

These criticisms resulting in pressure on McGloon, which he in turn passed on to the auditors, seem, in these cases and in others we will cite elsewhere, to be based partly upon a hardheaded businessman's desire to keep down the cost and partly upon an inadequate knowledge of necessary auditing procedure, extending even to McGloon on some points, although he had had over 8 years experience in public accounting work with Price, Waterhouse & Co.⁵⁸⁹ However, the arrangement for the audit was renewed each year even though the fee was not reduced 50% in 1930, the goal set in the memorandum quoted above.⁵⁹⁰ The policy of year-end discussions and exchange of closing and audit instructions established in that year may have aided in removing, to some extent at least, the conception that too much work or unnecessary work was being done. The propriety of giving the client a copy of the audit instructions was discussed at some length throughout the testimony in the hearings as it appeared at least possible that Coster's interest in the instructions may have been due to ulterior motives. Whether or not this was so, it seems that some

⁵⁸⁹ R. 1583-1586.

"Q. [By Mr. GALPEER.] Mr. McGloon, would you say that it was your effort to keep these fees at a minimum?

A. Yes.

Q. Would you say, Mr. McGloon, that your familiarity with the procedure followed by Price, Waterhouse & Company gained while you were employed by them, aided you in this undertaking, in other words, of knowing whether the auditors were doing more than necessary or less than necessary?

A. No, I don't think so.

Q. Well, in the various discussions that came up, would you judge what they did by what you thought necessary, gained from the experience while you were employed by them?

A. No, when I discussed the point with Price, Waterhouse & Company I tried to find a yardstick so that we could measure the fee of one house against the other, and I remember one year preparing a schedule to show the total assets involved, broken down to show cash and receivables and inventory, and I listed the figures according to size and then I compared the fee and that was the only yardstick that I ever used in discussing reduction of fee with Price, Waterhouse & Company.

Q. Did you follow the type of work they did each year based upon your experience?

A. No, I didn't follow what they did except through these closing instructions we would check with Price, Waterhouse & Company before they were engaged or immediately after they were engaged and we would see what schedules we could prepare for them but I never made any attempt at any time to find out what they were doing on their assignment.

Q. Who would you say exerted the pressure so far as McKesson & Robbins was concerned as to keeping these fees down to a minimum, who was interested in that, who took an active part?

A. I think it can be said that all the members of the operating committee of McKesson & Robbins including myself." R. 1585-1586.

⁵⁹⁰ A letter from Jaureguy of the New York office to the Seattle office followed a criticism from that source and indicates one method of dealing with the problem:

"While we feel that on the whole your recent examinations were probably conducted intelligently and without waste of time, and this letter is not intended as a criticism of your work, we feel that, coming through Mr. Coster, Mr. Ballinger's latest complaints are of sufficient importance to warrant our calling them to your attention. We believe that some time after formal instructions for the December 31st audit are received by us from Mr. Coster, Mr. White should call on Mr. Ballinger to discuss the points he has mentioned and that a special effort should be made, both in planning the work and in assigning assistants, to have the next audit conducted to Mr. Ballinger's entire satisfaction, if possible. We are, of course, quite aware that clients frequently have an inadequate idea of what is required in an audit and it might be well for you to furnish him with a copy of the Federal Reserve Bulletin and tell him that, in a general way, we follow the procedure outlined therein.

"McKesson & Robbins, Incorporated has become a large organization and we consider the connection of sufficient importance to warrant our making every effort to clear up without delay any sore spots which may develop among the executives. Since Mr. White is to be in New York within the next few days to attend the meeting of partners and managers, we shall be glad to discuss the above matter with him at that time." Ex. 119.

arrangement was necessary to insure harmonious preparation for the actual work of the audit which now will be considered.⁵⁹¹ In the detailed description of the audit which is to follow, the principal emphasis must be placed on the work done on the Connecticut Division and its predecessor companies, McKesson & Robbins, Incorporated (Connecticut) and Girard & Co., Inc.; and on McKesson & Robbins, Limited (Canada) as the fraudulent transactions discussed herein were confined to these units.⁵⁹² To give a proper conception of the size of the engagement, the nature of the problems arising on the entire audit, and the relationship of the two units in which principal interest lies to the entire work directed from the New York office of Price, Waterhouse & Co., it is necessary to point out deviations in the conduct of the work at Bridgeport from that in the other units and to describe to some extent at least the nature of the work done in those units.

C. INTERNAL CHECK AND CONTROL

In the preceding pages the negotiations with F. Donald Coster surrounding the origin and continuance of the series of audits have been set forth in sufficient detail to establish that the work was in the nature of a so-called balance sheet audit or examination and that as a general guide for this type of work Price, Waterhouse & Co. accepted the series of bulletins which culminated in the one published in January 1936 by the American Institute of Accountants under the title "Examination of Financial Statements by Independent Public Accountants."

In introducing the outline for the audit this Bulletin states:

"In determining the nature and extent of his examination the accountant will necessarily take into consideration, among other things, (a) the purpose of the examination, (b) the amount of detail included in the statements to be covered by his report, (c) the type of business the accounts of which are to be examined, and (d) the system of internal check and control."⁵⁹³

Each of the first three points in the quoted paragraph are given a short paragraph of explanation in the Bulletin but the fourth on "internal check and control" is given a relatively extended discussion. This, in view of the importance of the subject generally and particularly in this case, is reproduced here:

"An important factor to be considered by an accountant in formulating his program is the nature and extent of the internal check and control in the organization under examination. The more extensive a company's system of accounting and internal control the less extensive will be the detailed checking necessary.

⁵⁹¹ R. 1724, 1586, 674-676, 965-969, 981-991, 1973-1975.

⁵⁹² At December 31, 1934, inventories of crude drugs, since proven to be non-existent, were supposed to have been stored in the plant at Bridgeport, whereas at December 31, 1937, such inventories were supposed to have been in the hands of the suppliers in Canada. On December 31, 1930, payments on purchases and sales since proven to have been fictitious were made directly by and to McKesson, whereas subsequently they were purportedly made by and to Manning & Company, the pretended bank. By selecting these three dates for detailed study, the major differences in the conditions existing throughout the period were covered.

⁵⁹³ Ex. 117 (p. 7).

For example, a plant addition in a large-sized company may be limited to the amount of a specific appropriation made by the administration; the work may be undertaken by a construction department, the funds be disbursed by the treasurer's department and the whole be subject to review in the controller's department when the necessary entries are made. In such a case the accountant is obviously warranted in making a much less extensive check of the details than in a small company where the manager orders the expenditure and the bookkeeper makes the entries.

"The term 'internal check and control' is used to describe those measures and methods adopted within the organization itself to safeguard the cash and other assets of the company as well as to check the clerical accuracy of the bookkeeping. The safeguards will cover such matters as the handling of incoming mail and remittances, the proceeds of cash sales, the preparation and payment of payrolls and the disbursement of funds generally, and the receipt and shipment of goods. These safeguards will frequently take the form of a definite segregation of duties or the utilization of mechanical devices. For example, the cashier will have no part in the entering of customers' accounts or the preparation of their statements, and neither he nor the ledger keeper will have authority to issue or approve credits to customers; the clerk recording the labor time and preparing the payroll will not be permitted to handle the funds; approval and entry of vouchers will be made by others than the disbursing officer; and stock records and inventory control will be kept independent of both the shipping and receiving departments. The extent to which these and other measures are practicable will naturally vary with the size of the organization and the personnel employed.

