A View of an Accounting Fraud and Litigation from Inside the Courtroom

What the Jury Heard in the Phar-Mor Case[1]

In the Phar-Mor case, several members of top management confessed to, and were convicted of, financial statement fraud. Certain of Phar-Mor's creditors and investors subsequently brought suit against Phar-Mor's independent auditor, Coopers & Lybrand, alleging the firm was reckless in performing its audits. A jury found the audit firm liable for fraud. While this module can only contain a very small portion of what the jury heard in the five-month trial, we identify the most important points presented to the jury through a careful review of the trial transcripts and selected interviews with attorneys who were in the courtroom on a daily basis. Unless otherwise noted, all facts and statements are based on actual trial transcripts.

Background

The $500 million accounting fraud at Phar-Mor, Inc., led to the bankruptcy of one of the largest private companies in the United States in 1992. As a result of the company's fraud and subsequent failure, charges were filed against both Phar-Mor's management and the company's auditors. Phar-Mor's former management was collectively fined just over $1 million, and two former members of Phar-Mor management received prison sentences. The company's former auditors, Coopers & Lybrand LLP (Coopers), faced claims of more than $1 billion, although final settlements were a small fraction of that amount. Even though Phar-Mor's management, the plaintiffs' attorneys, or anyone else associated with the case never alleged the auditors knowingly participated in the Phar-Mor fraud, on February 14, 1996, a jury found Coopers liable under a fraud claim. The crux of this fraud charge was that Coopers made representations recklessly without regard to whether they were true or false, which legally enabled plaintiffs to sue the auditors for fraud under statutory and common law.

Between 1985 and 1992, Phar-Mor grew from 15 to 310 stores in 32 states, posting sales of more than $3 billion. By seemingly all standards, Phar-Mor was a rising star touted by some retail experts as the next Wal-Mart. However, in summer 1992, the illusion of Phar-Mor's success came to an abrupt end—the company's executives had cooked the books. The magnitude of the collusive management fraud at the company was almost inconceivable. The fraud was carefully carried out over several years by individuals at several organizational layers, including the president, CFO, COO, vice president of marketing, director of accounting, controller, and a host of others.

[1] Adapted with permission from David Cottrell and Steven Glover, "Finding Auditors Liable for Fraud: What the Jury Heard in the Phar-Mor Case," *CPA Journal* (July 1997).

Investors and creditors filed suit against Coopers under Section 10(b) of the Federal Securities Exchange Act of 1934 and under Pennsylvania state common law.[2] To prevail against auditors on a claim filed under Section 10(b), a plaintiff must prove by preponderance of the evidence that the auditors acted knowingly or with reckless disregard for the truth. While the burden of proof under the federal law is substantial, the burden of proof is even higher under Pennsylvania state common law. The judge in the Phar-Mor case ruled the plaintiffs were not primary beneficiaries under Pennsylvania law, meaning the plaintiffs were required to prove by clear and convincing evidence that either (1) the auditor knew the financial statements were misrepresented or (2) the auditor issued an audit opinion recklessly.

Courtroom Strategies

The Defense. Attorneys for Coopers continually impressed upon the jury that the fraud was perpetrated by Phar-Mor's management, not by the auditor. They clearly illustrated that the fraud was a collusive effort by multiple individuals within upper management at Phar-Mor, which continually worked to hide evidence from the auditors. The auditors were portrayed as victims of the fraud team at Phar-Mor that would, and did, do whatever it took to cover up the fraud. The perpetrators lied, forged documents, and carefully "scrubbed" everything the auditors saw to hide any indications of malfeasance. The fraud team included several former auditors, including auditors who had worked for Coopers on prior Phar-Mor audits.

After the verdict was rendered against the auditors, Coopers' attorney said, "The jury [rightly] saw that a corporate fraud had been committed, but it mistakenly blamed the outside auditor for not uncovering something no one but the perpetrators could have known about." He added, "It . . . effectively turns outside auditors into insurers against crooked management."

