

Auditor Faux Pas and Managerial Fraud at McKesson and Robbins: A Preliminary Study

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Forensic accounting has seen a remarkable growth in the last decade due to accounting scandals like Enron, Arthur Anderson, and Bernie Madoff Investments. This study explicates the history and impact of the McKesson & Robbins fraud. This fraud indirectly led to the establishment of the Generally Accepted Auditing Standards (GAAS). Today, every audit is planned and executed based on the provisions of GAAS. In this pilot study, an instrument measuring awareness of the McKesson & Robbins fraud is administered to 115 accounting students. The results of this pilot study indicate that students have very little knowledge of this monumental fraud.

INTRODUCTION

The age old adage of “history repeats itself” may have some implications in the tumultuous world of auditing today. In the current decade, corporate scandals have made headlines in nearly every form of news media. From the likes of Bernie Madoff to the bankruptcies of Enron, Arthur Anderson, and WorldCom; scandals have created a public outcry for action. The aftermath of Enron saw the creation of the Sarbanes-Oxley Act (2002) and the establishment of the Public Company Accounting Oversight Board (PCAOB). Many corporate frauds were blamed on audit failures, such as Arthur Anderson’s failures with Enron.

Definitions of Fraud

In academia, as well as the workplace, there are many definitions of fraud. For classification purposes, these definitions can be classified from an etymological, regulatory/legal, and academic standpoint. An etymological definition of fraud is that which defines fraud from the earliest times it was

used in the English language. Thus, the Merriam-Webster's Collegiate Dictionary defines fraud as "an act of deceiving or misrepresenting."

A definition of fraud in the current regulatory and legal standpoint is given by various agencies like the Securities and Exchange Commission (SEC), Federal Bureau of Investigation (FBI), Public Company Accounting Oversight Board (PCAOB), etc. Thus, The Audit Commission defines fraud as any fraudulent behavior by which someone intends to gain a dishonest advantage over someone else (PCAOB, 2011).

The FBI defines accounting fraud as schemes designed to deceive investors, auditors, and analysts about the true financial condition of a corporation (FBI, 2006). These schemes may be material, or non-material, but if the intention is to deceive investors, auditors, analysts, and the general public - then, these schemes may be classified as a fraud.

The Public Company Accounting Oversight Board (PCAOB) which was formed by the Sarbanes-Oxley Act of 2002 defines fraud as an intentional act that results in a material misstatement in financial statements (PCAOB, 2011). SAS No. 99 (AICPA, 2002, Statement on Auditing Standards No. 99: 10) defines fraud as "misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets." Misstatements arising from fraudulent financial reporting arise from intentionally falsifying financial statements. Misstatements arising from misappropriation of assets arise from theft of assets.

A definition of fraud from an academic standpoint is given by Ramamoorti and Olsen (2007:115), who define fraud as "...a human endeavor, involving deception, purposeful intent, intensity of desire, risk of apprehension, violation of trust, rationalization, etc."

The impact of the fraudulent practices of Enron and its auditor, Arthur Anderson has had not only a serious impact on the accounting industry, but also the larger society in terms of legislative reform. In terms of market capitalization, Enron and WorldCom were the largest scandals in American History (Giroux, 2008). "The bankruptcy of Enron Corp. has evolved into a scandal of enormous proportions involving allegations of fraud, corruption and unethical practices on the part of Enron's corporate executives, members of its board of directors, external auditors, and high government officials in the USA" (Baker, 2003: 446). Many academicians and practitioners believe that the accounting frauds committed by Enron and Arthur Anderson resulted in the passage of the Sarbanes-Oxley Act of 2002 (Giroux, 2008).

Increased Demand in Understanding Fraud Accounting

There is an increased demand in understanding fraud accounting from both accounting practitioners and educators. As such, fraud accounting has become a popular topic in accounting firms and accounting education. Fraud examination and forensic accounting (FFA) are hot subjects in accounting today (Pearson & Singleton, 2008).

