner but I think we would not consider them points of any particular importance.

We are only concerned, in other words, with the profit-and-loss accounts as they have relationship to the assets and liabilities of the company.

In these particular items which we are discussing, that gross profit which the company makes on all its transactions is of interest to us because it has a bearing on the inventories of the company. That is why we do give that consideration." R. 1078.

¹¹²⁹ " * * * I don't think, in a case like this, where Coster was supposed to be the leading crude drug expert of this country, and I think that is proved by the confidence in him of his own directors who were also practical drug men, and I do not think in view of the volume of business he was doing that this last thing would have caused me any disquiet because I think he was in a position to wait for his market if he wanted to." R. 1950-1951.

¹¹³⁰ Sales of hand lotion and Dandrofuge ("Special Finished Stock") after 1932 were less than \$50,000. Ex. 267.

¹¹³¹ R. 1808-1812.

erence to the subject appeared therein) for the statement that the accountant has no “* * * control or right of criticism of the company’s operating policies.”¹¹³²

Rowbotham’s testimony on concentration of sales in short periods appeared in connection with three exhibits referred to earlier.¹¹³³ As a part of the audit program for checking the year-end sales cut-off, he stated that the auditor should see that the client “* * * does not pile up sales in the first 10 days of January and take them into December.” The important point here was to see that the cut-off was clean and the sales were not deliberately piled up. For example, if he saw a disproportionate number of sales at the year end he would wonder what was being done.¹¹³⁴ He thought that the situation disclosed in the Girard & Co., Inc., accounts must have been explained to the man in charge of the audit perhaps as the natural result of an expanding business.¹¹³⁵

Rowbotham seemed more concerned about the sale of approximately half the December 31, 1932 inventory of crude drugs prior to February 18, 1933, for he thought that the sentence in the memorandum reporting this fact meant that the client had firm contracts for future delivery for that amount but had not actually billed customers for half the year-end inventory in a month and a half. Ritts, however, stated that actual sales were meant. With this point clear Rowbotham felt that these figures did represent a substantial increase in activity from the previous year’s annual inventory turnover of 1.67 times. The 1933 rate was 2.38, the highest of the last 6 years but still much under the rate for the period in question.¹¹³⁶

2. Other Profit and Loss Accounts

Memoranda on the Connecticut Company through 1933 indicated that the profit and loss accounts were reviewed in some detail. In 1930, for example, it was reported that over \$1,000,000 of various classes of advertising expenses were charged to the Maryland Company with the approval of the operating committee and Coster.¹¹³⁷ In 1931, 1932, and 1933, an analysis of deferred charges, budgeted

¹¹³² R. 1896-1897.

¹¹³³ Ex. 43, 81, 170; pages 246 ff., 304 *supra*.

¹¹³⁴ R. 1868.

¹¹³⁵ R. 2032-2033. “* * * it would come to us as an increase in the month and not in the 15 days.” R. 2033.

¹¹³⁶ R. 1957-1960; Ex. 43. Later more accurate schedules (Ex. Q, 267) show the annual turnover of foreign crude drug inventories to have been as follows:

| Year: | Connecticut Division | Canadian Company |
|-----------|-------------------------|---------------------|
| 1932..... | 1.21 | 1.57 |
| 1933..... | 2.12 | 1.98 |
| 1934..... | 1.82 | 2.23 |
| 1935..... | 1.75 | 2.58 |
| 1936..... | 1.79 | 2.72 |
| 1937..... | 1.60 | 3.01 |

¹¹³⁷ Ex. 83.

expenses, and changes in net profit were set out.¹¹³⁸ Beginning in 1934 a sufficient analysis of expenses was made to meet the requirements of Forms 10 and 10-K filed with the Securities and Exchange Commission.¹¹³⁹ In recent years comparison of profit and loss accounts in the memoranda was ended at gross profit except in the Canadian Company where complete condensed profit and loss statements were given showing percentages of all items to sales.¹¹⁴⁰ The accounts for the Connecticut Division, as submitted to Coster without comment by the auditors, included a two-year comparative statement of profit and loss in which the percentage of major categories of expenses to sales was set out. The principal expense item in this statement "other selling, distributing, administrative and general expenses" was supported by a detailed statement of these expenses. No departmental analysis of the operations of the Connecticut Division was reflected in these statements.^{1140a}

The monthly reports prepared by the comptroller and submitted to the directors and operating heads of the Company in addition to sales and net profits for each of the wholesale houses, included a statement of profit and loss in five categories for the Connecticut Division. The categories were: general sales (which merged real domestic and fictitious foreign crude drugs in one figure), cosmetics, McKesson products (manufactured goods), Spanish-American (exports of Stebe's department), Angostura bitters, and spice department. Selling, distributing, administrative, and fixed expenses, as well as other income (interest, dividends, cash discounts, etc.) and other charges (interest, provision for doubtful notes and accounts, etc.) were reported separately for each category. Income tax was charged to the profitable ones.¹¹⁴¹ This means that Thorn was correct in his views that net results for what has been found to be the fictitious business were not determined separately from real transactions, but he was unaware, when questioned at the hearings, that net results on resale transactions were reported separately from net profits on manufactured goods.¹¹⁴²

Keeping in mind that Company schedules in Price, Waterhouse & Co.'s working papers in recent years showed sales, returns and allowances, and gross profits for what have been discovered to have been fictitious crude drug sales separately from the real business but that McGloon's profit and loss statements combined these classes of sales in the department "General Sales", a comparison of the statements with the schedules may be of interest. In 1937, for example, fictitious gross sales (shown on the Company's schedule in the working papers

¹¹³⁸ Ex. 82, 81, 80.

