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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 the magnifying glass the path to failure of Sunbeam Corp. and emphasizes the reasons of 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 the presence of an exceptional sampled case. In fact, the maximum value of this temporal variable is estimated equal to 840 days: it is really far from the range estimated by the survival function for the entire sample and it refers to Sunbeam Corp. Different hypotheses are evaluated in the paper, starting from the consideration of Sunbeam's history peculiarities: fraud duration, scapegoating and creative auditing represent the three main points of analysis. Starting from a micro-analysis of this case that the SEC investigated in depth and this work describes in detail, inputs for future research are then provided about more general problems 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

Differently from the traditional literature which focuses on creating a substantial agreement over the most suitable methodology for predicting the final business failure (Beaver 1967; Altman 1968), more recent pieces of research try to emphasize relations between time dimension, failure stages and accounting information (Hill *et al.*, 1996; Cybinski, 2001). This paper aims to be inserted in this second stream of research whose importance has been repeatedly emphasized in the last years. In particular, Humphrey (2008) reviews audit research and criticizes the relevance of quantitative modeling 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 into these crashes is highlighted by other authoritative literature (Lee, 2004; Humphrey, 2005; Parker, 2005). For instance, Armstrong (2008) stresses the importance of qualitative studies for accounting research: the lack of specific and precise knowledge implied that Enron case, fraud and consequences came “as a surprise”. These works and 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.”

For these reasons, starting from previous works (Agostini, 2012) which shown that fraud disclosure makes firms fall down bankruptcy very fast, this paper analyzes in detail an exceptional opposite corporate case. The worth of considering “deviant cases” is emphasized in the theoretical framework of path dependency to which the present paper makes reference for the analysis of 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). In fact, the presence of the outlier, here considered, emerges from the analysis (TABLE 1) of the TIME2 variable , *i.e.* the time between the fraud disclosure date and the bankruptcy date, for the US fraud cases¹ mentioned by WebBRD. Overall, the survival function estimates about a 25% chance of falling down bankruptcy within 53 days after

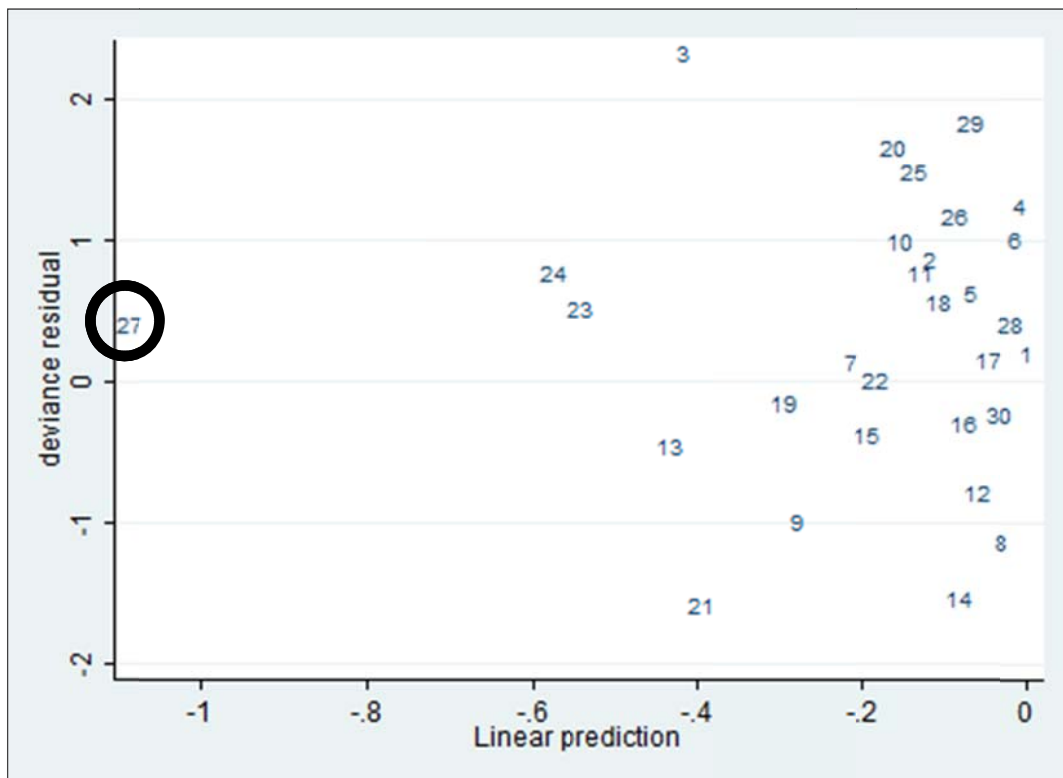
¹ The sampled firms are included in the WebBRD (Bankruptcy Research Database) which contains data on all large, public company bankruptcy cases filed in the United States Bankruptcy Courts from October 1, 1979 through March 1, 2010. The sample selection is made according to the cause of bankruptcy (*i.e.* fraud) and the type of activity (*i.e.* different from finance, insurance, and real estate).

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: it is really far from the range estimated by the survival function and it refers to Sunbeam Corp (Fig.1).

TABLE 1 – TIME2 variable analysis

.stsum						
failure _d: status						
analysis time _t: time2						
	time at risk	incidence rate	no. of subjects	Survival time		
				25%	50%	75%
total	4646	.0062419	29	53	99	215
.stsum if id==27						
failure _d: status						
analysis time _t: time2						
	time at risk	incidence rate	no. of subjects	Survival time		
				25%	50%	75%
total	840	.0011905	1	.	.	.
.sumtime2						
Variable	Obs	Mean	Std. Dev.	Min	Max	
time2	30	154.8667	178.4815	0	840	
.sumtime2 if id==27						
Variable	Obs	Mean	Std. Dev.	Min	Max	
time2	1	840	.	840	840	

Fig.1 - One outlier from TIME2 variable analysis



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 of its uniqueness in order to derive from this micro-analysis new questions and considerations concerning the accounting fraud cases.

The micro-analytical approach, here adopted, was developed in the historical disciplines some decades ago in order to test (and eventually deny) the validity of macro-scale explanatory paradigms and to revisit and put under discussion the commonplace notions underlying them (Trivellato, 2011). In order to attain this result, the starting point is the critical comparison of all available sources (in our case annual reports -with obvious caveats-, business articles and mainly the results of the SEC investigation). This intensive approach is useful to avoid simplification, "*not to sacrifice knowledge of individual elements to wider generalization*", but should be coupled with the informed use of "*all forms of abstraction since minimal facts and individual cases can serve to reveal more general phenomena*" (Levi, 1992, p. 109). Theoretical models are then used here as a repertoire of instruments useful to detect what are the actual mechanisms at work in the concerned case (Favero, 2011). The latter in its turn should be chosen precisely because it poses some problems, and should be used as a clue to detect the presence of some faults in general models and explanations (Ginzburg, 1989). In this way, the interpretation of an extra-ordinary case, as the outlier here taken into exam, could allow to shed light on broader trends and eventually to falsify general assumptions about what is possible or not (Grendi, 1977, p. 512). In this perspective, the basic research questions of this chapter concern primarily the method itself, and its usefulness in the inquiry of general issues in accounting and organization studies.

