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Finding Auditors Liable for Fraud: What the Jury Heard in the Phar Mor Case

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Finding Auditors Liable for Fraud: What the Jury Heard in the Phar Mor Case

By David M. Cottrell and Steven M. Glover

In Brief

Convincing a Jury You Followed GAAS

The *Phar Mor* case involved a massive collusive fraud by management. Although there were no claims the auditors participated in the fraud, plaintiffs' attorneys were able to convince the jury that the firm was liable for fraud on the grounds it made representations recklessly with regard to GAAS and GAAP.

In addition to covering the overall courtroom strategy by both plaintiffs and defense, the authors discuss the following areas of the audit on which such claims were based, covering the fact pattern, plaintiff allegations, and the defense response.

* Related party transactions.

* Price testing of inventories.

* Inventory compilations.

* Scanning the general ledger for unusual entries.

* Roll forward of inventories.

There are lessons to be learned by all auditors.

In the *Phar Mor* case, several members of top management confessed to, and were convicted of, financial statement fraud. Certain creditors and investors in Phar Mor subsequently brought suit against Phar Mor's independent auditors alleging it was reckless in performing its audits, and a jury found the firm liable for fraud. The evidence heard by the jury was used to gain an understanding of the factors determining the outcome in the cases. While it is not possible to detail every item of information the jury heard during a five-month trial, a careful review of the trial transcripts and selected interviews with attorneys who were in the courtroom on a daily basis, is the basis for identifying what is believed are the salient points presented to the jury. Unless otherwise noted, all facts and statements are based on actual trial transcripts.

No opinion is given on the propriety of the jury's decision; it is simply not possible to determine whether the jury fully understood the legal issue or whether nonevidential factors, such as personalities and presentation styles, influenced the jury's decision. As with all accounting frauds, hindsight is 20/20, and methods of fraud detection are easily created after the facts of the fraud are available. Nevertheless, the case is instructive in that it clearly illustrates how accounting firms that audit companies that engage in widespread fraud can be held liable for investor and creditor losses even if they had no knowledge of the fraud and conducted the engagement in a seemingly responsible manner.

Background

The $500 million accounting fraud at Phar Mor led to the bankruptcy of one of the largest private companies in the United States in 1992. As a result of the fraud and subsequent business 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 Phar Mor management employees received prison sentences. The company's former auditors, Coopers & Lybrand LLP (Coopers), faced claims of more than $1 billion, which it settled for a fraction of that amount. Even though neither Phar Mor's management, the plaintiffs' attorneys, nor anyone else associated with the case ever 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, as unfolded in the trial, was the plaintiffs' allegation that Coopers made representations recklessly without regard to whether they were true or false, which legally enabled plaintiffs to sue the auditors for fraud.

Between 1985 and 1992, Phar Mor grew from 15 stores 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 the summer of 1992, Phar Mor's illusion of success came to an abrupt end. Phar Mor's executives had cooked the books. The magnitude of the collusive management fraud is almost inconceivable. The fraud was carefully carried out over several years by persons at many organizational layers including the president, CFO, COO, vice president of marketing, director of accounting, controller, and a host of others.

Thirty-eight investors and creditors filed suit against Coopers, Phar Mor's independent auditors, under Section 10(b) of the Federal Securities Exchange Act and under Pennsylvania state common law. All but eight plaintiffs settled their claims with Coopers without going to trial. However, the remaining plaintiffs chose to take their cases to a jury trial.

To prevail against auditors on a claim under Section 10(b), a plaintiff must prove by a 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. However, under Pennsylvania law, the judge in the Phar Mor case ruled the plaintiffs were not primary beneficiaries, 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 (i.e., without caring if the representations in the financial statements were true or false). While this is obviously a very difficult standard to meet, the jury found that Coopers had knowing or reckless disregard for material problems in the reported financial condition of Phar Mor.

Courtroom Strategies

The Defense. Attorneys for Coopers continually impressed upon the jury that this was a massive fraud perpetrated by Phar Mor's management. They clearly illustrated the fraud was a collusive effort by multiple individuals within the upper management at Phar Mor who continually worked to hide evidence from the auditors. The auditors were portrayed as victims of a 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 Big Six auditors, including auditors who had worked for Coopers on prior Phar Mor audits. Members of the fraud team indicated that one reason the fraud wasn't detected by the auditors was because Phar Mor executives knew what the auditors would be looking for, and they made sure Phar Mor's numbers made sense analytically year to year.

