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LESSONS LEARNED FROM ENRON'S COLLAPSE: AUDITING THE ACCOUNTING INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON ENERGY AND COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

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LESSONS LEARNED FROM ENRON'S COLLAPSE: AUDITING THE ACCOUNTING INDUSTRY

WEDNESDAY, FEBRUARY 6, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
Washington, DC.

The committee met, pursuant to notice, at 12:53 p.m., in room 345 Cannon House Office Building, Hon. W.J. "Billy' Tauzin (chairman) presiding.

Members present: Representatives Tauzin, Bilirakis, Barton, Stearns, Gillmor, Greenwood, Cox, Deal, Largent, Burr, Whitfield, Ganske, Norwood, Shimkus, Shadegg, Pickering, Blunt, Davis, Bryant, Ehrlich, Buyer, Radanovich, Bass, Pitts, Walden, Terry, Dingell, Waxman, Markey, Hall, Boucher, Towns, Pallone, Brown, Gordon, Deutsch, Rush, Eshoo, Stupak, Engel, Sawyer, Wynn, Green, McCarthy, DeGette, Barrett, Capps, Doyle, John, and Harman.

Staff present: Jim Barnette, general counsel; David Cavicke, majority counsel, Shannon Vildostegui, majority counsel; Brian McCullough, majority counsel, Jon Tripp, assistant press secretary; Will Carty, legislative clerk, Jill Latham, staff assistant; David R. Schooler, minority general counsel and deputy staff director; Sue Sheridan, minority counsel; Consuela Washington, minority counsel; Candy Butler, minority professional staff; Nicole Kenner, minority legislative clerk; and Jessica McNiece, minority intern.

Chairman TAUZIN. Let me announce the order of business. We will begin opening statements on the full committee hearing this morning, but we will suspend and interrupt those opening statements as soon as staff informs me that we have a full quorum of the committee present to do business. At that point, we will introduce a resolution before the full committee with the concurrence of the minority, which will authorize the Chair with again the concurrence of the minority to issue subpoenas in this case as we further need them in our investigation. And then we will go back to opening statements and introduce our witnesses and finish the hearing.

The Chair will first recognize himself for an opening statement. Today, we're taking the extraordinary step of holding a full Energy and Commerce Committee hearing to consider some of the most important policy issues that relate to Enron's collapse. These issues include corporate governance, accounting and governance of the auditing profession and very importantly, the health of our energy interest and markets. We take this step because of the profoundly troubling things we've discovered in the investigation of Enron.

Most significantly we have learned that first, senior Enron management engaged in self-dealing transactions, and second, Enron transacted with partnerships controlled by CFO, the Chief Financial Officer, Andrew Fastow, his associate, Michael Kopper and others, and that Enron appeared to shift the risk of loss on risky investments in these partnerships, but in fact, remained fully liable for their investments and those risks.

And third, Enron went ahead and reported fictitious gains on these transactions with the LJM and Raptor entities when the hedged investments declined in value, and that these gains were illusory. The partnerships lacked the economic resources to make good on the transactions. The effect of these sham transactions was to inflate Enron's publicly reported earnings in 1999, 2000 and 2001 significantly by more than $1 billion.

We have found substantial evidence of illegal activity by Enron and its management. And this activity served to deceive the public about Enron's financial condition. It artificially pumped up Enron's stock price and allowed these same executives to enrich themselves with the sales of Enron stock.

We have also found that Enron's auditor, Andersen, knew or should have known or should have discovered the fraudulent nature of the Fastow transactions and we have found that Enron's financial statements violated numerous existing accounting rules. These statements misled investors about Enron's financial condition and over-estimated that net income by over $1 billion. In the end it turns out that the Enron debacle is an old fashioned example of theft by insiders and a failure of those responsible for them to prevent that theft. We believe this is a huge aberration of corporate behavior in America. For example, in one transaction, Fastow and Kopper informed the investors in LJM2, a partnership at the center of this theft, that the expected rate of return on the transaction was 2,503 percent to be realized in just 8 days.

In each of the so-called Raptor transactions, Fastow extracted all of his equity, along with additional fees in the tens of millions of dollars before any transactions that involved any economic risk took place. In this way, Enron was doing business with an entity with only one asset and that was Enron's shares that Enron had contributed. This was not a hedging transaction. Enron was merely issuing shares and calling the issuance earnings. This clearly violated existing law and the most basic norms of corporate behavior.

Enron's Board of Directors, its Finance Committee and its Audit Committee failed to exercise due care with respect to these transactions and it simply boggles the mind that the Chief Financial Officer of a company was allowed to organize partnerships and simultaneously take the other side of deals with this company. Such an arrangement should never have happened and does not ordinarily happen in any corporation that I know of in America.

Additionally, we have learned that the SEC conducted no meaningful review of Enron disclosures from 1997 through 2001, so before we rush to impose new laws and regulations in the wake of the scandal, we want to be sure that we're actually enforcing existing law and today, we're going to look at some of the broader implications of Enron and what it means for the controls and safeguards we have built into our capital raising system.

We'll hear from experts in corporate governance, in accounting, in the governance of auditors and we'll hear from an energy firm. We'll look at the state of current law and the current practice to see if reforms are necessary.

Now I want to also make some other comments. Next week, I've asked the Energy Subcommittee, chaired by Joe Barton to suspend action on his energy package, the electricity package, until we can thoroughly understand the effect of this Enron collapse under the energy markets. And he will conduct a hearing next week on that issue.

I've also asked the chairman of our Commerce, Trade, and Consumer Protection Subcommittee, Mr. Stearns to conduct a hearing into FASB's Rules, the accounting principles involved here and the accounting rules that may need improvement as we go forward and learn more from today's hearing and other hearings about this important area.

In short, this hearing today will feed into the hearing tomorrow by the Oversight and Investigations Subommittee in which we will have the principals whom we are investigating at Enron and who may have been responsible for some of this mess before us, and into the substantive committees on the Enron energy market's effect, as well as the effects on FASB and the need for changes in accounting principles or rules or governance in this country.

Today's hearing will give us a chance to look into those three areas and to get a clear understanding of what happened at Enron, what perhaps ought to be happening in the governance of accounting, and what perhaps ought to be happening in terms of board memberships and the quality and the capacity of board members to serve in America, and finally, the situation in the energy markets as a result of the collapse of Enron.

After the hearing or some time in the middle of the hearing, we will conduct the disposition of the resolution authorizing subpoenas, and then we will take up our witnesses.

Let me again, as I've done throughout this process, offer my sincere and deep appreciation to the ranking minority member of this committee, Mr. Dingell, for his extraordinary cooperation and for the fact that this investigation is being conducted in such a truly bipartisan fashion. Our joint investigators are doing a superb job, not simply for this committee, but I think for our country, and again I want to thank the ranking member as I recognize him for his opening statement.

Mr. Dingell.

[The prepared statement of Hon. W.J. "Billy" Tauzin follows:]

PREPARED STATEMENT OF W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON ENERGY AND COMMERCE

Today, we are taking the extraordinary step of holding a full Energy and Commerce Committee hearing to consider some of the most important policy issues raised by Enron's collapse. These issues include corporate governance, accounting and governance of the auditing profession and the health of our energy markets.

We take this step, because of the profoundly troubling things we've discovered in our investigation of Enron. Most significantly, we've learned that:

1. Senior Enron Management engaged in self-dealing transactions.
2. Enron transacted with partnerships controlled by CFO Andrew Fastow, his associate Michael Kopper and others. And that Enron appeared to shift the risk of

loss on risky investments to the partnerships, but in fact it remained fully liable for those investments.

3. Enron went ahead and reported fictitious gains on these transactions with the LJM and Raptor entities when the hedged investments declined in value. These gains were illusory; the partnerships lacked the economic resources to make good on the transactions. The effect of these sham transactions was to inflate Enron's publicly reported earnings in 1999, 2000 and 2001 significantly—by more than a billion dollars.

We have found substantial evidence of illegal activity by Enron and its management. This activity served to deceive the public about Enron's financial condition. It artificially pumped up Enron's stock price and allowed these same executives to enrich themselves with sales of Enron stock.

We have also found that Enron's auditor, Andersen, knew or should have discovered the fraudulent nature of the Fastow transactions. We have found that Enron's financial statements violated numerous existing accounting rules. These statements mislead investors about Enron's financial condition and overestimated Enron's net income by over $1 billion.

In the end, it turns out that the Enron debacle is an old fashion example of theft by insiders, and a failure by those responsible for them to prevent that theft. For example, in one transaction, Fastow and Kopper informed the investors in LJM2—a partnership at the center of this theft—that the expected rate of return on the transaction was 2,503%, to be realized in just eight days.

In each of the so-called Raptor transactions, Fastow extracted all of his equity, along with additional fees in the tens of millions of dollars, before any transactions that involved any economic risk took place. In this way, Enron was doing business with an entity whose only asset was Enron shares that Enron had contributed. This was not a hedging transaction; Enron was merely issuing shares and calling the issuance earnings.

This clearly violated existing law and the most basic norms of corporate behavior.

Enron's board of directors, its Finance Committee and Audit Committee failed to exercise due care with respect to these transactions. It simply boggles the mind that the chief financial officer of a company was allowed to organize partnerships and simultaneously take the other side of deals with his company. Such an arrangement should never have happened.

Additionally, we have learned that the SEC conducted no meaningful review of Enron disclosures from 1997-2001. So before we rush to impose new laws and regulations in the wake of this scandal, we will want to be sure that we are actually enforcing existing law.

Today, we are going look at some of the broader implications of Enron and what it means for the controls and safeguards we have built into our capital-raising system.

We will hear from experts in corporate governance, accounting, governance of auditors and an energy firm. We will look at the state of current law and current practice and to see if reforms are necessary.

In the area of corporate governance, we will examine the proper role of a board, and the role of outside directors. We will consider what incentives are necessary to get the outside directors to invest the time and effort necessary to oversee a company in times of difficulty. We will compare that effort to the woeful performance of the Enron board.

In the area of accounting, we will examine existing rules governing disclosure of these now notorious Special Purpose Vehicles, the so-called 3% test, and mark-to-market accounting. We will consider whether FASB, which has been considering changes to the rules governing accounting for off-balance sheet transactions for the better part of a decade, should be encouraged to expedite those changes.

We will also consider the changes that need to be made in the area governance of the accounting profession. We need to restore public confidence in the important work performed by the accountants. We also need to be certain that adequate regulation of accounting firms is in place to encourage them to put investor's interest ahead of getting a particular deal done.

In the vital area of energy policy, we will consider what effect, it any, Enron's collapse had on the market for electricity and natural gas and its effect on consumers. We will also consider the implications for reliability on an ongoing basis and whether prudent regulatory changes are called for.

After this hearing of the full Committee, our bipartisan investigation will continue under Subcommittee Chairman Greenwood. Importantly, both Subcommittee Chairmen Barton and Stearns will begin a more detailed review of the policy implications in these areas and work to ensure that there are no future financial calamities of this type.

I welcome our witnesses, and look forward to their knowledgeable testimony.

Mr. DINGELL. Mr. Chairman, I thank you. I commend you for this hearing and I join you in the comment you have just made about the bipartisan character of this inquiry.

I commend you for that and I say that we on this side look forward to continuing the fine relationship which we have had in connection with this investigation. It has been a bipartisan investigation and it is something which has been most welcome to me and to us over here.

Mr. Chairman, I want to commend you for scheduling this full committee Hearing on the lessons of Enron. A week ago today, the Kids Post Page of the Washington Post summed it up nicely under the banner headline, "Greedy Liars, the Enron Scandal", perhaps showing that while figures don't lie, liars can figure.

There was a picture of Enron's CEO, Kay Lay, with the caption, "Did this Man Get Rich . . . " and a picture of a former Enron employee and his wife with the caption, ". . . while These People Got Poor?"

Then there was a little box at the bottom on the accountants with a caption, "The Watchdog Doesn't Bark." In a nutshell, these comments accurately sum up what happened here. And I join you, Mr. Chairman, in beginning to discuss it.

Last month, SEC Chairman Harvey Pitt made a profound declaration: "There's nothing rotten in the accounting profession." This is just plain hooey. There are many honest accountants, and there are many fine and honest accounting firms. I happen to retain one accountant and accounting firm to deal with my affairs and I find them to be completely honest and worthy of respect and admiration.

There are, however, systematic problems with the way the profession is governed and compensated, coupled with corrosive pressures put on honest auditors to bring in nonaudit business at almost any price and to satisfy their clients and employers, by coming up with acceptable answers.

It is almost impossible for many honest people to stand up and blow the whistle on management. I held hearings on these matters in the late 1980's and early 1990's. The accountants said that I was wrong, but now history says they were wrong. The accountants promised that they would reform themselves. They did not.

So, Mr. Chairman, we must now do it for them. And in so doing we must recognize that this action constitutes protection of our entire economic system which functions on facts, truth and, most importantly, on the trust of the people.

Today we start the process of looking broadly at regulatory issues. As I said, Mr. Chairman, I welcome this event and I commend you for it and I welcome this morning's distinguished panel witnesses and I look forward to their testimony and guidance.

I note that amongst others we have before us today a witness suggested by the minority, Mr. James Chanos, who recently appeared on the cover of Barron's as "The Guy Who Called Enron." I ask unanimous consent to include a copy of that article in the hearing record.

Chairman TAUZIN. Without objection, so ordered.

Mr. DINGELL. Thank you, Mr. Chairman. Along with a copy of Bethany McLean's March 5, 2001, Fortune article entitled, "Is Enron Overpriced?"

Chairman TAUZIN. Without objection, so ordered.

Mr. DINGELL. Apparently, there were red flags waving all over Enron's financial statement, if you wanted to see them. Was everybody else blind? Why did the accountants not see them and if so, why?

We also have at the minority's request, Mr. Bevis Longstreth, who had a distinguished career as an SEC Commissioner during the Reagan Administration. He recently served 2 years on the O'Malley Panel on Audit Effectiveness which reported a number of critical findings and recommendations in August 2000 for improving the performance of the profession and its governance system.

All the witnesses are here today because Enron is not unique. It is huge. Indeed, the biggest bankruptcy in history, but it is not unique. Similar events may well be out there at this time, waiting to happen after similar or identical causes and reasons.

The SEC has been reporting in increasingly record numbers of financial fraud in cases involving bad accounting. Enron is only an exclamation point in a long list of accounting frauds that include Waste Management, Sunbeam—and I note that those were both matters which were under the trust of, guess who, Arthur Andersen—Cendant, Rite Aid, Microstrategy, just to name a few. I supported Arthur Levitt's efforts to rein in the abuse and I supported FASB's efforts to write tough accounting standards. Others saw fit to bully the SEC and FASB on behalf of special interests who were opposed to what the regulators were trying to do.

I hope today, Mr. Chairman, that we will all stand shoulder-to-shoulder in our resolve to do the right thing by the American people and to fix a badly broken system.

Mr. Chairman, this system smells bad enough for either repair or early burial and I suggest that the continued health and well-being of our financial system depends upon it.

Mr. Chairman, I thank you for this recognition and we on this side will support the motion on subpoena authority at the proper time.

[The prepared statement of Hon. John D. Dingell follows:]

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. Chairman, I commend you for scheduling this full Committee hearing on the lessons of Enron. A week ago today the KidsPost page of the *Washington Post* I think summed it up nicely under the banner headline **"Greedy Liars? The Enron Scandal."** There was a picture of Enron CEO Ken Lay with the caption **"Did this man get rich . . ."** and a picture of a former Enron employee and his wife with the caption **". . . while these people got poor?"** Then there was a little box at the bottom on the accountants with the caption **"The Watchdog Doesn't Bark."** In a nutshell, that pretty accurately sums up what happened here, and it's disgusting.

Last month SEC chairman Harvey Pitt declared: "There is nothing rotten in the accounting profession." This is bunk. There are many honest accountants—I happen to think that I retain one—and many honest accounting firms. But there are systemic problems with the way the profession is governed and compensated. Coupled with the corrosive pressures put on honest auditors to bring in nonaudit business at almost any price, it is almost impossible for honest people to stand up and blow the whistle on management. I held hearings on these issues in the late '80s and early '90s. The accountants said I was wrong, but we now know they were wrong.

