

## Section V

# CONCLUSIONS AS TO THE PRICE, WATERHOUSE & CO. AUDIT OF McKESSON & ROBBINS, INCORPORATED, AND AS TO THE ADEQUACY OF THE SAFEGUARDS INHERING IN GENERALLY ACCEPTED AUDITING PRACTICES

In section II of this report the circumstances surrounding the exposure of the Musica brothers and in section III a description of the manner by which they accomplished the manipulation of the accounts of the McKesson Companies were set forth as fully as the facts were developed. In section IV a detailed description of the manner in which Price, Waterhouse & Co. performed the audit for the McKesson Companies was presented with special emphasis on the work done on the divisions in which the manipulation of the accounts was carried out. In this section, the work of Price, Waterhouse & Co. will be evaluated in the light of available published material on auditing theory and practice and of the testimony of witnesses called by the Commission to give their expert opinions on auditing procedures.<sup>1284</sup> The purpose of this appraisal will be to reach a conclusion as to whether Price, Waterhouse & Co. in their work followed auditing procedures generally accepted at that time and, if so, whether those procedures are adequate to assure to investors the reliability of financial statements certified by independent public accountants. Where weaknesses appear to exist it will be our purpose to indicate the defects and, in a general way, the manner in which we believe they may be overcome.

In developing our conclusions we find it necessary to recognize a distinction between auditing procedures as such and the manner in which they are applied in a given case. In the pages to follow, after an introductory consideration of the material available for judging existing standards, we examine the various procedures involved and comment upon the manner of their application by Price, Waterhouse & Co. However, in arriving at our conclusions under each topic we limit ourselves to an opinion as to whether the procedures as outlined for this engagement equalled those accepted by the profession generally and whether the latter are adequate for the purpose

<sup>1284</sup> Since this section of the report generally follows the same order as section IV, specific cross references thereto will be omitted except for references to material not contained in the corresponding subsection.

intended. Although the manner in which Price, Waterhouse & Co. applied particular procedures is to some extent also discussed under each of the topics, a conclusion as to whether, within the procedures followed, there was sufficient evidence to have led properly alert and inquisitive auditors to the discovery of the fraud must be reserved for discussion to the end of this section where it seems to us the matter can be better considered in a subsection devoted exclusively to that topic.<sup>1285</sup>

## A. MATERIAL FOR JUDGING STANDARDS PREVAILING DURING THE PERIOD OF THE GIRARD-MCKESSON ENGAGEMENT

### 1. Published Materials

Authoritative published material on auditing principles and procedures is not as extensive as that on accounting principles and procedures nor as voluminous as the growth in the profession might suggest.<sup>1286</sup> This may be attributed, possibly, to a reluctance on the part of professional accountants to write in specific terms about practices they follow in the profession or, possibly, to the thorough character of the first important contribution to the literature of auditing.<sup>1287</sup> The great demand for auditing instruction in this country in the last twenty-five years, however, has brought a few textbooks into the field.

The most useful material for our purpose, however, is the series of bulletins referred to in section IV of this report,<sup>1288</sup> which culminated in the one entitled, "Examination of Financial Statements by Independent Public Accountants," a 41 page pamphlet prepared and published by the American Institute of Accountants in January 1936. A

<sup>1285</sup> Subsection N, pages 438 ff. *infra*.

<sup>1286</sup> Broadly speaking, accounting principles and procedures govern the manner in which the accounts are kept and the results presented in financial statements; e. g. whether inventories should be stated at cost, market, or cost or market whichever is lower. Auditing principles and procedures relate to the manner in which the accounting records are reviewed and the resulting financial statements are verified by persons who had no part in making the original record; e. g., an independent review of the accounts and supporting evidence to determine that the inventory has been accurately stated on whatever basis selected.

<sup>1287</sup> The first important contribution to the literature appears to have been "Auditing: A Practical Manual for Auditors" by Lawrence R. Dicksee, F. C. A., of the firm of Price & Dicksee, Formerly Lecturer on Bookkeeping at the Technical Schools of the County Borough of Cardiff, London, Gee and Co., 34 Moor-gate Street, E. C., 1892; viii and 305 pages. One thousand copies of this edition were printed, followed by the same number of the second, third, and fourth editions in 1895, 1898, and 1900; 1500 copies each of the fifth through the ninth editions in 1902, 1904, 1907, 1909, and 1912; 2500 copies of the tenth, eleventh, and twelfth editions in 1915, 1919, and 1922; and 3000 copies of the thirteenth and fourteenth editions in 1924 and 1928. In 1905 the first authorized American edition of this work, edited by Robert H. Montgomery and containing an introduction by Arthur Lowes Dickinson, a volume of 385 pages, was published in a printing of 1000 copies. Reprintings of this edition were 500 copies in May 1907, 2000 copies in January 1908, and 750 copies in April 1908. A second American edition, edited by Montgomery, appeared in a printing of 3500 copies in 1909. This was followed by five editions of Montgomery's Auditing Theory and Practice in 1912, 1915, 1921, 1927, and 1934; the fifth printing of the last edition being dated October 1933, a volume of viii and 772 pages. 84,000 copies of this book had been sold prior to December 31, 1933, and 18,000 copies of the abridged edition, Montgomery and Staub, Auditing Principles. Ritts named Robert H. Montgomery's Auditing Theory and Practice as the recognized book on auditing procedure. R. 852-854.

<sup>1288</sup> Page 141 *supra*.

partner of Price, Waterhouse & Co. participated in the preparation of this Bulletin, and members of their staff wrote interpretations of this Bulletin and its immediate predecessor. Forty-one and twenty-six page bulletins cannot be considered exhaustive treatises on the subject of auditing, yet by virtue of their sponsorship and wide acceptance among the profession and their avowed purpose of making known to bankers and business men the nature of the work done by an accountant in the performance of an examination of financial statements, they have been the most acceptable general guide to the requirements of such work. In the preceding section it was observed that the Price, Waterhouse & Co. questionnaire on internal check and control<sup>1289</sup> referred to the first of this series of Bulletins, and that Thorn and Rowbotham accepted the latest edition as a fair general statement of the procedure to be followed in an examination of financial statements.<sup>1290</sup> As will be seen in the next subsection, partners of other public accounting firms also expressed similar opinions.

## 2. Testimony of Expert Witnesses

As an addition to available published material, the importance of the conclusions to be drawn from the facts developed in this proceeding warranted calling upon a number of public accountants of broad experience in the profession to aid in developing a clear impression of what was considered generally accepted auditing procedure as practiced by representative firms. On the morning of January 4, 1939, (the day before hearings opened) representatives of the American Institute of Accountants called upon the Chairman and other representatives of the Commission and offered to cooperate with the Commission in any way possible. Further discussions were held in the office of the Regional Administrator in New York, during which it was determined that the Institute could be of assistance in arranging for the appearance of representative accountants to testify as to the authoritative character of the Bulletin referred to above, and in some detail as to the interpretation they placed upon some of its more important provisions.

In the hearings twelve accountants were asked to testify, three of these on the suggestion of the Institute. The list included eleven partners of public accounting firms and one representative of the teaching profession.

In the order of their appearance, they were:

Samuel J. Broad—Peat, Marwick, Mitchell & Co., New York.  
Charles Oliver Wellington—Scovell, Wellington & Co., New York.  
William H. Bell—Haskins & Sells, New York.  
Victor H. Stempf—Touche, Niven & Co., New York.

<sup>1289</sup> Ex. 17.

<sup>1290</sup> See pages 155-157, 358 *supra*.

Norman J. Lenhart—Lybrand, Ross Bros. & Montgomery, New York.

John K. Mathieson—Mathieson, Aitken & Co., Philadelphia.

Henry A. Horne—Webster, Horne & Blanchard, New York.

Charles B. Couchman—Barrow, Wade, Guthrie & Co., New York.

Hiram T. Scovill—professor of accountancy and head of the Department of Business Organization and Operation, University of Illinois, Urbana.

Joseph J. Klein—Klein, Hinds & Finke, New York.

George D. Bailey—Ernst & Ernst, Detroit.

Charles W. Jones—Arthur Andersen & Co., Chicago.<sup>1201</sup>

Testimony of these witnesses upon uniform questions based upon the Bulletin occupied one day for each witness during the period February 20, 1939 to March 14, 1939, a time of intense activity in the accounting profession, during which, nevertheless, the witnesses devoted considerable time to the preparation for their appearance.<sup>1202</sup>

All of the witnesses were thoroughly familiar with the bulletin, "Examination of Financial Statements by Independent Public Accountants." Broad served as chairman and Lenhart as an active member of the Committee which drafted it. Six others of the group were represented in its preparation, either in criticizing the draft, or as members of firms which were represented on the Committee by another partner. The prevailing opinion of the group was that the Bulletin was designed to provide the public, as well as the profession, with an up-to-date outline of accepted procedures followed by independent auditors in examining financial statements for credit purposes and for annual reports to stockholders and to describe the functions of auditors and the limitations inhering in their work.<sup>1203</sup>

<sup>1201</sup> The activity of the profession during the season of the year when the testimony was taken dictated that the majority of the witnesses be called from the city in which the hearings were held. The experience of the partners of public accounting firms averaged twenty-six years in public practice of which an average of approximately eighteen years was as a partner. With four exceptions, substantially all of the business life of the witnesses had been devoted to public accounting. Scovill, following five years in public accounting practice, became professor of accountancy and then head of his department in which he had served twenty-five years at the time of the hearings. A schedule showing the size of the firms represented is given at page 137 *supra*.

<sup>1202</sup> *In the Matter of McKesson & Robbins, Inc.*, Testimony of Expert Witnesses, Government Printing Office, Washington, D. C., 638 pp., price 65 cents. This testimony will be referred to repeatedly in the pages to follow. However, since that volume contains a comprehensive table of contents, page references to it will be omitted in those cases in which the basis for a general statement may be found by consulting the table of contents. In this report P. followed by a numeral refers to pages in this printed testimony. See footnote 1 *supra*.

