Accounting fraud, business failure and creative auditing: A micro-analysis of the strange case of Sunbeam Corp.

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Accounting Fraud, Business Failure and Creative Auditing: A Micro-Analysis of the Strange Case of Sunbeam Corp.

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Abstract

This paper puts under a magnifying glass the path to failure of Sunbeam Corp. and emphasizes the reasons for its singularity and exceptionality. This corporate case emerges as an outlier from the analysis of the US fraud cases mentioned by WebBRD: the consideration of the time between fraud disclosure and the final bankruptcy reveals that the value of this temporal variable is estimated equal to 840 days in the case of Sunbeam, really far from the range estimated by the survival function for the entire sample. Different hypotheses explaining this exceptionality are evaluated in the paper, starting from the consideration of the peculiarities of Sunbeam’s history: fraud duration, scapegoating and creative auditing represent the three main points of analysis. Taking to heart the fact itself that the case under examination is an outlier, we perform a micro-analysis of this case that the SEC investigated in depth and this work describes in detail, providing unexpected insights and inputs for future research concerning auditing and accounting fraud.

Keywords: accounting fraud, failure path, creative auditing, historical micro-analysis

JEL Classification Numbers: M41, M42, N80, N82, M48

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1) INTRODUCTION

Unlike traditional literature, which is focused on reaching a substantial agreement over the most suitable methodology for predicting final business failure (Beaver, 1968; Altman, 1968), more recent pieces of research emphasize the relationship between time dimension, failure stages and accounting information (Hill, Perry & Andes, 1996; Cybinski, 2001). This paper aims to be part of this second stream of research, whose importance has been repeatedly emphasized in the last few years. In particular, Humphrey (2008) reviews audit research and questions the relevance of quantitative modelling studies to auditors, auditees, professional accounting associations and corporate regulatory authorities both before and after the lesson of famous corporate scandals (e.g. Enron and WorldCom). The need for detailed qualitative contextual research on these crashes is highlighted in other authoritative literature (Lee, 2004; Humphrey, 2005; Parker, 2005): the lack of specific and precise knowledge implied in fact that in the Enron case, for instance, fraud and its consequences came “as a surprise”. These considerations represent the premise of the present paper, which aims to implement what Parker (2012, p. 67) observes: “The qualitative agenda has much to offer in unpacking these processes of accounting, auditing and accountability, and in addition translating qualitative management accounting issues and research designs into the financial accounting and auditing arenas, as well as bringing questions of internal management and accounting control systems in large scale corporate crash experiences under the microscope.” On the other hand, Armstrong (2008) among others have stressed the need for qualitative studies to cope with the problem of the idiosyncratic significance of ethnographic case studies.

For these reasons, starting from a previous study (Agostini, 2012), demonstrating that fraud disclosure usually takes firms to bankruptcy very fast, this paper analyses in detail an exception to this statistical rule. The usefulness of considering “deviant cases” is emphasized in the theoretical debate on path dependency, to which the present paper also makes reference for the analysis of the business failure path: the “deviant cases” follow a peculiar path-dependent logic where early contingent events set cases on an historical trajectory of change that diverges from theoretical expectations (Emigh, 1997; Mahoney, 2000). Path dependence, however, is only one of the possible approaches to exceptional cases. A specific methodology, useful to deal with the idiosyncratic nature of exceptional cases in order to logically extract from their analysis new theoretical hypotheses, was developed in the historical disciplines some decades ago in the context of the debate on micro-history (Trivellato, 2011), which then spread to accounting history (Williams, 1999). The starting point for a micro-analytical approach is the critical comparison of all available
sources: in our case, annual reports with obvious caveats, business columns, published interviews, and the results of the US Securities and Exchange Commission (SEC) investigation. This is coupled with the effort to avoid simplification, “not to sacrifice knowledge of individual elements to wider generalization”: in fact, when dealing with historical reality, where the experimental “ability to reproduce the causes is excluded, even the smallest dissonances prove to be indicators of meaning which can potentially assume general dimensions” (Levi, 1992, p. 109). In this perspective, the interpretation of an extraordinary case, such as the outlier here taken into consideration, can indeed shed light on broader trends and possibly falsify general assumptions about what is possible or not. In this paper, we take this idea to heart and try to develop it, starting from the proper statistical identification of our exceptional case as an outlier.

In fact, the presence of the outlier, here considered, emerges from the analysis (TABLE 1) of the time between the fraud disclosure date and the date of bankruptcy (i.e. the TIME2 variable, as defined in Agostini, 2012) in the US fraud cases mentioned by WebBRD¹. Overall, the survival function estimates about a 25% chance of falling into bankruptcy within 53 days after the fraud disclosure date, 50% within 99 days and 75% within 215 days. Considering some descriptive statistics, the maximum value of the TIME2 variable is estimated equal to 840 days: this is really far from the range estimated by the survival function and it refers to Sunbeam Corp. (Fig.1).

TABLE 1 – TIME2 variable analysis

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>time2</td>
<td>30</td>
<td>154.8667</td>
<td>178.4815</td>
<td>0</td>
<td>840</td>
</tr>
</tbody>
</table>

In this table (TABLE 1), as in the following figure (Fig. 1), the number-label “27” identifies the

¹ The sampled firms are included in the WebBRD (Bankruptcy Research Database) which contains data on all large, public company bankruptcy cases filed in the United States Bankruptcy Courts from October 1, 1979 through March 1, 2010. The sample selection is made according to the cause of bankruptcy (i.e. fraud) and the type of activity (i.e. different from finance, insurance, and real estate).
sample case of Sunbeam Corp: the survival function reveals that this company took 840 days (i.e. the maximum number of days for the sample) to fall into bankruptcy after the fraud disclosure.

Fig.1 - One outlier from TIME2 variable analysis

In this chart (Fig. 1), as in the previous table (TABLE 1), the number-label “27” identifies the sample case of Sunbeam Corp: the survival function reveals that this company took 840 days (i.e. the maximum number of days for the sample) to fall into bankruptcy after the fraud disclosure.

Given the exceptionality of the case, both from a descriptive-statistical point of view and in the light of the existing literature on the determinants and characteristics of accounting fraud, the present work focuses on an in-depth study of Sunbeam’s path to failure. It aims to explain the reasons for its uniqueness in order to derive from this micro-analysis new questions and considerations concerning accounting fraud and bankruptcy. A correct approach to this methods requires us to define our research questions by asking at first what the micro-analysis of this single case (selected as an outlier in the statistical distribution described above) can show us about the mechanisms relating to accounting fraud and business failure. This matter requires an articulated answer that we have translated into the multiple operational research questions listed below.

Firstly, the micro-analysis of a single case can shed light on causal mechanisms which are too complex to emerge from standard empirical studies based on statistical approaches. A coherent research strategy in this case is to ask how the specific fraudulent strategy of performance overstatement adopted in the Sunbeam case can be connected to the peculiar modality of its disclosure, making it possible to scapegoat the CEO, to (temporarily) discharge the board and the company of any responsibility, and to pursue a business recovery.
Secondly, the exceptional features characterizing the case can suggest (by contrast) new hypotheses about what are the usual mechanisms at work, explaining the reasons for the concentration around average values of the statistical variables considered. The related operational research question will be about the factors (not existing in other cases) which may explain Sunbeam’s exceptionally long time to macro-failure (in this case, bankruptcy).

However, the outlier can sometimes represent the “tip of the iceberg” of not measurable phenomena (as, for instance, cases of undetected fraud). Consequently, the paper investigates what made possible for Sunbeam’s fraud to be discovered and in what measure the exceptional factors explaining the odd behaviour of Sunbeam could be interpreted as usually invisible.

Finally, the outlier can be the signal (i.e. the visible sign or red flag) of a dynamic evolution that explains its emergence as the result of a “blind evolutionary path”. In this case, the operational research question takes a counter-factual aspect: what could have made this case unexceptional, or what could have made it possible to generalize some of its specific features?

