

Section I

SUMMARY OF FINDINGS AND CONCLUSIONS

This is a report on a proceeding pursuant to our order of December 29, 1938 under Section 21 (a) of the Securities Exchange Act of 1934. The order was based upon evidence that the information set forth in the registration statement and annual reports of McKesson & Robbins, Incorporated, especially the financial statements and schedules included therein which were prepared and certified by Price, Waterhouse & Co., was materially false and misleading. We stated our purpose to be to determine:

(1) the character, detail and scope of the audit procedure followed by Price, Waterhouse & Co. in the preparation of the financial statements included in the said registration statement and reports;

(2) the extent to which prevailing and generally accepted standards and requirements of audit procedure were adhered to and applied by Price, Waterhouse & Co. in the preparation of the said financial statements; and

(3) the adequacy of the safeguards inhering in the said generally accepted practices and principles of audit procedure to assure reliability and accuracy of financial statements.

As directed, hearings commenced on January 5, 1939 and continued, with some necessary adjournments, through April 25, 1939. Throughout the hearings Price, Waterhouse & Co. were represented by counsel, as were all witnesses who desired counsel. Opportunity was accorded such counsel to examine witnesses called by the Commission and to call their own witnesses. In all, 46 witnesses were examined. Of these, 9 were partners and employees of Price, Waterhouse & Co.; 12 were accountants of other firms called to testify as experts; 1 represented the Controllers Institute of America and 1 the American Institute of Consulting Engineers; 2 were from S. D. Leidesdorf & Co., accountants for the Trustee of McKesson & Robbins; 1 was a person who prepared many of the fictitious documents; 8 were employees of McKesson & Robbins; 11 were McKesson directors; and the last was a Commission investigator, who was called to identify certain documents. Throughout, Price, Waterhouse & Co., the witnesses, and their counsel extended the fullest cooperation

in facilitating the conduct of the proceedings. The record of the public hearings is contained in 4587 pages of testimony and 285 exhibits comprising in excess of 3000 pages.¹

This report based upon the testimony and the exhibits and our study of recognized authoritative works on auditing consists of five sections in the text and five appendices as follows:

Section I. A summary of our findings and conclusions;

Section II. A brief statement reciting the manner in which the fraud came to the attention of the public and this Commission;

Section III. A description of the manner in which the manipulation of the accounts of McKesson & Robbins was carried out by Coster-Musica and his associates;

Section IV. A description of the audit conducted by Price, Waterhouse & Co.;

Section V. Our 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;

Appendix A. A brief summary of action taken subsequent to the discovery of the fraud by accounting organizations and others interested in the work of independent public accountants;

Appendix B. A comparison of those sections of the English Companies Act of 1929 dealing with appointment of auditors and Horace B. Samuel's suggested amendments to those sections of that Act;

Appendix C. Our order for public hearings in this matter;

Appendix D. A list of all witnesses who testified, with the page numbers of their testimony;

Appendix E. A description of all exhibits introduced in the hearings.

¹ A list of all witnesses who testified, with the page numbers of their testimony, is appended to this report. The testimony of the accountants called as experts and statements by representatives of the Controllers Institute of America and the American Institute of Consulting Engineers have been printed and may be obtained from the Superintendent of Documents, United States Government Printing Office, Washington, D. C. (*In the Matter of McKesson & Robbins, Inc., Testimony of Expert Witnesses*, Price 65 cents.) The remaining testimony, in mimeographed form, is available for public inspection at the Washington, New York, and Chicago Offices of the Commission. Transcripts of any portion thereof may be obtained from Smith & Hulse, Official Reporters, 1742 K Street, N. W., Washington, D. C., at 35 cents per page.

A list of all exhibits introduced in the hearings is also appended to this report. Photocopies of any of the exhibits may be obtained from the Securities and Exchange Commission, 1778 Pennsylvania Avenue, Washington, D. C. at the following rates per photocopy, whether several copies of a single original page or one or more copies of several original pages are ordered: 10 cents per photocopy of each page, for all copies up to and including 100 pages in a single order; 7 cents per photocopy of each page, for all copies over 100 in a single order.