¹¹³⁹ R. 406-412; Ex. 27.

¹¹⁴⁰ Ex. 79, 78, 49, 73, 72, 26.

^{1140a} Ex. 261.

¹¹⁴¹ The reports, however, did not give such breakdown of assets, only of operating accounts.

¹¹⁴² R. 1897-1902, 901-904.

as "Special Resale Crude") were \$15,126,825.20 and real general crude gross sales (shown as "General Crude") were \$2,711,150.89 for the same period.¹¹⁴³ There were no returns and allowances charged to the former but \$38,327.20 to the latter. The real crude sales produced 6.45% gross profit while the fictitious gross profit reported was 10.02%. The comptroller's report for the same period, as presented to the directors, combined these classes of sales and included "General Camphor" and "Drums and Containers" to make a total for general gross sales of \$18,136,180.77.¹¹⁴⁴ Applicable to the total, the profit and loss statement shows merchandise returned \$39,318.72, cash discounts allowed \$34,228.63, transportation on sales of \$4,234.94, and cash discounts received of \$103,935.35. Among the detailed selling and distributing expenses are salesmen's salaries and commissions, salesmen's traveling expense, miscellaneous selling expense (the largest item, 0.69% of net sales, apparently included the Smith guaranty premium and fee), warehouse payroll, drayage and cartage, outside storage charges, and miscellaneous distributing expenses. In accordance with explanations given by the auditors and the terms of the W. W. Smith & Company, Inc. contract, *none* of the expenses mentioned in this paragraph, with the one exception of the guaranty premium and fee, apply to the foreign resale crude drug business conducted through Smith. Therefore, as indicated in the table below, prepared from the comptroller's report, comparison of percentages to sales of the various items in the statements was futile and misleading because of the distortion in the general sales figure caused by combining the domestic resales with the foreign resale business to which many of the expense and adjustment accounts did not apply.

¹¹⁴³ Ex. N. In addition to the two categories mentioned General Camphor sales were \$271,132.28, less returns of \$991.52.

¹¹⁴⁴ Ex. 262 reconciled with details in Ex. N.

McKESSON & ROBBINS, INCORPORATED (CONNECTICUT DIVISION),

Statement of Profit and Loss by Departments

Twelve Months Ending December 31, 1937

(Expressed in Percent to Net Sales)

| | General Sales | Cosmet- ics | Manu- factured Goods | Spanish Ameri- can | Spice Depart- ment | Total |
|--|------------------|----------------|----------------------------|--------------------------|--------------------------|-----------|
| Gross Sales (000's omit- ted) | \$18, 136 | \$343 | \$6, 357 | \$446 | \$168 | \$25, 451 |
| Percent to Net Sales | 100. 22 | 110. 92 | 103. 66 | 102. 48 | 100. 00 | 101. 23 |
| Merchandise Returned | . 22 | 10. 92 | 3. 66 | 2. 48 | — | 1. 23 |
| Sales, less Returns | 100. 00 | 100. 00 | 100. 00 | 100. 00 | 100. 00 | 100. 00 |
| Cost of Sales | 90. 63 | 87. 92 | 52. 09 | 80. 37 | 92. 78 | 81. 03 |
| Gross Profit before Discounts | 9. 37 | 12. 08 | 47. 91 | 19. 63 | 7. 22 | 18. 97 |
| Deduct: | | | | | | |
| Cash Discounts | . 19 | . 46 | 1. 33 | — | . 32 | . 47 |
| Transportation on Sales | . 02 | 1. 26 | 4. 72 | — | — | 1. 18 |
| Samples and Free Goods | — | 2. 33 | 6. 67 | — | — | 1. 66 |
| Total Discounts and Transportation | . 21 | 4. 05 | 12. 72 | — | . 32 | 3. 31 |
| Gross Profit after Discounts | 9. 16 | 8. 03 | 35. 19 | 19. 63 | 6. 90 | 15. 66 |
| Selling Expenses | . 87 | 8. 89 | 17. 20 | 5. 06 | 1. 08 | 5. 03 |
| Distributing Expenses | . 33 | . 65 | 1. 65 | 5. 97 | 1. 45 | . 76 |
| Administrative Ex- penses | . 48 | . 84 | 2. 63 | 8. 45 | 4. 47 | 1. 17 |
| Fixed Expenses | . 11 | . 05 | . 29 | 1. 58 | . 57 | . 19 |
| Total Operating Expenses | 1. 79 | 10. 43 | 21. 77 | 21. 06 | 7. 57 | 7. 15 |
| Profit from Operations | 7. 37 | (2. 40) | 13. 42 | (1. 43) | (. 67) | 8. 51 |
| Balance of Statement Selected Items Only: | | | | | | |
| Cash Discounts Re- ceived | . 58 | . 32 | . 44 | . 49 | — | . 53 |
| Provision for Doubtful Notes and Accounts | . 03 | (. 32) | . 04 | . 48 | — | . 04 |
| Net Profit after Federal Income Tax * | 6. 87 | (2. 17) | 11. 29 | (1. 25) | (. 67) | 7. 72 |

* Ex. 262. Bedsole testified that a report in this form was given to the directors beginning in 1932. Ex, 185; R. 2517-2519, 4254. McGloon testified that the foreign resale and domestic resale business were always merged in all the profit and loss statements prepared by his department and that no one ever suggested separating the two. R. 1708. See also testimony of Murray, R. 2157-2158; Weinberg, R. 2423; Michaels, R. 4265-4266.

