Ritts was asked to explain how the intercompany sales were handled by the affiliated companies. His examination of the December 31, 1937 balance sheet of the Canadian Company indicated no substantial intercompany account receivable at that date, the only item being $2,998.75 due from the London subsidiary. This led to the conclusion that the sales under discussion must have been cleared in some way during the year but he did not know how. Neither had he considered how the Canadian Company got funds for the payment of dividends and expenses.[874]

From the reputed establishment of Manning & Company as a bank in 1931 to the close of 1936 most of the Canadian Company's cash came from transfers from accounts maintained in the name of Manning & Company with recognized banks.[875] Miss Walsh testified, however, that most of the cash that came into the Canadian Company during the "last two years, or so", came from the sale of merchandise to the Connecticut Division.[876] Seal of S. D. Leidesdorf & Co. matched these sales and collections thereon from the parent company with the Canadian Company's need of funds for dividend purposes and testified that bank balances prior to such collections were inadequate to meet the dividend payments on the dates shown.[877] The following extract from a brief table prepared by him shows this relationship.

Evidence of Sale of Fictitious Drugs by the Canadian Company to the Maryland Company in Connection With the Payment of Dividends by the Canadian Company

Merchandise Sold		Cash Received	Dividends Paid	
Date	Amount	Date	Date	Amount
Apr. 21, 1937	$55, 000	Apr. 29, 1937	May 1, 1937	$48, 000
Oct. 13, 1937	50, 400	Oct. 27, 1937	Nov. 1, 1937	48, 000

In respect to transactions between the Maryland Company and the Connecticut Division and wholesale houses, it should be remembered that after 1934 most of the latter were operated as divisions. McGloon, during the last several years, caused to be prepared in his office a statement showing the changes in the branch control accounts and the employment of capital in the various divisions and subsidiary corporations. This document consisted of a covering letter addressed to Coster, Michaels, Murray, Thompson, and the "Divisional Vice Presidents"; and seven pages showing for each McKesson unit the balance

[874] R. 554–560, especially:

"Q. [By Mr. Galpeer.] Let me summarize it in one or two questions in connection with these intercompany sales which you refer to in Commission's Exhibit 26, which is Mr. Wyman's memorandum, in the amount of $244,875. Do you know how the Connecticut Division paid this sum to the Limited Company?

A. [By Ritts.] No, I do not.

Q. And the second question: Do you know from what source the Limited Company got the cash with which to pay the dividends on its securities and to pay the three-fourths of one per cent to Smith?

A. No, I do not." R. 559–560.

[875] Footnotes 200 and 407 *supra*.

[876] R. 4423.

[877] Ex. 258; R. 4585–4586.

in the branch control or, in the case of separately incorporated units, the Corporation's capital employed at the beginning and end of the year, the increase or decrease for the year, the net cash advanced to or from the home office, the net profit or loss of the unit for the year, and an analysis of other charges or credits to the account during the year.[878] This report for 1937 indicated that the majority of the units paid cash to the home office, a substantial number turning in amounts much in excess of the profit for the year. The total net profit attributed to the wholesale drug and liquor houses, was $3,233,571 and the net cash remitted to the home office from these units was $3,766,421. The liquor production divisions showed a profit of only $151,422 but paid to the home office $1,628,125 net. The Canadian Company, including its London subsidiary, made a profit of approximately $178,000 and paid the home office $43,500, of which $21,000 was a dividend paid the Connecticut Division which was its direct parent. The difference represented interest of $22,500. In addition, this Company paid dividends of $75,000 to the public.[879] The Connecticut Division, which included the manufacturing, import and export activities, real and fictitious, paid $236,889 to a foreign subsidiary, and drew $90,000 from the home office. However, the net result of all of this Division's transactions for the year, as revealed by this report, was that its profit of $1,940,058 remained in the Division plus an additional investment of approximately $100,000.

McGloon testified that reports of this type were never sent to Price, Waterhouse & Co. and he did not believe they knew they were in existence. If they had asked for them he would have produced them.[880] The report referred to above is dated March 10, 1938, while Ritts' memorandum covering his work at Bridgeport for the same year is dated in New York, February 24, 1938.

Other officers of the Company were questioned about this situation. Joseph L. Bedsole, vice-president and director, referred to the report we have just described as a source from which it appeared, after a little study, that the Connecticut Division profits were going back

[878] Ex. 115; R. 1740–1743.

[879] The manner in which funds for this and foregoing payments was made available was explained at pages 241–242 *supra*.

[880] "Q. [By Mr. GALPEER.] So that if Price, Waterhouse & Co. had not asked for, or seen, or had any connection with this particular report, they could have at any time obtained the facts therein set forth by referring to the books of the company?

A. [By MCGLOON.] Yes.

Mr. STEWART. If it was any part of the scope of the examination they were conducting.

By Mr. GALPEER:

Q. You wouldn't have refused them access to any books, would you?

A. No.

Mr. STEWART. If they had been doing work they hadn't been employed to do, you would have been complaining about paying them for it, wouldn't you, Mr. McGloon?

A. Do you want an answer to that?

Q. I thought Mr. Galpeer might have some doubts about it. I don't. I think we had better have an answer.

A. Yes." R. 1740–1742.

into that Division, whereas other divisions were contributing cash to the home office. His own company at Mobile, for example, had returned $518,000 from May 1, 1928 through 1938 on an original investment of $413,000 by the Maryland Company. He accepted the situation as satisfactory because he thought the manufacturing department was growing and the heavy general sales required the reinvestment of the Connecticut Division profits where they were earned.[881]

The treasurer of the Corporation did not take this condition quite so calmly. Thompson prepared a memorandum on inventories in the early part of 1938 with the aid of McGloon's staff [882] and sent it to Coster, Michaels, and Murray under date of April 18, 1938. This report referred to the fact that a year before the treasurer had warned these officers that all inventories should be reduced and an agreement had been reached at that time to do so within the year. The report mentioned that since then liquor inventories had decreased, wholesale drug inventories were about the same, and Connecticut inventories had increased. A 3-year summary of sales, inventory, receivables, net profit, net worth, and net amount paid to Maryland Company was given for the Connecticut Division separating what he called the bulk department from other activities.[883]

Thompson's conclusions in his report on this particular subject were very concise:

"It will be observed that the inventory and receivables of the Bulk Department increase annually and approximately the amount of the profit of the department, and that the Connecticut division has not contributed a net balance to the Corporation for the purposes of bond interest, dividends or bank debt reduction during the past three years. In mentioning this fact, however, it would not be fair to fail to point out that through the use of the capital in the Connecticut division there is contributed approximately two-fifths of the profits available for interest, dividends, taxes, etc."[884]

Thompson in his testimony stated that the first time he noticed this condition was early in 1936 and that he grew quite concerned about it when the bank debt began to go up, which led to a desire on his part to get cash up from the divisions in order to reduce the debt.[885] As pointed out heretofore it was Thompson's following up on this subject that led to the uncovering of the fraud.[886]

The auditors were questioned at the hearings as to whether the condition cited above was known to them and whether they had set forth the situation in any way. Ritts testified that during the last

[881] R. 2489–2493.

[882] R. 1737–1739.

[883] Comparison of sales figures used in this summary with departmental statements (Ex. N, 124) indicates that the former included both the real and fictitious bulk business, of which the fictitious was much the larger.

[884] Ex. 114.

[885] R. 2065–2066.

[886] Pages 128 ff. *supra*.

several years he prepared "* * * a 'Source and Application of Funds Statement', which would indicate the increase or decrease in both these accounts receivable and inventories * * *" for the Connecticut Division as a whole "* * * but there again it may be that such changes would be substantially changes in the crude drug stocks and crude drug receivables." [887] These statements indicated increases in inventories in some years and increases in receivables in some years, with a net increase in the sum of the two but not in each in every year. It never occurred to Ritts that apparently all of the earnings of this Division were being plowed "* * * back into one type of asset or another * * *"; consequently, he never set it forth in any of his reports. Even if he had noticed that fact, he thought it would be "* * * an operating question for the company rather than an accounting question." [888] In any event the increases in inventories and receivables by divisions were indicated in schedules included in the reports submitted to Coster, but Ritts never discussed the matter with anyone prior to the exposure.[889]

It should be noted that the financial statements for the Connecticut Division which were submitted to Coster, without comment by the auditors, included a "Statement of Branch Control Account" which displayed substantially the same information as that reflected in McGloon's report described above. The statement for 1937 is so brief that it may be reproduced here: [889a]

"Exhibit B

CONNECTICUT DIVISION

McKESSON & ROBBINS, INCORPORATED

STATEMENT OF BRANCH CONTROL ACCOUNT

FOR THE YEAR ENDING DECEMBER 31, 1937

* * * * *

Balance, December 31, 1936		$18, 405, 970. 77
Net profit for the year ending December 31, 1937 (Exhibit C)		1, 940, 058. 04
Advances received from the head office		455, 000. 00
Value of net assets transferred from Lucretia Vanderbilt, Incorporated, as shown by the books of that company		5, 090. 15
		$20, 806, 118. 96
Deduct:		
Payments made to the head office	$290, 000. 00	
Payment made to New Haven Division	75, 000. 00	365, 000. 00
Balance, December 31, 1937 (to Exhibit A)		$20, 441, 118. 96"

[887] R. 534. This was not a new idea, for such a statement was included in the audit report on Girard & Co., Inc., submitted to Coster under date of March 9, 1925, and each report thereafter on that Company and McKesson & Robbins, Incorporated (Connecticut) through 1929, when separate reports on the Connecticut Company were discontinued. See Ex. 138-148, 151. See also Ex. M-2, M-11.