More precisely, the main research question is about what the micro-analysis of this single case (selected as an outlier in the statistical distribution described above) can show about the mechanisms relating accounting fraud and business failure. This methodological question arises a series of answers, concerning the focus of the investigation, which can be translated into more operational research questions listed below.

Firstly, the micro-analysis of a single case can enlighten causal mechanisms which are too complex to emerge from standard empirical studies based on statistical approaches. A coherent operational research question in this case may ask how the specific fraudulent strategy of performance overstatement adopted in the Sunbeam case can be connected to the peculiar modality

of its disclosure, allowing 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 considered statistical variables. 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 (bankruptcy in this case).

Moreover, the outlier can sometimes represent the "tip of the iceberg" of not measurable phenomena (as, for instance, cases of undetected fraud). So, the paper investigates what allowed 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 remaining spy or red flag) of a dynamic evolution that explains its same 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 allowed to generalize some of its specific features?

Different hypotheses will be consequently analyzed in the following paragraphs, starting from the consideration of Sunbeam's history peculiarities. In fact, the paper is organized as follows. The next section reviews the relevant literature about the factors characterizing Sunbeam's fraud process: fraud duration, scapegoating and creative auditing. The third section analyzes the presence and the relevance of these factors in the concrete examined case. Section four illustrates the relations between the identified variables and the contribution of the chapter to the literature. Lastly, some concluding remarks are presented.

2) REVIEW OF THE THEORETICAL LITERATURE

2.1 Determinants of fraud and time to disclosure

As long as the starting problem of this paper is the exceptionally long time from fraud disclosure to bankruptcy in Sunbeam Corp. case, most of the existing literature focusing on the determinants of fraud and its duration (time to disclosure) seems out of target. However, the micro-analytical approach, here adopted, suggests the opportunity to make reference to a wide set of literature about different aspects of the theoretical debate, in order to allow a whole 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 reminded 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); still it 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 was also the longest to be discovered, with a median duration of 27 months 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 second one 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 Sunbeam case, as discussed below, the responsibility of 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

² The Association of Certified Fraud Examiners (ACFE) 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" (*Report to the Nation on Occupational Fraud and Abuse*, p. 2).

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 monitor in depth the state of a firm or rely on public information about it: this implies consequent changes in managers' cost opportunity about the performance overstatement (Povel *et al.*, 2007). Another approach considers instead the effects of the varying ability to predict aggregate trends as affecting the dynamic interrelation between the number of firms performing less than generally expected (correlated with the realised aggregate performance), and the incentive for managers of under-performing firms to overstate their company performance in order to keep up with their fellow competitors on the job market correlated with expectations (Fernandes and Guedes, 2009).

It is worth to signal also the existence of endogenous explanations of the fraud cyclical trend, 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 (McAffee *et al.*, 2011) affected by (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 in case of fraud cessation (Baer, 2008). This peculiar situation implies in its turn an adverse incentive of increased vigilance on "current" fraud perpetrators that goes along with a more classical effect on "potential" ones. In particular, higher sanctions increase the opportunity cost of stopping manipulation, generally increasing also the time to disclosure by using means apt to conceal the presence of misstatements and manipulations in the accounts: among them, lobbying (Yu and Yu, 2011) and acquisition (Erickson *et al.*, 2011) emerge in literature as the most used strategies.

Acquisition is particularly interesting in the analysis of the case considered in this work because it was adopted as a strategy to conceal fraud only after an attempt to sale 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 discovered yet: the shift of the blame to other people may represent one of few conditions leading the manipulator to leave the game, but it is very difficult to inquire such problems, as long as undetected frauds are here concerned. Summers and Scott (1998) tried to control for undetected frauds by screening the litigation history of their sample:

their method implies the assumption that before or later any fraud will be detected. In a more recent chapter anticipating an upcoming article, Wang (2004; 2011) proposes the use of an econometric model in order to disentangle from the observed probability of a detected fraud an estimate of the two component probabilities of committing and detecting fraud: the analysis shows how such components can be affected by different variables and how they can interact. In particular, the application of Wang's (2011) model suggests that acquisitions are correlated to fraud because of the high visibility of these transactions, despite the fact that active acquirers are less likely to commit fraud than the average, as long as they are more likely to be discovered. Very interesting is also the correlation between the presence of investments implying higher volatility in their results and the higher probability to commit financial misstatements because the probability of fraud detection is lower: the "veil" created by business uncertainty can foster fraudulent behaviour by exposing companies to both more frequent performance shocks and higher financial needs (Wang, 2011), but also allowing managers to appeal to volatility as a justification for any alteration of expected or assessed performances.

2.2 Time to bankruptcy and managerial scapegoating

The focus on governance mechanisms and fraud deterrence was criticized in literature as not taking into account the role of executives' personal features such as the overconfidence in their choices and the imperative to "correct" poor performances that could threaten their job (Schrand and Zechman, 2011). This kind of argument is particularly relevant in the case under scrutiny, given the renown aggressive managerial style of Al Dunlap, *i.e.* the CEO who was in 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 relevance of personal attitudes appears relevant also in relationship with the differential effects on market performances observed where financial restatements had negative implications for management integrity, in comparison with those considered to be connected to technical accounting issues (Palmrose, Richardson and Scholz, 2004). As shown below, one argument put forward by the fired CEO after the Sunbeam fraud disclosure was exactly concerning the technical nature of the misstatement, in the unsuccessful attempt to avoid being made guilty alone for the fraud.

However, what is more interesting in the 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 fraud

responsibility by immediately dismissing and scapegoating the CEO. Some more clarifications are needed on this point. On the one hand, indeed, the literature about the consequences of financial misrepresentation shows that it is very difficult, for both companies and regulators, to really sanction fraudulent managers (Velikonja, 2011). On the other hand, it exists clear evidence of heavy reputational effects on managers identified as responsible for accounting fraud (Karpoff *et al.*, 2008).

