

/// Interview //////////////////////////////////////

‘YOU NEVER FIND JUST ONE COCKROACH IN THE KITCHEN’

Enron’s lessons are still highly relevant 17 years after the fall of the American energy giant. Former CFO Andy Fastow talked about it with Dutch executive and non-executive directors. His advice is this: don’t put executives on a pedestal, keep an eye on the grey area between rules and principles and be alert to hidden signals. ‘Can a new Enron disaster arise?’ *‘It’s happening right now!’*

Only in prison did Andy Fastow repent. In his cell, Enron’s former CFO had time to think and understand the Jewish Talmud. For the first time, he was not concerned with spreadsheets, with clever tricks to make optimal use of loopholes in the law, but with norms and values and principles instead of rules. Fastow was sentenced to six years in prison for his part in the accounting scandal that brought down the American energy company Enron in 2001, at the time the largest bankruptcy in business history. The years before Enron had been put on a pedestal by investors. The

company received one prize after another and Fastow was named ‘CFO of the year’. During the round-table discussion he holds up the award: a glass object in different colours. Symbolically enough, a piece of it has broken off by now. It is hardly surprising that Fastow drags the thing with him all over the world, as an attribute at his lectures for leaders, students of business schools and accountants. In his right hand he holds his prison ID card. With a crooked smile on his face, he says, ‘I got them both for the same thing: *off-balance* and structured finance deals.’ Fastow was the king of

special-purpose vehicles, which enabled him to move hundreds of millions of dollars off the balance sheet, making it look a lot more promising than the company’s true financial position warranted. This was always done with the intention to follow the letter of the law, according to Fastow, but not its spirit. When the accounting fraud came to light in 2001, 40 billion dollars in market value was lost and 21,000 employees became unemployed. Accountancy firm Arthur Andersen was dragged into the scandal.

ENRON IN THE LOWLANDS

Seventeen years later Fastow is standing in a Dutch boardroom before a mixed group of executive and non-executive directors, a senior government official and a director of a sustainability platform. They were invited by Ron Soonieus, managing partner at the consultancy firm Camunico, and INSEAD Executive-in-Residence in the field of sustainable business strategy, leadership and governance, and Petri Hofsté, top non-executive at Rabobank, Achmea, Fugro and Kas Bank, among others. Both want to gain a better insight into the impact of culture and behaviour in creating long-term value for the company.

Both want to examine the board’s role in long-term value creation.

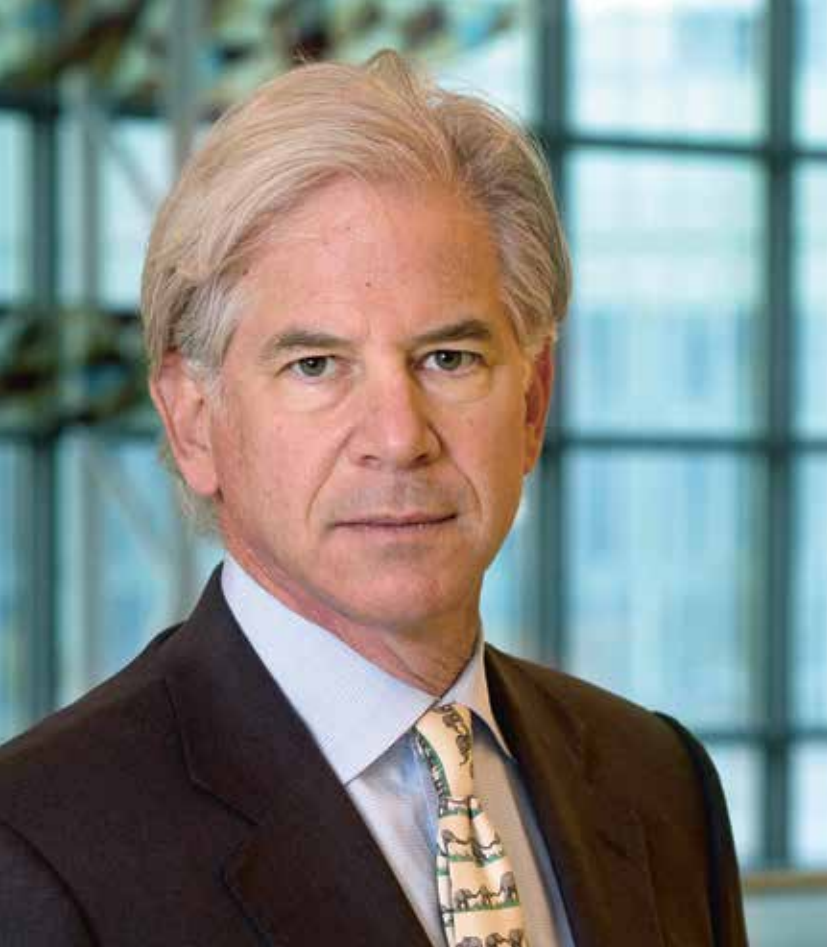
The guests have come to hear Fastow’s story, intrigued by the legendary Enron case, which gave rise to the equally illustrious Sarbanes-Oxley Corporate Governance Act. Not much later, at the beginning of 2003, the Netherlands had its own ‘Enron in the lowlands’ with the Ahold accounting scandal, and governance problems were no longer a remote spectacle for ‘our’ executives and non-executive directors, but harsh reality – and that is what it is more than ever before after several other affairs.