For the past seven years, it has been an explicit goal of the Association of Certified Fraud Examiners (ACFE) to increase the teaching of fraud courses in U.S. universities. The ACFE has publicly announced its goal of having more than 50% of the U.S. universities teaching a fraud related course (Carozza, 2002). "In addition ... the American Institute of Certified Public Accountants (AICPA), stated that the AICPA will work toward "promptly incorporating fraud prevention materials into the accounting curriculum and university textbooks" (Peterson, 2003:263).

The Need to Teach Fraud Examination and Forensic Accounting

The increase of accounting fraud in terms of number of fraud cases, and the increase in the dollar amount of the fraud, increases the need to educate students on understanding fraud, recognizing red flags of fraud, and dealing with fraud. Also, as explained in the previous sections, the increase in fraud cases and dollar amounts has led to an increase the need for fraud education.

Yet, traditional business and accounting curriculums devote very little time to fraud education. Among other things, this lack of focus on fraud education raises questions on the applicability and practicality of business education in general, and accounting education in particular. Some academicians have been very vocal about the inadequacies of accounting and business education, particularly in terms

of teaching students how to recognize, avoid, and catch fraudulent activity. The accounting profession has been lacking in the areas of setting rigorous accounting standards by capitulating to clients in terms of setting accounting standards, as well as being non-rigorous in terms of applying those accounting standards (Ravenscroft and Williams, 2004).

What has been the impact on accounting education of the heightened awareness of fraud accounting? Are universities offering an increased number of fraud courses and forensic accounting tracks in traditional accounting programs? Many academicians feel that there is an urgent need for accounting educators offer more fraud courses, and devote more time to fraud topics. "...Colleges and universities must do their part by encouraging business, criminology, and law faculty to carry out much-needed research in this important area and teach courses in fraud and forensic accounting" (Ramamoorti, 2008: 521).

Other scholars posit that in order to detect and deter fraudulent activities, accounting curricula has to have a broader base. To be an effective faculty member (particularly in teaching accounting fraud), accounting faculty may need to enable students to have a multidisciplinary approach (LaSalle, 2007). Some accounting faculty feel that this need for increasing the awareness of fraud amongst accounting students is not being currently addressed adequately by accounting departments. Currently, accounting students are getting very little in terms of education in the areas of fraud accounting (Peterson & Reider, 2001).

History of the McKesson & Robbins Fraud & the Rationale of this Paper

The accounting fraud of McKesson & Robbins Inc. was one of the biggest frauds before the establishment of the Generally Accepted Accounting Principles (GAAP). The management fraud and the lack of professional skepticism shown by the auditors of McKesson & Robbins shocked the auditing and larger accounting community. Also, in 1937 - when the general public discovered the extent and the impact of the fraud, there was a tremendous hue and cry. The discovery of the McKesson & Robbins fraud resulted in a profound impact on the accounting profession at the time (Baxter, 1999). It was during these trying times that the accounting profession first came under public scrutiny and government criticism (Barr, 1987).

The fraud at McKesson & Robbins, Inc. lasted for 13 years before its discovery in 1937. The historical impact of this scandal on the auditing profession has been monumental. In today's dollars, the scandal of McKesson & Robbins would rank it in the top five accounting scandals in history. Yet, the impact in terms of regulations was even higher. After the discovery of the fraud, the accounting professional moved swiftly to counter charges of lack of enforcement by enacting the Generally Accepted Auditing Standards (GAAS).

From an academic standpoint, the lack of knowledge of the fraud at McKesson & Robbins Inc. prevents a full understanding of how the accounting profession has evolved through the years. Accounting students are held responsible for knowing the rules, concepts, and proper methods of their chosen profession, but there is a whole other side to accounting. The reasons for why certain standards and procedures are in place are lost on many students. Thus, the lack of knowledge of a monumental fraud like McKesson & Robbins which directly led to the passage of GAAS may reduce the historical perspective of accounting students in understanding the larger context of fraud and its impact on auditing standards. This lack of historical perspective may also impede students' ability to recognize current fraud.