After the verdict was rendered against the auditors, Coopers' attorney Robert J. Sisk (chairman of New York's Hughes Hubbard & Reed) 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's a first . . . that effectively turns outside auditors into insurers against crooked management."

The Plaintiffs. The plaintiffs opened their case by acknowledging the incidence of 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 because they did not find the fraud. Rather, plaintiffs alleged Coopers made fraudulent representations in their audit opinions. The two key alleged misrepresentations were Coopers' statements that their 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:

. . . [W]e're not going to try to prove in this case what happened at Coopers & Lybrand. That's not our burden. We don't know what happened. We do know that 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. . . . [I]f Coopers can demonstrate to you 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, plaintiff attorney Sarah Wolff indicated this case could prove to be the model for getting a jury to find a respected accounting firm behaved "recklessly." These statements seemingly ignore plaintiff's burden to prove either knowing or reckless misconduct.

In addition, throughout the five-month trial, the plaintiffs continually emphasized the following facts in their effort to have the jury believe 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 internal accountants never provided the auditors with requested documents or data without first carefully reviewing them.

* Greg Finnerty, the Coopers partner in-charge of the Phar Mor audit, had previously been criticized for exceeding audit 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."

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

Early Warning Signs--The Tamco Settlement

The Fact Pattern. In 1988, internal gross profit reports at Phar Mor indicated serious deterioration in margins. Phar Mor was facing an unexpected $5 million pretax loss. It was determined, with the assistance of a specialist from Coopers, that the drop in margins was not due to a problem with Phar Mor's inventory accounting system. Internal investigations determined the problem was mainly due to inventory shortages from one of Phar Mor's primary suppliers, Tamco. Tamco, a subsidiary of Giant Eagle, Phar Mor's principal shareholder, had been shipping partial orders but billing Phar Mor for full orders. Unfortunately, Tamco's records were so poor they could not calculate the amount of the shortage. Likewise, Phar Mor had no way to determine the exact amount of the shortage because during this time period Phar Mor was not logging in shipments from Tamco.

A Phar Mor accountant performed the only formal analysis of the shortage, which he estimated to be $4 million. However, negotiations between Phar Mor and Tamco (along with its parent company Giant Eagle) resulted in a $7 million settlement. Phar Mor recorded the $7 million as a reduction to purchases, resulting in a pretax profit of approximately $2 million in 1988. Because Tamco and Phar Mor were both subsidiaries of Giant Eagle, the settlement was disclosed in a related party footnote to the financial statements.

Trial evidence indicates the final settlement amount was determined, in part, by looking at Phar Mor's profitability in prior years. After the settlement, Phar Mor's gross margin was nearly identical to the prior year. After the fraud was uncovered, it was determined there were signals that Phar Mor's profitability had slipped in 1988.

Plaintiff Allegations. The plaintiffs claim the settlement was a disguised capital contribution and thus simply a vehicle to artificially inflate Phar Mor's earnings. The plaintiffs alleged Coopers acted recklessly by not obtaining sufficient persuasive evidence to support this highly material transaction. The following excerpts are from testimony given (in a deposition) by Pat Finn, former CFO of Phar Mor, and Charles Drott, an expert witness for the plaintiffs:

There was really no way to support the amount of the settlement. We did a number of tests, but based on our in-house review, we didn't think that we could support $7 million. Mickey [Monus] did an excellent job of negotiating with David [Shapira] and he got us $7 million. (Pat Finn)

What Mr. Finn is basically describing is that, although there may well have been some shortages, that what Phar Mor was really doing was entering into a transaction which would enable them to manipulate its profit to overcome losses, to hide losses. So, essentially what he's describing is fraudulent financial reporting. . . . [T]he Coopers & Lybrand workpapers contain no independent verification, nor was there any attempt by Coopers & Lybrand to determine the actual amount of the shortages. It simply just was not done. (Charles Drott)

Plaintiffs also alleged the footnote documenting the receipt and the accounting treatment of the settlement was misleading. While the footnote disclosed the nature and amount of the related-party transaction, the plaintiffs argued the footnote should have more clearly indicated the uncertainty in the settlement estimate. And plaintiffs felt the footnote should have explicitly stated that without the settlement, Phar Mor would have shown a loss.