"The detailed scrutiny and check of cash transactions of large companies can be performed more economically by permanent company employees. Where such a check is provided, the accountant will modify his program accordingly. Where the internal check and control are necessarily limited or severely restricted the examination to be made will be more comprehensive in character but no examination should be regarded as taking the place of sound measures of internal check and control, except in cases where the organization is so small as to make adequate internal check impracticable. Except in the case of a small business, the cost of a detailed audit would be prohibitive, and the problem is to develop a general system of examination under which reasonably adequate safeguards may be secured at a cost that will be within the limits of a prudent economy. In the large majority of cases a detailed audit is not justified and the accountant relies on various test-checks of the records. The extent of the examination and of these test-checks is essentially a matter of judgment which must be exercised by the accountant, based on his experience, on his knowledge of the individual situation and on the extent of the internal check and control."⁵⁹⁴

The third point of the four set forth in the Bulletin indicates that the accountant should consider the type of business of the client in determining the character of the work to be done. Berger said that with a new client inquiry as to the principal characteristics of the business should be made when arranging for the work.⁵⁹⁵ This preliminary knowledge, or in a continuing engagement knowledge gained

⁵⁹⁴ Ex. 117 (pp. 8-9).

⁵⁹⁵ "When receiving instructions from new clients it is also desirable to have a brief discussion as to the nature of the business, the manner of conducting it, the condition of the records, whether the Company sells direct to customers, or to jobbers, whether any branches are maintained, etc., and whether there are any peculiarities in the business. Information of this kind is useful in instructing our representatives assigned to the work and a bare outline is frequently sufficient to enable a principal to direct attention to special features which should be stressed or pitfalls which should be guarded against." Ex. 168 (p. 12).

by seniors in charge, can be supplemented by more detailed discussions with officials during the course of the work.

Of the Price, Waterhouse & Co. staff who testified in these proceedings, Thorn seems to have been the only member, at least since the 1928 audit, who inspected the plant.⁵⁹⁶ When he was placed in charge in 1929, he wanted to familiarize himself with the business and with that in mind made a trip through the manufacturing sections, because he felt that some cost accounting problems might develop there. Thorn also testified that during the same year he had a long discussion with Coster about the crude drug operations and visited the Cliff Street office in New York to discuss the operations there in crude drugs (real).⁵⁹⁷

However, as a junior on the audit for 1927, Thorn (under Jaureguy) had not been through the plant nor did he (Thorn) take any of his juniors through when he took charge.⁵⁹⁸ Ritts had been through a portion of one of the units of the building not as a part of his audit work but because when leaving at night the main entrance was closed and he and his crew had to use the employee's exit.⁵⁹⁹ Ritts testified that he did not take his staff on inspection tours and that he had never been on one himself. Contact with various divisions of the office was limited to that gained in carrying out various audit steps. When any staff member started a new phase of the work, Ritts escorted his assistant to the proper division and introduced him to the persons in charge of the records.⁶⁰⁰ Headquarters for the auditors, where most

⁵⁹⁶ The plant at Fairfield (near Bridgeport) consisted of one large building housing storage, manufacturing, and office activities of the business.

⁵⁹⁷ R. 866, 954, 1134.

⁵⁹⁸ R. 866-867.

⁵⁹⁹ R. 649. See also R. 390, 1337, 1343.

⁶⁰⁰ "Q. [By Mr. GALPEER.] When you get up there with your staff, Mr. Ritts, you would sometimes have men who were on the job for the first time with you?

A. Yes, that is true. That is their first assignment on the McKesson job.

Q. Do you take men who have this first assignment, take them into the plant, acquaint them with the physical layout, warehouses, accounting offices, et cetera?

A. No, we don't do that. Each man, however, is introduced to the various people whom he will come in contact with later on throughout his examination, but we make no physical inspection of the plant or the offices and such.

Q. Where does he meet these people? Do you make your headquarters in a certain room and these people come in and meet you?

A. In recent years, we have done most of our work in the director's room in the company's office in Bridgeport, and when a man, say, was assigned to the verification of cash he would be taken into the cashier's office and introduced to the various people with whom he would deal in order to obtain the records and necessary information he needed.

Another one would be assigned to do accounts receivable and would be taken out into the company's general accounting office and introduced to the office manager and the various people he would come in contact with in the Accounts Receivable Department et cetera, throughout the entire job.

Q. In other words, you do take them and introduce them to specific people where there were specific jobs to be done, but there would be no general inspection?

A. No.

Q. When you first came on the job yourself, if you can take your mind back to that time, when Mr. Thorn, I believe was there in charge, was that correct?

A. Yes.

Q. Was the same procedure followed then?

A. Yes.

Q. In other words, you were taken through no general inspection tour of the plant?

A. No, I was not." R. 234-235.

of their work was done, was established in the directors' room which was next to Coster's office. In short, in recent years, with the exception of Thorn, no member of the auditors' staff who testified in the hearings seems to have had more than a limited knowledge of the plant in which he worked.⁶⁰¹

Rowbotham, when asked generally if the paragraphs on internal control quoted above indicated "* * *" that the accountant in charge should have a complete and thorough knowledge of the extent of the internal control in the particular house on which he is doing the audit * * *" replied, "Yes, I should say he should understand it."⁶⁰²

Various methods are employed by accountants in ascertaining and appraising the effectiveness of the client's system. Price, Waterhouse & Co. for a number of years have used questionnaires as an aid in developing the necessary information as to the adequacy of their client's system of internal check and control. The cover page of their general questionnaire contained instructions for the completion of the questionnaire and is of sufficient importance to warrant its reproduction here:

"QUESTIONNAIRE RE SYSTEM OF INTERNAL CHECK
(FOR USE ON BALANCE SHEET AUDITS)

"The scope of a balance sheet audit as defined in the Federal Reserve Bulletin of April 1917, comprises a verification of the Assets and Liabilities as of a certain date, a general examination of the Profit and Loss Account for a period ending on that date, and incidental thereto *an examination into essential features of the accounting, i. e., the system of internal check.* There is reason for believing that the latter requirement has not always received the attention it deserves and the following questions have been prepared partially to correct this weakness. It should be borne in mind, however, that the questions are more suggestive than exhaustive and are, of course, not precisely applicable to every balance sheet audit.

"The majority of the questions will be found to be answerable from observations actually made during the course of the work and **should be answered by the assistant doing the particular section of the work to which the questions apply.** If the assistant is unable to answer the questions on the work assigned to him it is evident that a careful and thorough verification has not been made.

"In cases where the direct method of interrogation is used, the questions should be taken up with the Comptroller or other responsible officials of the Company and a note made as to the source of the replies.

"The questions under each section should be answered during the progress of that part of the work and while the matter is fresh in the mind of the assistant.

"If this method is adopted it will be found that the questionnaire is not at all burdensome, and that it requires comparatively little time.

"In cases where the name of an employee is asked, his position (when not evident from the question) should also be stated.

"In filling out questionnaire you should not only ascertain that the necessary

⁶⁰¹ Footnotes 598, 599, 600 *supra* and R. 1115-1117, 1339, 1317-1318 with which cf. R. 1365-1368.