Thus, one rationale of this paper is to examine the knowledge of current accounting students about the McKesson & Robbins fraud - a fraud that resulted directly in the enactment of GAAS and changed the accounting/auditing professional dramatically. Another rationale for this paper is to encourage accounting programs to adopt fraud education which looks both at past and present frauds in an attempt to create better fraud recognition for the future. The authors hope that this paper will encourage accounting educators to teach students how to recognize fraud. This recognition can be best done by teaching accounting students about the monumental frauds in the past, like McKesson & Robbins and the monumental frauds in the present like Enron, Bernie Madoff Investments, and Arthur Anderson.

HISTORY AND HYPOTHESES

Philip Musica, the brain of the McKesson & Robbins scandal, was a prominent member of the business and political world. Musica legitimately had made his career in fraud. By the time he reached his 30th birthday, he had already committed two very serious fraudulent acts. This is the reason for his first alias, Frank D. Costa, which he assumed in 1919. Also in the same year, he founded Adelphi Pharmaceutical Manufacturing Company, which manufactured high alcohol content products such as hair tonic and cosmetics. He was successful because he sold large amounts of his products to bootleggers who then produced booze from the distilled alcohol.

From his bootlegging success, in 1925, Musica was able to buy McKesson & Robbins Inc. with his second alias, F. Donald Coster, M.D., Ph.D. At that time, McKesson & Robbins was “an old, highly respected manufacturer of drugs and chemicals that in the 1920’s was taken over by a ‘distinguished MD and PhD,’ who absorbed the company into his own firm but retained the McKesson and Robbins name” (Lodge, 1987). Immediately after acquisition of McKesson & Robbins Inc., Musica sought out ‘the finest auditors in the country’ and chose Price, Waterhouse & Company (Baker and Bealing, 2006).

Musica recruited the help of his three younger brothers in his scheming for this company. He placed one brother, alias George Vernard, in charge of W.W. Smith & Co. which “was a ‘letter-writing plant’ containing seven typewriters, each with a distinct typeface and a unique supply of stationery” (Clikeman, 2003). His role was to create fictitious purchase orders to be mailed to McKesson & Robbins Inc. Robert Dietrich, alias for another Musica brother, managed the shipping department. To make it appear that inventory was being sent to the customers, he would forge shipping documents. McKesson & Robbins’ assistant treasurer was the fourth Musica brother, alias George Dietrich. His job was to transfer money between numerous accounts to show the payment and receipt of cash. For each completed sale, McKesson & Robbins Inc. would pay the fictitious W.W. Smith & Co. a .75 percent, divided among the brothers.

Musica was caught at the height of the 1937 recession when McKesson & Robbins directors wanted to pay off a large amount of the debt by turning four million dollars worth of inventory into cash. Musica was not able to come up with this money because the cash did not exist. This preempted a SEC investigation, which determined that “approximately \$19,000,000 of the assets included in the 1937 financial statements audited by Price, Waterhouse & Company were entirely fictitious” (Baker and Bealing, 2006).

This scandal was monumental in establishing new procedures for conducting audits and led to the creation of the independent audit committee. The first standard developed by the committee, *Extensions of Auditing Procedure*, made “observing inventory and confirming accounts receivable, two procedures that would have helped detect the McKesson & Robbins fraud, standard audit procedures” (Clikeman, 2003).

HYPOTHESES

After conducting research, we found that there is little documentation on McKesson & Robbins. Based on this lack of information, it could explain why students are not aware of this monumental case in history. Again, it is hoped that to fully understand the rules and concepts of the accounting profession; students need to understand the history behind the accounting standards and why they were established. We have developed two hypotheses that will be tested through a survey given to accounting students at two different Midwestern state universities.

H1: Accounting students are not fully aware of the McKesson & Robbins fraud.