In this report references to the testimony and exhibits will be abbreviated as follows: R. followed by a numeral refers to pages of testimony in mimeographed form; P. followed by a numeral refers to pages of testimony in printed form; Ex. followed by a numeral refers to a Commission exhibit; and Ex. followed by a letter refers to a Price, Waterhouse & Co. exhibit. Printed reproductions of exhibits or parts of exhibits follow the copy as exactly as type limitations permit, including reproduction of errors without indication of where these occur.

A. SUMMARY OF PRINCIPAL FACTS

The securities of McKesson & Robbins, Incorporated (Maryland) were listed and traded on the New York Stock Exchange and registered under the Securities Exchange Act of 1934. Financial statements of the Corporation and its subsidiaries for the year ended December 31, 1937 (the last before the disclosure of the fraud hereinafter described) certified by Price, Waterhouse & Co., filed with this Commission and the New York Stock Exchange, and issued to stockholders reported total consolidated assets in excess of \$87,000,000. Approximately \$19,000,000 of these assets are now known to have been entirely fictitious. The fictitious items consisted of inventories, \$10,000,000; accounts receivable, \$9,000,000; and cash in bank, \$75,000; and arose out of the operation at the Bridgeport offices of a wholly fictitious foreign crude drug business shown on the books of the Connecticut Division of McKesson & Robbins, Incorporated (Maryland) and McKesson & Robbins, Limited (Canada), one of its subsidiaries. For the year 1937, fictitious sales in these units amounted to \$18,247,020.60 on which fictitious gross profit of \$1,801,390.60 was recorded. At the time of the exposure of the fraud on or about December 5, 1938 the fictitious assets had increased to approximately \$21,000,000.

The fraud was engineered by Frank Donald Coster, president of McKesson & Robbins since its merger with Girard & Co., Inc. in November 1926. In reality Coster was Philip M. Musica who, under the latter name, had been convicted of commercial frauds. In carrying out the fraud Coster, in the later years, was assisted principally by his three brothers: George E. Dietrich, assistant treasurer of the Corporation, who was in reality George Musica; Robert J. Dietrich, head of the shipping, receiving, and warehousing department of McKesson & Robbins at Bridgeport, Connecticut, who was in reality Robert Musica; and George Vernard, who was in reality Arthur Musica and who managed the offices, mailing addresses, bank accounts and other activities of the dummy concerns with whom the McKesson Companies supposedly conducted the fictitious business.

To accomplish the deception, purchases were pretended to have been made by the McKesson Companies from five Canadian vendors, who thereafter purportedly retained the merchandise at their warehouses for the account of McKesson. Sales were pretended to have been made for McKesson's account by W. W. Smith & Company, Inc. and the goods shipped directly by the latter from the Canadian vendors to the customers. Payments for goods purchased and collections from customers for goods sold were pretended to have been made by the Montreal banking firm of Manning & Company also for the account of McKesson. W. W. Smith & Company, Inc.,

Manning & Company, and the five Canadian vendors are now known to have been either entirely fictitious or merely blinds used by Coster for the purpose of supporting the fictitious transactions.

Invoices, advices, and other documents prepared on printed forms in the names of these firms were used to give an appearance of reality to the fictitious transactions. In addition to this manufacture of documents, a series of contracts and guaranties with Smith and Manning and forged credit reports on Smith were also utilized. The foreign firms to whom the goods were supposed to have been sold were real but had done no business of the type indicated with McKesson.

The fictitious transactions originated early in the life of Girard & Co., Inc., Coster's predecessor concern, incorporated on January 31, 1923 and increased until they reached the proportions mentioned above. The manner of handling the transactions described above was the one in vogue since the middle of 1935. Prior to that time the fictitious goods were supposed to have been physically received at and reshipped from the Bridgeport plant of McKesson. And prior to 1931 McKesson made actual cash payments directly for the fictitious purchases, which at that time were supposed to have been made from a group of domestic vendors, but recovered a large part of this cash purportedly as collections on the fictitious sales. The change from using actual cash to the supposed clearance through Manning & Company was not effected abruptly but for some time after 1931 both systems were used. The Canadian vendors, however, were used only in connection with the Manning clearance system. From the report of the accountant for the Trustee in reorganization of McKesson & Robbins, Incorporated, it appears that out of an actual cash outgo from the McKesson Companies in connection with these fictitious transactions of \$24,777,851.90 all but \$2,869,482.95 came back to the McKesson Companies in collection of fictitious receivables or as cash transfers from the pretended bank of Manning & Company.