A possible solution to this puzzle can be found in the auditing literature because auditors are usually scapegoated after fraud disclosure. This represents another item of exceptionality in Sunbeam Corp. case where there is a shift from the auditors to the CEO of the scapegoat function. It will be discussed in more detail in the next paragraph. The interesting point here regards the inherent ambiguity of the scapegoat role: the same CEO was identified before as the major intangible asset of the company and then as the major threat to its survival. According to Girard (2005), indeed, the struggle of all against all 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, 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 and 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 decades is concerned, as shown in the following paragraphs. However, these considerations seem far from the Sunbeam case where auditors' peculiar behaviour and work allow to recognize the scapegoat in the CEO: he is rapidly fired in order to help the company recover. This shift in the CEO's reputation was mirrored by a parallel boom and burst of Sunbeam's share value, following the typical trend of speculative bubbles.

It is from this point of view that Girard's (1987) first explanation about the origin of the scapegoating mechanism turns out to have more than expected to tell about the relationship between accounting fraud and business failure. In fact, in Girard's archetypal story, it is *mimesis* (imitation) that explains the desire to possess things others possess, the struggle of all against all and the identification of a scapegoat to be sacrificed: it is a progressive shift of the same focus of imitation from the act of appropriation to the object of appropriation (mimetic desire), from the act of fighting

(generalized conflict) to the object of fighting (the scapegoat as everybody's enemy). Imitation is the main mechanism explaining speculative bubbles: investors imitate other investors creating waves of optimism and pessimism that explain volatility (Corcos *et al.*, 2002). So, this imitation mechanism can explain also the abrupt change in the value the market assigned to the CEO of Sunbeam Corp., making him a perfect scapegoat to exit from the difficult situation the company found itself.

2.3 Creative auditing

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 have been provided about it. Omurgonulsen and Omurgonulsen (2009) summarizes 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 will not be welcome. So, creative accounting can be framed and related to the "agency theory" (Amat *et al.*, 1999): 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 agent provide a theoretical framework to understand the failing path of such companies (Arnold and Lange, 2004). The framework of "principal-agent relationship" emphasizes also one of the most frequent possible causes of creative accounting: this practice sometimes occurs due to the pressure coming from the top management (Leib, 2002). Anyway, 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 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 stepping outside the regulatory framework deliberately to give a false picture of the accounts. So, just the last one represents the fraudulent financial reporting, which has been defined as "an intentional misstatement of financial statements" (Arens *et*

al., 2010): the three practices (*i.e.* not-tort, creative accounting and fraud) represent an escalation in the bad use of accounting by managers.

The same differentiation among separated practices has not been introduced in the literature for the auditing process yet. In the fraud detection literature, accounting and auditing have followed different paths: they have been separated from a temporal point of view, but they are similar because of other aspects. In fact, a fruitful area of prior research has been related to tools and techniques to improve fraud detection such as ratios analysis, checklists, analytical procedures, regression analysis, digital analysis, and neural networks (Hogan *et al.*, 2008) before in accounting and then in auditing process. Moreover, there is a significant amount of literature on the cause and features of fraud processes: pressures to meet analysts' forecasts, rapid growth, compensation incentives, stock options, the need for financing, and poor performance increase the likelihood of fraudulent financial reporting (Bell and Carcello 2000; Rezaee 2005; Erickson *et al.*, 2006). The correct and incorrect accounting practices (*i.e.* not-tort, creative accounting and fraud) implemented by managers because of such reasons may find a correspondence into the practices used by auditors, with the same escalation from good to bad methods.

First, external auditors both may and should play a role in reducing opportunities to manage earnings or commit fraud (Becker *et al.*, 1998; Francis and Krishnan, 1999; Iyer and Rama, 2004; Myers *et al.*, 2003; Carcello and Nagy, 2004). This is related to the same definition of auditing (Arens *et al.*, 1997) 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 auditing importance in order to implement fraud detection. Chen *et al.* (2011) examine whether different audit procedures and attitudes conveyed to management deter aggressive earnings misstatement that may be fraudulent, and whether such different procedures and attitudes conveyed influence managers' perceptions about the ethicality of any anticipated earnings management. So, audits are claimed to not only enhance the detection of fraud but also its deterrence or prevention (US Treasury Department, 2008). The long-time claim of the financial audit as a fraud deterrence mechanism (Mautz and Sharaf, 1961; Wells, 2004) is more based on logical reasoning than on empirical evidence (Schneider and Wilner, 1990): management reports more honestly because its actions will be audited (Baiman *et al.*, 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. More in details, deterrence theory (Chen *et al.*, 2011) proposes three factors that affect people's judgments about engaging in illegal or undesirable activities, *i.e.* 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 costs of committing the act increases which reduces the act's expected utility and the likelihood of people committing the act in the first place: according to deterrence theory, managers would be deterred from potentially fraudulent activities if they perceive an increased probability of punishment when they observe changes in auditor actions and activities. Moreover, detection and deterrence are intimately interwoven because 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, as an attempt to prevent fraud, the Auditing Standard Board (ASB) in 2002 issued the Statements of Auditing Standard 99 (SAS 99) which introduced a "Fraud Triangle". Fraud Triangle indicates that the probability of committing fraud is high in situations when a) management or other employees has incentive or is 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) have advocated 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.

Second, on the other hand, some studies have emphasized as external auditors may be involved in managers' fraud plans. This has been related to a decrease in audit quality: 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, audit "quality" is defined in terms of the level of assurances, *i.e.* the probability financial statements contain no material omissions or misstatements. This definition is consistent with both DeAngelo's (1981) definition of audit quality and the professional literature that describes 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, Enron external auditor, has been charged with obstruction of justice related to the destruction of Enron documents (Berkowitz, 2002). So, auditors, who were once held in high, have

started to be now 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 independence requirement. A lot of literature also 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. In the USA, Baron *et al.* (1977) examined the extent of auditors’ detection responsibilities with respect to the material errors, irregularities and illegal acts. They attempted to establish whether there were any differences in the perceptions regarding the auditors’ detection and disclosure duties between the auditors and users of accounting reports (*i.e.* financial analysts, bank loan officers and corporate financial managers). They found that auditors and users of accounting reports had significantly different beliefs and preferences on the extent of auditors’ responsibilities for detecting and disclosing the irregularities and illegal acts. In particular, users held auditors to be more responsible for detecting and disclosing irregularities and illegal acts than the auditors believed themselves to be. Recent regulations have tried to reduce both this gap and the first examined cause which has induced some restrictions and affected the decision to outsource the internal audit function (such as the *Sarbanes–Oxley Act* in the USA) to the external audit firm: after famous scandals, a fundamental change in the way audits are performed has been needed to win back the public’s trust (Tackett *et al.*, 2004). Moreover, 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 *et al.* (2011) reveal that those who commit fraud are not necessarily genius or have creative mind because they just copy fraud schemes from the past. Therefore, there must be more emphasis on past mistakes, as highlighted in the introduction.