The interest of the directors present therefore goes beyond mere curiosity, beyond just listening. Intriguing questions are fired at Fastow. One of the non-executives expressed the most pressing of these during the round-table discussion: ‘How can you, as a non-executive director, know what is really going on in the operation, what’s the smell of the place? And how do you breathe in that smell? I’ve had sleepless nights about that in recent years. And another director: ‘How do you prevent yourself from becoming part of that culture and no longer seeing abuses? All these questions – which we do not attribute to a specific director in view of the *Chatham House Rule* – together with Fastow’s answers, make up this interview.

Did you believe at the time in what you did as CFO?

Yes, I now understand that my behaviour was wrong, unethical and illegal. I also take full responsibility for that. After the fall of Enron, friends asked me: ‘How could you sleep quietly at night, how could you look at yourself in the mirror in the morning?’ When I did those finance deals, I thought it was my





ANDY FASTOW (1961)

Began his career at Continental Illinois National Bank and Trust Company in Chicago, after obtaining an MBA Finance at Kellogg School of Management. In 1990, Fastow started at Enron Finance Corp., where he became cfo in 1998. He remained in that position until Enron's fall in 2001. For his involvement in the Enron scandal, he was sentenced to prison. After his release in 2011, he joined a law firm in Houston. He also gives lectures about the Enron case.

‘Companies often think they can manage risks in the grey area, but they no longer see them or ignore the risks’

job to discover the loopholes in the law and make use of them. I thought, if I don't do it, the competition will. I fooled myself by believing that my actions were in the interest of the shareholders.

Didn't the non-executives offer any resistance?

‘No. Non-executives tend to put executives on a pedestal. They do this for the right reasons: to encourage executives and to support their performance. But there is also a danger: if you tell executives how brilliant they are, they start to believe in it and they no longer show the humility needed to make good decisions. Unfortunately, I, too, started to believe in it. I'll give you an example: I had made a spreadsheet, which I cynically called Truthsheet.xls. Enron had received a triple B-plus rating for creditworthiness from the credit rating agencies, while I only rated it internally as a double B-minus. On the spreadsheet I based the impact of all my finance deals on that external rating. At the bottom of the line it turned out that our credit status was actually double B-minus. I was so proud of it that I showed the spreadsheet to the board; the accountant had it too, by the way. The chairman of the audit committee literally said, ‘Fastow, you're a fucking genius’. None of the non-executives said, ‘Oh yeah, we have a fraud problem here, or an integrity risk. They only saw the value it generated for our shareholders.’

How is it possible that the accountant and the non-executive directors did not see how great the risk to continuity and the reputation was?

‘Accountants and lawyers were only interested in whether someone complied with the rules, and I always tried to comply with them. They didn't verify whether the underlying assumptions were reasonable. Accountants and lawyers in their monitoring role are focused on finding *rule-breakers*, on people who ignore the rules. Enron's fall was not caused by compliance problems, but rather by cultural problems. This is where the non-executives should have been vigilant. But the point precisely is that integrity risks concern the *rule users*, who operate in the grey area: people who use laws and regulations creatively or even deliberately exploit them for their own benefit. Non-executives should realize that their gatekeepers and advisers sometimes interpret questions differently, consciously or unconsciously. Accountants and lawyers often base their answers to questions on the idea ‘do you follow the rules?’ while non-executives base their answer on the idea ‘is this right?’ Companies often think they can manage the risks in that grey area, but they are in the middle of it and can no longer see them, or they ignore the risks.’

The immediate reaction after the accounting scandals was: more rules. Do we need fewer rules?

‘Rules form a double-edged sword, because the human mind is creative enough to find ways of circumventing them. So more regulation can only make things worse. I say: delete all financial reporting rules, except one: annual reports must be correct and honest.’

Were you a scapegoat?

‘Yes, but I was indeed guilty. What I did was common practice, but I don't want to hide behind it. If you get caught for speeding, you can't argue in your defence that others do it too. You should not only abide by the rules, but honour the principles behind them. I didn't know the difference between them at the time. Nowadays my favourite definition of ethics is that of the late judge Potter Stewart of the Federal Supreme Court of the United States: *Ethics is knowing the difference between what you have a right to do and what is right to do.*’

What question put by the non-executives at Enron could have made you see the light?

‘I don't know if I had seen the light as a result of a question. But in hindsight, there are a few questions that non-executives can ask to assess integrity risks (see box ‘*The lessons of the Enron case in eight questions*’). I myself am not allowed ever to become an executive or a non-executive director of a listed company again and non-listed companies no longer ask me. But if I were a non-executive, I would like to understand how Andy Fastow thought. I would like to know how an activist shareholder, the lawyer of a class action or a dissatisfied employee would feel about my company. I would like to know how someone can attack my company tomorrow. Many boards are reactive, not proactive. They are polite, they tend to display group behaviour when it comes to their opinions and decision-making and they are too dependent on the information they receive from management.’