<sup>1203</sup> As an introduction to their testimony these witnesses were asked to define the classes of accountancy services rendered by independent public accountants as a basis for the issuance of a certificate. Three witnesses stated that occasionally an examination confined only to the balance sheet would lead to a certificate. (Broad, Lenhart, Bailey, P. 3, 223, 538.) Four other witnesses stated that special examinations could lead to a certificate but rarely did. (Wellington, Stempf, Mathieson, Klein, P. 64, 121, 272, 479.) The witnesses agreed that a detailed audit could lead to a certificate, but it was pointed out that such audits for large corporations were out of the question and that such work usually was confined to special features of an examination and therefore rarely led to a certificate. *There was, therefore, a general and complete concurrence in the view that a balance sheet examination which included a review of the profit and loss account was the type of service generally resulting in the certification of financial statements. It is this type of work which is contemplated when, in this report, we use the terms financial or balance sheet examination or audit.* This type of work supplemented by additional analyses required to complete schedules included in registration statements and annual reports was considered by all of the witnesses in public practice to be the type contemplated by the rules and regulations of the Commission.

Except for variations based on the extent of internal check and control and special circumstances of each individual case, there was a general agreement among the accountants that the principles laid down in the Bulletin were of general application to all types and sizes of companies, and most witnesses stated that the Bulletin was used as a general guide in their practice. This was to be construed broadly, however, as audit programs were developed for each individual engagement and the majority considered the procedures outlined to be a minimum for most examinations. Six of the twelve witnesses stated that they generally went beyond the requirements of the Bulletin, and the other six stated that their work was generally about the same as prescribed but that limiting the work to this minimum depended upon the circumstances of each case. The consensus was that the Bulletin represented a codification of existing accepted practice and probably resulted in a re-examination of procedures followed by individual firms but that the publication of the work did not lead to any material changes in auditing procedures. With one exception, the witnesses stated that all members of their staffs were required to be familiar with the Bulletin and in some instances were supplied with copies.<sup>1294</sup>

## B. APPOINTMENT OF AUDITORS, ORGANIZATION OF STAFF, AND BEGINNING THE EXAMINATION

### 1. Appointment and Responsibility of Auditors; Determination of the Scope of the Engagement

All appointments of Price, Waterhouse & Co. as auditors for Girard & Co., Inc. and the successor McKesson Companies were made by letter from Coster or McGloon near the close of the year to be audited. Likewise, all of the long-form reports were addressed to Coster as president of the several Companies. The certificates published in the Corporations' reports to stockholders in the early years contained no salutation but from 1930 on the Maryland Company reports were addressed to the directors, and the Canadian Company reports to the shareholders as required by Canadian law.<sup>1295</sup> Of these, as noted above, only the printed reports to stockholders, as distinguished from the type-written long-form reports addressed to Coster, reached the hands of all of the directors.

The tenor of the testimony of Rowbotham, Thorn, and Ritts, as previously referred to, especially in connection with the auditors' report, leaves the distinct impression that they all regarded Coster

<sup>1294</sup> Klein stated that his firm had no precise requirement but that as a matter of fact all of his firm's staff were familiar with the Bulletin. P. 480. Scovill requires all of his instruction staff to be familiar with it and uses it himself as a basis for lectures but pointed out that it is inadequate as a textbook. However, his advanced students are urged to get it. P. 434.

<sup>1295</sup> Page 333 *supra*.

as their firm's employer. Ritts, as will be recalled, stated that the first duty of the auditors was to "\* \* \* the President or the Board of Directors, the people that hired us. \* \* \*"<sup>1296</sup> Thorn in explaining the omission of comments in submitting the accounts of the units whose books were kept at Bridgeport stated that while matters would be brought to their attention during the examination, written comment was unnecessary for the auditors "\* \* \* would be reporting to them on their own houses in that case."<sup>1297</sup> Rowbotham, although stating that he thought the report was to the Corporation through Coster, would, with the possible exception in the case of serious suspicions as to Coster himself, have first referred an individual director to Coster in all cases before disclosing information requested on any Division except his own.<sup>1298</sup>

The manner of appointing the auditors in this case was the same as that described by the expert witnesses as perhaps the typical American situation. They testified that an executive officer, ordinarily the president but sometimes the treasurer or comptroller, appoints the auditors usually with no affirmative action by the board of directors, especially in the case of renewals. In rare cases the stockholders elect, but in the usual case under the proxy system, this usually means, in practical effect, indirect appointment by the officers. In respect to the responsibility of the auditors, most of the accountant witnesses stated that they felt that their primary responsibility ran to the Corporation or to the directors as representing the stockholders. While all admitted responsibility to stockholders through some chain, only one stated a primary responsibility directly to them.

The manner in which the auditors are appointed raises an interesting question of public policy and may also directly affect the approach and responsibility which the auditors and their staffs take toward

<sup>1296</sup> Page 344 *supra*.

<sup>1297</sup> Page 330 *supra*.

<sup>1298</sup> Page 344 *supra*. While there is no evidence that the majority of other accountants would have acted differently, we cannot help but commend the procedure suggested in the following quotation from Montgomery, Robert H., *Auditing Theory and Practice*, 5th Ed., Ronald Press, New York, 1934 (hereinafter referred to as *Montgomery*, 5th Ed.), p. 743:

"As the persons responsible for the corporation's affairs, the directors are legally entitled to see any and all accounts and records of the corporation and cannot properly be refused access thereto by officers or employees. This is a very important right. Knowledge of it and action under it may enable representatives of minority interests on a board to protect the interests they represent from illegal discrimination against them by the majority. Auditors should feel free to invite any and all of the directors to have the benefit, individually, of such information as the auditor can give from his examination."

their work.<sup>1299</sup> A much discussed proposal has been that American corporations should adopt the English and Canadian practice of requiring appointment of auditors by the stockholders. The efficacy of this proposal as a panacea for all the weaknesses in the procedures most commonly followed in this country is challenged at once by some who state that in practice appointment would be controlled by those who solicit the proxies, most often the officer-directors of the company.

An alternative proposal is that in the larger corporations, appointment of the auditors by a non-officer committee of the board of directors would have the merit of placing the appointment in a group of men familiar with the corporation's affairs but at the same time removed from the daily routine of the business. Appointment by such a group should emphasize the necessity for including the entire operating organization within the scope of the auditors' examination.

A third proposal is a blend of the first two and it is claimed secures advantages attributed to each of them. This plan contemplates the election of the auditors by vote of the stockholders, with the company or management nomination to be made by a committee of the board selected from the non-officer members.

For an adequate consideration of the foregoing problem, two collateral questions must be treated at the same time. The first is the time of the appointment and the second is who, under any one of the three options, will be delegated to confer with the auditors as to the details of the engagement.

The importance of these aspects of the question is illustrated very well by the history of the Girard-McKesson engagement. It will be recalled that all of the work was done after the closing date, under constant pressure by Coster for early completion of the work and submission of the final report. The scope of the engagement was set forth in the letters exchanged between Coster or McGlooin and the auditors as related in an earlier part of this report. These letters indicated that Price, Waterhouse & Co. performed a balance sheet audit apparently without limitations being imposed by the client until 1930,

<sup>1299</sup> Cf. the position of lawyers as stated in Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VII, Management Plans without Aid of Committees, p. 13:

"In many respects the conflicts which attach to a management which promulgates a voluntary plan [of reorganization] likewise attach to the company's counsel. These plans are often involved and complex; counsel necessarily must play a large part in their preparation and in their presentation to security holders. Moreover counsel frequently must solve difficult legal problems involving the validity of the proposed corporate action. In brief the company's counsel in these voluntary situations often assumes as important a role as in reorganizations consummated in judicial proceedings. But these voluntary plans frequently place counsel in an equivocal position. To the extent that the management's duty to security holders is attenuated by the existence of conflicts of interest of the nature described above, the same will hold true of company's counsel because of the relations between them. Ostensibly they are retained by the corporation and paid by it; actually their loyalties run to the management which was responsible for the creation and continuance of their employment. Consciously or otherwise their point of view is likely to be identical with the management's. And where the management's interests clash with those of security holders, the company's counsel often will be found supporting and furthering the management's objectives."

when Coster instructed Jaureguy not to carry out the auditors' proposal that a few days' original bank deposit slips be checked to the cash receipts book.<sup>1300</sup> In subsequent years this limitation was retained and an understanding that receivables, and later accounts payable, would not be circularized, was incorporated in letters acknowledging the engagement. The testimony of the directors is that with rare exceptions, members of the board had no part in arranging for the audit and did not know the content either of the letters of engagement or of the long-form report addressed to Coster, in which the character of the work was set forth. The principal contact the directors had with the audit was by observation in their own wholesale houses which led them to infer that the work at Bridgeport was of the same nature.

Returning to the main question of the method of appointing auditors, a study of the various proposals which have been communicated to the Commission and of the testimony of the expert witnesses who were asked their opinion on the various aspects of the question leads to the conclusion that the general adoption of changes in respect to the appointment of auditors would have a salutary effect upon auditing practice in the United States. The following program appears to us to have some advantages over others:<sup>1301</sup>

1. Election of the auditors for the current year by a vote of the stockholders at the annual meeting followed immediately by notice to the auditors of their appointment.

2. Establishment of a committee to be selected from non-officer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement.

3. The certificate (sometimes called short-form report or opinion) should be addressed to the stockholders. All other reports should be addressed to the board of directors and copies delivered by the auditors to each member of the board.

