
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.

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 drugstores, based in Youngstown, Ohio, and founded in 1982 by Michael Monus and David Shapira. In less than 10 years, the company grew from 15 to 310 stores and had 25,000 employees. According to Litigation Release No. 14716 issued by the SEC,¹ Phar-Mor had cumulatively overstated income by \$290 million between 1987 and 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 (COO) of Phar-Mor from its inception until a corporate restructuring was announced on July 28, 1992.

David Shapira was the CEO of both Phar-Mor and 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 CFO of Phar-Mor from 1988 to 1992. Finn, who holds the Certified Management Accountant (CMA) certification, 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 the SEC filing and a PBS *Frontline* episode called "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 took out his pen, crossed off the losses, and then wrote 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 short-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 and made phony journal entries to increase inventory and decrease cost of sales. The company overcounted and double-counted merchandise in inventory.

The fraud was helped by the fact that the auditors from Coopers observed inventory in only 4 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 4 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 off the company for nonpayment of bills.

Stan Cherelstein's Role

Cherelstein, a CPA, was hired to be the controller of Phar-Mor in 1991, long after the fraud had begun. One day, 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 "subledger," that showed the falsified numbers that were presented to the auditors.

¹Securities and Exchange Commission, Litigation Release No. 14716, November 9, 1995, *SEC v. Michael Monus, Patrick Finn, John Anderson and Jeffrey Walley*, Case No. 4:95, CV 975 (N.D. OH, filed May 2, 1995), www.sec.gov/litigation/litreleases/lr14716.txt.

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 (personal) investment of company funds into the World Basketball League (WBL). 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," which vendors paid 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 Monus's personal habits. One example was the movement of \$10 million in company funds to help start the WBL.

False Financial Statements

According to the ruling by the U.S. Court of Appeals that heard Monus's appeal of his conviction on all 109 counts of fraud, 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 10-year senior secured notes issued to Phar-Mor; Westinghouse Credit Corporation, which had executed a \$50 million loan commitment to Phar-Mor in 1987; and 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 this 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. He thought about the fact that he didn't start the fraud or engage in 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.

Questions

1. How do you assess blame for the fraud? That is, to what extent was it caused by Finn's willingness to go along with the actions of Monus? What about Shapira's lax oversight? Should all the blame go to Monus? What role did Coopers & Lybrand play with respect to its professional judgment?
2. Assume Cherelstein decides to use Rest's Model of Morality to reason out what the right thing to do is and how to carry out the action. Apply the logic of the model to Cherelstein's decision-making process. What do you think he should do at this point and why?
3. What is the ethical message of Phar-Mor? That is, explain what you think is the moral of this story.