[888] R. 536. [889] R. 538. [889a] Ex. 261.

After the fraud was exposed, Ritts collected his working papers and during the week of December 19 to 24, 1938, he prepared a schedule showing crude drug inventories, sales, and accounts receivable for the Connecticut Division and the Canadian Company for the years 1932 to 1937, inclusive.[890] This schedule included a comparatively small amount of real resale business in some years. Subject to the influence of this inaccuracy Ritts agreed that his schedule revealed that gross profit on foreign crude drugs over this period for the two units was substantially equal to the sum of the increases in accounts receivable and inventories, and that for each year that there was a close similarity in totals, but that inventories and receivables separately did not increase constantly each year.[891]

The following tables were condensed from a later more accurate schedule prepared from material in Price, Waterhouse & Co.'s working papers.[892]

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[890] Ex. 43.

[891] R. 526–533.

[892] Ex. Q. The 1933 schedules in Price, Waterhouse & Co.'s papers do not segregate "Special Resale Stock" (fictitious foreign crude drugs). An adjustment to eliminate $131,000 gross profit for this year on real business of the Connecticut Division with which the fictitious was combined has therefore been made to arrive at the amount shown in the tables. Ex. 267. Other minor differences have been ignored as immaterial.

Statement of Foreign Crude Drug Gross Profits, Inventories, and Accounts Receivable for the Canadian Company, Connecticut Division, and the Two Units Combined

(000's omitted)

Year		Gross Profit	Increase or (Decrease) in Inventories and Accounts Receivable Combined	Increase or (Decrease) in Inventories	Increase or (Decrease) in Accounts Receivable
		Canadian Company			
1933		$ 237	$ (60)	$ (51)	$ (9)
1934		238	51	(37)	88
1935		256	78	(148)	226
1936		275	100	103	(3)
1937		285	32	(63)	95
	Total	$1, 291	$ 201	$ (196)	$ 397
		Connecticut Division			
1933		$ 994	$1, 679	$ 375	$1, 304
1934		922	1, 069	1, 168	(99)
1935		1, 437	1, 619	(236)	1, 855
1936		1, 513	1, 622	1, 775	(153)
1937		1, 516	1, 872	1, 169	703
	Total	$6, 382	$7, 861	$4, 251	$3, 610
		Canadian Company and Connecticut Division Combined			
1933		$1, 231	$1, 619	$ 324	$1, 295
1934		1, 160	1, 120	1, 131	(11)
1935		1, 693	1, 697	(384)	2, 081
1936		1, 788	1, 722	1, 878	(156)
1937		1, 801	1, 904	1, 106	798
	Total	$7, 673	$8, 062	$4, 055	$4, 007

The year 1932, included on the schedules, has been omitted from the above tables because the relation between gross profit and asset changes was obscured by the fact that in that year most of the change was made from an actual disbursement and receipt of cash to the device of Manning & Company debit and credit advices. For the entire period after 1932, the difference between the gross profit and the increase in accounts receivable and inventories for the Canadian Company and Connecticut Division combined is accounted for principally by fluctuations in the balance in the Manning & Company account (the third fictitious asset affected by the fictitious crude drug business) and by the fact that cash discounts recorded as taken on fictitious purchases from some of the purported vendors were included in "Other Income" in the profit and loss accounts rather than as an adjustment of purchases.

It will be noted that the fictitious assets of the Canadian Company did not rise with succeeding years' profits but that the fictitious items in the Connecticut Division rose in excess of the fictitious profits of that unit. The difference between the excess of approximately $1,500,000 of increase in fictitious assets over profits for the five-year period in the latter Division and the $1,100,000 excess of profits over the increase in fictitious assets in the former is approximately the amount of purchase discounts which should be included in determining the gross profits for this purpose. The shift in the growth of the assets from the Canadian Company to the Connecticut Division is accounted for by the fact that it was necessary to get actual cash into the Canadian Company so that actual disbursements could be made for expenses and dividends, since that unit, unlike the Connecticut Division, had no substantial real business which it could draw on directly for this purpose.

Thorn and Rowbotham echoed Ritts' views as to whether it was an auditor's duty to notice and bring matters such as those discussed above to the attention of the client's directors. Thorn did not see why the directors would be interested in knowing whether the increases mentioned were in the resale crude drug department or the manufacturing departments, the total was there if they wanted it, compared with the preceding year. In Thorn's discussion of the increases with Rowbotham the only question raised would be as to collectibility of the accounts and salability of the merchandise, both of which could be demonstrated to their entire satisfaction. In this connection, Thorn testified that he did not know, at the time, that all of these crude drug transactions handled through W. W. Smith & Company, Inc., were cleared through Manning & Company and that the cash for dividends and commission and expenses in connection with them, at least in later years, must have come from other departments of the business.[893] As a matter of fact, he felt that he would not have had any occasion to observe the movement of cash during the year. He had no idea as

[893] Ritts testified to the same effect. R. 554–560, 140. The last cash received as coming from Manning & Company was in 1933 for the Connecticut Company and 1936 for the Canadian Company. See footnote 200 *supra*.

to how much cash moved from the head office to the branch or the reverse.[894]

Rowbotham, as has been seen, was entirely convinced of the excellence of the accounts receivable, and, as will be shown in the next section, he also was satisfied with the inventory so that the plowing back of profits and the failure of the crude drug operations to contribute any cash toward the payment of dividends or reduction of debt never disturbed him. Rather, he felt that this was the way American business was done and it was highly commendable.[895]

In addition to the "Statement of Branch Control Account" reproduced above, there were occasional references in the audit reports to intercompany accounts and proration of expenses between Companies for one purpose or another, such as an analysis of intercompany accounts receivable appearing in the report on the 1929 audit [896], but it appears from the testimony of Rowbotham, Ritts, and Thorn that they attached no auditing significance to such analyses as were made year after year of the growing investment of the parent in the Connecticut Division as they considered the reinvestment of earnings in this unit to be an operating question rather than a problem for the auditors.

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[894] "A. [By THORN.] * * * Then beyond that point it becomes an operating problem because, after all, companies making money, having a profitable business, and able to expand that business—there is nothing we can say in the way of criticism even. In other words, that is an operating problem from then on out after we have satisfied ourselves.

Q. [By MR. GALPEER.] Did you at that time discuss the connection of cash to these transactions: In other words, that as a result of this Manning clearance account, at least during the last three years or so that no cash was coming out of the transactions and that the actual payment to Smith of commission and the other expenses had to be borne in cash by the other branches of this business?

A. No, that I am sure hasn't been discussed because of the fact that I wasn't aware of that, as I didn't know at the time that all crude drug transactions were handled through Manning and I haven't known through the years exactly as to how much cash might have been paid over to the head office or the parent company or vice versa. As to that cash position, it is transactions that are occurring throughout the year and I wouldn't come in contact with those, so that I am sure that has not been discussed with the partners." R. 910-911.

[895] "[By ROWBOTHAM.] * * * I think undoubtedly one of the points on this job is the fact that this crude drug business was expanding and that the profits on the crude drug business were being plowed back into it.

I didn't know that all the profits were being plowed and I don't understand that that is the fact. I believe money did come out of it. I am not certain of that, but I did know broadly that the profits of the crude drug business were being plowed back into that business.

Now, that is one of the points that would come up and would be discussed between Thorn and me, though I don't recollect for the moment that there is any specific sentence in any of those memoranda which says these words: 'The profits of this business are being plowed back' but that is one of the things that was discussed at the time that I knew about.

If I may say a word right there, it didn't seem to me at the time, it didn't cause me any discomfort, it didn't cause me any disquiet because it seemed to be just plain common sense that if a man has got a good business he ought to plow back his profits in there as long as that business is good. That is the way American business has been run in the past and it is only in very recent years that the other idea, that every cent of profit ought to be distributed to stockholders has come around and we have had, as you know, the undistributed profit tax and even then there has been quite a measure of opposition to that.

* * * * * * *

So that when this question of plowing back profits came up, to me it didn't seem anything unnatural and didn't seem to me out of the way and it just seemed to me just common sense if you had a business that could make profit." R. 1917-1919.

[896] Ex. 151.

G. INVENTORIES

Inventories of merchandise constituted the largest single asset of the McKesson Companies, approximately 50% of total assets, and consequently required a substantial portion of the time spent on the audit. The following table [897] indicates clearly the heavy concentration of the assets of the Company as a whole, as well as of the Connecticut Division and Canadian Company, in inventories and in cash and customers' accounts receivable discussed above. Together these three categories comprised approximately 85% of the total assets of the three units.

