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Cutter & Buck (B)

In the summer of 2002 I received a call from Fran telling me that we might have a potential problem. As things unfolded it became apparent that the company had sold inventory to some distributors very late in FY 2000 and it was on a consignment basis, with the goods coming back in FY 2001. It shouldn't have been recognized as a sale in FY 2000, and the company had moved revenue from one year to the next. My initial thought was, "What's the big deal?" But then it became clear that the goods coming back in FY 2001 had come back marked for a different channel, actually divided into multiple channels. This then became a concealment issue. We held a quick board meeting and unanimously agreed that as painful as this might be, and we had no idea at the time just how painful it would be, we needed to go full bore and bare all facts and take the consequences. As a publicly held company there is only one way to do things, and that's the right way.

—Larry Mounger, Board Member, Cutter & Buck

The Onslaught

It felt as though just when it could not get any worse, it did. One Cutter & Buck board member likened the fall of 2002 to attempting to play a tennis game gone awry: the balls are coming over the net one at a time, and then all of a sudden they are thrown all at once. Conley and her board were working to put out all the fires and fully cooperate with regulators. They were also trying not to lose sight of the fact that their business was "broken" and needed fixing.

The SEC and Department of Justice

On Monday morning, July 29, Cutter & Buck filed for a 15-day extension with the Securities and Exchange Commission for the 10-K filing. (See **Exhibit 1** for Cutter & Buck timeline.) Cutter & Buck was under tremendous pressure to get the 10-K out. Conley called a meeting on Sunday, July 28 with both partners from their accounting firm, Ernst & Young, pulling both men from vacation. Ernst & Young Seattle had signed off on the financials, so Conley was relying on them to help her understand what had happened. As part of procedure, Ernst & Young Seattle contacted their San Francisco office, which provided regional expertise on accounting problems. Conley recalled that they very quickly identified that Cutter & Buck had not only a series of actual accounting problems but appearance issues as well. "They [Ernst & Young] seemed to serve as the voice of doom!" Conley commented.

By the end of that first week of questions and searching, both Conley and the board realized that they needed more than an internal investigation. They brought in an outside forensic legal firm,

Professor William A. Sahlman and Research Associate Victoria W. Winston prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

which in turn hired forensic accountants to help get to the bottom of the issues. Board member Jim Towne explained:

> We brought in an outside investigative attorney who grilled people. It was like the cops coming in. They found inconsistencies. They were working for the board. This is a very wonderful, smart thing for a board to do. It takes the board off the hook as investigators, and board members are not skilled at that kind of thing anyway. It costs a few bucks, but it's worth everything. It says very loudly that "this board is going to find out exactly what happened; the board will be firm, decisive, and tough with regard to wrongful behavior and will not stand for it." It's a dispassionate approach to uncovering the facts. It is professional, clear, and complete; it doesn't damage our relationships with management for the future. A special committee of the board was appointed, and methodical interviews with internal staff, led by the outside investigators, began to uncover what was behind the distributor accounting.

As soon as they knew there was a problem, Cutter & Buck had called the SEC in Washington, D.C. and started working with them. Conley, guided by her board and legal counsel Mike Morgan, decided to go public with the information as soon as she realized they did not know what had really happened and that it would take some time to figure it all out. Conley reflected, "I had a strong belief that the ongoing integrity of the business demanded that we say something more than just what we were obligated to release. This is all a pretty gray area as to what you have to tell versus what you might choose to tell. We had to tell the public, at least by filing the appropriate forms, that we were going to be 15 days late in filing the 10-K. We probably didn't have to explain why publicly."

On August 12 (see **Exhibit 2** for Cutter & Buck accounting irregularities press release) the company announced that they would not be filing their 2002 return in a timely fashion and that they would also be restating 2000 and 2001 past financials. As a result of the August 12 press release, things started to snowball.

On August 31, the Friday before the long Labor Day weekend, the SEC informed Cutter & Buck that it was under investigation and started an inquiry. They would need access to hundreds of corporate documents to aid the effort. To make matters worse, Cutter & Buck was executing a long-planned corporate headquarters move across town that weekend. To streamline the moving process, all documents and paperwork were boxed up and on pallets for the move or had been shredded if thought to be irrelevant.

