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SUNBEAM CORPORATION: BOARD MEMBER ASSESSING EARNINGS QUALITY (A)

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It was June 9, 1998, and Charles Elson, a law professor and Director on Sunbeam's Board, had just left a distressing board meeting. The board had met suddenly because, the previous day, Barron's had published an article suggesting that Al Dunlap, CEO of Sunbeam, had been manufacturing earnings since he joined the company in July 1996. This disturbing article came shortly after other bad news. Two months earlier, on April 3, Sunbeam had warned the market that it would report a surprise first quarter loss and, as a result, the stock dropped 25 percent to $34.38 from the previous day's close of $45.56. Sunbeam was now at about $20, 62 percent off its high of $52 achieved just three months earlier.

Elson, an academic, had been friends with Dunlap since before he joined the board. Dunlap had even visited Elson's classroom. They were both proponents of the idea that corporate directors better represent shareholder values when they also own significant amounts of the company's stock. In fact, Dunlop had been one of the first to support Elson's idea to pay corporate directors in stock. It was at Dunlap's request that Elson joined the board in September 1996.[1]

Elson had been confident in Dunlap's ability as a turnaround specialist, especially after his success turning around Scott Paper. But between the recent earnings disappointment and the Barron's article, Elson was beginning to question his friend's actions. Elson needed to confirm for himself if the accusations detailed in the Barron's article were true or not. Was Sunbeam's first quarter earnings shortfall a one-time hiccup to be expected in a turnaround situation or an indication of the larger problems detailed in the Barron's article? He took home the most recent annual report to determine for himself.

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[1] Robert Trigaux, "Innocence lost with Chainsaw Al's fall," St. Petersburg Times, June 21, 1998.

MBA 1998 Colm Callan prepared this case under the supervision of Professor Maureen McNichols as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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Company Background

In 1998 Sunbeam was a leading designer, manufacturer, and marketer of branded consumer products. The company specialized in durable household consumer goods in five separate product categories:

1) Appliances (e.g., blenders and coffee makers)
2) Health Care (e.g., vaporizers and humidifiers)
3) Personal Care and Comfort (e.g., shower massagers and hair clippers)
4) Outdoor Cooking (e.g., electric and gas grills and accessories)
5) Away From Home (e.g., clippers and related products for the professional)

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Sunbeam enjoyed a long-standing reputation for quality, and a number of the company's sales were from products that ranked number one or two in market share in their respective product categories. However, after Sunbeam's stock price reached an all-time high of $25 per share in December 1994, the company proceeded to fall short of analysts' earnings estimates in five of the next six quarters due to a lack of strategic planning and cost overruns. By early 1996, the stock was trading in the range of $12 to $15 per share. Sensing the need for a more focused approach to the business, Sunbeam's board fired the existing CEO and on July 18, 1996 elected Al Dunlap to take his place.

Al Dunlap

The market responded favorably to Dunlap's hiring. Sunbeam's stock price jumped 59 percent overnight, from $12.50 per share to $18.63 per share on the announcement, representing one of the biggest increases in New York Stock Exchange history based solely on the naming of a new CEO. Dunlap had engineered eight extremely successful turnarounds prior to becoming CEO of Sunbeam, including his most notable performance at Scott Paper. In his 19 months on the job at Scott, the company's stock price increased 220 percent, from $19 per share to $61 per share, as Dunlap implemented a number of cost cutting moves, which included eliminating one-third of the workforce and selling $2 billion of assets. Dunlap was notorious for such dramatic reductions in personnel, which earned him such nicknames as "Chainsaw Al" and "Rambo in pinstripes." Furthermore, he had consistently stated that shareholders were the one stakeholder group with which he was most concerned. "If you want friendship," Dunlap once said, "buy a dog."

While employees might have been unhappy with the tactics Dunlap employed in his turnarounds, shareholders could not argue with his performance. Upon selling Scott to Kimberly-Clark for $9 billion, he increased the market capitalization of the company by more than $6.5 billion during his tenure. Based on Dunlap's early performance at Scott, the market was betting that he was about to work his magic yet again. According to Dean Witter analyst William Steele, "Sunbeam's number one problem was its lack of strategic planning, and its number two problem was its lack of managerial accountability. There is no question Al is a task master with those issues."

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Sunbeam's Performance under Dunlap

True to form, Dunlap implemented a dramatic cost-cutting program at Sunbeam, including the elimination of 6,000 jobs through either direct layoffs and consolidations or the divestiture of various business units. In the fall of 1996 the company announced a major restructuring and growth plan that was designed to generate approximately $225 million in annual savings. Additionally, Sunbeam announced aggressive targets for revenues and profitability, anticipating revenues doubling to $2 billion by 1999 and operating margins improving to 20 percent in the typically low-margin, cutthroat small-appliance industry.

Despite the aggressiveness of the targets, Sunbeam appeared capable of achieving them, reaching a 17.1 percent operating margin on record revenues of $1.2 billion in 1997. This led to record earnings of $109 million, or $1.29 per share, which the market rewarded with an ever-increasing stock price. Sunbeam's stock reached a high of $52 per share on March 4, 1998 following the announcement that Sunbeam would acquire Coleman (a grill manufacturer), Signature Brands (maker of Mr. Coffee), and First Alert (most widely recognized consumer brand name in home safety)—the first acquisitions that Dunlap had attempted. Analysts believed that the acquisition of strong brand names meshed well with Dunlap's plan to build-up consumer products that were number one or two in their market, and many analysts continued to recommend Sunbeam with a "strong buy" investment rating. Additionally, the acquisitions would nearly triple Sunbeam's revenues and were predicted to contribute "meaningfully" to earnings within 12 months.

Appropriate Valuation for Sunbeam

However, Sunbeam's earlier earnings disappointment and the Barron's article worried Elson. Not only did Elson have tremendous responsibility for the situation as a member of the board, but he also had a personal stake: Elson had purchased 10,500 shares, at a cost that exceeded his investment in his own home.[2] Was it possible that Sunbeam's earnings were not what they seemed? What areas of Sunbeam's accounting were subject to management's discretion and how much of an effect could they have on reported earnings? What questions should he and the industry analysts have been asking about Sunbeam's financials? Following any adjustments to Sunbeam's 1997 earnings, what would be an appropriate value for Sunbeam's stock? If it did appear that Dunlap had manipulated Sunbeam's earnings, what action should he and the other board members take? The market was losing confidence in Sunbeam. Time was running out.

[2] Trigaux.

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