⁶⁰² R. 1840.

safeguards for purposes of internal control are provided, but you should also be able to say definitely from observation, inquiry and tests during the course of the examination that the prescribed procedure is being observed." [Emphasis in original.]⁶⁰³

The first questionnaire used on this engagement at Bridgeport was the printed one from which we have reproduced above the instructions for its use. Ritts testified that this general questionnaire was prepared with the Connecticut Company in mind but that it was " * * * fair to say that it also * * * [applied] in general to the Canadian Company."⁶⁰⁴ It was filled in for the first time on the 1932 audit in conference with McGloon who, in Ritts' presence, wrote all of the answers to the printed questions. Ritts stated that in subsequent years the accounting procedures were reviewed with some responsible accounting officer and by observation.⁶⁰⁵ "I don't know that we would sit down and actually review it, but if any major changes came to our attention, I believe we would examine the questionnaire to see what was reported for the prior year, make such changes wherever necessary."⁶⁰⁶ McGloon, however, testified that if he had again been asked the answers to some of these questions, for example, "Do employees in position of trust take regular annual vacations?" he would have changed the answer from "Yes," stating, " * * * I would have said that the Dietrichs didn't take vacations, and I don't know yet why I didn't say it in that particular memorandum because everybody knew that the Dietrichs didn't take vacations."⁶⁰⁷ Rowbotham testified in respect to this question that he would have asked it again each year but not necessarily of the same person.⁶⁰⁸

On the audits for 1936 and 1937 supplementary questionnaires for the Canadian Company and Connecticut Division dealing with cash, receivables and inventories were prepared in mimeographed form and filled in anew in both of these years by the assistants handling each part of the work.⁶⁰⁹ In addition to the questionnaire in 1937 there were also handwritten memoranda on accounts payable and cash receipts. Likewise on the 1932 audit the working papers contained a handwritten supplement to the cash questions in which a junior described the disbursing and payroll system and Ritts recorded

⁶⁰³ Ex. 17.

⁶⁰⁴ R. 260. In fact major differences prevailed between them. See section III *supra* and page 187 *infra*.

⁶⁰⁵ R. 214, 1154-1155.

⁶⁰⁶ R. 262-263. The questionnaire was amended as to two questions. One of these, were creditors' statements compared with balances shown in accounts payable record, as amended to "No" is not entirely consistent with the accounts payable work program "(5) Test check open balances at December 31st by reference to creditors' monthly statements." Ex. 47.

⁶⁰⁷ R. 1700-1701.

"Mr. STEWART. You don't intend to testify that the representatives of Price, Waterhouse & Company knew it, do you, Mr. McGloon?"

The WITNESS. No, I am speaking of employees of McKesson here." R. 1702.

⁶⁰⁸ R. 1852-1853.

⁶⁰⁹ R. 257-268.

answers to sundry questions in regard to cash receipts and disbursements. In 1933 there was another memorandum on the payroll system and in 1934 there was a note on the Company's physical count of inventories. A junior, who prepared the inventory supplementary questionnaires in 1936 and 1937, was the only assistant who signed or initialed the supplementary questionnaires.⁶¹⁰

Rowbotham was questioned as to the propriety of Ritts' method of procedure in having McGloon fill in the questionnaire completely when the instructions we reproduced above indicated that assistants were to supply some of the information and the last page of the form had spaces for indicating the pages filled up by the different assistants but in this case signed only by Ritts. Rowbotham's interpretation was that Ritts must have verified McGloon's answers in consultation with his assistants or by his own observation but that in any event McGloon's answers were "basic compliance." He felt that the main responsibility for the questionnaire laid with the man in charge of the job.⁶¹¹

Testimony of a junior⁶¹² on the 1937 audit, indicates the manner in which the answering of one of the questionnaires was approached by one of the assistants on the audit. This junior did certain work on receivables and was asked by Ritts to get answers to some of the questions in connection with that work. He sought out Johnson, the office manager of McKesson & Robbins, as the best source of the information he wanted. The following extract is significant:

"Q. [By Mr. GALPEER] Did Mr. Johnson give you a detailed explanation?

A. Well, as I recall it, on the first question he was going to go into detail, but I explained to him that I just wanted the question answered in as brief a way and as accurate a way as possible, and just wanted to get the answers down in here, that is all I recall on that.

Q. And you gave that back to Mr. Ritts?

A. I gave that back to Mr. Ritts and told him that I had filled that out as per his instructions."⁶¹³

Rowbotham stated that he thought Price, Waterhouse & Co. "would have a look at" internal control every year and that while knowledge of the system of internal control should be current at least in the minds of the men on the job, he did not think it necessary that the questionnaire be changed or rewritten yearly. When confronted, apparently for the first time, with the fact that the questionnaires, especially the more recent ones, contained several unanswered questions and others

⁶¹⁰ Ex. 18, 19, M-3, M-16, M-21, M-26.

⁶¹¹ R. 1773-1780.

⁶¹² Graduated from a large southern university, with an A. B. degree in 1936, where he had studied accounting and assisted in the accounting department during his senior year. Following graduation he worked for a year as an investigator for the Household Finance Corporation. He joined the staff of Price, Waterhouse & Co. December 16, 1937, through the aid of an employment agency. He worked that winter until February 15 and again the next season from November 28 to December 28 when he resigned to take a State Civil Service position in New Jersey.

⁶¹³ R.1112-1113.

incorrectly or incompletely answered his reaction was that the purpose of the procedure was to provide information for the senior on the job, and that the senior would not be misled by minor errors and omissions, and although the answers should be corrected as a matter of routine,⁶¹⁴ that Ritts “* * * simply taking the job in his stride doesn't bother correcting the questionnaire in what has seemed to him probably at the time as detail.” As a practical matter, Rowbotham felt that the manager in charge of the work would learn of changes in the client's procedure by questioning the senior on the engagement, and therefore the deficiencies were merely “a matter of paper work.”⁶¹⁵

Rowbotham was asked to characterize certain of the conditions reported in the questionnaires as to whether they indicated points of strength or weakness in the system. “Does the cashier have access to any of the ledgers?” was asked in 1932, 1936, and 1937, and resulted in apparently conflicting answers. McGloon's answer for 1932—“Yes, customers ledgers”—was correct as far as it went. “No” in 1936 revealed a possible failure to discover all the facts. This was remedied by a more comprehensive answer in 1937: “Not under conditions which would permit of entries being made—Sometimes consults ledger cards to determine applicability of a cash item received.” Rowbotham felt that the condition which seemed to be indicated by the 1932 answer would not be a point of strength.⁶¹⁶

The questionnaire in 1932 indicated that the president, F. D. Coster (he was also treasurer of the Connecticut and Canadian Companies), and assistant treasurer, George E. Dietrich, each had authority to sign checks without countersignature. Although not so indicated on the questionnaire this procedure was changed later to require countersignatures, which Rowbotham approved as the better procedure.⁶¹⁷ In the Canadian Company, however, the countersigner was Margaret Walsh, the only bookkeeper, who worked solely under George E. Dietrich's direction; while in the Connecticut Division the countersigner could be one of George E. Dietrich's women cashiers.

To the question “Who reconciles the bank accounts and does employee preparing or approving checks effect or have supervision over bank reconciliations?” McGloon answered “Bank accounts reconciled by cashiers who prepare checks.” Rowbotham's opinion of this situation was that it “was not strong.”⁶¹⁸ In 1936 and 1937 this question was changed to read “If employee keeping part or all of cash book(s) also reconciles bank accounts—how often, by whom and to

⁶¹⁴ R. 1933-1934. Rowbotham remarked with respect to paper work:

“Well, sir, if I ever saw a perfect set of working papers I would want to fire the man because I would think he was paying too much attention to the questionnaire and that he was not attending to the job.” R. 1907.

⁶¹⁵ R. 1781-1782, 1829-1832.

⁶¹⁶ R. 1780-1781; Ex. 19.

⁶¹⁷ Ex. 17; R. 1781.

⁶¹⁸ R. 1785.

what extent are reconciliations verified (other than P. W. & Co. examinations)?" The answer for 1936 was "Yes—semi-monthly—None," and for 1937 no answer appeared.

