

A conversation with Andy Fastow

Audit Committee Institute
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Andy Fastow, former CFO of Enron and architect of the greatest fraud in American history, seeks to shed some light on what went wrong. He makes no denial and seeks no redemption, but he is clear that "technically [he] always tried to comply with the rule book".

Addressing our FTSE100 audit and risk committee chairs' group, Andy acknowledges that while governance has come a long way since the early 2000's, boards must continue to be vigilant of the risks associated with operating in the grey area.

Andy starts his presentation to the meeting of experienced audit committee chairs by acknowledging that he "did something wrong, illegal and unethical". He cost people their jobs and retirement savings; he cost shareholders billions of dollars. Today, he is unreservedly apologetic and wants to increase awareness of his story in an effort to prevent something similar from happening again.

Despite this, and without diverting blame, Andy is clear that many people in and around Enron played a significant role in what happened. Worryingly, he is confident that similar behaviour is still rife in listed businesses.

“There was not a single day at Enron when I thought I was committing fraud.”

Andy recalled how people would ask him why he had spent so much money on legal and accounting advice and if he had wanted to commit fraud why didn't he just change the numbers like others did. In response, he is keen to make it understood that fraud was never what he intended. "I always tried to follow all the rules. Accounting rules are not black and white. The energy industry rules weren't even written then. The more unclear the rules, the easier it is to find a loophole. I wanted to be the guy who found the loopholes."

Looking at each of the factors which allowed Andy to operate unchallenged – and not only this, but actually to support him, to reward him, at times even congratulate him – helps identify some of the pitfalls all companies should be wary of.

Below, we identify the roles each of these factors played in the collapse of Enron.

The role of targets

As CFO of Enron, Andy Fastow understood his role to be to increase the value of the company – and the way he was appraised and remunerated supported this. "Did I know I was being misleading? Yes. I was trying to make Enron look better financially than it actually was."

He thought he was the shareholders' hero for vastly inflating Enron's market capitalisation; for making its balance sheet look much better than it actually was; and for earning it a credit rating that he knew it didn't deserve.

At Enron they had multiple assessment and reward criteria, including teamwork and good character traits. But employees knew that in practice it was all about the sales and profit figures they were able to show.

“I was being intentionally misleading. It was my job and I was great at it.”

Results are inherently easy to measure and lend themselves to great SMART goals, but alone they will not drive the right behaviours. The challenge of how to measure the softer side of performance is not an uncommon one, and cannot be ignored. Is the board clear on the executive performance measures and how they compare across the population? Where unusual accounting proposals have been challenged and overturned does that impact on pay? Are incentive plan performance measures set with reference to the companies goals outside of financial performance? Has sufficient consideration been given to company performance as a whole? What about any impact from the wider environment?

The role of the board

The real dichotomy that underpins Andy Fastow's story is that every single one of his deals was approved by "really smart people" – the board of directors; numerous accountants; internal and external attorneys; as well as Enron's external audit firm – most of whom have been exonerated from any responsibility (albeit too late for Arthur Anderson to have survived).

How does the board really challenge what they are presented with? When results appear rosier than they feel, is management challenged hard enough on why?

It is human nature for management to emphasise the positive aspects of a proposed transaction. Where the board is convinced of the validity of the proposal and the likelihood of the outcome it is normal to allow such treatments. But how do we build an environment where management are as keen to highlight issues or propose accounting treatments or disclosures which create a less positive image? Things which highlight a flaw or a risk that are not immediately visible under the rules – but nevertheless should be disclosed?

Andy highlights an example of the 'fair value' of oil reserves defined as the average market price in the preceding twelve months – fine in a stable market, unhelpful in a growing one, but a jackpot in a declining one. The board needs to push for the disclosures around the impact of fair value measurements to be as bold and as clear in those jackpot years as they are in the unhelpful ones. Yes, there is an obligation to increase value for the shareholders – but this value must be real. Sustainable. Transparent.

The role of the expectation gap

There is a big disconnect between the question being answered and what the users think has been asked. The public typically believes that an audit opinion is a clean bill of health – in reality it is little more than a confirmation that the rules are, on the whole, being followed.



Accountants, auditors, compliance ... they each focus on tracking down people who break the rules. The bigger risk is people who exploit the rules, who operate in grey areas, to get the answers they want."

