Case 4.8

Sunbeam: A Focus on Revenue Recognition

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.[259] 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.[260]

Sunbeam's Customer Discounts and Other Incentives and Sales to Distributors

Under GAAP, sales revenue can only be recognized if the buyer assumes the risks and rewards of ownership of merchandise, for example, the risk of damage or physical loss. A sale with a right of return can be recognized as revenue only if the seller takes a reserve against possible future returns. The size of this reserve must be based on the company's history with returns; the sales revenue may not be recorded if no such history exists.

Beginning with the first quarter of 1997, Sunbeam began offering its customers discounts and other incentives if they placed their orders in the current period, rather than holding off until the next period. Sunbeam did not disclose this practice of accelerating expected sales from later periods in their financial statements, however. In the other

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

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

quarters of 1997, Sunbeam also allegedly relied on additional price discounting and other incentives in an attempt to accelerate the recognition of revenue from future periods.[261]

One example of a special arrangement with a customer took place at the end of March 1997, just before the first quarter closed. Sunbeam recognized $1.5 million in revenue and contributed $400,000 toward net income from the sale of barbecue grills to a wholesaler. The contract with the wholesaler provided that the wholesaler could return all of the merchandise, with Sunbeam paying all costs of shipment and storage, if it was unable to sell it. In fact, the wholesaler wound up returning all of the grills to Sunbeam during the third quarter of 1997, and the wholesaler incurred no expenses in the transaction.[262]

Sales to Distributors

In December 1997, Sunbeam devised a “distributor program” that would help improve the company’s sales. The program was designed to help Sunbeam accelerate the recognition of sales revenue for merchandise it placed with distributors in advance of actual retail demand. Sunbeam allegedly used favorable payment terms, discounts, guaranteed mark-ups, and, consistently, the right to return unsold product as incentives for distributors to participate in the program.

The sales under the distributor program represented a new distribution channel for the company. Therefore, Sunbeam was unable to set an appropriate level of reserves for any returns.[263]

Bill and Hold Sales

In the second quarter of 1997, Sunbeam recognized $14 million in sales revenue from bill and hold sales. By the fourth quarter, Sunbeam had recognized $29 million in revenues and contributed an additional $4.5 million toward net income in bill and hold sales after it began promoting its bill-and-hold program. In all, bill and hold sales contributed to 10 percent of the fourth quarter’s revenue.[264]

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

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

[263] SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 30–31.

[264] SEC Accounting and Auditing Enforcement Release No. 1394, May 15, 2001.

At year-end 1997, Sunbeam disclosed in its annual filing to the SEC that "the amount of [the] bill and hold sales at December 29, 1997 was approximately 3 percent of consolidated revenues." It did not disclose the extent to which the bill and hold sales had been booked in the final quarter.[265]

Revenue Recognition Criteria for Bill and Hold Sales

The SEC had stipulated that the following criteria must be met for revenue to be recognized in bill and hold transactions:[266]

- The risks of ownership must have passed to the buyer.
- The buyer must have made a fixed commitment to purchase the goods.
- The buyer must request that the transaction be on a bill and hold basis, and must have a substantial business purpose for this request.
- There must be a fixed schedule for delivery of the goods.
- The seller must not have retained any specific performance obligations such that the earning process is not complete.
- The ordered goods must be segregated from the seller's inventory.
- The goods must be complete and ready for shipment.

Characteristics of Sunbeam's Bill and Hold Sales

The SEC found that Sunbeam's bill and hold sales were not requested by Sunbeam's customers and served no business purpose other than to accelerate revenue recognition by Sunbeam. Sunbeam's bill and hold sales were typically accompanied by financial incentives being offered to customers, such as discounted pricing, to encourage the sale to occur long before the customer actually needed the goods. Sunbeam would then typically hold the product until delivery was requested by the customer. Sunbeam also paid the costs of storage, shipment, and insurance related to the products. In addition, Sunbeam's customers had the right to return the unsold product.[267]

Restatement of Revenues

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[265] SEC Accounting and Auditing Enforcement Release No. 1394, May 15, 2001.

[266] Staff Accounting Bulletin No. 101.

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

In 1998, Sunbeam restated its revenues for 1997 from $1,168,182 to $1,073,090. In an amended filing of its 10-K to the SEC, management wrote: "Upon examination, it was determined certain revenue was improperly recognized (principally "bill and hold" and guaranteed sales transactions)…."[268] The company had reversed all "bill and hold" sales, which amounted to $29 million in 1997, and about $36 million in guaranteed or consignment sales, whose liberal return policies made the recognition of their revenue improper.[269]

Case Questions

1. Please consider Paragraphs #61–65 of PCAOB Auditing Standard No. 2. Do you believe that revenue derived from bill and hold sales, and revenue derived from sales to customers receiving special discounts should be evaluated differently when considering the design and operating effectiveness of the internal control system? Why or why not?
2. As an auditor, what type of evidence would you want to examine to determine whether Sunbeam was inappropriately recording revenue from special discount sales?
3. Please consider Paragraph #96 of PCAOB Auditing Standard No. 2. Do you believe that the control activity described would be helpful to detect the fraudulent sales recorded by Sunbeam to customers receiving special discounts? Why?
4. Consider Paragraphs #55–59 of PCAOB Auditing Standard No. 2. Identify one action that the Audit Committee of Sunbeam could have taken to help insure that a revenue recognition fraud would not have occurred?

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[268] Amended 1997 10K filing to SEC.

[269] Martha Brannigan, "Sunbeam Slashes Its 1997 Earnings in Restatement," *Wall Street Journal,* October 21, 1998, 1.