Defense Response. A copy of the analysis conducted by the Phar Mor accountant indicating a $4 million shortage was included in Coopers' workpapers. However, Coopers considered the analysis very crude and included it only as support for the existence of a shortage, not the dollar amount. While the workpapers contained relatively little documentation specifically supporting a $7 million settlement, Coopers, who audited all three companies party to the negotiation, did perform a number of procedures to satisfy themselves of the propriety of the settlement. After the internal investigation pointed to Tamco, Phar Mor began to maintain a log of Tamco shipments. Coopers tracked the results of the log and in every subsequent Tamco shipment shortages were found. Coopers also contacted another company that had received Tamco shipments during this time period and learned that retailer was also experiencing shortages from Tamco. Coopers experts examined Tamco's operations and confirmed the shortages were due to a new computer inventory system at Tamco. Greg Finnerty, Coopers' partner in charge of the audit, explained the auditors' position as follows:

. . . [I]t's a related-party transaction, and we don't have the responsibility to validate the amount. The responsibilities in accordance with GAAS standards are twofold. One, in any related-party transaction, is to understand the business purpose of the transaction; and two, to agree to the disclosure of the transaction. . . . [W]e understood the business transaction, and the disclosure was adequate. It talked about the $7 million transaction; and we saw a check, not just an intercompany account. We did a lot of those transactions, so we fulfilled our two responsibilities that are the standards for related-party transactions. I was not in that settlement session, nor should I have been. That was between the two related parties. When the discussions were over with, I talked to both parties separately, myself, and talked to them about the settlement, the reasonableness of that settlement. I, in fact, asked David Shapira--and I specifically recall asking David Shapira--of the $7 million, is that all merchandise or is there any sense that you are--you or the board of directors of Giant Eagle--passing additional capital into Phar Mor through this transaction? And I was given absolute assurance that he was satisfied that the $7 million was a reasonable number; and, in fact, he indicated that this was a number much lower than what Phar Mor thought it should have been. So it seemed to me that there was a reasonable negotiation that went on between these parties. (Greg Finnerty)

Regarding the footnote disclosure, Coopers pointed out the footnote was typical of related party footnotes, and that it was rather obvious that without the $7 million settlement, Phar Mor would have reported a loss. Evidence also showed that, prior to the release of the financial statements, Phar Mor met with investors and creditors to cover the terms and significance of the settlement.

Finally, to this day, none of the parties involved--Tamco, Phar Mor, or Giant Eagle--have suggested the settlement was part of the fraud. Further testimony in the trial suggested the Tamco settlement was not an issue of concern with investors and creditors until their attorneys made it an issue years later in the litigation.

The Price Test

The Fact Pattern. Inventory at Phar Mor increased rapidly from $11 million in 1989 to $36 million in 1990 to $153 million in 1991. Phar Mor's inventory system did not include a perpetual inventory record. Therefore, Phar Mor 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%, resulting in a gross margin of 16.7% and a cost complement of 83.3%. 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%, resulting in a cost complement of 84.5%.

Coopers identified inventory valuation as a high risk area in their workpapers. As a detailed test of Phar Mor's inventory costing, Coopers annually attended the physical inventory at four stores and selected from 25 to 30 items per store to perform price testing. Sample items were determined by the attending auditor in a haphazard fashion. 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%. Coopers explained the difference between the expected 15.5% gross margin and the sample gross margin resulted because the sample taken did not include 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 consistent with their expectations.

After a store had a physical inventory, 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 year. It was this type of schedule that first identified the falling margins that triggered the Tamco related-party settlement discussed above. 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 really much lower than the budgeted 15.5%, because the price sensitive items made up a relatively large percentage of sales. When Phar Mor's management saw the fiscal 1989 gross profit reports were coming in below historical levels, they started changing the gross margin reports because they feared Giant Eagle would want back some of the $7 million paid in Tamco settlement money. Management continued to alter the gross profit reports from that time until the fraud was uncovered.

Plaintiffs' Allegations. The plaintiffs argued that had Coopers employed a more extensive and representative price test, they 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 both woefully inadequate and unreliable due to the sample size and acknowledged lack of representativeness.

. . . [T]he 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's--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)

The plaintiffs also pointed to Coopers' workpapers where the auditors had indicated that even a one-half percent misstatement in gross margin would result in a material misstatement. 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. And when it was tested . . . the price tests [and] the cost complement did not meet Coopers' expectations. It was not what it was supposed to be. (Sarah Wolff)

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

. . . [I]n the context of all our inventory testing and testing the gross profit, which is a continuous testing of the pricing philosophy, we felt it was adequate testing for our purposes. . . . [T]he price test is just one element of what we did to confirm our understanding and the representation of management as to their pricing philosophy. The primary test of all that is the continuation of taking the physical inventories that they did throughout the year, reconciling that through the compilation and determining the gross profit. If [Phar Mor is] receiving the gross profit that [they] expected, that is the truest indication and the most valid indication that the pricing philosophy is, in fact, working.

