



The Case of Phar-Mor Inc.

Could SOX Have Prevented the Fraud?

By S. Lansing Williams

The Sarbanes-Oxley Act of 2002 (SOX) was an effort to increase the confidence of investors after a number of high-profile corporate failures due to malfeasance on the part of corporate officers and poor internal controls. After the failures of Enron, WorldCom, and other large companies—which resulted in huge losses to investors—Senator Paul Sarbanes (D-Md.) and Representative Michael Oxley (R-Ohio) coauthored a bill that resulted in public companies improving the accuracy of their financial reports. The law contains 11 major sections, including (Title I) Public Company Accounting Oversight Board, (Title II) Auditor Independence, (Title III) Corporate

Responsibility, (Title IV) Enhanced Financial Disclosures, (Title V) Analyst Conflicts of Interest, and (Title VI) Commission Resources and Authority. Titles VII, VIII, IX, X, and XI deal with studies and reports, corporate and criminal fraud accountability and white-collar crime penalties, corporate tax returns, and corporate fraud and accountability.

While SOX came about as a direct result of the Enron meltdown in 2001, followed by the WorldCom bankruptcy in 2002, these two companies were not the only failures that led to its passage. The 1992 bankruptcy of Phar-Mor Inc. cost its investors \$500 million. Although the bankruptcy occurred 10 years

prior to the enactment of SOX, this article attempts, with hindsight, to determine if the bankruptcy might have been prevented if the provisions of SOX had been in effect and applied to Phar-Mor Inc.

Background

Phar-Mor Inc., a deep discount drugstore chain, came into existence in 1982 as an affiliate of family-owned grocery chain Giant Eagle, which also owned a distribution company, Tamco Distributors Co. The deep discount concept consisted of using "power buying," or purchasing the largest possible amount of product at the best terms, then selling at discounts of up to 25%-40% off retail prices.

The then vice-president of Tamco, Michael J. "Mickey" Monus, was named president of the new company. Phar-Mor had grown to 70 stores by 1987 and saw further expansion, reaching 200 stores in 1990; by 1992, it reached 310 outlets with 25,000 employees in 34 states (www.fundinguniverse.com/company-histories/PharMor-Inc-Company-History.html).

The first indication of financial problems came to light in 1988, when investigation of lower-than-expected profit margins revealed that Phar-Mor was being billed for inventory it had not received from its sister company, Tamco, a primary supplier. Because Phar-Mor did not maintain receiving records of its purchases from Tamco, it was impossible to substantiate products received. At the same time, Tamco's records were equally poor. A formal analysis of the shortage by a Phar-Mor accountant indicated that the inventory shortage/overbilling was around \$4 million; however, the two subsidiaries of Giant Eagle settled on \$7 million, giving Phar-Mor a \$2 million profit for the year. It is interesting to note that the settlement resulted in a nearly identical gross margin as the prior year (David M. Cottrell and Steven M. Glover, "Finding Auditors Liable for Fraud," *The CPA Journal*, July 1997).

While not on the radar for several years, another source of problems for Phar-Mor began with the formation of the World Basketball League (WBL) in 1987. Monus owned at least 60% of each of the 10 teams and was responsible for that portion of each team's losses, which a fellow investor in the WBL told a Cleveland *Plain Dealer*

reporter averaged \$13,000 per game, or \$7,800 for Monus's share (www.fundinguniverse.com). It was estimated that Monus embezzled about \$15 million from Phar-Mor in support of WBL activities (Gabriella Stern, "One Messy Store: Chicanery at Phar-Mor Ran Deep, Close Look at Discounter Shows," *Wall Street Journal*, January 20, 1994).

By 1989 Phar-Mor's losses were mounting. In addition to funding of WBL activities, Monus had diverted over \$200,000 for improvements to his personal residence and meals at a country club (Stern 1994), and profit margins continued to deteriorate. When the chief financial officer, Patrick Finn, first reported losses to Monus, the president crossed off the loss and wrote in a profit (Jim

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Gilmore, Paul Judge, and Paul Solman, "How to Steal \$500 Million," *Frontline*, November 8, 1994). The losses were charged to what the senior staff involved in the fraud called a "bucket account," in which cover-up activities were recorded, and which was reallocated to the inventory of the existing stores. It was known that the auditor, Coopers & Lybrand, did not audit accounts with a zero balance; thus, the activity in the bucket accounts that was reallocated was not reviewed (Steven M. Mintz and Roselyn E. Morris, *Ethical Obligations and Decision Making in Accounting*, McGraw-Hill/Irwin, 2008, pp. 132–133).