The general questionnaire was supplemented in 1932 by another work paper in Ritts' handwriting which contained a few pertinent questions on cash disbursements and by a memorandum on "Cash System" prepared by a junior. These stated that vouchers for cash disbursements were prepared by a woman employee and approved for payment by George E. Dietrich although he usually neglected to indicate this in writing for his signature rarely appeared on the voucher. A special form was used for all disbursements such as advances, transfers, and sundry items for which no vouchers were prepared in advance. These disbursements could originate in several departments including that of George Dietrich, who approved all of them. In these cases the payment was made before the liability was recorded in the accounting department.⁶¹⁹ It should be recalled that George Dietrich, as assistant treasurer, not only approved these vouchers, but also signed the checks with a counter-signature by a person under his control.⁶²⁰

The fact that the assistant treasurer opened the mail Rowbotham thought was "definitely a point of strength" for he felt that some responsible person should do this work. The fact that George Dietrich in addition to his other duties also handled foreign crude drug purchases and sales for Coster did not alter his opinion on this point so long as he did not have access to the general books, specifically the accounts receivable ledgers which he understood were controlled by McGloon and thus served as a check on Dietrich.⁶²¹

As for the question, "Is an independent record of incoming remittances prepared for comparison later with the collections recorded by the cashier and, if so, is the comparison made, and by whom?" which was answered "No," Rowbotham stated that although lists were frequently made, this was not much of a point either way; failure to do it "would not necessarily be a point of weakness."⁶²² A point closely related to this was covered by Ritts in the short supplementary questionnaire for 1932, mentioned above, in which he asked "Are duplicate certified deposit slips retained?" The answer being "No," it followed that no answer appeared for his next question "Can they be checked out in detail with cash books receipts?" The memorandum on the cash system referred to above likewise stated that "No duplicate deposit slips are received. The deposits are made up by Miss

⁶¹⁹ Ex. M-3; R. 1624-1642.

⁶²⁰ R. 1639.

⁶²¹ R. 1786-1788.

⁶²² Compare this point of view with letters to McKesson-Whittlesey Company and Milwaukee Drug Division reproduced at pages 321-322 and 324 *infra*.

Bohus.”⁶²³ It seems that this refers to Miss Bakos who testified that prior to the use of Manning & Company as a bank, she made up deposits of actual cash and checks received from real customers but not the deposits purporting to cover receipts from foreign crude drug customers, since shown to be false, for which memoranda were given to her by George Dietrich.⁶²⁴ At the time the receipts on the latter accounts which amounted to approximately 65% of the Connecticut Company's receipts on sales were reported on Manning & Company credit advices and were not covered in the memorandum.

Questions on receivables included two dealing with circularization which Rowbotham felt were out of place in a questionnaire as that subject was covered in arranging for the audit. These were followed by two questions dealing with regular monthly statements sent to customers and a third which asked “Who mails them?” to which the answer was given simply “Asst. Treas.,” referring to George Dietrich. Rowbotham, when asked about this, first questioned whether it was in fact done by the particular person as stated in the questionnaire but limiting his reply to the answer as made, said that it was not a point of strength. Three other questions dealing with the credit limit of customers he felt were inapplicable to this audit. The first “Does ledger sheet show credit limit or what record is kept of it?” was answered “No.” The next two questions asked about accounts receivable in excess of credit limits and unusually large balances. These were merely checked. A question similar to the first of the three was answered in 1936 and 1937 by stating that the credit manager did set limits and that they were followed.⁶²⁵ In the 1932 questionnaire in addition to Titus, a credit manager, George Dietrich and F. D. Coster were listed as passing on credit terms. Rowbotham stated that he could not remember seeing a credit limit shown on a ledger sheet of a large industry as distinguished from a department store, so he could not see the purpose of the questions when applied to the Connecticut Company.⁶²⁶

George E. Dietrich was custodian of securities at Bridgeport. Rowbotham felt that all purchases of securities should be authorized by the Board of Directors which was not the case here at least at the time the 1932 questionnaire was prepared. It may be noted that the same questionnaire stated that George Dietrich was also the custodian of all notes receivable and related collateral and that he also retained control of all notes which had been written off as uncollectible.

G. E. Dietrich and F. D. Coster, with only one signature required, were listed by McGlooin as the only ones authorized to sign notes

⁶²³ Ex. M-3.

⁶²⁴ R. 2649-2654, quoted in part at pages 113 *ff. supra*.

⁶²⁵ The answers do not distinguish foreign crude drug and other business. See pages 232 *infra*.

⁶²⁶ R. 1795-1798.

payable and acceptances while the same officers and McGloon were authorized to approve loans to officials and employees. Rowbotham was surprised at this latter point, for he supposed that only Coster had that power.⁶²⁷

Rowbotham agreed that the answers to questions dealing with shipments were not informative although Ritts had previously referred to the questionnaires in explanation of this subject.⁶²⁸ Shipments it seemed were made on regular "order forms" which went to the production and shipping departments. What happened after that was left with a question mark, and whether the tick mark after a question about back orders meant there were none was left to conjecture. These answers were all in McGloon's handwriting.

The question, "Do employees in position of trust take regular annual vacations?" was answered "Yes," although the testimony in these proceedings indicated that the answer was incorrect when applied to the brothers Dietrich. Rowbotham's attitude toward this point may be considered in connection with his attitude on the desirability of outlining the Company's organization to show each department and to whom it is responsible, a step required by the questionnaire. Both points to Rowbotham were more or less textbook matters rather than the concern of practical working accountants; neither one would come to a partner's attention.⁶²⁹

The last point worthy of comment in connection with Rowbotham's review of the questionnaires are his observations on a question and

⁶²⁷ R. 1802-1804.

⁶²⁸ R. 214.

⁶²⁹ "Q. [By Mr. GALPEER]: Mr. Rowbotham, on page 14 of the questionnaire under the category of General, question No. 7: 'Do employees in position of trust take regular annual vacations?' The answer to that is 'Yes.' If the answer had been recorded as 'No,' what would your reactions have been?"

A. Well, as a matter of fact, my reaction would have been this: That I am afraid I am approaching it not from the accounting end. My reaction was that it was a bad policy for the corporation not to give its employees vacations because in our place I think officials absolutely need vacations.

I know that is not the answer you want, but that is the way I would have approached the thing.

In the same thing in this, if there had been some fairly high placed employee who hadn't taken it for several years, I might have taken it up with, let us say, the president of the company and asked him why this was so. I might have gotten some satisfactory explanation. I would have gone back or had the men go back and check that man's book a little more carefully than previously, but beyond that, if the president, the executive officer, had been satisfied I don't think that it would have concerned me very greatly.

* * * * *
Q. On the next page, item 16: 'Outline the company's organization, showing each department and to whom it is responsible.' Would you say that that would be a useful thing to do in connection with your audit and check, or your check of the internal check?

A. I think the man ought to have the outline of the thing pretty clearly in his head. I mean, we don't as a rule insist upon a man going out and coming back with a chart. Is there a place here where they speak of a chart?

Mr. GALPEER: Not that I know of. I don't know.

The WITNESS: That simply isn't the way we work. I think the man ought to have the outline of the organization in his head and know what he is doing. And I think he should take it up with his particular superior, Ritts, let us say here, with Thorn.