The accountants promised that they would reform themselves. They did not. We will now do it for them.

Today we start the process of looking broadly at regulatory issues. I welcome this morning's distinguished panel of witnesses and I look forward to their testimony and guidance. I note that, among others, we have before us today a witness suggested by the Minority, Mr. James Chanos who appeared on the cover of a recent *Barron's* issue as "The Guy Who Called Enron." I ask unanimous consent to include a copy of that article in the hearing record, along with a copy of Bethany McLean's March 5, 2001, *Fortune* article, "Is Enron Overpriced?" Apparently, there were red flags waving all over Enron's financial statements if you wanted to see them. Was everybody else blind? And, if so, why?

We also have, at the Minority's request, Mr. Bevis Longstreth who had a distinguished career as an SEC commissioner during the Reagan Administration. He recently served two years on the O'Malley Panel on Audit Effectiveness which reported a number of critical findings and recommendations in August 2000 for improving the performance of the profession and its governance system.

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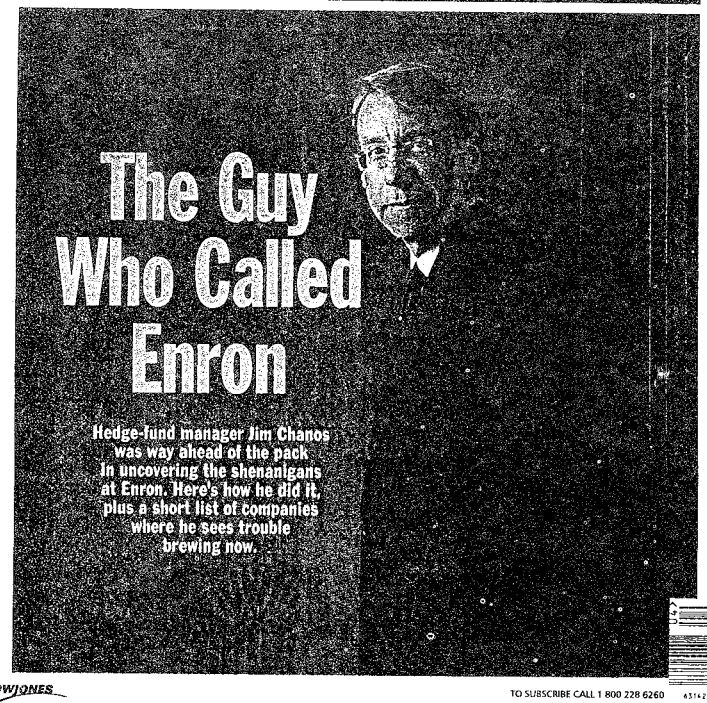

The Guy Who Called Enron

Hedge-fund manager Jim Chanos was way ahead of the pack in uncovering the shenanigans at Enron. Here's how he did it, plus a short list of companies where he sees trouble brewing now.

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The Bear That Roared

How short-seller Jim Chanos helped expose Enron

BY JONATHAN R. LAING

Over the past 20 years, short-seller Jim Chanos has had a volatile career of exhilarating highs and gut-wrenching lows. As a callow 24-year-old analyst in 1982, he made the call that's still the stuff of Wall Street legend. In August of that year—"the day before the great post-1982 bull market began its epic ascent," he laughs—Chanos put out a sell recommendation on Baldwin-United, then a high-flying annuity company. He declared the firm a "house of cards" doomed to collapse from over-leverage, kinky accounting and negative cash flow.

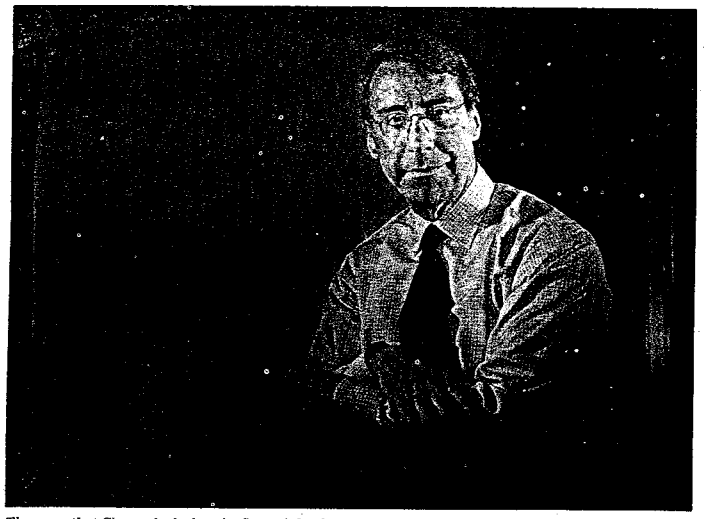
The young analyst stuck to his guns over the succeeding months in the face of withering criticism by fellow Wall Street analysts, virtually all of whom were wildly bullish on Baldwin, and threats of lawsuits from the company. He was vindicated, however, when 13 months later Baldwin filed for Chapter 11, vaporizing some $6 billion in stock value and leaving the holders of billions of dollars in annuities in the lurch.

Chanos received deserved star treatment in the financial news media, as a result. A front-page story in The Wall Street Journal in the fall of 1983 hailed him as a David who'd slain Goliath by "defying the experts."

His hot streak in selling short continued into the early-'Nineties despite the severe head winds of a bull market. He exploited the serial collapse in the late 'Eighties of commercial real estate in Texas, Arizona, California, New England and finally Canada, making millions off short positions in the stocks of various regional banks, savings and loans and real-estate development companies. Moreover, he presciently saw Mike Milken's junk-bond kingdom for what it was, a daisy chain of Drexel Burnham-financed holding companies that were able to loot heavily-regulated insurance companies and S&L subsidiaries of funds by buying each other's junk-bonds. He rode the stocks of such Milken-financed companies as Integrated Resources, Southland Financial, Columbia S&L and First Executive all the way to their oblivion. His **Ursus Partners** hedge fund—ursus being Latin for bear—more than quadrupled in value between its formation in October 1985 through the end of December 1990. That was twice the rise in the Standard & Poor's Index over the same time span.

But as so often happens, early success seemed to breed subsequent failure. For Chanos was brutalized by the torrid bull climb in stock prices in early 1991 that kicked in following the onset of the Allied invasion of Kuwait, and continued with only a few interruptions through the end of 1999. The net asset value of Ursus Partners dropped nearly 75% over that period, virtually wiping out all the gains the fund had achieved over the previous five and a half years. At various times during the 'Nineties, the fund was down nearly 85% from its high-water mark achieved in late-1990. Over the same 15-year period, the S&P rocketed up a cumulative 12-fold.

Sitting recently in his cramped office on the 44th floor of the Citigroup Center in midtown Manhattan, the tall and lanky Chanos clinically analyzed his problems during the 'Nineties. He had missed the sea change that had occurred in the financial markets after Federal Reserve Chairman Alan Greenspan had begun to flood the economy with liquidity to bail out Citicorp and other then-shaky major banks in the early 'Nineties. Salubrious stock and bond markets during the



The more that Chanos looked at the financials, the more suspicious he became.

decade had allowed even companies with overstretched balance sheets and dubious business plans to heal themselves and finance their dreams.

He admitted to making a number of analytic errors that cost Ursus dearly. A large short position in McDonnell-Douglas blew up in his face after a series of large contract awards by the Pentagon after the Gulf War bailed out the troubled company. America Online was another disaster. He thought that the way it accounted for marketing costs by putting them on the balance sheet rather than running them through the income statement was suspect. What he missed, he now admits, was the dimension of the Internet boom that ensued, turning AOL into an impregnable brand name.

And his short positions in mutual fund company **Franklin Resources** and brokerage firm **Charles Schwab** in 1995 and 1996 went south because the stock market mania wasn't ending as he thought. It was just going into overdrive. "We were making a market-timing call which is not something our investors pay us to do," he concedes with obvious chagrin.

And just perhaps, Chanos was laid low by an element of hubris. At least that's what a hedge-fund competitor and admirer claims. He elaborates: "Jim is a spectacular analyst, a straight-up guy loaded with integrity and ability. He deals in facts rather than innuendo, unlike so many shorts. But he was typical of the ball player who bats .400 in his first season in the majors and assumed that it would be easy to repeat it every year. Success may have gone to his head. He allowed Mr. Market to take away way too much of his money by staying with losing positions too long and ignoring the market forces arrayed against him."

The bull market ultimately brought a certain pragmatism to Chanos' business strategy, however. In late 1996, he reduced the leverage on Ursus Partners. And his firm, Kynikos Associates, opened the Beta Hedge fund, which was designed to take the risk of raging-bull markets by offsetting every dollar of short exposure with a dollar of long exposure. The fund's long positions are selected quantitatively by another manager solely to mimic the volatility of the fund's short selections. Beta Hedge has delivered a compound annual growth rate of over 13%. Today, it comprises about half of Chanos' more than $1 billion under management.

The flagship Ursus fund is now leading the revival of Chanos's fortunes. Ursus posted a gain of 47.4%, before fees, in 2000 and 18.2% in 2001. The big money came from anticipating the collapse of Internet stocks—Chanos thought their business plans were screwy—and telecom stocks, which he reasoned would be felled by overcapacity. Among his winning shorts were **Amazon.com**, **Priceline**, **Williams Communications**, along with **McLeod USA**. Finally, Chanos seems to have his groove back.

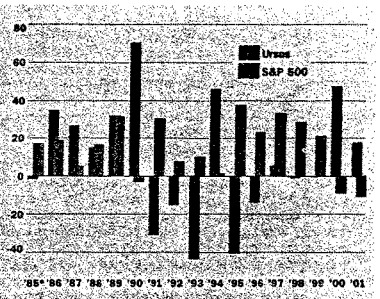
The bursting of the tech bubble also put Chanos back in the media limelight after a decade or more in the shadows. The searing bear market of the last two years has helped raise his profile. And perhaps most important, he's now widely credited with being the first on Wall Street to blow the whistle on the biggest bankruptcy in U.S. history, **Enron**. It was surely the market call of the decade, if not the past 50 years. And made by the very same analyst who had wowed

the investment world with Baldwin-United some 20 years ago. Not bad coups in anyone's career.

In a wide-ranging interview with *Barron's*, Chanos chronicled the tale of what led him to first short Enron in late 2000, when the company was trading near its all-time high of 90 and enjoying near universal acclaim on Wall Street. He continued to short the shares in early 2001, when soaring electricity prices in California seemed to only strengthen the likelihood of profit growth for wholesale energy marketers like Enron.

Caught Short

The bull market of the 1990s was not kind to Jim Chanos' Ursus Partners fund, stripping away virtually all of its early gains. From it's inception in October 1985 through December 2001, Ursus posted compound average annual gains of 4%, before fees, compared with 11.9% for the S&P 500. Now the ball is back in Chanos' court.



*October through December

He concedes that, initially, he thought the energy-trading concern was viable, but that its stock was wildly overpriced. But further research convinced him that Enron had been engaging in fraudulent accounting and that the company's condition was likely terminal. The resignation of Enron Chief Executive Jeffrey Skilling in August for half-baked reasons only solidified that conclusion in Chanos's mind. Skilling sensed big trouble ahead. (Friday, J. Clifford Baxter, a former Enron vice chairman, was found shot in the head in a car. Initial reports described his death as a suicide.)

CHANOS' INTEREST IN ENRON WAS FIRST piqued in october 2000 when he chanced upon an article that had appeared the previous month in the Texas regional section of The Wall Street Journal, penned by the paper's current accounting writer, Jonathan Weil. (*Barron's* and The Wall Street Journal are published by Dow Jones.) The writer asserted that Enron and other leading marketers of electricity and natural gas were artificially boosting their profits by reporting unrealized, non-cash gains on long-term energy deals that wouldn't be actually booked for years to come. Some of these contracts extended out more than 20 years. And whether these profits would ever be realized depended on seeming unknowable, difficult-to-hedge assumptions such as the future course of natural gas and electricity prices stretching out over decades, interest-rate trends and importantly, it turned out, Enron's maintenance of its non-junk credit rating.

The article resonated with Chanos. Abuses of so-called "gain-on-sale" accounting over the years had led to some of his biggest investment coups. Baldwin-United, for example, had gunned its reported earnings by making all sorts of fraudulent assumptions on the present value of its future profits on its annuity sales. Chanos had also made a bundle on such avid gain-on-sale exponents as the mobile home-financier Conseco, the sub-prime auto-finance company Mercury Finance and the sub-prime mortgage company First Plus. All used faulty assumptions in their securitizations to gin up fancy profit growth.

"It has been our experience that gain-on-sale accounting creates an irresistible temptation on the part of managements heavily incentivized with options and heavy stock ownership to create earnings out of thin air," he says.

At the same time, Chanos and an associate began to pore over Enron's financials. Selling at the time for some 60 times earnings, the stock seemed "priced for perfection." Yet another picture emerged in the company's 1999 10-K and 10-Q filings with the SEC for the nine months ended September 30, 2000.

Instead, the company seemed to be "a hedge fund in disguise," relying on energy trading for more than 80% of its current earnings. And not a very good hedge fund. By Chanos' calculations, Enron was only able to churn out a paltry 7% return on its capital, while its cost of capital was over 10%. In other words, Enron would require more and more capital just to eke out continuing modest returns, let alone enjoy any profit growth. At the time,

neither Chanos nor any outsiders suspected that two-thirds of Enron's debt resided off the balance sheet in the now-infamous partnerships and other special-purpose entities.

Chanos concluded that investors were crazy to pay six times book value to own the stock when other far-better-performing hedge-fund portfolios could be purchased for their net asset value.

The 10-K and 10-Q also revealed other tantalizing clues. He remembers being "baffled" by a flurry of "related party" transactions detailed in various footnotes. Mentioned were two outside partnerships, headed by an unnamed senior officer of Enron, that seemed to be engaged in a flurry of transactions that took assets off Enron's books and yielded lush pre-tax gains and revenues to the parent.

The revelation in October 2001 that the manager of these partnerships was Enron's chief financial officer, Andrew Fastow, and that he made more than $30 million on the side running the entities, created the crisis in confidence that ultimately drove Enron into bankruptcy proceedings. But Chanos had no way of knowing this in late 2000, or fully grasping the import of the convoluted disclosures in the SEC documents. His original copies of these filings bear his notations made at the time, a series of exclamation points and question marks in the margins. "We're pretty good at deciphering footnotes and other disclosures, but these reports left us scratching our heads," he recalls. "We did decide, however, that it's rarely good news when a company is engaged in deals with an outside entity run by one of its senior officers. How could it be an arm's-length transaction?"

Chanos continued to add to his short position in early 2001, but as a precaution he talked to a number of sell-side analysts on Wall Street, almost all wildly bullish on Enron's prospects, to get the bull's argument for the stock. He was heartened to find that many were pinning their hopes on Enron's entry into trading in excess fiberoptic bandwidth capacity. No less than Jeff Skilling had asserted to analysts in January 2001 that bandwidth trading would likely add as much as $35 to the stock, which was then trading in the low 80s.

Chanos knew differently. From his reading of the opaque footnotes, he realized that Enron was dumping its unused fiber and other physical broadband assets on the partnerships. Moreover, he had shorted a number of fiberoptic-network companies, correctly judging that the industry was going into free fall as a result of gross overcapacity and a collapse in pricing. "Didn't the energy analysts touting Enron ever bother to talk to any of the telecom analysts?" he still wonders.

Chanos and his associates also talked to several energy traders at leading financial institutions. They expressed incredulity at the trading profits Enron was reporting. They described the business as a fairly blue-collar, low-margin affair of matching buyers with sellers. He deduced from this that Enron must be making a lot of directional, unhedged bets, and with the bull market in natural-gas prices and electricity rates starting to turn, Enron might suffer severe losses.

At this point, Chanos began to publicize his views on Enron. In February 2001, at the "Bears in Hibernation" meeting he hosts annually in Miami, he made Enron one of his two short picks. He counted on the

Doubting Tyco

JIM CHANOS FINDS NO DEARTH OF SHORT-SELLing ideas in the post-Enron stock market. Wall Street's new-found abhorrence of opaque accounting, he says, will hasten the decline in the stocks of a number a firms that are using aggressive accounting methods to boost reported earnings.