Different hypotheses will consequently be analysed in the following sections, starting from the consideration of the peculiarities of Sunbeam’s history. The paper is organized as follows. The following section reviews the relevant literature about the factors characterizing Sunbeam’s fraud process: fraud duration, scapegoating and creative auditing. The third section analyses the presence and the relevance of these factors in the concrete case under examination. Section four illustrates the relationship among these variables, providing answers to the above questions and highlighting the contribution of this paper to the literature. Lastly, some concluding remarks summarizing the paper are presented.

2) REVIEW OF THE THEORETICAL LITERATURE

2.1 Determinants of fraud, time to disclosure and time to bankruptcy.

As the starting problem of this paper is the exceptionally long time from fraud disclosure to bankruptcy in the case of Sunbeam Corp., most of the existing literature focusing on the determinants of fraud and its duration (time to disclosure) seems off target. However, the micro-analytical approach, adopted here, provides the opportunity to make reference to a wide set of literature about different aspects of the theoretical debate, in order to allow an overall understanding of its complex evolutionary path, going from fraud to disclosure and then to macro-failure (i.e. bankruptcy).
Generally speaking, the literature, considered below, starts from the empirical analysis of statistical correlations at aggregate level between fraud dynamics and other variables concerning the firm (endogenous) or its environment (exogenous) to infer some explanatory models: these contributions are very useful in order to build up a repertoire of models to be tested on the case, but also to correctly define the relevant context and the pertinent issues (Jones, 2011).

In this respect, it should be first recalled that this work deals with a specific kind of fraud, related to financial misstatement. This typology represents a small minority (4.8 %) of the number of frauds occurring at global level in 2009, following a survey of the Association of Certified Fraud Examiners (ACFE, 2010); however, it still made up the absolute majority (68 %) of reported losses, with a median loss of $ 4,100,000 ($ 1,730,000 considering only frauds committed in the United States) against $ 160,000 for all kinds of occupational fraud;² perhaps more interestingly here, it also took the longest to be discovered, with a median duration of 27 months, as against 18 months for all frauds (ACFE, 2010, pp. 10-14). More specifically, a further distinction between two main typologies of accounting fraud can be pointed out considering different systems of corporate governance (Jones, 2011): an excess of power retained by entrepreneurs or managers is usually at the origin of misstatement crimes in continental (European) financial systems, whereas in the United States (as in most of the Anglo-Saxon countries) accounting fraud seems mainly to result from the pressure on performance exerted by financial investors, market analysts and internal budgeting on top and middle managers. If the latter is assumed to represent the set of pertinent circumstances in our case, the search for private benefit would be only the indirect result of a managerial conduct aimed, above all, at meeting the expected results. In the Sunbeam case, as discussed below, responsibility for the fraud was mainly attached to the company’s CEO, emphasizing his managerial style as directly connected to the resulting misstatement.

Moreover, the models proposed by the literature to explain the motivations for fraudulent overstatement of company financial performances usually apply an opportunity-cost framework with contrasting results related to the considered system of incentives. For instance, the non-linear correlation between the number of frauds committed and the expected aggregate economic performance (i.e. optimism) is explained making reference to different mechanisms (Davidson, 2011). A first explanation takes into consideration the changing performance threshold according to which investors decide whether to monitor in depth the state of a firm or rely on public information.

² ACFE (2010) defines occupational fraud as the “use of one’s occupation for personal enrichment through the deliberate misuse or misappropriation of the employing organization’s resources or assets” (p. 2).
about it: this implies consequent changes in managers’ cost opportunity about the performance overstatement (Povel, Singh & Winton, 2007). Another explanation considers instead the varying ability of analysts to effectively predict aggregate trends as affecting the number of firms performing less than expected, pushing their managers to overstate performances in order to keep up with their competitors on the job market (Fernandes & Guedes, 2009).

It is also worth signalling the existence of endogenous explanations of the cyclical trend of fraud, making reference to a circular predator-prey model (Volterra, 1928) and using the number of scammers (and the lagged number of victims) as the dependent (or independent) variable affected by (or affecting) the return to fraud (or to vigilance), in its turn (Gong, McAfee & Williams, 2011) affected by (or affecting) the level of vigilance (fraud). However, this kind of approach does not consider that accounting fraud is a special case of the classical deterrence hypothesis (Becker, 1968) because of the presence of a “linkage” problem: this implies for the budget manipulator a higher probability of being discovered should the fraud cease (Baer, 2008). Higher sanctions increase then the opportunity cost of stopping manipulation, generally increasing also the time to disclosure, pushing managers to resort to lobbying (Yu & Yu, 2011) or M&A (Erickson, Heitzman & Zhang, 2011) as a means to postpone or possibly avoid fraud disclosure.

Acquisition is particularly interesting in the analysis of the case considered in this study because it was adopted as a strategy to conceal fraud only after an attempt to sell the company itself. Looking at the issue from this perspective, it is interesting to consider (Baer, 2008) what can lead manipulators to stop their conduct if not yet discovered: shifting the blame to other people may represent one of the few conditions leading the manipulator to leave the game, but it is very difficult to investigate such problems, as far as undetected frauds are concerned. For instance, Summers and Sweeney (1998) tried to control for undetected frauds by screening the litigation history of their sample, but their method implies the assumption that sooner or later any fraud will be detected. In a more recent paper, Wang (2011) proposes the use of an econometric model in order to separate out from the probability of fraud the two component probabilities of committing and detecting fraud: her analysis shows how such components can be affected by different variables and how they can interact. In particular, she suggests that acquisitions are correlated to fraud because of the high visibility of these transactions, despite the fact that active acquirers are actually less likely to commit fraud than the average, as they are more likely to be discovered. The correlation between the presence of investments implying higher volatility in their results and a higher probability of producing financial misstatements is also very interesting because in this cases fraud detection is less likely: the “veil” created by business uncertainty can foster fraudulent behaviour by exposing
companies to both more frequent performance shocks and higher financial needs, but also allowing managers to appeal to volatility as a justification for any alteration in expected or assessed performances.

The focus on the mechanisms of governance and fraud deterrence has been criticized in the literature as not taking into account the role of executives’ personal features such as overconfidence in their choices and the imperative to “correct” poor performances that could threaten their jobs (Schrand & Zechman, 2011). This kind of argument is particularly relevant in the case under scrutiny, given the renowned aggressive managerial style of Al Dunlap, the CEO who was chief of Sunbeam during the fraud period: the CEO’s personal conduct emerges as a first peculiar characteristic of the case, influencing its exceptionality.

The importance of personal attitudes appears significant also in relation with the differential effects on market performances that were observed where management integrity was concerned, in comparison with those connected to technical accounting issues (Palmrose, Richardson & Scholz, 2004). As shown below, one argument put forward by the fired CEO after the Sunbeam fraud disclosure was precisely that concerning the technical nature of the misstatement, in an unsuccessful attempt to avoid being made the sole guilty party in the fraud.

However, what is more interesting in this case is the “survival strategy” adopted by the company immediately after the fraud disclosure. This strategy, following the analysis proposed by Sutton and Callahan (1987), could be identified as a mix of denying and (partially) accepting responsibility for the fraud, resulting in the immediate dismissal and scapegoating of the CEO, who was finally banned from serving as an officer or a director of a public company. This outcome is indeed exceptional if compared with the usual effects of the disclosure of accounting fraud on fraudulent managers, for whom it is usually very unlikely to receive legal sanctions (Velikonja, 2011), but who suffer from negative effects on their reputation (Karpoff, Lee & Martin, 2008).

