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## Wall Street's Den of Thieves

By [John Ellis](#)

The first thing you learn on Wall Street: Earnings don't mean anything. Everyone assumes that earnings are financially engineered (sometimes downward!) to meet a variety of stakeholder expectations. The key expectation -- the one that stakeholders want companies to meet -- is steady growth. Earnings that spike and swoon set off alarm bells at places like Fidelity. Steady growth makes fund managers feel calm and content.

That's exactly what big companies -- such as General Electric, IBM, Wal-Mart, and, for a time, Enron -- deliver. Go back and read the quarterly reports of those companies over the past few years, and you'll feel as if you've taken Valium, so steady and predictable is the metronome of their results.

The second thing you learn on Wall Street has to do with the length of the auditor's letter and the number of footnotes included. Simply put, shorter and fewer is better than longer and more. If the auditor's letter is a paragraph long, go directly to the footnotes. If the auditor's letter is two paragraphs long, read the footnotes carefully. If the auditor's letter is four paragraphs long, all hands on deck and hedge your position. For the record, Enron's auditors wrote long letters that had a lot of footnotes.

The third thing you learn on Wall Street is that cash flow and sales are really what matter (since earnings can be engineered). If a company is booking revenue and its cash flow is strong, then it has flexibility. And if the company is well managed -- if the people in charge know what they're doing -- then it's probably worth more tomorrow than it is today. That makes it a buy if it's a stock or a bond. During the run-up years from 1996 to 2000, Enron appeared to be all that and more.

The fourth thing you learn on Wall Street -- and this one is what they call a "job ender" or a "job keeper" -- is that one hand washes the other. If the firm that you work for happens to do a lot of other business with a firm that you've been assigned to cover, you do not ever forget that there is no "I" in "team." You are on the team, and you will do what's right for the team. If you don't, well, don't kid yourself: No one is irreplaceable. That's why Enron was always a strong buy with all of those firms that did business with the company. Even as the stock sank like a stone during the spring, summer, and fall of 2001, ENE was always a buy or a strong buy. There's no one on Wall Street who doesn't understand that one hand washes the other.

After the music stopped and the stock tanked and Enron collapsed into bankruptcy, everyone on Wall Street pretended to be absolutely shocked that such a thing could happen. Happily enough, the more excitable members of the press and their allies in the Democratic Party saw Enron's collapse as a huge opportunity to rebrand President George W. Bush and his Republican friends as the running dogs of dastardly corporate interests. Enron CEO Kenneth Lay, ex-CEO Jeffrey Skilling, and ex-CFO Andrew Fastow were all quickly sketched as Dr. Evils, and the games (known in Washington as congressional hearings) began.

The hearings, of course, have been a joke. Andersen's hapless David Duncan, former lead auditor for Enron, was the first sacrificial offering. Next up was Skilling, who declined to take the Fifth Amendment. Skilling's lack of contrition discombobulated hearing members, causing them to embark on great flights of rhetoric in which they denounced the perfidy and the heinousness of the whole affair. Next came Lay, who did take the Fifth, thus enabling various senators to slap him around at will. On and on it went, each hearing dumber and more irrelevant than the next. The net result was disgust -- shared equally between Enron and the members.

Sensing that the Enron scandal was not playing out as they had hoped, the members directed their attention toward Wall Street, and a shower of subpoenas rained. Wall Street's response (figuratively speaking) was, "Go ahead. Make my day." After all, Wall Street is the mother lode of political fund-raising, and 2002 is an election year. The congressional subpoenas were fishing lines with no bait and no hook. The exercise had everything to do with headlines and nothing to do with substance.

And for good reason. Because at the core of Enron's collapse is the fact that virtually everything the company did was legal. Accounting and financial engineering obey rules -- not laws, morals, or notions of right and wrong. If Andersen, Ernst & Young, and PricewaterhouseCoopers operate within the rules of accounting as outlined by the FASB and the SEC, then it doesn't matter if the company that they're auditing covers up debt, misstates earnings, or misleads investors. Tough luck. The rules were obeyed. If accounting regulations don't specifically say, "Do not create an offshore SPE collateralized by company stock to keep debt off the company's balance sheet," then all the \$600-per-hour brainpower that money can buy will find a way to do it. And it will be legal.

So if Enron's actions weren't a crime, and they weren't a political scandal, then what were they? I've spent the better part of two months talking to people on Wall Street and around the country about Enron. I've read everything that I could get my hands on since the company's collapse became a scandal. Here's what I come away with: Enron was nothing more than an old Wall Street scam called the "pump and dump."

Experienced Wall Street watchers define the pump and dump as a private selling spree conducted in the middle of a public-relations blitz, which is designed to pump up the price of a stock. That was exactly what Enron's senior management did in the first quarter of 2001, hyping a target price of \$120 per share while selling blocks of the company's stock by the boatload. And it appears that they did it again in July and August of last year -- but this time by other means.

Concerned about a cascading stock price (and fearful that its employees would begin to bail out of its stock), Enron switched its 401(k) administrator, firing Charles Schwab and signing up UBS Warburg. Why any company would fire Charles Schwab as its 401(k) administrator is a complete mystery -- unless that company wanted to freeze employee stock selling. Significantly, a freeze is required when a 401(k) shifts from one administrator to another.

The pump and dump is now the focus of the SEC's investigation into Enron. It is likely that charges will be filed soon. The government's chances of "winning" are fairly good. The chances of successful prosecution of Enron management on charges of fraud or criminal malfeasance, however, are not nearly as good, since the gray areas of private-partnership accounting, debt securitization, and all the rest of its complex business transactions are as vast as the North Sea.

But the most important thing that I learned is this: Enron is not the story. The larger, more important story is the whole culture of dishonesty on what we call Wall Street. It starts with a lie: Earnings don't mean anything; they can be engineered. It is seconded by another lie: Those financially engineered numbers are right. It is complicated by yet more lies: Sales revenue and cash flow can be manipulated as well. And then it is all locked down in a code of omertà: Enron is a strong buy!

The next Wall Street scandal will probably be called the "lazy Susan" or the "round-tripper." Lazy Susans are revenue deals that work as follows: Company A gives company B \$400 million. Company B, after an insignificant amount of time, spins the \$400 million back to company A. And both

companies book \$400 million as "revenue." It is alleged that lazy-Susan deals are endemic in the information-technology and telecom sectors and may well have spread to financial services and the media. Global Crossing, which went belly-up in January, is just one of many companies charged with spinning the wheel.

If lazy Susans turn out to be epidemic, then investors will know that on Wall Street, earnings don't mean anything, revenue doesn't mean anything, and cash flow doesn't mean anything. They will suspect that every analyst is out there to deceive -- and, in some cases, to pump-and-dump on television. That's a gigantic crisis of confidence. That's what we're approaching, unless Wall Street, the SEC, and the political community get their act together. Don't hold your breath.

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