Case 2.4

Sunbeam: A Focus on Fraud and Inherent Risk Assessment

Synopsis

In April 1996, Sunbeam named Albert J. Dunlap as its CEO and Chairman. Formerly with Scott Paper Co., Dunlap was known as a turnaround specialist and was even nicknamed "Chainsaw Al" because of the cost-cutting measures he typically employed. Almost immediately, Dunlap began replacing nearly all of the upper management team and led the company into an aggressive corporate restructuring that included the elimination of half of its 12,000 employees and the elimination of 87 percent of Sunbeam's products.

Unfortunately, in May 1998, Sunbeam disappointed investors with its announcement that it had earned a worse-than-expected loss of $44.6 million in the first quarter of 1998.[99] CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that it would need to restate its financial statements for 1996, 1997 and 1998.[100]

Sunbeam's History[101]

The early beginnings of Sunbeam Corporation can be traced back to the Chicago Flexible Shaft Company, founded by John Stewart and Thomas Clark in 1897. Although the company did not change its name to Sunbeam until 1946, it adopted the name Sunbeam in its advertising shortly after it expanded into manufacturing electrical appliances in 1910.

Successful products in the 1930s included the Sunbeam Mixmaster, a stationary food mixer; the Sunbeam Shavemaster Shaver, the first automatic coffeemaker; and the first pop-up electric toaster. Later appliances included

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

[100] Much of this section is based on information from GAO-03-138, Appendix XVII "Sunbeam Corporation," 201.

[101] Hoovers Online.

the hair dryer (1949), humidifiers (1950), ice crushers (1950), a knife sharpener (1950), the Sunbeam Egg Cooker (1950), the Sunbeam Controlled Heat fry pan (1953), and the electric blanket (1955). The company acquired rival household appliance maker Oster in 1960.

In 1981, Sunbeam was acquired by industrial conglomerate Allegheny International, which fell into bankruptcy in 1988 due to economic difficulties in its other divisions. Michael Price, Michael Steinhardt, and Paul Kazarian bought Allegheny from its creditors in 1990 and named the company Sunbeam-Oster. Kazarian assumed the positions of CEO and Chairman. Under his leadership, the company paid off its debt, reorganized operations, and cut its workforce dramatically.[102]

The company went public in 1992. Mr. Kazarian was forced out in 1993 and replaced by Roger Schipke, a former manager of General Electric's appliance division. Kazarian was subsequently awarded $160 million in a lawsuit he filed for being forced out. The company was renamed Sunbeam in 1995. That year, the company faced stagnant product prices and other difficult industry conditions, such as the growth of discount chains. In the face of these conditions, Sunbeam introduced new product lines, made acquisitions, and invested in greater production capacity.[103] After several quarters of disappointing sales and earnings results, Schipke tendered his resignation in April 1996. The company named Albert J. Dunlap, chief of Scott Paper Co., as Schipke's successor.

Sunbeam in 1996

Sunbeam Corporation had five major product lines in its domestic operations: household appliances, health care products, personal care and comfort products, outdoor cooking products, and "away from home" business. It also had international sales that accounted for approximately 19 percent of its total net sales.[104]

Household appliances (29 percent of 1996 domestic net sales) included blenders, food steamers, bread makers, rice cookers, coffee makers, toasters, and irons. Examples of health care products (11 percent) were vaporizers,

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

[103] Ibid.

[104] 1996 10K filing to SEC, Item 1 ("Business").

humidifiers, air cleaners, massagers, and blood pressure monitors. Its line of personal care and comfort products (21 percent) included shower massagers, hair clipper and trimmers, and electric warming blankets. Some of its major outdoor cooking products (29 percent) were electric, gas, and charcoal grills, and grill accessories. Its "away from home" business (5 percent) marketed clippers and related products for the professional and veterinarian trade as well as products to commercial and institutional channels.