Among his current shorts are lenders with large exposures to the sub-prime credit market, including **Household International**, the consumer-finance giant ("Does It Add Up?" December 3, 2001), as well as **Metris** and **Capital One**, both credit-card firms. A rotten economy has exposed their borrower base to hard times, says Chanos, and high lending rates and fat lending margins won't be enough to insulate the firms from rising credit losses. Rapid growth in loan receivables at all three companies, can only mask the rising delinquency rates for so long, he says. The growing deterioration in sub-prime lending, it should be noted, has already laid low other former Chanos shorts, including **AmeriCredit**, Conseco and **Providian**. The sector has also engaged in aggressive accounting to burnish current results.

Chanos is also short the stock of **Bally Total Fitness**. The health-club concern, he says, is being hurt by flattening membership growth and high capital spending requirements to keep club equipment up-to-date. As a result, cash flow, including maintenance capital spending, remains negative even after the company recently slowed its expansion drive.

But his latest jihad is against the industrial-conglomerate **Tyco International**, which he began shorting late last year in the high 50s. The company's stock is now trading at around 45, hurt by a lowering in its guidance for earnings growth in the fiscal second quarter, ending March 30, 2002, and the Enron-inspired disaffection for companies with complicated financials.

Chanos argues that the hyper-acquisitive Tyco has used accounting legerdemain to turbocharge earnings growth, which topped 40% annually for the five years through fiscal 2000, and came in at 28% last year. He claims, for example, that the managements of several firms that Tyco acquired, including medical-supply company US Surgical, electronic-components maker AMP and finance-company CIT Group, all artificially depressed the operating results of their companies in the final months before the deals were completed. This was done by taking numerous charges, slowing down sales and pushing up expenses. As a result, he says, Tyco's operating results were "spring-loaded" for a quarter or two after the acquisition closed, as sales suddenly surged and profit margins exploded.

Jim Chanos' Pans

Company	Symbol	Recent Price
Bally Total Fitness	BFT	$21.72
Capital One	[illegible]	[illegible]
Household Intl	HI	53.75
Metris	[illegible]	[illegible]
Tyco Intl	TYC	44.37

Chanos also contends that Tyco abused accounting rules by essentially writing down the net asset value to zero of some $30 billion in acquisitions made in the last three years. Thus, the purchase prices were all allocated to goodwill on the balance sheet. This intangible asset was amortized over a 40-year period as compared to, say, property, plant and equipment that must be expensed on the income statement over far shorter depreciation periods. Under new accounting regulations, the earnings hit from goodwill has all but disappeared.

This is the second holy war that Chanos and the other major shorts have waged against Tyco. In late 1999, they raised questions about other aspects of Tyco's acquisition accounting. The stock swooned

Continued on page 20

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for a time before smartly recovering in mid-2000 after the SEC gave the company a clean bill of health on the accounting issue. Tyco was only required to make a few minor adjustments to its acquisition reserves and restructuring charges from earlier years.

Barron's published a bullish cover story, "Tyco's Titan" in the April 12, 1999, issue, profiling Tyco's hard-charging chairman Dennis Kozlowski. Among other things, we examined Tyco's complicated financial reporting and concluded that their accounting appeared to pass muster. The company, then and since, has enjoyed strong growth in free cash flow, or cash flow after all required capital spending. That number, which reached nearly $5 billion in fiscal 2001, is a difficult one to fake. The stock ultimately rose to over 60 late last year from a split-adjusted 38 when the *Barron's* story appeared.

Yet Tyco stunned the investment community last week by announcing plans to break up the company into four pieces: security and electronic components; fire-protection and flow controls; health care and financial services. Moreover, Tyco hopes to cuts its $23 billion debt in its non-finance operations by

fact that many of the attendees, including other well-known bears and hedge-fund managers, would be intrigued by his Enron story and assist him in much of the heavy lifting in researching such a complicated situation.

A reporter from Fortune magazine called him later that month to query him about his latest investment ideas. He methodically took her through the Enron story. Though the resulting story in March was somewhat pallid, it did raise questions about Enron's valuation, promotional style and opaque financials for the first time since the Weil effort the previous fall.

As the year wore on, Chanos dug more deeply into accounting issues at Enron. By then, he and other hedge-fund managers were scouring documents, often from anonymous sources, relating to various secret Enron off-balance-sheet partnerships with names like Osprey, Marlin Water and Yosemite Securities.

There was a certain invariable pattern to the flurry of transactions between the partnerships and Enron. Millions of dollars in Enron assets and attendant debt would dance off Enron's books, and the parent would reap lush benefits from sale revenues, trading profits and merchant banking gains. What Chanos didn't know was that Enron had created literally thousands of partnerships and other special-purpose entities to shield losses from investors' view.

But the odor of the deals was unmistakable. For one thing, some of the assets being transferred, such as parts of Enron's broadband system, water-company holdings and various stock investment holdings, were plummeting in value.

And Chanos realized after a close reading of the partnership documents that, though the partnerships were technically independent entities, Enron was still on the hook for any losses in value the partnerships suffered. These "make good" arrangements required Enron to contribute additional Enron shares to the partnerships to make them whole in the event of losses.

Likewise, the partnership debt was not non-recourse to Enron. In the event of a downgrade in Enron's credit rating, to below investment grade, the company would be on the hook for much of this supposedly off-balance-sheet debt.

With the stock steadily falling, from over 70 to the mid-40s during the summer, the potential for a China Syndrome meltdown in Enron's balance sheet loomed. "We could see the partnerships becoming insolvent and this in turn causing a financial death spiral for the parent," Chanos recalls. "We knew we were right when Skilling quit the company in August. In our opinion, he saw that Enron's declining stock price meant the game was over for Enron."

The rapidity of Enron's collapse left Chanos agog nonetheless. And he is stunned by the scabrous tales of document-shredding at Enron's accounting firm and company headquarters.

It will take months of forensic accounting effort to fully plumb the depths of the apparent fraud at Enron. But he suspects that far more will be discovered than just Enron's apparent attempt to use the now infamous partnerships to hide debt. He contends that Enron also used the partnerships to boost Enron profits by acting as a dumping ground for losing trades, bad long-term investments and busted Enron investment-banking deals. Moreover, he thinks that millions of dollars in past-reported Enron profits will melt away once its long-term energy trades are properly marked-to-the-market. "That's the next big shoe to drop," he predicts.

But for a bear like Chanos, Enron's travails are hardly unwelcome. Especially because, suddenly, Wall Street is zealously burrowing into the financials of other companies with opaque financial statements. Trust-me managements are coming under scrutiny as never before. And the stock market appears to be treading water.

In short, it's the best of all possible worlds for a confirmed cynic and accounting-whiz like Jim Chanos. The stock market is now in his dojo. ■

$11 billion by using proceeds from the initial public offerings of three of the new units and the sale of Tyco's plastics business. Last week, Kozlowski told *Barron's* that the breakup grew out of management's dissatisfaction with the stock's low price-to-earnings ratio (now below 12 based on fiscal '02 estimates) and a post-Enron need to simplify financial reporting by simplifying business structures. "After being a fast-growing conglomerate over the past decade, it's clear now that we can deliver more value to the shareholder by breaking up," Kozlowski contends.

He puts the breakup value of Tyco at between 75 and 90. The sudden shift in Tyco's management philosophy didn't initially boost the stock, however. Late in the week, it was trading around 44, or nearly 2½ points below where it had stood before the breakup announcement. Chanos says that he sold more Tyco short on the day of the announcement, during which the price initially spiked up more than four points before settling back.

It remains to be seen who's right, Kozlowski or Chanos. We should know within the next year, however, when the breakup is expected to be completed.

—*J.R.L.*

It's in a bunch of complex businesses. Its financial statements are nearly impenetrable. So why is Enron trading at such a huge multiple?

By Bethany McLean

Is Enron Overpriced?

In Hollywood parlance, the "It Girl" is someone who commands the spotlight at any given moment—you know, like Jennifer Lopez or Kate Hudson. Wall Street is a far less glitzy place, but there's still such a thing as an "It Stock." Right now, that title belongs to Enron, the Houston energy giant. While tech stocks were bombing at the box office last year, fans couldn't get enough of Enron, whose shares returned 89%. By almost every measure, the company turned in a virtuoso performance: Earnings increased 25%, and revenues more than doubled, to over $100 billion. Not surprisingly, the critics are gushing. "Enron has built unique and, in our view, extraordinary franchises in several business units in very large markets," says Goldman Sachs analyst David Fleischer.

Along with "It" status come high multiples and high expectations. Enron now trades at roughly 55 times trailing earnings. That's more than 2½ times the multiple of a competitor like Duke Energy, more than twice that of the S&P 500, and about on a par with new-economy sex symbol Cisco Systems. Enron has an even higher opinion of itself. At a late-January meeting with analysts in Houston, the company declared that it should be valued at $126 a share, more than 50% above current levels. "Enron has no shame in telling you what it's worth," says one portfolio manager, who describes such gatherings as "revival meetings." Indeed, First Call says that 13 of Enron's 18 analysts rate the stock a buy.

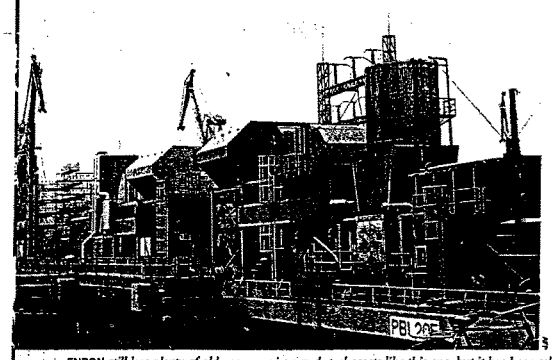
SOME PEOPLE *liken Enron, with its massive trading operation, to a Wall Street securities firm.*

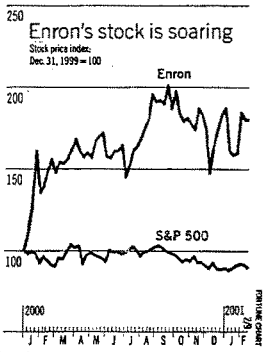
But for all the attention that's lavished on Enron, the company remains largely impenetrable to outsiders, as even some of its admirers are quick to admit. Start with a pretty straightforward question: How exactly does Enron make its money? Details are hard to come by because Enron keeps many of the specifics confidential for what it terms "competitive reasons." And the numbers that Enron does present are often extremely complicated. Even quantitatively minded Wall Streeters who scrutinize the company for a living think so. "If you figure it out, let me know," laughs credit analyst Todd Shipman at S&P. "Do you have a year?" asks Ralph Pellecchia, Fitch's credit analyst, in response to the same question.

To skeptics, the lack of clarity raises a red flag about Enron's pricey stock. Even owners of the stock aren't uniformly sanguine. "I'm somewhat afraid of it," admits one portfolio manager. And the inability to get behind the numbers combined with ever higher expectations for the company may increase the chance of a nasty surprise. "Enron is an earnings-at-risk story," says Chris Wolfe, the equity market strategist at J.P. Morgan's private bank, who despite his remark is an Enron fan. "If it doesn't meet earnings, [the stock] could implode."

What's clear is that Enron isn't the company it was a decade ago. In 1990 around 80% of its revenues came from the regulated gas-pipeline business. But Enron has been steadily selling off its old-economy iron and steel assets and expanding into new areas. In 2000, 95% of its revenues and more than 80% of its operating profits came from "wholesale energy operations and services." This business, which Enron pioneered, is usually described in vague, grandiose terms like the "financialization of energy"—but also, more simply, as "buying and selling gas and electricity." In fact, Enron's view is that it can create a market for just about anything; as if to underscore that point, the company announced last year that it would begin trading excess broadband capacity.

But describing what Enron does isn't easy, because what it





ENRON *still has plenty of old-economy iron and steel assets like this one, but it has been selling them off at a steady clip.*

does is mind-numbingly complex. CEO Jeff Skilling calls Enron a "logistics company" that ties together supply and demand for a given commodity and figures out the most cost-effective way to transport that commodity to its destination. Enron also uses derivatives, like swaps, options, and forwards, to create contracts for third parties and to hedge its exposure to credit risks and other variables. If you thought Enron was just an energy company, have a look at its SEC filings. In its 1999 annual report the company wrote that "the use of financial instruments by Enron's businesses may expose Enron to market and credit risks resulting from adverse changes in commodity and equity prices, interest rates, and foreign exchange rates."

Analyzing Enron can be deeply frustrating. "It's very difficult for us on Wall Street with as little information as we have," says Fleischer, who is a big bull. (The same is true for Enron's competitors, but "wholesale operations" are usually a smaller part of their business, and they trade at far lower multiples.) "Enron is a big black box," gripes another analyst. Without having access to each and every one of Enron's contracts and its minute-by-minute activities, there isn't any way to independently answer critical questions about the company. For instance, many Wall Streeters believe that the current volatility in gas and power markets is boosting Enron's profits, but there is no way to know for sure. "The ability to develop a somewhat predictable model of this business for the future is mostly an exercise in futility," wrote Bear Stearns analyst Robert Winters in a recent report.

To some observers, Enron resembles a Wall Street firm. Indeed, people commonly refer to the company as "the Goldman Sachs of energy trading." That's meant as a compliment. But the fact that part of Goldman's business is inherently risky and impenetrable to outsiders is precisely the reason that Goldman, despite its powerful franchise, trades at 17 times trailing earnings—or less than one-third of Enron's P/E. And as Long Term Capital taught us, the best-laid hedges, even those designed by geniuses, can go disastrously wrong. "Trying to get a good grip on Enron's risk profile is challenging," says Shipman.

Nor at the moment is Enron's profitability close to that of brokerages (which, in fairness, do tend to be more leveraged). While Wall Street firms routinely earn north of 20% returns on their equity—Goldman's ROE last year was 27%—Enron's rate for the 12 months ended in September (the last period for which balance sheet information is available) was 13%. Even less appealing is Enron's return on invested capital (a measure including debt), which is around 7%. That's about the same rate of return you get on far less risky U.S. Treasuries.

Enron vehemently disagrees with any characterization of its business as black box–like. It also dismisses any comparison to a securities firm. "We are not a trading company," CEO Andrew Fastow emphatically declares. In Enron's view, its core business—where the company says it makes most of its money—is delivering a physical commodity, something a Goldman Sachs doesn't do. And unlike a trading firm, which thrives when prices are going wild, Enron says that volatility has no effect on its profits—other than to increase customers, who flock to the company in turbulent times. Both Skilling, who describes Enron's wholesale business as "very simple to model," and Fastow note that the growth in Enron's profitability tracks the growth in its volumes almost perfectly. "People who raise questions are people who have not gone through [our business] in detail and who want to throw rocks at us," says Skilling. Indeed, Enron dismisses criticism as ignorance or as sour grapes on the part of analysts who failed to win its investment-banking business. The company also blames short-sellers for talking down Enron. As for the details about how it makes money, Enron says that's proprietary information, sort of like Coca-Cola's secret formula. Fastow, who points out that Enron has 1,217 trading "books" for different commodities, says, "We don't want anyone to know what's on those books. We don't want to tell anyone where we're making money."

In addition to its commodities business, Enron has another division called Assets and Investments that is every bit as mysterious. This business involves building power plants around the world, operating them, selling off pieces of them, "invest[ing] in debt and equity securities of energy and communications-related business," as Enron's filings note, and other things.

Actually, analysts don't seem to have a clue what's in Assets and

PAUL FENDER/JUNION

JEFF SKILLING, *a former consultant, has taken over the reins from chief executive officer Kenneth Lay.*

Investments or, more to the point, what sort of earnings it will generate. Enron's results from that part of its business tend to be quite volatile—profits fell from $325 million in the second quarter of 1999 to $55 million in the second quarter of 2000. In written reports, Morgan Stanley chalked up the decline to the poor performance of Enron's "significant number of investments" in telecom stocks; Dain Rauscher Wessels blamed it on a lack of asset sales.