4. The auditors should be required to attend meetings of the stockholders at which their report is presented to answer questions thereon, to state whether or not they have been given all the information and access to all the books and records which they have required, and to have the right to make any statement or explanation they desire with respect to the accounts.

5. If for any reason the auditors do not complete the engagement and render a report thereon, they shall nevertheless render a report

<sup>1300</sup> See pages 196-197 and footnote 682 *supra*.

<sup>1301</sup> Cf. recommendations of the American Institute of Accountants and of the New York Stock Exchange, Appendix A; and provisions of the English Companies Act, 1929 and Horace B. Samuel's proposed amendments to that Act, Appendix B. See also Samuel's discussion in *Shareholders' Money*, Sir Isaac Pitman & Sons, Ltd., London, 1933, at pp. 231-235, 315-321. For a recent adoption in the United States of the essential features of a program substantially in accord with that proposed in the text, see Section 32 (a) of the Investment Company Act of 1940.



on the amount of work they have done and the reasons for non-completion, which report should be sent by the company to all stockholders.

Election by the stockholders should carry with it unquestioned direct responsibility of the auditors to them. In the event of a disagreement over procedures, the knowledge that the cause of a breach in relations would have to be reported to the stockholders should strengthen the position of the auditor. Respecting determination of the scope of the audit Montgomery states:

“The auditor should insist that he be permitted to make such an examination of the books and records of the undertaking as will enable him to fulfill the purpose for which the audit is to be made. He must make it clear that the object cannot be attained unless he alone defines the extent of the work to be done. Only harm can result from any departure from this rule.”<sup>1302</sup>

The quotation above raises a distinction which was emphasized by several of the witnesses, namely that the client may specify the class of work desired or in the words of the quotation, the “object” desired to be attained but the auditor must reserve to himself the decision as to the scope or extent of the work to be done. Whether the purpose of the engagement is to be more comprehensive than merely securing certified financial statements is usually determined by discussion between a partner of the accounting firm and an officer of the client (to be determined by the committee on auditing in the above program), but in any case determination of the scope of the examination necessary to achieve the purpose or object of the engagement must be reserved to a partner or supervisor of the accounting firm.<sup>1303</sup>

Election of the auditors at the annual meeting early in the year to be audited is desirable as an aid to efficient work for such election should carry with it the opportunity for the auditors to do part of their work during the year. This will not only alleviate the burden at the year end, but will also permit a more deliberate review and check of the accounting procedures of the company.

Copies of all reports rendered by the auditors should be sent to all of the directors to insure that their contents are not confined to certain officers or to a minority of the board as was the case with McKesson & Robbins. The short report or certificate under the program should be addressed to the stockholders. With the auditors also available for questioning when the report is presented at stockholders' meetings, a greater feeling of direct responsibility to others than the officers of the company should be engendered and since the certificate not only usually forms a part of the corporation's annual

<sup>1302</sup> Montgomery, 5th Ed., p. 33.

<sup>1303</sup> The materiality of the limitations in the McKesson case will be discussed in connection with the various topics which they concern.

report to stockholders but also is included in the annual report filed with this Commission under the Securities Exchange Act of 1934, this inclusion must recognize also the auditors' responsibility to all classes of investors whom the Act seeks to protect.

In short, while the appointment of Price, Waterhouse & Co. and the determination of the scope of the engagement in this case was made in the manner followed by generally accepted practice, we do not feel that it affords sufficient safeguards to investors. While, as we have previously said,<sup>1304</sup> the primary responsibility for the accuracy of information filed with us and disseminated among investors rests upon management, it is the duty of auditors to check the purported results of operation of that management and to report thereon to investors. Therefore we think that the appointment and absolute control of the selection of auditors by management or by any program short of that suggested above would not sufficiently mark the lines of responsibility to investors or give the auditors sufficient freedom of action to insure to them that independence which we deem necessary for the purpose of certifying financial statements to be filed with us and to be rendered to stockholders.

## 2. Organization and Training of Staff

An important problem which this case presents is whether the composition of the Price, Waterhouse & Co. staff was materially different from that of contemporary public accounting organizations and whether the character and training of the staff and its supervision were contributing factors in the failure of the auditing procedures to reveal the fraud perpetrated over a period of fourteen years in a business subject to the auditors' scrutiny at least annually during that time.

The subject is necessarily intangible and because of the human factors involved does not lend itself to absolute appraisal, but some analysis must be attempted as a background for estimating the adequacy of the audit as a whole. Staff organization in an accountant's office varies with the size of the office, but all follow substantially the same pattern. Almost all public accounting firms are partnerships of varying size. Excluding stenographic and other office employees, the professional staff in a large organization consists of managers of offices, supervising or managing accountants, senior accountants, semi-senior accountants, and junior accountants. The smaller firms do not have managers or supervisors as the partners fulfill those functions, and some of the firms do not use the classification of semi-senior.

The size of staff employed by firms represented by partners who testified in the hearings was presented in section IV of this report.

<sup>1304</sup> *In the Matter of Interstate Hosiery Mills, Inc.*, 4 S. E. C. 706 (1939).

An indication of the seasonal nature of public accounting work and the responsibilities devolving upon partners of the firms is given below:

Firm <sup>a</sup>	Number of Staff Per Partner <sup>b</sup>		Peak Season Increase — Per Cent of Permanent	
	Number of Partners	Permanent		
Price, Waterhouse & Co.	24	31.3	61.0	95
Peat, Marwick, Mitchell & Co.	25	(c)	(c)	(c)
Scovell, Wellington & Co.	11	11.4	15.9	39
Touche, Niven & Co.	17	8.8	13.5	54
Haskins & Sells	57	12.6	19.7	56
Lybrand, Ross Bros. & Montgomery	32	18.4	25.5	39
Mathieson, Aitken & Co.	4	10.0	10.0	0
Webster, Horne & Blanchard	4	6.3	6.3	0
Barrow, Wade, Guthrie & Co.	17	15.3	20.6	35
Klein, Hinds & Finke	6	8.3	16.7	100
Ernst & Ernst	27	24.1	35.2	46
Arthur Andersen & Co.	15	(c)	(c)	54

<sup>a</sup> Arranged in the order of the partner's appearance in the hearings.

<sup>b</sup> Partner load is calculated from data shown in the table at page 137 *supra*.

<sup>c</sup> Information sufficiently accurate for this purpose not supplied.

The table shows clearly that Price, Waterhouse & Co., with the exception of one much smaller firm, expanded its staff in the peak season to a much greater extent than the other firms represented and that this expansion was added to a staff which in the slack season was much larger in relation to the number of partners than was the case for any of the other firms listed. It seems inevitable that the burden on the partners, managers, and permanent staff seniors must have been greater with an increase of ninety-five per cent in the staff during the peak season (over sixty per cent of these serving for the first time) than with the increase of fifty-six per cent or less shown for the other large firms.<sup>1305</sup> And although it is claimed by Price, Waterhouse & Co. that their managers, by virtue of their long service and of their contracts giving them a share in the profits

<sup>1305</sup> Thornton, F. W., *Duties of the Senior Accountant*, Published for The American Institute of Accountants by the American Institute Publishing Co., Inc., New York, 1932, (hereinafter referred to as *Duties of the Senior Accountant*), pp. 88-89:

"In all the better accounting organizations even reasonably good seniors are kept employed through good business and bad; it is the juniors and mediocre seniors that are employed only during the busy season. For this reason the senior is more distinctly a part of the firm organization and has the stronger obligation to support his firm's standards of work. Seniors are the hardest worked of all the men in any accounting organization. The junior does his day's work, under direction, somewhat mechanically, perhaps, and forgets it when the whistle blows. The manager and partner have worries enough, but they do not have a great amount of actual clerical calculation to do. The senior must do quite as much actual computing as any of his juniors and must also bear some of the same kind of worry that besets the manager. The responsibility is good for him if he is ever to become a managing accountant or partner."

of the firm, are exceptionally qualified to take over the important responsibilities that are delegated to them by the partners, nevertheless the conclusion seems inescapable that, based upon figures supplied to the Commission in this investigation, Price, Waterhouse & Co. partners could not have given adequate attention to the training, development, and supervision of their staff.

In the assignments of the staff, Price, Waterhouse & Co.'s practice as revealed in this case was supported uniformly by all of the expert witnesses. Partners and top staff men are usually permanently assigned to a client, seniors below those in charge are shifted to some extent, while juniors are generally rotated. This practice has both advantages and disadvantages. Permanent assignment of top men is frequently, if not generally, requested by the client and tends to keep down the cost of the engagement and increase its efficiency because of the familiarity with the client's problems gained through consecutive years on the work. Danger from staleness and intimacy is present in this arrangement but is avoided, to some extent at least, by the rotation of seniors and juniors who provide a new point of view. Rotation in these lower classes is provided by normal progress in the ranks and by a desire on the part of the firms to provide a broad experience for permanent staff members. Assignments in all cases are made on the basis of availability and adaptability for the work in hand.

It will be recalled that prior to Rowbotham's assignment in 1928 as partner in charge, the Girard-McKesson engagement was a relatively small one and the men employed on the work were mostly from the permanent staff. With the corporate expansion of the client, the group assigned to the work at Bridgeport included a high percentage of new and temporary employees, higher in fact than the average for the firm as a whole, for of the thirty-seven different staff men who were engaged on the audits at Bridgeport for 1928 to 1937 inclusive, twenty-eight were temporary juniors and three others who later became permanent members of the staff served there in the first year of their employment. Moreover, during this period from 1928 through 1937, seventeen juniors were assigned to Bridgeport in the first or only year of their employment with Price, Waterhouse & Co. and except for the New York manager in charge of the entire engagement, in only two years (1928 and 1937) did the staff assigned to the Bridgeport work include any one who had received a certified public accountant's certificate or was a chartered accountant.