Q. Would that come to your attention, or would that end with Thorn?

A. That would end with Thorn.

Q. Shouldn't there be some list of officials with titles, duties, perhaps, somewhere in your papers?

A. That is,—I don't want to be misunderstood,—a text book requirement, it is not done in real life."

R. 1812-1815.

answer on the Canadian Company supplemental questionnaire for 1937, which brought out the fact that one person kept all the books. This one person was at first George Dietrich, and since 1931 Margaret Walsh, a bookkeeper, who worked solely for him on the Canadian Company as bookkeeper and stenographer. This situation, Rowbotham agreed, would require more detailed auditing than a situation in which a greater subdivision of work could be obtained.⁶³⁰

Rowbotham's attitude toward the details of auditing mechanics is clearly evident from many of the answers given to the questions in the part of his testimony reviewed above. With regard to the adequacy of the client's system of internal control he testified:

"No, I did not specifically review the questionnaire, and on the question of internal control all that I would say to Mr. Thorn was:—I do not remember any precise form of words,—but what kind of internal control have they got up there and he would tell me whatever it was that he told me which, in this case, was that they had a good control and I would not sit down with him and go into the internal control specifically for this reason,—I may be giving you an individual opinion here,—but it is this, that I do not think an accountant can go into a system of internal control unless he actually goes up and sees it himself. In other words, sir, I think if Thorn here went into the system, I mean, if he is the man on the job, he has to go up and look into it and satisfy himself * * *."⁶³¹

Thorn, in this case, had been close to the work as junior and senior and since confining himself to managerial duties had received reports currently from Ritts. If Thorn had brought any weaknesses to his attention, Rowbotham stated he would have gone into the matter more thoroughly.

"Q. [By Mr. STEWART.] Just one other question on that. Did you regard Mr. Thorn, during the time he was manager of the McKesson job as being a perfectly competent man to pass on the adequacy of the system of internal control?

A. Yes, I most undoubtedly did."⁶³²

⁶³⁰ "Q. [By Mr. GALPEER.] Now, on question 9 of the cash questionnaire of the Limited Company for 1937, reading: 'Does the cashier have access to any of the ledgers?' The answer is: 'One employee keeps all the books,' would you say that that condition would require a more careful audit than otherwise, Mr. Rowbotham?

A. I think it would, and I think it does.

Q. Would you say in view of that that the audit of the Limited Company was the audit of a large or a small company?

A. It is an audit of an actually—legally, it does happen to be a separate corporation, but it does form part of this whole McKesson picture. I don't think that you can quite call it a small company. In quite the sense—I do agree and I think this is the point you have in mind, I do agree that more care should be exercised where one man has control of the books, as I think was true in this case.

Q. As a matter of fact, just to clear the record and see if we can come to a common view: In a situation like this, where the Limited Company's books were all kept by one man, in what respect would the audit of that company be any different for being a subsidiary of McKesson than if you had just gone in and, let us say, had been retained solely to do these books for the Limited Company?

A. If you had been retained solely to do these books for the Limited Company and one man had access to everything, I think you would make a pretty well detailed audit. If it fits into part of a larger picture, I think you can lessen the amount of detail, but I think you do more detail than you do on the ordinary financial or balance sheet examination." R. 1825-1827.

⁶³¹ R. 1932.

⁶³² R. 1933-1934.

The foregoing review of the questionnaires indicates that Rowbotham held Thorn, the manager in charge, responsible for a correct appraisal of the adequacy of McKessen's system of internal check and control. Thorn's appraisal of the system is summarized in the following paragraphs.

The fact that George Dietrich combined the office of assistant treasurer (in which capacity he controlled all receipts and disbursements) and his duties in buying and selling foreign crude drugs, did not seem to Thorn to have any bearing on internal check, even though these foreign transactions were approximately 65% of the Connecticut Division's business and approximately 90% of the Canadian Company's business.⁶³³ As Thorn understood the system as it applied to foreign crude drugs, Dietrich was merely a clerk executing orders for Coster who made the decisions. Thorn had talked with Coster in 1929, and at various times since then, and had the definite impression that Coster had been in that business for many years and continued to decide all questions of purchase and sale of crude drugs himself. While theoretically Thorn thought there might be a minor weakness in this system, nevertheless he felt that Coster's control over Dietrich was so close, that Coster would have caught the first attempt to put through a fictitious order. Observation convinced him as to who gave the orders and who did the clerical work.⁶³⁴

Thorn testified that all incoming mail came to George Dietrich's office, that no list of remittances was prepared, and that he could not recall ever having suggested that it be done nor could he recall having discussed the problem with Ritts.⁶³⁵ Thorn also related that until recent years, all customers' statements went over George Dietrich's desk for approval before mailing, but that W. E. Titus, credit manager for receivables of the Connecticut Division other than crude drugs complained of the delay in mailing statements, so that thereafter only foreign crude drug statements were sent to Dietrich prior to mailing.⁶³⁶ McGloon testified that Titus, whose office was in New York, then made it a practice to go to Bridgeport the first of each month to review the statements of the other customers.⁶³⁷

The cashier's office was under George Dietrich and bank accounts were reconciled by the women in this office. Thorn did not know to whom they were responsible, whether McGloon or Dietrich.⁶³⁸ McGloon, whose department received duplicates of checks as prepared, testified that bank statements and cancelled checks themselves were kept in the vault in Dietrich's office, to which he did not have

⁶³³ Page 45 *supra*.

⁶³⁴ R. 1163-1169.

⁶³⁵ R. 1171.

⁶³⁶ R. 1169-1170.

⁶³⁷ R. 1646-1650.

⁶³⁸ R. 1172.

access, although he did not remember having been refused any documents he requested from Dietrich.⁶³⁹

Although purchase orders went to the receiving department and while it was better for the receiving clerk not to know what had been ordered, Thorn was of the opinion that the men actually preparing the receiving tickets would not have the orders, even though Robert Dietrich, who controlled their work, would have them. The fact that Robert Dietrich was in control of warehousing, as well as head of the receiving and shipping departments, Thorn thought was only a minor weakness. During the last 3 years when the foreign crude drugs presumably were held at suppliers Robert Dietrich's clerks made out memoranda indicating this, using the regular receiving ticket forms. On the basis of the documents in evidence it would appear that these memoranda must have been prepared either from a copy of the McKesson purchase order or from the vendor's invoice.

The effect of the series of transactions as Thorn understood them was that he relied on the purchase order originating with Coster and initialed by George Dietrich, a purchase invoice from outside and a debit advice from Manning & Company.⁶⁴⁰ For sales he relied on an order from outside, "W. W. Smith & Co.", an approval by Coster passed along by George Dietrich, shipment from an outside source, "Smith acting as shipping agent" and, finally, on actual receipts of cash. However, the apparent actual collection of the cash was to him the most positive evidence of the transactions.⁶⁴¹ But Thorn did not know that soon after the pretended establishment of Manning & Company as a bank all of the foreign crude drug customers supposedly paid through it.⁶⁴²

The question was raised with Thorn as to whether George Dietrich could have authorized credits to customers' accounts to cover up abstraction of receipts from customers. He thought that if this had been attempted the transactions would have come to the attention of Johnson (office manager) or McGloon, but that it was probable that Dietrich's authority to order the credits would have been recognized by these men, although Thorn thought that Dietrich "* * * couldn't have done that consistently at least."⁶⁴³

Thorn got the impression from conversations with George Dietrich that he went on hunting trips. Thorn was not sure now what he would have done but said that if he had known that George Dietrich

⁶³⁹ R. 1590, 1663-1665.

⁶⁴⁰ R. 1175.