The Plaintiffs. The plaintiffs opened their case by acknowledging that the incidence of management fraud does not, by itself, prove there was an audit failure. Moreover, they did not allege that Coopers knowingly participated in the Phar-Mor fraud; nor did they allege Coopers was liable just because it did not find the fraud. Rather, the plaintiffs alleged that Coopers made fraudulent representations in its audit opinions. The two key alleged misrepresentations were Coopers' statements that its audits of Phar-Mor were performed in accordance with generally accepted auditing standards (GAAS) and the audited statements of Phar-Mor were in conformity with generally accepted accounting principles (GAAP). The following quotes from plaintiff attorneys' statements to the jury illustrate the plaintiffs' strategy:

> We invested in Phar-Mor on the basis of the financials of Phar-Mor, with the clean opinions of Coopers & Lybrand. We've now lost our investment, and it's a very simple case. We just want our money back. . . . If Coopers can demonstrate to you

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[2] While Phar-Mor was a private company, it had public debt and was subject to the federal securities laws.

> that they performed a GAAS audit in the relevant time periods, then you should find for them. But if you find based upon the testimony of our experts and our witnesses that Coopers never, ever conducted a GAAS audit . . . then I submit you should ultimately find for [plaintiffs]. (Ed Klett, attorney for Westinghouse)

> So the question, ladies and gentlemen, is not whether Coopers could have discovered the fraud. The question is whether Coopers falsely and misleadingly stated that it conducted a GAAS audit and falsely and misleadingly told [plaintiffs] that Phar-Mor's worthless financial statements were fairly presented. And the answer to that question is yes. (Sarah Wolff, attorney for Sears)

After the verdict, plaintiffs' attorney Sarah Wolff indicated that the Phar-Mor case could prove to be a model for getting a jury to find that a respected accounting firm behaved "recklessly." The key to proving reckless behavior is that it is sufficient to achieve a guilty verdict on fraud charges.

In addition, throughout the five-month trial, the plaintiffs continually emphasized the following facts in their effort to convince the jury that the auditors were motivated to overlook any problems that might have been apparent to a diligent auditor:

- The fraud went on for a period of three to six years and, therefore, should have become apparent to a diligent auditor.
- Coopers was aware that Phar-Mor's accountants never provided the auditors with requested documents or data without first carefully reviewing them.
- Greg Finnerty, the partner-in-charge of the Phar-Mor audit, had previously been criticized for exceeding audit cost budgets and, therefore, was under pressure to carefully control audit costs.
- Mickey Monus, Phar-Mor's president, was viewed by Finnerty as a "constant source of new business" and thus a boon to his personal career at Coopers.

The areas where the plaintiffs alleged the auditors were reckless and did not perform an audit in accordance with professional auditing standards centered around accounting for inventory and corresponding effects on both the balance sheet and income statement. The plaintiffs' allegations centered on the four major issues detailed below.

The Price Test Fact Pattern

Inventory at Phar-Mor increased rapidly from $11 million in 1989 to $36 million in 1990 and $153 million in 1991. Phar-Mor did not keep perpetual inventory records but made periodic counts and used the retail method for valuing inventory. Phar-Mor contracted with an outside firm to physically count and provide the retail price of each item in inventory twice per year. Phar-Mor would then apply a "cost complement" to determine the cost of inventory. Phar-Mor's

initial strategy was to mark all merchandise up 20 percent, resulting in a gross margin of 16.7 percent and a corresponding cost complement of 83.3 percent. However, to be competitive, Phar-Mor lowered the margins on certain "price-sensitive" items to get customers in the door. As a result, Phar-Mor's overall budgeted gross margin fell to 15.5 percent, resulting in a cost complement of 84.5 percent.