With the current state of accounting/auditing education, and the lack of emphasis on fraud education particularly in terms of the historical significance of fraud, we believe that the accounting students will have a very low awareness of the McKesson & Robbins fraud.

H2: Accounting students are not fully aware of the impact that McKesson & Robbins had on the establishment of GAAS.

The discovery of McKesson & Robbins scandal directly led to the creation of not only the independent audit committee but also a set of standards for auditors, Generally Accepted Auditing Standards (GAAS). We believe that accounting students will have a low awareness of how GAAS evolved and what was the historical significance of the McKesson & Robbins scandal was on establishment of GAAS.

As part of a pilot test, the authors developed a six item survey instrument to test student awareness of the McKesson & Robbins fraud. The survey was administered to two Midwestern schools. The survey used a Likert type scale to check the knowledge that students had about the McKesson & Robbins fraud and its impact on GAAS. The survey was administered at both these schools as a part of school work and the students did not get any extra credit for completing the survey. Again, as mentioned above this was a pilot test. The survey's psychometric properties were not tested in great detail because at this stage of the survey, we just wanted to find out the general state of awareness/knowledge that the students had about the McKesson & Robbins fraud.

RESULTS

The descriptive statistics of the survey are given in Table 1. We had a total of 121 respondents from both the schools. There were six incomplete responses. These responses were deleted. Thus, the final sample of our survey from both schools (n1 + n2) was 115. There was a pretty even distribution in terms of the gender (51.3% Males). In terms of the ethnicity of respondents, majority of the respondents were Caucasian (94%). The rest were non-Caucasian (Hispanic, Asian, African-American, etc.).

**TABLE 1
DEMOGRAPHIC INFORMATION**

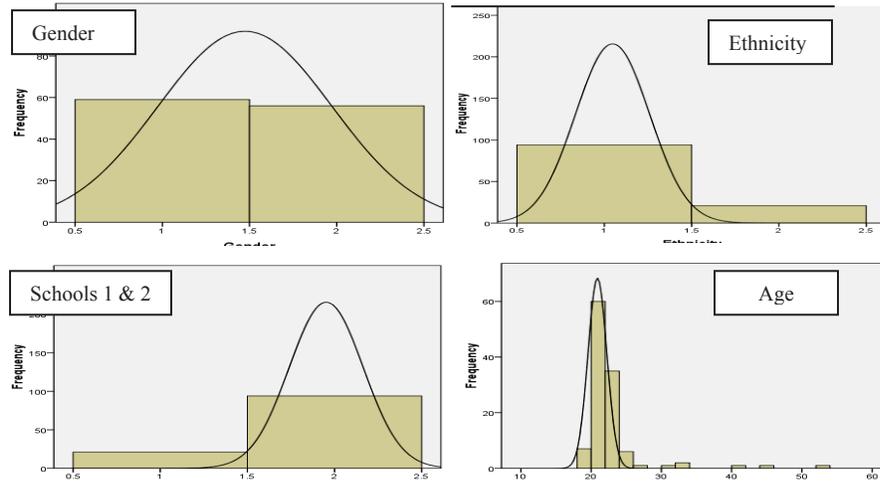
Gender	Frequency	Percent	Valid Percent	Cumulative Percent
Valid 1=Male	59	51.3	51.3	51.3
2=Female	56	48.7	48.7	100.0
Total	115	100.0	100.0	

Ethnicity	Frequency	Percent	Valid Percent	Cumulative Percent
Valid 1 = Caucasian	94	81.7	81.7	81.7
2=NC	21	18.3	18.3	100.0
Total	115	100.0	100.0	

Schools	Frequency	Percent	Valid Percent	Cumulative Percent
Valid 1=School1	21	18.3	18.3	18.3
2=School2	94	81.7	81.7	100.0
Total	115	100.0	100.0	

Since this was a pilot study, we did not categorize responses based on the demographics of the responders (gender, age, school, and ethnicity). Summary of the demographics is given in Figure 1.