Would it have made any difference if the non-executives had regularly visited the shop floor?

‘People behave differently when an executive or a non-executive director visits the shop floor. If, as a non-executive, you believe that this is the only way to find out what is going on, then you are naive. If spouses or good friends do not always tell you what they think, why should they tell the truth to a non-executive director? If that's what you think, you are deceiving yourself. But non-executives must be alert to hidden signals. I myself use a list of 75 *red flags*, in the area of finance and culture, that can indicate problems.’

ENRON CASE LESSONS IN EIGHT QUESTIONS, DRAWN UP BY ANDY FASTOW:

- **What question do our advisers answer?**
If the accountant or company lawyer says that a deal is okay, does he or she mean that the deal is honest and acceptable in a behavioural sense? Or just that it is technically in accordance with the rules?
- **Do we have a list of all the assumptions used in reporting and do we correctly assess the risks involved?**
Are the assumptions based on healthy ratios, or formulated too aggressively? And what are the risks involved (for example, an unrealistically high return on pension plans, which leads to a coverage problem if the company is not doing too well)?
- **Are the financial statements that are presented to us inflated?**
If all aggressive assumptions are reduced to healthy ratios, what does the balance sheet look like and what does it mean for the bonuses?
- **What if we gave a short seller (an investor speculating on a fall in the share price, ed.) access to all internal information?**
Which three items on the balance sheet would this short seller choose to bring the price down?
- **What if this was a family business?**
If this was your own business, which you want to transfer to your children and grandchildren, would you also approve these financial transactions?
- **Do we have a devil's advocate?**
Has anyone been selected who can play the role of *asshole*, without being punished for his or her dissenting opinion?
- **Do we have enough women on the board?**
Is there sufficient diversity? A board with only men is (generally speaking) aggressive and acquisitive. Women are more focused on protection and preservation and can provide the right balance.
- **Do we have sufficient data?**
Do we only get financial data, or independent information about people and ‘soft’ themes: *the hard and the heart stuff*?

‘Some deals even make me blush’

What role does reward play in an unhealthy culture?

At Enron we had 12 assessment and reward criteria, including teamwork and good character traits. But employees knew that in practice it was only about the sales and profit figures they were able to show. They were working on meeting short-term targets, not creating sustainable economic value. I don't blame them for that, because it was ingrained in the remuneration system. Some boards do not realise how strongly employees can react to remuneration incentives. So make sure the reward criteria are long-term and lead to the right behaviour.'

Can another disaster like the one at Enron happen?

It is happening right now: at General Electric. It is quite possible that it will be dismantled in the next two years. I am convinced that both GE and the accounting firm KPMG have technically adhered to the rules, but the company wanted to meet profit targets every quarter. If this could not be achieved by means of organic growth, the financial people would take care of it. Some people estimate that GE will have to write off 100 billion dollars. It seems that a large portion of this is a reversal of earlier financial and accounting manoeuvres. I am also concerned about some banks. For example, about deals they call *capital relief* or *capital arbitration*, which create a false picture of the capital buffers the regulators require them to hold. These deals even make me, the former CFO of Enron, blush. The American investor Warren Buffett once said, 'You never find just one cockroach in the kitchen. If a company is willing to take one unethical action, you can reasonably assume that there are other examples you can't see.'

The Netherlands has a *principle-based* rather than *rule-based* governance system. The revised corporate governance code devotes a great deal of attention to long-term value creation and culture. In addition, companies are increasingly focusing on societal impact. Is the world getting better, or are you cynical about that?

'I don't know the Dutch governance code. It sounds like good intentions, but it cannot be ruled out that people here too are looking for creative ways to circumvent the rules. Moreover, it is difficult that we still do not know exactly what we mean by terms such as culture and sustainability. But in any case, we are talking about it together, which did not happen 30 years ago. We've even developed new vocabulary. For exam-

ple, we're now talking about "stakeholders". At my business school, everything still centred around the "shareholder". We have only just started this journey, but the attention paid to it makes me optimistic.'

And your own catharsis? You only came to repentance in prison.

'A rabbi helped me understand what I had done wrong. He visited me in prison and brought me some stories from the Talmud. One of these stories is about the 613 commandments. Some of them are positive commandments: "you shall", others are negative: "you shall not". The last commandment, number 613, reads: "You shall be holy." In the story a rabbi asks the following question: if someone follows all 612 commandments, isn't that person holy by definition? The answer given by his fellow rabbis was unanimous: no. To be holy, you have to act not only according to the letter, but also according to the spirit of the law. Not only the rules, therefore, but also the principles. When I read this story, I had to cry. It was my moment of truth. I had fooled myself for so long that I was unable to see it until that moment. Every morning when I wake up, I think of what happened and the damage I caused. That is horrible, I wanted to be able to undo it. I will feel ashamed about that the rest of my life.'

TEXT **MARIKE VAN ZANTEN**

Journalist *Management Scope*.