Case 4.7

Sunbeam: A Focus on Restructuring Reserves

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.[247] 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.[248]

Background

Included in Sunbeam's fraudulent accounting was its creation of accounting reserves that were aimed at lowering Sunbeam's reported 1996 net income so as to make the company's 1997 net income appear better by comparison. In addition, the reserves served as a "cookie jar" that management could dip into at its discretion to increase income in 1997, thereby creating a picture of a rapid turnaround.[249] Further, Sunbeam's restructuring costs included items that benefited future activities, a violation of GAAP, which did not allow the inclusion of restructuring costs that

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[247] Robert Frank and Joann S. Lublin. "Dunlap's Ax Falls—6,000 Times—at Sunbeam." *Wall Street Journal*, November 13, 1996, B1.

[248] GAO-03-138, Appendix XVII "Sunbeam Corporation," 201.

[249] SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 2–3.

benefited future operations.[250]

Sunbeam's Restructuring Charges

Associated with its operational restructuring, Sunbeam's 1996 results included a pretax charge to earnings of $337.6 million, which was allocated as follows:[251]

Restructuring, Impairment, and Other Costs	$154.9 million
Cost of Goods Sold	$92.3 million
Selling, General, and Administrative (SG&A)	$42.5 million
Estimated Loss from Discontinued Operations	$47.9 million
Total	$337.6 million

Restructuring, Impairment, and Other Costs

The "Restructuring, Impairment, and Other Costs" category included the following cash items: severance and other employee costs ($43.0 million), lease obligations and other exit costs associated with facility closures ($12.6 million), back office outsourcing start-up costs, and other costs related to the implementation of the restructuring and growth plan ($7.5 million). Noncash items in this category ($91.8 million) were related to asset write-downs for disposals of excess facilities and equipment, and noncore product lines; write-offs of redundant computer systems from the administrative back-office consolidations and outsourcing initiatives; and intangible, packaging, and other asset write-downs related to exited product lines and SKU reductions.

Importantly, this amount also included approximately $18.7 million of items that benefited future activities, for example, costs of redesigning product packaging, costs of relocating employees and equipment, and certain consulting fees.[252] Inclusion of these items was not allowed under GAAP because these costs related to activities that benefited future periods.

[250] SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 11–13.

[251] 1996 10K filing to SEC. Also see 1997 10K SEC filing, Note 8 ("Restructuring, Impairment, and Other Costs").

[252] SEC Accounting and Auditing Enforcement Release No. 1706, January 27, 2003.

Cost of Goods Sold, SG&A, and Estimated Loss from Discontinued Operations

As part of its operational restructuring, Sunbeam sold the inventory of its eliminated products to liquidators at a substantial discount. As such, the Cost of Goods Sold portion of the restructuring charge related principally to inventory write-downs and costs of inventory liquidation programs.

The SG&A portion of the restructuring charge related principally to increases in environmental, litigation, and other reserves. The litigation reserve was created for a lawsuit alleging Sunbeam's potential obligation to cover a portion of the cleanup costs for a hazardous waste site. To establish a litigation reserve under GAAP, management must determine that the reserved amount reflects a loss that is probable and able to be reasonably estimated. However, Sunbeam allegedly failed to take sufficient steps to determine what reserve amount would have been appropriate under GAAP.[253] Finally, the estimated loss from the discontinued operations portion of the restructuring reserve related to the divestiture of the company's furniture business.[254]

Using Excess Reserves to Offset Current Expenses

Initially, during the first quarter of 1997, Sunbeam used $4.3 million of these restructuring reserves to offset against costs incurred in that period. Essentially, this reserve was set up as a "cookie jar" in 1996 that allowed Sunbeam's 1997 income to improve by approximately 13 percent. Sunbeam failed to disclose this "infrequent item" in its quarterly filing. In the second quarter of 1997, Sunbeam offset $8.2 million in second quarter costs against the restructuring and other reserves created at year-end 1996, without making the appropriate disclosures. It made similar offsets of current period expenses in the third and fourth quarters of 1997: $2.9 million and $1.5 million, respectively.[255]

Final Restatement of Restructuring Charge

In November 1998, Sunbeam ultimately restated the pretax restructuring charge from $337.6 million to $239.2

[253] SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 12.

[254] 1996 10K filed with the SEC.

[255] SEC Accounting and Auditing Enforcement Release No. 1393, May 15, 2001.

million, which was allocated as follows:[256]

Restructuring, Impairment, and Other Costs	$110.1 million
Cost of Goods Sold	$60.8 million
Selling, General, and Administrative (SG&A)	$10.1 million
Estimated Loss from Discontinued Operations	$58.2 million
Total	$239.2 million

Restructuring, Impairment, and Other Costs

Restructuring, Impairment, and Other Costs was restated as follows: severance and other employee costs of $24.7 million, lease obligations and other exit costs associated with facility closures of $16.7 million. Noncash items—related to asset write-downs for disposals of excess facilities, and equipment and noncore product lines; write-offs of redundant computer systems from the administrative back-office consolidations and outsourcing initiatives; and intangible, packaging, and other asset write-downs related to exited product lines and SKU reductions—totaled $68.7 million.[257]

Cost of Goods Sold, SG&A, and Estimated Loss from Discontinued Operations

Contributing to the company's need to restate its Cost of Goods Sold expense related to restructuring stemmed from the fact that, in calculating its estimate for year-end inventory of household products, management failed to distinguish excess and obsolete inventory from inventory that was part of its continuing product lines. Thus, the value of Sunbeam's inventory from its continuing household product lines had been understated by $2.1 million on its balance sheet. In addition, its restatement to its SG&A included a revision of a $12 million litigation reserve that initially was improperly overstated by at least $6 million.[258]

Case Questions

1. Please explain what is meant by a restructuring reserve. As an auditor, what type of evidence would you want to

[256] Amended 1997 10K filed with the SEC.

[257] Amended 1997 10K filed with the SEC.

[258] SEC Accounting and Auditing Enforcement Release No. 1393, May 15, 2001.

examine to determine whether a company was inappropriately accounting for its restructuring reserve?

2. Refer to Paragraph #72 of PCAOB Auditing Standard No. 2. As an auditor, would you consider the different components of the restructuring reserve as having a “differing level” of inherent risk? Why or why not?
3. Please refer to Paragraphs #68–70 of PCAOB Auditing Standard No. 2. Identify one relevant financial statement assertion related to the restructuring reserve account? Why is it relevant?
4. This case describes a situation where a company overstated its recorded expenses in 1996 (as compared to understating recorded expenses). Why would a company choose to overstate its expenses and understate its net income?