

Thornton, September 1933:

"It is worthwhile to compare inventories as prepared by the client for his balance-sheet with the corresponding inventories shown on federal, state and other tax returns. It usually happens that it is to the interest of a taxpayer to state his inventory at as low a figure as possible in his return, while an inclination to over-value it for balance-sheet purposes may at times exist."<sup>1402</sup>

Trouant, January 1937:

"Substantiation of amounts of accrued taxes should include reference to expense accounts, to state and local tax laws and to copies of tax notices and tax returns."<sup>1403</sup>

Complete compliance with any of the three suggestions would have turned up the fact that the foreign crude drug inventories shown on inventory books as in the Fairfield (Bridgeport) plant as at December 31, 1934 were shown on the Maryland Company's Connecticut tax return for the period ended that date as outside Connecticut. A similar disparity between the supposed location of the inventories and the location assigned for tax purposes was disclosed on the Connecticut Company's state tax return for 1934 and resulted in a lower tax payable to Connecticut.<sup>1403a</sup> Examination of the tax receipts during the 1935 audit should have disclosed a substantial discrepancy between the amount of tax actually paid in 1935 and the amount accrued at the time of the previous year's audit based on the assumption that the merchandise was in Connecticut during the year 1934. The discrepancy should have been sufficient to have warranted investigation as to its cause. Similarly, a review of the Canadian Company's Connecticut tax return and supporting papers for 1935 would have revealed inventory certificates from the Canadian vendors giving the location of the merchandise as New Jersey rather than Canada as understood by the auditors.<sup>1404</sup>

#### d. CONTINGENT LIABILITIES

All accountants are aware of the difficulties involved in assuring themselves that they have done everything a prudent accountant should do to uncover contingent liabilities. Much of the work done on other phases of the audit contributes information as to various contingencies that exist. In addition, the reading of contracts and minutes of various governing bodies of the client is generally accepted practice and was done by Price, Waterhouse & Co.

As an added precaution in connection with all liabilities, it is customary for the auditor to secure a certificate from responsible officers

<sup>1402</sup> Financial Examinations, pp. 56-57.

<sup>1403</sup> Trouant, p. 105.

<sup>1403a</sup> The Connecticut Company's return, introduced at the trial of *U. S. of America v. George Musica et al.*, footnote 23 *supra*, covered the operations of that Company to the date when the Maryland Company took over its business on or about October 31, 1934, and was filed under its subsequently changed name, McK & R Manufacturing Company, Incorporated.

<sup>1404</sup> See pages 276-280 *supra*.

of the client to the effect that all liabilities of every description have been disclosed. The customary certificate was secured in this case.

In connection with the reading of contracts and minutes it may be recalled with respect to the Smith-Manning arrangement which governed the conduct of substantially all of the Canadian Company's business and approximately sixty-five percent of that of the Connecticut Company, later Division, that although the minutes of September 3, 1931, referred to a contract with Manning & Company and one with W. W. Smith & Company, Inc. the auditors were unaware of the former and that in abstracting the latter no reference was made to the 100% ownership of W. W. Smith & Company, Inc. by Manning & Company, a fact at variance with other evidence relied on by the auditors. One way of avoiding such errors is suggested by Bacas, Madden, and Rosenkamppff when they point out the necessity of verbatim copies of important documents having a bearing on the accounts. They suggest that photostating provides the method of producing such copies in many cases. This method has the advantage of preserving in the working papers a document which may be reviewed by a manager or a partner without raising doubts as to the accuracy of the copy.

## I. PROFIT AND LOSS ACCOUNTS

### I. Sales, Cost of Sales, and Gross Profit

As previously pointed out, the working papers on Girard & Co., Inc. indicate that the billings during the last fifteen days prior to audit dates were disproportionately heavy as compared with prior sales. Also, the auditors' papers on the Connecticut Company for 1931 carried the notation, "Why are December sales higher?" Opposite this there was a red vertical line indicating that the step had been disposed of, apparently with satisfactory results, for no comment was made concerning this point in the memorandum on accounts submitted to the partner. In view of the length of time since the events and lack of more definite information in the working papers, the auditors were unable to say precisely how these things were disposed of at the time. Rowbotham thought that they might have been explained as the natural result of an expanding business. In any event, the testimony of Rowbotham and Thorn is clear that the primary purpose of any check they might have made in this connection was to see that the cut-off was proper, and that they would not have gone behind the factory orders or duplicate invoices to see that the transactions were real.<sup>1405</sup>

Their work in this respect was subject to another weakness—their failure to use proper departmentalized figures for such tests or com-

<sup>1405</sup> For discussion of this point see page 402 *supra*.

parisons as might have been made with sales or gross profit figures. Such widely dissimilar products as hand lotion and Dandrofuge (manufactured items) were combined with crude drugs and essential oils (resale items) because supposedly exported to the same type of customers. The gross profit on the former was over 80% and on the latter under 15%, yet the memoranda on accounts listed only the combined sales and gross profit figures. And since 1932 it was maintained that no separate consideration could have been given to foreign crude drug sales as distinguished from the domestic because the Company did not classify its accounts separately. Yet sales and gross profit schedules obtained from the client and contained in the auditors' working papers gave the necessary departmental breakdown.<sup>1406</sup> Obviously comparison of sales and of gross profit percentages in which different departments are lumped together defeats the purpose of these tests in disclosing and locating variations. Employing these tests only for the Company as a whole and using the gross profit test with the sole purpose in mind of checking the valuation of inventories, as Thorn's testimony would indicate he did, falls far short we feel of the full utilization of these tests to discover variations which if not properly explained may indicate possibilities of fraud. That the possibility of uncovering fraud is one object of this study should be clear from the following quotations:

Cipriani: "Some test must be made of the accuracy of sales records to be sure that only genuine sales have been included" <sup>1407</sup>

Thornton: "Abnormal fluctuations should be examined and explained. The officers of the client company should be consulted as to such fluctuations and their opinions should be given due but not conclusive weight. The auditor would not be held free of blame if, accepting without verification the opinions expressed by officers, those opinions were found to be in error. Independent investigation of wide variations from normal are necessary." <sup>1408</sup>

Trouant: "Changes in sales volume and prices, the withdrawal of old products and the introduction of new products are all of interest to the accountant and may have a direct bearing upon the tests of inventories and sales expenses. A comparison of unfilled sales orders with amounts at the close of previous periods may throw additional light on the company's condition and prospects. Comparison of the company's sales volume with published information as to volume for the trade as a whole and comparison of monthly sales figures for the current and prior years may be helpful. If abnormally large billings are recorded for the closing months of the period, they should be investigated." <sup>1409</sup>

And finally in this connection it should be noted that while a sales and gross profit schedule would not on its face disclose such fact, greater consideration of departmental records should have revealed what the inventory work papers clearly indicated, that every trans-

<sup>1406</sup> Ex. N. The auditors claim that they used these schedules but solely as a basis for eliminating unrealized profits on inter-company sales of manufactured products from the consolidated accounts.

<sup>1407</sup> Cipriani, p. 155.

<sup>1408</sup> Financial Examinations, p. 186.

<sup>1409</sup> Trouant, p. 140.

action in foreign crude drugs was concluded at a gross profit and so recorded in a separate sales register. While Coster's alleged expertness in this trading might explain over-all good results, it seems to us that some question might well have been raised when year after year the many hundreds of transactions were concluded, every one at a gross profit. Further inquiry would then have revealed that all these foreign sales were allegedly paid when due in United States currency with never a deduction for allowances of any kind.

## 2. Other Profit and Loss Accounts

Examination of the comptroller's monthly reports of operations of McKesson & Robbins would not disclose the amount of foreign and domestic crude drug sales separately. As a result these reports left the directors uninformed as to the proportion of these two classes of business and, therefore, as to the significance of the expenses charged to the combined departments. That foreign business and domestic business have marked differences in many respects is widely recognized. How Thorn could believe, as he testified he did, that the directors and operating heads were properly informed of the Company's operations by these statements from McGloon's department is not clear. Perhaps general auditing practice did not dictate that he should have urged improvement in this respect. However, it seems to us that one of the services that independent auditors should render to clients is to make suggestions looking toward improvement in the client's accounting and internal auditing procedure so that the results obtained will be truly informative and reliable. And in any event with the separate figures available,<sup>1410</sup> Ritts' use of the combined figures from these reports for such review as he claims to have made does not seem logical.

