

Case 7-7

Sunbeam Corporation

One of the earliest frauds during the late 1990s and early 2000s was at Sunbeam. The SEC alleged in its charges against Sunbeam that top management engaged in a scheme to fraudulently misrepresent Sunbeam's operating results in connection with a purported "turnaround" of the company. When Sunbeam's turnaround was exposed as a sham, the stock price plummeted, causing investors billions of dollars in losses. The defendants in the action included Sunbeam's former CEO and chair Albert J. Dunlap, former principal financial officer Russell A. Kersh, former controller Robert J. Gluck, former vice presidents Donald R. Uzzi and Lee B. Griffith, and Arthur Andersen LLP partner Phillip Harlow.

The SEC complaint described several questionable management decisions and fraudulent actions that led to the manipulation of financial statement amounts in the company's 1996 year-end results, quarterly and year-end 1997 results, and the first quarter of 1998. The fraud was enabled by weak or nonexistent internal controls, inadequate or non-existent board of directors and audit committee oversight, and the failure of the Andersen auditor to follow GAAS. The following is an excerpt from the SEC's *AAER 1393*, issued on May 15, 2001:

From the last quarter of 1996 until June 1998, Sunbeam Corporation's senior management created the illusion of a successful restructuring of Sunbeam in order to inflate its stock price and thus improve its value as an acquisition target. To this end, management employed numerous improper earnings management techniques to falsify the Company's results and conceal its deteriorating financial condition. Specifically, senior management created \$35 million in improper restructuring reserves and other "cookie-jar" reserves as part of a year-end 1996 restructuring, which were reversed into income the following year. Also in 1997, Sunbeam's management engaged in guaranteed sales, improper "bill and hold" sales, and other fraudulent practices. At year-end 1997, at least \$62 million of Sunbeam's reported income of \$189 million came from accounting fraud. The undisclosed or inadequately disclosed acceleration of sales through "channel-stuffing" also materially distorted the Company's reported results of operations and contributed to the inaccurate picture of a successful turnaround.¹

A brief summary of the case follows.²

04/10 50,134,181,13

¹Securities and Exchange Commission, *In the Matter of Sunbeam Corporation, Respondent, Accounting and Auditing Enforcement Release No. 1393*, May 15, 2001, Available at www.sec.gov/litigation/admin/33-7976.htm.

²Securities and Exchange Commission, *Litigation Release 17001, Securities and Exchange Commission v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow*, 01-8437-CIV-Dimitrouleas (S.D. Fla., May 15, 2001), www.sec.gov/litigation/admin/33-7977.htm.

Chainsaw Al

Al Dunlap, a turnaround specialist who had gained the nickname "Chainsaw Al" for his reputation of cutting companies to the bone, was hired by Sunbeam's board in July 1996 to restructure the financially ailing company. He promised a rapid turnaround, thereby raising expectations in the marketplace. The fraudulent actions helped raise the market price to a high of \$52 in 1997. Following the disclosure of the fraud in the first quarter of 1998, the price of Sunbeam shares dropped by 25 percent, to \$34.63. The price continued to decline as the board of directors investigated the fraud and fired Dunlap and the CFO. An extensive restatement of earnings from the fourth quarter of 1996 through the first quarter of 1998 eliminated half of the reported 1997 profits. On February 6, 2001, Sunbeam filed for Chapter 11 bankruptcy protection in U.S. Bankruptcy Court.

Accounting Issues

Cookie-Jar Reserves

The illegal conduct began in late 1996, with the creation of cookie-jar reserves that were used to inflate income in 1997. Sunbeam then engaged in fraudulent revenue transactions that inflated the company's record-setting earnings of \$189 million by at least \$60 million in 1997. The transactions were designed to create the impression that Sunbeam was experiencing significant revenue growth, thereby further misleading the investors and financial markets.

Channel Stuffing

Eager to extend the selling season for its gas grills and to boost sales in 1996, CEO Dunlap's "turnaround year," the company tried to convince retailers to buy grills nearly six months before they were needed, in exchange for major discounts. Retailers agreed to purchase merchandise that they would not receive physically until six months after billing. In the meantime, the goods were shipped to a third-party warehouse and held there until the customers requested them. These bill-and-hold transactions led to recording \$35 million in revenue too soon. However, the auditors (Andersen) reviewed the documents and reversed \$29 million.

In 1997, the company failed to disclose that Sunbeam's 1997 revenue growth was partly achieved at the expense of future results. The company had offered discounts and other inducements to customers to sell merchandise immediately that otherwise would have been sold in later periods, a practice referred to as "channel stuffing." The resulting revenue shift threatened to suppress Sunbeam's future results of operations.

Sunbeam either didn't realize or totally ignored the fact that by stuffing the channels with product to make one year

look better, the company had to continue to find outlets for their product in advance of when it was desired by customers. In other words, it created a balloon effect, in that the same amount or more accelerated amount of revenue was needed year after year. Ultimately, Sunbeam (and its customers) just couldn't keep up, and there was no way to fix the numbers.

Sunbeam's Shenanigans

Exhibit 1 presents an analysis of Sunbeam's accounting with respect to Schilit's financial shenanigans.

