

## **Case 2-9**

### **Phar-Mor**

#### **The Dilemma**

The story of Phar-Mor shows how quickly a company that built its earnings on fraudulent transactions can dissolve like an alka-seltzer® tablet.

One day Stan Cherelstein, the controller of Phar-Mor, discovered cabinets stuffed with held checks totaling \$10 million. Phar-Mor couldn't release the checks to vendors because it did not have enough cash in the bank to cover the amount. Cherelstein wondered what he should do.

#### **Background**

Phar-Mor was a chain of discount drug stores, based in Youngstown, Ohio and founded in 1982 by Michael Monus and David Shapira. The company grew from 15 to 310 stores in less than ten years and had 25,000 employees. According to Litigation Release No. 14716 issued by the SEC<sup>1</sup>, Phar-Mor had cumulatively overstated income by \$290 million between 1987 through 1991. In 1992, prior to disclosure of the fraud, the company overstated income by an additional \$238 million.

#### **The Cast of Characters**

Mickey Monus personifies the hard-driving entrepreneur who is bound and determined to make it big whatever the cost. He served as the president and chief operating officer of Phar-Mor from its inception until a corporate restructuring was announced on July 28, 1992.

David Shapira was the chief executive officer of Phar-Mor and the CEO of Giant Eagle, Phar-Mor's parent company and majority stockholder. Giant Eagle also owned

Tamco, which was one of Phar-Mor's major suppliers. Shapira left day-to-day operations of Phar-Mor to Monus until the fraud became too large and persistent to ignore.

Patrick Finn was the chief financial officer of Phar-Mor from 1988 to 1992. Finn initially brought Monus the bad news that following a number of years of eroding profits, the company faced millions in losses in 1989.

John Anderson was the accounting manager at Phar-Mor. Hired after completing a college degree in accounting at Youngstown State University, Anderson became a part of the fraud.

Coopers & Lybrand, prior to its merger with Price Waterhouse, were the auditors of Phar-Mor. The firm failed to detect the fraud as it was unfolding.

### **How it Started**

The facts of this case are taken from SEC filings in the matter and a Public Broadcasting System Frontline program, "How to steal \$500 million." The interpretation of the facts is consistent with reports but some literary license has been taken to add intrigue to the case.

Finn approached Monus with the bad news. Monus reacted by taking out his pen, crossing off the losses, and writing in higher numbers to show a profit. Monus couldn't bear the thought of his hot growth-company that had been sizzling for five years suddenly flaming-out. In the beginning, it was to be a sort-term fix to buy time while the company improved efficiency, put the heat on suppliers for lower prices, and turned a profit. Finn believed in Monus's ability to turn things around so he went along with the fraud. Finn prepared the reports and Monus changed the numbers for four months before turning the

task over to Finn. These reports with the false numbers were faxed to Shapira and given to Phar-Mor's board. Basically, the company was lying to its owners.

The fraud occurred by dumping the losses into a "bucket account" and then reallocating the sums to one of the company's hundreds of stores in the form of increases in inventory amounts. Phar-Mor issued fake invoices for merchandise purchases, made phony journal entries to increase inventory and decrease cost of sales. The company over-counted and double-counted merchandise in inventory.

The fraud was helped by the fact that the auditors from Coopers observed inventory in only four out of 300 stores, and that allowed the finance department at Phar-Mor to conceal the shortages. Moreover, Coopers informed Phar-Mor in advance which stores they would visit. Phar-Mor executives fully stocked the four selected stores but allocated the phony inventory increases to the other 296 stores. Regardless of the accounting tricks, Phar-Mor was heading for collapse and its suppliers threatened to cut the company off for nonpayment of bills.<sup>1</sup>

### **Stan Cherelstein's Role**

Cherelstein was hired to be the controller of Phar-Mor in 1991 long after the fraud had begun. One day, John Anderson, Phar-Mor's accounting manager, called Cherelstein into his office and explained that the company had been keeping two sets of books – one that showed the true state of the company with the losses and the other, called the sub ledger, that showed the falsified numbers that were presented to the auditors.