Judging from the testimony of the partners of other firms, partiality for apprenticeship training, as expressed by Rowbotham, has now been abandoned by those firms, for the majority of them in the present selection of juniors for the permanent staff seemed to favor

college graduates who had concentrated in accounting and had had some business experience. This does not mean that actual auditing experience is not also necessary before a staffman is ready to assume important responsibilities or that in the past capable auditors have not been developed through such training, but it does mean that in accord with the trend in other professions broader academic training as a present and future prerequisite to ultimate professional standing is now recognized. However, in the selection of men for the temporary staff, who are employed sometimes for a few days and seldom for more than a few months during the peak season, all agreed that the emphasis was on prior public accounting experience so that time would not be lost in training. We cannot state too strongly that such short periods of employment are inherently unfair not only to the men but also, in view of the nature of the professional services that might reasonably be expected under such conditions of employment, to the firms themselves in their efforts to maintain high standards of professional responsibility.

The general practice of all the firms, including Price, Waterhouse & Co., seems to be to require the permanent staff to study for and obtain the certified public accountant certificate to qualify for advancement to the higher ranks. In addition to actual work on engagements, various methods of training are followed, such as staff meetings and prescribed reading. The trend seems to be to urge attendance at night schools, if available, since the instruction to be obtained in that way was considered by the witnesses to be more effective than office classes. In line with this policy the status of staff senior is attained in most cases through promotion within the firm.

The rapid rise of Thorn and Ritts under the sponsorship of Rowbotham requires consideration. Rowbotham, the partner in charge of the McKesson work since 1928, was apprentice trained. Of his principal assistants, Jaureguy was college trained. Thorn and Ritts had never taken any college courses in accountancy,<sup>1306</sup> but were trained in the apprenticeship fashion, the former by Jaureguy and the latter, for the period on the McKesson job, by Thorn. Thorn had never been on an audit before he joined Jaureguy at Bridgeport in January 1928. A substantial part of that year and much of the next he worked on the mechanics of the merger, and early in 1930 became senior in charge of the work at Bridgeport. This record seems to indicate relatively little experience or training in the basic principles of auditing. Ritts in turn had had two years of junior experience before coming under Thorn's tutelage early in 1931 and became senior

<sup>1306</sup> It is interesting to note that Hartzell and McGloon who carried out most of the work for Girard & Co., Inc. had much less business experience and very little more formal education than Ritts prior to their employment by Price, Waterhouse & Co.

in charge at Bridgeport early in 1933 about the time Thorn was appointed manager of the entire engagement. In this connection it is interesting to recall that Ritts passed his C. P. A. examination in 1936, nearly four years after attaining the status of senior in charge at Bridgeport and Thorn passed the examination in 1931, two years after attaining a senior rating. Neither of these men could be called well-seasoned auditors with a broad training at the time they were placed in charge of the examination of the home office divisions of McKesson which were under the direct supervision of Coster, a man recognized as having a powerful personality.

These then were the men upon whom Rowbotham relied during a major part of the life of the McKesson work. Rowbotham's control of the work was exercised through formal approval of the audit program, consultation with the manager in charge at New York, and review of the accounts and reports. On the whole McKesson engagement for 1937, comprising approximately 84 separate units, total partners' time in all offices was 86 hours against 21,534 hours spent by the staff.<sup>1306a</sup> While there was no consistent testimony that other accountants would necessarily have done more, this procedure would certainly appear to be a minimum of partner participation in conducting the audit.

An appraisal of the character of the work done on the various phases of the job by the several juniors engaged on the 1937 audit will be the subject of subsequent comment. It seems desirable here to make only a few general comments on the training and supervision of the juniors while on the job. The record indicates that guidance of the juniors on the work was of two types—reference to the papers used on the prior year's engagement, which were followed meticulously, and instruction from the senior in charge. It appears that Ritts' emphasis throughout was on dispatch in completing the mechanical work rather than in making sure that his staff had a proper understanding of the work they did. This impression is gained, for example, from one junior's inability to explain the purpose of certain steps he performed in his cash work; another's acceptance of and work on the foreign crude drug sales register believing it covered all crude drugs and his refusal to comment upon phases of inventory work not done by him; a third's insistence upon short answers to questions on the questionnaires and his apparent lack of interest in his surroundings; a fourth junior's mechanical approach to the inventory work; Wyman's unquestioning following of the prior year's papers on the Canadian Company work; and Ritts' failure to insist that correct explanations be obtained for accounting procedures.<sup>1307</sup> Ritts' own difficulty in

<sup>1306a</sup> Time spent by the staff was as follows: managers 1,769 hours, seniors 3,714 hours, and assistants 16,051 hours. See page 355 *supra*.

<sup>1307</sup> See pages 199-200; 260-261, 262-263; 178, 267; 267; 217, 218, 222; 178-179, 231-232 *supra*.

identifying documents and in explaining the client's methods seem to indicate that his supervision of his staff was not sufficiently detailed to keep these matters fresh in his own mind. If he had followed Thornton's advice more closely his testimony in this proceeding should have been clearer.<sup>1308</sup> Not all of the accountant witnesses would go as far as Thornton suggests though some indicated as much.<sup>1309</sup>

The entire Price, Waterhouse & Co. staff on the Bridgeport unit of the engagement from Rowbotham down indicated a surprising lack of interest in the nature of the documents used in carrying on what they understood to be the leading crude drug business in this country. They also failed to make any independent inquiry as to the nature of the products and the characteristics of the crude drug trade. It is not surprising that the juniors on the work did no more than they were told when their superiors had so little interest in learning what they could about the crude drug business over a period of fourteen years. Rowbotham testified that he had no other experience in that field. Ritts and Thorn likewise had no other experience in the field but accepted Coster as the leading crude drug expert in the country. After the exposure of the fraud an encyclopedia was consulted for enlightenment as to the nature of the products which were supposed to have been bought and sold in such quantities. It apparently never occurred to anyone while on this engagement to study any public sources of information about the drug business in general or the crude drug trade in particular.<sup>1310</sup>

<sup>1308</sup> Duties of the Senior Accountant, pp. 15-17:

"A senior should work with his staff on the detailed vouching until the character of the vouchers is established, after which the assistants may be instructed which they are to accept and which are to be questioned.

"Only by taking some part in the detail work of each section can the senior be reasonably sure that the assistants, however conscientious they be, are doing their work as it should be done.

"Systematically inadequate vouchers and questionable entries will have a far better chance of passing without notice if they are scrutinized only by relatively inexperienced assistants.

"Upon the whole, the senior will find the trouble of doing some of the routine work highly recompensed by the lively understanding of the accounts that it gives.

"After the assistants have been fairly started on their work, attention may be given to the work to be done personally by the senior. This is to be interrupted at intervals so that the senior may inspect the work being done by his subordinates."

<sup>1309</sup> Another evidence of weakness of supervision and training of the staff is found in the condition of some of the working papers. Although Ritts, himself, seems to have been careful to write legibly and to date and initial all papers he prepared, he does not seem to have required this of his juniors for there are numerous papers in the record which are illegible or with no evidence on them to indicate the year of the audit or who prepared them. Perfection in these matters is not just an end in itself, for Cipriani includes these points in a list of six " \* \* \* important, though apparently trivial points to which the junior accountant should pay particular attention in preparing working papers." Cipriani, Alfred B., *Duties of the Junior Accountant*, American Institute Publishing Co., Inc., New York, 1933 (hereinafter referred to as Cipriani) pp. 34-35. See also Montgomery, 5th Ed., p. 47; Jackson, J. Hugh, *Audit Working Papers*, American Institute of Accountants Foundation, New York, 1923, (hereinafter referred to as Jackson) pp. 11, 19 and model set of working papers in the appendix; Palmer, Leslie E., and Bell, William H., *Accountants' Working Papers*, Rev. Ed., The Ronald Press Company, New York, 1929, pp. 7-8; and Wildman, John R., *Principles of Auditing*, The William G. Hewitt Press, Brooklyn, 1920, pp. 54-55.

<sup>1310</sup> In the wholesale houses, to some extent at least, each of the 60 odd houses acted as a source of information for and comparative check on the other. But the crude drug business, particularly the foreign which was considered by the auditors as a specialty business operated by a specialist in that field (Coster), was in the absence of any independent knowledge, a blind spot.

Without exception, all of the expert witnesses testified generally that they expected their staffs to become familiar with the trade or industry of the client before going on the job or at least before finishing it the first time. Many of the witnesses merely answered "Yes" or "We do" without further explanation.<sup>1311</sup> While the evidence before us is not conclusive that most other accountants would have done more, it does not seem unreasonable to us to expect an accountant to have sufficient interest in his client's business to learn enough independently about that trade or industry to give him a background for his work and a basis for appraising the operations of his client.<sup>1312</sup> Failure to do this in this case was an omission of the first magnitude. On the first point made in the preceding paragraph, all of the experts expected the seniors on their staffs to instruct juniors in the determination of the authenticity of documentary evidence of transactions, and all were quite positive in their assertion that staff members were expected to be alert to detect significant irregularities. The answers indicated full support of the old idea that an audit should reveal evidence of fraud if reflected by significant irregularities in the documents under review.<sup>1313</sup>

In general the witnesses stated paradoxically that while fraud accomplished by means of widespread collusion would not necessarily be uncovered by methods followed in a balance sheet audit, such methods should ordinarily lead to a reliable conclusion as to the general accuracy and integrity of the records.<sup>1314</sup> We can only interpret this as meaning that the discovery of fraud is a matter of alertness and not of simple mathematical precision and that, therefore, an inadequately trained staff unaware of the purpose of steps pursued by them and not fully supervised, especially when accentuated by a large number

<sup>1311</sup> But see Scovill's answer at P. 442 for an excellent statement of the means by which such information may be acquired.