Red Flags

Schilit points to several red flags that existed at Sunbeam but either went undetected or were ignored by Andersen, including the following:³

1. *Excessive charges recorded shortly after Dunlap arrived.* The theory is that an incoming CEO will create cookie-jar reserves by overstating expenses, even though it reduces earnings for the first year, based on the belief that

increases in future earnings through the release of the reserves or other techniques make it appear that the CEO has turned the company around, as evidenced by turning losses into profits. Some companies might take it to an extreme and pile on losses by creating reserves in a loss year, believing that it doesn't matter whether you show a \$1.2 million loss for the year or a \$1.8 million loss (\$0.6 million reserve). This is known as the "big-bath accounting."

2. *Reserve amounts reduced after initial overstatement.* Fluctuations in the reserve amount should have raised a red flag because they evidenced earnings management as initially record reserves were restored into net income.
3. *Receivables grew much faster than sales.* A simple ratio of the increase in receivables to the increase in revenues should have provided another warning signal. Schilit provides the following for Sunbeam's operational performance in Exhibit 2 that should have created doubts in the minds of the auditors about the accuracy of reported

EXHIBIT 1
Sunbeam Corporation's Aggressive Accounting Techniques

Technique	Example	Shenanigan Number
Recorded bogus revenue	Bill and hold sales	2
Released questionable reserves into income	Cookie jar reserves	5
Inflated special charges	Litigation reserve	7

EXHIBIT 2
Sunbeam Corporation's Operational Performance

	Operational Performance		
	9 months 9/97 (\$ in millions)	9 months 9/96 (\$ in millions)	% Change
Revenue	\$830.1	\$715.4	16%
Gross profit	231.1	123.1	86%
Operating revenue	132.6	4.0	3,215%
Receivables	309.1	194.6	59%
Inventory	290.9	330.2	12%
Cash flow from operations	(60.8)	(18.8)	N/A

revenue amounts in relation to the collectibility of receivables, as indicated by the significantly larger percentage increase in receivables compared to revenues.

4. *Accrual earnings increased much faster than cash from operating activities.* While Sunbeam made \$189 million in

1997, its cash flow from operating activities was a negative \$60.8 million. This is a \$250 million difference that should raise a red flag, even under a cursory analytical review about the quality of recorded receivables. Accrual earnings and cash flow from operating activity amounts are not expected to be equal, but the differential in these amounts at Sunbeam seems to defy logic. Financial analysts tend to rely on the cash figure because of the inherent unreliability of the estimates and judgments that go into determining accrual earnings.

³Howard M. Schilit, *Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports*, 2d ed. (New York: McGraw-Hill, 2002).

Quality of Earnings

No one transaction more than the following illustrates questions about the quality of earnings at Sunbeam. Sunbeam owned a lot of spare parts that were used to fix its blenders and grills when they broke. Those parts were stored in the warehouse of a company called EPI Printers, which sent the parts out as needed. To inflate profits, Sunbeam approached EPI at the end of December 1997, to sell it parts for \$11 million (and book an \$5 million profit). EPI balked, stating that the parts were worth only \$2 million, but Sunbeam found a way around that. EPI was persuaded to sign an “agreement to agree” to buy the parts for \$11 million, with a clause letting EPI walk away in January 1998. In fact, the parts were never sold, but the profit was posted anyway.

Paine Webber, Inc. analyst Andrew Shore had been following Sunbeam since the day Dunlap was hired.⁴ As an analyst, Shore’s job was to make educated guesses about investing clients’ money in stocks. Thus, he had been scrutinizing Sunbeam’s financial statements every quarter and considered Sunbeam’s reported levels of inventory for certain items to be unusual for the time of year. For example, he noted massive increases in the sales of electric blankets in the third quarter of 1997, although they usually sell well in the fourth quarter. He also observed that sales of grills were high in the fourth quarter, which is an unusual time of year for grills to be sold, and noted that accounts receivable were high. On April 3, 1998, just hours before Sunbeam announced a first-quarter loss of \$44.6 million, Shore down-

graded his assessment of the stock. By the end of the day, Sunbeam’s stock prices had fallen 25 percent.

Questions

1. Is there a difference between aggressive accounting and earnings management? Would the motivation for using the techniques described in this case influence whether they should be labeled as aggressive accounting or earnings management? Incorporate ethical considerations in your answer.
2. How did pressures for financial performance contribute to Sunbeam’s culture, where quarterly sales were manipulated to influence investors? To what extent do you believe the Andersen auditors should have considered the resulting culture in planning and executing its audit?
3. Chapter 3 addresses issues related to corporate governance and ethical management. Given the facts of the case, identify the deficiencies in ethics and corporate governance failures at Sunbeam.
4. Given the variety of income adjusting techniques described in the case that were used by Sunbeam to manipulate the numbers, do you think it was proper for the Andersen auditors to dismiss \$2 million of the \$5 million income from the sale of the spare parts inventory? What factors do you think Andersen should have considered in addition to materiality in making the determination?

Optional Question

5. Why is it important for auditors to use analytical comparisons such as the ratios in the Sunbeam case to evaluate possible red flags that may indicate additional auditing is required?

⁴“Sunbeam Corporation: ‘Chainsaw Al,’ Greed, and Recovery,” Available at <http://danielsethics.mgt.unm.edu/pdf/Sunbeam%20Case.pdf>.