Nevertheless Thorn did not consider it the duty of the auditors to make or suggest a proper segregation of the departments of the business.¹¹⁴⁵ Rowbotham considered it to be an auditor's duty to review the operating accounts sufficiently to uncover any abnormal variations but insisted that this did not extend to a criticism of the client's operating policies.¹¹⁴⁶

In connection with the subject of profit and loss analysis Ritts and Thorn were asked to what extent they used statements prepared by the client's accounting department. Thorn testified that while he may have seen copies of internal profit and loss accounts prepared by McGloon's department and thought some of them were included in his working papers with extracts from directors' minutes, he did

¹¹⁴⁵ "A. [By THORN.] When I say crude drugs I mean all of their resale transactions. In examining those accounts, I don't care whether the crude drugs are sold by Mr. Coster or by Mr. Hermann or by Mr. Jackson. It is all the same type of business." R. 1082.

"By Mr. GALPEER:

Q. But the two types of business, I am now looking at it as a business, are distinguishable?

A. As I say, from an accounting standpoint there is a distinction between the manufacturing business and goods which are simply resold without processing, which require a different type of verification work.

Q. Didn't you think it was your duty as an accountant to suggest, if anybody wanted to study this picture, in order to get a clearer concept of exactly what the Connecticut Division consisted of, that those two things, those two businesses which were different in nature be set up separately so that the results of each could be definitely determined?

A. No, I did not feel that was my duty as an accountant. I think from an accounting standpoint I was interested in an examination of this kind so that I could give an opinion on them, and from an operating standpoint, if that was of importance to the operating heads of the business, that they could develop that information for themselves internally, but for me, as an outside accountant, I feel that I might even have been presumptuous to have told them to divide up their business into several different baskets there.

* * * * *

* * * I believe that the monthly reports furnished to the operating heads,—that is the internal report prepared by the companies themselves, showed some breakdown of those operations. To sum up, I feel that is an internal matter with which I am not concerned.

* * * * *

I might say that the only work we have done has been on the annual year end examination so that when we talk about any monthly report or anything of that kind, it is something that we have had nothing to do with, but in these monthly reports—I don't know that I have ever seen a copy of those, but I have seen copies of reports made to the directors by Mr. Coster; I would see those in reviewing the minutes. As I recall it, there is a break down of figures there. I do not recall how extensive it is, but I think they do show, at least, the gross results of operations as between the manufacturing and the raw material transactions, but I am very hazy on that.

* * * * *

Q. And you felt here that there was no duty on you as an auditor or as an accountant, in preparing your report for the directors, to take a division like the Connecticut Division where you have two different types of operations and to work your report up so that it would disclose each type of operation separately?

A. Yes, that is true. As I say, from reading the extract of the minutes, I gained the impression that the directors were being fully informed by the internal report which they received as to operations." R. 899-903.

¹¹⁴⁶ "Q. [By Mr. GALPEER.] Coming back now, Mr. Rowbotham, to something you stated, I believe your final statement was that you were not concerned with operating results. My question is whether it is necessary as part of an auditing job, part of an examination, in order to verify the balance sheet, to observe the operating details, to determine whether there are variations from normal and if such variations appear to trace down those variations to see whether there were legitimate reasons for their existence or whether there is something illegitimate or unauthentic about them.

A. [By ROWBOTHAM.] Well, I think the auditor ought to observe variation in the sense that if he sees anything that needs explanation, he ought to ask for an explanation of it, but the point I was trying to make is what I thought your question was, was whether the accountant was concerned with controlling or criticizing the operating policies of the company as such, and I don't think he is.

Q. Well, my question was not directed to that. My question is, whether it should be part of an accountant's job to look for variations, as a test of authenticity.

A. I think you should look for those variations, yes, sir." R. 1899-1900.

not remember what they were.¹¹⁴⁷ Ritts, who was questioned on this point after the hearings had progressed for nearly 4 months and he had had more time than Thorn to review the working papers, explained that he made a practice of getting all of these reports and that he reviewed them for variations in sales during the year. As part of this review he made test checks with the sales registers. He also reviewed schedules of cost of sales and factory burden accounts with special reference to year-end adjustments of these accounts, but he could not recall for how long these reports had been available.¹¹⁴⁸

J. THE WHOLESALE HOUSES

1. Number of Houses

The head office, wholesale houses, and other divisions and subsidiaries of McKesson & Robbins, Incorporated, exclusive of the Connecticut Division and Canadian Company, varied slightly in number during the last few years but approximated 80 different units each year. These units accounted for about 70% of the total assets and about 85% of the total volume of business. The net income of these units fluctuated widely, presenting a sharp contrast to the two units we have examined in detail which were engaged in an entirely different type of business and were apparently consistently profitable during periods of prosperity and depression.