In any event, some analysts seem to like the fact that Enron has some discretion over the results it reports in this area. In a footnote to its 1999 financials, Enron notes that it booked "pretax gains from sales of merchant assets and investments totaling $756 million, $628 million, and $136 million" in 1999, 1998, and 1997. "This is an enormous earnings vehicle, which can often be called upon when and if market conditions require," notes UBS Warburg analyst Ron Barone. Not everyone is so chipper. "We are concerned they are liquidating their asset base and booking it as recurring revenue, especially in Latin America," says analyst Andre Meade at Commerzbank—who has a hold rating on the stock. At the least, these sorts of hard-to-predict earnings are usually assigned a lower multiple.

There are other concerns: Despite the fact that Enron has been talking about reducing its debt, in the first nine months of 2000 its debt went up substantially. During this period, Enron issued a net $3.9 billion in debt, bringing its total debt up to a net $13 billion at the end of September and its debt-to-capital ratio up to 50%, vs. 39% at the end of 1999. Nor does Enron make life easy for those who measure the health of a business by its cash flow from operations. In 1999 its cash flow from operations fell from $1.6 billion the previous year to $1.2 billion. In the first nine months of 2000, the company generated just $100 million in cash. (In fact, cash flow would have been negative if not for the $410 million in tax breaks it received from employees' exercising their options.)

But Enron says that extrapolating from its financial statements is misleading. The fact that Enron's cash flow this year was meager, at least when compared with earnings, was partly a result of its wholesale business. Accounting standards mandate that its assets and liabilities from its wholesale business be "marked to market"—valued at their market price at a given moment in time. Changes in the valuation are reported in earnings. But these earnings aren't necessarily cash at the instant they are recorded. Skilling says that Enron can convert these contracts to cash anytime it chooses by "securitizing" them, or selling them off to a financial institution. Enron then receives a "servicing fee," but Skilling says that all the risks (for example, changes in the value of the assets and liabilities) are then transferred to the buyer. That's why, he says, Enron's cash flow will be up dramatically, while debt will be "way down, way down" when the company publishes its full year-end results, which are due out soon.

That's good, because Enron will need plenty of cash to fund its new, high-cost initiatives: namely, the high-cost buildout of its broadband operations. In order to facilitate its plan to trade excess bandwidth capacity, Enron is constructing its own network. This requires big capital expenditures. So broadband had better be a good business. Both Enron and some of the analysts who cover it think it already is. Included in the $126 a share that Enron says it's worth is $40 a share—or $35 billion—for broadband. Several of Enron's analysts value broadband at $25 a share, or roughly $22 billion (and congratulate themselves for being conservative). But $22 billion seems like a high valuation for a business that reported $408 million of revenues and $60 million of losses in 2000. Not all analysts are so aggressive. "Valuing the broadband business is an "extremely difficult, uncertain exercise at this point in time," notes Bear Stearns' Winters, who thinks that broadband, while promising, is worth some $5 a share today.

Of course everything could go swimmingly. Enron has told analysts that it plans to sell between $2 billion and $4 billion of assets over the next 12 months. The bullish scenario for Enron is that the proceeds from those sales will reduce debt, and as earnings from new businesses kick in, the company's return on invested capital will shoot upward. Along with broadband, Enron has ambitious plans to create big businesses trading a huge number of other commodities, from pulp and paper to data storage to advertising time and space. Perhaps most promising is its Enron Energy Services business, which manages all the energy needs of big commercial and industrial companies. Skilling has told analysts that its new businesses will generate a return on invested capital of about 25% over the long run.

But all of these expectations are based on what Wolfe, the J.P. Morgan strategist, calls "a little bit of the China syndrome"—in other words, if you get *x*% of *y* enormous market, you'll get *z* in revenues. For instance, Enron says the global market for broadband and storage services will expand from $155 billion in 2001 to somewhere around $383 billion in 2004. "Even a modest market share and thin margins provide excellent potential here," writes Ed Tirello, a Deutsche Bank Alex. Brown senior power strategist. The problem, as we know from innumerable failed dot-coms, is that the *y* enormous market doesn't always materialize on schedule. And Enron isn't leaving itself a lot of room for the normal wobbles and glitches that happen in any developing business.

In the end, it boils down to a question of faith. "Enron is no black box," says Goldman's Fleischer. "That's like calling Michael Jordan a black box just because you don't know what he's going to score every quarter." Then again, Jordan never had to promise to hit a certain number of shots in order to please investors. ■

FEEDBACK: *bmclean@fortunemail.com*

Chairman TAUZIN. I thank my friend for his statement. We obviously have a different view of some of that history, but we do stand shoulder to shoulder, Mr. Dingell.

The Chair will now interrupt the opening statements for the business meeting of the committee which is the resolution on subpoena power.

[Business meeting.]

Chairman TAUZIN. The Chair will now ask if there are any other members who seek recognition first on this side? The gentleman from Florida, Mr. Bilirakis, is recognized for 5 minutes.

Mr. BILIRAKIS. Thank you very much, Mr. Chairman. I won't take anywhere near that much time. I have no prepared statement. I would just merely like to thank you and particularly the witnesses for their willingness to come here today to give us this broad overview of the implosion, if you will, of Enron and what led up to it. I know we're all concerned about the lack of confidence and the lack of credibility which has suddenly taken place in our minds, particularly regarding the accounting industry and the auditing industry. Hopefully you gentlemen here today may help us to back away from that lack of confidence and credibility so that some of the things that we see happening today not only to employees, but also in the stock market, will change course.

I appreciate being here, Mr. Chairman, and again, thank you very much.

Chairman TAUZIN. The gentleman yields back his time. Under our rules, our members will be recognized for 3 minutes under our rules. The Chair asks if there are any members on this side seeking recognition. The gentleman from California, the gentleman, Mr. Boucher, is recognized for 3 minutes.

Mr. BOUCHER. Thank you very much, Mr. Chairman. I want to commend you and Ranking Member Dingell for the very thoughtful way in which you have handled our committee's investigation into the Enron collapse. It is a seismic event. It resulted from a total system failure. The safeguards upon which we have traditionally relied were inadequate to prevent this collapse and to warn that it was coming. Enron's accountants did not detect and require reporting of more than $1 billion of inflated earnings over a 15-month period as recently revealed in the report prepared by the Dean of the University of Texas Law School. Banks extended credit without determining the corporation's true, financial condition. Stock analysts who should have achieved a deeper understanding of the company's off the balance sheet liabilities continued to recommend the stock.

Chairman TAUZIN. Excuse me, Mr. Boucher. The Chair will ask for the cooperation of all the members and guests present. This room is cavernous and even small whispers and talk is exaggerated here. Let's give the speakers the courtesy of listening to them, please.

Mr. Boucher is recognized to complete his statement.

Mr. BOUCHER. Thank you, Mr. Chairman. Stock analysts who should have achieved a deeper understanding of the company's off the balance sheet liabilities continued to recommend the stock as recently as a few months ago. The ERISA law did not prevent Enron employees from losing their retirement funds and even al-

lowed a freeze on their ability to sell Enron shares in their 401(k) accounts while the shares lost value throughout the fall and became almost worthless. The corporation's directors failed in their duties as representatives of the stockholders. They apparently took no actions. They were either unaware of the corporation's precarious financial condition or complicit in permitting that condition to continue. Either way, they failed in their duties. And some company executives who had front line responsibility for the financial success of the company were making huge profits from the businesses they were doing themselves with the company, as the self-serving arrangements they created sent Enron on a path to corporate collapse.

This committee's careful investigative work has contributed greatly to the public understanding of what went wrong and I again commend Chairman Tauzin for his stewardship of that work. Many of the events contributing to the failures at Enron are within the purview of this committee's legislative jurisdiction. Today, we will hear from knowledgeable witnesses who will speak to many of these matters from corporate governance to the use of derivative financial instruments to accounting practices. As we assess the steps that need to be taken to assure that other companies do not suffer the same fate as Enron.

I look forward to the examination of those issues and to the recommendations of these witnesses and others from whom our full committee and various cubcommittees will hear concerning appropriate steps for this committee to take.

Thank you, Mr. Chairman.

Chairman TAUZIN. I thank the gentleman. Further requests for opening statements on this side? The gentleman, Mr. Brown from Ohio is recognized with 3 minutes for an opening statement.

Mr. BROWN. Thank you, Mr. Chairman, for calling this hearing and for your dogged investigation of this scandal. We all know that Enron was the seventh largest corporation in America. We all know that it was the largest energy trading company in the world. We all know that the company was a Wall Street powerhouse and the darling of the Bush Administration. Now we know that Enron is a company predicated on little more than greed and deceit. It was no more than a pyramid scheme, a company that vastly overstated profits and concealed liabilities while using political and financial clout to free themselves from accountability, to rig the energy markets in their favor, then use their position to ravage consumers, investors and employees. Some have called this crony capitalism, others Enron conservatism.

Its fall has had a devastating impact on its employees and its retirees, as we know. The Public Pension Fund in my home State of Ohio lost $62 million in Enron investments. Florida's Public Pension Fund managed by that State's very own Bush Administration lost $300 million. One of the Nation's most esteemed accounting firms, Arthur Andersen, has also been implicated in this scandal.

We'd be remiss to avoid discussion of Enron's relationship with the Bush White House and how that may have influenced the Federal response to the company's decline. Before his company's spectacular flameout, Ken Lay, the former Chair and CEO of Enron, was a close friend of President Bush's, such a close friend that he

was referred to as Kenny Boy. Kenny Boy had unfettered access to the White House and enormous influence within the administration. He contacted Curt Hébert, the Chairman of the Federal Energy Regulatory Commission and told him that if he wanted to keep his job, he would do well to bring his thinking into line with Enron's. Mr. Hébert declined. He's no longer FERC's Chairman.

When Vice President Cheney wrote the administration's energy plan, he met with Enron officials six separate times. He's declined to release information about that.

While none of us is eager to see a return to the witch hunt mentality that surrounded the White Water investigation, we should carefully examine the closeness of the relationship between the White House and Enron and the impact it's had on that company's demise. The President's friends at Fox News and elsewhere have assured the American people that because the President did not rush to save Enron from failure, that the President did nothing wrong.

But it isn't the administration's lack of action during Enron's death throes that concern me most. What concerns me is what this administration and its allies on Capitol Hill did before Enron's collapse to create a permissive culture, a permissive culture for large corporations in America and to encourage rapacious behavior at companies like Enron. The Bush White House last year called off a Clinton Administration initiative to stop money laundering through offshore banks. The manipulation of our tax laws through offshore bank accounts and partnerships reduced Enron's 5-year tax liability to substantially less than zero. In four of the last 5 years Enron paid no taxes at all.

Ironically, on the very same day that we are here investigating the spectacular collapse of Enron, we're being asked to confirm on the House floor right this minute the appropriateness of last year's Bush tax cut plan. Enron and Ken Lay were one of the plan's greatest proponents. Instead of wasting time affirming a plan that gives billions in tax breaks to corporate giants like Enron, $256 million in the tax plan, a plan that has, in essence, spent the Nation's surplus, we should instead, Mr. Chairman, be worrying—we should worry about preventing the collapse of the next Enron.

I'm hoping that his hearing will be a first step toward that goal.

I thank the chairman.

[The prepared statement of Hon. Sherrod Brown follows:]

PREPARED STATEMENT OF HON. SHERROD BROWN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Good afternoon. Chairman Tauzin, thank you for calling this hearing into Enron's collapse, and for your dogged investigation of this scandal.

Less than a year ago, Enron was the seventh largest corporation in America and the largest energy trading company in the world. The company was a Wall Street powerhouse and a darling of the Bush Administration.

Then a couple of months ago, Enron abruptly declared bankruptcy and was exposed as a company predicated on little more than greed and deceit.

Enron was no more than a pyramid scheme—a company that vastly overstated profits and concealed liabilities—while using political and financial clout to free themselves from accountability, rig the energy markets in their favor, and then use their position to ravage consumers investors, and employees. This style has been called "Enron conservatism"

Enron's fall has had a devastating impact on its employees and retirees, on its shareholders and customers, and on the confidence many Americans have in private equity markets and their government.

Average workers and investors were cheated out of their life savings—while a small group of executives and insiders made off with over a billion dollars from well-timed stock sales.

The public pension fund in my home state of Ohio lost $62 million on Enron investments—and Florida's public pension fund—managed by that state's very own Bush Administration, lost $306 million.

One of the nation's most esteemed accounting firms, Arthur Andersen, has also been implicated in this scandal—accused of helping to conceal its client's deceit.

Despite internal misgivings about Enron's methods of financial reporting, Andersen continued to certify the company's required financial disclosures as "full and accurate."

At a time when over 60 percent of Americans own stock, concerns about the lack of transparency in financial disclosures—and a lack of independence among auditors—has damaged the confidence of the investing public.

The Powers Report, released earlier this week, makes clear that the series of complex transactions that brought Enron down were not well-intentioned deals that went bad. They were deliberate gimmicks created to conceal losses and to deceive investors.

This committee has a responsibility to the American people to conduct a comprehensive investigation into the malfeasance of Enron's executives, its auditors, and its board of directors.

And to better protect the thousands of employees and investors who have suffered from Enron's untimely and unnatural demise, this committee must also ask if the relevant federal agencies did everything they *could have* to protect the public.

I am confident that we will discharge these responsibilities.

We would be remiss, however, to avoid discussion of how Enron's relationship with the Bush White House may have influenced the federal response to the company's decline.

Before his company's spectacular flame-out, Ken Lay, the former Chairman and CEO of Enron was such a close friend of President Bush's that the President referred to him as "Kenny-boy."

Kenny-boy had unfettered access to the White House and enormous influence within the Administration, and he wielded this influence freely.

At one point last year, Mr. Lay contacted Curt Hebert, the Chairman of the Federal Energy Regulatory Commission—the agency that regulated much of Enron's business—and told him that if he wanted to keep his job he would do well to bring his thinking into line with Enron's.

Mr. Hebert declined to do so, and is no longer FERC's chairman.

When Vice-President Cheney "wrote" the Administration's energy policy, he met with Enron officials six times. Not surprisingly, the plan favored the same energy goals that Enron did.

Since May, the Vice President has refused to turnover the records of his meetings with Enron on the grounds that Congress and the GAO have no right to this information.

Vice President Cheney has also said that any similarities between Enron's recommendations and the Administration's Energy Plan are just a matter of (right-mindedness) like-mindedness.

In December, columnist Molly Ivins wrote that if Bill Clinton were still in the White House—and he were as close to Ken Lay as this President is—"we'd have four congressional investigations, three special prosecutors, two impeachment inquiries and a partridge in a pear tree by now."

While none of us is eager to see a return to the witch hunt mentality that surrounded the Whitewater investigation, we *should* carefully examine the closeness of the relationship between this White House and Enron, and the impact it had on that company's demise.

The President's friends at Fox News and elsewhere have assured the American people that because the President did not rush to save Enron from failure that he couldn't have done anything wrong.

Treasury Secretary Paul O'Neill and Commerce Secretary Don Evans have said they were aware of Enron's difficulties before the company went bankrupt—and have celebrated their decisions to do nothing on the company's behalf.

Secretary O'Neill even went so far as to say this incident was emblematic of "the genius of capitalism."

Tell that to Enron's former employees.

It isn't the Administration's lack of action during Enron's death throes that concern me most.

What concerns me most is what this Administration and its allies on Capitol Hill did before Enron's collapse to create a permissive culture for large corporations in America, and to encourage rapacious behavior at companies like Enron.

Last year, the Bush White House called off a Clinton Administration initiative to stop money-laundering through offshore banks.

The manipulation of our tax laws through offshore bank accounts and partnerships reduced Enron's five-year tax liability to substantially less than zero, and in four of the last five years—Enron paid no taxes at all.

These same activities ultimately led to Enron's implosion, but they went unreported by the company's independent auditors—and the initiative to prevent this behavior was deemed unnecessary by President Bush.

Ironically—on the very same day that we are here investigating the spectacular collapse of Enron we are also being asked to confirm the appropriateness of last year's Bush tax cut plan. Enron was one of the plan's greatest proponents.

Instead of wasting time affirming a plan that gives billions in tax breaks to corporate giants like Enron—a plan that has helped to eliminate the nation's surplus—we should worry about preventing the collapse of the next Enron.

I am hopeful that this hearing will be the first step toward that goal.

Chairman TAUZIN. I thank the gentleman. The gentleman's time has expired. The Chair would ask if there are other members present who want to make a statement. The Chair does not see any member present and the Chair will announce that the committee will suspend until Mr. Greenwood is in the Chair.