Percentage of Certain Assets to Total per Balance Sheets as at December 31, 1937

	Maryland Company and Subsidiaries Consolidated	Connecticut Division	Canadian Company and Subsidiary
Total assets	$87, 182, 766	$21, 686, 133	$3, 067, 432
Cash	$ 3, 358, 571	$ 498, 763	$ 60, 779
Percent of division's assets	—	(2. 3)	(2. 0)
Percent of consolidated assets	(4. 0)	(. 6)	(. 1)
Customers' accounts	$25, 791, 604	$ 7, 803, 808	$1, 582, 703
Percent of division's assets	—	(35. 9)	(51. 0)
Percent of consolidated assets	(29. 5)	(8. 9)	(1. 8)
Inventories	$44, 254, 736	$10, 634, 944	$1, 002, 322
Percent of division's assets	—	(48. 8)	(33. 0)
Percent of consolidated assets	(51. 0)	(12. 2)	(1. 1)
Total	$73, 404, 911	$18, 937, 515	$2, 645, 804
Percent of division's assets	—	(87. 0)	(86. 0)
Percent of consolidated assets	(84. 5)	(21. 7)	(3. 0)

The Canadian Company and subsidiary total assets of $3,067,431.57 as stated on their own consolidated balance sheet included $420,000.00 for goodwill, trade names, franchises, etc., which was eliminated in consolidation with the Maryland Company. If the intangibles were eliminated from the total assets of the Canadian Company and subsidiary the three categories of assets set forth in the table above would constitute 99.9% of the total assets of that Company and subsidiary, there having been in addition only a negligible amount of furniture and fixtures and prepaid expenses. The distribution on this basis would have been: cash, 2.3%; customers' accounts, 59.8%; and inventories, 37.8% of the adjusted total.

Except for cash of the head office which amounted to approximately $1,000,000, the half million cash of the Connecticut Division was the largest balance in the 66 divisions and 14 subsidiary corporations at December 31, 1937. The other balances ranged from $75.00 to

[897] Adapted from Ex. 28 prepared by Price, Waterhouse & Co. R. 429-431.

$246,585.40.[898] The receivables in both the Connecticut Division and Canadian Company were each greater than in any of the other units of the Company. These other 80 units showed balances at that time ranging from $6,596.64 to $1,275,596.08.[899] The inventory balances were allocated to 78 units, some of the liquor divisions having been grouped to give them the second largest inventory total—$4,370,560.32 compared with the inventory in the Connecticut Division of $10,634,-943.94 and in the Canadian Company and subsidiary of $1,002,321.60. The other inventory balances ranged from $17,553.55 to $2,320,889.14 in the wholesale houses.[900]

The inventory on the books at Bridgeport in the Connecticut Division at December 31, 1937, as summarized by Ritts, consisted of 12 categories, the major items of which were listed as finished stock (manufactured products of the Company) $726,061.23, outside warehouses (other than Canadian vendors) $311,679.20, and book 7, general crude (stock listed as with the fictitious Canadian vendors and a small amount of real resale crude) $9,145,962.14.[901] The Canadian Company inventory of $990,585 at December 31, 1937 consisted entirely of merchandise listed as with the same Canadian vendors.[902]

Clifford H. Hill,[903] with the aid of two other juniors, carried out all of the work program as laid down for the audit of inventories of the Connecticut Division on the 1935, 1936, and 1937 engagements.[904] Wyman did all of the work on the Canadian Company for 1937 except one item investigated by Ritts.

At the outset it should be recalled that since some time in 1935, the inventories which were discovered to have been fictitious were supposed to have been in the warehouses of the vendors in Canada, but prior to that time these inventories were supposed to have been stored in some years (1933, 1934) entirely in the Company's plant at Bridgeport and in earlier years partly in outside public warehouses. Because of its relative simplicity and because it consisted entirely of the fictitious crude drugs and essential oils in question, the inventory work

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898 Ex. 4; R. 100.

899 Ex. 5; R. 100.

900 Ex. 3; R. 98.

901 Ex. 6; R. 115.

902 Ex. 65. In addition, the Canadian Company consolidated balance sheet includes a small inventory of real products carried by its subsidiary, the London Company.

903 *Clifford H. Hill* was employed by Price, Waterhouse & Co. for the first time on January 6, 1936, and released on February 17, 1936. He was reemployed the following season from November 23, 1936, to April 8, 1937, and again from December 6, 1937, to April 20, 1938. He was further reemployed on December 9, 1938, and although a temporary employee, had not been released at April 20, 1939, when Exhibit 212 was placed in the record. In explaining his period of employment with Price, Waterhouse & Co., he testified on January 20, 1939, "In order not to lead you astray, I have had seven months vacation each year * * * ." He attended Nelson's Business College, Cincinnati, Ohio, for 10 months in 1909 following which he held several clerical positions there for 2 years; was bookkeeper for a coal company for 2 years; spent several years each with various insurance companies and agencies as cashier, bookkeeper, and accountant; and for eleven years prior to his engagement by Price, Waterhouse & Co. he was accountant for a firm of iron workers. He is not a certified public accountant. Ex. 212; R. 1255-1259.

904 Ex. 41, 40, 37.

program for the Canadian Company as carried out by Wyman in his examination for 1937, will be considered before reviewing the work in the Connecticut Division which also covered real merchandise.

In introducing the supplementary questionnaires on internal control it was mentioned that one of these covered inventories for the Connecticut Division. A separate questionnaire was not filled out for the Canadian Company for, Ritts explained, the problem was the same in the Canadian Company as in the Connecticut Division so there was no purpose in preparing a questionnaire on the Canadian procedure.[905] Wyman's work then was confined to the inventory work program itself which was a mimeographed sheet of instructions used for the Canadian Company and the wholesale houses audited by the New York office of Price, Waterhouse & Co.[906]

For reference later, the full work program is reproduced here:

"(1) Obtain the company's inventory sheets and discuss the method of taking the inventory with responsible officials.

"(2) If any inventories were stored in outside warehouses, obtain confirmations direct from the custodians and inspect warehouse receipts, if any.

"(3) Make inquiries relative to merchandise held on consignment or merchandise billed and not yet shipped to see that such items are not included in the inventories.

"(4) Make inquiries relative to merchandise shipped on consignment to see that it is included in the inventory and not in accounts receivable.

"(5) If the company has prepared price-test schedules, check particulars of schedules from the inventory sheets and add additional items considered necessary. If the company has not prepared such schedules, have them made up immediately so that invoices required for price verification may be assembled by the company while the other verification work is being done.

"(6) Foot inventory sheets from the $1 column. Foot only a representative number of sheets totaling less than $100 and scrutinize the others.

"(7) Summarize inventory page totals and agree grand total with general ledger control.

"(8) If company maintains stock cards, check a representative number of the larger items on the inventory sheets to the cards, note any substantial differences and see that the cards are adjusted to physical count; state what disposition is made of differences.

"(9) Verify extensions of items over a minimum amount determined by the assistant in charge and of enough smaller items to make a verification of two items on each other page.

"(10) Make an eye test of each extension not verified to determine that the decimal point is in the right place. In both this work and the verification of extensions, care should be taken to see that the same unit is used for quantities and pricing.

"(11) Schedule all differences for client's attention, and for any adjustments considered necessary.

"(12) Verify unit prices by reference to vendors' invoices and insert all pertinent information on price-test schedules. Price list may be used in some cases as specified in our instructions.

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[905] R. 266.

[906] Ex. 23.

"(13) Insert last year's quantities and unit prices on price-test schedules in red for the more important items.

"(14) Obtain market quotations when available.

"(15) Schedule all items priced in excess of cost or market, whichever is lower, and adjust where necessary.

"(16) Scrutinize inventory records, especially stock cards, for slow and inactive goods.

"(17) Classify inventory in accordance with the company's instructions showing as many detailed classifications as possible.

"(18) Submit particulars of intercompany and interdivision inventories to New York office as instructed.

"(19) Take up all merchandise in transit at the close of the period, if it was billed or shipped F. O. B. on or before the closing date.

"(20) State the inventory value of any merchandise hypothecated or assigned, with particular reference to accepted drafts.

"(21) Show amount of taxes or duties payable on merchandise in bond or stored in foreign warehouses, if any.

"(22) Examine contracts for purchase commitments to see that quantities were neither in excess of normal requirements nor at prices in excess of current market prices at the date of the examination.

"(23) Prepare inventory certificate and obtain signatures of responsible officials.

"(24) The foregoing program should be modified and extended to meet the requirements of each particular examination. Additional work done may be described below."