2. Control of the Audit

The entire audit since the organization of the Maryland Company was controlled by Price, Waterhouse & Co. from its New York office under Rowbotham's direction, with Jaureguy as manager for the years 1928 to 1932, inclusive, and Thorn from 1933 to the end. All of the United States offices of Price, Waterhouse & Co. were called upon to do one or more of the branch audits, while two foreign subsidiaries were handled by the English and Continental firms of Price, Waterhouse & Co. and several small houses were examined by other independent accountants.

All of this work was coordinated by means of the closing instructions issued from Bridgeport by McGlooin and "Private and Confidential * * * Instructions to Representatives of Price, Waterhouse & Co. in Charge of Examinations * * *" ¹¹⁴⁹ issued from the latter's New York office. The first of these documents it will be recalled contained detailed instructions to McKesson accountants for preparing the accounts for closing and for preparing schedules required by the auditors to expedite their work. The second document included instructions to Price, Waterhouse & Co. representatives as to the form in which work-

¹¹⁴⁷ R. 904.

¹¹⁴⁸ R. 4447-4449; Ex. 185.

¹¹⁴⁹ Ex. 15, 13; pages 165-166 *supra*.

ing papers were to be prepared and the papers to be sent to the New York office. There followed a general description of the work to be done on the various accounts, and finally a list of the divisions and subsidiary companies to be examined. Audit steps to be omitted, as specified in the letters of engagement, were mentioned.

For work done out of the New York office directly, work programs and questionnaires were prepared in mimeographed form. For work done by other Price, Waterhouse & Co. offices, responsibility for detailed work meeting the requirements of the instructions issued from the New York office rested with the Price, Waterhouse & Co. branches involved. Only noted deviations from the programs used at Bridgeport will be considered in connection with the wholesale houses.¹¹⁵⁰

3. Special Features of the Work in the Wholesale Houses

a. CASH

Two significant differences appeared on the cash program. As drawn up for general use this required the checking of “* * * the details of the last three deposits in December and first three deposits in January from the cash receipts book to the company’s duplicate deposit tickets.” It will be recalled that this was not done at Bridgeport because there were no duplicate deposit tickets.¹¹⁵¹ A second bank reconciliation at July 31st, as required by the program, was carried out for the branches but “That work was not done at Bridgeport. It was a special step inserted for the purpose of the satisfaction of the officials at Bridgeport as to the handling of cash at the branches, I understand.”¹¹⁵²

b. ACCOUNTS RECEIVABLE AND BAD DEBT RESERVES

One of the major problems, perhaps recognized as the most troublesome problem especially in the depression years, was the proper determination of bad debt reserves for receivables due from thousands of retail druggists. The adequate control of cash collections from these customers also gave the auditors some concern which, from time to time, led to the suggestion that test circularization of receivables should be made. Circularization of the accounts was not a part of the regular examination procedure.¹¹⁵³ However, the possible desirability of circularizing accounts was noted in a letter dated January 27, 1930, from Price, Waterhouse & Co.’s representative at work on a McKesson branch in New Orleans, to his office in St. Louis. The letter reported an unsatisfactory condition found in that branch which led to calling

¹¹⁵⁰ R. 354, 879.

¹¹⁵¹ Ex. 21, 29; R. 430-441.

¹¹⁵² R. 328 (testimony of Wyman); see also page 197 *supra*.

¹¹⁵³ Pages 145 ff. *supra*.

for original deposit slips at the bank and an agreement by the house to make a circularization of receivables as at January 31, 1930.¹¹⁵⁴ The general condition of the accounts in the wholesale houses led finally to the letter which is quoted earlier in this report,¹¹⁵⁵ wherein Jaureguy, with Rowbotham's approval, urged the surprise circularization of the larger notes and accounts receivable. More recently a similar situation developed in one of the liquor subsidiaries after discovery that salesmen were withholding collections from customers. The Price, Waterhouse & Co. office handling this engagement suggested to the New York office that a circularization of the accounts should be made at December 31, 1937, in connection with their audit, even though the client had done so in November but with unsatisfactory results. After consultation with McGlooin it was decided that the losses involved were not sufficient to warrant a test circularization by the auditors.¹¹⁵⁶

A number of the directors were questioned on their views as to the circularization of accounts with retail drug stores. All made the statement that conditions in the trade were such that circularization would tend to destroy confidence in the wholesale houses, as the druggists were not bookkeepers and accepted the creditor's statement as correct. They all feared that such customers would not understand a request to confirm a balance, but that in the case of manufacturers and other large customers, this argument would not hold and circularization might be desirable.¹¹⁵⁷

The question of bad debt reserves was not so easily solved and led to much discussion between the auditors and officers of the client.¹¹⁵⁸ A dispute about reserves at the time of the bank holiday in 1933, during which the auditors insisted upon very much larger reserves than had been provided, set George V. Doerr, a vice-president, director, and, at that time, chairman of the Sub-committee on Accounting, to thinking about the problem. He worked out a plan for setting up reserves which he thought might avoid the inevitable dispute that would arise if the credit manager thought an account was good but the auditors' representative thought it was not. Doerr felt that Company employees were better judges than the auditors. The results of this plan, when put in operation, ultimately led to excess reserves.¹¹⁵⁹

¹¹⁵⁴ Ex. 113.