Cherelstein and Anderson discussed what to do about the fraud. Cherelstein was not happy about it at all and demanded to meet with Monus. Cherelstein did get Monus to agree to repay the company for the losses from Monus's investment of company funds

into the World Basketball League. But Monus never kept his word. In the beginning Cherelstein felt compelled to give Monus some time to turn things around through increased efficiencies and by using a device called exclusivity fees that were paid by vendors to get Phar-Mor to stock their products. Over time, Cherelstein became more and more uncomfortable as the suppliers called more and more frequently demanding payment on their invoices.

## **Accounting Fraud**

### *Misappropriation of Assets*

The unfortunate reality of the Phar-Mor saga was that it involved not only bogus inventory but also the diversion of company funds to feed Monuses personal habits. One example was the movement of \$10 million in company funds to help start a new basketball league, the World Basketball League (WBL) that limited player participation to those six feet and under.

### *False Financial Statements*

According to the ruling by the United States Court of Appeals that heard Monuses appeal of his conviction on all 109 counts of fraud,<sup>1</sup> the company submitted false financial statements to Pittsburgh National Bank, which increased a revolving credit line for Phar-Mor from \$435 million to \$600 million in March 1992. It also defrauded Corporate Partners, an investment group that bought \$200 million in Phar-Mor stock in June 1991. The list goes on including the defrauding of Chemical Bank, which served as the placing agent for \$155 million in ten-year senior secured notes issued to Phar-Mor; Westinghouse Credit Corporation, which had executed a \$50 million loan commitment to

PharMor in 1987; and to Westminster National Bank, which served as the placing agent for \$112 million in Phar-Mor stock sold to various financial institutions in 1991.

### *Tamco Relationship*

The early financial troubles experienced by Phar-Mor in 1988, can be attributed to at least two transactions. The first was that the company provided deep discounts to retailers to stock its stores with product. There was concern early on that the margins were too thin. The second was that its supplier, Tamco, was shipping partial orders to Phar-Mor while billing for full orders. Phar-Mor had no way of knowing because it was not logging in shipments from Tamco.

After the deficiency was discovered, Giant Eagle agreed to pay Phar-Mor \$7 million in 1988 on behalf of Tamco. Phar-Mor later bought Tamco from Giant Eagle in an additional effort to solve the inventory and billing problems. However, the losses just kept on coming.

### **Back to the Dilemma**

Cherelstein looked out the window at the driving rain storm. He thought about the fact that he didn't start the fraud or the cover-up. Still, he knows about it now and feels compelled to do something. Cherelstein thought about the persistent complaints by vendors that they were not being paid and their threats to cut off shipments to Phar-Mor. Cherelstein knows that without any product in Phar-Mor stores, the company could not last much longer.

This case discusses the accounting scandal of Phar-Mor and show the rationalization of giving time to fix a situation, which may not be fixable.

### **Ethical Issues**

This case highlights rationalization used to justify not doing ethical obligations. The rationalization was that all the misrepresentation was short-term so that the company

could recover losses and make the reported financial statements correct. The short term turned into long term and the losses kept mounting. Monus refused to report losses and had taken company funds for a personal investment in the World basketball League. Monus failed in his fiduciary duties and the values of honesty, integrity, trustworthiness, and responsibility. Sharipa also failed on his fiduciary duties and responsibility to oversee Phar-Mor. Finn, Cherelestein, and Anderson failed to account in accordance with GAAP and adequately disclose accounting treatments and procedures in the financial statements.

