

Case 1.5

Sunbeam: A Focus on Ethics and Due Professional Care

Synopsis

In April 1996, Sunbeam named Albert J. Dunlap as its CEO and Chairman. Formerly with Scott Paper Co., Dunlap was known as a turnaround specialist and was even nicknamed “Chainsaw Al” because of the cost-cutting measures he typically employed. Almost immediately, Dunlap began replacing nearly all of the upper management team and led the company into an aggressive corporate restructuring that included the elimination of half of its 12,000 employees and the elimination of 87 percent of Sunbeam’s products.

Unfortunately, in May 1998, Sunbeam disappointed investors with its announcement that it had earned a worse-than-expected loss of \$44.6 million in the first quarter of 1998.⁵⁵ CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that it would need to restate its financial statements for 1996, 1997 and 1998.⁵⁶

Independent Auditor Arthur Andersen

Sunbeam’s auditor, Arthur Andersen, came under fire for having issued an unqualified opinion on the company’s financial statements for both 1996 and 1997. In January 1999, a class action lawsuit alleging violation of the federal securities laws was filed in the U.S. District Court for the Southern District of Florida against Sunbeam, Arthur Andersen, and Sunbeam executives. The suit reached the settlement stage in 2001. As part of the settlement, Andersen agreed to pay \$110 million.⁵⁷

Not surprisingly, Phillip Harlow the engagement Partner-in-Charge of the Sunbeam audit during this time period

⁵⁵ Robert Frank and Joann S. Lublin. “Dunlap’s Ax Falls—6,000 Times—at Sunbeam.” *Wall Street Journal*, November 13, 1996, B1.

⁵⁶ GAO-03-138, Appendix XVII “Sunbeam Corporation,” 201.

⁵⁷ Nicole Harris, “Andersen to Pay \$110 Million to Settle Sunbeam Accounting-Fraud Lawsuit,” *Wall Street Journal*, May 2, 2001, B11.

also found himself under fire on an individual basis for his work on the audits. The Securities and Exchange Commission (SEC) barred Harlow from serving as a public accountant for three years after it found that Harlow failed to exercise professional care in performing the audits of Sunbeam's financial statements.⁵⁸

1996 Audit

Through the course of the 1996 audit, Andersen Partner Phillip Harlow allegedly became aware of several accounting practices that failed to comply with GAAP. In particular, he allegedly knew about Sunbeam's improper restructuring costs, excessive litigation reserves, and an excessive "cooperative advertising" figure.

Improper Restructuring Costs

During the 1996 audit, Harlow allegedly identified \$18.7 million in items within Sunbeam's restructuring reserve that were improperly classified as restructuring costs because they benefited Sunbeam's future operations. Harlow proposed that the company reverse the improper accounting entries, but management rejected his proposed adjustments for these entries. Harlow relented on his demand after deciding that the items were immaterial for the 1996 financials.⁵⁹

Excessive Litigation Reserves

Sunbeam also failed to comply with GAAP on a \$12 million reserve recorded for a lawsuit that alleged Sunbeam's potential obligation to cover a portion of the cleanup costs for a hazardous waste site. Management did not take appropriate steps to determine whether the amount reflected a probable and reasonable estimate of the loss, as required by GAAP. Had they done so, the reserve would not have passed either of the criteria. Harlow relied on statements from Sunbeam's General Counsel and did not take additional steps to determine whether the litigation reserve level was in accordance with GAAP.⁶⁰

Excessive "Cooperative Advertising" Reserve

Sunbeam also recognized an excessive figure for a "cooperative advertising" reserve established to fund a portion of

⁵⁸ Cassell Bryan-Low, "Deals & Deal Makers," *Wall Street Journal*, January 28, 2003, C5.

⁵⁹ SEC Accounting and Auditing Enforcement Release No. 1393, May 15, 2001.