¹¹⁵⁵ Ex. 88; footnote 544 *supra*.

¹¹⁵⁶ Ex. C 1, C 2, C 3.

¹¹⁵⁷ Bedsole, R. 2498, 2505; Doerr, R. 2579-2582; Faxon, R. 2530; Michaels, R. 4296-4297.

¹¹⁵⁸ R. 2193; Ex. 247 (p. 2); Ex. 243 (p. 1); Ex. 246 (pp. 5, 7-11).

¹¹⁵⁹ R. 2570-2571; Ex. 188-A and B, 189-A and B. The plan is described as follows in the audit report for 1935:

"Prior to 1935, the amount of the provision for bad debt losses was based on an appraisal of the notes and accounts receivable, and on the bad debt experience of the particular division or company. Beginning January 1, 1935, the policy was adopted of providing reserves against balances arising since January 1, 1934 according to the age of the balance. Under this plan, a reserve of one-half of one percent. is provided for balances arising during the current month and the percentage is increased each month until a full reserve is provided against balances one year old. The amount of the provision for balances arising prior to January 1, 1934 was determined as heretofore by an appraisal of the balances." Ex. 158 (pp. 11-12).

c. INVENTORIES

The inventory program followed at Bridgeport was also used for the branches, at least those done by the New York office, which meant that the auditors' representatives had no specific instructions to make any physical tests by inspection or counting of stock to establish the quantities on hand. In some houses the auditors seem to have gone beyond this to some extent, for directors who were heads of wholesale houses testified that they personally accompanied the auditors to the warehouse to inspect certain items of merchandise, or that their house managers had reported to them, in response to direct inquiries on the subject, that such tests had been made, at least prior to the 1937 audit. Murray, for example, said the auditors asked to see particularly large items,¹¹⁶⁰ Bedsole recalled that they checked on slow moving stock,¹¹⁶¹ Faxon¹¹⁶² and Doerr¹¹⁶³ had been informed recently that some physical inspection of inventories was a part of the auditors' procedure. On at least one occasion the examination included extensive spot checking:

"We have conferred with you a number of times recently regarding the tampering with the inventory stock sheets by employees of the company which was discovered by our representative in charge of the audit. As a result of this a second inventory was taken on January 23, 1932, after which it appeared that the inventory had been overstated to the extent of some \$7,000 in the stock sheets originally given to us. The second inventory taken, which was worked back to December 31, 1931, showed a total shrinkage of \$8,371.55 as compared with the book inventory. While we are not, of course, in a position to be held responsible for the correctness of the quantities in the second inventory, our representatives made extensive spot checks the following day and found a few discrepancies, all of which were of a minor nature."¹¹⁶⁴

d. INTERNAL CHECK AND CONTROL

The perennial problem in the wholesale houses was the difficulty encountered because of faulty bookkeeping and the inadequacy of internal control primarily due to the small staffs in the houses. Price, Waterhouse & Co., in accordance with Coster's request, reported to him each year on the condition of each house. These reports were brief letters transmitting financial statements and giving a summary of significant financial changes during the year, accounting for changes in profit, and closing with special reference to weaknesses in internal check and control. These letters were reviewed by McGlooin and copies or extracts¹¹⁶⁵ were sent to the divisional vice-presidents in charge of the houses involved for remedial action.

¹¹⁶⁰ R. 2168-2169, 2193-2195, 2204-2205.

¹¹⁶¹ R. 2514-2516.

¹¹⁶² R. 2534, 2537.

¹¹⁶³ R. 2577-2579.

¹¹⁶⁴ Ex. 242. Price, Waterhouse & Co.'s letter to F. D. Coster, February 19, 1932, re McKesson-Peter-Neat-Richardson Company.

¹¹⁶⁵ Ex. 246.

A summary of the comments in these letters for the years 1931, 1934, and 1937, gives a birdseye view of the nature and persistence of the weaknesses reported. Criticisms were most frequent in 1931, which might have been expected because of the short time since the organization of the Company. The 1934 letters were relatively free from criticism although some chronic cases seemed to persist. In 1937 there was a recurrence of rather wide criticism, especially on the score that accounting staffs were too small to permit of adequate internal control. Specific topics covered in the several years included general cash control, handling of petty cash, control of cash and c. o. d. sales, payrolls, inventories, bad debts and allowances, consignments in, charge sales, purchases, claims, and the handling of customers' and creditors' accounts. The most frequent criticisms, in addition to inadequate staff, were on the handling of cash and cash sales. The criticisms, in one year or another, were reported by every Price, Waterhouse & Co. office in this country and judging from letters available were lodged against all but seven of the 57 wholesale houses acquired prior to 1934. Of 20 units organized after 1931 (mostly liquor units) eight escaped specific criticism, while nine had inadequate accounting staffs to afford effective control (as well as other specified weaknesses in five cases—in one of these cases weaknesses reported in 1934 had not been corrected by 1937).¹¹⁶⁶

Some of these comments and criticisms are quoted below from letters covering the 1931 audit. Except for the first letter which was addressed to the New York office of Price, Waterhouse & Co. by their Chicago office, all of the remaining quotations are from letters addressed to F. D. Coster, president of McKesson & Robbins, by the New York office of Price, Waterhouse & Co.¹¹⁶⁷

Letter dated February 27, 1932, referring to:

"MCKESSON-CHURCHILL DRUG COMPANY
BURLINGTON, IOWA

"During the recent examination of the books and accounts of the above named Company for the year 1931, our representatives made a brief review of the system of internal check and the following comments set forth the principal weaknesses which came to our attention:

"(1) The Treasurer also serves in the capacity of chief accountant and Credit Manager.