Right on the heels of the SEC announcement, the Department of Justice became involved, with FBI agents questioning employees and managers as well as scouring computer drives.

NASDAQ and a Delisting

On August 15 NASDAQ National Market alerted Cutter & Buck that its stock might be delisted for the company's failing to maintain at least three years of audited financial statements. If this occurred, the value of the stock might decline even further, trading volume might decline even more, and the company might experience increased difficulty in obtaining the capital necessary to operate its business. While the stock was not delisted during the appeal process, it traded under the CBUKE symbol (rather than CBUK), indicating its pending status until the delisting issue was resolved.

The CFO

Understanding exactly what went on surrounding the accounting irregularities, who was involved, and who to trust was difficult. Harvey Jones, the ex-CEO, and Marty Marks, the ex-president, were gone, and CFO Steve Lowber was being less than cooperative. Conley had worked with Lowber for a number of years and had great respect for his capabilities. She had chaired the audit committee, worked with Lowber at another company, and had in fact even recommended him for the CFO position at Cutter & Buck. But as that first week in August unfolded, Lowber made himself less and less available. And then, only a day or two later, when the forensic accountants got to the point of interviewing the three senior people who ran Cutter & Buck during the 2000 and 2001 period, Lowber and his lawyers refused to talk at all. The following day, August 9, Lowber resigned.

The D&O Insurance

When the accounting discrepancies were discovered, Cutter & Buck alerted the insurance company that provided the directors and officers (D&O) coverage, Genesis, to everything they knew at the time. Coincidentally, the policy was up for renewal. Without D&O coverage, Cutter & Buck could be responsible for litigation costs tied to lawsuits filed against the company as well as former and current officers and directors.

On December 6 notification arrived that the D&O insurance had been rescinded. The liability concerns were very real. As Ernie Johnson, who had served Cutter & Buck on a consulting basis but had just been made CFO, explained, "Corporate financial restatements, regardless of the magnitude, generally attract litigation. In theory, D&O insurance covers you assuming that you are acting in the best interests of the company. But once coverage gets pulled, both the company and the individual executives become very susceptible to ambulance chasers."

Bank Credit Line

In August Conley informed Cutter & Buck's bank, Washington Mutual, of the accounting problems. The company had a combined $35 million bank line of credit with Washington Mutual ($20 million) and Bank of America ($15 million). The bank line was running out, and with all of Cutter & Buck's apparent problems, the banks had lost all confidence in the financials and wanted to pull their credit funding. In looking at the security of their loans, banks look for stable management, a proven earnings record, and a controlled environment. Cutter & Buck had none of these.

Class-Action Lawsuits

By September 13, four separate class-action suits were filed against Cutter & Buck in U.S. District Court in Seattle, claiming that the company had misled stockholders. The suits alleged that the company and certain executives issued false and misleading statements during FY 2000, 2001, and 2002 and that the statements constituted a violation of federal securities law. The suits named Cutter & Buck as well as ex-CEO Jones and ex-CFO Lowber.

Personnel

Morale among Cutter & Buck's 500-plus employees during that time was described by one senior executive as "lower than the black pit." Employees found it difficult to think that managers they had respected may have violated the law. Cutter & Buck was a hometown company, and the local press was following every chapter as it unfolded. Board member Towne noted, "The press was hard on us. We were a local company, and our employees had to deal with every aspect of this scandal playing out publicly."

Senior management at Cutter & Buck was thinly staffed. They had lost their CFO at a time when a lot was being demanded of that function to oversee the various audits and restatements. As part of her evaluation of the business prior to uncovering the accounting scandal, Conley had identified functional areas such as human resources and product design that sorely needed to be restructured and run more professionally by seasoned veterans. Conley had to figure out how to get the bases covered and the turnaround under way in a situation where most managers would not want to come to the company. The company was certainly not in a position, given the bad press and accounting situation, to replace Conley, as she and the board had initially assumed. On top of all that, the small board (three remaining outside members) was meeting multiple times a week, and members were individually being called upon to spend far more time and energy on the company than was typical. More board members were needed. (See **Exhibit 3** for a chart depicting changes in Cutter & Buck's stock price.)