Differently from both the two previous streams of literature, Guénin-Paracini and Gendron (2010), whose work has already been mentioned in the previous paragraph, emphasize the paradoxical nature of legitimacy surrounding the financial audit function in society. On the one hand, scandals surrounding fraudulent financial statements typically result in litigation against specific auditors while generating reproaches targeted at the whole profession. On the other hand, in spite of lawsuits and criticisms: the influence of auditing as a technical means of control invariably keeps strengthening and the auditors’ moral legitimacy eventually is always restored in the eyes of most stakeholders. In other words, they contend that auditors can be conceived of as modern *pharmakoi*, constituting a reservoir of victims to sacrifice whenever the occurrence of some

fraudulent financial statements threatens the reproduction of economic order auditors have been scapegoated in the aftermath of a number of financial crises: the process of moral condemnation of auditors, which can take place in the wake of fraudulent financial statements emerging in the public sphere, bears resemblance to sacrificial rituals as theorized by René Girard. From this perspective, auditors can be thought of as modern *pharmakoi*, constituting a reservoir of victims to sacrifice when fraud threatens the smooth-functioning of capital markets. In contending that auditors are modern *pharmakoi*, they have explicitly stated that auditors are not systematically designated as scapegoats in the aftermath of all capitalistic crises: their point is that auditors have been scapegoated in the aftermath of a number of financial crises.

Starting from Guénin-Paracini and Gendron's work, this chapter aims to provide an explanation for some different fraud processes where auditors are nor watchdogs nor victims nor legally guilty, *i.e.* "creative auditing" which represents the main focus of this work: it is the first comprehensive attempt, as far as we are aware, at identifying another possible way of auditing, *i.e.* creative auditing. This may be framed and related to the "agency theory" as creative accounting was: auditors (agents) may use their professional knowledge, the 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 agency theory, information asymmetry occurs where agents (auditors) have the competitive advantage of information within the company over that of the principals (e.g. owners, investors, etc.). This results in the principal's inability to control the desired action of the agent (Godfrey *et al.*, 2003). 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 is worsened by shareholders' (*i.e.* principal) 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 and Torsvik, 1998) arises between auditors and managers, as emphasized by few 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).

These phenomena may be related to the theory developed in the late 1920s by the Dutch professor Theodore Limperg (Hayes *et al.*, 1999). Limperg's theory of inspired confidence addresses both the demand for and the supply of audit services. According to Limperg, the demand

for audit services is the direct consequence of the participation of outside stakeholders in the company. These stakeholders demand accountability from the management, in return for their contribution to the company. With regard to the level of audit assurance that auditors should provide (the supply side), Limperg adopts a normative approach: the auditor's job should be executed in such a way that the expectations of a rational outsider are not thwarted. So, given the possibilities of audit technology, the auditor should do everything to meet reasonable public expectations. This theory differs from the credibility theory in some extents: the second theory regards the primary function of auditing to be the addition of credibility to the financial statements. Audited financial statements are used by management (agent) in order to enhance the principal's faith in the agent's stewardship and reduce the information asymmetry. This has been related to the most widely held theory on auditing until the 1940s (Hayes *et al.*, 1999): under the watchdog theory, an auditor acts as a policeman focusing on arithmetical accuracy and on prevention and detection of fraud. However, due to its inability to explain the shift of auditing to "verification of truth and fairness of the financial statements" this theory seems to have lost much of its explanatory power.

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 Mr. Dunlap had improved the economic-financial situation of the company: Sunbeam's stock leaped nearly 50 percent the day Mr. Dunlap was hired to run the company in 1996 and he became a sort of corporate star in the U.S. Although Sunbeam's fortunes initially seemed to improve under Mr. Dunlap and the company took a huge write-off in 1996 as it closed plants and laid off employees, its reported profits soared in 1997 and, also according to the S.E.C., Mr. Dunlap and Russell A. Kersh (a longtime close associate of 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 S.E.C., regards "the illusion of a successful restructuring of Sunbeam": the S.E.C. compliant against Sunbeam states that "at least \$62 million of Sunbeam's reported \$189 million in income for the year (1997) did not comply" with accounting rules. In particular, the SEC Release No. 7976, issued on May 15, 2001, addresses a variety of improper

earnings management techniques employed by the management of Sunbeam Corporation from the last quarter of 1996 through June of 1998. Among the fraudulent accounting practices employed by Sunbeam was the improper recording of bill and hold sales. This practice began in the second quarter of 1997 and was repeated in the first quarter of 1998. In these purported bill and hold transactions Sunbeam offered incentives to customers to persuade them write purchase orders before they would have otherwise. The Commission concluded that these inducements to purchase meant that it was really the seller, Sunbeam, not the purchaser, that had requested the bill and hold arrangement. Also, because Sunbeam typically paid the cost of storage, shipment and insurance of the product, the risks of ownership were deemed not to have passed to the buyer, one critical criterion for the proper recognition of a bill and hold transaction. The “bill and hold” sale recorded in 1997 contributed to the approximate \$62 million in fraudulent income reported in 1997. To avoid reporting a sales decline in the first quarter of 1998, Sunbeam again misused bill and hold transactions. In this instance they recorded \$35 million in fictitious sales. Millions of dollars in expenses in 1997 were wrongly charged to 1996, when the company had taken the write-off for Mr. Dunlap’s reorganization. The S.E.C. said the reorganization created what it called “cookie jar” reserves, which could be used to create improper profits in 1997. It also said that Sunbeam unreasonably reduced the value of its inventory so that it could record large profits when the goods were sold: a variety of methods has been used, in particular the so called “channel stuffing”, *i.e.* putting inventory onto the books of distributors and retailers. For instance, electric blankets, which had been packaged for a certain retailer, were sent to a distributor who agreed, in return for a guaranteed profit, to hold the blankets until the retailer was ready to accept them. Other sales were made by offering deep discounts to persuade customers to buy merchandise that they would not need for many months. The S.E.C. said that the company should have disclosed those discounts and that the sales should have been recorded in later quarters.

The second point, emphasized by the S.E.C., regards Mr. Dunlap’s strategy to sell the company. This has been wrong because, as analyzed by several authors, Dunlap’s celebrity pushed Sunbeam stock to premium levels, making it too rich for most acquirers and selling Sunbeam was not possible. 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).