"(2) The Treasurer, as Credit Manager, authorizes credits to customers and also authorizes bad debt write offs, which are not approved by any other official of the Company.

"(3) Checks are not countersigned.

"(4) Payrolls are not checked or otherwise approved and while wages are paid in cash, receipts are not obtained therefor.

¹¹⁶⁶ Ex. 253.

¹¹⁶⁷ Ex. (in order quoted) 126, 127, 240, 241, 243, 244, 245.

"(5) The procedure with respect to cash sales is unsatisfactory and it would appear that misappropriation of merchandise could only be detected by observations of officers and employees.

"(6) Vouchers in respect of disbursements from office cash fund are not marked 'paid' or otherwise cancelled so as to preclude their use in support of irregular disbursements.

"(7) Vouchers and supporting documents, such as vendors' invoices, are not always scrutinized by the officers when checks are signed.

"The foregoing observations cover the more important weaknesses noted in the system of internal check and so far as we were able to determine, no apparent improvements or changes were made during the year 1931 in the routine office procedure."

Letter dated March 22, 1932, quoting from letter from Price, Waterhouse & Co., Chicago:

"So far as we were able to determine, there has been no substantial improvement during the year 1931 in the system of internal check at any of the points visited by us and it would appear that the companies are not generally safeguarded against misappropriation of merchandise excepting as to such special stocks as liquors, narcotics, etc.

'We realize that the organization of most of the subsidiary companies does not permit the arranging of the office duties in such a manner as to provide an adequate system of internal check and it is not unlikely that in most of the smaller companies, the chief source of protection must be in obtaining suitable and sufficient amount of fidelity insurance.'

Letter dated February 20, 1932, in regard to McKesson-More & Porterfield, a division covered by the above general comment:

"With reference to the company's accounting records and the system of internal check, our representatives have offered the following comments:

(1) The cashier is in charge of all accounting records including the general ledger, which is posted by the cashier.

(2) Checks are not countersigned.

(3) Vouchers and supporting documents have not been presented to officials simultaneously with checks presented for signature.

(4) Petty cash vouchers have not been cancelled so as to preclude their use a second time.

(5) Cashier reconciles bank accounts.

(6) Cash funds are not audited by an official or a responsible employee.

(7) Cash sales are not adequately safeguarded.

(8) Checks are issued payable to currency.

(9) Treasurer at times opens the mail and an independent record of incoming remittances is not prepared.

(10) Cashier prepares payrolls and generally distributes salaries and wages. Temporary employees are paid in cash and receipts are not obtained for cash payments.

(11) Accounts receivable ledger clerks also check extensions on sales invoices.

(12) Secretary and Treasurer is also credit manager and authorizes bad debt write offs, which are not otherwise approved.

(13) Notes on hand are not regularly balanced with relative control account.

(14) Excepting in the case of liquors, narcotics and a few other items, there is no satisfactory check against misappropriation of merchandise by employees.

(15) The procedure with respect of city orders does not afford a check as to whether all such orders are properly charged on books.

The books were found to have been carefully kept and so far as the examination extended there is no reason to question the general accuracy of the accounts for the year.' ”

Letter dated February 17, 1932, re McKesson-Pacific Drug Company:

“With reference to the company's system of internal check, our Portland representatives have written us as follows:

‘In connection with our examination for the prior year, various weaknesses were found in the company's accounting methods which were fully discussed with Mr. Woodruff and Mr. Fry and our recommendations were set forth in our letter to the company under date of February 20, 1931. While certain changes have been made in the company's routine, it is found for the most part, that our suggestions have not been adopted and the condition at present is still subject to criticism. It does not appear that the local officials are willing to accept our recommendations as they feel that the present practice is satisfactory. The absence of internal check in certain respects appears to us to be sufficiently important to require the serious consideration of the officials of the parent company.’ ” (Detailed criticism omitted to avoid repetition.)

Letter dated February 20, 1932, re McKesson-Schuh Drug Company:

“‘Certain matters concerning the system of accounting and internal check are discussed in the memorandum. *Mr. Schuh does not appear disposed to adopt our suggestions.* In considering the system of internal check, it should be borne in mind that the organization is very small.’ ” [Italics supplied.] (Compare with letter in 1934 and 1937 to follow.)