It was also known that Coopers did not observe inventory in all stores, but instead only used four stores for testing, some time before the June 30 year-end, and rolled the inventory value forward from the test counts (Mintz and Morris 2008). Furthermore, Coopers told Phar-Mor in advance which stores would be tested, allowing Phar-Mor to ensure that a good "representative count" was taken at those stores, which then allowed the allocation of the bucket account balances as phantom inventory to the other, uncounted stores (Mintz and Morris 2008). Thus, allocating a loss of \$12 million, for example, to 125

stores resulted in an inventory increase of \$96,000 per store, which was explained to Coopers as building the inventory up for the July 4 holiday, which had a heavy sales demand. The drop-off of inventory right after the June 30 year-end was also explained by the high volume of July 4 sales (Cottrell and Glover 1997).

By the time Phar-Mor opened its 310th store in 1992, the fraudulent activities being covered up included—

- fictitious inventory on the books to cover up operating losses;
- Monus's personal expenses charged to the bucket accounts; and
- World Basketball League expenses paid by Phar-Mor, also charged to the bucket accounts.

The cover-up of all this fraudulent activity required a great deal of coordination among the senior staff. The group that auditors referred to as the "fraud team" consisted of—

- Monus, president;
- Patrick Finn, chief financial officer, a former Coopers & Lybrand auditor;
- Jeffrey Walley, vice president of finance, a former Coopers & Lybrand auditor;
- Stanley Chelstein, controller, a former Coopers & Lybrand auditor; and
- John Anderson, accounting manager, hired right out of Youngstown State University.

In order to carry out a fraud involving fictitious inventory, the embezzlement of funds covering WBL expenses, and personal embezzlement, there had to be a great deal of understanding of audit procedures and how to circumvent them. With three of the four key financial executives having been previously employed by the auditors, this was accomplished. "The perpetrators lied, forged documents, and carefully 'scrubbed' everything the auditors saw to hide any indications of malfeasance" (Cottrell and Glover 1997). They knew that Coopers traditionally did not review zero-balance accounts, so by parking erroneous amounts in the bucket accounts, then allocating the balances of those accounts to inventory at year end, they were successful. In fact, Finn, the CFO, stated in a video clip of a deposition that if Coopers had asked for the backup to any one of the fraudulent journal entries, the fraud "would have been all over." Finn also testified that if Coopers had asked for the closing jour-

THE FATE OF PHAR-MOR

The financial cover-up began to unravel when a travel agent was paid \$80,000 for a delinquent World Basketball League (WBL) travel expense on a Phar-Mor check. Curious about the source, she asked a friend, an outside Phar-Mor shareholder, who asked Phar-Mor's outside counsel, the brother of Chief Executive Officer David Shapira, who asked questions.

With the disclosure of what became a \$500 million accounting fraud, Phar-Mor filed for Chapter 11 bankruptcy, closed 167 of 310 stores, and laid off 15,000 employees (www.fundinguniverse.com).

Phar-Mor President Michael Monus was indicted on 129 counts of fraud by a federal grand jury in 1993. A hung jury resulted in a mistrial, after which a second grand jury brought more than 100 new charges against him. He was found guilty of embezzling more than \$10 million and sentenced to 19 years, seven months in prison.

Vice President of Finance Jeffrey Walley cooperated with authorities, pleaded guilty to four counts of fraud, and was sentenced to six months house arrest.

Chief Financial Officer Patrick Finn was sentenced to 33 months in federal prison and fined \$7,000 after pleading guilty and cooperating with authorities.

Auditors Coopers & Lybrand were sued \$1 billion for fraud, settling for an undisclosed amount.

Sources:

Mark S. Beasley, Frank A. Buckless, Steven M. Glover, and Douglas Prawitt, "Phar-Mor, Inc.: Accounting Fraud, Litigation, and Auditor Liability," *Auditing Cases: An Interactive Learning Approach*, Prentice Hall PTR, 2006.

Zabihollah Rezaee and Richard Riley, *Financial Statement Fraud, Prevention and Detection*, Wiley, 2010, pp. 121–125.