Coopers identified inventory valuation as a high-risk area in its workpapers. Coopers annually observed the company's physical inventory count at four stores and selected from 25 to 30 items per store on which to perform price testing. Sample items were determined by the attending auditor using a "haphazard" sample selection approach (see Chapters 8 and 9 for a discussion of audit sampling techniques). Purchase invoices were examined for the items selected, and an overall gross margin for the sample was determined. In the years 1988 through 1991, Coopers' sample gross margins averaged from 16.1 to 17.7 percent. Coopers explained that the difference between the expected 15.5 percent gross margin and the sample gross margin resulted because the sample taken did not include very many price-sensitive items, and therefore the sample gross margin was higher than Phar-Mor's overall margin. Coopers concluded the difference noted was reasonable and not unexpected given Phar-Mor's approach to valuing inventory.

After a store had a physical inventory count, a gross profit schedule was prepared by Phar-Mor accountants. These schedules compared gross margins based on the physical inventory with the general ledger for the current and prior years. Coopers tested a sample of these gross profit schedules each year. After the fraud was uncovered, it was determined that Phar-Mor's actual margins were much lower than the budgeted 15.5 percent, because the price-sensitive items made up a relatively large percentage of sales. Beginning in 1989, when Phar-Mor's management saw that the fiscal gross profit reports were coming in below historical levels, it started changing the gross margin reports reviewed by the auditor. Management continued to alter the gross profit reports from that time until the fraud was uncovered in 1992.

Plaintiff Allegations. The plaintiffs argued that if Coopers had employed a more extensive and representative price test, it would have known what Phar-Mor's gross margins actually were, no matter what the fraud team was doing to the gross profit reports. Plaintiffs alleged the way the auditors conducted their price test and the way they interpreted the results were woefully inadequate and unreliable due to the small sample size and acknowledged lack of representativeness of the sample to the whole population of Phar-Mor merchandise.

> The attitudes of the people involved in this were simply that even though there was clear recognition in the workpapers that this test was so flawed that it was virtually worthless, did not produce anything to them that they could use in their audit, yet they still concluded year after year that everything was reasonable, and that defies my imagination. I don't understand how that conclusion can come from their own recognition of that, the test was so severely flawed. Also, they gave consideration to doing a better price test, but in fact never made any attempt to do so because in each

> of the four years they did the same exact kind of test, year after year after year, even though they knew the test produced unreliable results. (Charles Drott, expert witness)

The plaintiffs also pointed to Coopers' workpapers where the auditors had indicated that even a .5 percent misstatement in gross margin would result in a material misstatement in net profits. Plaintiffs argued the auditors recklessly ignored the sample results indicating a material misstatement. The plaintiffs also argued the gross profit schedules could not be used to independently test the cost complement, because the calculated profit margin and ending inventory were a function of the standard cost complement that was applied to the retail inventory balance derived from the physical inventory.

> So, what we have here is a daisy chain . . . the price test is the basis for the gross margin test. The price test is reasonable because the gross margins are reasonable. But, the only reason the gross margins are reasonable is because they are based on the price test. It keeps ping-ponging back and forth. And the problem is, none of this was tested. (Sarah Wolff, attorney)

Defense Response. Coopers explained to the jury that the price test was simply a reasonableness analysis intended to provide limited assurance that Phar-Mor was properly applying its methodology for pricing and costing inventory.

> It was a valid test, it still is a valid test after reviewing it time and time again. And the staff person suggesting we drop it was just not . . . right. And throughout the whole time that we audited Phar-Mor, we continued to do the price test. It was a valid test, and it still is. (Greg Finnerty, partner)

Coopers pointed out that some differences are always expected in reasonableness analyses and that those differences do not usually represent actual misstatements. Coopers also explained that it performed a number of other procedures that compensated for the weaknesses in the price tests. The primary testing was performed on Phar-Mor's gross profit reports. Coopers recalculated percentages and traced inventory balances back to the physical inventory report submitted by the independent count firm for a sample of gross profit schedules.