2.2 Managerial scapegoating and creative auditing.

The fact that the CEO alone was scapegoated for the emerging fraud represents another instance of the exceptionality of the case. As the auditing literature shows clearly, auditors are in fact usually scapegoated after fraud disclosure: in the case of Sunbeam Corp. there was a shift from the auditors to the CEO of the scapegoat function, as we will discuss in detail below.
It is important to emphasize the inherent ambiguity of the scapegoat role: in the case of Sunbeam Corp., the CEO himself was first identified as the major intangible asset of the company and then as the major threat to its survival. According to René Girard (1972; 2005), indeed, the all-against-all struggle characterizing a crisis turns into a fight of all against one (i.e. the scapegoat) who comes to be seen as the only party responsible for the turmoil through a process of *mythification*. Terrified and angry, the actors want to identify the cause of the crisis. Naturally, rather than blaming themselves, they are inclined to suspect others: mutual distrust and accusations spread throughout the entire group. The selection of the surrogate victim is rarely totally random. In most cases, the chosen scapegoat possesses certain victimizing signs, i.e. signs making him an actor somehow departing from normality within the group. The focus on the auditing function (Guénin-Paracini & Gendron, 2010) as warranting the credibility of capital markets, even becoming the sacrificial victims of corporate scandals, is perfectly justified where the general evolution of fraud cases and legislative measures in the last few decades is concerned, as shown in the following paragraphs.

However, this was not the case of Sunbeam, where the auditors’ peculiar behaviour and work made it possible to recognize the scapegoat in the CEO: he was rapidly fired in order to help the company recover. We cannot avoid noticing that this reversal in the CEO’s reputation was mirrored by a parallel boom and bust of Sunbeam’s share value, which followed the typical trend of speculative bubbles. It is from this point of view that Girard’s (1978; 1987) first explanation about the origin of the scapegoating mechanism turns out to have more than expected to tell us about the relation between accounting fraud and business failure. In fact, in Girard’s archetypal story, it is the *mimesis* (imitation) mechanism that explains the desire to possess things that others possess, the struggle of all against all and the identification of a scapegoat to be sacrificed, in a progressive shift of the same focus of imitation from the act of appropriation to the object of appropriation (mimetic desire), and from the act of fighting (generalized conflict) to the object of fighting (the scapegoat as everybody’s enemy). In this perspective, it is worth recalling that imitation is also the main mechanism explaining speculative bubbles: investors imitate other investors creating waves of optimism and pessimism that explain volatility (Corcos, Eckmann, Malaspinas, Malevergne & Sornette, 2002). This imitation mechanism can also explain the abrupt change in the value the market assigned to the CEO of Sunbeam Corp., transforming him from a major asset into a major threat for the company and making him into a perfect scapegoat in order to exit from a difficult situation. It is then possible to say that in this case market trends clearly reproduced the logics behind Girard’s scapegoating mechanism.
On the other hand, we should recall that in the Sunbeam case the auditors were able to escape their fate as privileged scapegoats by means of their peculiar behaviour, which is worth analysing in more depth as its interpretation requires the introduction of a new theoretical concept, i.e. the category of “creative auditing”. Let us explain this in detail.

After famous accounting scandals occurred and influenced the world economy, the concept of creative accounting has emerged as a set of legal and illegal aspects due to the flexibility of accounting policy. Several definitions of it have been provided. Omurgonulsen and Omurgonulsen (2009) summarize them: creative accounting represents both a process whereby managers use their knowledge of accounting rules to manipulate the figures reported in the accounts of a business and a set of undesirable practices which prevent people seeing the true and fair financial state of a company. Managers prefer to use creative accounting practices to manipulate profit to tie into forecasts and to distract attention from the news, which would not be welcome. Thus, creative accounting can be framed and related to the “agency theory” (Amat, Blake & Dowds, 1998): the information asymmetry between principals (owners or shareholders) and agents (managers), the opportunistic behavior of agents and the inability of principals to control the desired action of agents provide a theoretical framework to understand such cases (Arnold & de Lange, 2004). The framework of the “principal–agent relationship” emphasizes also one of the most frequent possible causes of creative accounting: this practice sometimes occurs due to pressure from top management (Leib, 2002). In any case, the first and most relevant feature of creative accounting is represented by its legacy: it is totally legitimate (Griffiths, 1986). Starting from this consideration, the concept of creative accounting has been isolated from other practices. In fact, an important differentiation (Jones, 2011) must be made between a fair presentation, where the flexibility within accounting is used to give a true and fair picture of the accounts so that they serve the interests of users; creative accounting, where the flexibility within accounting is used to manage the measurement and presentation of the accounts so that they serve the interests of preparers; and fraud, which consists in deliberately stepping outside the regulatory framework to give a false picture of the accounts. In this perspective, only the latter represents fraudulent financial reporting, which has been defined as “an intentional misstatement of financial statements” (Arens, Beasley & Elder, 2003): the three practices (i.e. not-tort, creative accounting and fraud) represent three possible different levels of use and misuse of accounting by managers.

The same distinction among different practices has not yet been introduced in the literature for the auditing process. In the literature on fraud detection, accounting and auditing have indeed followed different paths. However, even though they are separated from a temporal point of view,
they are quite similar with regard to other aspects. In fact, a fruitful area of prior research has been related to the tools and techniques to improve fraud detection such as ratio analysis, checklists, analytical procedures, regression analysis, digital analysis, and neural networks, which were applied first to the accounting and then to the auditing process (Hogan, Rezaee, Riley & Velury, 2008). Moreover, there is a significant amount of literature on the causes and features of fraud processes: pressures to meet analysts’ forecasts, rapid growth, compensation incentives, stock options, the need for financing, and poor performances all increase the likelihood of fraudulent financial reporting (Bell & Carcello, 2000; Rezaee, 2005; Erickson, Hanlon & Maydew, 2006). The correct and incorrect accounting practices (i.e. not-tort, creative accounting and fraud) implemented by managers for such reasons may find a correspondence in the practices used by auditors, with the same escalation from good to bad methods. However, those categories have not been used to interpret the auditing process in the main streams of literature that deal with it: let us briefly analyse this literature.

First, several contributions start from the point that external auditors both may and should play a role in reducing the opportunities to manipulate earnings or commit fraud (Becker, Defond, Jiambalvo & Subramanyam, 1998; Francis & Krishnan, 1999; Iyer & Rama, 2004; Myers, Myers & Omer, 2003; Carcello & Nagy, 2004). This is related to the definition of auditing itself (Arens et al., 2003), which is “a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users” (American Accounting Association, 1973). According to this definition, several authors emphasize the importance of auditing in implementing fraud detection. Chen, Kelly and Salterio (2012) examine whether different audit procedures and attitudes conveyed to management are useful to deter aggressive earnings misstatement that may be fraudulent, and whether such different procedures and attitudes have an influence on managers’ perceptions about the ethicality of any earnings manipulation. So, audits are claimed not only to enhance the detection of fraud but also its deterrence or prevention (US Treasury Department, 2008). The longstanding claim about financial auditing as a fraud deterrence mechanism (Mautz & Sharaf, 1961; Wells, 2004) is based more on logical reasoning than on empirical evidence (Schneider & Wilner, 1990): management reports more honestly because its actions will be audited (Baiman, Evans & Noel, 1987). Fraud deterrence should logically increase when managers perceive that an audit increases the probability of detection, whether or not the detection probability actually increases (Decker, 2003; Scheider, 2001): they know that any perpetuated fraud has a higher chance of being discovered with auditing.
In more detail, the theory of deterrence (Chen et al., 2012) proposes three factors that affect people’s judgments about engaging in illegal or undesirable activities, i.e. the certainty, severity, and swiftness of punishment. When people perceive an increase in the certainty of being caught in an illegal or socially undesirable act that results in severe and quick punishment, the cost of committing the act increases, reducing the act’s expected utility and the likelihood that people will commit the act in the first place: according to the deterrence theory, managers would be deterred from potentially fraudulent activities if they perceive an increased probability of punishment when they observe changes in auditors’ actions and activities. Moreover, detection and deterrence are intimately interwoven, as an increase in the detection ability of the auditor, if it becomes widely known, should also lead to an increase in the deterrence ability of an audit. In this role, auditors’ activity has been supported also by standard-setters. In fact, in an attempt to prevent fraud, the Auditing Standards Board (2002) issued the Statement on auditing standards 99 (SAS 99), which introduced a “fraud triangle”. The fraud triangle indicates that the probability of committing fraud is higher in situations where a) management or other employees have incentives to fraud or are under financial pressure, b) there exist conditions that provide opportunities for management or employees to commit fraud, and c) there exist ethical values or characteristics that cause management or employees to rationalize the fraudulent act. Peecher, Schwartz, and Solomon (2007) advocate that auditors triangulate audit evidence from both internal and external sources to identify inconsistencies that could improve the auditor’s ability to detect intentional misstatements.