## J. THE WHOLESALE HOUSES

In judging the work of Price, Waterhouse & Co. it must not be forgotten that since the formation of the Maryland Company in 1928 the work at Bridgeport on the Canadian Company and the Connecticut Company, later Division, represented only a small portion of the auditors' entire engagement. In the last year (1937) sixty-four wholesale houses and eighteen other units in addition to the Canadian Company and Connecticut Division made up the work for which Price, Waterhouse & Co. were engaged. On these last two units the auditors spent less than three per cent of their time on the last five audits.

The work in the other units was criticized by some of the directors and managers of those units as too thorough. Such criticism came especially from employees who themselves were criticized for unsatis-

<sup>1410</sup> See footnote 1406 *supra*.

factory bookkeeping and who in some cases subsequently were caught in defalcations. Although the bulk of the testimony and evidence produced in this case deals with the situation at Bridgeport, enough material bearing on the work in the other units was introduced at the hearings to indicate that the work there was carried out in a thorough fashion and in accordance with generally accepted auditing practice prevailing during the periods involved. This important fact must not be overlooked in arriving at an opinion of the work of over two hundred men in any single year who represented Price, Waterhouse & Co. on this engagement throughout the country and which required the attention of every branch office of the firm in the United States.

The success of the work in the branches as contrasted with that done in Bridgeport may possibly be found in a difference in approach toward management. All of the branches were subjected to a thorough audit when merged with McKesson & Robbins and under instructions from the New York office of Price, Waterhouse & Co. the auditors of the branches were on the alert to report annually any defects in internal check and control.<sup>1411</sup> These instructions seem to have been interpreted quite literally, judging from the mass of criticism registered each year and passed on by Rowbotham to Coster in the individual reports on each house. This criticism, it may be observed, did not exempt the highest officers in the various branches if it appeared to the auditors that such officers were responsible for the conditions reported.

At Bridgeport, on the other hand, the audit work grew out of an engagement for a small corporation, all of whose stock was held by officers. With the development of the business the work at Bridgeport became an audit of units of a large organization, but these units had the distinction of having the president in residence and in charge of a major portion of the operations. This president and his chief aid, George Dietrich, had apparently won the confidence of successive Price, Waterhouse & Co. representatives and at the same time kept the other branches on the defensive because the Bridgeport operations apparently were always profitable, while those in the field were not uniformly successful. It may be recalled in this connection that Thorn and Ritts did not consider the instructions for work at the branches to be applicable to the Bridgeport units and never considered it necessary to report in detail on the system of internal check and control in these units.<sup>1412</sup>

The conditions in the wholesale houses which Price, Waterhouse & Co. did report in detail year after year were not their responsibility to correct. Their obligation was met when they adjusted their audit work to fit the situation and warned the client that the system of

<sup>1411</sup> Page 165 *supra*.

<sup>1412</sup> Page 187 *supra*.

internal check and control was inadequate in most of the units of the Company. If the registrant is to take full advantage of the economy of an audit based upon tests and samples under which, by our rules, the auditor “\* \* \* may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant’s own staff \* \* \*”,<sup>1413</sup> it would appear to be a duty of the registrant to cooperate with the independent auditors by improving accounting procedures wherever practicable and more particularly to correct weaknesses brought to their attention by the auditors.

The general principle which we observed in our opinion in the *Interstate Hosiery* case appears to be applicable here. In that opinion we said:

“\* \* \* The fundamental and primary responsibility for accuracy of information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants’ certificates are required not as a substitute for management’s accounting of its stewardship, but as a check upon that accounting \* \* \*.”<sup>1414</sup>

Failure of the client to provide an adequate system of internal check and control can only be overcome by the auditors, if at all, by making a more comprehensive audit than would otherwise be necessary. Under existing standards the auditors appear to have done more than the minimum necessary in order to overcome this situation at the wholesale houses and would have done still more, as for example, in confirming receivables and securing original deposit slips from the bank if these steps had been acceptable to the management.

The facts of this case impel us to observe that the auditors should not be looked upon as the only defense against collusive fraud committed by dishonest corporate officials. In the corporate organization the directors presumably represent the stockholders in the management of the company’s affairs and they in turn entrust active operation of the business to certain of their number or to others who are elected to serve as administrative officers. It seems to us that the directors have a duty to the stockholders to inform themselves concerning the nature of the business conducted and to see that proper internal safeguards are provided to protect the assets committed to their care. Among the safeguards suggested by this record are appropriate subdivision of operating and accounting functions consistent with available personnel and reasonable economy, and the strengthening of the position of the comptroller by making him responsible to the board of directors rather than subservient to operating officials whose operations he is expected to report upon in a

<sup>1413</sup> Instruction Book for Form 10 for Corporations, p. 15; Instruction Book for Form 10-K for Corporations, pp. 11-12; and Regulations S-X, Rule 2-02 (b). Interpreted in practice as including an adequate system of internal check and control.

<sup>1414</sup> In the *Matter of Interstate Hosiery Mills, Inc.*, 4 S. E. C. 706 (1939).

candid manner. To fulfill his protective function the comptroller needs the sympathetic support of the board in providing him with assistance to perform his many duties in an effective manner.

### K. REVIEW PROCEDURE

Adequate and competent supervision of the audit seems to be taken for granted by most writers on auditing for very little attention is given in the texts to the problems of staff management and review procedure. On this latter point, the testimony of Ritts, Thorn, and Rowbotham as to the part played by senior, manager, and partner parallels quite closely Thornton's book on the "Duties of the Senior Accountant". This pocket-size book of ninety-one pages appears to be a fair summary of the Price, Waterhouse & Co. conception of staff management and control and review of the work.

The procedure laid down contemplates a continuous process of review, for the senior is expected to check all schedules turned in by juniors and to apply various tests to determine the reliability of the results obtained.

"Small errors and inflations are not to be detected in this way; the object is to make certain that the accounts are not grossly wrong. The detail work of the staff must be depended upon for detection of smaller errors.

"Briefly, the statement of what a company claims to have should be met with the question: Where did the company get it? Conversely, the claim that profits have been made should be met by the question: Where are the proceeds? If the auditor can satisfy himself that the records answer these questions satisfactorily he is not likely to be seriously deceived."<sup>145</sup>

Work on McKesson units audited by branch offices of Price, Waterhouse & Co. was subjected to a double check—once in the branch and again by the manager in the New York office before the reports were submitted to the partner. Responsibility for making a final review of all work in the McKesson case rested on the partner, Rowbotham. On an engagement of this size the detailed review of the working papers ended with the manager, and the partner's time was saved by the preparation of a memorandum covering the important points on the job. As to this stage in the procedure Thornton observes:

"A senior who is once detected in the act of smoothing over defects in order that the partner who reviews the work may not know of them is forever barred from complete trust and will find promotion limited.

"Partners' time is valuable; the senior should try to present his work and explain his ideas about it as briefly as possible consistent with a clear exposition of the facts. At the same time, if there be any questionable matter involved in the work he must, if necessary, force it upon the attention of the reviewer. If trouble should come later because of such a matter, the excuse that the partner was too busy to listen would not be accepted.

<sup>145</sup> Duties of a Senior Accountant, p. 27.

"When accounts have been made up correctly in accordance with the records, the senior's work is not completed. If the work has been done properly the senior should have formed definite opinions as to the amount of faith that may be put in the records and the system of accounting, the faults and weaknesses of methods in use and the possibilities of improvement. These conclusions should be laid concisely before the reviewing partner."<sup>1416</sup>

This review program, which in addition included the checking by staff members of extensions, footings, and references in the typed report, is fairly representative of current practice. However, the question remains as to how well it was executed by Rowbotham in his review of Jaureguy's and Thorn's work over a period of ten years.