The first point on the Canadian program required that the inventory sheets be obtained and the method of taking inventory be discussed with responsible officials. Wyman secured the inventory book sheets which had been prepared for him but did not compare them with the original count sheets nor did he discuss the method of taking the inventory with any official since the inventory was supposed to be in the warehouses of the vendors from whom, as the second requirement of his program, he was to get confirmations and inspect warehouse receipts, if any. Wyman secured confirmations which Price, Waterhouse & Co. obtained direct from the vendors but decided that it was unnecessary to ask for warehouse receipts as it had not been done before and the confirmations seemed sufficient.[907] As to this point he wrote in his memorandum that "The merchandise comprising the inventory at December 31, 1937 was all held by Canadian suppliers at that date and was confirmed by certificates received direct from the custodians thereof." [908] These false confirmations were received through the mail on letter-heads of the five fictitious Canadian vendors: B. Miller & Company, Importers and Brokers, 45 Queen Street, Ottawa; H. Monroe & Company, Brokers & Agents, 27 Wellington Street East, Toronto; P. Pierson & Company, Foreign Representatives, University Tower, Montreal; A. H. Raymond & Company, Importers, 504 Dominion Square Building, Montreal; and D. C. Reynolds & Company, Commission Merchants, 192 Bank Street, Ottawa. All of

[907] R. 357-361.
[908] Ex. 26.

them used a slightly different wording, such as, "holding for their account and subject to their disposition. * * * No charges are due," "held by us as their property," "held for their account," "holding * * * for account of," and "carried by us for their account * * * free of all charges and subject to their withdrawal." None of them stated the address at which the goods were held unless it be assumed to be at the letter-head address which, however, in some cases at least, appeared to be an office building. The number of items carried by each vendor varied from one to four, making a total at December 31, 1937 of 13 different items all of substantial quantities [909] easily checked against the inventory book sheets and verified as to purchase prices. Both of these steps were required, and done by Wyman.

The inventory was footed, extensions checked, purchase invoices examined for evidence of acquisition and unit prices, items compared with stock cards, quantities compared with prior years, and an inventory certificate was obtained signed by F. D. Coster as president and treasurer, Geo. E. Dietrich as secretary and assistant treasurer, J. H. McGloon as comptroller, and, for identification purposes only, by G. F. Wyman for Price, Waterhouse & Co. Since the inventory certificate obtained by Wyman from officials of the Canadian Company was the same as that on the Connecticut Division, except for two items in the latter referring to counting, a step not taken in the Canadian Company, a detailed consideration of certificates is deferred until that of the Connecticut Division is reached.

All of the 24 points on the work program for the Canadian Company were either covered, or crossed out as inapplicable. In addition, Wyman added three points not on the mimeographed work program. Sales subsequent to December 31 were listed and unit sales prices compared with the inventory prices; opening and closing inventories, both quantity and amount, were reconciled by commodities; and year-end purchases were traced to the purchase register to see that the proper liability was recorded.

Wyman was questioned in more detail on a few points of the work program. Item 12 required the verification of prices by reference to vendors' invoices, all of which quoted terms "Cash against documents." Although he recalled the form of these invoices, Wyman could not recall the terms and does not think he would have looked at the terms. He never asked anyone for documents and did not recall any discussions concerning them.

Item 21 of the program requested that the amount of taxes or duties payable on merchandise in bond or stored in foreign warehouses be shown, if any. It was marked "none." Wyman marked this but did not remember having done anything on it. He thought he might have

[909] Ex. 54. The total number of items for other years varied from two at December 31, 1928 to twenty at December 31, 1933. Ex. 149, 75; see also Ex. 72, 73, 74, 76, 205.

inquired of McGloon or possibly Dietrich but, if so, the answer was not important enough to record more fully than indicated. He did not recall how the taxes were handled but was sure they were taken care of—possibly W. W. Smith & Co. were required to take care of them under their contract.[910]

In his memorandum Wyman reported that "A dollar statement of the sales and cost of sales by commodities for the year, prepared in connection with the reconciliation of the quantities in the December 31, 1937 inventory, with those of the previous year, indicates that the company consistently realized a profit from its transactions throughout the year." That a profit was realized on all transactions was mentioned first by Ritts in his memorandum on the 1935 accounts when he said, "Because of the relatively small number of transactions during the year, we were able to reconcile the quantities in the opening and closing inventories by applying the purchases and sales of the several commodities. The dollar amounts of sales and cost of sales were also verified in connection with the above-mentioned reconciliation and it was noted that the company realized a profit on all their transactions throughout the year." [911]

Wyman also stated in the 1937 memorandum that the pricing was at cost, which appeared to be below current market quotations, although as they had been required to do in the past, they accepted quotations furnished by a vendor for several items not currently quoted. Wyman's only original contribution to the memorandum (he followed Ritts' 1936 memorandum closely) occurred at this point when he reported that the items for which quotations were not available were purchased in November or December, 1937, and that the stock records of the company did not disclose any price changes in any of the commodities traded in since April 21, 1937.[912]

The situation revealed above as to failure to find published quotations on some items in the inventory had prevailed since 1931, at least, for a similar comment to that referred to appears in the memorandum on the Canadian Company work of that year, the first reference to inventories. In that year Coster assured the auditors that the items in question "* * * could not have been bought at a lower price at December 31." Thorn, who wrote this memorandum, could not say at the hearings why he included his next remark in a document of this kind which was condensed and supposed to highlight important points on the job, but he said, "All the merchandise was purchased from J. P. Meyer & Co., Inc. of Brooklyn whose address is the same as that of Smith & Co., mentioned above" (in connection with the contract). He testified that "* * * there are inconse-

910 R. 351–364 cover the discussion of items 12 and 21.

911 Ex. 26, 73. See also Ex. 72.

912 Ex. 26.

quential things that get into these memoranda because we can't always pick out what is important and what isn't" and that he presumed he was showing that these people being in the same class of business were in the same location or at the same addresses and that Jaureguy, who was then manager and had been on the work in some capacity since the audit at November 30, 1926, probably did not see any significance in it either but failed to take it out. Thorn saw no possibility that the similarity of addresses of J. P. Meyer (from whom all of the goods were supposedly purchased at this time) and of W. W. Smith (through whom they were all supposed to have been sold and shipped) might suggest some connection between the two concerns which would throw suspicion on the merchandise or the price or that the notation had been made for that reason.[913]

In the same memorandum Thorn stated that the inventory of the Canadian Company, which in former years had been in a public warehouse in Canada, was then in the Connecticut Company's warehouse in Bridgeport and that the goods were billed and shipped from Bridgeport. A warehouse in Montreal, to which the inventory was to have been transferred the following year, was rented in 1931 but at the next year-end the inventory was still in Bridgeport. Thorn's memorandum for 1933 had only one sentence in respect to inventories in which he said "The inventory consists of twenty items of crude drugs and we are satisfied as to the pricing." [914] The 1934 memorandum again stated definitely that the merchandise was stored in Bridgeport.

In 1935 the system was changed for the memorandum on the Canadian Company accounts that year stated that "The merchandise was all held by Canadian suppliers as at December 31, 1935 and was confirmed by certificates received direct from the vendors. The confirmations did not state the location of the stocks, but we were informed by the company that the merchandise is shipped from the vendors' various warehouses upon advices submitted from the company's Bridgeport office." [915]

The memorandum on the 1934 accounts commented on the small number of items in the Canadian Company inventory (18 in that year, 13 to 20 during the period 1931 to 1937), and noted that, "Because of the relatively small number of transactions during the year * * * ," it was possible to reconcile the beginning and ending inventory by taking purchases and sales into account.[916] The simplicity of these accounts is clearly demonstrated by reference to the copy of the inventory summary for December 31, 1934, included

913 Ex. 76; R. 962–965. See also page 66 *supra*; Ex. 170, 176.
914 Ex. 75.
915 Ex. 73.
"* * * the reference here to the location of the goods meant that I didn t know whether the office of this vendor was in his warehouse or whether he had warehouses some place else in the city or conceivably outside of Canada, * * *." Testimony of Thorn, R. 941.
916 Ex. 74.

in Price, Waterhouse & Co.'s working papers. Opposite each of the 18 items on the sheet the invoices of the vendors from whom the goods were purchased were shown. These invoices were all dated after July 1, 1934, and purchase quantities of one, or a combination of two or three, in 17 of the 18 items, exactly equaled the quantity and value shown for the inventory. The eighteenth item in the inventory is 2,000 pounds less than the invoice for 15,000 pounds of pure white vanillin with which it is matched.[917]

This merchandise was supposed to have been on hand and actually counted by the inventory crews at December 31, 1934. What purport to be inventory count sheets, an original and six carbons, with the name of the item and method of packing typed and the number of barrels, drums, etc., and quantity these represent written in with pencil on the original and two carbons, were discovered in McKesson's storage files. Each of the three sheets was in a different but regular handwriting with items not in stock crossed out in three cases on each sheet, but in a different manner. There were no erasures or corrections on any one of the three sheets, and none bore dates or initials to indicate when the goods were counted or by whom.[918] The caption on each sheet, typed was:

"LIMITED CRUDE DRUG INVENTORY
BUILDING #1—BASEMENT"

On the original, the first of these two lines is in heavy black type as from a new ribbon while the second line is in lighter type as from a ribbon half worn out. On all carbon copies the second line is not in carbon but in type apparently from the same ribbon as was used on the second line of the original indicating the possibility that the location was put on the sheets after the quantities were filled out in pencil.