Hunting out and challenging the implicit is difficult, especially from the outside. How can you see what is not in front of you? The board relies on the messaging to make its way up to be utterly transparent and that relies on people being unafraid to fail, unafraid to share bad news, brave enough to actively tell a difficult truth – not natural behaviours.

The role of the auditor

Does the auditor have the authority to really question management's motives? As accounting and financial reporting standards (IFRS in particular) move increasingly towards a more principles based approach, understanding the company becomes even more important. A good auditor must seek to understand the motives behind each decision, and must be in a position to challenge management on those motives.



How is it possible to have all these gatekeepers approving your deals and still commit the biggest fraud in American history?"

Are the auditors overly deferential to, even afraid of, management? Are junior team members chastised for asking questions that make the client feel uncomfortable? Only when the auditor is utterly at ease in their role, fully empowered to ask any question, to challenge any statement or decision, can they be effective. Does the audit firm present impartiality?

The role of culture

The finance function is a subset of the larger business and a company's culture is never isolated – bad culture anywhere in the organisation will eventually reach every corner – or as Andy Fastow put it "you never find just one cockroach in the kitchen".

In 2000 Enron traders worked out that the market value of energy across the State was measured based on output from a handful of plants. They effectively took control of those plants by buying up the output at fixed price, then by temporarily shutting them down they were able to artificially increase the price of energy on the open market. They earned US\$1.5 billion in the process and when they were discovered and stopped, the head of Enron trading condemned the regulators' "stupid rules".



That was the culture of Enron. Compliance wasn't the problem; the culture and the focus on sales and profits was."

No-one was breaking any laws but nor were they thinking of anything other than making money. No-one was thinking of the hospital without power, or the vulnerable old person home alone with no light. Not because they were cruel or heartless but because they forgot to think. Compliance alone cannot prevent a bad culture from taking hold.

Andy was far removed from these deals but he heard what the individuals had achieved and how they were celebrated for it. "All I thought was 'those traders are damned clever'"

The role of complacency

"We all know the answer" claims Andy, "we just sometimes forget". He described how, at the time, he never once thought he was doing anything wrong. How he didn't even see an ethical problem – and even when he did see it, he misjudged it. Now he teaches ethics and culture in business schools where he poses questions designed to explore the shades of grey.

A relatable analogy is that of the sportsman who wants to win. What if there's a performance enhancing drug with no side effects and is not on the list of banned substances – would you use it? Does it matter if your peers are? Does it matter if it will be in the list of banned substances in two years' time? He finds that students are wired to justify decisions, to be creative and to compete. The list of banned substances may be incomplete and the regulators ability to find them might be restricted but the spirit of the rules are clear – don't use performance enhancing drugs. "We all know the answer".

II If this were a private company, with my name above the door, and one the grandchildren stood to inherit, would I behave in the same way?"

Is this what we find in the board room? Do we seek to interpret the rules to our advantage rather than follow their 'true' meaning?

Many companies talk about doing the right thing but how many processes call for what's 'right' to be considered up front? Embedding it into the heart of what people do every day makes it harder to avoid. How can we encourage people to self-challenge on values as opposed to on problem solving?

The role of responsibility

Andy reflects on the management team structure during his time at Enron when responsibility for the financials was devolved across five executive roles – each held, like so many roles of influence in the business, by thirty-something guys full of macho bravado. As CFO, and despite not being an accountant, Andy was responsible for the external reporting, working alongside peers each individually responsible for other areas such as financial reporting controls, management reporting and M&A activity.

This devolved responsibility is sometimes considered a benefit – where Chinese walls maintain independence and four eyes review reduces the confirmation bias – but Andy points out that it can also create an opportunity for fragmentation.

It doesn't need for one team to even mislead another, only for an individual to convince themselves that they don't need to worry about x because somebody else will – all too easily done when many teams share responsibility for the same thing.

Finally, Andy raises the topic of diversity – more specifically the lack of. He references his experience of a competitive testosterone-fuelled environment where fearless young men compete to be the best, and reflects that simply diversifying gender or age isn't enough. What's required is a genuine diversity of thought and perspective.

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Contact us

Timothy Copnell

Board Leadership Centre

T: +44 (0)20 7694 8082

E: tim.copnell@kpmg.co.uk



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