TABLE 2 - Highlights from Albert Dunlap's Career (New York Times, Dec. 23, 1997)

<p><i>Lily-Tulip:</i></p> <ul style="list-style-type: none"> o In 1983, he fired all but two of the company's senior managers on his first day at work. o Cut corporate staff by one half and cut 20% of the company's workforce. o He took the company public in 1985.
<p><i>Crown Zellerbach:</i></p> <ul style="list-style-type: none"> o Hired in 1986. o Split the natural resources company into two parts. At the part he kept, he laid off approximately 20% of the company's employees and renegotiated labor contracts to cut costs.
<p><i>Consolidated Press Holdings:</i></p> <ul style="list-style-type: none"> o Began work in 1991 to restructure the company. o Sold most of the holding company's businesses and revoked company perks
<p><i>Scott Paper:</i></p> <ul style="list-style-type: none"> o In April 1993, he laid off one third of the company's workforce. o In July 1995, a weakened Scott Paper was sold to Kimberly Clark for around \$7 billion.
<p><i>Sunbeam:</i></p> <ul style="list-style-type: none"> o Shortly after taking over, he replaced most of the senior management. o Three months after taking over, he announced 6,000 employee would be laid off.

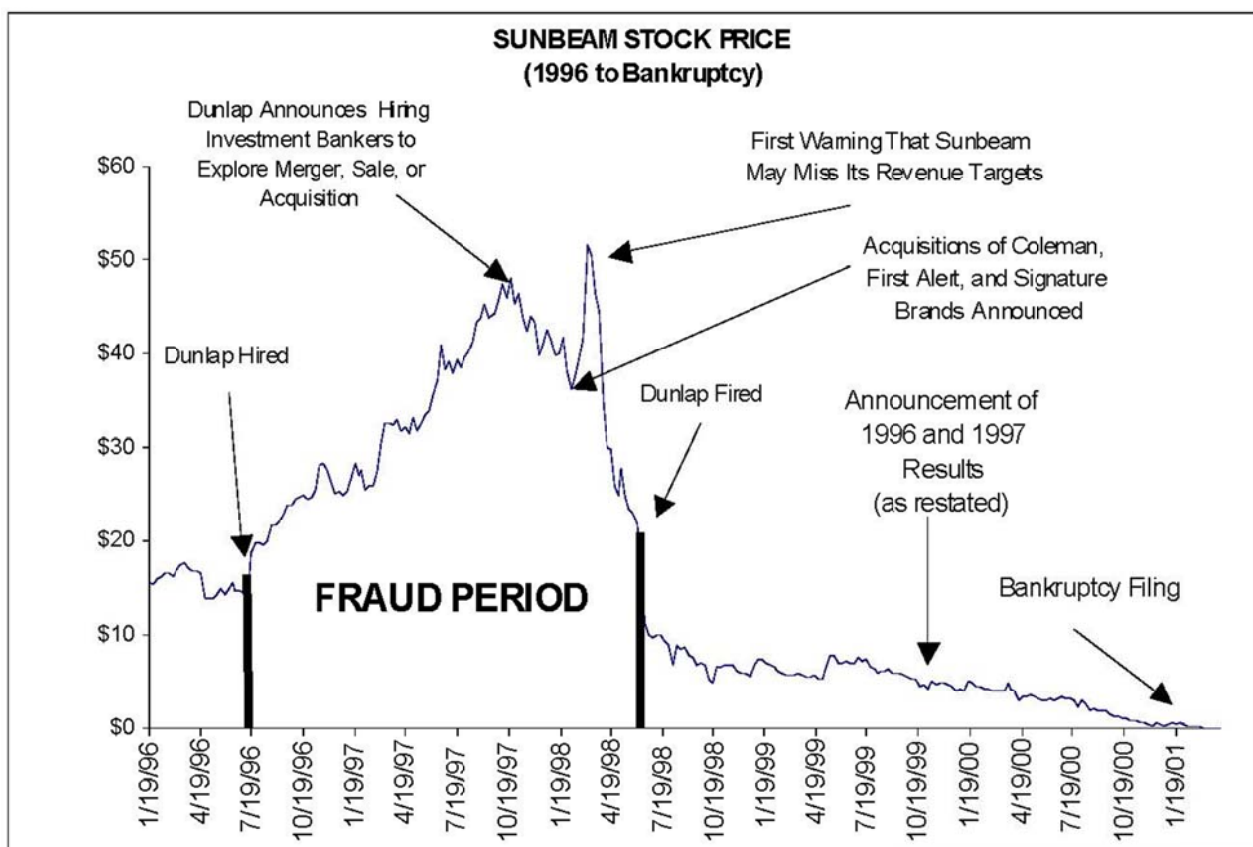
Albert "Chainsaw Al" Dunlap took over the reins at Sunbeam Corporation in July 1996 in a hire meant to provide the company with a turnaround in the small appliance industry. His plan involved massive cuts to the company's product lines, plant closings and major cutbacks in the number of employees at Sunbeam. He called for the same types of cutbacks at previous companies he headed, including Scott Paper where, within a few months, he had fired 11,200 workers, including 71 percent at headquarters and 50 percent of the managers, and departed 20 months later with an extra \$100 million in his wallet after selling a leaner, meaner, money-making Scott to Kimberly-Clark. Mr. Dunlap would have applied the same strategy to Sunbeam. So, he choose his collaborators: of the five board members, four had been chosen by Dunlap himself. Moreover, on December 23, 1997, the New York Times reported that since Dunlap took over at Sunbeam, in the previous year one half of the company's 12,000 jobs had been eliminated, approximately 90% of the products produced had been discontinued, and 18 of the 26 plants had been closed. Given the implementation of these same actions, Mr. Dunlap thought to be ready for Sunbeam sale (as was for Scott Paper Co.), but this couldn't be concluded in spite of Sunbeam investment bankers' attempts which approached numerous companies, including Gillette, Black and Decker, Rubbermaid, Maytag and Whirlpool. This was due to the strong increase of Sunbeam's stock price: when Dunlap took over Sunbeam in July 1996, the company's stock was trading at \$12.50. In

March 1998, the stock had risen to a high of around \$53: with the stock trading near \$50 per share, no other company was interested in acquiring Sunbeam.