It's my understanding, Mr. Brown, that we have about 4 minutes to make this vote, if you have not made it yet.

So I will patiently wait and see that Mr. Greenwood arrives and then I will make the vote.

Mr. GREENWOOD [presiding]. The Chair recognizes himself for 90 minutes for the purpose of an opening statement.

The captains of American industry in the early 20th century were not without serious flaws and yet they also left us a remarkable legacy of new ideas, new technologies and in many cases enduring enterprises. Simply taking a roll call of some of the more illustrious and in some cases notorious of these industrialists bears witness to this truth. Henry Ford, John D. Rockefeller, Andrew Carnegie, John and Horace Dodge, George Westinghouse, Henry Firestone, Thomas Edison, George Eastman and Henry Heinz. What they built, they built to last. But in many ways, they were also rapacious and grasping men whose monopolistic tendencies trampled on the legitimate rights of smaller businesses, threatening free enterprise and the birth of new technologies.

The first Republican President of the 20th century, Theodore Roosevelt, rightly called them malefactors of great wealth. But for all their faults, it was the wealth they themselves had created. It is not clear that even this much can be said of the authors of the Enron debacle. If they were malefactors of wealth, it appears it was largely the wealth of many unsuspecting others and in this reckless enterprise they were enabled and empowered, if not openly encouraged, by the accountants who were supposed to serve as watchdogs, sadly, at the time investors failed to notice these watchdogs' peculiar behavior. They did not bark.

Perhaps our witnesses today are familiar with the demand that Cuba Gooding, Jr.'s character makes in the movie, Jerry MaGuire, "show me the money." Surely this is the question Enron's shareholders are asking from the pension fund in my own Common-

wealth of Pennsylvania, to the President's mother-in-law, nearly all those who had invested in this darling of Wall Street, got hurt.

Winston Churchill once observed that some people regard private enterprise as if it were a predatory tiger to be shot. Others look upon it as a cow that they can milk. Only a handful sees it for what it really is, the strong horse that pulls the whole cart. How surprised he would have been to discover that the system of free enterprise for honest profit which lies at the core of our Republic's greatness and success was assaulted not by its enemies, but by those who profess the greatest allegiance to it. This was perhaps their greatest betrayal.

For the triumph of free markets and the wealth they create, depend on the confidence of the investor, more and more of whom are average Americans. In 1960, only 18 percent of American households had any investments in the stock market. By 1999, that number was nearly 50 percent. And here we get to the heart of the matter, for all their vaunted talk of aggressive accounting, an oxymoron that would be amusing if it had not led to such terrible consequences. Their failure is about so much more than money lost or money gained. These were men who in the single minded pursuit of personal wealth apparently jettisoned any shred of personal morals or business ethics and replaced them with the morals of a dealer in a game of Three Card Monte. The antidote to this behavior is not difficult to find. In 1913 in a thoughtful essay on the lessons of history and free enterprise, former President Theodore Roosevelt wrote this, "First and foremost, we must stand firmly on a basis of good, sound ethics. We intend to do what is right for the ample and sufficient reason that it is right." He then continued with these prophetic words. "If business is hurt by the stern exposure of crookedness and the result of efforts to punish the crooked man, then business must be hurt, even though good men are involved in the hurting." In this matter, too, the reputations of many who sought to do their best will be swallowed up in the bad dealings of the few. Sadly, this too is part of the unfolding Enron tragedy.

The Chair recognizes the gentlelady from California, Ms. Eshoo.

[The prepared statement of Hon. James Greenwood follows:]

PREPARED STATEMENT OF HON. JAMES GREENWOOD, CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

The captains of American industry in the early 20th century were not without serious flaws. And yet they also left us a remarkable legacy of new ideas, new technologies and in many cases enduring enterprises. Simply taking a roll call of some of the more illustrious, and in some cases, notorious, of these industrialists bears witness to this truth.

Henry Ford, John D. Rockefeller, Andrew Carnegie, John and Horace Dodge, George Westinghouse, Henry Firestone, Thomas Edison, George Eastman, and Henry Heinz . . . what they built, they built to last.

But, in many ways, they were also rapacious and grasping men, who's monopolistic tendencies trampled on the legitimate rights of smaller businesses, threatening free enterprise and the birth of new technologies.

The first Republican president of the 20th century, Theodore Roosevelt, rightly called them malefactors of great weatlh. But for all their faults, it was the wealth they themselves had created.

It is not clear that even this much can be said of the authors of the Enron debacle. If they were malefactors of wealth, it appears it was largely the wealth of many unsuspecting others.

And in this reckless enterprise they were enabled and empowered, if not openly encouraged, by the accountants who were there to serve as watchdogs. Sadly, at the time, investors failed notice their peculiar behavior—they did not bark.

Perhaps our witnesses today are familiar with the demand that Cuba Gooding Jr's character makes in the movie *Jerry McGuire.* "Show Me the Money"?

Surely this is the question Enron's shareholders are asking. From the pension fund in my own Commonwealth of Pennsylvania to the President's mother-in-law, nearly all those who had invested in this "darling of Wall Street" got hurt.

Winston Churchill once observed that, some people regard, "private enterprise as if it were a predatory tiger to be shot. Others look upon it as a cow that they can milk. Only a handful sees it for what it really is—the strong horse that pulls the whole cart."

How surprised he would have been to discover that the system of free enterprise for honest profit—which lies at the core of the Republic's greatness and success—was assaulted not by its enemies, but by those who professed the greatest allegience to it.

This was their greatest betrayal.

For the triumph of free markets and the wealth they create, depend on the confidence of the investor . . . more and more of whom are average Americans. in 1960, for example only 18% of American households had any investment in the stock market. By 1999, that number was nearly 50%.

And here we get to the heart of the matter. For all their vaunted talk of aggressive accounting, an oximoron that would be amusing if it had not led to such terrible consequences, their failure is about so much more than money lost or money gained.

These were men who, in the singleminded pursuit of personal wealth, aparently jettisoned any shred of personal morals or business ethics.

And replaced them with the morals of the dealer in a game of three-card monte.

The antitote to this behavior is not difficult to find. In 1913, in a thoughtful essay on the lessons of history and free enterprise, former President Theodore Roosevelt wrote this: *"First and foremost, we must stand firmly on a basis of good sound ethics. We intend to do what is right for the ample and sufficient reason that it is right."*

He then continued with these prophetic words *"If business is hurt by the stern exposure of crookedness and the result of efforts to punish the crooked man, then business must be hurt, even though good men are involved in the hurting . . .".* In this matter too, the reputations of many who sought to do their best, will be swallowed up in the bad dealings of the few.

Sadly, this too is part of the unfolding Enron tragedy.

Ms. ESHOO. Thank you, Mr. Chairman. I appreciate the thoughtful comments that you have made since this issue has imploded and I have confidence that what you will do as Chair of the Oversight and Investigations Subcommittee is going to cast more light and help the Congress come to grips with what needs to be done relative to Enron, the abuses that are now known, and the areas where we need to make reforms.

As a member of California's Congressional Delegation, I have a very special interest in this issue of Enron and what went wrong, as do my constituents and as do all Californians. As early as November of 2000, the Federal Energy Regulatory Commission, FERC, declared that consumers in California had been and were paying "unjust and unreasonable rates" yet nothing substantive was done about it. Some estimate that the gouging amounted to hundreds of millions of dollars, perhaps a billion. The California's ISO says it was in the ballpark of $9 billion.

When the 107th Congress convened in January of 2001, a year ago, I introduced bipartisan legislation that allowed the Secretary of Energy to control price gouging. In the following months, I called for hearings. I called on the Attorney General to investigate. I introduced legislation that would have imposed cost of service based pricing. I introduced bipartisan legislation to provide refunds to consumers. Enron and the rest of the industry in opposition said

that these calls should go unheeded. And the process then became politicized.

So in this hearing and in other hearings, we're not only going to examine what went wrong inside, what did Enron do wrong inside and anyone, the professions included, that were associated with them, but also I think a worthy area of exploration is what they did wrong to others.

I believe that if the Congress had heeded the call of many of us on this very committee, on this issue, that we could have cast light on some of the wrongdoing of Enron at the time. Californians paid. Other people's pockets were lined. Californians paid as did shareholders and Enron's employees. So this is tragic not only in the fall of supposedly the seventh largest corporation in the country, but what they imposed in terms of policy, in terms of their lobbying, in terms of public policy and what was left unheeded, including the calls that some of us made right here in this Energy and Commerce Committee.

So I look forward to being part of the solution. We know we have to have campaign finance reform. We know that we need to have reforms relative to the accounting industry. We know that we have to have reforms relative to the Securities and Exchange Commission, but I also think that it is worthwhile, very worthwhile in terms of my constituents and Californians to place on the record today that some of us were on to this a long time ago. It went unheeded. It's high time that the Congress come to grips with it.

Thank you, Mr. Chairman. And I yield back any balance of my time.

[The prepared statement of Hon. Anna Eshoo follows:]

PREPARED STATEMENT OF HON. ANNA G. ESHOO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Thank you, Mr. Chairman.

As a member of California's Congressional delegation, I have a special interest in these hearings. Enron and other energy marketers, generators and gas suppliers gouged the people of California and my district for more than a year.

According to Administrative Law Judge Curtis Wagner, consumers in California were gouged by "hundreds of millions of dollars, probably more than a billion in aggregate sum" (Report and Recommendation of Chief Judge and Certification of Record, Federal Energy Regulatory Commission, July 12, 2001). I think this is a rather conservative estimate. According to the California Independent System Operator, the sum was closer to $9 billion. One day my constituents may recover a portion of these overcharges, but I have my doubts and Enron's collapse certainly does not help this effort.

The fact is that Enron and its business go to the heart of the gouging and its collapse.

What was Enron's business? While all Americans know that Ford and GM make cars, I doubt many people could explain what Enron, seventh on the Fortune 500, actually did. Enron was an energy company that really didn't produce or distribute energy. Instead, it acted as a middleman, making deals between producers and users. These were paper transactions that added no value to the product it sold. It was corporate alchemy; it was like producing gold from straw. Maybe this explains why other participants in the electricity market didn't suffer after Enron collapsed and why the industry doesn't seem to miss the company today.

Perhaps Enron's mysterious business explains why some call Enron's glass-walled headquarters in Houston "the Black Box"—a more apt name might be Oz. By stretching and breaking complex accounting rules, Enron wove a mystical shroud. The mystery of what lay behind that curtain made Enron even more appealing to investors, as did its majestic profits.

Many Congressional committees, including this one, have focused on Enron's corporate structure and governance and acts of malfeasance that allowed Enron to con-

vert debt for profit whenever it wished. However, it seems that nobody is asking questions about the transactions between Enron and its clients. It seems to me that the same creative minds that created Chewco, one of Enron's corporate shells, might also have one or two tricks to raise artificially the price of electricity in the West. I hope this Committee and other investigators will be looking at these activities and transactions.

Last March I called upon Attorney General Ashcroft to look into the pricing practices of Enron and other energy companies operating in the West. At that time, massive amounts of electricity were being withheld from the market, and wholesale energy costs rose by as much as 1,000%. Yet to my knowledge, the Department of Justice did not investigate. As the DOJ and Committees conduct a postmortem of Enron, the company's day-to-day business operations must be examined. I've called on just written to Deputy Attorney General Larry D. Thompson (who has taken over the oversight of the Enron investigation following Attorney General Ashcroft's recusal) to explore fully this line of inquiry.

But accounting is only part of the Enron story. While Enron exploited the complexity of accounting rules to manufacture profits, it also tried to exploit its political connections to create a business environment—an environment without rules—in which it could thrive. To do this, Enron greased the wheels with millions in campaign contributions to both parties. That bought access and arguably more.

In interviews for the television program *Frontline* last year, former Enron CEO Kenneth Lay acknowledged that he provided the Administration with a list of Enron-favored nominees for the Federal Energy Regulatory Commission (FERC). He also acknowledged that he and Enron executives interviewed potential nominees to judge their suitability.

This was Ken Lay's casting couch, and a candidate's suitability was judged by how likely he or she was to agree with Enron's view of how the energy market should operate. Several news reports indicate that Mr. Lay's top choices for FERC were accepted by the Administration. These reports are extremely disturbing.

Citing potential bias, this Administration broke with a half-century tradition begun by President Eisenhower when it decided to refuse independent advice from the American Bar Association about the professional qualifications of potential nominees to the federal bench. But, the Administration seemed more than willing to accept the same kind of advice from Enron in the selection of the regulators who are charged with overseeing the company.

Mr. Lay was not only lobbying the White House. He attempted to influence FERC directly. Mr. Lay himself called then-FERC Chairman Curtis Hébert to discuss issues of policy and to talk about whether the President would retain Mr. Hébert as the Chairman of the Commission.

Mr. Hbert described these conversations as unusual, noting that he never had similar conversations with other industry chief executives. In the end, Mr. Hbert resigned from FERC after Vice President Cheney told reporters that Patrick Wood would replace him as Chairman.

In an interview for *Frontline* in 2001, Mr. Hébert was told, "Our sources tell us that he [Mr. Lay] offered to talk to the President on your behalf if you would go along with what he wanted [open access to wholesale and retail markets]." Mr. Hébert responded, "I don't think there's any doubt he would be a much stronger supporter of mine if I—were willing to do what he wanted."

Perhaps this heavy lobbying didn't amount to anything, but I think we're beyond accepting "trust me" as an answer when it comes to matters involving Enron. The Administration must be more forthcoming about its dealings with Mr. Lay and his company.

Mr. Chairman, the collapse of Enron is a tragedy for the company's employees and an embarrassment for the energy and accounting industries. It's obvious that Congress must legislate a number of reforms. Chief among these are campaign finance reform, pension reform, and accounting reform.

What we should not do is enact legislation that fundamentally restructures the electricity market until we have all the answers about Enron. California made a huge mistake in hastily adopting a restructuring bill in 1996. We should not make a similar mistake in Congress.

Mr. Chairman, thank you, for holding this Committee hearing on Enron. I hope that along with today's examinations that you call a Committee hearing on the role of Enron in electricity pricing and practices.

Mr. GREENWOOD. The Chair thanks the gentlelady and recognizes the gentleman from Florida, Mr. Stearns for 3 minutes for an opening statement.

Mr. STEARNS. Thank you, Mr. Chairman, and let me just say that—commend you and the staff for all the hard work you're doing on the Oversight Committee on which I serve. I ask by unanimous consent that my complete opening statement be part of the record.

Mr. GREENWOOD. Without objection, the gentleman's statement will be entered into the record.

Mr. STEARNS. And also, Mr. Chairman, as chairman of my Subcommittee on Commerce, Trade, and Consumer Protection, I wrote to the Financial Accounting Standards Board shortly after this fiasco, this debacle and I asked in that letter that they answer some questions and they wrote back to me on December 18, 2001 and I ask unanimous consent that the reply by the Financial Accounting Standards Board President be made part of the record.

Mr. GREENWOOD. Without objection, that document will be entered into the record.

Mr. STEARNS. Mr. Chairman, what we have seen so far is that Enron's collapse was a result of a complete failure and meltdown of fundamental responsibilities and oversight and thereby allowing what appears to be unscrupulous Enron executives, the opportunity to reap fortunes on questionable transactions, ultimately draining the retirement security of thousands of employees and investors. Professor Dharan of Rice University appearing before us today, directly states that "Enron's collapse may be the biggest case of security fraud." I believe he may be the first witness before the committee to unequivocally state what many have been surmising over the past few months, especially with more Enron executives invoking the fifth amendment. So perhaps we're just scratching the surface here, the complexity is very astounding. We've heard the term aggressive accounting. Accounting isn't just math. It also means making judgment calls about what the rules allow. Aggressive accounting isn't illegal, but it should be when it tells investors that red is black and so we hear the term aggressive accounting or cutting edge accounting to justify Enron's pursuit of these partnerships and Arthur Andersen has also used those terms. But I think we need to get beyond the rhetoric here and get to what standards are adequate. Is the private sector handling enforcement of these standards properly? Are these standards in line with economic innovation or is the accounting industry lagging behind with new rules?