Judging from Rowbotham's testimony, reported elsewhere in this volume, his primary interest was in assuring himself that sound accounting principles were employed and that proper inquiry had been made in connection with certain features which he called "points of the job." Except to ask whether the matter had been looked into, he did not concern himself directly with the question of internal check and control.

Under the regular procedure established by Price, Waterhouse & Co., important points, worthy of Rowbotham's mature reflection (he had been with the firm twenty years when he took over the McKesson assignment), were reported to him in writing in two ways—in the memoranda prepared by the senior or manager to bring out important points in the work and in the detailed report on the consolidated accounts and shorter letters on the other accounts prepared for submission to Coster. As previously stated, however, the letters on the Canadian Company and Connecticut Company, later Division, usually contained no comment.

While the memoranda pointed out many of the significant features of the business purportedly carried on through W. W. Smith & Company, Inc., particularly the remarkable record of collections, something would appear to have been lacking either in their preparation or review for Rowbotham remained uninformed on some vital points. For example, the 1932 memorandum on the Connecticut Company<sup>1417</sup> mentioned on one page that the bulk of the crude stocks were purchased from W. W. Smith & Co., and on the next that McKesson's sales to a large class of foreign trade were made through this concern.<sup>1418</sup> In connection with a discussion of the difficulty of getting satisfactory price quotations on the foreign crude drug inventory and in considering whether because of falling market prices the inventory should have been marked down at the year end, the memorandum also noted that approximately 50% of the Connecticut Company's December 31, 1932 inventory was sold at a small margin of profit

<sup>1416</sup> *Idem*, pp. 35-36.

<sup>1417</sup> Ex. 81.

<sup>1418</sup> Pages 225-226 *supra*.



prior to the completion of the examination, indicating an annual rate of turnover for 1933 based on the period to February 18, 1933 (the date of the memorandum) of approximately 4 times. The annual rate of turnover for 1933 was only slightly over 2 times and for 1932 had been below 2.<sup>1419</sup> Rowbotham when questioned at the hearings concerning this disproportion testified that he thought the sentence in the memorandum referred to firm contracts for future billings, thus not indicating recorded sales; but Ritts then stated that actual sales were meant.<sup>1420</sup> It thus appears that the manner in which the business was purportedly conducted through Smith was not clear to Rowbotham.

Again the 1935 memorandum on the Canadian Company reported that the Company intended to claim exemption “\* \* \* under Section 4K, Part II, of the Dominion Income War Tax Act on all profits arising since \* \* \*” April 3, 1935 as of which date it was authorized to carry on business as a foreign corporation in the State of Connecticut.<sup>1421</sup> Also, on top of the 1935 working papers, Ritts had made a notation to the effect that at December 31, 1935 all stocks were stored in Canada “\* \* \* meaning that there is a point I must clear with someone.”<sup>1422</sup> (The inventories were supposed to have been in Bridgeport at December 31, 1934.) As previously pointed out, the 4(k) exemption applied only to companies whose assets were situated entirely outside of Canada.<sup>1423</sup>

Finally there was only one reference in any of the memoranda to Manning & Company as a bank. The 1931 memorandum on the Connecticut Company<sup>1424</sup> reported that “\* \* \* Prior to 1931, McKesson & Robbins did this class of business through Manning & Co., Montreal, but during the year the latter went into the private banking business exclusively and sold its export business to W. W. Smith & Co. \* \* \*.”<sup>1425</sup> But no further mention was ever made of Manning & Company or that since 1932 all payments on account of foreign crude drug sales throughout the year were purportedly made by the customers directly to Manning & Company who in recent years also purportedly made all payments on account of foreign crude drug purchases. Since even Ritts and Thorn testified that they were unaware of this prior to the hearings,<sup>1426</sup> Rowbotham must also have

<sup>1419</sup> Page 304 *supra*.

<sup>1420</sup> Page 310 *supra*.

<sup>1421</sup> Ex. 73.

<sup>1422</sup> R. 518 quoted at page 275 *supra*. See also R. 599, 4474. The 1935 memorandum on the Canadian Company and the 1936 and 1937 memoranda on the Connecticut Division point out that the confirmations received from the Canadian vendor-custodians did not state the exact location of the stocks. Page 274 *supra*.

<sup>1423</sup> Pages 286-287 *supra*. Cf. also indenture provision “\* \* \* exclusive of goods purchased abroad which are either in foreign warehouses or in transit \* \* \*” The inventories in question were not so considered and treated by the auditors. Pages 341-342 *supra*.

<sup>1424</sup> Ex. 82.

<sup>1425</sup> Pages 201-202 *supra*.

<sup>1426</sup> Footnote 642 *supra*.

been uninformed on this. It follows that Rowbotham must also have been unaware of, and thus could not have reviewed the work with respect to, the fact that for the last three years of the engagement the actual remittances from customers were not available for anyone's inspection at the client's premises and since the goods themselves were supposedly held by the suppliers and shipped to the customers by Smith, the transactions were conducted entirely "offstage".<sup>1427</sup>

Turning now to a consideration of the detailed audit reports on the consolidated accounts, it seems to us that such figures as were set forth concerning particulars of the foreign crude drug business and indicating its remarkable growth with all profits going back into increased inventories and receivables<sup>1428</sup> should have suggested the desirability of independent inquiry to a person with some knowledge of the drug trade. If review by a partner is to prevent less experienced staff men from being too easily satisfied by explanations of clients and to keep them from erroneous conclusions as to the satisfactory state of the clients' affairs, it would appear necessary that the partner have had experience with other companies in the same line of business or else undertake to inform himself in respect to the industry as a basis for a sound judgment.<sup>1429</sup>

A paragraph in Montgomery's *Auditing* is so directly in point here that it is quoted:

"There is available a constantly increasing quantity of informative business statistics compiled by government bureaus, chambers of commerce, bureaus of research, financial institutions, trade associations, and manufacturing groups. Many large audit firms have available statistical information relative to clients in the same line of business which they can ethically use without divulging confidential information. The auditor should take advantage of the comparisons which these sources of information afford. He may be enabled to make valuable comparisons of the client's production costs with those of the industry as a whole or of ratios based on the client's records with ratios for the industry as a whole. The knowledge thus gained should be of great aid in reviewing the client's operations."<sup>1430</sup>

The mechanics of the review procedure as carried out by Price, Waterhouse & Co. on the McKesson & Robbins engagement were substantially the same as that of the majority of accounting firms. A review of the record convinces us that the seniors' reports to the partner in charge were intended to be fully informative of important points of the engagement, and that any omissions now noted were due to a failure to perceive their significance at the time. It is equally clear that in Rowbotham's mind Thornton's two questions: "Where

<sup>1427</sup> Cf. page 392 *supra*.

<sup>1428</sup> Pages 334 ff. *supra*.

<sup>1429</sup> R. 1945-1946 (Rowbotham): "No, I have not had any other experience in a business like this except this."

<sup>1430</sup> Montgomery, 5th Ed., p. 685. See also Thornton and Trouant quoted at page 420 *supra*. Cf. footnote 1311 *supra*.

did the company get what it had?" and "Where are the proceeds of profitable operations?" were answered to his satisfaction before he approved the report. However, the review of the work did not result in a searching analysis of the ultimate facts developed in the course of the actual audit, because, although performed by a partner of many years' experience,<sup>1431</sup> it was not done by a person sufficiently familiar with the business practices of the client's industry, or with a sufficient interest in the basic questions of internal check and control to comprehend the significance of the facts reported.<sup>1432</sup>

## L. THE REPORT AND CERTIFICATE

Our conclusions concerning the use of the auditors' detailed report submitted to Coster have already been discussed<sup>1433</sup> and therefore present consideration of this subject may be limited to the certificate which is attached to the financial statements which are filed with this Commission and the various stock exchanges, which are submitted to stockholders, and which are otherwise made available to investors. As to the form of the certificate, Price, Waterhouse & Co. followed generally accepted practice during the period of the Girard-McKesson engagement and hence the facts in this case may be used as a point of departure for a discussion of the general problem.

For five years prior to the McKesson hearings the form of certificate below, developed by the American Institute of Accountants in collab-

<sup>1431</sup> See page 374 *supra*.

