Of Enron, entanglement and enlightenment

Former Enron CFO Andrew Fastow says that following the rules landed him the CFO of the Year award, and in prison.

Some 200 directors and business leaders came to listen to Mr Andrew Fastow describe how he went from hero to zero at a forum on financial fraud organised by SID and Straits Interactive at Capital Tower on 31 May 2016. Many left feeling inspired and touched by his candor and humility, but also disturbed by his revelations of potential "Enrons".

SID Executive Director Joyce Koh opened the forum by describing how a multi-billion dollar company like Enron, once the darling of Wall Street and named "American's Most Innovative Company" for six consecutive years before its collapse in 2001, had led to the collapse of Arthur Andersen and the introduction of legislative reforms such as the Sarbanes-Oxley Act of 2002.

Mr Fastow started off his presentation with a meā culpā: "I am guilty and mostly to be blamed for what happened at Enron". He admitted that he knowingly engaged in financial engineering that was designed to mislead investors by hiding debt in special purpose entities. At the same time, every single one of these transactions were knowingly approved by the auditor, the lawyers and the board of directors. "It is therefore possible to follow the rules and still commit fraud," he said (see box on "The Loophole Industry").

When asked by members of the audience why he did what he did knowingly, Mr Fastow explained how unethical behavior can be rationalised. These include the individual believing that what he was doing was for the benefit of the company, that it was "technically" within the rules, that "everyone else is doing it", and that there are rewards for the acts.

Mr Andrew Fastow showing his CFO of the Year trophy and prison card

More troublingly, Mr Fastow went on to give numerous examples of how many major companies today are doing similar things that "make me blush – and I am the CFO of Enron".

A panel of financial experts that followed Mr Fastow's talk added their views on ethics and financial fraud, and answered questions from the audience.

Finally, Mr Kevin Shepherdson, CEO of Straits Interactive shared on the launch of the Governance, Risk Management & Compliance (GRC) Professional Course in Singapore. He emphasised that it was a first-of-its-kind GRC course with international certification by OCEG, and comes with project work and GRC software.

The "loophole industry"

Summarised here are some of the insights regarding rules versus principles shared by Mr Andrew Fastow:

Rules are created to effect sound principles of corporate governance and accounting. It is, however, possible to follow the rules and commit fraud (through loopholes).

Loopholes are permitted assumptions and contrived structures that technically adhere to a rule but actually contravenes the purpose, or principle, of the rule.

Two key tools are available to transform how the accounts are presented:

- **Accounting assumptions**

  Example 1: The top 100 U.S. public companies with pension assets have an average expected rate of return of 7.5 per cent on those assets, but the largest U.S public pension fund (CalPERS) expects to earn only 2.4 per cent in FY2015.

  Example 2: At end of 2014, most companies used US$95 per barrel to value their oil reserves, but the price of oil at the end of 2014 was about US$50 per barrel.

- **Structured finance**

  Example 1: Enron can acquire a US$1 billion pipeline using an off-balance sheet special purpose entity (SPE) to lower financing costs and improve its credit rating. How: the bank sets up the SPE by contributing US$30 million "equity"; the bank lends US$970 million to SPE, SPE buys the pipeline and allows Enron to use it for ten years, but conditions are such that Enron effectively retains 100 per cent of the risk and rewards of the pipeline.

  Example 2: Many of today's operating leases have the same characteristics of the Enron's SPEs. There are over US$2 trillion off-balance sheet operating leases worldwide.

These created a grey area that can be a problem (for innocent investors) or an opportunity (for those in the "loophole industry").

The loophole industry arose from two major systemic changes in the 1980s. The first was the advent of structured finance. The second was the explosion in accounting rules, and securities and tax laws – rules which can be nonsensical, complex, vague or non-existent. An industry comprising accountants, lawyers and securities consultants arose to create financial structures that exploit this complexity, enabling companies to alter reported financials and avoid taxes, all the while "technically" complying with the rules and regulations.

Directors who are responsible for ensuring that their companies act both legally and ethically should remember that:

- When times are good, the market and the regulators may ask "Did you follow the rules?"

- But when times are bad, the market and regulators will ask "Are the numbers right?"

The two questions are very different, and if the answers to both are not "yes", then the company and the directors could be exposed.

Panel on "Financial fraud: Lessons learnt and to be relearnt"

Ensuring ethical behavior

"As we all know, fraud occurs when there is a confluence of three factors: motivation, rationalisation and opportunity."

Mr Ng Siew Quan
Partner & Corporate Governance Leader, PWC

"Good regulation must go beyond the rules to examine if the substance of the transaction had been properly reflected in the accounts. That is the approach under ACRA's Financial Reporting Surveillance Programme. Similarly, as directors, you must enquire and challenge management's accounting treatment to ensure investors receive reliable financial statements. "

Ms Julia Tay
Deputy Chief Executive, ACRA

"Companies are often driven by short term objectives. However, I believe that when KPIs conflict, values should prevail, and it is therefore important for management and board to understand and agree on the value of long-term objectives for the company."

Mr Lee Wai Fai
CFO, UOB

Making ethical choices

"Ethical choices are common in everyday life. Is it not easy to rationalise when we are faced with ethical dilemmas, especially when the accountants, lawyers and consultants agree with it?"

Mr Lim Hock San
CEO, UIC

"Yes, some decisions can be hard and are not clear cut. Sometimes, assumptions have to be made to stay in business. It is very easy to look at something that looks bad in retrospect, and see it as good at that time. For example, at Enron, we were rated BBB+, although our internal workings showed that we would have been BB- if the transactions were not off-balance sheet. I was praised by a board member for engineering the ratings."

Mr Andrew Fastow
Former CFO, Enron

"If it is something that you would not be proud to tell your mother, don't do it."

Mr Chaly Mah
CEO, Deloitte SE Asia

L to R: Mr Andrew Fastow, Mr Tan Chin Hwee, Ms Julia Tay, Mr Chaly Mah, Mr Lee Wai Fai, Mr Ng Siew Quan

Ensuring auditor independence

"There would be a potential or perceived conflict of interest when auditors are paid by the companies directly. Would it be feasible to setup a general fund to independently appoint and pay auditors? All companies subject to statutory audit must contribute to the fund annually on reasonable basis. Public fund or tax payers' money should not be involved in any sense. Meanwhile, the audit quality monitoring system should also be overhauled."

Mr Wang Xinbin
ED, Everbright Business Consultancy

"There has not been a market failure to suggest the need to nationalise the external audit function. Additionally, there are several lines of defence within the company that can ensure proper corporate governance of the company."

Ms Julia Tay
Deputy Chief Executive, ACRA

"Audit independence should not be affected by who is responsible for paying audit fees. Independence is a frame of mind, the most crucial factor is the ethical behavior of the professionals."

Mr Chaly Mah
CEO, Deloitte SE Asia

"There should be multiple players in the corporate ecosystem. The short-sellers may be extreme, but they have a role to play. They are motivated to find financial frauds. They are more focused on the cash flow while auditors are focused on the accounting rules."

Mr Tan Chin Hwee
co-author of *Asian Financial Statement Analysis: Detecting Financial Fraud*

Moving on

"How has your personal life changed, post-Enron?"

Mr Daniel Ee
Vice Chairman, SID

"Despite what I went through, I would consider myself very fortunate that I have a very supportive family. My wife kept our family together. I would say that now I am much more humble, patient and understanding than I used to be."

Mr Andrew Fastow
Former CFO, Enron