After Sunbeam's investment bankers failure in finding a buyer, Dunlap decided to use his company's inflated stock to acquire other companies: Sunbeam planned to buy three additional companies, *i.e.* Coleman, Signature Brands and First Alert. 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 the Company'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 1920's. 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. The above acquisitions will be accounted for by the purchase method of accounting and the results of operations of the acquired entities will be included in the Company's Consolidated Statement of Operations from the respective acquisition dates. Also in connection with the purchases of these three companies, Dunlap demanded a new contract from the Board of Directors even though he still had two years left on his current one. He also demanded a new contract for Kersh. Under the new agreement, Dunlap doubled his base salary to \$2 million, received a grant of shares that netted him approximately \$15 million immediately, and received approximately another \$41 million as a result of the early vesting of all of his then outstanding options. He also received a new grant of 3,750,000 options. Kersh also had his salary doubled to \$875,000. He too received grants of restricted stock representing a net gain of approximately \$1.4 million. Kersh received 1,125,000 new options, a quarter of which vested immediately. As a result of these new agreements, Dunlap and Kersh beneficially owned, respectively, 5% and 1% of a company with a market capitalization of over \$3.5 billion, *i.e.*, over \$125 million for Dunlap and \$25 million for Kersh. As was the case with their original employment agreements, under these new agreements, Dunlap and Kersh had the incentive to raise the price of Sunbeam's stock and sell the Company to cash in all of these holdings.

It wasn't until April 3, after Dunlap had just acquired that trio of companies and already warned Wall Street of a slowdown in first-quarter sales, that Sunbeam began to publicly unravel. In fact, Sunbeam's fourth-quarter financials disappointed Wall Street. When Dunlap finally reported the numbers on January 28, he turned in earnings of 47 cents per share, which was a cent short of analysts' expectations. The shortfall caused Sunbeam stock to fall nearly 10%, to \$37.625 (Fig. 2).

Fig. 2 - Sunbeam's stock scheme. The chart illustrates, public investors, ranging from individuals to investment funds, who bought and held Sunbeam's stock in anticipation of a true turnaround lost billions as a result of the scheme (extract from the "Complaint For Civil Injunction And Civil Penalties" exposed by the Securities and Exchange Commission in front of The United States District Court Southern District Of Florida)



Dunlap attributed the stumble to lower sales of electric blankets. What investors didn't know would have caused Sunbeam's stock to suffer a total collapse. Shifting the \$21.5 million from reserves into income, *i.e.* a transaction that only came to light when Sunbeam restated its financial results a year later, enabled Kersh to disguise the company's calamitous erosion in profit margins. It helped to cover up the deep discounts given to customers by Sunbeam to stuff and load the retail channels. Auditors later concluded that grill sales made under massive discounts, extended credit terms, and "bill-and-hold" transactions inflated fourth-quarter sales by \$50 million. Instead of

reporting revenues that were up 26%, to \$338.1 million, Sunbeam sales would have increased by only 7%.

As the company's performance deteriorated, the pressure inside Sunbeam was building. There were signs that it was even getting to Dunlap. According to Sunbeam's employees, the CEO's behavior inside the company was still worse than outside. It was becoming increasingly difficult to meet Dunlap's projections. To double revenues to \$2 billion by 1999, Sunbeam would have to increase sales five times faster than rivals. To boost operating margins to 20% in just over a year, Sunbeam would have to improve its profitability more than twelvefold from the measly 2.5% margins it had. To generate \$600 million in sales through new products by 1999, the company would have to smash home runs with every at-bat. Almost all his executives believed these goals were impractical. Complaints and employees' testimonies revealed that Dunlap refused to acknowledge the near-impossibility of meeting the goals. Instead, he began putting excruciating pressure on those who reported to him, who in turn passed that intimidation down the line. People were told that either they meet their goals or another person would be found to do it for them. Executives said he would throw papers or furniture, bang his hands on his desk, and shout so ferociously that a manager's hair would be blown back by the stream of air that rushed from Dunlap's mouth, but those people didn't refuse their wages. The top 250 to 300 executives and managers at Sunbeam received option grants that were typically twice the size of what they might get at other companies. All were aware of what such grants had meant for managers at Scott, many of whom walked away with millions. Sunbeam managers did not understand that Dunlap's generosity had a perverse impact. Complaints suggest that the outsize rewards made it easier for employees to do things they might otherwise refuse to do and accept the little enthusiasm and the frustration inside Sunbeam. In an effort to hang on to their jobs and their options, some Sunbeam managers began all sorts of game playing. Commissions were withheld from independent sales reps. Bills went unpaid. Some vendors were forced to accept partial payment. One director reported getting a call from a headhunter

begging for help in collecting a bill from Sunbeam. "It was personally humiliating," recalled Susan Robertson, a manager in new-product development. "I couldn't tell for sure if they were simply pinching pennies or (if it was) because we were short on cash. Later on it became apparent it was the latter." Other dubious techniques were used to boost sales. Product was heavily discounted to get retailers to buy more than needed. Credit terms were extended. By May of 1998, an internal memo shows, all of the company's major customers were loaded to the gills with Sunbeam

merchandise. Wal-Mart Stores, for example, which prefers four weeks of inventory, was loaded with 23.6 weeks of Sunbeam appliances. “We were jamming inventory at people like you couldn’t believe,” said a top salesman. “Most of the stuff I had done before for solid companies. We just took it to another level. We did it every quarter, with every customer, on every product.”

The variety of improper methods did not go completely unnoticed, even on Wall Street. By mid-1997, William H. Steele of Buckingham Research Group in San Francisco saw signs of trouble. Inventory in the second quarter hit \$208 million, up \$60 million from first-quarter levels. Meanwhile, cash on hand fell by \$36 million. Steele downgraded the stock to neutral in July. By June 1998, the stock had fallen to around \$22 per share and Barron’s Online (June 8, 1998) investigate the reasons of such sudden drop: by early June, Barron’s published an article noting that Sunbeam had negative operating cash flow in 1997 and suggesting that all the company’s profits had come from questionable accounting maneuvers. Despite the chaos inside the company because of such paper, Sunbeam’s chief kept up a steady drumbeat of optimistic sales and earnings forecasts, promises of tantalizing new products, and assurances that the Dunlap magic was working. Even Andrew Shore, an analyst at PaineWebber Inc. and one of the few who hadn’t entirely bought into the Dunlap mystique, upgraded the stock to a buy in October, 1997. He noticed the same disturbing trends as Steele, but wrote: “Sunbeam possesses an intangible asset, the Dunlap factor.”

Although several analysts still continued to believe in Sunbeam and its CEO, the company took soon a radical choice: Mr. Dunlap was soon forced to resign after board members began looking into the claims and hearing from employees of questionable accounting practices. By June 1998, the company’s directors had fired “Chainsaw Al”, commenting that they had “lost confidence” in his leadership abilities (Los Angeles Times, June 16, 1998). A SEC deep investigation started after that and the following emerged: this announcement 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 (Plain Dealer; July 14, 1998). The investigation would centre around recording the sales of barbeque grills too early. The company announced it began to recover from “Chainsaw Al” and the new chief executive officer said they had no intention of going bankrupt (The Toronto Star; August 26, 1998). Finally, on October 20, 1998, Sunbeam announced its long awaited restated results. Blame was pointed to Al Dunlap and the improper accounting practices he was alleged to have used during his tenure at Sunbeam. It was found that the 1997 profit, one of the best in Sunbeam’s history, was inflated by \$95 million because of sales of grills and other products (using bill and hold strategies) and the operating expenses for 1997 were included in a 1996

restructuring charge (St. Louis Post Dispatch; October 21, 1998). The company restated results from the last quarter 1996 through the first quarter 1998. Al Dunlap reiterated his remark that he relied on the company's outside auditors and that the restatement was actually "technical accounting issues" (The New York Times; October 21, 1998).