<sup>1432</sup> "We think it is self-evident that the review upon which an accounting firm assumes responsibility for work done by subordinates must be more than a series of perfunctory questions as to the performance of particular items in an audit program. Nor should explanations of unusual items be accepted by a reviewer without support in detail from the working papers. As a matter of principle, a review should, it seems to us, be designed with two objectives in mind: first, to insure the integration of the original work papers with the financial statements; second, a searching analysis of the ultimate facts developed in the course of the actual audit. An adequate review with the first purpose in mind should serve not only to disclose intentional or accidental misstatements but should also serve as a method of internal check and control on the work of the firm's subordinates. This branch of the review, it seems to us, need not necessarily be carried out by a partner but should at least be done by one well versed in the procedures adopted by the firm and in the general principles and terminology of auditing and accounting. If not a partner of the firm, such review should, in our opinion, be made by persons who are independent of those actually performing or supervising the audit work as well as of those who prepared the draft of the financial statements. The second branch of the review is designed to enable the accounting firm to interpret intelligently the figures it has obtained and to which it is to certify. This part of the review should, it seems to us, be made by a person, preferably a partner, qualified by his knowledge of sound accounting principles and his familiarity with the accounting phases of the industry and the more important problems of the particular company. In this manner the facts ascertained by competent employees can be subjected to the independent and broader judgment of a more experienced person who can by searching inquiry of the supervisor or senior and by examination of significant items in the work papers and schedules reach an informed judgment both as to the adequacy of the audit work done and as to the integrity and clarity of the financial statements themselves. We are satisfied that a review along these lines would have exposed the irregularities in this case." *In the Matter of Interstate Hosiery Mills, Inc.*, 4 S. E. C. 705 (1939).

Of the testimony of the expert witnesses, at least that of Horne, P. 362-363; Couchman, P. 415-417; Bailey, P. 573-575; and Jones, P. 614-615, indicates that their practice is fully as strong as that contemplated in the opinion quoted. It should be noted in this regard that this testimony was given before the opinion referred to was published.

In respect to the importance of a thorough inquiry into the client's system of internal audit and control in relation to the audit by independent public accountants, see *In the Matter of Monroe Loan Society*, 3 S. E. C. 407 (1938).

<sup>1433</sup> Pages 368 ff., 427 *supra*.

oration with the New York Stock Exchange, had been in common use:  
 "To the XYZ COMPANY:

"We have made an examination of the balance sheet of the XYZ Company as at December 31, 1935, and of the statement of income and surplus for the year 1935. In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.

"In our opinion, based upon such examination, the accompanying balance sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the XYZ Company during the year under review, its position at December 31, 1935, and the results of its operations for the year."

This form of certificate is set out in the bulletin, "Examination of Financial Statements by Independent Public Accountants," but it is there stated that its use is appropriate only if the terms laid down in the following notes, which are published immediately below the form, have been observed:

"1. It is contemplated that, before signing a report of the type suggested, the accountant will be satisfied that his examination has been adequate and in conformity with the principles outlined in this bulletin.

"2. The report should be addressed to the directors of the company or to the stockholders, if the appointment is made by them.

"3. The statement of what has been examined would, of course, conform to the titles of the accounts or statements reported upon.

"4. In the second sentence, any special forms of confirmation could be mentioned: e. g., 'including confirmation of cash and securities by inspection or certificates from depositaries.'

"5. This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year. If there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated.

"6. It is contemplated that the form of report would be modified when and as necessary to embody any qualifications, reservations or supplementary explanations." 1434

The essential features of the foregoing certificate have also been used by independent public accountants as complying with the requirements of this Commission as expressed in the Instruction Book for Form 10-K for Corporations:

#### "ACCOUNTANTS' CERTIFICATE

The financial statements required shall be accompanied by a certificate of an independent public or independent certified public accountant or accountants. This certificate shall be dated, shall be reasonably comprehensive as to the scope of the audit made, and shall state clearly the opinion of the accountant or accountants in respect of the financial statements of, and the accounting principles and procedures followed by, the registrant and its subsidiaries. In certifying to the

<sup>1434</sup> Ex. 117 (p. 41).

financial statements, independent public or independent certified public accountants may give due weight to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. In such case the independent accountants shall review the accounting procedures followed by the registrant and its subsidiaries and by appropriate measures shall satisfy themselves that such accounting procedures are in fact being followed. Nothing in these instructions shall be construed to imply authority for the omission of any procedure which independent public accountants would ordinarily employ in the course of a regular annual audit."<sup>1435</sup>

All of the witnesses interpreted the last three sentences so as to permit and not to forbid the certifying accountant to give due weight to the client's system of internal check and control, whether or not this system included a staff of internal auditors.<sup>1436</sup> That the accountant must determine as a part of his audit the effectiveness of this system and adjust his audit program thereto should be recognized as the cornerstone of any examination of financial statements. In our opinion, the determination of the effectiveness of control requires the attention of an auditor of experience and sound judgment as many of the factors involved are of an intangible nature and not capable of reduction to precise rules. Final appraisal of the extent to which the audit program may be affected by the system of internal control is a problem worthy of consideration by the person who signs the certificate and should be the subject of searching review by him before the conclusion of the engagement.

On another point opinion among the accountants was also substantially uniform. The second sentence of the standard certificate was understood to be in full compliance with that part of the Commission's rule which requires that the certificate "\* \* \* shall be reasonably comprehensive as to the scope of the audit made \* \* \*."<sup>1437</sup> This general opinion was based on the fact that accountants understood that the certificate in this form should not be used unless the examination has been substantially that outlined in the Bulletin. Although the Bulletin has had a fairly wide distribution in financial circles, it may be safely assumed that the majority of corporation stockholders have either never heard of it or are unfamiliar with its contents. This raises a puzzling problem therefore as to whether the second sentence in the certificate, as respects the average investor, actually amounts to a reasonably comprehensive description of the audit made and if not, how the defect can be cured. In expressing their opinion on the sentence, two witnesses extended their answers to suggest possible solutions to the problem just raised.

<sup>1435</sup> Pp. 11-12. Similar requirements appear in other forms adopted by the Commission under the Securities Exchange Act of 1934 and in Rule 651 under the Securities Act of 1933. See Regulation S-X, Rule 2-02 adopted in 1940, for a restatement of the requirements.

<sup>1436</sup> E. g. Rowbotham, pages 348-350 *supra*; Bell, P. 212; Lenhart, P. 264; Bailey, P. 577.

<sup>1437</sup> Rowbotham, page 348 *supra*; P. 50, 107, 161, 212, 261, 308, 364, 417, 469, 526 (taking exception), 616.

The question asked of all the expert witnesses was:

Q. [By MR. WERNTZ.] \* \* \* is it your understanding that the second sentence of the first paragraph [of the standard certificate] is intended to be a reasonably comprehensive statement of the scope of the audit?

\* \* \* \* \*

A. [By STEMPF.] Yes. Here it is a question of deciding where to draw the line. Full details of all audit steps are obviously impossible, because they are so voluminous. The so-called long form of certificate goes only slightly further than the second sentence. The second sentence points out the general scope of the examination in conformity with the bulletin and indicates its limitations.

I should like to add there that the standard form of accountant's report cannot be read and cannot be understood unless the reader knows that it is directly related to the bulletin. And I am sorry to say that it is my distinct impression that there are relatively few investors who have any knowledge of that fact and perhaps to some degree a reasonable number of informed men who do not realize the relationship between the standard form of report and the pamphlet, and that in spite of the issuance of, I think, about 50,000 copies of the pamphlet.

Q. Have you any thought there as to how a better mutual understanding could be reached?

A. I think all of us should try to emphasize that fact whenever the discussion of accountant's reports, particularly in the standard form, arises, regardless of who may raise the question. I think if we can continue to reiterate the fact that the two must be read to be understood, that we'll do everyone a real service.<sup>1438</sup>

\* \* \* \* \*

A. [By BAILEY.] I don't think it is particularly comprehensive or definite. I think it is a conventional wording intended to be used for such an examination as is contemplated by the bulletin, but before the wording can be really useful I think there must be a wider appreciation of that particular convention.