In regards to Enron's practices, Paul Brown, Chairman of the Accounting Department of New York University, has been quoted as saying, "It's the old adage of a FASB rule, it takes 4 years to write it, and it takes 4 minutes for an astute investment banker to get around it." And that is not right. So Mr. Chairman, I look forward to the hearing and again, I compliment the staff for their developing this hearing and others. I yield back.

Chairman TAUZIN. I thank the gentleman. Is there anyone from this side? The gentleman from California, Mr. Waxman is recognized for 3 minutes.

Mr. WAXMAN. Mr. Chairman, thank you for holding this hearing and for your efforts to get to the bottom of the Enron scandal. Our committee has a proud history of oversight and the investigation you and Representative Dingell are leading is in keeping with that tradition. A small group of executives have robbed thousands of

American families of their financial security and we are holding these hearings to find out who did it and how they did it. But I don't think we can just look at Enron and Arthur Andersen and stop there. We also have to look at ourselves. When I've said that before, others have accused me of playing a partisan blame game that would divert attention from other issues. I couldn't disagree more.

To prevent future Enrons we have to understand how Ken Lay and other executives operated in the political system. We need to know how they acquired political influence and how they asserted the power they accumulated.

We must, of course, scrutinize Enron and Arthur Andersen. We have to scrutinize the regulators and we should scrutinize how Enron and Arthur Andersen exploited the political system. And even though I believe we must look at both parties, some of my Republican colleagues have told me that I'm being partisan. Now that we have a Republican President and a Republican House, I'm told that it's wrong to raise these issues and in doing so will only feed public cynicism. I don't buy that. We can't sit here sanctimoniously and browbeat Enron and Arthur Andersen executives and question every decision they made if we're not willing to give the same scrutiny to ourselves, to the Clinton Administration and to the Bush Administration. And if we don't examine how the political system broken down, the public will see through us and that, in truth, will only deepen cynicism.

Washington created the regulatory environment that allowed Enron executives to steal from thousands of families and Arthur Andersen auditors looked the other way and we in the Congress need to examine how that happened.

The Enron scandal is a searing indictment of a business culture that values stock prices over honesty and integrity and it elevates fictional performance over actual productivity. The Enron scandal is also an indictment of an accounting profession that has lost its way in values, profits and new business opportunities over honoring the public trust, and the Enron scandal is an indictment of a political system that allowed this calamity to happen.

Arthur Levitt's sensible accounting reform proposals didn't die an accidental death. They were a victim of the political system and it was that same system that allowed derivatives to go unregulated.

Last year, Enron was the most politically powerful company in Washington. Even as its foundation was rotting away, it was able to influence energy policy in a number of areas. It's leader, Ken Lay was able to screen potential FERC Commissioners and lead a successful House effort to retroactively repeal the corporate minimum tax which would have brought Enron $254 million. We owe it to all the victims and their children to hold Enron accountable. We owe it to them to hold Arthur Andersen responsible, and we owe it to them to hold ourselves accountable as well.

Chairman TAUZIN. The Chair thanks the gentleman. Further requests for statements on this side? The gentleman, Mr. Ganske from Iowa, is recognized for 3 minutes.

Mr. GANSKE. Thank you, Mr. Chairman. I'll be brief. Mr. Chairman, I am a Star Wars fan, a story about the triumph of good over evil. So I think it was sort of hypocritical when Enron subsidiaries

had names out of Star Wars like Jedi and Chewco. Well, Mr. Chairman, today Mr. Ken Lay is looking like Darth Vader and Enron like the Death Star to investors and all those company employees who have had their pensions evaporated.

The auditor should have been the real Jedi, policing evil doings. Instead, it appears like they were the bounty hunter, Boba Fett, doing the bidding of the evil empire.

Mr. Chairman, let us use our light sabers to cut to the quick of this galactic scandal. May we have the wisdom of Yoda to fix whatever accounting and pension laws needs strengthening in order to protect the innocent, punish the greedy and prevent clone wars in other companies like we've seen in Enron. I yield back, Mr. Chairman.

Chairman TAUZIN. May the force be with you.

I thank the gentleman for his statement. Further requests on this side? The gentleman, Mr. Green from Texas, is recognized for 3 minutes.

Mr. GREEN. Thank you, Mr. Chairman, and I appreciate you calling not only this hearing today, but the efforts of the full committee and the subcommittee to explore the circumstances surrounding the collapse of Enron.

As the only member of the Commerce Committee from Houston, I'm angered by the continuing disclosures of financial wrongdoing by the company. Enron was the largest company in Houston, employing over 20,000 Houstonians and helped make our city the energy capital of the world. Enron's position in our community and around the world has been permanently and probably irreparably damaged by the shenanigans of a few. Enron is now the buzz word for financial funny business. Enron's Ken Lay, Jeff Skilling and Andrew Fastow are all household names known for this financial funny business. They used Enron like a giant Monopoly game to enrich both themselves and their friends at the expense of their shareholders and employees and they were not able to accomplish this historic meltdown alone. They had the help from Arthur Andersen, the New York banking community, even their own legal counsel. Together, these entities were either blinded by the green of Enron's billions or just simply incompetent and allowed Enron to fool everyone.

So what have we learned about this tragedy? We need stronger accounting standards, better corporate financial disclosure and more Federal oversight by the Securities and Exchange Commission. Congress needs to take a hard look at forcing companies to file bankruptcy in the community or the State at least where their corporate headquarters reside. Enron made a corporate decision to file bankruptcy in New York which is a great deal, a long way away from small creditors and former employees to be able to address the bankruptcy. Enron was allowed to walk through loopholes in the law and conduct their illegal business practices. They used business practices which should be rarely used and created hundreds of off-the-book partnerships which enriched a few at the expense of the many. These holes need to be patched. Apart from these changes, I do want to take a minute and highlight what I believe has been one of the positive actions resulting from the collapse, probably the only positive action. Houston's remaining en-

ergy trading companies were able to weather the storm and I want my colleagues to understand that Enron is a unique case and not the model for the energy community.

Enron's entire trading business was efficiently absorbed by competitors without any interruption of service to their consumers. In addition, the demise of Enron has created more competition in the sector which will benefit consumers with lower energy prices.

Mr. Chairman, I want to thank you again for your hard work on the issue and I'm looking forward to continuing this process in the future. The people of Houston, the stockholders and the current and former employees deserve a clear answer to what happened here and to see that those responsible are held accountable and that we pass legislation to prevent these type of scams in the future and thank you again. I yield back my time.

[The prepared statement of Hon. Gene Green follows:]

PREPARED STATEMENT OF HON. GENE GREEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman: I want to commend you for calling this important hearing today, and I again appreciate the opportunity to participate with the Subcommittee.

I believe today will be our first real chance to receive firsthand information about what truly went on at Enron.

Let me begin by saying that I am pleased Mr. Skilling has decided to come forward and give the American people some insight into the inner workings of Enron and Enron's off-book partnerships.

I am truly disappointed that the rest of Enron's "Masters of the Universe" crowd failed to come forward and instead chose to exercise behind the Fifth Amendment.

While no American can be forced to testify against his or her will, I believe failing to provide answers to the Subcommittee is an indication that the witnesses are trying to hide and obscure their roles in this debacle.

The Powers Report that this Subcommittee received over the weekend outlined a pattern of malfeasance that spread from the Board of Directors, through the upper management and finally to the auditors and outside legal counsel.

The Board of Directors, Arthur Andersen, and Vinson & Elkins provided the enabling ability to Ken Lay, Jeffrey Skilling, and Andrew Fastow to manipulate the financial records of this once great company.

Along the way, each of these individuals began to see themselves as a new Rockefeller or J.P Morgan of the 21st century.

In reality, the upper management of Enron turned out to be only pretenders.

Their accomplishments were based on smoke and mirrors and their accomplishments did not rival those of our country's greatest industrialists.

However, their accomplishments do bare a striking similarity to a group of infamous financiers.

Ken Lay, Jeffrey Skilling and Andrew Fastow are now in the same league as Ivan Boesky, Michael Milken, and the true inventor of the complicated Rube Goldberg.

Mr. Chairman, I look forward to hearing from this witness panel, and I again want to thank you for allowing me to participate here today.

Chairman TAUZIN. I thank my friend. The Chair asks if any members on this side—the gentleman, Mr. Shimkus, is recognized for 3 minutes.

Mr. SHIMKUS. Thank you, Mr. Chairman, and I'll be brief. Along with my good friend, Gene Green from Texas, I room with Kevin Brady who's also really been involved with this for his constituents and he's fighting a good fight and I appreciate the lessons he's told me, about his neighbors and the problems that they've fallen into.

As you said in your opening statement, this is old fashioned theft by insiders. We need to make sure we have things in place to protect our folks. That's why the subpoena power is so important and I'm glad we did that as a first order of business. I ask unanimous

consent that my additional comments be submitted in the record and I look forward to the hearing and I yield back my time.

[The prepared statement of Hon. John Shimkus follows:]

PREPARED STATEMENT OF HON. JOHN SHIMKUS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Thank you Mr. Chairman for holding this hearing today. I am looking forward to hearing from the witnesses on their take of what exactly has happened here and what can be done to prevent it from happening again in the future.

This hearing should focus on the accounting problems that occurred in the Enron collapse, because that is what falls under the jurisdiction of Committee. Congress may need to address possible changes in accounting laws and any loopholes that need to be closed regarding allowing accountants to also perform auditing functions. I am happy to hear that Chairman Tauzin has stated that the Committee will be holding future hearings on the Financial Accounting Standards Board.

Aside from Enron, accounting concerns are being raised about other recent bankruptcies, including Kmart and Global Crossing, where insiders sold $1.3 billion in stock in the years prior to the bankruptcy.

So much in fact that accounting firms are looking at ways to change their business structure. PricewaterhouseCooper and Deloitte & Touche both have recently announced that they will spin off their consulting businesses.

The Illinois Department of Regulation has been investigating Arthur Andersen since before the Enron collapse over its business practices. Andersen was the auditor for Waste Management in 1998, when the company admitted that it had overstated its earnings by more than $1.4 billion.

The Committee also needs to look into the role of the states. Accountants are regulated in every state and many state regulators are believed to be looking at Andersen. Connecticut, for example, has taken steps that officials there say could lead to Andersen being banned from doing business in that state. These state investigations are in addition to federal probes being conducted by the Justice Department and the Securities and Exchange Commission.

One question that was asked in a hearing yesterday needs to be answered. Were Andersen's accountants and consultants involved in the complex deal by which Enron bought out its JEDI partnership by creating a new one called Chewco—one of the off-balance-sheet deals that greatly contributed to Enron's collapse?

Mr. Chairman, thank you for holding this hearing and I yield back the balance of my time.

Chairman TAUZIN. I thank my friend. Members on this side? The gentleman from Ohio, Mr. Sawyer, I think has sought recognition.

Mr. SAWYER. Thank you, Mr. Chairman, and thank you for your work with our ranking member, Mr. Dingell, to bring this opportunity before us today. The collapse of Enron is really almost inconceivable in its magnitude and its suddenness. It's like a mighty edifice now fallen that seems to have disappeared like a column of smoke. It is an extraordinary event. The nature and scope of this company's collapse is both multi-faceted and complex, but in the end, I have the sense that this is really a case about disclosure.

Our Federal securities' laws are there to protect shareholders, investors, not officers, not directors, not the companies' bottom line and it's designed to work through a system, yes, grounded in trust, but based on transparency, transparency through disclosure of relevant financial information. This framework is designed so that employees, shareholders and prospective investors could make sound and informed decisions about how they invest their money. In this case, where they were dealing with energy derivatives rather than securities, we simply didn't have that disclosure. For nearly a decade these complex, financial transactions escaped regulatory review and were exempt from the same disclosure and reporting requirements that their securities counterparts were subject to from

the beginning. It seems to me that at its base that is what we must change.

Enron's bankruptcy has triggered visceral responses in all of us. We're dismayed that this could have happened and more importantly, we must ask ourselves if it could happen again.

In the end, it's our role to ensure that it does not. And as tragic as this incident has been for our Nation and particularly for the thousands of Enron employees, it does raise important public policy questions for us to address. That's our job here today and in order to get on with it, I'm going to yield back the balance of my time, Mr. Chairman.

[The prepared statement of Hon. Thomas C. Sawyer follows:]

PREPARED STATEMENT OF HON. TOM C. SAWYER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Good morning Mr. Chairman, Mr. Dingell.

First, I would like thank you for the opportunity to be here today to address an issue of such importance to our nation. Mr. Chairman, I am grateful for both your leadership and insight in bringing this issue before the Committee.

The collapse of Enron—only one year ago—the seventh largest company in the world, a leader in energy trading and distribution, is almost inconceivable to us as we sit here today. It illustrates to all of us the vulnerability of American corporations—even the most seemingly solid—and the importance of government oversight to ensure that employees, shareholders and the American public receive adequate information upon which to make their investment decisions.

To ensure that employees have some degree of protection when it comes to their retirement and life savings.

The nature and scope of this company's collapse is both multi-faceted and complex. It involves myriad issues such as: the degree of regulation the federal government should assume over complex financial arrangements, the role that accounting firms play with the corporate clients they audit, and the degree to which we oversee 401(k) retirement plans.

In my opinion, this is a case about disclosure. The purpose of our federal securities laws, enacted in 1933 and 1934, is to protect shareholders—not officers—not directors—and not the company's bottom line. Our federal securities laws protect shareholders through a system that is based on *disclosure—disclosure* of all relevant financial information that a rational investor would use to assess the status of a company. We set up this framework so that employees, shareholders, and prospective investors could make sound decisions about how they invest their money.

In this case, where we were dealing with "energy derivatives" rather than "securities", we simply did not have that disclosure. For nearly a decade, these complex financial transactions escaped regulatory purview and were exempt from the same the disclosure and reporting requirements their securities counterparts were subject to from the beginning. This is what we must change.

It is not our role as members of Congress to legislate the nature of business transactions or the degree of risk that a company—or its investors for that matter—should assume. It is not our role to tell employees which funds to invest their retirement dollars or the degree of diversification that is necessary. However, we can, as members of Congress, set parameters. We can set the framework—so that employee pensions and 401(k) plans are protected and investors and employees are given clear and accurate information about a company's financial performance. It is our role set guidelines for auditors—to ensure that they are free from the inherent conflict of interest associated with both auditing and consulting for a client at the same time.

Enron's filing for bankruptcy has triggered visceral responses in all of us. We wonder how this could happened—and more importantly, if it could happen again. It is our role to ensure that it does not happen again. And, as tragic as this incident has been for our nation, and particularly for the thousands of Enron employees, it does raise important public policy issues for us to address:

- Is it necessary for there to be some federal oversight of "energy derivatives"? And, if so, who is the most logical body to oversee these transactions?
- What the scope of the auditors' role with their clients? Should accounting firms be restricted from providing information technology and "other consulting services" to the clients they audit?

- What amount of stock should own employees own of their company? Should employees be subject to a 10% cap as other federally-insured plans are?

These are the questions that I hope this Committee can answer and address in public policy. These are the answers I seek today in this proceeding.

Thank you, Mr. Chairman for giving us the opportunity to delve into these issues and provide some sort of solution for our country.

Chairman TAUZIN. I thank my friend for yielding and for his statement. The Chair seeks anyone on this side who seeks recognition? The chairman of the Environmental Subcommittee.

Mr. GILLMOR. Thank you very much, Mr. Chairman, and I appreciate your affording another opportunity to sort out the recent events, as well as focus on possible reforms regarding Enron's collapse. As we delve into the destruction of documents, listen to the findings of a special investigative committee concerning the illegal transactions between Enron and partnerships, controlled by its chief financial officer, I welcome the witnesses today and look forward to hearing the testimony.

My motivation regarding this issue lies with the well being of shareholders and employees and the reckless actions of those in corporate management should not come at their expense. In my own State of Ohio, the State Teachers Retirement System invested $4 million in Enron in late October 2001, and a month later it was worth $100,000 leaving the Teachers Pension Fund with 2.5 percent of its original investment. Their total loss stands at over $55 million and added to the Public Employees Retirement System, a loss of $59 million. Ohio's two principal employee pension systems were among the Nation's largest pension fund losers in Enron stock and while it is a sizable loss, fortunately both Ohio pension funds have assured teachers and public employees that it will not endanger member benefits.