John White, who worked in Robert Dietrich's department until a short time before the Commission's hearings were held, testified that, about 2 weeks before the hearings, he had marked the date and his initials "Dec. 1934 J. W." for identification purposes on the upper right hand corner of the top sheet when he took the sheets from the 1934 box of count sheets. He also testified that the writing on the first sheet was his but he could not identify the writing on the other two sheets. He could not remember whether the location was on the count sheets when he transcribed the quantities thereto, not from any actual count but from inventory cards.[919] The quantities shown on these sheets were the same as on the summary described above which appears to be a copy of the Canadian Company's inventory book

[917] Ex. 61.

[918] Ex. 60.

[919] R. 1532–1536. For White's description of the manner in which these sheets were prepared see pages 108–110 *supra*; R. 1478–1480.

sheets for that year. On these the spaces for the initials of those who counted and recounted the stock are likewise blank.[920]

Ritts was asked a few questions about the papers just described. He thought it would be better if the count sheets indicated by initials who had done the work. If they were missing, the sheets in some cases might be taken to the person who did the work and the initials obtained. But it would not necessarily be followed up. They might call the omission to the attention of some responsible person and be satisfied with that.[921]

Further consideration as to the existence of this merchandise and the authenticity of the documents just discussed will be given in connection with similar records of the Connecticut Division after reviewing the inventory work program followed in that unit. There are also other aspects of the inventory question which are common to both units and therefore may more clearly be treated together at that time.

The handwritten inventory work program carried out by Hill and his assistants in the Connecticut Division was identical in every respect during the last 2 years and these differed from 1935 only in the dropping of one item which related to the manufacturing operations. In that year the program carried a requirement to test check "* * * raw material costs method of applying overhead on production orders for work in process," but this does not appear in the later years.[922]

The first step for 1937 was to check the detail of price testing schedules to inventory books, after which these schedules were footed and extensions checked and a summary of the inventory books and price test schedules was spread across the work program and the percentage of inventory tested was calculated. The minimum amounts included in the tests varied by type of item. An item of $100.80 in the labels inventory was included while items under $1000 seemed to have been excluded in the larger departments. The total amounts tested ranged from 46.2% of book 10 (Cliff Street) to 99.9% of book 7 (general crude) which consisted almost entirely of foreign resale crude since proven to have been non-existent.

Items not on the price test schedules were sight checked for extension, noting particularly the placing of the decimal points. Page footings were checked to ten dollar amounts and totals traced to summaries which were footed. The balance of the work program was covered by the following steps, some of which will be discussed later.

"Examined latest invoices and/or production cards for all items on price testing schedules sufficient to account for quantity in the inventory

920 Ex. 61; R. 653-654.
921 R. 655-657.
922 Ex. 41.

"Trace all large quantities and test check smaller items on price test schedules to stock cards or warehouse receipts

"Obtain market quotations where available, showing source

"Trace larger shipments at close of year per Shipping Dept. record to inventory cards to verify their removal

"Scheduled all items over $10,000.00 for special consideration

"Trace items on price testing schedules carried over from 12/31/36 to 12/31/37 inventory, noting prices, quantities, etc." [923]

In connection with this work Hill filled out the supplementary questionnaire on inventories. A comparison of the answers written for 1936 and 1937 indicates a new attack on the problem in 1937 for the answers that year in several instances were more complete and on the whole appear to be accurate. The questions dealt largely with the mechanics of inventory taking, personnel in charge, and precautions taken to insure correct pricing and a proper cut-off of purchases and sales.[924]

Hill testified that in 1937 he was given no instructions except to do the inventory work as he had done it the previous 2 years.[925] As has been seen, this required him to develop answers to the questionnaire and follow a very definite routine. Hill, however, did a number of things not definitely listed to be done, yet quite significant in inventory work. His first step was to check through the inventory books to make sure that he had the correct one for that year and that each page was initialed. This he thought was a simple matter of common sense and should be done even though not on the program.

"* * * where I found sheets where initials fail to appear, I had Mr. Geiger, the man in charge of the inventory, I had him take them out in the factory, I sent him out in the factory with the sheets, and if he came back with one initial I sent him back for the second initial * * *."

Spaces on the inventory book sheets were blank above the captions, "Counted by" and "Recounted by." Initials appear for "Entered by"; "Count checked by" (two sets here in same handwriting); "Priced by"; "1st Extension"; and "2nd Extension." "Count checked by" Hill believed indicated "* * * the men who counted and recounted the merchandise" in accordance with instructions. Concerning sheets covering inventory in outside warehouses (there were a different pair of initials over "Count checked by" than on the sheets representing stock at the plant) he testified:

"A. I don't know what the initials indicate in this particular case for this merchandise—that this merchandise, you say, was in warehouses?

Q. [By Mr. Galpeer.] Well, I was just reading what it said on top of the page.

A. They were, yes. I assumed they were the initials of the people that compiled this sheet." [926]

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[923] Ex. 37.

[924] Ex. 19. See page 252 *supra*.

[925] R. 1300.

[926] R. 1266–1269; Ex. 85.

McGloon in his testimony explained that initials over "Count checked by" on McKesson inventory book sheets actually meant neither of the foregoing but that a second person had checked the accuracy of the posting of the inventory to new inventory cards.[927]

Another step not required by the program but generally considered essential is the checking of original count sheets or tickets against the final inventory sheets. Hill did this work to satisfy himself that the inventory had actually been taken. His method was indirect but effective, granting the authenticity of the count sheets which he saw were initialed although he could not say from a test inspection that they all were. His method was to check the count sheets to the perpetual inventory cards which, in turn, by the requirements of the program, were test checked against the price test schedules which then were checked to the inventory books.[928]

Hill's testimony indicated some familiarity with the mechanical aspects of inventory work but a reluctance to answer questions dealing with the relationship of his work to other phases of the audit. When questioned about various points in connection with accounting procedure surrounding inventory control, he was unable to see that the question was applicable. He thought, for example, that he could recognize a bill of lading but had never looked at any in connection with the McKesson inventory work and thought a question about the authenticity of the documents found in the files was irrelevant.[929] He did not make tests of the shipments to see which left the plant before and which after inventory taking. Someone else did this and he thought it "* * * better to confine the juniors to the work which they actually did rather than whether he knows the other man's job or not. We are supposed to know only our own job." [930] When asked if he would look at documents he handled to see if they were genuine, he said that he would not just out of curiosity, but if they did not look right he would verify the transaction in some other way.[931] If this could not be done to his satisfaction he would call the matter to the attention of a senior.[932]

Hill was familiar with purchases and the receiving of the merchandise but not with sales and shipping on which he did no work. His work included an examination of purchase invoices and receiving tickets to make sure that the proper liabilities were taken up and that receipts after the close of the year were excluded from the inven-

[927] R. 1679.

[928] R. 1317–1319; Ex. 37.

[929] R. 1302.

[930] R. 1305–1306. Work programs for 1935, 1936, 1937, and Hill's testimony indicate that he never worked on the sales cut-off feature of inventory work. Ex. 40, 41, 37.

[931] In connection with the initials on the inventory sheets, however, he disclaimed sufficient familiarity with handwriting to note that the initials of two persons over the words "Count checked by" appear to have been written by one person. R. 1268.

[932] R. 1308–1311.

tory and so forth. The receiving tickets covering merchandise in vendors' warehouses Hill was careful to describe as memorandum receiving tickets, "simply a record only" for he knew that this merchandise was held by the vendors and was not counted at the year end by employees of McKesson.[933]

Most of Hill's time seems to have been devoted to price testing which was quite thorough and covered practically 100% of the general crude inventory. This testing involved four distinct steps. First, sufficient recent purchase invoices were examined to account for the entire inventory.[934] The results of this test for 1937 were considered satisfactory for book 7, which combined general crude on hand in Bridgeport (real domestic) in the amount of $48,847.14 and $9,097,115.00 (fictitious foreign) listed as in vendors' warehouses in Canada. As in the case of the Canadian Company, the invoice quantities (varying from one to four in number) exactly equalled the quantity on hand for each item of crude drugs in vendors' warehouses except that in one case the quantity on hand was slightly in excess of the sum of the last two invoices. This practically perfect correspondence of most recent purchase invoices with inventory quantities did not exist for a single item among 16 chosen for price testing out of 72 items in the lists of stock actually on hand at Bridgeport. It is also notable that in all cases in which two or more invoices were necessary to make up the total of an item in vendors' warehouses the prices were the same on invoices covering a period, in one case from March to October, and in others from April to December. On the price test schedule for this book only $3,915.00 represented goods carried over from the previous year. None of the goods carried over was from stock supposed to have been in Canada [935] although the inventory turn-over in 1937 in crude drugs was less than two times.

The second test of price was to compare each item with the price in the preceding year's inventory. This comparison revealed only six changes in price and two new items among the forty in the 1937 inventory. This comparison was not made for the small amount of general crude stock at Bridgeport.