I think we accountants may find that the difficulty of a common understanding on that sentence is great, so great that we may find it advisable to make the scope paragraph more definite.<sup>1439</sup>

The issue is clearly drawn in these two views. Before the agreement on the standard form of certificate in 1934, accountants had used a rather wide variety of language in which to couch their certificate. Samples of three methods of attacking the problem are presented by Montgomery with his opinion of each. Two of his examples demonstrate methods of complying with Bailey's suggestion so that a somewhat extended quotation provides a suitable means of illustrating the differences of opinion on a question which has been debated extensively in recent years.

*Types of Certificates.*—In the author's opinion the certificate should be as short and concise as possible. Extended statements of the steps taken by the auditor in his verification are of little interest to the reader and do not belong in the formal certification. The auditor is expected to take responsibility for judging what constitutes a reasonable program of verification for any particular examination and based on such verification, to be prepared to express a positive opinion. Of course if he has been restricted in his examination but still feels justified in making

<sup>1438</sup> P. 161.

<sup>1439</sup> P. 576.

some formal statement, such limitation will have to be expressed as a qualification in the certificate.

"Likewise the author believes it is generally better to exclude from the certificate comments regarding items in the financial statements, except when explanations of material significance are required to make the statements complete. It is preferable that the financial statements be complete in themselves so that the auditor's certificate may conform as nearly as possible to the unqualified short type.

*Short Form.*—When asked their preference, most bankers and clients ask for short certificates. In support of the argument for a short certificate, the president of a large bank wrote the author, 'We frequently observe certificates which require as close an analysis as the figures themselves. Some standardized form of audit which would carry with it all that the word implies would be most acceptable, I think, to bankers generally.'

"The ideal certificate is brief, to the point and embodies conclusions based solely on the auditor's investigations.

\* \* \* \* \*

"When an income account is submitted in addition to a balance sheet, the following form of certificate (drawn also to cover the case of consolidated statements) may be used:

"D. E. F. COMPANY,

New York, N. Y.

"We have examined the accounts of D. E. F. Company and its subsidiary companies as at December 31, 1933, and we certify that, in our opinion, the above consolidated balance sheet and the accompanying consolidated income and surplus accounts set forth the financial position of the company and its subsidiaries at that date and the results of their operations for the year then ended.

X. Y. Z.

"NEW YORK, March 10, 1934.

\* \* \* \* \*

*Long Form.*—Some auditing firms frequently use the so-called long form or amplified certificate in which comments are made regarding the inventories, depreciation, plant additions, etc. A form of this type, subject to variations to suit particular situations, is as follows:

"THE BOARD OF DIRECTORS, A. B. C. COMPANY.

"We have made an examination of the books of account of A. B. C. Company and its subsidiaries as at December 31, 193—, and have made a general review of the accounting methods and of the operating and income accounts for the year.

"We have confirmed the cash and securities by count and inspection, or by certificates which we obtained from the depositaries. The investments in wholly owned and majority owned companies not consolidated, but included as 'investments' in the accompanying consolidated balance sheet, are carried at valuations which in our opinion are conservative.

"We have scrutinized the accounts and notes receivable and believe that full provision has been made for probable losses through bad and doubtful debts.

"Certified inventories of merchandise, work in progress and materials and supplies, have been submitted to us and, in our opinion, these inventories have been taken in a careful manner with ample allowance for old or inactive stocks and are conservatively stated on the basis of cost or market, whichever is lower.

"We examined the charges to capital accounts and believe them to represent additions or improvements to the company's property. In our opinion, adequate allowance has been made in the operating accounts for repairs, renewals and depreciation, and all ascertained liabilities at December 31, 193—, have been included in the accounts.

"In our opinion, based upon such examination, the accompanying consolidated balance sheet and statements of income and surplus, fairly present the consolidated financial position of the companies as at December 31, 193—, and the consolidated results of their operations for the year ended that date.

X. Y. Z.

"NEW YORK, February 10, 193—.

"The weakness of the long form of certificate illustrated above is that while certain specific aspects of the scope of verification are set forth, the phrase 'based upon such examination' in the last paragraph places the burden on the reader of judging whether the scope was adequate, a responsibility which, as has been pointed out, the auditor himself should assume.

"In the following portion of a certificate, which might replace all but the first paragraph of the preceding example, a brief statement of opinion on certain major matters is combined with the auditor's opinion regarding the statements as a whole in a manner which is not objectionable:

"In our opinion, based upon such examination, the charges to property accounts cover only actual additions and extensions, the allowances for depreciation and depletion are reasonable, the valuations of stocks of material and supplies on hand (as shown by inventories certified by the responsible officials) have been made at the lower of cost or market prices, proper allowance has been made for doubtful accounts receivable and for all ascertained liabilities, and the accompanying consolidated balance sheet and related consolidated income and surplus accounts fairly present, in accordance with acceptable principles of accounting consistently followed by the companies during the year under review, the consolidated financial position of \* \* \* Corporation and its subsidiary companies as at \* \* \*, 193—, and the consolidated results of their operations for the year then ended." 1440

Another problem in this field is illustrated in the present case by the fact that although the certificate was in the usual standard form without mentioning any limitations on the work, certain audit steps were specifically noted in the letters of engagement as points which were not to be done.

"In accordance with your instructions, our work will be conducted, as heretofore, along the lines of a financial or balance sheet examination consisting of an examination of the balance sheets of McKesson & Robbins, Incorporated and its subsidiary companies as at December 31, 1937 and a general review of the profit and loss accounts for the year ending on that date, but will not include a detailed check of the cash and other bookkeeping transactions such as might disclose a misappropriation of funds or manipulation of the accounts, should any exist. It is our understanding that the examination will not include an inspection of bank deposit slips or any circularization of debtors or creditors in verification of receivables and payables." 1441

<sup>1440</sup> Montgomery, 5th Ed. pp. 697-700.

<sup>1441</sup> Ex. 116. See also pages 151-152 *supra*. Cf. also Ex. 100, letter transmitting accounts of Canadian Company:

"In accordance with your instructions, our examination was conducted along the lines of a financial or balance sheet examination, and the debtors and creditors were not circularized for verifications of the receivables and payables. The merchandise carried in the inventories of McKesson & Robbins, Limited at December 31, 1937 was confirmed to us by the vendors who held this merchandise at that date but we have not attempted to otherwise verify the amount of merchandise so held."

The certificate on the Canadian Company accounts was addressed to the shareholders but was otherwise similar to the one on the accounts of the Maryland Company and subsidiaries consolidated. Page 348 *supra*.



And as previously pointed out the auditors placed a note on the balance sheet after inventories, "(certified as to quantity and condition by responsible officials)" "\* \* \* for the purpose of making it clear to anybody who reads the balance sheet that on that point they must accept the word of the company officials rather than the word of the accountants."<sup>1442</sup> At the time of the audits in question the observation of inventory taking or the making of systematic physical tests of inventories and the performance of other audit steps mentioned in the letters of engagement above quoted were not considered mandatory procedures for auditors. Construing the certificate as referring to the type of examination set forth in the Bulletin, no qualification or exception would therefore have been necessary in the auditors' opinion on account of such omissions.

The disclaimer by the auditors as expressed in their letters must, therefore, be construed as merely applying to possible steps which might have been done in excess of what was necessary in order to certify to the financial statements and which, not having been accepted by the client, the auditors specified in their letters in order to relieve themselves from liability for the non-detection of what might have been disclosed thereby. It is generally proper, for example, to certify financial statements without exception although auditing procedures have not been so extensively applied as to disclose every minor defalcation or manipulation, and to avoid any misunderstanding which may arise from subsequent events, for the accountant to state in writing to the client the steps omitted. Obviously, however, if the certificate attached to McKesson accounts is not to be construed as a misrepresentation, it must be interpreted as not limited by the letters of engagement or the note on the balance sheet in stating the full performance of a regular balance sheet examination sufficient in scope for the unqualified expression of opinion as to the authenticity of the accounts.<sup>1443</sup>

From all of the foregoing it appears to us that the following principles should be adopted respecting the form and content of accountants' certificates in order to avoid possibility of confusion in the future.

