Case Study: Revenue Recognition and Materiality

One of the underlying principles of accounting is that some items are too small to worry about. However, this is a subjective and relative determination. If you look at the size of the revenues of some publicly held companies, even small ones with $5 million in sales, a lot of small items like supplies are too costly to track. Even so, that doesn't mean there aren't rules.

In 1996, Albert J. Dunlap took over as CEO and chairman of struggling Sunbeam-Oster. Sunbeam had been around since the turn of the century, developing and producing home appliances, but in the late 80s, competition had driven the company to near bankruptcy. So Dunlap laid off half the workforce and restructured the entire company. The balance sheet and income statement in 1996 looked terrible, but his strategies seemed to pay off. In 1997, Sunbeam reported massive increases in sales for its various backyard and kitchen items. Stock soared to $52 a share. "Chainsaw" Al Dunlap made tens of millions in salary and his memoir became a bestseller.

But something odd was afoot. Investment analysts were wary of the numbers, and subsequent investigations by the U.S. Securities and Exchange Commission (SEC) and Sunbeam's own board of directors revealed that the company had been recording sales that came from "channel stuffing," which is basically shifting inventory to the accounting books of distributors and retailers. In one case, the SEC said, electric blankets that had been packaged for a certain retailer were sent to a distributor who agreed, in return for a guaranteed profit, to hold the blankets until the retailer was ready to accept them. Other sales were made by offering deep discounts to persuade customers to buy merchandise that they would not need for many months. The SEC said that, under GAAP revenue recognition rules, the company should have disclosed those discounts and that the sales should have been recorded in later quarters.

Even though the Arthur Andersen auditors had uncovered the questionable accounting practices before putting their required stamp of approval on the financial statements, Dunlap had convinced them that the challenged numbers, which produced 16 percent of the company's 1997 profits, were not material. The auditors certified the financial statements.

By the end of 2000, it was clear the "managed" accounting profits weren't real profits. The board of directors fired Dunlap and the company filed for Chapter 11 bankruptcy protection in 2001.

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The SEC determined that at least $60 million of the 1997 profits were fraudulent and sued Dunlap. Of course, Dunlap called the charges “baseless” and claimed to be a victim of SEC meddling. Dunlap ultimately paid a huge fine and was banned from serving again as an officer or director of a public company. Arthur Anderson would soon be implicated in one of the greatest accounting scandals of all time, the Enron fiasco, forever tarnishing its already shaky reputation and driving it out of business.

Sunbeam products can still be found today, but other than the brand name, the once-iconic company has faded into obscurity.

Questions for Discussion

1. How would you determine materiality for a company that hired you as an accountant? Would it depend on the job you were doing, e.g. managing cash and investments v. accounts payable v. property, plant, and equipment?
2. How would you proceed if the Chief Executive Officer of the company asked you to ignore a $50,000 sales chargeback because she considered it to be immaterial against total sales of $10 million?
3. In your own household budget, do you have a materiality level, or do you account for every penny earned and spent? Explain your reasoning.
4. Why was it wrong for Sunbeam to record sales when the items had been shipped to distributors? Why was it wrong to record sales to customers in advance of shipping the items? Why would it matter?

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