<sup>1312</sup> Cf. P. 488. See also Montgomery, 5th Ed., p. 184 at which it is stated in respect to inventories:

"A general familiarity with the normal stock which any well-conducted concern in the same business should carry is desirable."

<sup>1313</sup> Even though the examination of samples of the records arouses no suspicion it is not necessarily to be assumed that the remaining records are also free from irregularities, which might be contrary to the fact. To this extent a detailed audit brings more transactions under review than a balance sheet examination based on tests and samples. However, where, as in the instant case, a detailed audit would have merely brought under review more of the same kind of records as were examined in the course of the balance sheet examination, it does not appear that the broader scope of the detailed audit would thus have necessarily assisted in the disclosure of the fraud.

<sup>1314</sup> Cf. testimony of Victor H. Stempf:

"I think the public interest requires a continuance of a type of examination which provides reasonable protection under normal circumstances as has been demonstrated adequately in the past. This precludes detailed examinations and advocates the use of sampling and testing.

"On the other hand, it follows that the auditor's work does not follow the continuous path of recorded transactions, but on the contrary the auditor's course crosses and recrosses the path of recorded transactions. If the path be irregular, suspicion may be aroused. If the path be muddy, the inferences to be drawn become rather obvious, but if the path be scientifically built and particularly if its irregularities be screened with shrubbery and flowers, it is still likely that some of the irregularities will be found by the auditor who crosses and recrosses the path. But it is also probable that in so doing he may overlook or fail to encounter some of these irregularities which may in fact be the most vital." P. 168.



of temporary employees in the busy season, seems a dangerous basis for a conclusion that the records are reliable.<sup>1315</sup> In short, we feel that the increasing complexities of modern business require the highest type of trained personnel combined with adequate supervision if the auditors' signatures to the accounts are not to be misleading.

### 3. Investigation of New Clients

Public accountants are in an unusual position as compared with other professional and business men when it comes to the question of determining the precise nature of the business, financial standing, and reputation of the firm with which they are dealing. This unique position, however, arises only after the accountant has entered upon the first engagement and has had an opportunity to inspect the books of the client. The question is raised, therefore, as to whether it is good professional practice for public accountants to make an outside investigation of the reputation or credit rating of prospective clients, either before accepting an engagement or during the course of the first audit.

Price, Waterhouse & Co. accepted the Girard & Co., Inc. engagement without making any inquiry as to the nature of the business or the character of the men engaged in it. Coster was an acquaintance of a friend of a member of the Price, Waterhouse & Co. staff. Whether mere acquaintanceship constitutes a relationship such as to bring Coster into the category of a recommended client seems doubtful, although it may fairly be assumed that a friend of the firm would not knowingly send to them, as a prospect, a man with a record for manipulation of accounts and fraud of other descriptions.

Four of the eleven practicing accountant witnesses stated that new clients came to them through sources upon which they could rely so that no further investigation of the new client would be made. Seven of the eleven reported that if a prospective client came to them unrecommended, appropriate inquiries would be made before accepting the engagement. These inquiries were in some cases made of banks and in rare cases credit reports were obtained from investigating agencies. One witness stated, however, that it was a routine requirement of his organization to obtain credit ratings on all new clients.<sup>1316</sup> No advice to this effect in a treatise on auditing has come to our attention.

<sup>1315</sup> Kohler, Eric L., and Pettengill, Paul W., *Principles of Auditing*, McGraw-Hill Book Company, Inc., New York, 1932, (hereinafter referred to as Kohler and Pettengill) p. 39:

"... a mere inspection of accounts by an intelligent and seasoned auditor may be of much greater significance than the most detailed examination by a person less competent."

See also Bacas, P. E., Madden, J. T., and Rosenkampf, A. H., *Auditing Procedure*, Ronald Press, New York, 1937, (hereinafter referred to as Bacas, Madden, and Rosenkampf) pp. 180-181:

"There is really no special procedure which should be followed to bring fraud to light where there is no surface indication that something is not in order. It is necessary that the public accountant should do his work thoroughly so that nothing may escape him. Naturally, any peculiarities must be investigated, and, if suspicions are aroused, they should be the cause of a more concentrated effort. Fraud will usually be brought to light by capable public accountants if their work is done in an efficient manner."

<sup>1316</sup> Bailey, P. 640.

From the record, therefore, it appears that on the basis of general practice Price, Waterhouse & Co. were justified in accepting the engagement under the conditions recited and in not supplementing their own investigation of records by independent inquiry as to the reputation and past associations of the management of the business unless the fact that the firm of Girard & Co., Inc., described by its letterhead as "manufacturing chemists",<sup>1317</sup> was a newcomer during prohibition and a large user of alcohol for the preparation of hair tonics might be considered as taking the case out of the general rule. While there is no indication that an investigation by an independent agency would have, in this case, disclosed the fraud we feel that for the future the small expense involved in making some check of the reputation of the management of the client would be well warranted for even if such reports on their face do not disclose clear irregularities they may condition the approach to certain phases of the work or the acceptance of explanations given by officers of the client.

### C. REVIEW OF THE CLIENT'S SYSTEM OF INTERNAL CHECK AND CONTROL

On a balance sheet audit, the examination of the client's system of internal check and control has a twofold purpose. A correct appraisal of the client's system is needed not only to ascertain the proportion of transactions necessary to be examined but also the type of tests necessary to be made in order to determine the reliability of the records specifically examined and by inference (though not conclusive) of those not specifically examined. In other words, to reach his conclusion as to the reliability of the figures contained on the financial statements, the auditor will examine certain records and will make various tests not only based on the company's records but independent of them. The proportion of the records to be examined and the type of the tests to be made will depend upon how much confidence as to reliability of the records can, in the first instance, be placed in the company's own system—whether because of internal check and control arising automatically from division of functions of personnel or from physical and mechanical checks, or as the result of internal audits.

The review of internal control is then a most important step on balance sheet audits or examinations.<sup>1318</sup> In our opinion that review would also be pertinent even though a detailed audit of all transactions were made. To assume that on a detailed audit an appraisal

<sup>1317</sup> Ex. 116.

<sup>1318</sup> " \* \* \* the ordinary procedure of a balance sheet audit is adequate only when the auditor can satisfy himself of the sufficiency of the system of internal check—which in combination with a balance sheet audit and reasonable tests will afford substantial protection to the client against the risk of defalcations." Jackson, p. 8.

of internal control is superfluous is to assume that the auditor's concern with internal control is solely an attempt to assure himself that transactions not specifically reviewed are as reliable as those examined. Just as important however is a full knowledge of the company's system of internal control in order to appraise properly records specifically examined and to determine the procedures which should be followed to assure the reliability of those records. This latter point involving the relationship between the examination of internal control and the type of tests to be made as distinguished from the mere number of transactions to be examined has, it seems to us, not been properly emphasized in the past. Thornton's discussion of the subject is illustrative:

"There arises the question, important to the auditor, as to how far internal check can be used as an auxiliary to the auditor's own examination. It will not do to accept internal check as a substitute for audit; a certificate must not be based upon figures verified only by the client's internal check or even by the client's auditing staff, if there be one; but the amount of detailed checking may well be reduced where the internal checking system is good and the observation of the senior leads to the firm belief that the check is properly carried out. For example, if the customer's ledger be kept by a clerk who does not handle money, if monthly statements are compared with the trial balance and mailed by another clerk who also does not handle money, if the control account is in order, less detailed checking of the customers' ledger will be needed than would be proper if the ledger clerk handled collections and mailed the statements himself."<sup>1319</sup>

Finally it seems to us that an examination of the system of internal check is not to be limited to particular accounting functions but should lead to a full knowledge of the manner in which, persons by whom, and place where the transactions are handled. In this subsection we will consider first the method of examination of the system of internal check and control and then the appraisal of the system.

## 1. Examination of the System

### a. INSPECTION OF THE PLANT

In the work at Bridgeport it has been noted that Thorn in his first year as a senior in charge thought a knowledge of the manufacturing operations would be helpful to him in his work on the audit and that he did go through the plant. However, he did not take any of his staff through the plant. And Ritts neither inspected the plant himself nor took any of his staff through it. Contact was limited to that gained incidentally in going from the board room where most of the work was done to other offices on the same floor to do particular audit steps which could not conveniently be done elsewhere.

This lack of interest in making physical contact with the assets and operations of the business under examination is not supported by the

<sup>1319</sup> Duties of a Senior Accountant, pp. 80-81.

authorities. All of the expert witnesses testified that the men in charge of the examination were expected to become familiar, as accountants but not as engineering experts, with the nature of the plant, its products, and operating methods. Such knowledge was considered by the witnesses to be necessary as a background for appraising the adequacy of the system of internal check and as an aid in understanding the book records. Trouant sums up the advantages of a plant inspection very well:

"A tour of the plant may assist the accountant in many ways, viz:

"A look at the buildings and machinery may afford greater insight into the depreciation provisions required and the policy of the company with regard to maintenance; it may also help in reviewing the current capital expenditures and the charges for dismantled or abandoned equipment.

"A general knowledge of the processes is essential to an understanding of the cost-accounting records.

"Seeing the materials and supplies, processes and products assists in reviewing the methods of taking and pricing the inventory.

"It is not expected that the accountant will be able to understand all that he sees or to exercise the function of an engineer, efficiency expert or appraiser, but he may obtain much helpful information and his client is usually glad to afford him the opportunity."<sup>1320</sup>

Thornton although warning that "While the senior may and should use knowledge so gained to guide him in his accounting work, he must not permit the client to lead him into the position of one who approves the accounts on the basis of physical inspection of the assets" nevertheless notes similar advantages from such inspection and suggests that "\* \* \* The visit should be made after the examination has progressed so far that the senior has a rather comprehensive idea of the assets as shown by the books."<sup>1321</sup> Thus it appears that Thornton and Trouant of Price, Waterhouse & Co. advocate a procedure of plant inspection that Ritts would have done well to follow and which while it may have greater pertinency to manufacturing operations need not be so restricted but can well be extended to non-processing operations as well.