The work done should be described as the auditor sees fit and any desired information concerning the accounts may be stated. While we do not think that each audit step should necessarily be set forth, it is to be hoped that really descriptive language will be used as distinguished from a standard form based upon procedures set forth in

<sup>1442</sup> Testimony of Rowbotham, page 346 *supra*.

<sup>1443</sup> The most conservative free translation of the meaning of an accountant's certificate was given by the last to appear of the twelve expert witnesses:

"We mean to imply in our certificate that we have made such tests and examinations of the client's accounts and records and supplementary documents and have made such inquiry that we have reason to believe and no reason for disbelief that the statements which we are certifying fairly reflect the condition of the company and the results of its operations." P. 620 (Jones).

a bulletin neither of which is referred to in the certificate. While the road is left clear to the auditor to describe in his own language what he has done and what he has found, we suggest one positive requirement in this connection. The certificate should state as part of the description of the scope of examination every generally recognized normal auditing procedure which has been omitted and the reasons for the omission.

We believe that, in addition to the present expression of opinion that the company's position and results of operations are fairly presented by the accounts, the accountant should certify that the examination conducted was not less than that necessary in order to form the foregoing opinion. This statement may well replace the one generally in use in certificates prior to the present hearings in which the only reference to the examination in the opinion paragraph was in the words "based upon such examination" or "subject to the foregoing" following "In our opinion". Besides not definitely stating whether the examination was sufficient in scope, these words would seem to incorporate all prior references to the examination in the preceding paragraphs of the certificate and base the auditor's opinion thereupon without specifically stating whether those references were purely descriptive or in the nature of exceptions. Exceptions to the scope of the audit or to the accounts should be expressly so stated in the same sentence as the certification as to the scope of the audit and the opinion as to the accounts, respectively.<sup>1443a</sup> Exceptions may be incorporated by reference in such sentences but must be specifically designated as "exceptions". If any required information has been withheld by the client or access to records denied these facts should, of course be treated as exceptions.

We said above that the auditor should certify that the examination was not less than the required minimum of accepted practice both as to procedures and the manner of their application. While accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them, we do think they can and should certify that the examination, on which their opinion as to the financial statements was based, was at least equal to professional requirements.

It has been noted that the American Institute of Accountants has announced extensions of auditing procedure applicable to two important classes of assets—receivables and inventories. As adopted on May 9, 1939 the following instructions were given:

<sup>1443a</sup> But cf. *In the Matter of Resources Corporation International*, 7 S. E. C. — (1940) (Securities Act of 1933 Release No. 2294), in which it was held that because of their broad scope the "exceptions" to the accounts and to the auditing procedures employed were such as to prevent the report of the accountant being accepted as a "certificate" under the rules of this Commission.

“\* \* \* That hereafter, where the independent certified public accountant has not made, or observed the making of, physical tests by count, weight, or measurement, either because such tests in his opinion are not practicable or reasonable, or because he has departed from normal auditing procedure, he shall make suitable explanation or exception in reporting on the financial statements of a concern over his signature;”

and in respect to confirmation of receivables:

“\* \* \* That hereafter, where the independent certified public accountant, for any reason, has not made such confirmation, he shall make suitable explanation or exception in his report.”

These instructions were omitted from the modified version of “Extensions of Auditing Procedure” adopted by the Institute at the Annual Meeting, September 19, 1939, and the following explanation was offered:

“The committee reiterated its recommendation of May 9th that, where exceptions were required, such exceptions should be expressed clearly and unequivocally. However, where exception was not called for under the terms of the report, it was felt that no good purpose would be served by requiring negative explanations, because discussion and experience in the meantime had demonstrated that negative references in the auditors’ report gave rise to misconception in that they tended to convey implications of reservations or exceptions where none existed or was intended. In other words, they had the effect of casting an unwarranted cloud on the statements.”<sup>144</sup>

As indicated above, we feel that the position taken in May would lead to the more satisfactory results and that the disclosure required in that earlier version is the minimum that we should accept as complying with our requirements for disclosure of the scope of the audit. And if the form of the certificate follows our suggestion set forth above, it should be clear from its language whether the reference is intended as an exception on the one hand or purely as a matter of information or description on the other.

### M. THE FEE

As previously pointed out the officers and directors of McKesson many times considered the audit fees with a view to cutting or keeping them down and avoiding what they believed to be unnecessary and unorganized work. From the point of view of the client, it is clear that better work at possibly a lower cost could be obtained if it were possible for the auditors to spread their work more uniformly through the year and avoid the employment of large temporary staffs during the present peak season following the close of the calendar year. Obviously such highly temporary employment can be fair neither to the men employed nor to the responsibilities of the firm to have their work performed by men of high professional calibre. As a step to solve this problem accountants for many years have advocated what is known

<sup>144</sup> See Appendix A.

as the "natural business year", which means that a business should use as its accounting period any twelve consecutive months which contain one full cycle of operations. The closing date should be the month end at which activity is at its lowest ebb, and the company's staff is free to take on the added burden incidental to summarizing the year's work. Additional economies accruing to business from this procedure include a lower cost of inventory taking because of smaller stocks and resulting shorter interruption of normal activities, and a lower auditing expense due to the fact that less audit work would be required when many items such as customers' accounts, inventories, and creditors' accounts, to name the principal ones affected, are at low levels. Furthermore greater confidence could be placed in the accuracy of the results than under present-day conditions. The combination of these advantages should lead to more accurate statements of condition and operating results, which in turn should mean more reliable information for the credit grantor and investor.<sup>1445</sup>

Accountants for a long time have been aware of this situation, but the apparent inertia of business men in this connection warrants the reproduction of comments of two of the expert witnesses. These comments cover many of the points mentioned above, and do so in a frank and convincing manner:

"A. [By LENHART.] The most important results in my mind would be the fact that the public accountant could maintain an organization of higher ability. It is very, very difficult nowadays to handle the rush-season work for the reason that each concern must take on temporary men. With complexities of business that there are today, the large number of taxes, various regulations that arise, the number of competent men to do audit work is relatively scarcer than it was 10 or 15 years ago. If engagements were staggered so that the public accountant could maintain an even staff, he probably could do much more toward developing a more competent organization which would do better work, possibly take a little more time, undoubtedly could charge the client less, undoubtedly could pay the men more, with better results all around.

Q. [By Mr. WERNITZ.] Would there be any technical advantages in the point of view of the statement, determination of income, for example?

A. Yes. If each company were to adopt as its closing date the most logical date, they would certainly be able to present a better balance sheet. It would be able to make more effective comparisons with other companies in the same line of business, it would be under less expense to take its inventory and prepare its own financial statements. It will probably have more time to devote to the preparation of financial statements and there would also be corresponding benefits to credit grantors, to commissions, governmental bodies.

Q. Would you say that the allocation of income would be facilitated in view of the lower inventories, for example?

A. Yes; I think it would.<sup>1446</sup>

\* \* \* \* \*

A. [By BROAD.] In most accounting organizations an unduly large proportion of the work falls in the short period from, say, January 1 to March 31; probably more than half the number of engagements handled in a year reach their

<sup>1445</sup> See Securities and Exchange Commission, Accounting Series Release No. 17.

<sup>1446</sup> P. 266.

culmination within this period. This has resulted in a situation which no one deploras more than the auditor; namely, an excessive physical burden on all members of the accounting organization as well as the necessity for supplementing staffs by the addition of temporary assistants.

Under such continuous forced pressure, one would be a hardy soul who could conscientiously assert that the accountant has as much time for reflection, or to give all his clients the same amount of time, service, and attention, as he could if the work were spread more evenly throughout the year so that a full-time permanent staff could be occupied more or less continuously throughout the 12-month period.

Much could be done to alleviate the situation referred to through the adoption of a natural business year. There is no particular virtue in having a company's fiscal year end at the close of the calendar year; on the contrary, in many lines of business some other date would have distinct advantages to corporations and their officials in that the accounts could be closed at the end of a season of activity and before the commencement of the next season.