On the other hand, some studies have emphasized that external auditors may be involved in managers’ fraud plans. This has been related to a decrease in the quality of the audit: the value of external audits derives from users’ expectations that auditors will detect and reveal any material omissions or misstatements of financial information. In fact, the audit “quality” is defined in terms of the level of assurances, i.e. the probability that financial statements contain no material omissions or misstatements. This definition is consistent with both DeAngelo’s (1981) definition of audit quality and with the professional literature that defines audit quality in terms of audit risk, with higher quality services reflecting lower audit risk. Raiborn and Schorg (2004) describe the growing distrust in the auditing profession as “a cancer that is metastasizing” because of famous scandals: for instance, Arthur Andersen, the external auditor of Enron, was charged with obstruction of justice related to the destruction of Enron documents (Berkowitz, 2002). Consequently, auditors, who were once held in high esteem, have now started to be viewed as ineffective and complacent (Beasley and Hermanson, 2004). The main causes of these audit failures are recognized in the audit expectation gap and in the lack of the independence requirement. An abundant literature focuses on
the first emphasized cause, i.e. the audit expectation gap. Auditing is the act of attesting to the veracity of something, an evidentiary process analogous to the legal process of gathering evidence to establish the “facts of the case”: the audit function plausibly can provide only assurance that financial data correspond to certain specified events that have actually occurred. There is a gap between the beliefs and the preferences of the auditors with respect to those of the users of accounting reports (Baron, Douglas, Johnson, Searfoss & Smith, 1977; Salehi, 2011): the latter assign to auditors a greater responsibility in discovering accounting manipulation and illegal acts than the extent to which auditors feel themselves responsible for such a task.

Recent regulations have tried to reduce both this gap and the second emphasized cause of audit failure, that is the lack of independence, by introducing some restrictions affecting the decision to outsource the internal audit function (such as the Sarbanes–Oxley Act in the USA) to external audit firms: after the notorious scandals, a fundamental change in the way audits are performed was then needed to win back the public’s trust (Tackett, Wolf & Claypool, 2004). However, some inquiries on the quality of auditing during the recent financial crisis show that problems are far from being solved (Sikka, 2009), and other studies cast doubt on the likelihood that the stricter internal controls imposed by recent regulations will be effective, if the “dramaturgical exchanges between the SEC and corporate regulatees” will go on as they did in the past (Shapiro & Matson, 2008, p. 224). Many studies have emphasized the importance of the programs for fraud prevention/detection education and training programs to educate auditing professionals for fraud prevention/detection: Aliabadi, Chen and Dorestani (2011) reveal that those who commit fraud are not necessarily geniuses or have creative minds because they just copy fraud schemes from the past. Therefore, there should be more emphasis on past mistakes, as we have already highlighted in the introduction.

Unlike both the previous streams of literature, Guénin-Paracini and Gendron (2010), whose work has already been mentioned above, emphasize the paradoxical nature of the legitimacy surrounding the financial audit function in society. On the one hand, scandals surrounding fraudulent financial statements typically result in a litigation against specific auditors while generating reproaches targeted at the whole profession. On the other hand, in spite of lawsuits and criticism, the influence of auditing as a technical means of control invariably continues to gain strength, and the auditors’ moral legitimacy eventually is always restored in the eyes of most stakeholders. In other words, the authors contend that auditors can be thought of as modern
pharmakoi, constituting a reservoir of victims to sacrifice whenever the occurrence of some fraudulent financial statements threatens the stability of the economic order.

Auditors have been scapegoated in the aftermath of a number of financial scandals, and the process of their moral condemnation indeed bears some resemblance to the sacrificial rituals as described and interpreted by Girard. However, in contending that auditors are modern pharmakoi, Guénin-Paracini and Gendron (2010) do not state that auditors are systematically designated as scapegoats in the aftermath of all financial crises, but only in a certain number of them. Starting from their work, this paper aims to provide an explanation for some different fraud processes where auditors are neither watchdogs nor victims nor legally guilty and to introduce the concept of “creative auditing”. This represents one of the main focuses of this work, which is the first comprehensive attempt, as far as we are aware, to identify another possible way of auditing, i.e. creative auditing. It may be framed and related to the agency theory, as creative accounting was: auditors (agents) may use their professional knowledge, asymmetrical information and the flexibility inside auditing rules to distract the principals’ attention (owners, shareholders, investors, etc.) from news which will not be welcome. In fact, according to the agency theory, information asymmetry occurs where agents (auditors) enjoy a competitive advantage over principals (e.g. owners, investors, etc.) because of the information they have from within the company. This results in the principal’s inability to control the desired action of the agent (Godfrey, Hodgson & Holmes, 2003). Information within an organization is critical, and auditors working with the management of a company are privy to essential information that can be used in a legal, but not proper way, to maximize their own interests at the expense of the principal. This situation is worsened by the shareholders’ (i.e. the principals’) role in public companies: they “are an amorphous group and their ability to exert influence on their agents is diffuse and often indirect” (Brown, 2007, p. 181). For such reasons, the possibility of collusion (Tirole, 1986; Strausz, 1997; Olsen & Torsvik, 1998) arises between auditors and managers, as emphasized in some works: “Prior to scandal, many assumed that either legal liability or reputational concerns would prevent the large audit firms from engaging in collusion with their clients. Enron and the many frauds that followed have undermined these assumptions” (Brown, 2007, p. 178).

Starting from these premises, in the following paragraphs we will develop the concept of creative auditing as a tool to interpret and understand the peculiar role auditors were able to play in Sunbeam Corp. (in relationship with both managers and shareholders). We will also tentatively define the regulatory context where cases of creative auditing could emerge more frequently, in this
way historically situating our theoretical effort and paving the way for further inquiries on the matter.

3) MICRO-ANALYSIS OF THE DEVIANT CASE: A THICK DESCRIPTION OF THE EVENTS.

Sunbeam Corp. has surely represented a case of accounting fraud. Many analysts were initially persuaded that Albert Dunlap had improved the economic and financial situation of the company: Sunbeam’s stock soared nearly 50 per cent the day Dunlap was hired to run the company in 1996 and he became a sort of corporate star in the US Although Sunbeam’s fortunes initially seemed to improve under Dunlap, as the company took a huge write-off in 1996 when it closed plants and laid off employees, its reported profits soared in 1997: at that point, Dunlap and Russell A. Kersh (a longtime close associate of the Sunbeam’s chief financial officer) orchestrated a fraudulent scheme to create the illusion of a successful restructuring of Sunbeam and facilitate the sale of the company at an inflated price.

The first point emphasized by the SEC concerns “the illusion of a successful restructuring of Sunbeam in order to inflate its stock price and thus improve its value as an acquisition target”: the SEC complaint against Sunbeam states that “at least $62 million of Sunbeam’s reported income of $189 million came from accounting fraud” (SEC, 2001a). Among the many different fraudulent accounting techniques used by Sunbeam from October 1996 to June 1998, the SEC focused on “the improper recording of bill and hold sales”. Following the summary provided by Ryerson (2008, p. 149), these typically consist of anticipated purchase orders (“bills”) implying that the seller “holds” the product until the buyer eventually needs it, and they should be recorded as sales only when “the risk of ownership” is “passed to the buyer”, this being “one critical criterion for the proper recognition” of a transaction. Improperly recorded “bill and hold” sales were inflating Sunbeam’s 1997 income by $62 million, and by a further $35 million the income of the first quarter of 1998. As emphasized by the SEC in the above cited Release no. 1393, Al Dunlap’s claimed reorganization was also based on several other improper practices such as the “cookie jar” reserves to create improper profits in 1997 and the “channel stuffing” (i.e. putting inventory onto the books of distributors and retailers) to reduce the value of inventory and to record large profits when the goods were sold. Other irregularities regarded the discount policy which was used in order to push sales and to convince customers to buy goods that they did not really need. According to the SEC, those discounts should have been emphasized in the company’s reports.
The second point emphasized by the above cited SEC (2001a; 2001b) concerns Dunlap’s strategy to sell the company. As analyzed by several authors, starting from Laing (1998) and up to Hill (1999, p. 1104), this strategy went wrong because Dunlap’s celebrity pushed Sunbeam stock to premium levels, making it too expensive for most acquirers and making the sale of the company itself impossible. Before that, Dunlap’s corporate sale strategy was profitably applied to Scott Paper Co.: the CEO, also known as “Rambo in Pinstripes” for his cost-slashing and restructuring techniques, had been around for a long time before Sunbeam (TABLE 4; Dunlap, 1996).