This announcement raised some questions also about external auditors' position: on December 1, 1998, several months after Dunlap's discharge, Sunbeam dismissed Arthur Andersen as its outside auditors and named Deloitte & Touche as its new outside auditors (The New York Times; December 1, 1998). In the most of the fraud cases, auditors affirm to have not known the improper accounting practices used by the company. Sunbeam case has been different because Mr. 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. The S.E.C. investigation focused on a specific method of producing 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. Mr. Harlow sustained 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 just by \$3 million. After that, before deciding to sign, Mr. Harlow deeply analysed Sunbeam financial statements and understood that the remaining profit was not material: this was the same of saying that the part, which was not presented fairly, was not material, so it did not matter. After Sunbeam fraud disclosure, Mr. Harlow was supported by its partner (Arthur Andersen) which stated this case involved not fraud, but "professional disagreements about the application of sophisticated accounting standards." As emphasized by The New York Times (May 18, 2001), "in the typical accounting fraud case, the auditors say they were fooled. Here, at least according to the S.E.C., the auditors discovered a substantial part of what the commission calls sham profits". Moreover, stating the immateriality of a part of improper profits, they used their professional knowledge, the asymmetrical information and the flexibility inside auditing rules to distract other stakeholders' attention from news which will not be welcome. For these reasons the chapter may affirm that Sunbeam represents a case of creative auditing implementation. In fact, after Mr. Dunlap was fired, Arthur Andersen (Mr. Harlow

partner), along with another accounting firm, re-audited the books and concluded that the 1997 profits should have been far lower, but Sunbeam external auditors acted better than the typical auditor in the typical accounting fraud.

Sunbeam 840 days path from fraud disclosure to bankruptcy (it filed for Chapter 11 bankruptcy protection on February 6, 2001 – look at TABLE 3) was rapidly followed by the 2002 company announcement 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 (The New York Times; December 19, 2002). So, Sunbeam fraud path seemed to have just one bad cause whose elimination has permitted a long path before bankruptcy and a fast exit from bankruptcy. In fact, only Al Dunlap has been banned from ever serving as an officer or director of a public company because of its actions as Sunbeam CEO. His worst mistake, at a management and corporate governance level, seems to have been his tendency to surround himself with 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 one major shareholder (Franklin Resources with a 35% stake). Throughout his tenure, Dunlap exercised complete, unfettered authority over all aspects of Sunbeam’s business and staffing. Dunlap set goals, directed business activity, and fired and hired executives. Dunlap monitored Sunbeam’s affairs and executive performance through, among other things, participation in Operating Committee meetings, and other meetings held for the purpose of updating him on the conduct of the business, including restructuring efforts; frequent meetings with Kersh; and obtaining regular business reports prepared specifically for him (from the “Complaint For Civil Injunction And Civil Penalties” exposed by the Securities and Exchange Commission in front of The United States District Court Southern District Of Florida). Several authors have emphasized his sudden passage from a corporate star to a criminal, from Sunbeam best intangible asset to its worst liability: a business column, at Sunbeam fraud disclosure time and referring to Mr. Dunlap, titled “He anointed himself America’s best CEO. But Al Dunlap drove Sunbeam into the ground”. Corporate America treated Al Dunlap (and his way of behaving) as “a miracle worker” when he achieved fame by running Scott Paper for two years, drastically pruning its operations and finally selling the company to rival Kimberley Clark. After few years, he became to be considered Sunbeam fraud cause, also by the same executives who worked with him: “Dunlap and Kersh were looking for a way out,” Langerman told his fellow directors. “They were giving us the bait the other day, hoping that we would take it. That would

have let them off. Al could say, ‘I did my best. I succeeded, and this board decided it didn’t want me.’”

4) PUTTING THE CASE AT WORK

In this section of the chapter, a basic question will be addressed: what does this case, which the SEC investigated in depth and this chapter describes 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) and employed a such long time from fraud disclosure to bankruptcy. These variables 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 here in use, based on the micro-analysis of a case, could instead provide interesting insights (*e.g.* how different factors could interfere each other, how different lines of empirical research could successfully be connected together in order to attain a better understanding of fraud and failure mechanisms, etc.). Finally, as long as 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 corporate average fraudulent conduct: if it was an exception because of some factors, it means that usually this combination of factors is not present.

Why was Sunbeam story so exceptional? The narrative above suggests three points to focus on: over-manipulation of accounting information, the role of M&A (*i.e.* mergers and acquisitions) and “creative auditing” (a concept here introduced for the first time).

The first element (*i.e.* over-manipulation of accounting) concerns the fact that evidently Dunlap over-boosted company performance. Still, he exaggerated and made pervasive 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, partially already discussed in the literature mentioned in the second paragraph. The exceptional overstatement of Sunbeam performance finds in part its origin in a

peculiar phenomenon of short circuiting between the higher-than-usual amount of stock options entering the wage of managers and the effects that overstatement started soon 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 and Bebchuk, 2002; Goldman and Slezak, 2006) asserting that a connection exists between performance-based compensation and misreporting practices. Even more interesting than the causes of the exaggerated overstatement of Sunbeam performance are its effects: the increase in the stock price was so high it finally prevented Dunlap from selling the company. This point raises a theoretical problem: what does it mean saying 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 performances, but answering would be difficult; certainly they did not believe those performances were replicable.

