Too Good to Be True

by Victoria Grossack

Introduction

The last few decades have witnessed spectacular financial failures and disasters, including the savings and loans crisis that cost the United States $87.9 billion. We've also had Executive Life, the long-term management crisis, Enron, AIG and the subprime mortgage crisis. The collapse of the markets in 2008 also precipitated the implosion of history's greatest fraud, the Madoff Ponzi scheme, estimated somewhere between $50 billion and $65 billion.

After each crisis people asked, "How could these abuses have happened? Why were they not detected sooner?" After all, much of the information was available, and frequently there were many red flags. It is clear that, in addition to those committing fraud knowingly, many others were either fooled or looked the other way. Despite news being too good to be true, they accepted it.

This paper looks at the "too-good-to-be-true" syndrome. First it examines different shadings of "true." Second, it reviews company culture and how it can make it more difficult to seek the absolute truth. Finally, it makes suggestions on how a company can incorporate defenses against the too-good-to-be-true syndrome.

What Is Meant by True?

Before going into the "too-good-to-be-true" syndrome, it is helpful to look at what it means for something to be true. Of course, in many cases a statement is either completely true or completely false; however, there are other situations where statements can be somewhere in-between. Categorizing them is useful, so here is a description of areas along the gradient.

Absolutely true. Sometimes good news is completely genuine. Nevertheless, it is still worth studying because aspects can be copied and used in other sections of business. It is also important to remember that nothing lasts forever, which leads us to the next category.

Temporarily true. Something may be true for now but depends on conditions that may not hold true in the future. Examples abound: the underwriting cycle; a competitive edge that can't be maintained; the saturation of a market; the closing of a loophole in the tax code; bubbles in oil, stocks, housing or gold.

The problem with this is that investors, managers and employees become dependent on favorable conditions. The dependency may be partly due to vanity—some CEOs love the adulation awarded to high achievers—and also because management has a liking for large bonuses. But the dependency extends to others as well, such as employees who will lose their jobs when the good times end. So, when a profit source evaporates, some firms do whatever they can to continue achieving good results (or the illusion of good results). Some pursue risky opportunities, while others engage in questionable or even fraudulent, accounting. This, unfortunately, results in far greater disasters than might have occurred otherwise.

True but dishonest. Occasionally the money is there—the money exists—but it is coming from a different source. This was true of the Nugan Hand Bank failure, which was a conduit for dirty money. Many assumed it was true of Bernie Madoff. They assumed that his fantastic returns were based on illegal insider information and were happy to accept what

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they thought were ill-gotten gains. Unfortunately for them, Madoff's statements were completely false.

Questionably true. In many businesses, especially those that are financial- or insurance-based, some of the numbers, such as derivatives and reserves, are based on complicated calculations. These would be difficult enough to get right in the best of circumstances. Unfortunately, pressure is occasionally put on accountants, actuaries, auditors and many others to select assumptions that lead to a preferred result.

Simply missing. If numbers are not supplied, it is a very bad sign. Enron apparently found it too inconvenient to supply balance sheet statements along with its earnings statements.

Completely false. In other situations, there is no question about the falsehood of numbers being reported. Madoff made up everything for his Ponzi scheme; Olympus falsified results for years.

If a company's numbers are in the "questionably true" category, the moral hazard of slipping into "completely false" is fairly high. Furthermore, it is all too easy for outsiders to assume that a statement is in the absolutely true category when it might be in one of the others—especially when it is a statement that people want to hear.

Cultures of Complicity and Complaisance

It goes against human nature to doubt positive information. Messengers bringing bad news get shot; while those arriving with good receive medals. Expressing doubt is more difficult, especially doubting those who have been praised in the past, those who have received salaries and promotions and other acknowledgements as a reward for their achievements. Madoff was on the boards of many organizations, and even served as the non-executive chairman of the NASDAQ. Doubting his claims meant setting one's opinion not just against him but against all of the people who had praised and rewarded him.