Letter dated February 20, 1932 re McKesson-Springfield Drug Company:

“Our representatives have written as follows regarding the company's system of internal check:

‘We made a study of the system of internal check at this company and found it to be weak, mainly because of the numerous duties handled by one comparatively low-salaried employee, Mr. Jones, the accountant at this office. He is in charge of all books of account, is also credit manager, assistant treasurer, office manager and secretary of the corporation. Although he claims that he would discuss any bad accounts with the treasurer before charging them off, he evidently has authority to charge them off without doing so. A few small accounts were charged off during the period without being taken up with the treasurer. All mail pertaining to the accounts is opened by Mr. Jones.’ ”

Letter dated February 6, 1932, re McKesson-Whittlesey Company:

“In connection with our audit, we made it a point to look into this company's system of internal check. We consider the system of internal check inadequate to provide the necessary safeguard against malpractices, relative to the following matters:

(a) Cash in bank and on hand:

1. Checks may be signed by any one of five people, including the bookkeeper but they are not countersigned.

2. Vouchers and supporting documents are not presented to officials for inspection simultaneously with the checks presented for signature.

3. Supporting documents to vouchers are not impressed with paid stamp or other distinctive mark so as to prevent the presentation thereof for duplicate payment.

4. Bank accounts are reconciled by the same employee keeping cash records and preparing checks.

5. An independent record of incoming remittances is not prepared for comparison later with the collections recorded by the cashier.

6. No maximum figure has been established for payments out of imprest fund.

7. Receipts or other documentary evidence supporting disbursements from imprest fund are not cancelled to preclude the use thereof in support of fictitious disbursements.

8. Payrolls are not checked or approved; authorizations for increases are not kept on file.

(b) Accounts receivable:

1. No control is exercised over customers' accounts; charges are posted to accounts receivable cards and the totals of postings for the day are recorded in the general ledger.

2. No control is exercised over bad debts after they are written off.

(c) Sales:

1. Sales orders are not registered before being sent to stockroom for shipment.

2. No control is exercised over shipping orders and/or invoices to ensure proper charge to accounts."

The following are extracts from Price, Waterhouse & Co. letters compiled by McGlooin and sent to divisional vice-presidents for consideration and action following the 1934 audit.¹¹⁶⁸

"Eastern Wine & Spirits, Inc.:

* * * * *

'The internal check of the company was reviewed by us and found to be very unsatisfactory. The principal weaknesses are, briefly, as follows:

1. Inadequate inventory control.

2. Many checks are drawn to the order of "cash" and are not endorsed.

3. Cash receipts have not regularly been deposited daily intact.

4. There were no written approvals of payroll, either as to amount or rates.

5. There are no written approvals of write-offs of customers' accounts and salesmen's balances.

In general, we found an extreme laxity in many features of the accounting procedure. Disbursements in many cases were not supported by adequate evidence as to the propriety of the payment. The organization is small and no effective system of check of the work of individual employees by other employees has yet been developed.'

* * * * *

"McKesson-Berry-Martin:

* * * * *

'Regarding the system of internal check, we are pleased to report that the majority of our recommendations have been adopted by the company, and it is hoped that further improvements will be made in the near future. However, as previously explained, the organization is too small to permit of a very satisfactory system of internal control.'"

* * * * *

"McKesson-Peter-Neat:

* * * * *

'Our representatives state that the office force is too small to provide an adequate system of internal control, but they have suggested that the practice of officials signing blank checks should be discontinued.'

* * * * *

"McKesson-Fuller-Morrison:

* * * * *

'Our representatives understand that the accounts of the branch are examined from time to time by a representative of the head office, and they believe that these examinations should be fairly extensive in view of the fact that the responsibilities of the local officials are not divided sufficiently to provide the usual accounting safeguards.'

* * * * *

"McKesson-Schuh:

'Our representatives have advised us that the branch's system of internal check, which was mentioned in our letter to you of February 16, 1934, has been changed very little during the year. Our representatives have again this year written a letter to Mr. Schuh on this subject.'

The following comments are from letters addressed to F. D. Coster, president of McKesson & Robbins, by the New York office of Price, Waterhouse & Co. following completion of the 1937 examinations; ¹¹⁶⁹

Billings Division:

"Since one employee does a large part of the office work, there is no effective system of internal check."

McKesson Liquor Co. (Boston):

"Our Boston office made the following comments regarding the system of internal check:

'During November 1937 the office and warehouse of the Boston division of the company was moved from 14 Fulton Street, the location of the Boston division of McKesson & Robbins, Incorporated, to 481 Summer Street. The separation of the two organizations necessitated many changes in the system of accounting and control, and rearrangement of duties of the office personnel of this company. We feel that there now are several weaknesses in the system of internal check at the Boston division of this company, the more important of which are as follows:

(1) The cashier, who receives incoming mail remittances and makes up the daily deposit, also assists the credit manager and, in this capacity, necessarily has access to the accounts receivable ledger cards.

(2) The division accountant keeps the cash records and the general books, reconciles the bank account, vouches the invoices previously approved by the purchasing department, and draws and countersigns the checks.

(3) The checks are signed by the division manager, but we understand that the voucher jackets only, without the supporting documents, are presented to him at the time the checks are presented for signature.

(4) Individual invoices are not invariably stamped "paid" or otherwise cancelled to prevent duplicate payment, although the voucher jacket attached to one or more invoices is always so stamped.