⁶⁰ "Complaint for Civil Injunction and Civil Penalties," SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 7–8.

its retailers' costs of running local promotions. At an amount of \$21.8 million, the reserve was approximately 25 percent higher than the prior year's accrual amount, without a proportional increase in sales. Harlow accepted management's representations that the accrual was an appropriate figure and did not ask for additional documentation to test the amount.⁶¹

1997 Audit

Harlow also allegedly discovered several items that were not compliant with GAAP during the course of the 1997 audit. These items related to revenue, the restructuring reserves, and inventory, in particular. In several cases, he made proposed adjustments that management refused to make. In response to management's refusal, Harlow acquiesced, however. By the end of 1997, it appears Harlow knew that approximately 16 percent of Sunbeam's reported 1997 income came from items he found to be not in accordance with GAAP.⁶² In fact, at least \$62 million of Sunbeam's reported \$189 million of income before tax failed to comply with GAAP.⁶³ The following examples illustrate two of the different techniques used by Sunbeam to overstate revenue earned.

Bill and Hold Sales

The SEC found that Harlow "knew or recklessly disregarded facts, indicating that the fourth-quarter bill and hold transactions did not satisfy required revenue recognition criteria."⁶⁴ Among other things, Sunbeam's revenues earned through bill and hold sales should not have been recognized because these sales were not requested by Sunbeam's customers, and they served no business purpose other than to accelerate revenue recognition by Sunbeam. Sunbeam offered its customers the right to return any unsold product. Further, several of Sunbeam's bill and hold transactions were also characterized by Sunbeam offering its customers financial incentives, such as discounted pricing, to write

⁶¹ Ibid., 7–8.

⁶² "Complaint for Civil Injunction and Civil Penalties," SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 7–8.

⁶³ SEC Accounting and Auditing Enforcement Release No. 1393, May 15, 2001.

⁶⁴ "Complaint for Civil Injunction and Civil Penalties," SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 32–33.

purchase orders before they actually needed the goods.⁶⁵

Sale of Inventory

Sunbeam's fourth-quarter revenue included \$11 million from a sale of its spare parts inventory to EPI Printers, which, prior to this transaction, had satisfied spare parts and warranty requests for Sunbeam's customers on an as-needed basis. As part of the transaction, Sunbeam agreed to pay certain fees and guaranteed a 5 percent profit for EPI Printers on the resale of the inventory. The contract with EPI printers also stipulated that it would terminate in January 1998 if the parties did not agree on the value of the inventory underlying the contract.

Harlow allegedly knew that revenue recognition on this transaction did not comply with GAAP due to the profit guarantee and the indeterminate value of the contract. Thus, Harlow proposed an adjustment to reverse the accounting entries that reflected the revenue and income recognition for this transaction. Yet, Harlow acquiesced to management's refusal to reverse the sale.⁶⁶

Case Questions

1. Please consider the alleged accounting improprieties related to increased expenses from the 1996 audit. If you were auditing Sunbeam, what type of evidence would you like to review to determine whether Sunbeam had recorded the litigation reserve amount and the cooperative advertising amount in accordance with GAAP?
2. For the excessive litigation reserves and excessive "cooperative advertising" amount, please identify the journal entry that is likely to have been proposed by Andersen to correct each of these accounting improprieties. Why would Sunbeam be interested in recording journal entries that essentially reduced their income before tax in 1996?
3. As discussed in the case, during both the 1996 and the 1997 audit, Phillip Harlow allegedly discovered a number of different accounting entries made by Sunbeam that were not compliant with GAAP. Please speculate about how Mr. Harlow may have explained his decision not to require Sunbeam to correct these alleged misstatements in the audit working papers.

⁶⁵ SEC Accounting and Auditing Enforcement Release No. 1393, May 15, 2001.

⁶⁶ "Complaint for Civil Injunction and Civil Penalties," SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 33–34.

4. Consult Section 204 of SOX and Paragraphs 55–59 of PCAOB Auditing Standard No. 2. In the post-Sarbanes audit environment, which of the issues that arose in 1996 and 1997 would have to be reported to the audit committee at Sunbeam? Do you believe that communication to the audit committee would have made a difference in Mr. Harlow's decision not to record the adjusting journal entries? Why or why not?