TABLE 2 - Highlights from Albert Dunlap’s Career (“Sunbeam dances with Mr. D.,” 1997; Stanwick & Stanwick, 2003)

<table>
<thead>
<tr>
<th>Company</th>
<th>Events</th>
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| Lily-Tulip       | - In 1983, he fired all but two of the company’s senior managers on his first day at work.  
                  |  - Cut corporate staff by one half and cut 20% of the company’s workforce.  
                  |  - He took the company public in 1985.                                    |
                  |  - Split the natural resources company into two parts. In the part he kept, he laid off approximately 20% of the company’s employees and renegotiated labor contracts to cut costs. |
| Consolidated Press Holdings | - Began work in 1991 to restructure the company.  
                              |  - Sold most of the holding company’s businesses and revoked company perks. |
| Scott Paper      | - In April 1993, he laid off one-third of the company’s workforce.  
                  |  - In July 1995, a weakened Scott Paper was sold to Kimberly Clark for around $7 billion. |
| Sunbeam          | - Shortly after taking over, he replaced most of the senior management.  
                  |  - Three months after taking over, he announced 6,000 employees would be laid off. |

Let us then recall how the events at Sunbeam developed in succession. In the early 1990s the company had some problems due to bad performances and to the lost lawsuit against a former CEO who was fired in 1992. In June 1996, the main shareholders were two private funds: Franklin Mutual Advisers, a subsidiary of Franklin Resources Inc., with 22% of Sunbeam’s stock, and Steinhardt Partners with 21%, each with a seat on the board of directors. However, in September, a few months after Dunlap was hired, Steinhardt exited the board following on the decision taken at the end of 1995 to close the hedge fund and return the stock to investors: Franklin Mutual remained then the main shareholder, with Peter Langerman as its representative on the board (Browning & De Lisser, 1996; Hill, 1999, p. 1101). So, when Al Dunlap became Sunbeam Corp’s CEO in July 1996, there was the owners’ hope that this appointment would represent a turnaround for the company.
The new CEO implemented, from the outset, the same strategy he had already successfully applied when he headed other companies such as Scott Paper Co.: massive cuts to product lines, plants and employees (Lublin & Brannigan, 1996).

The new CEO enjoyed full powers: of the five board members, four were chosen by Dunlap himself (the fifth was Michael Price, as the main shareholder). Moreover, in the following year half of Sunbeam’s 12,000 jobs were eliminated, approximately 90% of the products were discontinued, and 18 of the 26 plants were closed (“Sunbeam dances with Mr. D.,” 1997). The implementation of these same actions excited analysts’ expectations for higher profits, pushing the stock to over $45 per share in September 1997: at this point, Dunlap thought he was ready to sell Sunbeam (as he did for Scott Paper Co.), but the sale could not be concluded despite the attempts of Sunbeam’s investment bankers, who approached several companies, including Gillette, Black and Decker, Rubbermaid, Maytag and Whirlpool. The unsuccessful sale was due to the price itself that Sunbeam’s stock was traded at: when Dunlap took over Sunbeam in July 1996, the company’s stock was trading at $12.50. A temporary downfall followed the announcement that Sunbeam was for sale, culminating in January 1998, when the reported level of earnings in the fourth quarter of 1997 (47 cents per share) fell barely short of the expectations of Wall Street analysts (48 cents): however, even with the stock trading under $38 per share, no other company seemed interested in acquiring Sunbeam (see Fig. 2).

Following Sunbeam’s investment bankers’ failure in finding a buyer, Dunlap decided then to use his company’s inflated stock to acquire other companies: in early March 1998, Sunbeam declared it planned to buy three other companies, i.e. Coleman, Signature Brands and First Alert (Kadlec, 1998). In the following days the stock price plunged again to close to $50 per share. On March 30, 1998, the company, through a wholly-owned subsidiary, acquired approximately 81% of the total number of the outstanding shares of common stock of the Coleman Company, Inc. (“Coleman”), from a subsidiary of MacAndrews and Forbes Holdings, Inc. (“M&F”), in exchange for 14,099,749 shares of Sunbeam’s common stock and approximately $160 million in cash as well as the assumption of $1,016 million in debt. Coleman was a leading manufacturer and marketer of consumer products for the worldwide outdoor recreation market. Its products had been sold domestically under the Coleman brand name since the 1920s. The acquisition by means of share exchange meant that Ronald O. Perelman, Coleman’s former majority shareholder, became with 14% of the stock the second largest shareholder of Sunbeam itself after Michael Price, who still owned 17% and remained the only representative of shareholders on the board, as Perelman did not take a seat (Pollock & Brannigan, 1998). On April 3, 1998, Sunbeam completed also the cash
acquisitions of First Alert, Inc. (“First Alert”), a leading manufacturer of smoke and carbon monoxide detectors, and Signature Brands USA, Inc. (“Signature Brands”), a leading manufacturer of a comprehensive line of consumer and professional products. The First Alert and the Signature Brands acquisitions were valued at approximately $178 million and $253 million, respectively, including the assumption of debt. All the above acquisitions were accounted for in the budget by using the purchase method and the results of the operations of the acquired entities were included in the company’s Consolidated Statement of Operations starting from their respective acquisition dates. In connection with the purchases of the three companies, Al Dunlap obtained new contracts for himself and for Kersh too: in this way, Dunlap and Kersh doubled their salaries and beneficially owned, respectively, 5% and 1% of the company. So, under these new agreements, they had even greater incentives “to raise the price of Sunbeam’s stock and sell the Company to cash in all of these holdings” (SEC vs. Dunlap et al., p. 41).

Fig. 2 - Sunbeam’s stock scheme.
In April 1998, after the acquisition of the three above-mentioned companies and a first warning of a slowdown in quarterly sales, “Sunbeam began to publicly unravel” (Byrne, 1999a), and a wholly different story came to light. As it emerged when Sunbeam restated its financial results, the company’s CFO Russell Kersh moved $21,500,000 from reserves into income and shifted part of operating expenses into a 1996 restructuring charge in order to hide the reduction in profits due to the hard discounts, credit extensions and “bill-and-hold” contracts used in order to inflate revenues with sales that should not have already been wholly counted in (US General Accounting Office [GAO], 2002, p. 202; Canedy, 1998). The story of the growing difficulties for Sunbeam in keeping up with market expectations and with the announcements of the CEO himself has been narratively reconstructed by John A. Byrne (1999b) in a book based on hundreds of interviews with Sunbeam executives, managers, employees and directors and with Wall Street analysts and investors. Dunlap was indeed setting unattainable goals, such as doubling sales in three years, or increasing operating margins to 20% from 2.5%. According to Sunbeam’s employees, “almost all executives believed these goals were impractical”, and, however, they did not refuse their wages (Byrne, 1999a). Indeed, the employees’ testimonies and complaints collected by Byrne reveal that Dunlap was not only urging his subordinates, from top executives to middle managers, to do whatever they could to reach almost impossible targets on pain of dismissal, but also that he was offering them much larger rewards in stock options than any other company if they met the goal. So they found themselves trying any trick to increase returns and sales, delaying payments and forcing customers to buy more than they needed by means of discounts and credit extensions that were not in the reports.