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)

Further, Coopers pointed out that differences are expected in reasonableness tests and those differences do not represent actual misstatements. It was obvious to Coopers that while Phar Mor's costing method was applying one standard cost factor, Phar Mor was applying a variety of pricing strategies. Coopers' price tests on the individual items selected resulted in a wide range of gross margins from items sold below cost to margins of 30% or higher.

Coopers also pointed out that they 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. For a sample of gross profit schedules, Coopers recalculated percentages and traced inventory balances back to the physical inventory report submitted by the independent count firm. This was an important procedure for Coopers because, if the margins were consistent, this indicated that the controls over purchases and sales were operating properly. In addition to these procedures, the control environment over purchases and inventory was documented, and certain controls were tested. Individual store and overall company inventory levels and gross margins were compared to prior years. Analytics, such as inventory turnover and days in inventory, were also examined.

Inventory Compilations

The Fact Pattern. After the outside inventory service submitted a report of their 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 operating 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 post fraud examination determined that many of Phar Mor's inventory compilations packets contained fraudulent journal entries. The entries were often large in even dollar amounts, did not have journal entry numbers, had no explanation 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 "bucket" account. The bucket accounts accumulated the fraudulent entries during the year. At year-end, to avoid auditor detection, the bucket accounts were emptied by allocating a portion back to the individual stores as inventory or some other asset.

Plaintiffs' 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)

Defense Response. Coopers was able to prove with their 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 their workpapers, they noted only key information from the packets on which they performed limited testing.

In preparation for the trial, the packets that had been subjected to only limited testing were pulled from Phar Mor's files, many of them containing fraudulent journal entries. However, there was evidence suggesting these compilations had been altered after Coopers reviewed them. For example, in many cases even the key information Coopers had noted in their workpapers no longer agreed to the file copies. Mark Kirsten, a Coopers audit manager who was the staff and senior auditor on the Phar Mor engagement, testified why he believes the compilations retrieved from Phar Mor's files were altered after Coopers performed their 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 pouring 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 . . . we know there is a fraud. That's why we are here. I know I did my job. My job was to review the packages. These packages went through extensive reviews. So, I am saying when you show me a package that has on one page something that . . . is fraud, I can't imagine that I saw that. We didn't see these packages for ten seconds during the audit. We spent days with these. I am a staff accountant who is doing my job, and I am pouring through these and asking questions. We don't audit in a box. (Mark Kirsten)

General Ledger

The Fact Pattern. A monthly operating general ledger (GL) was prepared and printed for each store and for corporate headquarters. The plaintiffs argued that not only could the fraud have been uncovered by examining the journal entries proposed on the inventory compilations, but through scanning the GL. Post-fraud reviews of the GLs revealed the fraudulent entries from the compilation reports were posted directly to the GLs. The GLs contained other fraudulent entries as well. Because the fraud team was aware that zero balance accounts typically draw little attention from the auditor, they recorded numerous "blow-out" entries in the last monthly corporate GL to empty the bucket accounts that had accumulated the fraud during the year. The bucket accounts were emptied by allocating a portion, usually in equal dollar amounts, back to the stores as inventory or other assets. These entries were typically very large. For example, in 1991, there was an entry labeled "Accrued Inventory" for $9,999,999.99. Also, in 1991, there was an entry labeled "Alloc Inv" (Allocate Inventory) for $139 million.

Plaintiffs' 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 following comments from plaintiff attorney Sarah Wolff to the jury illustrates the plaintiffs' allegations.

I want to talk about the issue of general ledger. . . . All we ask you to do in this issue is, don't listen to what the lawyers have told you . . . what we ask you to do is look at Coopers' own words. Look at Coopers' training materials. The auditor must also review for large or unusual nonstandard adjustments to inventory accounts.

Read Coopers & Lybrand's own audit program for this particular engagement that has steps nine and steps eleven that say look for fourth quarter large and unusual adjustments. Those are their words, ladies and gentlemen. That's their audit program, and you have seen witness after witness run from those words. (Sarah Wolff)

While a witness for the plaintiffs agreed it would not have been practical to carefully scan all the operating GLs, (which would have been a pile of computer paper 300 hundred feet tall), they felt it was reckless, and a failure to comply with GAAS, to not carefully scan at least the last month of the corporate office GL.