⁶⁴¹ "You first have the order coming in from the outside, in this case the order would be offered by W. W. Smith & Co., you have the approval by Mr. Coster passed along by George Dietrich. You have later the advice of shipment from the outside source, in this case, Smith, acting as shipping agent, and you have later on the actual cash coming in paying for that sale, the cash actually coming in, I say, and that is, it seems to me, the most positive evidence that you can have of these transactions." R. 1175-1176. See also R. 1128-1129 quoted at page 226 *infra*.

⁶⁴² "No, I had not understood that all these collections did go into Manning & Company." R. 1177. See also R. 910-911. Ritts testified to the same effect. R. 558-559, 140.

⁶⁴³ R. 1180.

never took regular vacations, he thought he would have gone to Thompson, the treasurer, rather than to Coster just as a matter of diplomacy, for Coster might have resented any implication he might take from the inquiry. Furthermore, George Dietrich was acting under Thompson as assistant treasurer of the Maryland Company.⁶⁴⁴ As a last resort Thorn said he would have gone to Coster from whom there would have been no appeal.⁶⁴⁵

As for the Canadian Company, Thorn did not know what Miss Walsh's duties were, whether she could co-sign checks or that she kept a cash book separate from those maintained by the cashiers under Dietrich's direction.⁶⁴⁶

Thorn's general approach to the use of questionnaires is indicated by the fact that he did not enforce their preparation on all divisions of the McKesson work for he said that a senior could omit revising or preparing a questionnaire:

"In cases where the senior thought that it was not necessary, I might say, if it will clarify this matter any, that that question of questionnaires is something that is in a continual state of revision, you might say. In fact, I believe new forms, new ideas are being applied to that almost every year, and there are some seniors that either because they think that particular examination does not require a questionnaire or because possibly in some cases that they do not believe in questionnaires, wouldn't make one out."⁶⁴⁷

Thus it appears that Thorn, as manager, delegated the decision as to the manner of securing such information to the men under him.⁶⁴⁸ On the Bridgeport work in recent years Ritts then was responsible for developing the facts with respect to the system of internal check and control.⁶⁴⁹ How thorough was his knowledge and how did he appraise his findings in reporting to his superiors?

Ritts is on record in only one place in the working papers, as to his opinion of the client's system of internal check and control. At the close of each engagement, a form, known as a condensed examination summary, was prepared and filed with the working papers. Although this practice was abandoned prior to the completion of the 1937 audit, Ritts for that year, as he had done for prior years, prepared and signed one of these summaries for the Canadian Company and one for the Maryland Company and subsidiaries.⁶⁵⁰ The report for the Maryland Company and subsidiaries for 1934 (approved by Thorn)⁶⁵¹ described the internal check as "fairly satisfactory." The first report of this type for the Canadian Company was prepared by Ritts

⁶⁴⁴ R. 1183.

⁶⁴⁵ R. 1238.

⁶⁴⁶ R. 1181.

⁶⁴⁷ R. 1153. But cf. page 165 *supra*.

⁶⁴⁸ Page 183 *supra*. Cf. R. 1128.

⁶⁴⁹ R. 1121.

⁶⁵⁰ R. 4449-4453.

⁶⁵¹ Ex. 211 (not prepared by Ritts).

for the 1935 audit. It described the internal check as "satisfactory."⁶⁵² For 1937, Ritts called the internal check of the Canadian Company "satisfactory" and that of the Maryland Company and subsidiaries "fairly satisfactory."⁶⁵³

The form carried brief specimen comments for matters on which a rating was requested. Under internal check were suggested "excellent," "fairly satisfactory," "should be strengthened," and "organization too small to permit adequate check." The Canadian Company's system of internal check, by this scale, was just short of excellent according to Ritts' judgment, yet the working papers indicated what has been shown above, that all the books were kept in the beginning by George Dietrich and in recent years by one bookkeeper under his supervision and Rowbotham testified that under such circumstances " * * * you do more detail than you do on the ordinary financial or balance sheet examination."⁶⁵⁴

Although the instructions to representatives of the firm required that comments on the system of internal check and control be included in the report to the New York office on each branch audit, Ritts never included such comments in his memorandum to Thorn on the work done at Bridgeport, although Thorn stated that such matters were discussed with him.^{655 656} Thorn testified that while he gave Ritts a copy of these instructions, they applied only to the wholesale houses and not to the divisions at Bridgeport, and it was his opinion that Ritts never read them.⁶⁵⁷

Ritts, whom Thorn considered competent and understood what to do, stated that he made a survey of the system and was sure he was satisfied that the system was satisfactory.⁶⁵⁸ In respect to the foreign crude drug transactions, Ritts relied upon the fact that all the transactions went through the general office staff on both purchases and sales at at least one point and that they were not a segregated division of the office routine. There seemed to him to be enough people required in the receiving and shipping office to prepare the receiving tickets besides Robert Dietrich to preclude their being forged. He also relied upon the fact that there was an outside invoice in addition to George Dietrich's approval of the purchase order, and that it was matched in the comptroller's office with the order and receiving ticket.⁶⁵⁹ This was the same system that applied to other purchases.

⁶⁵² Ex. 209.

⁶⁵³ Ex. 208, 210. The rating for the latter would appear to be lower than the former because of the influence of unsatisfactory conditions in the wholesale houses which will be discussed in a subsequent subsection, pages 315 ff. *infra*.

⁶⁵⁴ R. 1826 quoted at footnote 630 *supra*. See also pages 51 and 182-183 *supra*.

^{655 656} R. 1121.

⁶⁵⁷ R. 614, 985, 1120.

⁶⁵⁸ R. 209, 615, 969-971, 1120.

⁶⁵⁹ R. 619-621.

On sales, Ritts explained that the billing was done on the basis of a factory order, which in turn was based upon a W. W. Smith & Co. shipping notice (from an outside source) but he gave conflicting testimony as to how these transactions were handled for he could not recollect the details. He did not recall seeing any bills of lading, consular invoices or insurance certificates covering these shipments, and explained that these must have been sent to the customer with the invoice. He could not state definitely from recollection how the system worked but he agreed that all the documents involved, insofar as the general accounting office was concerned with these sales transactions, came from or went back to George Dietrich's office.⁶⁰⁰ In short, as will be shown more fully hereinafter in connection with the discussion of the audit of cash, accounts receivable, intercompany accounts, inventories, accounts payable, sales, and other profit and loss accounts, Ritts although on the job at Bridgeport for 8 years could not state with precision the manner in which the foreign crude drug transactions were handled at the Bridgeport offices. In particular it should be observed that important differences in the manner of handling the foreign crude drug accounts and the other accounts receivable seem to have been overlooked by Ritts and his staff.⁶⁰¹

Ritts' conception of the reliance to be placed upon officers and the extent to which he would determine by independent checking whether the answers as given to him by McGloon, were, in fact, a correct statement of the conditions actually prevailing in the office is indicated by the following quotation from his testimony:

"Q. [By Mr. GALPEER.] And if you had known, as a matter of fact that Mr. Robert Dietrich and George Dietrich had never taken an annual vacation, would that have made a difference to you?

A. It may or may not have.

Q. What is the purpose of asking this question if the answer does not make any difference to you?

A. If the question there had been no, they do not, or if you had inquired specifically regarding any one particular employee and you were told no, then, you might inquire as to why, or call it to the attention of the company and place the responsibility direct with them.

Q. Well, isn't it the auditor's responsibility—what is the purpose of asking these questions if you are not to assume some responsibility for their answers?

A. Well, I think when we answered the question yes, that they did, that that was as far as we need go.

Q. And you took Mr. McGloon's word for that and you didn't make any independent check aside from that to determine whether the two men in fact did take or did not take annual vacations?