Exhibit 1 Cutter & Buck Timeline—July 2002 to June 2004

July 29, 2002	CBUK files for a 15-day extension on the 10-K filing.
August 9, 2002	Stephen Lowber, CFO, resigns.
August 12, 2002	CBUK announces irregularities and plans to restate its audited financial statements for the fiscal years ended April 30, 2000 and April 30, 2001.
August 15, 2002	NASDAQ alerts CBUK to potential delisting due to rules violation.
August 31, 2002	CBUK moves corporate headquarters over Labor Day weekend. SEC tells CBUK they are under investigation.
September 13, 2002	Four class-action security lawsuits are filed against CBUK.
October 9, 2002	CBUK files restated earnings with the SEC.
October 14, 2002	NASDAQ closes down its delisting proceedings against CBUK as they become compliant upon filing the restated earnings with the SEC.
November 15, 2002	CBUK announces the hiring of a new CFO, executive vice president for products and markets, and corporate director of human resources.
December 4, 2002	CBUK announces business restructuring and the closing of its retail stores.
December 6, 2002	CBUK's directors and officers (D&O) liability insurance carrier notifies CBUK that they are rescinding insurance coverage.

Source: Developed by casewriter.

Exhibit 2 Cutter & Buck Accounting Irregularities Press Release

Cutter & Buck Announces Discovery of Accounting Irregularities in Fiscal Years 2000 and 2001; Reports Resignation of Chief Financial Officer

Announces Preliminary First Quarter Fiscal Year 2003 Operating Results

SEATTLE, Aug 12, 2002 (BUSINESS WIRE)—Cutter & Buck, Inc. (Nasdaq:CBUK)—CEO Fran Conley today announced that the Company plans to restate its audited financial statements for the fiscal years ended April 30, 2000 and April 30, 2001. The restatements will correct entries of sales into incorrect periods, and inaccurate reporting of sales by distribution channels. Although the matter is still under review, the Company does not have any reason to believe that its current net worth will be affected or that there will be any change in the Company's total sales for the past three years.

The adjustments stem from certain transactions that were discovered by Conley following her recent appointment as Chief Executive Officer. A Committee formed by Conley, and made up of her and the Board's Audit Committee is conducting an investigation of accounting issues with respect to revenue recognition for the fiscal years ended April 30, 2000 and April 30, 2001 and its potential impact on the past fiscal year ended April 30, 2002. The Committee has retained special outside counsel to assist with this investigation.

The investigation was triggered by shipments of approximately $5.8 million to three distributors during fiscal year 2000 which had been recorded as sales of inventory for that year but were evidently made on a consignment basis. These shipments should not have been recorded as sales until the merchandise was resold by the distributors. After it became apparent to the Company's former management that the three distributors would not be able to sell most of this product, the Company arranged for the merchandise to be returned to Cutter & Buck at the end of fiscal year 2001. That reacquisition was accounted for as a reduction in sales during fiscal year 2001.

The business transactions at issue were not disclosed to the Company's then outside members of its Board of Directors and were not discussed with the Company's auditors. Rather, there is evidence that the Company's standard accounting practices and controls were circumvented and that sales returns in fiscal 2001 were intentionally mis-allocated to several of the Company's business lines instead of the business line under which those sales were originally booked. The Committee believes that some members of the Company's former management may have received increased incentive compensation as a result of the overstated FY 2000 financial results.

“The Board has always been committed to operating the Company with the highest levels of integrity,” said Conley. “We are appalled at this discovery and we are determined that nothing like this will happen at Cutter & Buck in the future. We want this investigation to root out the full extent of any financial reporting issues. I am absolutely committed, as is the current leadership team, to strengthening our Company's values and building the systems we need. Cutter & Buck will be the kind of company that our shareholders and employees want it to be—rooted in integrity, and bolstered with strong systems and controls.