Gabriella Stern, "One Messy Store: Chicanery at Phar-Mor Ran Deep, Close Look at Discounter Shows," *Wall Street Journal*, January 20, 1994.

www.fundinguniverse.com/company-histories/PharMor-Inc-Company-History.html

"Report Sheds Light on Evolution of Phar-Mor Scandal" *Chain Drug Review*, February 14, 1994.

nal entries, he would have removed the entries that emptied the fraud bucket before giving them to the auditors (Cottell and Glover 1997).

Potential Effects of SOX

There are five specific sections of SOX that address aspects of the fraudulent activities of Phar-Mor management. A review of these sections and how they could have impacted Phar-Mor follows.

Title II, section 203, "Audit Partner Rotation." This provides that a registered public accounting firm may not provide an audit if the lead audit partner or the reviewing audit partner has performed audit services for that issuer in each of the five previous fiscal years of the issuer. References to the audit partner only relate to his defense of audit procedures and allegations that he had previously been criticized for exceeding audit budgets and was under pressure to carefully control audit costs (Cottrell and Glover 1997).

If one assumes that the audit partner was on the job at the initiation of the fraud in 1989, it is likely that he would have been rotated off and a new partner would have taken over during the four-year period in which the fraud was carried out. The question would then become: Would the new audit partner use the same procedures as his predecessor, and be under the same pressures as the partner?

Title II, section 206, "Conflicts of Interest." This section makes it unlawful "for a registered public accounting firm to perform for an issuer any audit service ... if a chief executive officer, controller, chief financial officer, chief accounting officer ... was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit."

As stated above, three of the members of the fraud team at Phar-Mor—Walley, Finn, and Chernelstein—were former Coopers & Lybrand auditors. While the author has not been able to determine the hire date of Walley, in *Frontline's* "How to Steal \$500 Million," he learned that Finn was CFO from 1988 to 1992, and that when the fraud was initiated (1989), he had been with the company for several years. One can thus conclude that because he was hired more than a year prior to the audit, he was

probably not subject to the one-year rule. Regardless of the timing of his hire, he knew and admitted that what he did to cover up the misstatement was illegal.

Chernelstein, the controller, is quoted in "How to Steal \$500 Million" as saying that he joined Phar-Mor in 1990 and did not become aware of the fraud until he became controller and Accounting Manager John

Anderson showed him a subledger schedule showing that the June 1991 financial statements were misstated by approximately \$150 million.

Chernelstein could not have been hired directly from Coopers without violating the one-year rule. Chernelstein stated that when he was told of the subledger, he did not report the fraud due to concerns for his personal

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health (Gilmore, Judge, and Solman). It takes a great deal of courage to become a whistleblower, which makes one wonder if someone hired without violation of the one-year rule would have reported the situation.

Title III, section 302, "Corporate Responsibility for Financial Reports." This section states that the principal executive officers and the principal financial officers are required to certify in each annual or quarterly report that—

- (1) the signing officer has reviewed the report;
- (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- (3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
- (4) the signing officers—
 - (A) are responsible for establishing and maintaining internal controls ...
 - (B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls.

This section would have required the principal executive officer, Monus, and the principal financial officer, Finn, to state that the financial statements of Phar-Mor did not contain any untrue statements of a material fact and that the financial statements fairly presented in all material respects the condition and results of operations.

The facts show that both individuals were deeply involved in the misstatement of Phar-Mor's financial health. It would be highly doubtful that they would have made

such a statement unless compelled to do so under the rules in SOX.

Part 4 of Title III, section 302 requires the signing officers to take responsibility for establishing and maintaining internal controls. In reality, the signing officers were responsible for ignoring internal control procedures, if any even existed.

Part 5 requires the signing officers to disclose to their auditors and board of directors' audit committee all significant deficiencies in internal controls and further disclose any fraud, material or not, that involves management. It seems clear from the actions of Monus and Finn that they would likely have felt little, if any, discomfort in perjuring themselves by complying falsely with the Title III, section 302 requirements.

Title IV, section 404, "Management Assessment of Internal Controls." Subsection (a) of this section requires management to include in annual reports an internal control report which shall—

- (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

It would probably be safe to say that since the management responsible for making, assessing, and asserting the establishment and maintenance of adequate internal control structure and procedures was the same management perpetuating the fraud, such assessments would likely still have been made without hesitation.

Additionally, subsection (b) requires that—

With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer.

Again, given that Finn testified that he would have given fraudulent journal entries to the auditors (Cottell and Glover), he would have provided Coopers with sufficient detailed internal control documentation that would have sufficed for a positive assessment.