At such a time inventories, accounts receivable, and accounts payable are normally lower and the company is usually in its most liquid position, so that statements based on a relatively larger proportion of completed transactions could be prepared in which the elements of judgment and estimate would be minimized.

Furthermore, the officials and their staff in a season when activities are reduced, could give more attention to closing transactions with less interruption to their normal daily duties. This idea of "the natural business year" has been supported by accountants quite strongly, but, as they would themselves also benefit from the change through relief in the present congested period, support from influential disinterested bodies or from industry itself would be much more effective."<sup>147</sup>

#### **N. CIRCUMSTANCES AVAILABLE FOR THE AUDITORS' OBSERVATION IN THE RECORDS AND PROCEDURES OF GIRARD & CO., INC., McKESSON & ROBBINS, LIMITED (CANADA), McKESSON & ROBBINS, INCORPORATED (CONNECTICUT), AND McKESSON & ROBBINS, INCORPORATED (MARYLAND-CONNECTICUT DIVISION) WHICH MIGHT HAVE LED TO THE DISCOVERY OF THE FRAUD**

The firm of Price, Waterhouse & Co. for fourteen years served as independent public accountants for F. Donald Coster's enterprises. Within range of the procedures which they followed there were numerous circumstances which, if they had been recognized and carefully investigated by resourceful auditors, should have revealed the gross inflation in the accounts.

We are convinced that despite collusion and skillfully prepared false documents these items repeated themselves to such an extent as to have permitted detection of the gross inflation by alert auditors intent upon knowing the truth about the foreign crude drug operations. Investigation of one item followed in turn by another and so on must, in time, have created a feeling of uncasiness which could not have been dispelled by explanations even from the highest officers of the Company

<sup>147</sup> P. 55-56.

but which should have caused the auditors to associate one unusual circumstance with another and to correlate their observations in such a way as to cast doubt upon the plausibility of the transactions under review. The known close association of F. Donald Coster and George E. Dietrich in their control and operation of the foreign crude drug business should have stimulated rather than discouraged such an approach.

A partial list of circumstances of the character suggested is given below. We must emphasize that the list has been prepared with the aid of hindsight after exposure of the fraud and a thorough investigation of the circumstances surrounding it. We, therefore, can not say and do not say that every one of the items should have been recognized by the auditors as significant and, if investigated, would have led to the exposure of the gross falsification of the financial statements. It is also quite conceivable that for a time many could have been and perhaps were explained away. We do believe, however, that the number of items and the period of time over which some of them repeated themselves gave ample opportunity for detection by alert and inquisitive auditors.

The list is presented in the same order as the discussion in previous sections of this report, to which reference is made after each item. Some of the items in the list were present in only one year, others in a limited number of years, but most of them apply to a substantial part of the period under review—1924 to 1938.

### 1. Internal Check and Control

1. Authority of F. D. Coster and George E. Dietrich, who originated all foreign crude drug transactions, to approve all vouchers and sign all checks. Pages 50, 179, 415–416.

2. No countersignature was required at first and this was later changed, in form only, by allowing minor subordinates of Dietrich to countersign. Page 179.

3. Disbursement vouchers for sundry expenses could originate with George E. Dietrich who signed the checks. Page 180.

4. George E. Dietrich's control over all incoming mail and foreign crude drug outgoing mail. Pages 50–51, 86, 184, 383.

5. Failure to record mail remittances independently and absence of duplicate deposit slips at Bridgeport. Pages 113–117, 180–181, 184, 196–197, 383, 387.

6. Cashiers did not at any time see actual remittances from foreign crude drug customers. Pages 91–93, 94, 113–117, 180–181, 197.

7. George E. and Robert J. Dietrich never took vacations. Pages 52–53, 182, 185–186, 188–189, 383, 385.

8. Combination in George E. Dietrich of duties of the treasurer's department with those in regard to foreign crude drug operations. All documents covering purchases and sales of foreign crude drugs, except receiving tickets, went through George E. Dietrich. Pages 49-50, 68-86, 89-92, 93-97, 99-101, 113-115, 183, 184-185, 187, 382, 383-385.

9. Bank statements were reconciled by the cashier's office under George E. Dietrich while the comptroller's office did not have free access to cancelled checks or to the bank statements. Pages 99, 130, 179-180, 200.

10. Concentration of control of receiving, shipping, and stock-keeping in the hands of Robert J. Dietrich. Pages 51-52, 76, 108-113, 185, 187, 281-283, 290.

11. The apparent close relations between Coster, George Dietrich, and Robert Dietrich in the operation of the foreign crude drug business and the inaccurate and misleading nature of the McKesson "Master Organization Chart" in failing to disclose this fact. Pages 49-50, 52-53, 179, 181-182, 184, 186, 190-191, 290.

12. Domineering control exercised by Coster over routine operating and accounting details of the business, especially at Bridgeport. Pages 107-108, 124, 156, 181-182, 184, 186, 188-189, 328-329. Ex. 14 (especially Item 12).

## 2. Cash in Banks and on Hand

13. Lack of evidence as to how customers were advised to pay Manning & Company. Pages 89-92, 95, 209-211, 391.

14. Unusual circumstances surrounding the operation of the Manning & Company transactions, including:

(a) Checks were never used on the Manning & Company account. Pages 67-68, 199, 212, 390.

(b) No documents of any kind were returned with the monthly statements or with the debit advices. Pages 99, 199, 212, 390.

(c) No service charges appear on either the debit or credit memoranda or on the monthly statements. Pages 57, 205, 390-391.

(d) Manning & Company was not listed on the daily cash report to the treasurer of McKesson although the balance shown on the books as held by this company was included with actual bank balances on the Company's balance sheet. Pages 68, 206-207.

15. Conflicting evidence as to whether W. W. Smith & Company, Inc. was owned by Manning & Company or W. W. Smith & Co. Pages 56-61, 66-67, 201-205, 389-390, 419.

16. All foreign crude drug transactions including those of the Canadian Company were carried on in United States dollars and the balances were supposedly carried by Manning & Company in New York although the reason advanced for using Manning & Company

(purportedly a Canadian firm) as agent to carry on this business was to promote goodwill within the British Empire. Pages 67, 205-208, 391.

### 3. Foreign Crude Drug Receivables

17. Remarkable collection experience—prompt payment in U. S. currency and complete absence of bad debts, allowances, or adjustments of any kind. Pages 93, 97, 98, 217-220, 222-224, 335-336, 393.

18. Goods bought f. o. b. New York and sold f. o. b. New York were purportedly shipped directly from Canada to foreign countries with no adjustments made on this account. Page 86.

19. Nature of the basic guaranty provisions of the W. W. Smith & Company, Inc., contracts as interpreted and applied by McKesson and accepted by the auditors. Pages 218, 220-225.

20. Use of United States domestic bill of lading forms made out to foreign crude drug customers beyond the seas showing "Route THEIR TRUCK" and shipping dates inconsistent with the time that would have been required after receipt of order to make shipments from Canada to overseas customers and without indication on this or other shipping documents as to which vendor was supposedly supplying the merchandise. Pages 77-80, 87-89, 234-238, 402.

21. "Pet" orders were handled in bunches and followed a different office routine from the other orders. Pages 80-86, 239, 302.

### 4. Intercompany Accounts

22. Sales of foreign crude drugs by Canadian Company to Connecticut Division providing funds for Canadian Company's dividend payments in 1937. Pages 98-99, 242, 397-399.

### 5. Foreign Crude Drug Inventories

23. Confirmations secured by Price, Waterhouse & Co. from the vendors did not state where the merchandise was held nor did they give any identifying markings of the items supposedly held. Pages 104, 107, 253-254, 256, 271-272, 276.

24. Lack of correspondence between market quotations and price, quality, packing, and description of items in McKesson's foreign crude drug inventory. Pages 106, 255, 263-270, 400-402.

25. Establishment of Canadian Company with the announced purpose to manufacture and distribute McKesson products in Canada and the British Empire, purchase of goodwill and rights thereto from the Connecticut Company, renting of a warehouse in Canada but failure to use it or to engage in such activities. Pages 28-30, 256-257.