The third test was to compare the inventory price with sales subsequent to the inventory taking but this was not done for the small amount of general crude stock actually carried at Bridgeport. Sale prices subsequent to the inventory date were available at the time the work was performed in 27 cases out of the 40 items listed at vendors' warehouses. This comparison revealed a uniform mark-up of approximately 10%.[935a] This test was made from duplicate copies of

933 R. 1274, 1267.

934 R. 1272.

935 Ex. 38, 85.

935a See pages 304 ff. *infra* for a discussion of gross profit percentages in the Connecticut Division. See also Ex. Q in which the rates of gross profit on fictitious crude drug sales of this Division are shown to range from 8.03% in 1934 to 11.57% in 1935 (10.02% in 1937).

sales invoices for January and part of February which were checked to the Company's sales book and stock cards.[936]

Of the 27 products appearing on the price test schedule, of which sales were made after the year end, 17 appeared in January and 10 for the first time on the first 3 days in February. Of the 17 products sold in January, on 15 the quantities sold exactly equalled one or more purchase quantities.[937] The sales after the year end listed on the 1936, 1935, and 1934 price test schedules were apparently limited to the month of January and in any event coincided with purchase quantities as nicely as did those for January in connection with the 1937 price test schedule.[938]

The exceptional coincidence of sales quantities with purchase quantities as illustrated by unbroken year-end inventory quantities and January sales apparently existed since at least 1934, the earliest that Price, Waterhouse & Co. work papers are available in this record for such observation.[939] And such regularity apparently can not be explained by the nature of the business since sales were supposedly made in quantities that were irregular at least when compared to purchase quantities. For example a purchase of oil of patchouli—finest of 23,000 lbs. was purportedly sold out in units of 3,700 lbs., 3,300 lbs., 3,600 lbs., 2,900 lbs., 3,500 lbs., 3,200 lbs., and 2,800 lbs.[940]

Further examination reveals that the price test schedule for 1937 brought into close juxtaposition the cost and selling prices of items in the December 31, 1937 inventory which were sold subsequent to that date while the audit was still in progress. This showed that every sale during a period of 5 weeks was made at a gross profit.[941] This situation of every sale being made at a profit was reflected in the inventory papers for earlier years as well.[942] And Ritts in the 1934 memorandum on the Connecticut Division wrote "* * * our review of the sales subsequent to December 31, 1934 has shown that the company is realizing a comfortable profit on each sale * * *."[943] The same idea was conveyed in the memoranda for 1933 and 1935.[944] This information may also be obtained from McKesson's sales register for this

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936 Ex. 38; R. 1113, 1283.

937 Ex. 38, 84.

938 Ex. 40, 41, 42.

939 See pages 104–105 *supra*.

940 Ex. 84.

941 Ex. 38, 84.

942 Ex. 40, 41, 42. Cf.

"Q. [By Mr. GALPEER.] Will you please look now at your price test schedules in that connection and tell me whether in relation to the foreign crude drug division there was ever a sale made at a loss or at a price below the cost price of the merchandise?

A. [By RITTS.] So far as I recall, sales made in January or February that we actually saw—no, I don't recall that they did have any losses." R. 798.

943 Ex. 268.

944 1933: "Sales of crude stocks made subsequent to December 31, 1933, amounting to approximately $700,000, have all realized a profit to the company." Ex. 80. 1935: "Crude drug sales since December 31, 1935 were all made at prices yielding a normal gross profit." Ex. 79.

business, copies of which, for the period while the audit was in progress, were included in the auditors' working papers for 1936 and 1937.[945] Although obvious from its face that it was limited to the foreign crude drug business, Hill apparently thought he had obtained the register on all crude drugs.[946] This sales register did not disclose a transaction at a loss at any time.[947] The auditors, however, disclaimed knowledge of the contents of the register for periods other than those included in their working papers.[948]

The fourth test on the price test schedule was to determine that the inventory price was under the market. This work presented some difficulties for published quotations were not available in all cases and even when they were it was difficult to be sure they were applicable for the quality of the merchandise was not indicated. In those cases in which prices were not quoted in the "Journal of Commerce" or the "Oil, Paint & Drug Reporter", prices were obtained from dealers. When Hill had difficulty in matching prices he sought enlightenment from Harry Osterhout, an old employee of McKesson who handled some of the inventory records and was understood by Hill to be an expert on prices.[949] Any unexplained discrepancies Hill would call to the attention of his superior, Ritts.[950]

Some of the trouble encountered in this work is reflected by a few samples from the 1937 inventory. Spanish saffron was quoted at $23 per pound in both of the journals named whereas the inventory and purchase invoice prices were both $12 per pound, and at December 31, 1936, the inventory had been priced at $8.10 per pound. Hill said Osterhout convinced him by explaining that this difference was due to the origin, quantity, and quality of the product; that McKesson dealt in such large quantities that quoted prices did not apply; and that in the case of some products the country of origin accounted for a great difference in quality. Hill noticed that the quoted prices of a drug originating in Spain would be different from the same product from China or South America, so the explanation he received seemed reasonable. In every case he either looked up invoices or had Osterhout convince him of the origin of the products, but he could not recall just

945 Ex. 84, 40 (D 13, D 14).

946 R. 1296-1300.

"Q. [By Mr. GALPEER.] Were you told to ask for it that way?

A. [By HILL.] I was told practically nothing. They told me to go ahead and do my job, those were my instructions.

I had been on the job two years consecutively and they told me to go ahead and do my job. They didn't give instructions unless I asked for them.

Mr. STEWART. That is, to do the same job as you did in the previous years about which you had been instructed before?

A. They told me I knew what I was supposed to do and to go ahead and do that.

Q. You knew that from the work you had done and the instructions you had in previous years?

A. I knew what I had to do as to that specific schedule at that time." R. 1300-1301.

947 R. 1373.

948 R. 814-820.

949 R. 1276.

950 R. 1277-1278.

how this was accomplished when most if not all of the products of foreign origin came in on invoices from a Canadian vendor rather than from the original shipper in the country of origin.[951] After the fraud had been disclosed Hill discovered from the Encyclopedia Britannica that many of the products came from the Far East.[952]

Another example was balsam of fir, Canada, priced at 60 cents per pound but quoted in both publications at $16 per gallon. The inventory sheet indicated a translation of this item at ten pounds to the gallon to reach a quoted price of $1.60 per pound. The weight of a gallon was obtained from Osterhout or Geiger (cost clerk in charge of inventories). But Osterhout testified that a gallon weighed eight pounds, which would give a per pound price of $2.[953] Hill thought Osterhout must have convinced him that the price was right but if he had had any doubt he would have checked with another employee.[954] The McKesson selling price was 67 cents per pound.

Mexican vanilla beans, 36,000 pounds at $2.25 per pound, were listed as packed in two hundred pound bags, whereas they were quoted at $4.25 per pound in tins. Hermann testified that these beans spoil quickly if not packed in air-tight containers.[955] Hill thought that difference in form of packing might have been a clerical error.[956]

As stated, Hill, on instructions from Ritts, relied to a great extent on Osterhout in his work on the price testing schedules. Osterhout, prior to joining Girard & Co., Inc. in November 1925 as an inventory clerk, had worked in a wholesale feed store and in a wholesale grocery store but had had no experience with drugs and chemicals.[957] His first duties were the keeping of inventory cards on manufactured products and for about a year and a half the cards on crude drugs, but after the merger of Girard with McKesson he was assigned in 1927 to keeping the inventories of Stebe's export department and Hermann's[958] crude drugs. In recent years his only contact with the records of the foreign crude drug inventories was during vacations of the clerks regularly assigned to the work.[959]

The extent of Osterhout's expert knowledge of crude drugs may be judged from the following extracts from his testimony:

"Q. [By Mr. GALPEER.] Mr. Osterhout, I show you a copy of Commission's exhibit 190, which is an extract of all the inventory sheets of McKesson and Robbins, December 31, 1937, in so far as it affects the crude drug department that was

[951] R. 1281–1283.

[952] R. 1279.

[953] R. 4519.

[954] "That is the way we usually do when there is any question in our minds—we approach two employees and get each one's version independently." R. 1285.

[955] R. 2598–2599.

[956] R. 1285–1286.

[957] R. 4516.

[958] See pages 268 ff. *infra* for further reference to Hermann.

[959] R. 4529–4530, 4516, 4522.

handled through W. W. Smith and Company. With the exception of such items as crude iodine and virgin mercury, which you might have handled also in Mr. Stebe's or Mr. Hermann's department can you tell me the country of origin of the items listed here?

A. No sir, some of them, I might have a smattering of an idea where it came from, but that is all.

Q. But take for instance, an item like Amidopyrine, would you know where that came from?

A. No, I don't know what it is.

Q. Could you, or did you ever have occasion to attempt to determine where these drugs came from, from the records available to you at McKesson and Robbins, that is, the drugs that were involved in this W. W. Smith department?

A. Determine where they came from?

Q. That's right.

A. No.

Q. Now, in this inventory, there is an item of Spanish Saffron. According to the exhibits already in evidence, the cost of that as shown on the work sheets of Price, Waterhouse and Company, the cost of that to McKesson was $12 a pound, whereas the Journal of Commerce quoted a market price for that of $23 a pound. Can you account for that discrepancy in price?

A. Well, those two prices given in the Journal of Commerce, I never did know exactly what they meant, but I imagine they meant the range of price from $12 to $23, to be according to the quality, something like that.

Q. I see. In other words, you meant if the Journal of Commerce had two prices in it, you would think that was the range depending on the quality?

