LAWRENCE WEISS

Lawrence Weiss is Professor of International Accounting at The Fletcher School of Law and Diplomacy at Tufts University, and an expert on corporate bankruptcy.

If the Auditors Sign Off, Does That Make It Okay?

Tuesday May 1, 2012, by Lawrence Weiss

Andrew Fastow, the former chief financial officer of Enron, recently completed a six-year prison sentence for his part in the scandalous deception that hid Enron's financial troubles from investors. After I was quoted late last year in an article on the 10th anniversary of the Enron debacle, Fastow contacted me and offered to speak to the Financial Statement Accounting class I teach at Tufts University's Fletcher School of Law and Diplomacy.

Last month, Fastow made good on his offer. Why did he commit fraud? Why did a bright, aspiring, stereotypical MBA cross the line and misrepresent the true financial picture of Enron? According to Fastow, greed, insecurity, ego, and corporate culture all played a part. But the key was his proclivity to rationalize his actions through a narrow application of "the rules."

Fastow's message, an important one for all managers and potential managers, has two key points. First, the rules provide managers with discretion to be misleading. Second, individuals are responsible for their actions and should not justify wrongful actions simply because attorneys, accountants, or corporate boards provide approval.

After his guilty plea for fraud, Fastow forfeited $23.8 million in cash and property. He has helped the Enron Trust recover over $27 billion, of which $6 billion has gone to shareholders. (And he was not compensated for his presentation to my class.)

He began the presentation by admitting he committed fraud and taking full responsibility for his actions. He made a heartfelt detailed apology and expressed remorse for having hurt so many people. He admitted making technical violations and taking wrongful actions that, while approved, were misleading. He said he knew what he was doing was wrong. But he rationalized those actions in his mind at the time, because the result was higher leverage, a higher return on equity, and a higher stock price. Further, he convinced himself that his actions were acceptable because they had been signed off by the firm's lawyers, accountants, and board and were disclosed in the financial reports. He told himself his actions were systemic, it is the way the game is played. All who cared to know knew. As Fastow rhetorically asked my students:

"If the internal and external auditors and lawyers sign off on it, does that make it okay?"

The problem is that attorneys, accountants, managers, boards, and bankers are not gatekeepers; rather, they are there to help businesses execute deals. They are enablers. In the case of Enron, these outside advisers played an active role in structuring and disclosing the deals, and the board approved them, but managers were still responsible for their own actions. Thus, technically following the rules as interpreted by these advisers, even if theirs is the best expertise money can buy, does not make a given action "right." Fastow emphasized that enablers are not an excuse: each individual is his or her own and only gatekeeper.

Fastow suggested that to avoid falling into an ethical trap he should have asked himself the right questions: *Am I only following the rules or am I following the principles? If this were a private partnership, would I do the same deal?*

Regulation has not prevented fraud. In fact, it may have exacerbated the problem. Enron viewed the complexity or ambiguity of rules as an opportunity to game the system.

Compare Enron's deals with the structured finance innovations we've seen since the passage of the Sarbanes-Oxley Act: Enron's prepays (circular commodity sales which moved debt off the balance sheet and generated funds flow) look very similar to Lehman's Repo 105s (short-term loans secured with a transfer of securities treated as a sale of securities). The mispriced investments and derivatives at Enron look similar to mortgage-backed securities at banks or companies with a disproportionate amount of Level 3 fair-value assets (illiquid assets with highly subjective estimated values). Enron's $35 billion in off-balance sheet debt looks puny compared to the $1.1 trillion of off-balance sheet debt at Citi in 2007. Enron did not pay income taxes in four of its last five years, and GE pays little today. Banks are now engaging in "capital relief" deals that inflate regulatory capital in advance of the new Basel standards. Are these deals true risk transfers or are they cosmetic?

If regulation is not the answer, then how can corporations and society prevent fraud in the future? Fastow said we can begin by understanding that structured finance is like steroids: a little can cure many illnesses, but a lot can destroy your organs. Its use needs to be limited, and investments in firms that use structured vehicles without a clear business reason should be avoided. Mark-to-market accounting can lead to more transparent financial statements but, if abused, can put a company in a hole that it can't climb out of. The market must value transparency. Companies with the fairest disclosures must be rewarded, not placed at a disadvantage as is now the case. Finally, executives must ask whether a transaction is consistent with the principle and not just the rules. Are they doing it for window dressing or for valid business purposes?

It is critical for analysts, directors, and managers to maintain a certain sense of humility and to understand how human nature, competitive pressures, and a lack of clear guidelines can lead to potentially disastrous choices. And it is not just corporations that engage in these practices. Yes, Enron hid debt in derivatives. So did Greece.