The failed sale of the company has even another implication, concerning its motivation. It 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 the sale and its commitment have represented a crucial step in the fraud process: they would have allowed to cover, under the so-called "veil of acquisition", all the problems that could emerge from 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.*, 2011a; literature about disclosed and undisclosed frauds as summarized in Jones *et al.*, 2011). Recent studies show that companies accused of committing accounting fraud result more prone to acquire other companies because they used acquisition (evidently without success) as a tool to conceal the fraud itself (Erickson *et al.*, 2011b): Sunbeam was not an exception, as will be discussed below. Moreover, the case analysis suggests that companies making fraud look at the acquisition of other companies as a second best strategy: they prefer to be acquired by other companies because this would provide a successful concealment of fraudulent accounting behaviour preceding the acquisition. Let's say that the historical budgets of acquired companies could result 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 long as the sale of the company resulted impossible, Dunlap resorted then to the second best strategy of acquiring other companies. The opportunity of this choice is explained by two factors: it provided an alternative tool, even if less effective, to conceal accounting fraud and it allowed to use over-valued company stocks as means of exchange (instead of money) for the acquisition. This has implied another interesting short circuit in Sunbeam story: Ronald O. Perelman, Coleman former majority shareholder, accepted Sunbeam stocks in reward of most part of Coleman acquisition, but he became the second largest shareholder of Sunbeam itself. Perelman's position allowed him to enter the board after Dunlap's removal of and support the appointment of Jerry Levin, the former CEO of Coleman, as his successor at Sunbeam in a tentative salvage of the company (Hill, 1999). In fact, company performances started showing some difficulties only two months after the triple acquisition was completed, perhaps a bit too early: it was evidently the unavoidable consequence of 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. Jonathan R. Laing's analysis for Barron's then started alarming the board who fired Dunlap after a rapid inspection about second-quarter results, and appointed Levin as CEO. By the way, this confirms what has recently pointed out in some empirical studies (e.g. Dyck *et al.*, 2006): analysts represent the most effective early whistle-blowers of frauds.

Was then 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 précised by saying that it concerns the mechanism of making a single person guilty for what was certainly a more complex process (Guénin-Paracini and Gendron, 2010, p. 136). Still, it is worth to recall that Dunlap's case is not at all exceptional (whereas Sunbeam's case *after* Dunlap is), as it fits quite well with the general results found in literature, showing a contrast between the difficulty in legally sanctioning the individuals responsible for the fraud inside the company (Velikonja, 2011) and the heavy professional consequences of disciplinary measures (Karpoff, Lee, and Martin, 2008). Did then the scapegoating of Dunlap explain the exceptionally long time to failure? Not alone. In fact, as explained above, Sunbeam Corp. has been selected because it emerged as an outlier from a statistical analysis and several factors, which may explain its unusualness and uniqueness, have been investigated in this chapter: creative auditing represents the third of the explaining factors listed above, but Arthur Andersen auditing failure has been publicly known and punished only after Enron bankruptcy, as greatly emphasized by the business and scientific literature. The financial

scandal surrounding the collapse of Enron caused erosion in the reputation of its auditor, leading to concerns about Andersen's ability to continue in existence and ultimately to the firm's demise. Some studies suggested that Andersen way of working was not different from that of other auditing firms: for instance, Cahan *et al.* (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. Despite these studies, 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 and Spira, 2009) and responsible in firms' fraud. The report by Powers *et al.* (2002) into the collapse of Enron for the US Securities and Exchange Commission (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 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 (Dewing and Russell, 2004). After Enron, the primary purpose of a financial statement audit has been stated in a more strict way: it consists in determining if a company's financial statements present fairly its financial position at a certain point in time. Since management is responsible for preparing the financial statements, someone independent of the company's management needs to vouch for the statements as being truthful and accurate. Such is the professional responsibility of the external auditors, who provide assurance that the financial statements both conform to generally accepted accounting principles and present fairly, in all material respects, the company's financial position (Buckhoff *et al.*, 2010). If properly planned and conducted, a financial statement audit should uncover material financial statement fraud. If the auditors issue an opinion that the financial statements present fairly, when in fact they do not, they can be held liable for any losses incurred by those who relied upon the misrepresented financial statements. Such liability was the downfall of Arthur Andersen, the external auditor for Enron and before for Sunbeam: this second company should have not represented an outlier in the statistical sample, from which it has been selected, if Enron fraud did not draw so much attention on the auditing function, implying such legal consequences and leading faster the company to its final macro-failure.

5) FINDINGS AND DISCUSSION

The main findings of this chapter are particularly interesting in light of recent research on the effectiveness of triangulating audit evidence in detecting financial statement fraud, but two clarifications must be made: first, in emphasizing 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 have been scapegoated in a number of fraud processes. 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. 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 to have 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 flexibility inside auditing rules to distract the principals' attention (*i.e.* owners, shareholders, investors, etc.) from news which will not be welcome. This results in the principal's 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.

There are at least four implications to be drawn from this research, reflecting the operational research questions posed in the introductory paragraph. First of all, the investigation of a single, statistically exceptional case, allowed to explain the succession of the events in a way that could never be made with a larger dataset, enlightening 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 lets emerge quite evidently the fact that usually auditors do not take distance 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 of accounting manipulation. However, what is more interesting is the fact that usually fraudulent managers do not exceed in overstating the performance and, in that case, they can succeed in selling

the company before the fraud is disclosed. So, the third implication suggests that some elements of the case could be exceptional not because they are really unusual, but because they are part of a 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”. This point is interestingly suggesting that a dataset rich in undetected cases of fraud could be usefully found studying the budgets of sold companies. Another interesting implication concerns the fact that evidently the acquisition of another company is not providing 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 could be taken into account. A final implication regards the collapse of Arthur Andersen which represented a sort of “historical turn” for auditing and generated a series of doubts about the extent to which the financial audit function is controllable (Gendron and Spira, 2009) and responsible in firms’ fraud. After Enron, the primary purpose of a financial statement audit has been stated in a more strict way (Sarbanes-Oxley Act of 2002): if properly planned and conducted, a financial statement audit should uncover material financial statement fraud. Sunbeam should have not represented an outlier in the statistical sample, from which it has been selected, if Enron fraud did not draw so much attention on the auditing function, imply such legal consequences and increase the vigilance.

There are also some limitations in this research. In fact, the analysis of a single case may represent a drawback of the study. However, as explained in the introduction, the examined case has been statistically selected from the sample built in the first chapter: it includes all the US fraud cases mentioned by WebBRD which filed for bankruptcy in the period 1986-2010 and whose activities differ from finance, insurance and real estate industries. In fact, the analysis of a specific variable (called TIME2, *i.e.* the time between the fraud disclosure date and the date of filing for bankruptcy) has revealed the presence of an outlier: its maximum value, which is really far from the range estimated by the survival function, has been estimated equal to 840 days and refers to Sunbeam Corp. 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 showed to give strange but rich fruits. Most of the study conclusions and implications are logically plausible, but require further investigations that could assess by means of empirical quantification the scope and diffusion of the discovered causal mechanisms. So, it can be said that this work started from the results of a statistical analysis and now comes back to it. Still, what the

micro-analysis of a case can provide is 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 inquiry of a piece of reality, as partial as it could be: if the case is carefully selected, as shown at the beginning of this chapter, it can also 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 hand-picked.

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