A. I did not inquire specifically of anyone, that is a question directed to any and all responsible employees, and when the vice-president and comptroller of the company tells you something, there is no need to question it that I could see.

Q. Without arguing about this further, will you just follow me here. Assuming you had independently checked, and assuming that you did find out that these two

⁶⁰⁰ R. 625-627

⁶⁰¹ E. g. pages 231-239 *infra*.

men in these two key positions never took any annual vacations, and assuming you did find out that whenever Mr. George Dietrich was away on account of illness, Mr. Robert Dietrich took his position, would that have had any effect on you?

A. That is a hypothetical question. I don't know. That would depend on the circumstances.

Q. What circumstances would help you determine?

A. I really couldn't say. It depends on a great many things, I suppose. I mean, isn't that rather hypothetical?

Q. I mean it as such. After all, one of our purposes here is to examine what safeguards exist and whether these things can be detected.

A. I suppose you might inquire as to why they didn't take annual vacations. If you got a reasonable explanation from them and had no further reason to inquire into that question, you may be inclined to drop it or if you felt you should follow or rather follow the question further on you would. You might discuss it with the treasurer of the company, you might discuss it with the president of the company—

Q. But at any rate, if you had run down some of these items, such as we have discussed this morning in regard to mail and in regard to vacations, you might have gotten some key to the situation that we are here trying to look into.

A. You may have. I don't know. My belief is that they would have probably given you some reasonable explanation that you would have been willing to accept in the absence of any information such as we have now.

Q. Well, isn't it the auditor's job also to be, perhaps, * * * a little suspicious of these things, not just take things at their say-so?

A. I don't think any auditor is ever instructed or told to be suspicious. I think the average auditor is inclined to be somewhat skeptical, but, on the other hand, when you are dealing with what appear to be responsible and reputable people, and they make a statement of fact to you, I don't think that I possess the tact to contradict them in such a way as not to offend them and imply that I do not believe what they are telling me.

Q. Do you believe it to be part of your job that if you are told by a comptroller or an assistant treasurer that a certain fact is the case, that so and so mailed letters, or that so and so does take a vacation, that you owe no further duty to make any further independent check?

A. I think so, yes.

Q. That would apply to any job you would do, not particularly McKesson & Robbins?

A. That's right.

Q. And, here, if such check had been made to a further degree, you might have discovered things that led to this entire situation?

A. I don't think I would subscribe to that statement. Actually I don't know what might happen. My belief is that I might have received some reasonable explanation from someone, which I might have been willing to accept.

Mr. HENDERSON. May I just ask one question there?

Mr. GALPEER. Certainly.

Mr. HENDERSON. To whom would you have next gone to get an explanation?

The WITNESS. Mr. Coster." 682

The foregoing review of the Price, Waterhouse & Co. approach to the important question of internal check and control may be summarized by recalling that the questionnaires used by the firm directed

attention to the importance of making sure that the procedures described by officials of the client were actually followed in practice and were adequate protection; that Rowbotham, the partner, did not read the questionnaires but relied instead on Thorn, the manager, to report any significant discoveries; that Thorn in turn felt that minor weaknesses in internal check and control as reflected in the questionnaires were not important enough to report to a partner, and furthermore that he left the manner of using the questionnaires to the discretion of the senior on the job; and that Ritts, upon whom Thorn relied to gather the facts at Bridgeport, felt that in making balance sheet examinations, the " * * * accountant is only charged with making general inquiries with regard to the internal control exercised by the company." ⁶⁶³

It may also be recalled that Rowbotham thought that the unanswered requirement on the questionnaire to outline the Company's organization to show each department and lines of responsibility was a textbook requirement not carried out by practical accountants, although he thought the man on the job ought to have the outline of the organization in his head and take it up with his immediate superior. ⁶⁶⁴

It is interesting to observe in this connection that although the McKesson & Robbins organization was set forth in a printed chart and was accompanied by a bulletin of instructions in the form of a letter by F. Donald Coster to all executives and heads of departments in the Company, both effective September 1, 1937, no member of the auditors' staff who was questioned about it could recall having seen either chart or bulletin. Ritts when asked about the bulletin said that other bulletins issued by Coster from time to time were sent to his office but that he had never seen this one and that in so far as he knew it was not in their permanent file for the engagement. ⁶⁶⁵

The style of this bulletin was marked by repeated emphasis on the direct responsibility of all departmental executives, including the secretary, treasurer, and vice-president in charge of auditing and accounting (the comptroller), to the president of the corporation. ⁶⁶⁶ Although the organization chart indicated that the president was responsible to the Executive Committee and it in turn to the Board of Directors, no reference to this control was made in the bulletin except that the bulletin mentioned that the chart was adopted and approved by the Executive Committee. Coster said in the bulletin, however, that "At all times it is to be made clear that every one in the company is responsible, directly or indirectly, to the President of the corporation. The President, however, in his general super-

⁶⁶³ R. 218.

⁶⁶⁴ Footnote 629 *supra*.

⁶⁶⁵ Ex. 14, 97; R. 240.

⁶⁶⁶ Cf. footnote 365 *supra*. Cf. also R. 4279-4280; Ex. 203.

vision of the business shall act through the men of proper responsibility as indicated in the chart attached hereto.”

“Mr. Geo. E. Dietrich” was shown on the chart as the senior of three officers of the “Drugs & Chemicals Trading & Buying” department. Shown as associated with him were “Mr. Chas. Hermann” and “Mr. Simon Baum.” Testimony of Hermann indicated that he and Baum operated the real trading of this department and that they were not subject to Dietrich in their work. The department was shown on the chart as a part of the Connecticut Division under “Mr. Wilbur Dewell”, vice-president in charge. All foreign subsidiaries and all foreign departments were shown as under the direct and exclusive supervision of Coster.

Thorn was asked if the chart seemed to him to be an accurate presentation of the organization as he knew it. Looking at it generally he could not point out any inaccuracies. Thorn’s opinion of George Dietrich’s position was that in respect to crude drug operations he acted only in a clerical capacity and did not have any executive position in the foreign department. When questioned specifically, however, Thorn agreed that in this capacity George Dietrich received instructions from Coster direct and not from Dewell as indicated on the chart. Thorn also agreed that the chart was in error in omitting any reference to George Dietrich as assistant treasurer, in which capacity he routed all routine receipts and signed the checks for most disbursements.⁶⁶⁷

Thorn understood that Robert Dietrich’s purchasing activities were confined to items other than crude drugs, and that he was in general charge of shipping and receiving and of inventories located at Bridgeport. In so far as these activities involved transactions in foreign crude drugs, Robert Dietrich also was not in fact subordinate to Dewell as shown on the chart.⁶⁶⁸

Thorn was quite certain that neither the bulletin nor chart were in the permanent files for the engagement as he reviewed those each year himself. When he was asked what he would have done if he had seen a reference to them in minutes of the Executive Committee, he testified that he might have looked at them and would have asked for copies had he thought them important.⁶⁶⁹

In closing this general survey of the auditors’ knowledge of the McKesson system of internal check and control it may be appropriate to quote a question asked of both Ritts and Thorn by counsel for Price, Waterhouse & Co.:

“Summarizing the net effect of all of the controls that you have described and the number of people who had to handle each transaction in the crude drug de-

⁶⁶⁷ R. 1157-1162.

⁶⁶⁸ R. 1162.

⁶⁶⁹ R. 1162-1163.

partment in the way it was handled, is it fair to say that it would have been impossible for the fraud which is now indicated in this situation to have been carried out without collusion between the president of the corporation, the assistant treasurer of the corporation, the head of the stock department of the corporation, and somebody on the outside to take care of sending in invoices from suppliers, bank statements, bank debit advices and other papers?"