**FIGURE 1
RESPONDENT INFORMATION**



In terms of the descriptive statistics of the scale items, MRAuditors (McKesson & Robbins Auditors) had the highest mean of 2.09 on a likert scale from 1 = No Knowledge to 5 = Complete Knowledge. The rest of the items (MRRecog, MRCEO, MRFraud, MRDollar, and MRImpact) were all below 2 (Table 2).

**TABLE 2
DESCRIPTIVE ANALYSIS OF SCALE ITEMS**

	N Statistic	Range Statistic	Min Statistic	Max Statistic	Mean Statistic	Std. Error	SD Statistic	VAR Statistic	Skewness Statistic	Std. Error
MRRecog	115	3	1	4	1.54	.066	.704	.496	1.391	.226
MRCEO	115	3	1	4	1.76	.069	.744	.554	.688	.226
MRFraud	115	4	1	5	1.43	.067	.715	.511	2.066	.226
MRAuditors	115	4	1	5	2.09	.092	.987	.975	.491	.226
MRDollar	115	4	1	5	1.94	.093	.994	.987	.833	.226
MRImpact	115	4	1	5	1.86	.089	.954	.910	1.641	.226
Valid N	115									

In terms of the correlations and the tests of significance, we ran the Kendall's Tau (rank correlation coefficient). The definition of Kendall's Tau is given in Figure 2 (Fagin, 2002; Kendall, 1938).

**FIGURE 1
DEFINITION OF KENDALL'S TAU**

$$K(\tau_1, \tau_2) = \sum_{\{i,j\} \in P} \bar{K}_{i,j}(\tau_1, \tau_2)$$

The Kendall's Tau looks at distance (metric) between two lists (Table 3). It does this by looking at the pair-wise disagreements. Kendall's Tau represents a probability, that is, the probability of the observed

data. Thus, Kendall's Tau is the difference between the probability that the observed data are in the same order as opposed to the probability that the observed data may not be in the same order.

**TABLE 3
NON-PARAMETRIC CORRELATIONS - KENDALL'S TAU B**

		MRRecog	MRCEO	MRFraud	MRAud	MRDollar	MRImpact	
b	MRRecog	Correlation Coefficient	1.000	-.024	-.070	-.232**	.079	.295**
		Sig. (2-tailed)	.	.778	.429	.006	.353	.001
		N	115	115	115	115	115	115
	MRCEO	Correlation Coefficient	-.024	1.000	-.090	-.218**	.172*	.101
		Sig. (2-tailed)	.778	.	.299	.008	.038	.233
		N	115	115	115	115	115	115
	MRFraud	Correlation Coefficient	-.070	-.090	1.000	.239**	.242**	-.084
		Sig. (2-tailed)	.429	.299	.	.005	.004	.331
		N	115	115	115	115	115	115
	MRAuditors	Correlation Coefficient	-.232**	-.218**	.239**	1.000	.065	-.053
		Sig. (2-tailed)	.006	.008	.005	.	.417	.517
		N	115	115	115	115	115	115
	MRDollar	Correlation Coefficient	.079	.172*	.242**	.065	1.000	.031
		Sig. (2-tailed)	.353	.038	.004	.417	.007.	.704
		N	115	115	115	115	115	115
	MRImpact	Correlation Coefficient	.295**	.101	-.084	-.053	.031	1.000
		Sig. (2-tailed)	.001	.233	.331	.517	.704	.
		N	115	115	115	115	115	115
		Sig. (2-tailed)	.005	.008	.004	.	.407	.548
		N	115	115	115	115	115	115

** . Correlation is significant at the 0.01 level (2-tailed), * . Correlation is significant at the 0.05 level (2-tailed).

In terms of the scale statistics, variance of the items was 5.17 and the standard deviation for the six items was 2.27. We also used Hotelling's T-Squared Test to check the distribution of our sample. The results of these tests are given in Table 4.