Executive Leadership

Chairman and CEO Albert J. Dunlap assumed leadership in 1996 and promptly invested $3 million of his own money in Sunbeam shares. "If I make a lot of money here [at Sunbeam]—which I certainly intend to do—then the shareholders will make a lot.… I'm in lockstep with the shareholders."[105]

Dunlap immediately hired Russell Kersh as Sunbeam's chief financial officer. Dunlap and Kersh both entered into lucrative three-year employment agreements that gave them strong financial incentives to raise the share price of the company. Dunlap then replaced almost all of top management, and their replacements were each provided with strong financial incentives to improve the company's share price.[106]

Corporate Restructuring and Plans for Growth

Under Dunlap's reign, Sunbeam embarked on an aggressive restructuring that would involve the elimination of half of the company's 12,000 employees; the sale or consolidation of 39 of its 53 facilities; the divestiture of several lines of businesses, such as its furniture business, the elimination of 87 percent of Sunbeam's product list; and the replacement of six regional headquarters in favor of a single office in Delray Beach, Florida. "We planned this like the invasion of Normandy.… We attacked every aspect of the business, said Dunlap."[107]

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[105] Joann S. Lublin and Martha Brannigan, "Sunbeam Names Albert Dunlap as Chief, Betting He Can Pull Off a Turnaround," *Wall Street Journal*, July 19, 1996, B2.

[106] "Complaint for Civil Injunction and Civil Penalties," SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 7–8.

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

Dunlap publicly predicted that, as a result of the restructuring, the company would attain operating margins of 20 percent of sales in 1997, and increase its sales by 20 percent, 30 percent, and 35 percent respectively in 1997, 1998, and 1999. This meant that the company would have to double its sales to $2 billion by 1999.[108] Other goals were to introduce 30 new products each year domestically, and to triple international sales to $600 million by 1999.[109]

Times of Trouble

After the first quarter of 1997, Dunlap heralded the success of the company's turnaround efforts:

> The impressive growth in both revenues and earnings is proof that the revitalization of Sunbeam is working. In fact, the sales growth in the first quarter is the highest level achieved without acquisitions since Sunbeam became public in 1992.… The substantially higher earnings in the quarter from ongoing operations were due to increased sales coupled with the successful implementation of our restructuring efforts.[110]

Yet, by the fourth quarter of 1997, Sunbeam's results had fallen below expectations. Its first quarter results in 1998 earned a worse-than-expected loss of $44.6 million.[111] CEO and Chairman Dunlap was fired in June 1998. In October 1998, Sunbeam announced that the audit committee of its Board of Directors had determined that the company would need to restate its prior financial statements, as follows: to reduce the 1996 net loss by $20 million (9 percent of reported losses); to reduce 1997 net income by $71 million (65 percent of reported earnings); and to

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[108] SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 10–11.

[109] 1996 10K filing to SEC, Item 1 ("Business").

[110] SEC v. Albert J. Dunlap, Russell A. Kersh, Robert J. Gluck, Donald R. Uzzi, Lee B. Griffith, and Phillip E. Harlow, 20.

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

increase 1998 earnings by $10 million (21 percent of reported losses).[112]

Sunbeam filed for Chapter 11 bankruptcy protection in February 2001. In May 2001, the U.S. Securities and Exchange Commission (SEC) brought charges of fraud against several former Sunbeam officials. At the end of 2002, the company emerged from Chapter 11 and changed its name to American Household. In early 2005, it was acquired by Jarden to be part of its consumer solutions division.

Case Questions

1. Based on your understanding of fraud risk assessment, what are the three conditions that are likely to be present when a fraud occurs? Based on your understanding of the Sunbeam audit, which of these three conditions appears to be most prevalent, and why?
2. Consult Paragraph #39 of PCAOB Auditing Standard No. 2. Based on your understanding of inherent risk assessment and the case information, please identify three specific factors about Sunbeam that might cause you to elevate inherent risk.
3. Please consult Q39 and Q43 of the PCAOB Staff Questions & Answers (May 16, 2005). Comment about how your understanding of the inherent risks identified at Sunbeam (in Question #2) would influence the nature, timing, and extent of your audit work at Sunbeam.
4. Consult Paragraphs #71–72 of the PCAOB Auditing Standard No. 2. First, explain what is meant by "classes of transactions." Next, based on the case information, list the different classes of transactions for the revenue account. Finally, do you believe that the different classes of transactions have differing levels of inherent risk? Why or why not?
5. Paragraph #25 of PCAOB Auditing Standard No. 2 requires management to design and implement controls to prevent, deter, and detect fraud. In addition, the standard requires the auditor to evaluate such controls (Paragraph #24). For one of Sunbeam's classes of revenue transactions (choose one), please brainstorm about how a revenue recognition fraud might occur. Next, can you think of an internal control procedure that would prevent, detect, or deter such a fraudulent scheme?

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