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 have 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 Coopers auditors asked Phar Mor accountants if there were any large and unusual adjusting entries and the auditors were told there were none. Coopers pointed out it is normal for the client to provide the auditor with an audit packet including lead schedules that agree to the GL and tie to the financial statements. None of the lead schedules contained fraudulent or "bucket" accounts. When it was suggested by plaintiff attorneys that if the auditors had reviewed the operating general ledgers, there would have been a high probability that they would have discovered the fraud, the partner responded:

No. I would say that it wouldn't be a high probability of that because we are doing a GAAS audit. A GAAS audit requires us to do the procedures that we did. There is no requirement in GAAS--none of my partners or I have ever followed a procedure that says you review operating general ledgers line by line, or whatever, unless you are doing a fraud audit. In the course of doing our GAAS audit, we would look to the general ledgers to the extent necessary in order to do our work on the account balances. We don't audit all the various ways that the balances are arrived at. . . . We don't look at day-to-day activity. This is not what we do as accountants, not only at Phar Mor, but in every audit we do. We look at the ending balances and audit the ending balances. (Greg Finnerty)

While Coopers was aware of the operating GLs, they 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 "bucket" or fraud accounts were either completely absent or had zero balances. Also, many of the accounts used in the fraud (e.g., "Cookies") had been legitimately used as clearing accounts in the years prior to the fraud.

To counter the plaintiffs' video clip of the CFO saying the auditors never asked for backup to the blowout entries, the defense played their own video clip of this same CFO (who was a former Big Six auditor), testifying he and his fraud team went to great lengths to prepare for the audit. Based on the fraud team's experience from prior year audits and because the team included former Coopers auditors, they understood Coopers' audit approach very well. On this same video clip, the former CFO also testified that if Coopers had asked for the closing journal entry binder, he would have removed the journal entries that emptied the fraud bucket before giving it to the auditors. Members of the fraud team also testified that had Coopers changed their approach to more carefully scrutinize the operating GLs, they would have changed their approach to cover up the fraud.

Roll Forward

The 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 there was a large increase in the ending book inventory balance. Phar Mor explained to the auditors that the "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 Fourth of July holiday demand. The drop-off in inventory just after year-end was attributed mainly to the large amounts of inventory sold over July 4th. 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 due to the fraud.

Plaintiffs' Allegations. Plaintiffs claimed the spike was a big red flag that Coopers recklessly overlooked.

And what this is simply showing is that that increase is a sharp spike upward at fiscal year-end. Interestingly, also, is that subsequent to the fiscal year, just a short time thereafter--the inventory levels drop off. Now, that is a very interesting red flag as to why would that be. 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; so if you're adding--and we're talking like entries . . . as high as $139 million of false inventory being added in one journal entry to these stores. When you have that, being false inventory, added to the stores at fiscal year-end, that's obviously going to spike up the books at year-end. And then subsequent to year-end, many of these entries are what we call reversed or taken out of the stores, which would cause some of that spike, if not all of it, to come down. (Charles Drott)

The plaintiffs also argued that auditing texts and an AICPA practice guide describe tests of controls and tests of detail that must be performed for the interim period. And, plaintiffs pointed to a procedure described as scrutinizing the books of original entry to identify unusual transactions during the roll-forward period.

Defense Response. When asked if the spike would cause an experienced retail auditor to have suspicions 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)

Given that this sort of spike was not unusual, Coopers expected the inventory roll forward comparisons to result in differences. Coopers explained the difference noted in their reasonableness test comparing year-end inventory and the previous physical inventory was within their expectations and differences in reasonableness tests do not represent known, actual misstatements.

Coopers elected not to test specific purchases or sales transactions during the roll forward period. Rather, they relied on their tests of the gross profit schedules both before and after year-end which suggested the controls over purchases and sales were functioning properly. Coopers contended that if any large or unusual journal entries were recorded after the last physical and before year-end, they should affect the gross profit of the general ledger, which was one of the comparisons made on the gross profit reports. Unfortunately, the fraud team was falsifying the gross profit reports.

What Can Be Learned?

The intent is not to determine whether or not the trial evidence in fact provided clear and convincing proof of reckless behavior. However, this case can be informative and educational for the auditing profession on at least two levels. First, the profession should continually be reminded that plaintiffs in a law suit can successfully replace allegations of knowing intent with assertions of reckless conduct to prevail in a lawsuit against auditors even where the legal standard requires evidence of auditor fraud.

Secondly, 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 may be made to appear as reckless misconduct. *

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