(5) From our discussion, it appears that the company does not invariably account for sales invoices by number each day to be sure that all invoices are listed on the daily sales summary and are posted to the control and to the customers' accounts. There may be some further weakness in the fact that sales invoices are not prenumbered but are numbered consecutively by a numbering machine after the invoice has been made out.

¹¹⁶⁹ Ex. (in order quoted) 248, 249, 250, 251, 247.

'We have discussed the above weaknesses with the division accountant and have made such suggestions for strengthening the system as seemed to us to be practicable. To some extent the weaknesses are inherent in an organization of this relatively small size, because of the limited number of office employees to whom the various duties and functions may be assigned.

'For several years we have recommended a perpetual stock record for this company, which we feel could be maintained with relatively little additional expense. The principal advantages seem to us to be:

- (1) Better accounting control and protection.
- (2) Better control over purchasing.
- (3) Possible elimination of the present procedure of taking physical inventories once a month.
 - (4) Possible savings of time in
 - (a) Preparing the required monthly state tax reports.
 - (b) Pricing the inventories each month or every six months.
 - (c) Listing stocks of intercompany merchandise.

'The system of internal check of the Springfield division appears to be reasonably satisfactory.' "

Milwaukee Drug Division:

"Our Milwaukee office made the following comments with regard to weaknesses in the system of internal check:

'(A) The cashier has access to the customers' ledgers; he assists in preparing customers' statements and investigates differences reported by customers.

'(B) The general ledger bookkeeper (1) reconciles the bank accounts (including payroll accounts); (2) prepares and countersigns checks drawn on the general bank account; and (3) prepares, signs and distributes the payroll checks.

'(C) No independent record of remittances received through the mail is maintained for comparison later with recorded cash collections.

'(D) Receipts and other evidence supporting petty cash disbursements are not cancelled or impressed with a 'paid' stamp. (We were advised that this would be done in the future).

'(E) The payroll is not checked or approved before payment thereof (See (B) above).'

Rochester Division

"With reference to the system of internal check, our Buffalo office has reported the following weaknesses which came to their attention:

(1) No independent record of incoming remittances is prepared for comparison later with the collections recorded by the Cashier.

(2) Pay envelopes are distributed by Mr. Nelson who also checks payroll. Occasionally envelopes are distributed by Mr. Fairchild, Assistant to Mr. Nelson, who prepares payroll.

(3) Differences in accounts receivable reported by customers are investigated by General Cashier who also keeps cash receipts book wherein collections on accounts receivable are recorded for posting to customers' accounts."

Schuh Drug Division:

"The comments of our St. Louis office regarding the system of internal check are quoted below:

'1. Preparation of request for petty cash reimbursement, compiling and approving of supporting data, and cashing of reimbursing cheque all done by same man, who also signs cheques, reconciles bank accounts, distributes payroll, and keeps general ledger.

'2. It was observed that certain disbursements from petty cash during November and December had no supporting data attached.

'3. Receipts evidencing petty cash disbursements are not approved until reimbursed.

'4. Petty cash receipts are usually written in pencil, and the amounts appear to be frequently changed.

'5. There is no adequate check on cash sales, and no independent record is made of incoming receipts.

'6. Receipts are not deposited intact, due to sundry cheques cashed and expenditures made therefrom.

'7. Payroll is paid in cash; employees sign for pay received, but sheet does not show amount paid.

'8. Accounts receivable records are kept by the cashier.

'9. It was noted that merchandise stock is accessible to sundry persons during and after regular business hours.

'10. During December, 1937, and January, 1938, * * *, vice-president, and * * *, office manager, drew their salaries in advance. On January 14, * * * drew \$150 against his February salary.' "

These letters are an effective demonstration of the conditions under which the audit of the wholesale houses was carried out. The situation in the McKesson-Schuh Division is an outstanding example of the lack of understanding on the part of the vice-presidents in charge of the houses as to auditing methods and the necessity for observing, in so far as personnel permits, of sound methods of internal control. With the weaknesses set forth in the last quotation in mind one series of three letters and a memorandum is of special interest. The first letter dated January 24, 1938, from Price, Waterhouse & Co.'s St. Louis office to the New York office enclosed a schedule of discrepancies uncovered in an examination of petty cash vouchers. The list included an exceptionally wide range of methods of falsification in this limited sphere of action. A copy of this schedule had been given to Schuh when unsatisfactory explanations were obtained from the cashier, who complained to the auditors that they were spending an unreasonable time on a petty cash fund of \$300. The New York office passed the schedule on to McGloon by letter dated January 28, 1938. The following letter from Price, Waterhouse & Co.'s New York office to their St. Louis office on March 16, 1938, closed the matter:

"McKESSON & ROBBINS, INCORPORATED,
SCHUH DRUG DIVISION"

"You may be interested to know that, as a result of the information and recommendations in your memorandum and letter of January 24, 1938, the comptroller at Bridgeport made an investigation of the accounts of the above-named division which disclosed a defalcation of at least several hundred dollars.

"Before the investigation was completed, the office manager, * * * confessed that he had been misappropriating funds over a period of several months. We understand that most of the money was taken from the petty cash fund in the manner suggested in your letter, but we have not been furnished with full particulars." 1170