However, the illegal transactions of a few at Enron turning thousands into millions in a matter of weeks, the same can't be said of other State funds of Enron employees and individual shareholders. Enron stands as a company comprised of improperly structured transactions, faulty accounting, lack of internal oversight and an overall attempt to misrepresent the company's financial condition. And most importantly, Enron hid its behavior from all those who had an interest in it.

Unfortunately, I think Enron is just an extreme example of a change of attitude over the last couple of decades of too many corporate managements in large publicly held companies where you have an atmosphere of management enrichment, regardless of whether the company does well, of management enrichment at the expense of the shareholders and at the expense of the employees. There has been, I think, a continuing breakdown in corporate management responsibility, whether it's the way options are turned into a game where management can only win, they can't lose, so that they don't have a community of interest with the shareholders, whether it's the disguising or the failure to disclose corporate charitable contributions which may or may not be made for any corporate purpose, so there are a number issues here and I look forward to hearing the witnesses' viewpoint today and I thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Gillmor follows:]

PREPARED STATEMENT OF HON. PAUL E. GILLMOR, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Thank you Mr. Chairman, for yet another opportunity to sort out the recent events as well as focus on possible reforms regarding Enron's collapse. As we have delved into the destruction of documents and listened to the findings of a Special Investigative Committee concerning the illegal transactions between Enron and partnerships controlled by its Chief Financial Officer, I welcome the witnesses today and look forward to hearing their testimony.

As I stated before, my motivation concerning this issue lies with the well-being of the shareholders and employees—The reckless actions of those in corporate management should never come at their expense.

In my home state of Ohio, the State Teachers Retirement System invested **$4 million** into Enron stock in late October of 2001. A month later it was worth just **$100,000,** leaving the teachers' pension fund with **2.5%** of its original investment. Their total loss stands at **$55.6 million.** Added to the Public Employees Retirement System's (PERS) loss of **$58.8 million,** Ohio's two principal public employee pension systems were among the nation's largest pension fund losers in Enron stock at a combined **$114.4 million.**

While it can be perceived as a sizable loss, both Ohio pension funds assured teachers and public employees that it would not endanger the funds' bottom lines or affect member benefits. However, with the illegal transactions of a few at Enron, turning thousands into millions in a matter of weeks, the same cannot be said by other state funds, Enron employees, and individual shareholders.

In the end, Enron stands as a company comprised of improperly structured transactions, faulty accounting, lack of internal oversight, and an overall attempt to misrepresent the company's financial condition. Most importantly, Enron hid its behavior from all who had an interest in them.

I look forward to hearing the witnesses' viewpoints from their respective sectors as well as further congressional oversight regarding this issue.

Chairman TAUZIN. I thank my friend for his statement. Further members on this side? The gentleman from Texas, first, will be recognized, I think for unanimous consent.

Mr. GREEN. Mr. Chairman, I ask unanimous consent to put my opening statement in the record and for all others to put an opening statement in the record.

Chairman TAUZIN. Without objection, the gentleman's unanimous consent request is granted. His statement and all the members' written statements will be part of the record, and I thank the gentleman. Anyone else on this side, first of all, in the order of seniority? Mr. Stupak, I believe would be next. You are recognized for 3 minutes.

Mr. STUPAK. Thank you, Mr. Chairman, and thanks for once again holding his hearing. I greatly appreciate our distinguished panel for coming before us today to help to explain the many complex and technical issues related to the Enron transactions. I look forward to hearing from various industry perspectives on how and why this happened as well as what can be done to prevent this from happening in the future.

Mr. Chairman, over the past several weeks, the Oversight Investigation Subcommittee has held hearings to explore this house of cards that was once the mighty Enron Corporation. We have heard from Andersen employees about the shredding of documents, the destruction of e-mails that went on in an effort, I'm sure, to cover up their whole mess.

We have heard from Mr. Powers about his Commission's findings and the actions of several Enron employees who set up the special purpose entities to assist in cooking the financial books at Enron. We have heard and read about the totally lax oversight of Mr. Lay

and Mr. Skilling and other executives on the Enron Board of Directors.

The Board of Directors gave dangerous flexibility to Mr. Fastow in allowing him to establish several of these special purpose entities. They supposedly put a number of checks and balances in place when they waived their conflict of interest provisions. But thus far all we have seen of the checks are tens of millions of dollars worth going into Mr. Fastow's bank accounts. There certainly were no balances in the equation and no follow up to make sure the company wasn't being bilked.

We've learned new terms like aggressive accounting which in this case relates in my interpretation into making fat cats of Enron richer while sticking it to the shareholder. This aggressive accounting, I believe, was the result of a new cavalier attitude in corporate America since the passage of the Securities Litigation Act of 1995.

You know, back then in 1995, many of us referred to this as the Securities Rip Off Act as I and others fought against this bill, because it insulates corporations from legal actions by putting up roadblocks, making it difficult for shareholders and employees to take action against them.

Mr. Chairman, this committee and the Powers Report have only scratched the surface of a thick veneer on Enron's house of cards. We have not had the time or the cooperation from the parties involved to get to the root of this cancerous corporate greed. We have not looked into allegations of corruption in Enron's worldwide holdings, corporations and partnerships. We do not know who got bilked overseas who may have been cooking the books. We do not know who all the investors were in these special purpose entities and what role, if any, they may have played in the aiding and abetting the leaders of this corporation.

Mr. Chairman, the top executives and board at Enron have allowed the seventh largest corporation in America to collapse. In their wake, lies thousands of Enron employees and retirees with shattered financial lives while the corporate executives, many of whom are still working at Enron today, have lined their pockets. It will be difficult, if not impossible for Enron to emerge as a credible company from bankruptcy without a comprehensive purging of Enron executives and board members who were at the helm during this debacle. They must be held accountable and I hope the investors in Enron will get themselves a true board of directors and new senior management team.

Thank you again, Mr. Chairman, for holding these hearings. I look forward to learning from our panel's perspective on the Enron transactions. I'm sure they'll provide us additional insight that will be useful in questioning many of the key players in this Enron scheme at tomorrow's oversight hearing.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Bart Stupak follows:]

PREPARED STATEMENT OF HON. BART STUPAK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. Chairman, thank you for holding this full committee hearing today. I greatly appreciate our distinguished panel for coming before us today to help explain the many complex and technical issues related to the Enron transactions. I look forward

to hearing their various industry perspectives on how and why this happened as well as what can be done to prevent this from happening again in the future.

Mr. Chairman, over the last several weeks the Oversight and Investigations Subcommittee has held hearings to explore this house of cards that was once the mighty Enron Corporation. We have heard from Andersen employees about the shredding of documents and destruction of e-mails that went on in an effort, I'm sure, to cover-up their role in this mess. We have heard from Mr. Powers about his Commission's findings and the actions of several of Enron's employees to set up these Special Purpose Entities to assist in cooking the financial books at Enron. We have heard and read about the totally lax oversight by Mr. Lay, Mr. Skilling, other executives and Enron's Board of Directors. The Board of Directors gave dangerous flexibility to Mr. Fastow in allowing him to establish several of these Special Purpose Entities. They supposedly put a number of "checks and balances" in place when they waived their conflict of interest provisions, but thus far all we have seen are checks—tens of millions of dollars worth—into Mr. Fastow's bank accounts. There certainly were no balances in the equations and no follow-up to make sure the company wasn't being bilked.

We have learned new terms like "aggressive accounting" which in this case translates in my interpretation into making fat cats in Enron richer while sticking it to the shareholders. This aggressive accounting I believe is the result of a new cavalier attitude in corporate America since the passage of the Securities Litigation Reform Act of 1995—or the Securities Rip Off Act as I refer to it—which insulats corporations from legal actions by putting up roadblocks—making it difficult for shareholders and employees to take legal action against them.

Mr. Chairman, this committee and the Powers report have only scratched the surface of a thick veneer on Enron's house of cards. We have not had the time or the cooperation from parties involved to get to the root of this cancerous corporate greed. We have not looked into allegations of corruption in Enron's world-wide holdings, corporations, and partnerships. We do not know who got bilked overseas or who may have been cooking the books. We do not know who all of the investors were in the Special Purpose Entities and what role—if any—they may have played in aiding and abetting the leaders of this corporate scam.

Mr. Chairman, the top executives and Board at Enron have allowed the 7th largest corporation in America to collapse. In their wake lies thousands of Enron employees and retirees with shattered financial lives while the corporate executives, many of whom are still working at Enron today, have lined their pockets. It will be difficult—if not impossible—for Enron to emerge as a credible company from bankruptcy without a comprehensive purging of Enron executives and Board members who were at the helm during this debacle. They must be held accountable and I hope the investors in Enron will get themselves a new TRUE Board of Directors and new Senior Management team.

Thanks you again Mr. Chairman for holding this hearing. I look forward to learning our panel's perspective on the Enron transactions. I'm sure they will provide us with additional insight that will be useful in questioning many of the key players in this scheme at tomorrow's Oversight hearing.

Chairman TAUZIN. I thank my friend for his statement and for yielding back. The Chair now recognizes the soon to be leaving us, in fact, the gentleman from Oklahoma, whom we'll sorely miss from my committee and from the Congress, but I know he's going on to bigger and bigger things in the great State of Oklahoma. The gentleman from Oklahoma, Mr. Largent, is recognized for 3 minutes.

Mr. LARGENT. Thank you, Mr. Chairman. I want to commend you for holding these important hearings this week. The Enron debacle is of particular importance to my constituents in Tulsa, many of whom are employed by the energy industry. As you may have heard from various news reports, the Enron bankruptcy is having a ripple effect on many other energy companies, specifically Williams Company, one of the largest employers in my District realized that $100 million fourth quarter loss due to unmet obligations by Enron. Further, Williams' stock prices have fallen significantly, due to the fear of many on Wall Street that companies who engage in complicated transactions cannot be trusted to accurately list

their assets and liabilities. This is a guilt by association type mentality.

The purpose of these hearings should be to find out what went wrong at Enron and to make sure that it never happens again. The backbone of a free market economy rests on the clear and transparent display of information that allows investors and employees the ability to make accurate decisions on how to invest their money. Congress must now take a good look at corporate American and our accounting standards to see if we can prevent the type of shell games that created the largest bankruptcy in American history.

At the same time, the Department of Justice should vigorously prosecute any one and every one who violated the law with respect to Enron. It is important to remember though, as horrible as the Enron bankruptcy is, for the most part our energy markets seem to be weathering the storm. The fact is that markets formerly served by Enron are quickly being absorbed by other companies without widespread price or supply disruption. This is an industry that is far from broken or in need of repair.

I understand that in the coming weeks the committee may consider legislation to reform our Nation's electricity markets. I am concerned, however, that some of my colleagues might want to use the Enron bankruptcy as a means to advance an unneeded regulatory barrage on the energy industry. I hope that we will resist that temptation and focus on the task at hand. Let's not forget that in the end free markets do work.

Thank you, Mr. Chairman. I yield back.

[The prepared statement of Hon. Steve Largent follows:]

PREPARED STATEMENT OF HON. STEVE LARGENT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. Chairman, I want to commend you for holding these important hearings this week. The Enron debacle is of particular importance to my constituents in Tulsa, many of whom are employed by the energy industry. As you may have heard from various news reports, the Enron bankruptcy is having a ripple effect on many other energy companies. Specifically, Williams Companies, one of the largest employers in my district, realized a $100 million fourth quarter loss due to unmet obligations by Enron. Further, Williams stock price has fallen significantly due to the fear of many on Wall Street that companies who engage in complicated transactions cannot be trusted to accurately list their assets and liabilities. This is a guilt by association type mentality.

The purpose of these hearings should be to find out what went wrong at Enron and to make sure that it never happens again. The backbone of a free market economy rests on the clear and transparent display of information that allows investors and employees the ability to make accurate decisions on how to invest their money. Congress must now take a good look at corporate America and our accounting standards to see if we can prevent the type of shell games that created the largest bankruptcy in American history. At the same time, the Department of Justice should vigorously prosecute anyone and everyone who violated the law with respect to Enron.

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temptation and focus on the task at hand. Lets not forget, in the end, free markets work.

Chairman TAUZIN. I thank the gentleman for his statement and ask if there are members on this side, the gentleman from New York, Mr. Engel, is recognized for 3 minutes.

Mr. ENGEL. Thank you, Mr. Chairman. There's an old saying and it goes like this, "Oh what a tangled web we weave, when first we practice to deceive."

It's evident to me and to all of us that there's has been a concerted effort by the top brass of Enron to create an intricate web of lies, so intricate in fact, that it will take months and years to discover the whole truth.

Our ability to learn the truth would be greatly facilitated by the assistance of Enron's top brass. Thus, I'm saddened by the fact that Mr. Lay has chosen not to testify. I believe that Mr. Lay, Mr. Skilling and Mr. Fastow should be doing everything they can to help us uncover the truth. Instead, they're doing everything they can to cover their own proverbial backsides.

I'm especially interested in knowing for what purposes Mr. Lay used the money he was loaned by Enron. As I understand, Mr. Lay had a $4 million line of credit with Enron. I have to wonder if he used any of this money to set up any of the hundreds of partnerships. These partnerships took on debt for Enron, thus making Enron's bottom line look better. This, in turn, caused Enron stock to increase in price and finally Mr. Lay paid off these loans with Enron stock. A tangled web indeed.

Then we come to the other player in this tragic comedy, Arthur Andersen. Arthur Andersen in the terms of addiction was an enabler. And as Enron's auditor they enabled Enron to set up hundreds of partnerships, enabled Enron to hide debt in the hundreds of millions of dollars, enabled Enron's top executives to personally profit through this tangled web of deceit, and enabled thousands of investors and employees to be misled and victimized.

During the oversight investigation hearings I questioned some of the Andersen employees about their code of professional conduct. They responded that they did not view their actions as violation of the AICPA's code but as, and I quote, "a gross error."

I again quote from AICPA's code of professional standards that the code "cannot accommodate deceit or subordination of principle."

I must beg to differ with Andersen in its assessment of its culpability in this matter. Andersen was a party to and did accommodate deceit. The Powers report not only states that Andersen failed in its role as auditor, but that it directly participated in the structuring and accounting of the Raptor transactions.

Luckily for Andersen there is little chance that the AICPA will take any action against it. AICPA has failed time and time again to properly oversee its members in the industry.

I have with me two articles from the Washington Post that delve into the poor performance of the AICPA. They detail a history of lax oversight. In fact, often when an individual was cited and fined by the SEC, the AICPA did nothing. For an industry that has fought tooth and nail for the power of self-regulation, this is a shameful track record.

Mr. Chairman, I ask unanimous consent that the articles be added to the official record.

Chairman TAUZIN. Without objection, so ordered.

Mr. ENGEL. Already we have a number of proposals to deal with some of the aftermath of this failure. I strongly support preventing auditing companies from providing consulting services at the same time. I believe we must take a serious look at how well AICPA, FASB and the SEC enforce ethical standards. I think we should make companies disclose at the very least all of their partnerships and the debt and assets thereof. The Federal Reserve has expressed its concerns about SPEs and how they are being used to hide the true nature of so many corporations' debt. This is material information that is constantly being hidden from the view of the investor and the general public.

Chairman TAUZIN. The gentleman's time——

Mr. ENGEL. I read in today's paper that the Houston Astros baseball team is trying to change the name of Enron Field.

Chairman TAUZIN. The gentleman's time is expiring.

Mr. ENGEL. It's no wonder. I thank you, Mr. Chairman, and I look forward to these hearings.

[The prepared statement of Hon. Eliot L. Engel follows:]

PREPARED STATEMENT OF HON. ELIOT L. ENGEL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Chairman: There is an old saying "Oh what a tangled web we weave, when first we practice to deceive!"

It is evident to me that there has been a concerted effort by the top brass of Enron to create an intricate web of lies. So intricate, in fact, that it will take months, possibly years to discover the whole truth.

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A tangled web indeed!!

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- enabled Enron to hide debt in the hundreds of millions of dollars
- enabled Enron's top executives to personally profit through this tangled web of deceit
- enabled thousands of investors and employees to be misled and victimized

During the Oversight and Investigations hearing, I questioned some of the Andersen employees about their code of professional conduct. They responded that they did not view their actions as violation of the AICPA's code, but—and I quote— a gross error!