B. SUMMARY OF CONCLUSIONS AS TO INDIVIDUAL AUDITING PROCEDURES

Our conclusions as to the individual auditing procedures are developed in detail in section V of our report. The full discussion of each topic should be consulted for the basis and complete statement of the conclusions which we here summarize.

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 the comptroller, McGlooin, near the close of the year to be audited. 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.

While the appointment of Price, Waterhouse & Co. and the method of determining the scope of the engagement in this case was in accord with generally accepted practice, we do not feel that it insures to the auditor, in all cases, that degree of independence which we deem necessary for the protection of investors. Adoption of the following program, we feel, would aid materially in correcting present conditions:

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 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.

In approaching his work with respect to companies which file with us* or in which there is a large public interest, the auditor must realize that, regardless of what his position and obligations might have been when reporting to managers or to owner-managers, he must now recognize fully his responsibility to public investors by including the

activities of the management itself within the scope of his work and by reporting thereon to investors. The adoption of a program such as that outlined above should serve to secure recognition of these newly emphasized obligations of the auditor to public investors.

2. Organization and Training of Staff

We have found that there is great similarity among accounting firms in the organization of the staff and assignments to engagements. We deplore, as do accounting firms, the necessity for recruiting large numbers of temporary employees during a very short busy season. This condition and the lack of training in the firm's methods which it ordinarily entails are inimical to attaining the best results from the auditors' services. A major improvement in this condition could be made by the general adoption by corporations of the natural business year for accounting purposes. The recruiting of temporary employees was more aggravated in Price, Waterhouse & Co. than in other comparable firms whose representatives testified as experts. This situation, coupled with the fact that Price, Waterhouse & Co. had a higher ratio of both permanent and peak staff per partner than other firms, leads us to the conclusion that Price, Waterhouse & Co. partners could not have given adequate attention to the training, development, and supervision of their staff.

3. Investigation of New Clients

The facts of this case suggest that for new and unknown clients some independent investigation should be made of the company and of its principal officers prior to undertaking the work. Such an inquiry should provide a valuable background for interpreting conditions revealed during the audit or, in extreme cases, might lead to a refusal of the engagement.

4. Review of the Client's System of Internal Check and Control

We are convinced by the record that the review of the system of internal check and control at the Bridgeport offices of McKesson & Robbins was carried out in an unsatisfactory manner. The testimony of the experts leads us to the further conclusion that this vital and basic problem of all audits for the purpose of certifying financial statements has been treated in entirely too casual a manner by many accountants. Since in examinations of financial statements of corporations whose securities are publicly owned the procedures of testing and sampling are employed in most cases, it appears to us that the necessity for a comprehensive knowledge of the client's system of internal check and control cannot be overemphasized.

5. Cash

The record is clear that the cash work performed on this engagement by Price, Waterhouse & Co. conformed in scope to the then generally accepted standards of the profession. It is equally clear to us that prior to this case many independent public accountants depended entirely too much upon the verification of cash as the basis for the whole auditing program and hence as underlying proof of the authenticity of all transactions. Where, as here, during the final three years of the audit, physical contact with the operations of a major portion of the business was limited to examination of supposed documentary evidence of transactions carried on completely offstage through agents unknown to the auditors save in connection with the one engagement, it appears to us that the reliability of these agents must be established by completely independent methods. Confirmation of the bank balance under these circumstances was proven in this case to be an inadequate basis for concluding that all the transactions were authentic.

6. Accounts Receivable

Viewed as a whole the audit program for accounts receivable as used by Price, Waterhouse & Co. conformed to then generally accepted procedures for an examination of financial statements although confirmation of the accounts was not included in the program. The facts of this case, however, demonstrate the utility of circularization and the wisdom of the profession in subsequently adopting confirmation of accounts and notes receivable as a required procedure “* * * wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern * * *.”