Inventory Compilations Fact Pattern

After the outside inventory service submitted a report of its physical count, Phar-Mor accountants would prepare an inventory compilation packet. The package included the physical counts, retail pricing, Phar-Mor's calculations of inventory at cost, and cost of goods sold. Based on the compilation, a series of journal entries were prepared and recorded in the general ledger. Each year, the auditors randomly selected one compilation packet for extensive testing and 14 other packets for limited testing. The auditors reviewed journal entries for reasonableness for all 15 packets.

The court-appointed fraud examiners determined that many of Phar-Mor's

inventory compilation packets contained fraudulent journal entries. The entries were often large, even-dollar amounts without journal entry numbers, explanations, or supporting documentation and contained suspicious account names like "Accounts Receivable Inventory Contra" or "Cookies." Phar-Mor's fraud team used these entries to inflate inventory and earnings. Based on the physical count and results of the compilation, an appropriate entry was made to reduce (credit) inventory. However, rather than record the offsetting debit to cost of goods sold, a debit entry was recorded to a "fraud holding" account. The fraudulent holding accounts accumulated the fraudulent entries during the year. At year-end, to avoid auditor detection, the holding accounts were emptied by allocating a portion back to the individual stores as inventory or some other asset.

Plaintiff Allegations. The plaintiffs alleged that some of the compilations reviewed by the auditors contained fraudulent entries. Plaintiffs' experts claimed Coopers should have noticed these unusual entries.

> Coopers' audit work in this inventory compilation area, because of its failure to investigate all of these fraudulent entries which were obvious, suspicious entries on their face, their failure to do this is a failure, in my opinion, that is reckless professional conduct, meaning that it is an extreme departure from the standard of care. They had the entries in front of them, and they chose to do nothing whatsoever to investigate. Had they done so, they would have found the fraud right then and there. (Charles Drott, expert witness)

Defense Response. Coopers was able to prove, using the firm's workpapers, that none of the compilations selected by the auditors for extensive review over the years contained fraudulent entries. While Coopers did retain an entire copy of the extensively tested compilation packet in its workpapers, it retained only notes of key information from the packets subjected to limited testing.

In preparation for the trial, the packets that had been subjected to limited testing were pulled from Phar-Mor's files, many of them containing fraudulent journal entries. However, evidence suggested these compilations were altered after Coopers had initially reviewed them. For example, in many cases, even the "key information" Coopers had noted in its workpapers no longer agreed to the file copies. Mark Kirsten, who had been a staff and senior auditor on the Phar-Mor engagement, testified why he believed the compilations retrieved from Phar-Mor's files were altered after Coopers performed its audit work:

> I never saw this entry or any other fraudulent entries. When we got these packages, we got them from John Anderson who was part of this fraud. And I refuse to agree that John Anderson walked into my audit room, and we are poring over these for a couple days at a time, and says, here, if you happen to turn to the third page, you are going to find a fraudulent entry that has no support. That's unimaginable. (Mark Kirsten, audit senior)

General Ledger Fact Pattern

A monthly operating general ledger (GL) was prepared and printed for each store and for corporate headquarters. The plaintiffs argued that the fraud could have been uncovered not only by examining the journal entries proposed on the inventory compilations but also by simply scanning the GL. Because the fraud team was aware that zero-balance accounts typically draw little attention from the auditor, it recorded numerous "blowout" entries in the last monthly corporate GL to empty the fraudulent holding accounts that had accumulated the fraud during the year. The holding accounts were emptied by allocating a portion, usually in equal-dollar amounts, back to the individual Phar-Mor retail stores as inventory or other assets. These entries were typically very large. For example, in 1991, an entry labeled "Accrued Inventory" for $9,999,999.99 was made.

Plaintiff Allegations. The plaintiffs pointed out that scanning the GL, which was a recognized procedure in Coopers' audit manual and training materials, would certainly and easily have uncovered the fraud. Further, plaintiffs pointed to Coopers' inventory audit program for Phar-Mor that included procedures requiring the examination of large and unusual entries.