A. Yes.

Q. But in this case, the Journal of Commerce price was a straight $23 and the McKesson price was a straight $12. Now, do you know why the Journal of Commerce price would be so much greater than the McKesson and Robbins price?

A. No, I would imagine it was inferior quality some way.

Q. But you don't know?

A. No.

Q. That is just a guess?

A. That's right.

Q. Now, there is an item on the same inventory, Mr. Osterhout, which is listed on McKesson records as Rhodinol, pure from oil of Geranium, Bourbon. In the Journal of Commerce that item is listed simply as Rhodinol. Do you know whether the two items are the same, or what the additional words "Pure from oil of Geranium, Bourbon" means?

A. No.

Q. Now, Mr. Osterhout, the records of McKesson showed that the Balsam of fir, Canada, which was supposedly carried in this department, were in 40 pound cans, and that the price was 60 cents a pound. The Journal of Commerce lists it at $16 a gallon can.

A. There are eight pounds to a gallon.

Q. There are eight pounds in a gallon?

A. Yes sir.

Q. In every product, or just that one?

A. No, not every, but there is in Balsam of fir, Canada; eight pounds constitutes a gallon.

Q. Do you know why the Journal of Commerce would list them as gallons and why you were carrying them as pounds?

A. No.

* * * * * * *

Q. Well, if there are eight pounds in a gallon, and it is 60 cents a pound, then it would be $4.80 a gallon; is that right?

A. Yes.

Q. Well, now, if that price would then come to $4.80 a gallon, and the Journal of Commerce price was $16 a gallon, can you account for that difference in price?

A. Its a big difference but I don't know why. I shouldn't think—I don't know but this is my opinion: I shouldn't think the Journal of Commerce would have given it at $16. I don't know. I imagine it did if it is there, but it seems to me that is a high price for it. We did handle that a little bit—Mr. Hermann, in his department, handled Balsam of fir, Canada.[960]

* * * * * * *

Q. Well, in any event, whatever created that difference in price, you don't know what would account for that?

A. No, I don't. One of those Balsams is handled in pounds and the other is in gallons. I don't know which it is. There is Balsam of fir, Oregon, and Balsam of fir, Canada. One of them is priced by pounds, and the other is priced by gallons. I don't know which is which.[961]

* * * * * * *

Q. Now, I think you testified to Mr. Stewart that the quantity that McKesson bought might affect the price that they paid for it. Do you mean that as a possibility, or as something that you know is a fact?

A. Well, it is a possibility. I wouldn't know for a fact, but I would imagine that the more of an article that a person would buy—they would get a reduction in price, perhaps.

Mr. Stewart. Don't be too modest, Mr. Osterhout. Don't you know that that is a fact; that they always do get more for the money when they buy in large quantities? Don't you know that from your experience?

The Witness. Well, I would say yes; I would suspect so.

Q. [By Mr. Galpeer.] Well, now, take this item on the inventory—any item here. Take Musk Pods, for example. Do you know whether what this department was buying would be considered a large quantity or a small quantity?

A. No, I don't know; I wouldn't know what the sale volume of Musk Pods would be.

Q. So that when you are referring to large quantities, which department do you mean—this department or Mr. Stebe's department?

A. Well, I might be referring more to Mr. Hermann's department.

Q. I see. And as far as this department through W. W. Smith was concerned, do you know whether the purchases which went through the McKesson books would be considered large or small in the trade?

A. No, because I wouldn't know what Mr. Coster's sale possibilities of that was, and I wouldn't know whether that was a large purchase for him or a small purchase.

Q. Would you know whether it was a large purchase or a small purchase in the trade as a whole in those particular products?

A. It would be for Mr. Hermann, yes.

* * * * * * *

Q. How about the items here that Mr. Hermann did not carry?

A. I wouldn't know about that, because I don't know—on those turpeneless oils, I don't know what the sale volume of those are liable to be." [962]

In all cases since 1934 the published prices and prices secured from dealers were higher than the McKesson inventory prices and fre-

[960] R. 4516–4520.
[961] R. 4521.
[962] R. 4526–4527.

quently substantially higher than the McKesson selling prices. An example was santonine crystals inventoried at $18, selling price $19.62 and quoted prices $23 and $25 per pound. Hill summed up his reaction to a situation like this and the entire pricing problem as follows:

"I never put too much faith in these market prices. The subsequent sale price was the thing I was chiefly interested in. As long as the price was higher than the price at which it was valued in the inventory and the subsequent sale price was higher than the cost, I was satisfied that the price in the inventory was conservative. It agreed with the vendor's invoice, it was under the market and compared favorably with the price at the end of the preceding year and was under the subsequent sale price.

With these four verifications it looked conservative to me. I wasn't looking for anything off-color. I mean, I wasn't looking for any trouble. I mean, I had no reason to suspicion any one. I was simply trying to confirm the price shown in the inventory. That was the object of the price test, to verify the price shown in the inventory. There was no other object in that price verification." [963]

Two juniors completed the inventory work at Bridgeport in 1937. One junior's work was chiefly checking extensions and footings. He also checked the price test schedules for several classes of goods to the inventory books, which involved a comparison of the descriptions, extensions, quantities, and unit prices. He traced the larger items (which meant all of the crude drugs held in Canada) to stock cards. The item on the program specified stock cards or warehouse receipts but he used the cards and never asked for warehouse receipts.[964] He worked on these cards in Robert Dietrich's office but could not say where the inventory itself, amounting to approximately $9,000,000, was supposed to have been held and never asked anybody.[965]

The other junior also did his work in Robert Dietrich's department in an office where a number of girls worked. What clerical work they did he didn't know. He traced year-end shipments to customers to make sure that they had been posted on inventory cards under the correct date. In this work he compared sales invoices (whether there were any papers attached he could not recall) with the cards which were handled by two girls. He did not know how the filing system worked or whether he could have worked on the files independently for he could see no reason for refusing help.[966]

The inventory work, as Hill pointed out, was subject to review by Ritts who was in charge of the job and who, therefore, was questioned in detail on various phases of the work. According to Ritts' testimony, all items in the inventory valued at $10,000 or more, were given special consideration by him in his review. This would include all of the crude drugs of the type sold through W. W. Smith & Com-

[963] R. 1291-1292.
[964] R. 395-396.
[965] R. 397-398.
[966] R. 1113-1117.

pany, Inc. and, in 1937, only about $200,000 of other merchandise in the Connecticut Division.[967]

In his review Ritts testified that he was not disturbed by wide variations between the McKesson prices and published quotations for it seemed obvious to him that the published prices might be based on transactions in smaller quantities than those handled by McKesson who he had always understood more or less controlled the world market in crude drugs.[968] When pressed as to his specific knowledge and consideration given to the balsam of fir item mentioned above, Ritts was unable to say whether the McKesson quantities dealt in as compared with the total market were large or small, or whether they were large or small as compared with the transactions of other dealers. He said that he did not know how the published price was reached and never had much confidence in such prices. The McKesson selling price he knew was higher than cost and quite reliable for his purpose and indicated that the inventory was not overvalued. The discrepancy in prices of a purchase on December 10, 1937, of 136,000 pounds of balsam of fir, Canada, at 60 cents, a published year-end quotation of $1.60 (if 10 pounds to the gallon is correct, $2 if 8 pounds to the gallon) and a sale of 24,960 pounds at 67 cents on February 2, 1938, to a customer in Brisbane, Australia, did not raise any question in his mind and certainly in his opinion did not require any action on his part, although if the published price had been below McKesson's cost, the Company would have been required to write down the value.[969] Discrepancies between the methods of packing of the McKesson inventory and the methods of packing referred to in the published quotations apparently caused him no concern.[970]

Charles Hermann, who is McKesson's buyer in the sales department of bulk drugs and chemicals conducted at the Cliff Street office in New York City (he started with the old McKesson firm as a boy 36 years before the hearings, had served in his present capacity over 20 years, and therefore had had a long experience in the crude drug trade) was not on hand at the plant at Bridgeport and was never

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[967] R. 481–482.

[968] "It was always my understanding that that was the biggest contribution that Coster and Dietrich made to McKesson & Robbins, Inc., their knowledge of this crude drug business, contacts that they had with people throughout the world, selling crude drug stocks." R. 491. But see footnote 1026 *infra* for what appears to be some uneasiness as to prices expressed in Ritts, first memorandum on the Connecticut accounts. Compare also the action taken by Jaureguy in obtaining prices for pepper as reported in his memorandum on the 1931 accounts of the Connecticut Company: "In attempting to obtain market prices as at December 31, 1931, it became apparent that the spice department of McKesson & Robbins was the principal factor in the pepper trade and we were, for this reason, inclined to be skeptical of the market quotations obtainable in New York. A great deal of the spice trade centers in London and Rotterdam. We therefore cabled our London office for quotations, which compared fairly closely with those we have secured in New York. The company's inventories have been written down about $40,000 to a cost or market basis.

"The importance of this department is evidenced by the fact that its gross long position at December 31, 1931 (mostly in pepper), was more than $1,500,000." Ex. 82.

[969] R. 487–494.

