Freddie Mac report: a further exposure of profit manipulations

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A report released last week on the accounting and management practices at Freddie Mac, America's second largest financier of housing mortgages, is a further exposure of the corporate culture which gave rise to the Enron and WorldCom scandals.

In this case the outcome of dubious financial procedures was not the overstatement of profit but understatement. The aim, however, was the same: to bring in profit results in line with so-called Wall Street expectations, thereby stabilising the company's share price and boosting its standing in financial markets.

Like Enron and WorldCom, the sums involved were not small with Freddie Mac misstating its earnings by as much as $4.5 billion. According to the report prepared by former Securities and Exchange Commission general counsel James R. Doty of the Baker Botts law firm, this was done in order to "smooth out" its results. Profits hidden at one point could then be recognised at another in order to satisfy Wall Street.

Freddie Mac has been under scrutiny since early June when it announced the departure of three top executives and the Justice Department revealed that it was undertaking a criminal investigation.

The report placed the blame for the accounting failures on the ousted executives. "It was well understood throughout the organisation that the tone of 'steady Freddie' came from the chief executive officer [Leland C. Brendsel].

"There was a long-standing practice at Freddie Mac of making discretionary accounting judgments with a view to producing financial statements that more closely approximated analysts' estimates," the report said.

The approach of senior management was to maintain a "public corporate image at the expense of good management practices and effectiveness of internal controls". The pattern which emerged was of an "institution whose culture discouraged the candid disclosure and explanation of errors."

The manipulation of profit figures took place in the false accounting for derivatives, the often complex financial deals used by financial institutions and corporations to hedge against fluctuations in interest rates and other financial variables.

While the Doty report found that Gregory Parseghian, the former chief investment officer who was appointed chief executive last month, was involved in some of the dubious transactions he was unaware that they did not comply with accepted accounting procedures and that his "involvement was not wrongful involvement."

Some commentators have found this hard to accept. An article by Jerry Knight in the *Washington Post* of July 28 said that the idea promoted at the time of Parseghian's appointment that he was "squeaky clean" and had nothing to do with cooking the books was "tough to swallow" in light of the report. Knight pointed out that the new chief executive's name "turns ups repeatedly" in the report.

According to Knight, the report found that:

* Parseghian was directly involved in finding ways for Freddie Mac to circumvent new accounting rules which came into effect on January 1, 2001 requiring companies to disclose "fair value" for their holdings of derivatives. According to the Doty report, management concluded that the new regulations should be "transacted around".

* Parseghian was one of several executives who approved a memo implementing a $700 million transaction known as the Coupon Trade-Up Giant (CTUG) that was designed to offset the new accounting standards for derivatives. He also helped devise a way to divide the CTUG into small pieces so that the company's board of directors did not have to be informed of them individually, even though they were part of a single plan. "This division had the effect of avoiding the need for Board authorisation," the report stated, adding that as a result "the company failed to adhere to its own

governance requirements."

* Parseghian was also involved in a meeting at which executives discussed five other ways they could get round the new accounting rules for derivatives and supervised several junior executives who participated in two working groups that coordinated efforts to minimise the effect of derivatives on profit figures.

He was clearly aware that transactions used to shift earnings had no economic benefit and were designed to "smooth" earnings. In a report summarising the minutes of a meeting held in August 2001, Parseghian noted that "a continuing challenge for Freddie Mac is managing the tradeoffs between achieving current period earnings, managing risk and meeting future period earnings expectations."

However, the board of directors has stood behind its new chief executive with board chairman Shaun O'Malley declaring they had no questions about his integrity and that they believed he was "absolutely the right person for the job."

While the Freddie Mac board is "reassessing" its internal accounting practices and procedures and is undertaking a "remediation process" over the next year, it is doubtful whether the exposure of the company's operations will have much effect on what has been described as a "culture of earnings management in corporate America."

Freddie Mac, along with many other firms, has engaged in "results-oriented, reverse engineering." Under this system, a decision is made about what profit is desired and then accounts are manipulated in order to achieve it.

One can hardly fail to notice that this procedure has its equivalent in the sphere of politics. In preparing for its desired goal—the invasion and conquest of Iraq—the Bush administration proceeded to organise the production of the necessary "intelligence" in order to provide the "justification" for its war aims.