Nevertheless, it should be noted that some analysts were able to detect from the early reports that something was wrong: following Byrne’s account, the increase in inventory and the parallel decrease in cash on hand from the first to the second quarter of 1997 alerted at least William H. Steele of the San Francisco-based Buckingham Research Group, who downgraded Sunbeam’s stock from “buy” to “neutral” in July 1997 (Byrne, 1999b, p. 152). However, the persistent optimism of the company’s forecasts convinced most analysts and investors that Sunbeam was going to attain its targets despite everything: this happened mainly because they were convinced, as even Andrew Shore of PaineWebber Inc. said in October 1997, that “Sunbeam possesses an intangible asset, the Dunlap factor” (Byrne, 1999a).

When, by June 1998, the stock had fallen to around $22 per share, following the stumbling of profits, an analyst of Barron’s Online (Laing, 1998) was the first to investigate in detail the reasons for such a sudden drop: Laing’s article disclosed that Sunbeam had realized a negative
operating cash flow in 1997 and insinuated that the company implemented questionable accounting practices (Norris, 2001a).

Although several analysts still continued to believe in Sunbeam and its CEO, the company soon made a radical choice: the first decision (8 days after Barron’s discrediting article) regarded Al Dunlap’s forced resignation because of both such “public” claims and employees’ assertions about Dunlap’s way of working. By June 1998, the company’s directors had fired “Chainsaw Al”, commenting that they had “lost confidence” in his leadership abilities (Mahabaj, 1998). Together with Dunlap, also Kersh and the outside director William T. Rutter resigned from the board. Franklin Mutual Advisers, as the main shareholder, appointed its representative, Peter Langerman, as chairman of the board, and Lawrence Sondike as an additional director. Following the influential suggestion of Ronald Perelman, the board then appointed Jerry W. Levin, the former CEO of Coleman, as Dunlap’s successor at Sunbeam in an attempt to salvage of the company. Levin immediately announced that a restatement of the 1997 results was forthcoming, and started working for a recovery of the company (“Sunbeam warns of financial review,” 1998).

Perelman was not on the board of directors, but he was one of the main shareholders and he was able to influence the choice of the new CEO. At the same time, he threatened the other shareholders and the board that he would sue Sunbeam for the losses resulting from the Coleman deal: this would have forced Levin to resign in order to avoid a conflict of interests, and pushed the company into bankruptcy. In the meanwhile, in fact, the announcement that the SEC had started a thorough investigation immediately after Dunlap’s dismissal had caused the company’s share price to plummet to $10.4375. By July 14, 1998, the SEC had upgraded its investigation of Sunbeam to a formal one (“SEC upgrades Sunbeam probe,” 1998). The investigation would centre around premature recording of the sales of barbecue grills.

In August, the board finally agreed to grant Perelman, in compensation for his losses, “warrants to buy 23 million shares of Sunbeam stock at $7 per share, which could raise his stake in the company to 28%,” (Hill, 1999, p. 1133) thus virtually allowing him to take the control of the company (Pollock & Brannigan, 1998). At this point, the company announced it had began to recover from “Chainsaw Al” and Levin said they had no intention of going bankrupt (Connor, 1998). Finally, on October 20, 1998, Sunbeam announced its long-awaited restated results: the restatement regarded the results from the last quarter of 1996 through the first quarter of 1998. Sunbeam’s 1997 net income was decreased by $ 71 million and 1997 operating expenses were mostly attributed to the previous year (GAO, 2002, p. 201). Al Dunlap argued that this restatement
concerned “technical accounting issues” (Canedy, 1998; Stanwick and Stanwick, 2003), which had been (or should have been) revised and approved by Sunbeam’s external auditors.

This announcement raised some questions also about external auditors’ position: on December 1, 1998, several months after Dunlap’s discharge, Sunbeam dismissed Arthur Andersen and named Deloitte & Touche as its new outside auditors (Eichenwald, 1998). In most of the fraud cases, auditors declared that they had no knowledge of the improper accounting practices used by the company. The Sunbeam case is different because Phillip E. Harlow, the Arthur Andersen partner in charge of the Sunbeam audit, discovered some of the fraudulent transactions and asked the company to change its financial statements.

In particular, Harlow focused on a specific fraudulent method of creating fake profits, the so-called spare-parts gambit: Sunbeam owned a lot of spare parts, used to fix its blenders and grills when they broke. Those parts were stored in the warehouse of a company called EPI Printers, which sent the parts out as needed. The improper method consisted in selling the parts for $11 million to EPI and booking an $8 million profit. Unfortunately, EPI thought the parts were worth $2 million. But Sunbeam found a way around that. EPI was persuaded to sign an “agreement to agree” to buy the parts for $11 million, with a clause letting EPI walk away in January. In fact, the parts were never sold, but the profit was posted. Harlow claimed to have effectively discovered that and concluded the profit was not allowed under generally accepted accounting rules, but the company’s management refused to make most of the requested changes: Sunbeam agreed to cut it by just $3 million. After that, before deciding to sign, Mr. Harlow analysed Sunbeam financial statements thoroughly and understood that the remaining profit was not material: this was the same as saying that the part, which was not presented fairly, was not material, so it did not matter.

As emphasized by Norris (2001b), after the Sunbeam fraud disclosure, Harlow was supported by his partner (Arthur Andersen), who stated this case involved not fraud, but “professional disagreements about the application of sophisticated accounting standards”: “in the typical accounting fraud case, the auditors say they were fooled. Here, at least according to the SEC, the auditors discovered a substantial part of what the commission calls sham profits”. We may say that stating the immateriality of a part of improper profits, they used their professional knowledge, the asymmetrical access to information and the flexibility inside auditing rules to distract other stakeholders’ attention from news which would not be welcome. For these reasons, we may affirm that Sunbeam represents a case of creative auditing implementation. In fact, after Dunlap was fired, Arthur Andersen (Harlow’s partner), along with another accounting firm, re-
audited the books and concluded that the 1997 profits should have been far lower, but also that Sunbeam’s external auditors acted better than the typical auditor in the typical accounting fraud.

Sunbeam’s 840 days path from fraud disclosure to bankruptcy (it filed for Chapter 11 bankruptcy protection on February 6, 2001 – “Sunbeam files for bankruptcy,” 2001) was rapidly followed by the company’s announcement in 2002 that it had emerged from Chapter 11 bankruptcy protection. This announcement came with a name change for the company, from Sunbeam Corporation to American Household Inc. (“Sunbeam emerges from bankruptcy,” 2002). So, the strange fraud path of Sunbeam seemed to have just one bad cause, whose elimination made it possible to wait for so long before bankruptcy and a fast exit from it. In fact, only Al Dunlap was banned from ever serving as an officer or director of a public company because of his actions as Sunbeam’s CEO. He paid $500,000 to settle SEC charges and $15 million to settle a class-action suit filed by investors (Brannigan, 2002; Norris, 2002).

The rapid recovery of the company actually allows some considerations on its actual situation at the moment when Dunlap was fired: the collapse in the stock price depended more from the uncertainty on the real situation of the company following the fraud disclosure than from an actual discovery of a bankruptcy situation. We may say that what pushed the management to commit fraud was in this case the gap between the actual performance and the exaggerated expectations of the market, which the managers themselves were stirring in order to boost the value of their stock options.