[970] R. 495–498.

consulted by the auditors concerning the foreign crude drug business. It is interesting, however, to contrast Hermann's testimony with Osterhout's set forth above.

In Hermann's opinion the quantities of practically all the items in the inventory were greater than would be traded in the United States either domestically or for export in the course of a year. Likewise, from an inspection of the list he indicated that eight of the 40 items were carried in sizes or types of containers not found in the trade. Santonine crystals is a good example of both conditions. This product, he stated, is packed in 25 one-kilo cans, rather than in 17-pound cases as the inventory stated. The United States, in Hermann's opinion, is the largest consumer and uses not over 5,000 pounds per year. The inventory listed 13,260 pounds on hand at December 31, 1937. 18,000 pounds of castor fibre powder, a product used in very small quantities in making perfume, was to him another highly improbable quantity.[971]

Four of the commodities were subject to cartel or other types of control and in Hermann's experience could not have been regularly brought to Canada and reshipped to other parts of the British Empire at a profit. These were crude iodine (controlled by a syndicate in Chile and one manufacturer in the United States), quinine (controlled by the Dutch), natural camphor (controlled by Japan) and santonine (controlled by Russia).[972] In this connection, it is significant that Hermann stated that the importing and exporting of many of the items on the inventory was abandoned by the old McKesson Company about 1924 because they could not make any money at it.[973] Hermann, a vice-president of the Canadian, Connecticut, and Maryland Companies for many years, testified that his activities were limited to the Cliff Street office and that he had not known that Coster and George Dietrich were operating in bulk drugs, chemicals, and essential oils in either the Connecticut Division or the Canadian Company, and that he had never seen the inventories of these items nor a list of them.[974] He also testified that Coster, although reputed to be a drug expert, never exercised any control over the real trading in drugs which he conducted at the Cliff Street office.[975]

While Osterhout "* * * wondered about it, because—well, they made $100,000 a month profit, and had big sales * * *" he had confidence that Coster knew what he was doing and, therefore, was not suspicious that there was anything wrong.[976] Hermann's

971 R. 2600–2603.
972 R. 2605–2609.
973 R. 2626.
974 R. 2612–2613, 2633.
975 R. 2616, 2628–2629.
976 R. 4524–4525.

testimony may be summed up by saying that he would have been suspicious of the physical existence of the inventory in any particular warehouses.[977]

Ritts in his appraisal of the inventory quantities and prices never consulted any public records reporting statistics of the drug trade.[978] It will be recalled that all of the fictitious business was supposed to have been carried on through Canada since early in 1935 and largely in products not native to Canada. Canadian statistics of imports easily available in a Dominion Government publication, like Hermann's testimony, also show the quantities in the McKesson crude drug inventories to have been impossible.[979]

Two items of the 40 in the inventory can be identified definitely as products of Canada. One of these mentioned previously, castor fibre powder, is not exported in sufficient quantities to give it a separate listing in a rather detailed report of exports; the other, balsam of fir, Canada, listed in the inventory at December 31, 1936 at $225,600 and a year later at $168,000 with no old stock carried, may be compared with Canadian exports of $14,184 in 1937, about equally divided between the United Kingdom, Germany, and the United States. A copy of the portion of the foreign crude drug sales book included in the Price, Waterhouse & Co. working papers in connection with the price testing showed a single shipment of this product under date of January 2, 1937 in the amount of $13,363.20 destined for London, England, and another 5 days later for $10,612.80 to another customer at the same place. Six other shipments averaging over $10,000 were made the same month, two to Scotland, two to England, and one each to Ireland and Australia.[980]

Fifteen of the 40 items on the list in 1937 as being carried in Canada appear to fall in the group reported in the Canadian statistics as essential oils. The 15, all acquired for the most part in the last 6 months of 1937 and none carried over from previous inventories, weighed 398,670 pounds and were valued at $3,680,230. The Canadian statistics, however, show that the aggregate of all essential oils imported for that year weighed 650,985 pounds and had a value of $927,699. There were no exports reported in this group. In addition, oil of peppermint is accorded a separate listing. Canada for the year imported for consumption 31,075 pounds of this commodity valued at $69,547 while McKesson was supposed to have held 189,000 pounds valued at $330,750, all acquired during the year.

Musk pods is another item not native to Canada of which she imported 147 ounces valued at $2,600 during 1937. No exports were

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[977] R. 2633–2635.

[978] R. 655.

[979] R. 2610–2611; Ex. 191. Trade of Canada (Imports for Consumption and Exports) calendar year 1937, Department of Trade and Commerce, Ottawa.

[980] Ex. 40.

reported. McKesson claimed to be carrying in Canada 12,800 ounces of this product valued at $153,600 at that year end. McKesson also reported a brisk business in Mexican vanilla beans for the inventory of 100,000 pounds carried in Canada at December 31, 1936 was entirely sold during 1937 to foreign customers, but Canada did not report any exports of the beans. This recital seems adequate to indicate the impossible character of the so-called crude drug inventories, most of which do not come under that definition as used in the drug trade;[981] but in addition we mention one product with an easily identifiable odor—camphor. Canadian imports of natural and synthetic camphor for 1937 totaled 121,865 pounds valued at $51,260. McKesson had purchased during the year and was supposedly carrying in Canada an inventory of 764,000 pounds of gum camphor slabs valued at $313,240.

As in the case of the Canadian Company, letters attesting the existence and ownership of these goods were obtained directly from the same five Canadian vendors, who were supposed to have been storing them at December 31, 1935, 1936, and 1937.[982] They were attested also by an over-all certificate which Price, Waterhouse & Co. secured from the responsible officers of the McKesson & Robbins organization.

Letters requesting confirmation of inventories were prepared by R. J. Dietrich under date of December 31, 1935, and were mailed under date of January 13, 1936 to Price, Waterhouse & Co., who in turn mailed them to the suppliers. These elicited replies from the five Canadian vendors under dates of January 20, 21, and 22, 1936. The copies of the requests in the auditors' working papers were uniform in wording and asked for a statement of merchandise held in storage for the McKesson account and the name of the state in which the merchandise was warehoused as the latter information was

[981] R. 2624; Ex. 191. See footnote 110 *supra*.

[982] At December 31, 1937, the five Canadian vendors were supposedly carrying the following inventories for the Connecticut Division (Ex. 85, 255):

B. Miller & Company	$2,079,480.00
H. Monroe & Company	1,530,520.00
P. Pierson & Company	3,078,215.00
A. H. Raymond & Company	653,750.00
D. C. Reynolds & Company	1,755,150.00
Total Connecticut Division	$9,097,115.00
In addition, the same vendors were supposedly carrying in the aggregate for the Canadian Company	990,585.00
Total, five Canadian vendors	$10,087,700.00

needed for tax purposes.[983] As in the case of the Canadian Company, the replies were all slightly different in wording and referred to carrying or holding the merchandise but without stating the location of the goods.[984]

A similar exchange of letters took place on the audits of 1936 and 1937. The 1936 working papers contained a list of 50 warehouses to which requests were sent, and a supplemental list for the spice department on which 10 names not common to the other list appeared.[985] The replies received from the five Canadian vendors in January 1938 were dated January 11, 12, and 13. The replies received in January 1937 revealed a slight variation from those of January 1936 and 1938. The address of B. Miller & Company on their letterhead was 45 Queen Street, Ottawa, Canada, but on the list sent to Price, Waterhouse & Co. by E. A. Johnson, Jr., office manager at McKesson & Robbins, the address was given as 48 Queen Street. The reply from this firm was dated January 25, while the other responses that year were dated on January 11 and 12. Johnson explained that on this occasion the letter addressed to 48 rather than 45 Queen Street came back undelivered to Price, Waterhouse & Co. and was returned to him for correction.[986]

The inventory certificate obtained from the responsible officials listed several classes of inventories on hand and included paragraphs covering quantities, ownership, valuation, and sundry other matters such as the cut-off and purchase commitments. This was signed by

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[983] Ex. 41 (D 86).

"C-O-P-Y

R. J. DIETRICH: AP;
December 31, 1935.

D. C. REYNOLDS & COMPANY,
192 Bank St.,
Ottawa, Canada.

GENTELEMEN:

In connection with our annual closing of our books and inventory, we shall be obliged if you will furnish our auditors, Price, Waterhouse and Company, of 56 Pine Street, New York City, with a statement certifying to the amount of merchandise you hold in storage for our account as of the close of business December 31, 1935.

As this will also serve for our checking of cards and for tax purpose, please state in what state this merchandise is warehoused, and we will appreciate if you will send this inventory in duplicate, one copy direct to our auditors and the carbon to us for our records.

For your convenience we are enclosing self-addressed stamped envelopes for both replies.

Very truly yours,
MCKESSON & ROBBINS, INC.

Production-Planning Manager"

ENC.

[984] See pages 102-103, 253-254 *supra*.

[985] Ex. 40.

[986] R. 1366. Ritts' testimony at R. 505-506 concerning the securing of a second confirmation from a Canadian supplier apparently has reference to this incident. B. Miller & Company at December 31, 1936 were supposed to have held for the McKesson Companies crude drugs valued in excess of $2,000,000. Ex. 40.