<sup>1320</sup> Trouant, D. L., *Financial Audits*, American Institute Publishing Co., Inc., New York, 1937, (hereinafter referred to as Trouant) p. 17. A similar opinion is expressed in Kohler and Pettengill, p. 29; also in Dicksee, Lawrence R., *Auditing*, First American Edition, Edited by Robert H. Montgomery, with an introduction by Arthur Lowes Dickinson, 1905, p. 106:

"Even the Auditor experienced in Colliery Accounts will probably find that the thorough inspection of a new mine is really a wise economy of time; *in fact, whatever the nature of the business may be, the Auditor who acquaints himself with the manner in which it is carried on does wisely.*" [Italics supplied.]

<sup>1321</sup> *Duties of a Senior Accountant*, p. 18. Cf. Thornton, F. W., *Financial Examination*, American Institute Publishing Co., Inc., New York, 1933 (hereinafter referred to as *Financial Examinations*), p. 50:

"If the auditor has been consulted before the stocktaking it will be to his advantage to review the book records and to determine how frequently stock on hand has been wholly or partly checked physically and ascertain what differences were found when physical counts were made. Then, after a visit to the warehouse, factory or storerooms in which the merchandise is kept, he may make such suggestions as he thinks will be in the interest of better arrangement of the stock and of more effective stocktaking."

## B. DETERMINATION OF DUTIES OF CLIENT'S PERSONNEL

Closely related to the physical properties of the client are the officers and employees who operate them and who record the transactions relating to them. All of the expert witnesses stated that a knowledge of the client's personnel and their respective duties was essential to the auditor and the majority stated that such knowledge was to be gained either by preparing charts of the organization or by listing the divisions of the business and the names of the persons working in the divisions having a bearing on the accounting work.<sup>1322</sup> These memoranda in whatever form were usually preserved in the permanent working paper file and brought up to date each year. A similar requirement, it will be recalled, appears on the Price, Waterhouse & Co. questionnaire on internal check and control but, except for occasional notes in the papers, was not fulfilled on this engagement at least for the Bridgeport office and plant. This failure may be attributed directly to Rowbotham for in his opinion, while the senior on the job should have such knowledge in his head and keep the manager posted, the partner would not be concerned with it and the firm's printed instruction he characterized as "\* \* \* a text book requirement; it is not done in real life."

However, it seems probable that the text books reflected the actual audit programs of practicing accountants. Dicksee's first edition published in 1892, reproduced an audit program of one "Mr. David Chadwick, F. C. A.", an accountant of fifty years' experience. The first three items in a list of twenty-two on this program were:

"1. In commencing a new audit you should obtain a list of all the books kept, and of all persons authorized to receive or pay money and order goods.

"2. In the case of a joint stock company, examine the articles and board minutes respecting the receipt and payment of money, and the drawing of cheques, acceptances, etc.

"3. Ascertain and take note of the general system upon which the books are constructed, and the plan of checking the correctness of the accounts paid, and whether exclusively or generally by cheques."<sup>1323</sup>

In any event the idea was good in 1892, possibly as early as 1842, and is still good. A requirement for a record of observations not only forces clearer analysis but makes possible a proper review of the facts by superiors.

## C. QUESTIONNAIRES

The questionnaire method of developing information in respect to the client's system of internal check and control as employed by Price, Waterhouse & Co. is one of several methods in general use among accountants today. Two of the expert witnesses stated that

<sup>1322</sup> See also Trouant, p. 17; Bacas, Madden, and Rosenkampff, p. 178; Kohler and Pettengill, p. 29; Montgomery, 5th Ed., p. 62; Jackson, pp. 13-14.

<sup>1323</sup> Dicksee, Lawrence R., *Auditing*, 1st Ed., Gee & Co., London, 1892, p. 3. The same program is reproduced in the 1928 edition of this book.

their firms used the questionnaire method, three provided their staff men with an outline to be followed in developing such information while the remaining seven had no formal program of this character but expected a permanent record to be made of important points. All stated that they relied upon inquiry and observation during the audit to determine that the system as explained to them was in fact being followed. Quite clearly the testimony of the several witnesses, including those from Price, Waterhouse & Co., indicates that this problem of reviewing the system of internal check and control is treated in entirely too casual a manner by many accountants.

On paper the Price, Waterhouse & Co. procedures would appear to be designed to produce a comprehensive review of the client's accounting procedures and the relationship of the various members of the office staff affected by the audit. However, the results obtained were weakened by two factors. The failure to carry out the item of the questionnaire which called for an outline of the company's organization showing each department and to whom it is responsible left undisclosed, at least in writing, that George Dietrich, the assistant treasurer, who, according to the 1932 questionnaire, controlled the cashiers, signed checks, supervised the cashiers who reconciled the bank accounts, held the petty cash fund, opened the mail, held unclaimed wages, mailed regular monthly statements to customers, passed on credits, held securities, authorized capital expenditures, signed notes payable and acceptances, and authorized loans to officials and employees, *also*, under Coster, ran the foreign crude drug business (which comprised over 65% of all business done at Bridgeport) at least to the extent that his initials or verbal clearance furnished the internal authority respecting all foreign crude drug purchase and sales transactions. The other factor concerns the failure, particularly in connection with the supplementary questionnaires and notes on individual phases of the system, to observe distinctions in the manner of handling foreign crude drug transactions which would have brought out more clearly the specific control of the Dietrich brothers over this business.<sup>1324</sup> This is particularly noticeable from Ritts' inability after eight years on the job to describe accurately the manner in which the foreign crude drug transactions were handled at the Bridgeport office and from his testimony stating that he did not know that since 1932 all foreign crude drug transactions throughout the year were purportedly collected by Manning & Company thus indicating that he could not have made the careful and thorough verification of the system of internal check required by his firm's printed instructions. This latter point is also illustrated by Ritts'

<sup>1324</sup> Answers to many of the questions were obtained from McGlooin, the comptroller, and Johnson, the office manager, whose testimony shows that they themselves, in many particulars, did not know the exact manner in which the foreign crude drug transactions were handled.

failure to discover, in subsequent years, at any rate, after McGloon's initial answer "Yes" in 1932 to the question "Do employees in position of trust take regular annual vacations?" that George Dietrich never took a vacation and that when he did leave his desk, even for a few hours, his brother Robert Dietrich (who himself was never away for more than two or three days) would move up and occupy George's office (next to Coster's) but not do any of his work.

It follows that if the use of samples and tests on an audit is governed by the adequacy of the company's system of internal check, the latter should be the subject of a careful examination each year, not only to determine where safeguards are provided and where not, but also as stated at the beginning of the Price, Waterhouse & Co. questionnaire to establish "\* \* \*" from observation, inquiry and tests during the course of the examination that the prescribed procedure is being observed."<sup>1325</sup> Entirely aside from the appraisal of the system of internal check and control, alert observation of the system in operation, whether weak or strong, affords one of the best opportunities for the detection of fraud. Nor can this requirement for observation of the procedures be satisfied without a full knowledge and careful testing of the procedures and this in turn cannot be accomplished by a mere interrogation of officials without independent observation of the basic facts.

## 2. Appraisal of the System

Ritts' report to Thorn and Thorn's to Rowbotham were to the effect that the system of internal check at Bridgeport was good but Rowbotham's review of the questionnaires on the witness stand (apparently the first time he had seen them) resulted in his opinion that numerous points did not indicate strength in the system. On two points at least sharp divergence would appear between the treatment of the situation at Bridgeport and in other divisions. Letters of Price, Waterhouse & Co. criticising the failure of some houses to make independent records of remittances<sup>1326</sup> and the procedure whereby all the books were kept by one bookkeeper<sup>1327</sup> were common. However, at Bridgeport, George Dietrich, who opened the mail, did not make such lists and all the books of the Canadian Company were kept at first by George Dietrich and later by one bookkeeper under his direction.

Some distinction arises from the fact that at Bridgeport, as distinguished from the other houses, little currency was handled. However, the difference in treatment can not be explained solely on this ground. Price, Waterhouse & Co. also place emphasis on the fact that in the wholesale houses, as distinguished from Bridgeport, the

<sup>1325</sup> Ex. 17. See also Instruction Book to Form 10-K, pp. 11-12 quoted at pages 429-430 *infra*.

<sup>1326</sup> See pages 320, 322, 324, 325 *supra*.

<sup>1327</sup> See pages 319 ff. *supra*, especially McKesson-Fuller-Morrison letter at page 323.

executive functions were so divided that no single executive had the necessary information which would enable him to act as an effective check upon the bookkeeper and on the fact that remittances were not received and opened in the first instance by a fiscal officer of the Company. In Bridgeport, George Dietrich and Coster were deemed to have the necessary knowledge and Dietrich, assistant treasurer, handled the mail. In our opinion criticisms leveled at the other houses were equally applicable to the Bridgeport office irrespective of the status of the persons involved.

While lack of segregation of executive functions may increase control over bookkeepers and cashiers, the price, with this case as an illustration, would seem to be a heavy one.<sup>1328</sup> To us it appears that a lack of segregation of operating or executive functions especially when, as here, it is coupled with control over cash and other functions shows a weakness which should call forth more detailed investigation or testing, in the same way as though there had been a lack of segregation of accounting functions.