Ritts answered, "I think that is quite obvious." Thorn's answer was, "It would have been absolutely impossible without very extensive collusion from the president of the company right on down" through all the people mentioned in the question.⁶⁷⁰

Then followed another question by counsel for Price, Waterhouse & Co.:

"* * * have you, in your study of accounting and in your experience as a public accountant prior to the present case ever read or come in contact with or heard of any situation in which there existed such widespread collusion between high officials, subordinates and outsiders?"

Both answered that they had not,⁶⁷¹ although Price, Waterhouse & Co. in an examination some years ago uncovered the clue to the gigantic fraud perpetrated by Ivar Kreuger.⁶⁷² While there may be points of dissimilarity between the fraud perpetrated by Ivar Kreuger and that perpetrated by Coster, the following excerpts from the Price, Waterhouse & Co.⁶⁷³ report in the earlier case seem particularly appropriate in view of the specific question asked of Ritts and Thorn.

"The perpetration of frauds on so large a scale and over so long a period would have been impossible but for * * * (4) the loyalty or unquestioning obedience of officials, who were evidently selected with great care (some for their ability and honesty, others for their weaknesses), having regard to the parts which Kreuger intended them to take in the execution of his plans.

* * * * *

"The frauds could not have been consummated without assistance—witting or unwitting—of some of his associates, including some of the officers of the holding and financial companies * * * It is apparent that * * * subserviency if not complicity on the part of some of the employees * * * and forgery of documents in order to meet demands for evidence confirmatory of book entries, all contributed to prevent such audits as were made from resulting in exposure."⁶⁷⁴

D. CASH IN BANKS AND ON HAND

The preceding subsection dealing with internal check and control indicated the importance of that subject in relation to the audit program and a subsequent section will demonstrate Price, Water-

⁶⁷⁰ R. 724, 724A, 1232. (For Rowbotham's opinion, see his testimony quoted as the conclusion of this section, page 358 *infra*.)

⁶⁷¹ R. 724A, 1233.

⁶⁷² P. 495.

⁶⁷³ Continental firm.

⁶⁷⁴ "A. B. Kreuger & Toll Group of Companies—Final Report dated November 28, 1932—Price, Waterhouse & Co., Stockholm" printed in Hearings before a Sub-Committee of the Committee on Banking and Currency of the United States Senate on Stock Exchange Practices, Part 4, January 11–12, 1933. Thorn stated he had read about the report but of course had nothing to do with the work on it. R. 1246. See also P. 495–496 and Ivar Kreuger II, "Fortune," June 1933.

house & Co.'s recognition of the inadequacy of such control in some of the units of McKesson & Robbins subject to their examination.⁶⁷⁵ Further recognition of the internal control feature of the work is found in the firm's instructions to the staff in connection with the examination of cash transactions. Testimony reviewed in the previous section, in this, and in sections to follow on receivables and inventories indicate that a proper verification of the cash transactions was considered an important step in establishing the authenticity of transactions with customers and creditors, as well as in verifying the balances of cash on hand and in bank. The following quotation is from the cover page of a two page Price, Waterhouse & Co. memorandum regarding verification of cash and bank balances in connection with so-called balance sheet audits and appears beneath the comment that "this is a supplement to, and not a substitute for, the Federal Reserve Bulletin."⁶⁷⁶

"TO THE MEMBERS OF THE STAFF:

We think it well to call the attention of our staff to the fact that, in organizations where an adequate system of internal check cannot be maintained by reason of the smallness of the organization, our examination into the cash transactions, particularly the verification of the cash and bank balances at the close of the period under audit, should be conducted in a careful and painstaking manner and that the limited verification as outlined in the Federal Reserve Bulletin of April, 1917, should be extended. We have, accordingly, prepared and are attaching hereto a memorandum outlining the procedure to be followed in connection with the verification of the cash and bank balances and it is requested that the schedules containing particulars thereof should show clearly the extent of the verification effected. Where bank practice does not permit of an exact adherence to the methods outlined (as in New York), the verifications should be of a character substantially equivalent.

PRICE, WATERHOUSE & Co."

The memorandum itself, because of its importance in relation to the work of the audit, is reproduced in full:

"MEMORANDUM REGARDING VERIFICATION OF CASH AND BANK
BALANCES IN CONNECTION WITH SO-CALLED BALANCE
SHEET AUDITS

"In verifying the cash the following procedure should be adopted, viz:

"(1) The cash on hand in so far as circumstances permit should be counted promptly at the close of business on the last day of the month of the period covered by the audit.

"(2) In the event that the cash is not counted at that time it may be necessary when it is actually counted to make a supplementary and simultaneous verification of the bank balances.

"NOTE.—This applies particularly to companies not having a petty cash fund under the imprest system.

⁶⁷⁵ Pages 186-187 *supra* and 318 ff. *infra*.

⁶⁷⁶ Ex. 17.

"(3) Items other than currency and coin must be listed in detail and the nature thereof properly described in the working schedules.

"(4) Checks and vouchers supporting disbursements and held in lieu of cash must be listed and full particulars regarding the date of the check and voucher and names of payee and payer embodied in the schedules.

"(5) Receipts from employees for advances or any other items should be listed in detail with dates.

"NOTE.—The items listed under (4) and (5) should be presented to a responsible official of the company for his approval.

"(6) The cancelled checks returned by the bank during the last month of the period should be compared with the entries in the cash book, i. e., name of payee and amount of check, while checks dated prior to the closing month should be compared with the previous reconciliation prepared by the client. The endorsements on the checks must be scrutinized; and where endorsements exist other than those of banks and the payee, inquiries should be made to determine whether or not irregularities exist in connection with such unusual or irregular endorsements. Before the completion of the audit the outstanding checks which form part of the bank reconciliation should be obtained from the bank direct and compared with entries in the cash book.

"(7) Outstanding checks not examined at previous audit on account of not being cancelled and returned by the bank before completion of work should be inspected and traced to the cash book entries.

"(8) In cases where the system of internal check in force is weak the cancelled checks for some other month than the last month of the year should also be examined and compared with the disbursements recorded in the cash book.

"(9) Currency checks for other than petty cash disbursements should be inquired into and tested by examination of supporting documents. A list of such checks and the account to which expenditure has been charged should be prepared for official's approval.

"(10) Any erasures on a check, indistinct endorsements or other suspicious features should be carefully inquired into.

"(11) Securities or negotiable instruments should be examined simultaneously with cash count.

"(12) Cash receipts (daily) for at least the last month of the period should be traced to the bank statement.

"(13) In cases where the internal check is weak a comparison of the collections recorded in the cash book should be made with the original deposit slips on file at the bank or with copies thereof obtained direct from the bank for a period of at least ten days prior or subsequent to the close of the period.

"NOTE.—If any suspicious circumstances develop during the course of the examination they should immediately be called to the attention of a principal of the firm or to the manager in charge of the work. This should be done by the assistant before the matter is discussed with the client."

The actual cash work program prepared for use on the McKesson engagement adhered closely to the requirements laid down in the memorandum. The program⁶⁷⁷ reproduced below was prepared in mimeographed form by Thorn for use on all units of McKesson & Robbins under examination by Price, Waterhouse & Co.'s New York staff. A similar program of work was followed in the other offices of the firm.⁶⁷⁸

⁶⁷⁷ Ex. 21, 20; R. 970.

⁶⁷⁸ R. 439-441, 970-971.