“The managers responsible for these business decisions and those who were responsible for the integrity of the Company's financial statements no longer have any role with the Company,” said Conley. “They include the former Chairman and Chief Executive Officer, the former President and Chief Operating Officer, the former Chief Financial Officer, the former Manager of Corporate Sales and the former Controller.”

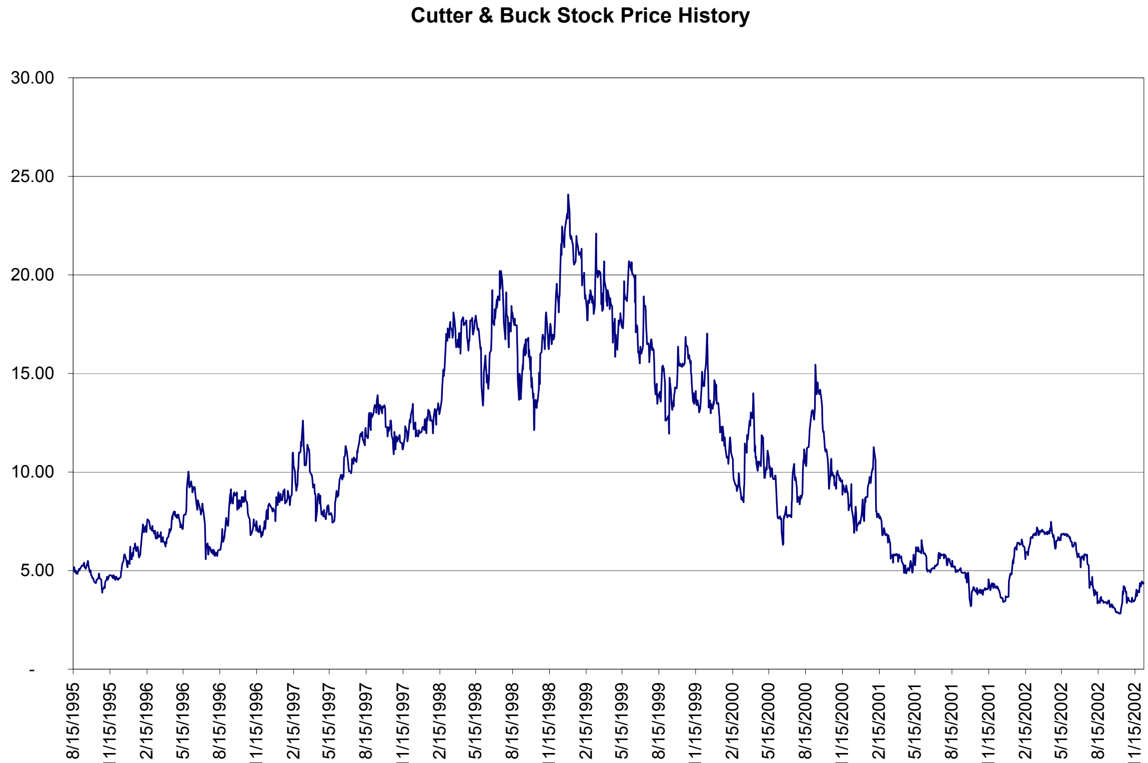
On Friday, the Company accepted the resignation of Stephen S. Lowber, the Company's Chief Financial Officer. Lowber joined the Company in 1997.

The Committee is working to conclude its investigation expeditiously and the Company currently anticipates filing its annual report on Form 10-K for the fiscal year ended April 30, 2002 by mid September. The Company also will restate its financial results for the relevant quarters during the periods in question and may need to correct other sales entries which more properly should have been reported in later periods. As a result, investors should not rely on the currently reported financial statements and reports for the fiscal years 2000 through 2002.

Due to the discovery of the accounting irregularities, the Company's auditor, Ernst & Young, believes there is a material weakness in the Company's internal controls and operations. The Committee is reviewing the matter as part of its investigation and will recommend that the Company immediately remedy any deficiencies. The Company has informed the staff of the SEC of its internal investigation and plans to keep the SEC informed of its progress.

Source: Company documents.

Exhibit 3 CBUK Stock Price History to December 6, 2002



Source: Company documents.