Dunlap’s worst mistake, at a management and corporate governance level, seems to have been his tendency to surround himself with a few loyal executives from prior ventures: after arriving at Sunbeam, Dunlap replaced almost all of top management with his own selections (appointed as formally “independent” members of the board), who were also provided with strong financial incentives to improve the company's stock price; and he quickly replaced all Sunbeam board members except the major shareholder (Franklin Mutual, represented by Peter Langerman). As the SEC complaint against him and other directors and managers of the company highlighted, “throughout his tenure, Dunlap exercised complete, unfettered authority over all aspects of Sunbeam’s business and staffing” (SEC vs. Dunlap et al., p. 8). Several authors have emphasized his sudden passage from corporate star to criminal, from Sunbeam’s best intangible asset to its worst liability. A business column, at the time of Sunbeam’s fraud disclosure and referring to Dunlap, headlined: “He anointed himself America’s best CEO. But Al Dunlap drove Sunbeam into the ground” (Byrne, 1999a). Dunlap suddenly shifted from being almost canonized as a “miracle worker” by corporate America for his use of the “chainsaw” to downsize and make companies
profitable and appealing for a buyer (Stewart, 1998), to being blamed as the sole culprit of Sunbeam’s fraud because of his tendency to intimidate his managers by pushing them to “make up” their numbers, as even Sunbeam top executives, when interviewed by Byrne (1999), were ready to declare.

4) PUTTING THE CASE TO WORK, OR FROM THE CASE BACK TO THE SAMPLE

In this section, a basic question will be addressed: what does this case, which the SEC investigated in depth and this paper analyses in detail, say about more general problems concerning the relationship between fraud and failure path? The reply can start by building up a complex but clear model in order to emphasize the factors (and their interactions) which can explain why Sunbeam emerged as an outlier (from the sample concerning fraudulent US companies), employing a such long time from fraud disclosure to bankruptcy. These factors and their relations are usually discussed in the literature one by one and in terms of statistical correlations emerging from the empirical study of large databases. This approach is necessary in order to test the general validity of the causal theories of the researchers, but it is not sufficient (Parker, 2012) to understand how different factors could be inter-connected. The approach used here, based on the micro-analysis of a case, could instead provide interesting insights on how different factors could interfere with each other, and how different lines of empirical research could then successfully be connected together in order to reach a better understanding of fraud and failure mechanisms. Finally, since the case under consideration was selected as an outlier in a statistical distribution, it is interesting to consider what it could say by contrast about the average corporate fraudulent conduct: if it was an exception because of some factors, it means that usually this combination of factors is not present.

Why was the Sunbeam story so exceptional? The narrative above suggests three main elements to focus on: the over-manipulation of accounting information, the role of mergers and acquisitions and “creative auditing” (a concept here introduced for the first time). The role of other possible factors was considered relevant but not specific to Sunbeam, following the detailed triangulation we performed by comparing the SEC report we used as the main narrative thread above and the other sources we referred to in detail.

The first element (i.e. over-manipulation of accounting) concerns the fact that evidently Dunlap over-boosted company performance that were not so bad, as the rapid recovery of the company from a relatively painless macro-failure proves. Putting this elements into the framework of the relation between fraud and bankruptcy, we may say that the micro-failure pushing the
manager to commit fraud was perhaps not so relevant in this case, the motivation for the manipulation of accounts being rather the gap with exaggerated expectations.

It should also be emphasized that Dunlap exaggerated and made pervasive some “boosting” practices that were usual in any business, taking creative accounting “to another level” (i.e. accounting fraud). This point has some interesting implications concerning the general diffusion of creative accounting practices and undisclosed fraud, already partially discussed in the literature mentioned in the second section. The exceptional overstatement of Sunbeam’s performance finds in part its origin in a peculiar phenomenon of short circuiting between the higher-than-usual amount of stock options entering managers’ executive pay and the effects that overstatement soon started exerting on the stock price, providing top and middle managers with stronger and stronger incentives to boost reported performances at any level of the company’s accounting process, following the inputs coming from the CEO. This mechanism is in line with theoretical models (Bar-Gill & Bebchuk, 2002; Goldman & Slezak, 2006) asserting that a connection exists between performance-based compensation and misreporting practices (Erickson et al., 2006). However, more interesting than the (general) causes of the exaggerated overstatement of Sunbeam’s performance are its (peculiar) effects: the increase in the stock price was so high that it finally prevented Dunlap from selling the company. This point raises a theoretical problem: what does it mean to say that the price of a company stock exceeded the threshold for selling the company itself? A stock is after all “a piece” of a company, isn’t it? Following the account of the events as reported above, this paradox may be interpreted as the result of an inverted premium for control: an eventual buyer would discount the fact that the company, once acquired, would lose its best non-replicable “intangible asset”, the CEO himself. The question may also regard whether buyers really believed in Sunbeam’s performances, but providing an answer would be difficult; certainly they did not believe those performances were replicable.

The failed sale of the company has even another implication, concerning the reasons behind it. The sale should have represented the final step of the process of business reorganization started by Dunlap and the realization of the value created in that process, but it would then have represented also a crucial step in the fraud process, making it possible to cover, under the so-called “veil of acquisition”, all the problems that might emerge from the inaccurate and inappropriate accounting practices preceding it. This finding has by contrast an important implication for the ongoing research concerning accounting fraud, information uncertainty and acquisition losses (Erickson et al., 2011; literature about disclosed and undisclosed frauds as summarized in Jones, 2011). Recent studies show that companies accused of committing accounting fraud are more prone
to acquire other companies because they use acquisition (evidently without success) as a tool to conceal the fraud itself (Erickson et al., 2011): Sunbeam was not an exception, as will be discussed below. But the analysis of the case suggests that companies committing fraud look at the acquisition of other companies only as a second-best strategy: they prefer to be acquired by other companies because this would almost certainly provide a successful concealment of the fraudulent accounting behaviour preceding the acquisition. Let’s say that the historical budgets of acquired companies could be an interesting source for an empirical investigation on the diffusion of undisclosed fraud.

This emphasizes the importance of the second element listed above, i.e. the role of M&A. As the sale of the company was impossible, Dunlap resorted to the second-best strategy of acquiring other companies. The expediency of this choice is explained by two factors: it provided an alternative, even if less effective, tool to conceal accounting fraud and it made it possible to use over-valued company stocks as means of exchange (instead of money) for the acquisition. This reveals another interesting short circuit in the Sunbeam story: Ron Perelman, Coleman’s former majority shareholder, accepted Sunbeam stocks as payment for his majority participation in Coleman, thus becoming the second-largest shareholder of Sunbeam itself. In fact, company performances started showing some difficulties only two months after the triple acquisition was completed, perhaps a little too early: it was evidently the unavoidable consequence of the short-term profit-boosting practices described above (i.e. channel stuffing, bill-and-hold sales and the improper transfer of reserves to incomes). The effect was a loss on the 1998 first quarter report and a consequent collapse in the stock price. Laing’s (1998) analysis for Barron’s then started to alarm the board, who fired Dunlap after a rapid inspection of the second-quarter results. Incidentally, this confirms what has recently been pointed out in some empirical studies (e.g. Dyck, Morse & Zingales, 2006): analysts represent the most effective early whistle-blowers of frauds. After Dunlap’s dismissal, Perelman acquired the position of second major shareholder: in this way he was allowed to support the appointment of Jerry Levin (i.e. the former CEO of Coleman) as the successor to Dunlap in an attempt to salvage Sunbeam. The factual explanation of Sunbeam’s exceptionally long time to failure can be found in this strategy pursued by Perelman: he tried to be repaid for the losses by acquiring control of Sunbeam and trying to pursue its recovery after Al Dunlap’s dismissal. In doing that, Perelman (and his long-time protégé Levin) played the part of the acquirers, despite the fact that Perelman acquired the company only after fraud disclosure. From this point of view, Perelman’s behaviour when coping with a disclosed fraud indirectly sheds some light on the motivations of acquirers who abstain from reporting previous fraudulent statements of the acquired entities that consequently remain undisclosed.
Was Dunlap used as a scapegoat in order to solve the difficult mess the company found itself in at that point? Without doubt he was, but this statement must be limited by defining *scapegoating* as the act of making a single person guilty for what was certainly a more complex process (Guénin-Paracini & Gendron, 2010, p. 136), even in the presence of direct responsibilities of the “scapegoat”, as was evidently the case with Dunlap. Did the scapegoating of Dunlap, as the strategy adopted by the board, and then by Perelman and Levin after the takeover of the company, explain the exceptionally long time to failure after fraud disclosure? Not on its own. In fact, as explained above, Sunbeam Corp. was selected for this case study because it emerged as an outlier from the statistical analysis of a large database, and several interacting factors that may explain its unusualness and uniqueness have been investigated in previous sections.