True, George Dietrich was subject to some internal checks on the foreign crude drug transactions. But the shipping, receiving, and warehousing were centered in his brother Robert and after 1934 when the goods were supposedly kept in Canada, fraud could have originated without Robert's assistance. On the accounting work, the check exercised by McGloon's department was based on documents, external and internal, which in every instance emanated from and were returned to George Dietrich with the single exception of inventory records prior to 1935 which came from George's brother Robert.<sup>1329</sup> As to the control exercised by Coster himself, while it seems to us that George Dietrich could have committed some frauds without the former's immediate cognizance, it is clear that a fraud in the amount and for the period indicated must have been within Coster's ken or conducted for him.

However, while these checks did exist, it nevertheless seems to us that the complete control assembled in George Dietrich's hands did

<sup>1328</sup> A feature of this case is that instead of using control of cash and mailing of statements to cover up misappropriations of collections from customers, these measures were used to conceal the fictitious nature of the accounts themselves and the falsity of the purported receipts. See also, *In the Matter of Monroe Loan Society*, 3 S. E. C. 407 (1938).

<sup>1329</sup> Cf. Bell's warning in Bell, William H. and Powelson, John A., *Auditing*, Prentice-Hall, Inc., New York, 1924 (hereinafter referred to as Bell and Powelson), p. 39:

"The auditor should be careful not to be misled by indications of internal control when in fact it may be non-existent or purely perfunctory. The office personnel may include an 'auditor' but it does not follow that there is any effectual control over even the disbursement of cash. \* \* \*"



indicate a possible point of weakness in the system <sup>1330</sup> whether to be used alone or in conjunction with Coster, particularly since this was supposedly a specialty business of which others, especially the auditors, had no independent knowledge. And the mere fact that George Dietrich could have committed some fraud should have caused a more detailed investigation which might well have led to the discovery of the larger fraud. And the further fact that, in addition, George Dietrich did not take any vacations, Price, Waterhouse & Co. apparently never discovered. The relative indifference to this latter point, as indicated in the testimony of Rowbotham and Ritts, is not supported by the authorities. <sup>1331</sup>

Whether other accountants would have broken through the mask of Coster-Dietrich explanations in their examination of the system of internal check and control or in their appraisal of it is difficult to say. One important conclusion, however, to be drawn from this case, which is of general applicability in auditing practice and with which those witnesses who were asked agreed, is that although the great majority of corporation officers may be assumed to be honest and statements

<sup>1330</sup> Cf.

"Typical of some of the basic features of a system of internal control, it is rudimentary that the functions of cashiering and the maintenance of accounts receivable ledgers should be separate functional divisions of the accounting department.

"Bookkeepers engaged on such ledgers should have no connection with the cashier's work and, on the other hand, cashiers should have no access to ledgers nor to statements sent to customers.

"Ideally, a responsible employee not associated with the cashier's department should supervise the opening of the mail and prepare for subsequent review by the accounting department an independent list of cash received in this manner.

"We do consider the mailing of statements at least partial assurance that the accounts are authentic, particularly if such statements are prepared and mailed by an accounts receivable section which is clearly independent of the cashier's department or even better, if such statements, although prepared in the accounts receivable department are checked by a representative of the comptroller's department before being actually mailed." P. 130, 143 (Testimony of Stempf).

In addition to being head of the cashier's department and conducting some of the other functions mentioned above, George Dietrich's activities in the handling of foreign crude drug purchase and sales transactions should also be remembered.

<sup>1331</sup> Dicksee, Auditing, First American Edition, 1905, p. 55:

"Every member of the [client's] staff should be required to take a holiday at least once a year." Montgomery, 5th Ed., 1934, p. 70:

"Every member of the office staff should be required to take a vacation at least once a year. It is advisable to transfer employees from one position to another more or less frequently, depending upon the class of work which they perform. Changing persons from one position to another often increases efficiency by relieving part of the monotony of routine work. Fraud is sometimes brought to light by an enforced vacation or by rotation of work."

Bell and Powelson, p. 82:

"\* \* \* As a matter of fact, nearly all frauds are committed by 'trusted' officers or employees; their opportunities for fraud arise through their being trusted.

"All officers and employees who are concerned with the handling of cash and securities and with keeping the accounts should be required to take vacations and should, whenever at all practicable, be assigned to different duties occasionally."

Bennett, George E., *Fraud, Its Control Through Accounts* (Published under the auspices of the American Institute of Accountants), The Century Co., New York, 1930, p. 39:

"Annual holidays should be enforced. No one should be considered so indispensable as to be given absolute and complete control over any one part of the work for more than fifty weeks each year; in fact, such control at all times should be subject to check by some other person \* \* \*."

made by them may be accepted as free from deliberate misrepresentation, facts susceptible of independent verification by the auditor in a reasonable and practicable manner should be so verified. The history of financial fraud indicates that the officers should not be exempted from the operation of the checks provided to prevent manipulation by employees. Adherence to such a rule may well cut short many manipulations of accounts by trusted officers.<sup>1332</sup>

## D. CASH

### 1. Adequacy of the Program

Testimony of Ritts, Thorn, and Rowbotham and exhibits introduced in evidence indicate that the apparent collection of cash was considered the best evidence of the authenticity of the transactions and that therefore great emphasis was placed on the results of the cash work.<sup>1333</sup> The comparison of the Price, Waterhouse & Co. cash program with the bulletin "Examination of Financial Statements" revealed that the Price, Waterhouse & Co. program was more extensive. The Price, Waterhouse & Co. methods compared favorably also with the testimony of the expert witnesses for while the majority of the witnesses recommended more extensive work on cash than that laid down in the Bulletin in only a few instances did they describe work of a stronger nature than that prescribed by Price, Waterhouse & Co. for the McKesson audit.

### 2. Confirmation of Deposits

Three witnesses testified that it was their usual practice to obtain from banks original or authenticated copies of deposit slips for a few days before and a few days after the close of the fiscal year.<sup>1334</sup> A fourth stated that his firm required this in cases where there were undeposited receipts at the year end.<sup>1335</sup> The other witnesses stated that this step would be taken only when there was suspicion of a defalcation or when other checks were lacking. Two of the witnesses

<sup>1332</sup> See Bacas, Madden, and Rosenkamppf, p. 17:

"The large business organizations, as a rule, can afford the services of competent chief accountants who, in many respects, may be as well qualified as the average public accountant. \* \* \* Even in these organizations it is usually considered advisable to have an audit by a public accountant as a means of protecting the concern so that losses of substantial amounts may not occur from fraudulent practices on the part of its officers or employees."

See also, Duties of the Senior Accountant, pp. 77-78:

"Assuming that a good system exists, there will still be danger if those employees who are supposed to be a check one upon another be especially intimate or if the head of an office have established himself as an unreasoning dictator, his subordinates compelled to follow his orders with or without explanation. If the outside auditor ask questions of subordinate bookkeepers and find them afraid to answer reasonable enquiries, referring the auditor always to the head of the office, the internal check is untrustworthy."

<sup>1333</sup> See pages 226-228, 231, 274-276 *supra*.

<sup>1334</sup> "In the usual case, however, we do make some of these tests and we generally find enough in the way of defalcation in that way to make it a continued practice." Lenhart, P. 238. See also Bell, P. 137-138; Klein, P. 497-498.

<sup>1335</sup> Jones, P. 600.

who made it their usual procedure (Lenhart and Klein) pointed out that there was a tendency, in recent years, for this test to be less reliable than formerly because of a change in practice in the larger banks in checking deposits. In view of the growth of this practice we strongly suggest that accountants reconsider this matter with the banks in question and adopt revised or substitute procedures to secure the necessary check since the authentication now rendered by such banks may be of little value and, in fact, may be misleading.

It will be recalled that Jaureguy on the 1930 audit requested Coster to consider whether the auditors should secure copies of original deposit slips from the banks but that after a few days Coster instructed them not to do this and this agreement was incorporated in subsequent letters of engagement and applied to the other branches as well as to Bridgeport. Insistence upon seeing original deposit slips at Bridgeport for the last few days of 1930 would have revealed the deposit of single checks covering collections from two or more customers. While Dietrich and Coster would doubtless have attempted some explanation, it seems to us that such a discovery should have led to a more thorough investigation of the method of handling the foreign accounts. Price, Waterhouse & Co. point out, however, that the situation at Bridgeport was not one where the obtaining of copies of original deposit slips was indicated to be a mandatory procedure and that, in their judgment, it was quite proper for them to forego this test even though duplicate deposit slips were not available in the client's Bridgeport office. Duplicate deposit slips were available and were inspected in the other offices. The test is used primarily (and the expert witnesses agreed) to detect kiting and lapping. Other methods of checking kiting are available and were used. Also, the danger from lapping was minimized at Bridgeport by the fact that substantially all receipts were in checks or drafts. Hence, the non-inspection at Bridgeport is upheld by a majority of at least two to one of the expert witnesses. None of the textbooks examined make the confirmation of deposits with the bank a mandatory feature of a balance sheet audit but some suggest rather strongly that it be done.<sup>1336</sup> The American Institute Bulletin mentions the procedure

<sup>1336</sup> Montgomery, 5th Ed., p. 118:

"The requests for confirmation of bank balances should include a request for confirmation of deposits made during the week immediately following the date of the balance confirmed."

Kohler and Pettengill, pp. 59-60:

"The detection of such fraud ('lapping') can usually be ascertained by checking the detailed deposit slips to the entries in the cash-receipts book by days. In making this check the auditor must be positive that the detailed deposit slips are copies of those actually used in making the deposit; this can be verified at the bank. While most banks file deposit slips by days, their officials have become accustomed to requests of auditors, and the auditor need not be afraid of imposing on any bank's good will by asking to see a reasonable number of deposit slips."