26. Small number of commodities and large quantity of each in the inventory. Pages 105-106, 254, 256-257, 268-271, 337-338.



27. Appearance of the foreign crude drug inventory count sheets of December 31 1934 when compared with other inventory count sheets of the same date, especially the absence of names or initials of inventory crews on the foreign crude drug count sheets. Pages 108-110, 111-112, 257-258, 280-281.

28. Space noted on December 31, 1934 inventory count sheets as the location of the foreign crude drug stocks was inadequate to hold the quantities listed and was designated on other count sheets as, and in fact was, occupied by other goods. Pages 110-111, 280-282, 403-404.

29. Perpetual inventory records never had to be adjusted for discrepancies with the physical count and very rarely to reduce cost to market at the inventory dates. Page 111-112, 283.

30. Slow inventory turn-over but with no goods held over from one year end to the next. Pages 261, 304, 310.

31. Although sales were in smaller quantities than purchases, year-end inventories with rare exceptions corresponded exactly with individual purchases. Pages 104-105 257, 261-262.

32. Lack of knowledge respecting foreign crude items on the part of the clerk to whom the auditors were referred and upon whom they relied for information and assistance in pricing. Pages 264-267.

33. Complete operating isolation of the foreign crude drug business from Hermann's department, although combined in the comptroller's reports to officials. Pages 107-108, 191, 262-263, 269, 301, 310-314.

34. Regular importing of foreign crude drug items for export in conflict with existing cartel restrictions or for shipment in bulk to countries nearer the source of supply. Pages 105-106, 269.

35. Auditors' request for confirmation of over \$2,000,000 in foreign crude drugs addressed to B. Miller & Company, 48 Queen Street, Ottawa, Canada, instead of to 45 Queen Street, was returned because of incorrect address. Pages 104, 272.

36. At December 31, 1934 when count sheets placed the stock in the Bridgeport plant, the Maryland Company's Connecticut tax return for 1934 placed the foreign crude drug inventories outside the state of Connecticut and was supported in McKesson's files with schedules showing this inventory in New Jersey at December 31, 1934. Pages 276-283, 418.

37. The auditors' acceptance of a representation of exemption from Canadian income taxes after 1934 based upon a law exempting corporations doing no business in and holding no assets in Canada although the auditors understood that the inventories were held in Canada after 1934. Pages 274-276, 285-287, 417, 426.

## 6. Other Balance Sheet Accounts

38. Lack of differentiation between W. W. Smith & Company, Inc., W. W. Smith & Co., and W. W. Smith & Co., Ltd. Pages 101, 129, 294-297.

39. Multiple relationships with the Smith Companies as vendee, vendor, sales agency, and guarantor of accounts. Pages 53-67, 99-101, 129, 294-297.

40. Problems encountered on foreign exchange in small matters as contrasted with the absence of such problems in the foreign crude drug business. Pages 205-208, 228, 298.

## 7. Profit and Loss Accounts

41. Classification of sales and cost of sales in comptroller's report to management so that the amount of the foreign crude drug business was not revealed. Pages 107-108, 120-127, 310-315, 421.

42. Every foreign crude drug sale was made at a gross profit. Pages 89-91, 301.

43. Discontinuance of the high profit Dandrofige and hand lotion line coincident with a compensating spurt in the low profit crude drug business in 1931 and 1932 to the same class of customers in Australia and New Zealand. Pages 301-306.

44. Sale of half the inventory prior to completion of the 1932 audit of the Connecticut Company as compared to an inventory turn-over of less than two times for the period under review. Pages 304, 310, 425-426.

45. Relation between the growth of foreign crude drug inventories and receivables and the gross profits of the Connecticut Division (and of the Connecticut Division and the Canadian Company combined) and the failure of the Connecticut Division to produce cash for the Maryland Company. Pages 241-249, 339-340, 427.

## O. SUMMARY

Our conclusion based upon the facts revealed by the record, the testimony of the expert witnesses, and the writings of recognized authorities is that the audits performed by Price, Waterhouse & Co. substantially conformed, in form, as to the scope and procedures employed, to what was generally considered mandatory during the period of the Girard-McKesson engagements. Their failure to discover the gross overstatement of assets and of earnings is attributable to the manner in which the audit work was done. In carrying out the work they failed to employ that degree of vigilance, inquisitiveness, and analysis of the evidence available that is necessary in a professional undertaking and is recommended in all well-known and authoritative works on auditing. In addition, the overstatement

should have been disclosed if the auditors had corroborated the Company's records by actual observation and independent confirmation through procedures involving regular inspection of inventories and confirmation of accounts receivable, audit steps which, although considered better practice and used by many accountants, were not considered mandatory by the profession prior to our hearings.

Price, Waterhouse & Co. maintain that a balance sheet examination is not intended and cannot be expected to detect a falsification of records concealing an inflation of assets and of earnings if accomplished by a widespread conspiracy carried on by the president of a corporation, aided by others within and without the recognized ranks of a corporation's operating personnel, and that no practical system of internal check can be devised the effectiveness of which cannot be nullified by criminal collusion on the part of a chief executive and key employees. Such cases are so rare, in their opinion, that there is no economic justification for the amount of auditing work which would be required to increase materially the protection against it.

The inference to be drawn from this position and from statements made by others in connection with this case is that a detailed audit of all transactions as distinguished from an examination based on tests and samples would have been necessary to reveal the falsification. However, as we view the situation in this case, a detailed audit of all transactions carried out by the same staff would merely have covered a larger volume of the same kinds of fictitious documents and transactions. While this might have brought under review more instances of what we have listed as circumstances suggesting further investigations, there is little ground for believing that this alone would have raised any greater question as to the authenticity of the transactions.

Moreover, we believe that, even in balance sheet examinations for corporations whose securities are held by the public, accountants can be expected to detect gross overstatements of assets and profits whether resulting from collusive fraud or otherwise. We believe that alertness on the part of the entire staff, coupled with intelligent analysis by experienced accountants of the manner of doing business, should detect overstatements in the accounts, regardless of their cause, long before they assume the magnitude reached in this case. Furthermore, an examination of this kind should not, in our opinion, exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted. Without underestimating the important service rendered by independent public accountants in their review of the accounting principles employed in the preparation of financial statements filed with us and issued to stockholders, we feel that the discovery of gross overstatements in the accounts is a major purpose of such an audit even though it be conceded that it might not disclose every minor defalcation. In short, Price, Water-

house & Co.'s failure to uncover the gross overstatement of assets and of earnings in this case should not, in our opinion, lead to general condemnation of recognized procedures for the examination of financial statements by means of tests and samples.

We do feel, however, that there should be a material advance in the development of auditing procedures whereby the facts disclosed by the records and documents of the firm being examined are to a greater extent checked by the auditors through physical inspection or independent confirmation. The time has long passed, if it ever existed, when the basis of an audit was restricted to the material appearing in the books and records. For many years accountants have in regularly applied procedures gone outside the records to establish the actual existence of assets and liabilities by physical inspection or independent confirmation. As pointed out repeatedly in this report, there are many ways in which this can be extended. Particularly, it is our opinion that auditing procedures relating to the inspection of inventories and confirmation of receivables, which, prior to our hearings, had been considered optional steps, should, in accordance with the resolutions already adopted by the various accounting societies, be accepted as normal auditing procedures in connection with the presentation of comprehensive and dependable financial statements to investors.

We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action has already been taken by the accounting profession adopting certain of the auditing procedures considered in this case. We have no reason to believe at this time that these extensions will not be maintained or that further extensions of auditing procedures along the lines suggested in this report will not be made. Further, the adoption of the specific recommendations made in this report as to the type of disclosure to be made in the accountant's certificate and as to the election of accountants by stockholders should insure that acceptable standards of auditing procedure will be observed, that specific deviations therefrom may be considered in the particular instances in which they arise, and that accountants will be more independent of management. Until experience should prove the contrary, we feel that this program is preferable to its alternative—the detailed prescription of the scope of and procedures to be followed in the audit for the various types of issuers of securities who file statements with us—and will allow for further consideration of varying audit procedures and for the development of different treatment for specific types of issuers.