Creative auditing represents the third of the explanatory factors listed above, and we related it to the hypothesis that the case of Sunbeam could be one of the last remaining signs of a blind path in the evolution of auditing practices. The point here is that the auditing failure of Arthur Andersen (Sunbeam's and then Enron’s external auditor) was made public and punished only after Enron’s bankruptcy, as greatly emphasized in the business and scientific literature. It was in fact the financial scandal surrounding the collapse of Enron that caused the erosion in the reputation of its auditor, leading first to concerns about Andersen’s ability to continue in existence and ultimately to the auditing firm’s demise. We should specify that Andersen’s involvement in previous fraud cases, among which Sunbeam, caused prosecutors to consider the auditing firm a recidivist offender, and led it to commit further offences in a desperate effort to avoid sanctions by destroying Enron-related documents (Weil, Barrionuevo & Bryan-Low, 2002). Some studies suggest that Andersen’s way of working was not significantly different in quality from that of other auditing firms: for instance, Cahan, Zhang and Veenan (2011) have examined the period 1992–2001 using a sample of 11,907 Andersen client-year observations and found no overall evidence suggesting that Andersen’s audit quality was lower relative to the Big 4 in the pre-Enron period. However, we may put forward the hypothesis that the peculiar way the auditors dealt with materiality judgements in the case of Sunbeam Corp. could be ascribed to a specific “firm culture”, borrowing this concept from Carpenter, Dirsmith and Gupta (1994).

The collapse of Arthur Andersen generated a series of questions in the media and elsewhere regarding the extent to which the financial audit function is controllable (Gendron & Spira, 2009) and responsible in firms’ fraud. The report by Powers, Troubh and Winokur (2002) into the collapse of Enron for the SEC identifies the significant failure of established safeguards, including: financial accounting and reporting standards and public disclosure requirements; the role of auditors and
oversight of the audit profession; and corporate governance regulations and practice. The report indicates that, overall, many of the consequences of Enron’s failure “could and should have been avoided”. Further financial scandals resulted in a “crisis of confidence” in American capitalism that led to wide-ranging debates culminating in the Sarbanes-Oxley Act of 2002 which reformed, and considerably strengthened, the regulation of accounting, auditing and corporate governance (Raiborn & Schorg, 2004). After Enron, then, the primary purpose of a financial statement audit has been stated in a stricter way: it consists in determining if a company’s financial reports properly disclose its results. The responsibility for the preparation of such reports is attributed to the company’s management, while the task of vouching for the accuracy of such statements (i.e. the conformity with generally accepted accounting standards and the fair presentation of the company’s financial position) is attributed to its external auditors. Given such a task, the latter should detect and disclose material irregularities. This implies that external auditors “can be held liable for any losses incurred by those who relied upon the misrepresented financial statements” (Buckhoff, Higgins & Sinclair, 2010, p. 32). It happened and caused the downfall of Arthur Andersen, the external auditor for Enron and previously for Sunbeam: the latter would probably not have been an outlier in the statistical sample, from which it was selected, had the Enron fraud not drawn so much attention to the auditing function, leading Enron faster to its final macro-failure, together with its auditor, and implying such consequences in the legislation.

5) FINDINGS AND DISCUSSION

The main findings of this study are particularly interesting in the light of recent research on the effectiveness of triangulating audit evidence in detecting financial statement fraud, but two clarifications should be made. First, in emphasizing the Sunbeam manager’s role in the fraud process, the study does not argue that managers are systematically designated as scapegoats in the aftermath of all fraud processes. There is no determinism involved: the point is that managers may be scapegoated in a fraud process. Second, in popular speech, the word “scapegoat” often implies the innocence of the “scapegoated” party. Importantly, this is not the case in Girard’s theory, to which we have made reference. For Girard, the scapegoat is not necessarily innocent. He can be guilty, but he is not the only one: everybody is somewhat responsible for the crisis that the scapegoat is accused of having provoked. In other words, by describing managers as scapegoats, the study does not argue that they are immaculate.

One of the main findings regards “creative auditing”: this work is the first comprehensive attempt, as far as we are aware, at identifying this different and possible way of auditing where
agents (i.e. auditors) use their professional knowledge, asymmetrical information and the flexibility of auditing rules to distract the principals’ (i.e. owners, shareholders, investors, etc.) attention from news which would not be welcome. This results in the principals’ inability to control the desired action of the agent: information within an organization is critical, and auditors working with management of the company are privy to essential information that can be used in a legal, but not proper, way to maximize their own interests at the expense of the principal. This said, there are at least four implications to be drawn from this research, reflecting the operational research questions posed in the introductory section. First of all, the investigation of a single, statistically exceptional case, made it possible to explain the succession of the events in a way that could never be done with a larger dataset, shedding light on a whole series of complex connections between accounting manipulation, market performance, M&A choices, auditing, and the reactions to fraud disclosure. Secondly, the unusual factors explaining Sunbeam’s exceptionally long time to macro-failure make it evident that auditors do not usually distance themselves from the fraudulent practices (and are consequently condemned), and the board of directors does not immediately replace (scapegoat) the CEO discharging on her or him the whole responsibility for accounting manipulation. What is even more interesting is the fact that fraudulent managers do not usually exceed in overstating the performance and, in that case, they can succeed in selling the company before the fraud is disclosed. Therefore, a third implication concerns the fact that some elements of the case could be exceptional not because they are really unusual, but because they are part of an usually successful fraudulent strategy: Sunbeam could not avoid fraud disclosure by means of the sale of the company and the consequent concealment of manipulation thanks to the “acquisition veil” (even if, following Perelman’s takeover, the case evolved in part as if the company had been sold). This point interestingly suggests that a dataset rich in undetected cases of fraud could be found by studying the budgets of companies that have been sold. On the other hand, the acquisition of another company does not provide the same concealment effect as the sale of the company itself: the correlation between fraud and acquisitions found by Erickson et al. (2011) should then be corrected if undetected fraud cases were to be taken into account. A final implication regards the collapse of Arthur Andersen which represented a sort of “historical turning point” for auditing and generated a series of doubts about the extent to which the financial audit function is controllable (Gendron & Spira, 2009) and responsible in firms’ fraud. After Enron, the primary purpose of a financial statement audit has been stated in a stricter way (Sarbanes-Oxley Act of 2002): if properly planned and conducted, a financial statement audit should uncover material financial statement fraud. Sunbeam would have not represented an outlier in the statistical sample, from which it has been selected, if the Enron fraud had not drawn so much attention to the auditing function, implied such
legal consequences and hence increased the vigilance. In this perspective, the case analysed here is strange as it represents one of the last remainings of a blind path in the evolution of auditing practice.

This brings us to the limitations of this research. In fact, the analysis of a single case may represent a drawback of the study. As explained in the introduction, the examined case was statistically selected as an outlier from a sample of fraud cases extracted from a large database. The decision to adopt a micro-analytical approach to investigate the outlier was then taken in the hypothesis that this methodology could be the best tool to exploit what seemed to be a puzzling secondary result of the statistical analysis. Indeed, transferring a method that was devised in order to cope with the inherent idiosyncrasy of historical events to the field of accounting studies has borne strange but rich fruits. Most of the study conclusions and implications pave the way for further investigations that could assess by means of empirical quantification the scope and diffusion of the causal mechanisms discovered to be at work here. Consequently, it can be said that this work started from the results of statistical analysis, to which it now invites to return. What the micro-analysis of a case can provide is indeed the possibility to sketch a model of the complex mechanisms relating fraud and failure that is not based on the theoretical imagination of single scholars, but on the actual investigation of a piece of reality, as exceptional as it may be, or better, actually exploiting its own exceptionality: a carefully selected case can in fact become a logical term of comparison, useful to suggest new general hypotheses about the characteristics and the representativeness of the same dataset from which it was chosen.
REFERENCES


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