The plaintiffs repeatedly played a video clip of one of the chief perpetrators of the Phar-Mor fraud, the former CFO, saying that if Coopers had asked for the backup to any one of the fraudulent journal entries, "It [the fraud] would have been all over."

Defense Response. Coopers' audit program did include a step to obtain selected nonstandard adjusting journal entries so that any large and unusual items could be further examined. The step was signed off by staff auditors without further explanation. Coopers' witnesses testified that the fact that the step was signed off indicated that either the step was performed or was considered not necessary. Trial testimony indicated that auditors had asked Phar-Mor accountants if there were any large and unusual adjusting entries and the auditors were told there were none.

While Coopers was aware of the operating GLs, the auditors worked primarily with the consolidated GL, which combined all the operating GLs and included only ending balances and not transaction detail. In the consolidated GL, the fraud holding accounts were either completely absent or had zero balances.

Roll-Forward Fact Pattern

Because the physical inventories were completed during the fiscal year, it was necessary to roll forward or account for the inventory purchase and sales transactions between the inventory count date and the balance sheet date. Coopers' roll-forward examinations always revealed a large increase in the ending book inventory balance. Phar-Mor explained to the auditors that the inventory "spike" was due to two factors. First, inventory levels at the physical count date were always lower than normal because a store would reduce inventory shipments in the weeks prior to the physical inventory to prepare for the physical count. Second, since the

fiscal year-end was June 30, there was always a buildup of inventory to handle the big July 4 holiday demand. The drop-off in inventory just after fiscal year-end was attributed mainly to the large amounts of inventory sold over July 4. While the client's explanation did account for a portion of the spike, investigations performed subsequent to the discovery of the fraud indicate that a large portion of the spike was attributable to the fraud.

Plaintiff Allegations. The plaintiffs claimed the spike was a prominent red flag that Coopers recklessly overlooked.

> This is simply showing a sharp spike upward at fiscal year-end . . . and subsequent to the fiscal year . . . the inventory levels drop off. Now, that is a very interesting red flag. If I were an auditor, I'd certainly want to know why the inventories increase sharply, reaching its crest right at the fiscal year-end date. In other words, when the financial statements were prepared, and why they drop off again after fiscal year-end, just two weeks later, as a matter of fact, and go down that much. It's what I call the spike. Clearly the spike, in my opinion, was caused in large part by the actual fraud at Phar-Mor, because if you recall, these fraudulent entries, these blow-out entries that I described, were these very large journal entries that were adding false inventory to each of the stores, and it was done at fiscal year-end. (Charles Drott, expert witness)

Defense Response. When asked if the spike would cause an experienced retail auditor to be suspicious about inventory at Phar-Mor, the Phar-Mor audit partner responded:

> Well, no, it wouldn't. But, let me give you an example. At Christmastime, it's the same concept. There is a tremendous spike in inventory of retailers at Christmastime, and then after that, after Christmas, sales go down. That is, you are going to see a natural decline in the inventory levels of a retailer after Christmas. So, it so happens in this analysis, this has to do with the year-end of Phar-Mor, June 30. (Greg Finnerty, partner)

Coopers elected not to test specific purchases or sales transactions during the roll-forward period. Rather, it relied on its tests of the gross profit schedules both before and after year-end, which suggested the controls over purchases and sales were functioning properly. Unfortunately, as discussed previously, the Phar-Mor fraud team was falsifying the gross profit reports.

What Can Be Learned?

The final settlement amounts were not publicly disclosed, but Coopers reported that it was a small fraction of the amount filed by plaintiffs. The Phar-Mor case highlights some important lessons. First, auditors should remember that plaintiffs in a lawsuit can successfully replace allegations of *knowing intent* ("scienter") with assertions of *reckless conduct* to prevail in a lawsuit against auditors where the legal standard requires evidence of auditor fraud. Second, while

we do not opine on whether or not the auditors were reckless, in the clear light of hindsight, audit weaknesses can be taken out of context and magnified in the jury's mind so that honest judgment calls or even mistakes may be made to appear as reckless misconduct.