7. Intercompany Accounts

The record indicates that it is not enough for auditors to reconcile intercompany balances and that valuable insight into the company's manner of doing business may be gained by a review of the transactions passed through such accounts during the year. Best practice we believe requires the latter procedure. In this case the recommended procedure, although employed to some extent, was not applied in a thoroughgoing and penetrating manner.

8. Inventories

Price, Waterhouse & Co.'s audit program for the verification of inventories was essentially that which was prescribed by generally accepted auditing practice for the period. However, we find that a

substantial difference of opinion existed among accountants during this time as to the extent of the auditors' duties and responsibilities in connection with physical verification of quantities, quality, and condition. Price, Waterhouse & Co., in common with a substantial portion of the profession, took the position that the verification of quantities, quality, and condition of inventories should be confined to the records. There was, however, a substantial body of equally authoritative opinion which supported the view, which we endorse, that auditors should gain physical contact with the inventory either by test counts, by observation of the inventory taking, or by a combination of these methods. Meticulous verification of the inventory was not needed in this case to discover the fraud. We are not satisfied, therefore, that even under Price, Waterhouse & Co.'s views other accountants would condone their failure to make inquiries of the employees who actually took the inventory and to determine by inspection whether there was an inventory as represented by the client. We commend the action of the profession in subsequently adopting, as normal, procedures requiring physical contact with clients' inventories.

9. Other Balance Sheet Accounts

a. The testimony in respect to the auditing of plant accounts suggests that some accountants, including Price, Waterhouse & Co., could, with advantage, devote more attention to physical inspection than has been general practice with them in the past.

b. The work in respect to liabilities was in accord with generally accepted practice but suggests the desirability of independent inquiry when large purchases are made from a very few otherwise unknown suppliers.

c. The record demonstrates the necessity of a thorough understanding of the client's tax situation which apparently was not obtained by Price, Waterhouse & Co. in regard to the application of the Canadian law.

10. Profit and Loss Accounts

We are of the opinion that such analyses of profit and loss accounts as were made were applied to improper combinations of departments with the result that significant relationships were concealed. It is our conclusion that the independent accountant is derelict in his duty if he does not insist upon having proper analyses available for his review. It is our opinion that best practice supports this view.

11. The Wholesale Houses

It must be emphasized again that although the bulk of this report deals with the two units in which the fraud occurred, which were

under the direct charge of the Company's principal officer, some material bearing on the work in the other units, mostly wholesale houses, was introduced at the hearings. As to this portion of the audit, which constituted the larger part of the Price, Waterhouse & Co. engagement, covering for 1937 approximately 70% of the reported assets and 85% of the net sales, and which occupied approximately 97% of the auditors' time, it appears that the work in these other units was carried out in a thorough fashion in accordance with generally accepted auditing practice prevailing during the periods involved, including limited inspections of inventories but no confirmation of accounts and notes receivable.

12. Review Procedure

The mechanics of the review procedure as carried out by Price, Waterhouse & Co. on this engagement were substantially the same as those of the majority of accounting firms. However, it is our opinion that the partner in charge in this case was not sufficiently familiar with the business practices of the industry in question and was not sufficiently concerned with the basic problems of internal check and control to make the searching review which an engagement requires

13. The Certificate

The form of certificate used by Price, Waterhouse & Co. conformed to generally accepted practice during the period of the Girard-McKesson engagement. We are of the opinion that the form of the accountant's certificate should be amended to include in addition to the description of the scope of the audit a clear certification that the audit performed was, or was not, adequate for the purpose of expressing an independent opinion in respect to the financial statements. If any generally accepted procedures are omitted these should be named together with the reasons for their omission. Exceptions to the scope of the audit or to the accounts must be clearly designated as "exceptions".

14. Circumstances Available for the Auditors' Observation in the Procedures and Records of the Girard-McKesson Companies 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 can not 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.

C. CONCLUSION

In conclusion we reproduce the summary from the last section of our report:

"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 investigation, 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, Waterhouse & 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."