**TABLE 4
SCALE STATISTICS**

Mean	Variance	Std. Deviation	N of Items
10.62	5.168	2.273	6

Hotelling's T-Squared	F	df1	df2	Sig
55.947	10.797	5	110	.000

	Intraclass Correlation ^a	95% Confidence Interval		F Test with True Value 0			
		Lower Bound	Upper Bound	Value	df1	df2	Sig
Single Measures	.033 ^b	-.014	.094	1.205	114	570	.089
Average Measures	.170 ^c	-.089	.385	1.205	114	570	.089

DISCUSSIONS

There was no analysis of the psychometric properties of the test because this is a pilot project. The items in the survey were six, which is not very exhaustive. We also wanted to find out the preliminary responses with a small body of students (in this case, we had $n = 115$). Since the responses turned out as expected, we plan to run a full-fledged study. In this study we will develop and validate a single-construct scale that tests the knowledge of students.

In terms of the results, the most noticeable outcome was that none of the 6 items scored more than 3 (Neutral) on a likert scale (1 = No Knowledge, 2 = Little Knowledge, 3 = Neutral, 4 = Good Knowledge, and 5 = Complete Knowledge). In-fact, there was only one item (MRAuditors - Recognizing that the auditors were responsible for the fraud) that scored more than 2 (MRAuditors = 2.09).

The results were also dramatic because we found that 115 accounting students had very little knowledge of recognizing the McKesson & Robbins fraud (MRRecog = 1.54), very little knowledge of who the CEO and the main culprit in the McKesson & Robbins case was (MRCEO = 1.76), very little knowledge of what the McKesson & Robbins fraud involved (MRFraud = 1.43), little knowledge of the dollar amount of the McKesson & Robbins fraud, and finally little knowledge of the impact of the McKesson & Robbins fraud (particularly as it relates to GAAS).

CONCLUSIONS

Upon graduation, accounting students are expected to have some idea about the standards and regulations required in their professions. Apart from these standards and regulations, accounting students are expected to have good recognition of fraud and ethical scenarios, and some knowledge in terms of finding the red flags of fraud know the standards and the procedures of their profession. In terms of the ethical requirement, the CPA exam has a separate module that tests student ethical ability. In terms of the students' knowledge of fraud, their ability to recognize fraud and their recognition of the basics of the monumental fraud of McKesson & Robbins, this study finds that the students are apathetically unprepared.

This is a pilot study, but it goes a long way in suggesting to accounting educators about the need in incorporating a historical perspective in teaching auditing and fraud. The age old adage of "History repeats itself," should be considered. Even though certain events may not replicate themselves identically, by not giving students a historical perspective - accounting faculty members are reducing student ability to recognize and prevent fraud. While research has shown that it is not possible to reduce fraud by just teaching students about the punitive effects of fraudulent behavior, it may be possible to put a dent in fraudulent activity by teaching students to recognize obvious red flags.

Certain limitations must be considered when referring to the study. The sample only included accounting students from two universities due to time limitations. Also, the number of students was not very large ($n = 115$). The sample was also a convenience sample. Thus, there is little external generalizability to this study. Another obvious drawback of this pilot study is the lack of a thorough psychological evaluation of the instrument.

Even with these drawbacks, this study clearly indicates that the accounting students are completely unprepared in terms of recognizing historical events such as the McKesson & Robbins fraud. Without the historical perspective of what caused the establishment of GAAS and the understanding of key frauds - it may be difficult for students to recognize fraud red flags when they enter the workforce.

The results of this study also suggest that additional fraud education of future accounting students may be necessary to prevent frauds like McKesson & Robbins, Enron, HealthSouth, etc. Participants in this study illustrated a lack of knowledge about a landmark fraud case that forever altered the standards of their chosen profession. History tends to repeat itself more than once and having knowledge of how and why past frauds materialized will arm students with the ability to better identify possible signs of fraud. Students need to learn the history of their profession to gain an understanding of not just what they are doing, but why are they doing it.

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