Title IV, section 406, "Code of Ethics for Senior Financial Officers." This section describes requirements for a code of ethics for senior financial officers, stating:

The Commission shall issue rules to require each issuer, together with periodic reports required ... to disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or person performing similar functions. ...

Definition.—In this section, the term "code of ethics" means such standards as are reasonably necessary to promote— ...

(2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer.

The senior management of Phar-Mor willingly and knowingly perpetuated a massive fraud and spent considerable energy and resources maintaining the cover-up. There is no reason to believe that a code of ethics would have been adhered to.

Would SOX Have Helped?

Had the Phar-Mor fraud been perpetrated in a post-SOX environment, the Coopers & Lybrand partner-in-charge would likely have been replaced by application of SOX regulations because he would have been responsible for the audit for more than five years by 1991 and therefore subject to audit partner rotation. There's a question as to whether his successor would have changed audit procedures to any great extent, and perhaps just as importantly, would have found himself under the same cost restraints.

The senior management of Phar-Mor deliberately concealed major losses of the company. Additionally, corporate funds were used to pay for both personal expenses of the president and an unrelated organization. The president, vice president of finance, CFO, controller, and accounting manager were all involved in the cover-up. Three members of this fraud team had worked for the auditor and were familiar with the audit steps that would be taken, thus helping them cover up their activities.

If SOX had been enacted in the mid-1980s, it would have prevented the hire

of Phar-Mor Controller Chernelstein, Walley and Finn, who were hired earlier in the company's existence, were the enablers, using their knowledge of Coopers audit procedures.

Because the senior management of Phar-Mor were responsible for perpetuating the fraud, it could be assumed that they would have had no compunction in asserting that all internal control structures and procedures were effective. Inasmuch as the fraud was dependent upon management knowledge of audit procedures used, it would probably be safe to assume that any management assessment of internal controls would have ignored areas that would have uncovered the fraud.

It can be argued that the auditor was negligent in the audit of Phar-Mor because it did not take proper action to ensure that documentation given to them was accurate and allowed procedures that enabled the cover-up, such as inventory observations weeks in advance of the audit date, at only four out of 300 stores. This is substantiated by the finding of negligence on the part of Coopers.

Heng Hsieu Lin and Frederick H. Wu in "Limitations of Section 404 of the Sarbanes-Oxley Act" (*The CPA Journal*, March 2006) correctly point out that "Reliable financial reports rely to a certain extent on effective internal controls, but effective internal controls rely to a large extent on a reliable management system coupled with strong corporate governance." In a situation like Phar-Mor, the management system was neither reliable, nor did it constitute strong corporate governance. Consequently, had SOX been enacted prior to 1988 when the company first began to encounter financial problems, Title III, section 302 may not have had much impact on the misdeeds of management, rendering it worthless. Furthermore, it would probably be safe to say that Title IV, section 406, establishing a code of ethics for senior financial officers, would have been ignored.

Section 207 did call for a study by the comptroller general of the United States to determine the feasibility of a mandatory rotation period for auditors. This study was conducted by the U.S. General Accounting Office (GAO), now the Government Accountability Office. This study, submitted to Congress in November 2003, concluded

that mandatory rotation would be more harmful than beneficial in improving audit reliability due to "the additional financial costs and the loss of institutional knowledge of the previous auditor of record," an opinion shared by the AICPA and individual members of the audit profession (Barbara Arel, Richard Brody, and Kurt Pany, "Audit Firm Rotation and Audit Quality," *The CPA Journal*, January 2005).

In retrospect, it would also be easy to argue that had a mandatory rotation of audit firms been in place prior to 1985, the Phar-Mor bankruptcy could well have been avoided. Much of the reason for the success of the fraud team was due to the knowledge the individuals had of the audit practices of Coopers. If a new audit firm had taken over the audit, management would have had to deal with new procedures, and the new firm may not have ignored transactions within zero-balance accounts.

It would seem that the Phar-Mor Inc. bankruptcy was what could be considered the perfect storm of corporate management malfeasance. It was the senior management—the individuals responsible for personal and inappropriate use of corporate assets, the individuals who refused to acknowledge operating losses, those responsible for development and implementation of internal controls, those responsible for accurate financial reporting, and those attesting to their auditors and investors—who were responsible for the fraud. This case appears to point out that laws designed to protect the public, which may be extremely costly to implement, may not always result in the desired outcome. □

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