Questioning good news within an organization can be especially difficult. First, people generally want to believe news that benefits them. Good news means bonuses, significant stock options and money for both necessities and perks. Second, casting doubt on good news—especially being the first person to do so—may have consequences for the employee expressing concern or disbelief. It often means making enemies; it may mean losing a client or a job. Third, if the good results are originating in a different department, expressing a lack of confidence in results may be dismissed because of a lack of expertise on the part of the skeptic. All of these lead to complaisance.

Another problem for a skeptical employee is not knowing who is complicit in a situation. The person to whom you are complaining may have ordered the procedure in the first place. Or, assuming that the leadership is innocent, this means pointing out that they are gullible. They may have the choice between playing knaves or fools; neither option is attractive.

Of course, uncovering these issues is a role for auditors—and they stop plenty of questionable activity and uncover a considerable amount of fraud—but auditors can be fooled. They also have a conflict of interest in that they are usually hired by those they audit. This conflict was reduced after the Enron scandal, in which Arthur Andersen failed to put

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a stop to Enron's fraud and ended up being put out of business. There is now a separation between the auditing and the consulting function.

Another check on malfeasance is the regulators: they have the authority, the expertise, and less conflict of interest. Of course, regulators are subject to many of the same human influences; hence the SEC did not take charges about Madoff. Regulators can also be lied to. To quote Shauna Fennes, one troubled bank had three steps for dealing with regulation: Ignore the regulator, placate the regulator, and then lie to the regulator. Furthermore, regulators are often short on resources, lack the expertise, and review information too infrequently to do much but clean up messes after they happen.

Madoff was found out by Harry Markopolos, a rival investor. Sometimes it is easier for someone outside of the organization to discover a problem. They have less information, but they can be more objective in their judgments. Markopolos actually had a reason to want Madoff's results to be false, because his own results were compared unfavorably with them. Unfortunately for Markopolos, when he tried to tell the SEC, he was ignored, even dismissed as jealous and incompetent.

Dealing with the Too-Good-to-Be-True Syndrome

Those serious about risk management can benefit by developing procedures to prevent dependencies on too-good-to-be-true assumptions in their own companies.

First, being aware of the bias that people have in accepting good news is important. Encouraging a company culture that practices genuine skepticism of good news is essential. It is important to separate the gold from the glitter: an expensive suit may make someone look good, but con men have made a point of dressing well for hundreds, perhaps thousands, of years. A company could even encourage role-playing sessions in which relevant personnel are trained to express doubt.

Second, identify the most significant contributors to good news in each area of your company and verify that they really are as strong as they say they are. What are the assumptions? Are these things really true?

Third, identify the biggest pieces of good news in your industry. Note that these may apply to your competitors, but also parts of the market on which your firm relies, such as brokers, customers, banks and rating agencies.

Fourth, apply rigorous audit techniques to these significant generators of good news. It is important to be thorough and to get as many different sources for confirmation as possible, especially external sources. If the SEC had done an external review of Madoff's claimed trades, instead of taking the paper he gave them on faith, his fraud would have ended years earlier.

Fifth, investigate external assertions and assumptions that appear too good to be true. Of course, companies may have limited ability to audit external entities. Suppliers and customers may allow access to some of their numbers, but external entities are unlikely to let third parties inspect everything. Competitors are likely to refuse all requests. So what can be done to determine the reliability of information? The answer is: model building.

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Modelers could review each piece of information used to support a statement, determine which are independent, and assign estimates of reliability to them in order to come up with an assessment of the probable truth of a situation. Modelers should do the same in the other direction: estimate how hard it would be to falsify an assertion. Markopolos did this with Madoff's alleged results and determined within a few minutes that they were impossible.

Conclusion

A healthy skepticism toward things purported to be true should be an important part of a company's well-functioning ORSA. Too much money has been lost because of risks, bubbles and frauds that should have been foreseen. Although it will never be possible to catch everything, catching more problems and catching them sooner can make a difference.

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