Bacas, Madden, and Rosenkampff, p. 208:

"This process should be used when a detailed audit is being made. It should also be used if a balance sheet audit is being made and there is no good system of automatic internal audit and the cash is of such a nature that it might be manipulated easily. The deposit for three to seven days just before the close of the period might be verified in this manner." (Continued on next page.)

only as an optional step: "In certain instances such comparison may be extended to include a check of original deposit slips or authenticated copies thereof."<sup>1337</sup>

While the character of the cash receipts was different in the wholesale houses and in view of the generally weak internal check and control created more justification for an examination of original deposit slips yet even here in view of such checks as were made and, more important, the dispersion of the risk, we conclude that normal audit procedure did not require Price, Waterhouse & Co. to secure original deposit slips from the banks as a part of their balance sheet examination. Having called the procedure to the attention of the client as a desirable step to take if the audit was expected to reveal defalcation by cashiers, they violated no professional responsibility when they acquiesced in Coster's instructions to omit the procedure. However, they did examine duplicate deposit slips kept in offices other than Bridgeport, and securing authenticated copies from the banks themselves would have entailed little, if any, extra work.<sup>1338</sup> Foregoing this additional step prompts an obvious reminder that if auditors in their judgment consider an audit procedure to be necessary under a given set of circumstances in order to provide a proper basis for their certification of financial statements, the omission of such a procedure at the request of the client would constitute an abdication of their professional responsibility if they nevertheless issued an unqualified certificate.

### 3. Manning & Company

Should Price, Waterhouse & Co. have discovered that Manning & Company was a bookkeeping fiction and not a bank? Of the many

Trouant, p. 37:

"\* \* \* copies of deposit slips may be made for confirmation by the bank."

Financial Examinations, p. 19:

"Then, total deposits shown on the bank statement should be reconciled with the total receipts entered in the cashbook, and for the last few days the bank deposit should be compared in detail with the entries of daily receipts as shown in the cashbook and with the duplicate deposit slips. If irregularities are suspected, the original slips may be inspected at the bank."

Cipriani, pp. 49-53:

"Cash in Banks:

"An acceptable program of work to be done, in the typical case, follows:

\* \* \* \* \*

"19—Make out copies of bank deposit slips for the last few days in December and the first few days in January, and ask banks to certify the slips and to return them direct to the auditor's office."

That Cipriani does not conceive this to be a mandatory procedure may be deduced from the following paragraph from p. 6:

"The procedure to be mentioned hereafter is applicable in the examination of the accounts of non-specialized types of medium-sized businesses. The work required is discussed in detail. It must be remembered, however, that in no specific case should it be necessary to do everything mentioned. What to do and what to leave undone are matters that experience alone can decide. In fact, it is not too much to say that the development of the accountant can be gauged by his increasing competence in knowing what to omit and when to omit it."

<sup>1337</sup> Ex. 117 (p. 12).

<sup>1338</sup> Except where request is made for copies of exceptionally numerous and lengthy deposit slips from the same bank, such copies are generally readily mailed by the bank direct to the auditor. In the other cases they are made easily available for inspection.

questions which will arise in the minds of those who read of this fraud, this should rank with the failure to discover that receivables and inventories were fictitious. Discovery that cash, or inventories, or receivables were fictitious would necessarily have exposed the entire fraud. The very acceptance of Manning & Company as real supported the acceptance of the cash transactions as authentic and thus helped support the entire fiction from 1931 to the day of its revelation.

No text examined suggests the necessity for making sure that accounts purporting to be with banks actually represent transactions with a real bank. Only one of the twelve expert witnesses stated that his firm had ever had occasion to inquire as to the character of a bank to determine its existence. This witness said that in certain cases inquiry as to the character of a particular depository was made from banks known to them and that reference had been made to a bank directory.<sup>1339</sup> All of the witnesses mentioned one or more of the following points as satisfactory evidence of the existence of a bank:

1. Common knowledge.
2. Resolutions of the board of directors authorizing the establishment of bank accounts and designating officers to sign checks.
3. Letterheads, statements, checks, and other stationery of the bank in customary form.
4. A confirmation of the balance with the bank signed by an officer of the bank.
5. Apparent regularity of the transactions.

In this case the auditors' acceptance of Manning & Company as represented was originally made by Thorn who testified that he would not discuss such a subject with a partner. Whether Thorn was justified in accepting Manning & Company on the evidence before him will be tested under the five points above:

1. Events have shown that common knowledge played no part in the decision, for the auditors had never heard of the name Manning & Company except in connection with the McKesson engagement.

2. At meetings held practically at the same time on September 3, 1931, the directors of the Canadian and Connecticut Companies who, with the exception of one member, were identical, approved "\* \* \* a contract with Manning & Co., a co-partnership of Montreal, Canada, and of a subsidiary contract with W. W. Smith, Inc., a New York corporation, dated as of the first day of August 1931 \* \* \*." <sup>1340</sup> Although the minutes stated that both contracts were exhibited, neither the resolutions nor the minutes mentioned banks or banking functions in any way—merely referring to foreign buying commissionnaires and brokers.<sup>1341</sup> The auditors never saw the contract with

<sup>1339</sup> Jones, P. 614. Klein stated that exceptionally large deposits in small country banks would be investigated. P. 500.

<sup>1340</sup> Footnote 177 *supra*.

<sup>1341</sup> Ex. 179, 180. Quoted at page 60 *supra*.

Manning & Company. The contract with W. W. Smith & Company, Inc., which they did see, recited that Charles Manning & Company, Limited, with whom the McKesson companies had in 1930 entered a contract to render certain services in connection with foreign trade, had been acquired by Manning & Company which had transferred the buying and selling agency business formerly conducted by Charles Manning & Company, Limited to W. W. Smith & Company, Inc. which Manning & Company had caused to be organized for that purpose and of which it owned one hundred per cent of the stock. However, the auditors were told, what certain other documents which they did examine indicated, that the one hundred per cent ownership of W. W. Smith & Company, Inc. was in W. W. Smith & Co. of Liverpool which by contract guaranteed performance of the foregoing contract of W. W. Smith & Company, Inc. The auditors were also informed that, as stated in the Manning & Company contract which they did not see, Manning & Company had acquired all of the foreign exchange and banking business formerly conducted by Charles Manning & Company, Limited and that it was thereafter going to continue such business under its own name, but there was no evidence that Charles Manning & Company, Limited had in fact ever conducted a banking business. Concerning the directors' meetings, a director testified that the names in the resolutions "\* \* \* meant nothing \* \* \*". However, in voting to appoint them as agents and so forth, I undoubtedly would have done it on the recommendation of the president."<sup>1342</sup> The only other record of directors' approval produced by the auditors at the hearings was a copy of a minute of a meeting of the Canadian Company board held on April 4, 1935 (abstracted by Ritts for the working papers), which approved Manning & Company as a bank depository for the Canadian Company.<sup>1343</sup>

3. Checks were not drawn on the Manning & Company account. The debit and credit memos, of which the Company received only one copy, an original, when considered from the point of view of form, lack of supporting documents, and the absence of entries for service charges were clearly different from those of ordinary commercial banks.

4. The confirmations mailed directly to the auditors each year end conformed in every respect with what they should have expected to find about the account except that in some years no qualification appeared after the request "state if balance is not subject to withdrawal by check."

<sup>1342</sup> R. 2330. Testimony of Phillips. Quoted at page 125 *supra*.

<sup>1343</sup> R. 694-695. Quoted at page 68 *supra*. A search of the minutes of the several Companies disclosed that Manning & Company was also included in a long list of banking depositories approved by the Executive Committee of the Maryland Company in October 1934 when the assets of the subsidiary companies were taken over and the Connecticut Company thereupon became the Connecticut Division of the Maryland Company.

5. It was noted above that Coster contrived to give an appearance of reality to the Manning account by starting business with the firm with a letter of credit in precisely the same manner in which he handled millions of dollars of business through New York banks and thereafter for several years, while using the debit and credit memo method of operation, purported to transfer funds from Manning & Company to New York banks. S. D. Leidesdorf & Co.'s investigation showed that cash transfers actually were made to bank accounts of the McKesson Companies and were recorded as coming from Manning & Company. From December 31, 1931 to December 18, 1933, \$1,013,000 was transferred on the Connecticut Company books and from December 24, 1931 to December 31, 1936, \$902,800 was transferred on the Canadian Company books. In addition, from November 25, 1932 to January 27, 1933, \$345,000 was deposited in the Connecticut Company's account with the Guaranty Trust Company of New York and recorded as coming from the Canadian Company's account with Manning & Company. These transactions would naturally tend to allay rather than to raise any suspicion. Thorn's acceptance of Coster's explanation that the purpose of the account was to generate goodwill with the British Empire customers by collecting and holding the funds in Canada seems in conflict with his further understanding that the money had to be paid in United States currency and that Manning kept it on deposit in New York. This conflict coupled with the absence of any evidence of charges by or income to Manning & Company from handling this business and the fact that neither Ritts nor Thorn was certain as to how customers were advised to pay Manning and how Manning was authorized to pay vendors, must in some degree undermine their conclusion that the transactions with Manning & Company appeared regular in every way. Both witnesses waived aside the advices and authorizations as unimportant mechanical details in the face of the confirmation letters which they accepted as authentic, and the other apparently conclusive evidence as to the reality of Manning & Company. Of interest also is the fact that the supposed balance carried with Manning & Company was not included in the cashier's daily cash report. While examination of such internal reports has not heretofore been regarded as necessary audit procedure, the many instances in which such somewhat informal reports on cash, sales, receivables, and so forth have for the necessities of actual business operation reflected the real situation while the more formal reports have been falsified <sup>1344</sup> indicates to us the usefulness of comparing such reports with the book records and of the thorough investigation of any discrepancies.

<sup>1344</sup> E. g. *In the Matter of Interstate Hosiery Mills, Inc.*, 4 S. E. C. 706, at 718-19 (1939); and *National Surety Corporation v. Lybrand et al.*, 9 N. Y. S. (2d) 554 at 558.