The stakeholders of Phar-Mor have a right not to be misled by financial statements making it look as though the company is doing better than it really is. Any attempt to intentionally misstate the financial statements violates the categorical imperative under rights theory. From a justice perspective, stakeholder interests are not fairly represented because the perceived interests of the management are given priority over the interest of all other stakeholders. From an utilitarian perspective, Rule-utilitarianism: It requires that the correct rule should be followed. Act-utilitarianism: Requires that the act that creates the greatest good for the greatest number of stakeholders should be selected. None of the stakeholders benefit from an action that misstates net income. Even Phar-Mor was harmed because the SEC imposed sanctions on it for false and misleading financial statements. From a virtue perspective, honesty requires that the statements should be truthful and follow generally accepted accounting principles. Objectivity requires that the company should approach its decision about the proper accounting procedures for investments and inventory with fair-mindedness and without partiality to one set of stakeholders. Trustworthiness means that the accountants should not violate the investors' faith that the statements are accurate and reliable. Due professional care requires that Coopers & Lybrand should have conducted the audit with skepticism and gathered sufficient evidence upon which to base an opinion.

## Questions

- 1. How do you assess blame for the fraud? That is, to what extent was it caused by Pat Finn's willingness to go along with the actions of Mikey Monus? What about David Shapira's lax oversight? What responsibilities exist for John Anderson and Sam Cherelestein that contributed to the fraud? Finally, should the blame all go to Mikey Monus? What role did Coopers & Lybrand play with respect to its professional judgment?**

The blame for the fraud lies mostly with Monus; he was using company assets for his personal purposes and pressured subordinates to go along with his schemes so that

his pride would not be hurt by reporting losses. Finn and Shapira were willing to go along and believe that the situation was short term rather than have to deal with the unpleasantness that reality would cause. Anderson was not a CPA and started at Phar-Mor right out of college; he may have thought the accounting treatments were correct. However, when the firm began keeping two sets of books, he should have realized that something was not right. His personal values should have told him that things should change to one set of books or he should have found another job. Chereinstein should have done his homework before he accepted the position with Phar-Mor. Once he found out about the fraud and agreed to go along, he became as guilty as Monus.

Professional judgment is exercised with due care, objectivity, and integrity. It seems that Coopers & Lybrand did not exercise due care and objectivity (skepticism).

Coopers & Lybrand contributed to the fraud by not being skeptically enough and informing Phar-Mor of which stores would be included in the inventory observation. The advance notification of the store locations allowed Phar-Mor to fully stock those stores to perpetuate the fraud cover-up. Coopers failed to exercise professional judgment in observing inventory at only 1.3% of the stores and following up on the analytical procedures showing that inventory was increasing and cost of sales decreasing as revenues were increasing. Phar-Mor was a discount pharmacy, which meant that retail model was to minimize inventory while using low prices to increase and maximize inventory turn-over. Increasing inventory amounts should have been a red flag to Coopers.

**2. Use the ethics standards of the AICPA and IMA to evaluate the actions of Pat Finn and Stan Cherelstein in the Phar-Mor fraud. Did they meet their ethical obligations?**

Both CMAs and CPAs need to keep their objectivity and skepticism to prevent and uncover fraud. A CMA has an obligation to act in accordance with the ethical principles of honesty, fairness, objectivity, and responsibility. The IMA Statement of Ethical Professional Practice notes that the standard of integrity requires that a member has a responsibility to abstain from engaging in or supporting any activity that might discredit the profession. A CPA has an obligation to act in accordance with the principles and standard of integrity, objectivity, confidentiality, and due care (competence and prudence). All state boards of accountancy and the AICPA code has a standard of not committing acts discreditable to the profession. Further the IMA statement has a section on resolution of ethical conflict. Following those guidelines, Finn was to follow Phar-Mor's established policies; report the ethical conflict within the company's chain of command; consult an IMA Ethics Counselor; and consult an attorney. By helping to continue and conceal the fraud Finn and Cherelstein engaged in discreditable acts to the professions.

**3. What is the ethical message of Phar-Mor? That is, explain what you think is the "moral of the story."**

The moral of the story is the tone at the top determines practices of a company, that pride should not get in the way of good business and that delaying bad news may only cause more harm.