I again quote from AICPA's code of professional standards that the code *"cannot accommodate deceit or subordination of principle"*

I must beg to differ with Andersen in its assessment of its culpability in this matter. Andersen was a party to and did accommodate deceit. The Powers report not only states that Andersen failed in its role as auditor, but that it directly participated in the structuring and accounting of the Raptor transactions.

Luckily for Andersen, there is little chance that the AICPA will take any action against it. AICPA has failed time and time again to properly oversee its members and the industry. I have with me two articles from the Washington Post that delve

into the poor performance of the AICPA. They detail a history of lax oversight. In fact, often when an individual was cited and fined by the SEC, the AICPA did nothing. For an industry that has fought tooth and nail for the power of self regulation, this is a shameful track record.

Mr. Chairman, I ask unanimous consent that the articles be added to the official record.

Already, we have a number of proposals to deal with some of the aftermath of this failure. I strongly support preventing auditing companies from providing consulting services at the same time. I believe we must take a serious look at how well AICPA, FASB, and the SEC enforce ethical standards.

I think we should make companies disclose at the very least all their partnerships and the debt and assets thereof. The Federal Reserve has expressed its concerns about SPE's and how they are being used to hide the true nature of so many corporations' debt. This is *material information* that is constantly being hidden from the view of the investor and general public.

I thank the Chairman and the Ranking Member and pledge to work with them to ensure that such unabashed abuses of accounting never occur again.

Chairman TAUZIN. I thank my friend. The gentleman's time has expired. Is there further request at this time? The gentleman, Mr. Buyer, is recognized from Indiana for 3 minutes.

Mr. BUYER. Mr. Chairman, thank you also for holding the hearings on the Enron collapse. I appreciate your leadership and that of Mr. Dingell and Mr. Greenwood. Like others on the committee have stated, it is very serious if financial books were altered, if investors were intentionally misled, if employees were intentionally given false information and treated differently than executives. It is appropriate for this committee to review all these allegations.

There are two things that trouble me at this time about the Enron collapse. First, how employees were treated. Executives were given the opportunity to sell stock when they knew the price was tumbling, but used the rules to prevent employees from doing the same. This stabs at the most basic ideals of fairness. If the rules were utilized to aid and abet this unfair treatment of employees, then we need to correct the wrong. 401(k)s are an important tool in retirement planning. This one instance of abuse should not be used to dismantle 401(k)s, but to strengthen them and I'm confident that Congress will address pension reform.

The second most troubling item to me at the moment is the scandal of culture that has a foundation, an architecture, in Washington, DC and how this scandal of Enron feeds into it. This is a business scandal, not a political scandal. There are those in this town that want to transfer it to the latter, rather than the former. It's important for us to put the microscope on this so we can understand the marketplace and a company and what went wrong.

This is a matter of a business failure. Despite the financial losses to thousands, and I am not minimizing this loss, I note that the free market economy, the most successful in the world that we've ever seen, lets businesses fail if they deserve to fail. We often hail victors of free markets and great innovators like Thomas Edison who developed an idea to benefit us all, but we must also realize that if the market rewards excellence, it also punishes failures. And in the Enron case, it was brutal. If Enron engaged in illegal and unethical business practices, then that is exactly what should happen in the end. There is a failure in the marketplace.

Some may question whether it is the responsibility of government to guarantee success in the marketplace. I submit it is not. The responsibility of government is to make sure the marketplace

is fair, free, open and competitive. If, in fact, someone is not operating in that marketplace under those standards, we then can bring the microscope in and find out what went wrong. And if, in fact, there are rules that need to be corrected, that is the responsibility for us to engage. So I want to thank you Mr. Chairman and Mr. Dingell, Mr. Greenwood and others. I think it's going to take time. It will take some patience. What I've learned is follow the facts, it will determine where the law should go and for the best result for the American society.

I return my time.

Chairman TAUZIN. I thank the gentleman for his thoughtful statement and I ask if there are members on this side who wish to be recognized first in order of seniority. The gentleman, Mr. Rush, would be in line from Chicago. Mr. Rush? He is recognized for 3 minutes.

Mr. RUSH. Thank you, Mr. Chairman, for holding today's——

Chairman TAUZIN. Bobby, would you turn your mike on? Thank you.

Mr. RUSH. I want to again thank you, Mr. Chairman, for holding this full committee's hearing on the Enron collapse. Mr. Chairman, today, I hope today's hearing will allow the committee to gain a panoramic view of the Enron debacle so that when all is said and done and we in the Congress can make the legal and policy changes necessary to prevent this disaster from ever occurring again. Today's hearing will be an opportunity to hopefully shed light on the various industry-wide accounting, corporate governance and energy concerns raised by the Enron collapse. And while I commend the committee for calling witnesses to discuss the roles and responsibilities of the executives, auditors and accountants, I fear that we have left out an important player in the story of Enron and its fall from grace. I feel that the lawyers should be also a focus of our deliberations and our investigations.

In Enron's own limited investigations of its shady business practices, Vinson & Elkins confirmed that the procedures for monitoring those practices was uniformly overseen, not only by accountants and executives, but lawyers as well. The legal department at Enron had a role to play. Unfortunately, the Vinson & Elkins investigation which was meant to root out mismanagement and illegality, seemed to be marked by a cloud mismanagement and missed opportunity. In its finding, Vinson & Elkins describe the monitoring procedures for its LJM transactions as generally adhered to, accounting as creative and aggressive and the working conditions as awkward. Even though Enron's SPE-related transactions and I quote "created a serious risk of adverse publicity and litigation", Vinson & Elkins nonetheless concluded that there was no need for an expanded investigation. In short, while the building was aflame and burning down around its client, Vinson & Elkins called for business as usual.

In the written testimony given today by the panelists, by one of our panelists, he tells of a corporate climate in which aggressive mismanagement, there's the accountant to "show me where it says I can't twist and stretch the rules to show a profit." Accountants were under the gun. They were dared to show management where

it said they couldn't bend the rules and stretch the rules to accomplish what they wanted to accomplish.

Certainly this component to the Enron collapse must be part of our public debate. What was the lawyers' role in this? The outside attorneys and also Enron's own legal department. And however, Mr. Chairman, in conclusion, it may be equally as important to discuss the importance of sound, legal advice that would have guided Enron to a very different place than where it is today. Again, where were the lawyers, what were they doing and why did they not advise Enron to do differently than they did.

[The prepared statement of Hon. Bobby L. Rush follows:]

PREPARED STATEMENT OF HON. BOBBY L. RUSH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr Chairman: Thank you for holding today's Full Committee hearing on the Lessons Learned from Enron's Collapse.

Today's hearing will allow the Committee to gain a panoramic view of the Enron debacle, so that when all is said and done, we in Congress can make the law and policy changes necessary to prevent this disaster from ever happening again.

Today's hearing will hopefully shed light on the various, industry wide accounting, corporate governance, and energy concerns raised by the Enron collapse.

And while I commend the committee for calling witnesses to discuss the roles and responsibilities of the executives, auditors, and accountants, I fear that we have left out an important player in the story of Enron and its fall from grace . . . The lawyers.

In Enron's own limited investigation of its shady business practices, Vinson and Elkins confirmed that the procedures for monitoring those practices was uniformly overseen, not only by accountants and officers, but lawyers as well.

Unfortunately, the very investigation meant to rout out mismanagement and illegality, seemed marked by a cloud of mismanagement and missed opportunity.In its findings Vinson and Elkins described the monitoring procedures for its LJM transactions as:

- generally adhered to,
- The accounting as, creative and aggressive and
- the working conditions as awkward.

Even though ENRON's SPE related transactions "created a serious risk of adverse publicity and litigation," . . . Vinson and Elkin's nonetheless concluded that, there was no need for an expanded investigation.

In short, while the store burned down around its client Vinson and Elkins called for business as usual.

In the written testimony given by one of today's panelists, he tells of a corporate climate in which aggressive management dares the accountant to "show me where I can't" bend twist and stretch the rules to show a profit. Certainly, this component to the Enron collapse must be a part of the public debate. However, it may be equally as important to discuss the importance of the sound legal advice that would have guided Enron to a very different place than where it is today.

Chairman TAUZIN. The gentleman's time is expired. The Chair thanks the gentleman for his statement. The Chair recognizes the gentleman from Oregon, Mr. Walden, for an opening statement.

Mr. WALDEN. Thank you very much, Mr. Chairman. Mr. Chairman, let me start by quoting some material from Robert Vigil, a constituent of mine living in Madras, Oregon, testifying in front of the Senate Committee on Commerce, Science and Transportation during their hearing on Enron. Mr. Vigil is an electrical machinist working as foreman for Portland General Electric, PGE. He works at PGE's Pelton Round Butte Hydroelectric Project in Central Oregon. He's 47 years old and has been employed by PGE for 23 years. Here's what he said. "Enron purchased PGE in 1997 at which time all of the PGE stock we had in our accounts automatically converted to Enron stock. At first this looked like good news for the employees. Enron was riding high and as we saw the com-

pany officers and supervisors investing in company stock, we felt assured that our own investments were solid. As you're probably aware by August of 2000 Enron's stock had shot up to all time high of $90.56. At that time, my 1800 shares were worth $163,000." Continuing with Mr. Vigil's comments: "We were all barred from trading our stock during the critical period this last fall. It seemed strange to me that as soon as the really bad news came out on Enron, we found ourselves unable to move out of the stock. Enron suddenly changed account managers and our investment accounts were locked down. I've seen that Enron says we were only locked out of our accounts for 10 trading days, from October 29 through November 12, but as early as September 26 my co-workers were finding they could get access to their accounts, but they could not conduct any transactions. As the truth about Enron started to come to light and as the officers at the top cashed out, we, the employees had no choice but to ride the stock into the ground."

Mr. Chairman, I encourage everyone here to read the entirety of Mr. Vigil's statement because it puts a human face on what we're talking about today. No longer is the giant energy marketing company Enron or the Big Five accounting firm Arthur Andersen. We can see how far reaching this collapse is from Houston, Texas, the fourth largest city in America to Madras, Oregon, population, 5,080.

We have to get to the bottom of this, Mr. Chairman, and I commend you and others in this committee for these hearings. Too many workers saw their retirement vanish, too many shareholders were misled, too many years of financial statements were misleading at best or downright fraudulent at worst. Credibility of companies and auditors has been lost. The impact on the financial markets and investor confidence has yet to be determined and it comes at a critical time of our economy.

What did the top execs at Enron and Arthur Andersen know and when did they know it? Particularly troubling is the timing of actions of both Enron and Arthur Andersen. Also, were they intentionally misleading investors and employees? Why were the blackout dates for employees inconsistent? Is it usual to destroy documents like Enron and Arthur Andersen did? Were there side letters that were made by Enron with its partners in relation to risk sharing and structure of those same partnerships? Has the FASB failed to issue regulations that may have prevented some of this from happening in the first place? Has the SEC failed to issue enhanced financial statement disclosure requirements describing partnerships? Do the disclosures need to be more comprehensible to the reader at large? Do auditor independence requirements need to be reviewed again in light of the current situation?

Any time there's a declining business environment, transactions inherently become more complicated. Companies like Enron and their auditors will continue to find ways to get around returns to their investors. The FASB and SEC must continue to evolve with these complex transactions. Delay is not an option.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Greg Walden follows:]

PREPARED STATEMENT OF HON. GREG WALDEN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OREGON

Thank you Mr. Chairman.

Mr. Chairman, let me start by quoting some material from Robert Vigil, a constituent of mine living in Madras, Oregon, testifying in front of the Senate Committee on Commerce, Science and Transportation during their hearing on Enron. Mr. Vigil is an Electrical Machinist Working Foreman for Portland General Electric ("PGE"). He works at PGE's Pelton/Round Butte Hydroelectric Project, in Central Oregon. He is 47 years old, and has been employed by PGE for 23 years.

"Enron purchased PGE in 1997, at which time all of the PGE stock we had in our accounts automatically converted to Enron stock. At first, this looked like good news for the employees. Enron was riding high, and as we saw the company officers and supervisors investing in company stock, we felt assured that our own investments were solid. As you are probably aware, by August 2000, Enron's stock had shot up to an all-time high of $90.56. At that time, my 1800 shares were worth $163,000.

"...we were all barred from trading our stock during a critical period this last fall. It seems strange to me that as soon as the really bad news came out on Enron, we found ourselves unable to move out of the stock. Enron suddenly changed account managers, and our investment accounts were 'locked down.' I have seen that Enron says we were only locked out of our accounts for ten trading days—from October 29 through November 12. But as early as September 26, my coworkers were finding that they could get access to their accounts, but they could not conduct any transactions. As the truth about Enron started to come to light—and as the officers at the top cashed out—we, the employees, had no choice but to ride the stock into the ground."

Mr. Chairman, I encourage everyone here to read the entirety of Mr. Vigil's statement. It puts a human face on what we are talking about today. No longer is it the "giant energy marketing company Enron" or the "big five accounting firm Arthur Anderson." We can see how far reaching this collapse is. From Houston, TX, the fourth largest city in America to Madras, OR: population 5,080.

I intend to get to the bottom of this. Too many workers saw their retirement vanish. Too many shareholders were misled. Too many years of financial statements were misleading at best, or downright fraudulent at worst. The credibility of companies and auditors has been lost. The impact on the financial markets and investor confidence is yet to be determined and comes at a critical time of our economy.

What did the top execs at Enron and Arthur Anderson know and when did they know it?

Particularly troubling is the timing of actions by both Enron and Arthur Anderson. Also, were they intentionally misleading investors and employees? Why were the blackout dates for employees inconsistent? Is it usual to destroy documents like Enron and Arthur Anderson did? Were there side letters that were made by Enron with its partners in relation to risk sharing and structure of those same partnerships? Has the FASB failed to issue regulations that may have prevented some of this from happening in the first place? Has the SEC failed to issue enhanced financial statement disclosure requirements describing partnerships? Do the disclosures need to be more comprehendible to the reader at large? Do auditor independence requirements need to be reviewed again in light of the current situation?

Anytime there is a declining business environment, transactions inherently become much more complicated. Companies like Enron and their auditors will continue to find ways to get the most return for their investors. The FASB and SEC must continue to evolve with these complex transactions. Delay is not an option.

Thank you for the time Mr. Chairman. I look forward to the question session in the hopes that I can provide answers to my constituents.

Chairman TAUZIN. The gentleman's time has expired. The Chair thanks the gentleman. The Chair is pleased to welcome and recognize the gentleman fresh from his victories in New Orleans, took the town by storm, chief sponsor and supporter of the Patriots, Mr. Markey.

Mr. MARKEY. I thank you, Mr. Chairman, very much, and I now realize why 9 of the 36 Super Bowls have been played in New Orleans. I think once you're there, you want to go back as quickly as you can.

Chairman TAUZIN. Glad you enjoyed it, Mr. Markey.

Mr. MARKEY. It was beautiful.

Chairman TAUZIN. It was truly a great Super Bowl and again, I think we all owe thanks to the United States securities forces for making it such a safe and amazing event for America. I think we're all very grateful and quite a game, Mr. Markey, congratulations.

Mr. MARKEY. For us, it was the expurgation of so many ghosts of years gone back, beginning with Bill Buckner, but then back so far into time that we can't remember them all and all of them now, the cloud has passed. Not unlike what we're going to have to do with Enron and Arthur Andersen in terms of the cloud that it's placed over the capital markets. For many of us the most striking thing about the Enron debacle is that the time these transactions were being put together no one ever appears to have stepped forward to say you can't do this. No one appears to have stepped forward to say that would be wrong. No one ever appears to have stepped forward said what you're trying to do is unethical and possibly illegal. Instead, every single financial professional who was supposedly there to protect the public investors, the outside auditors, the attorneys, the Wall Street investment banks and the corporate insiders, all of them got together and conspired with one another on how to structure deals that could evade or flout the rules.

And what about the Wall Street expert securities analysts who were supposedly scrutinizing Enron's performance and the credit rating agencies or supposedly evaluating the company's credit worthiness? Where were these when the shenanigans were taking place? The public wants to know how could this happen? Where was Enron's Board? Where was its senior management? Where were the risk management systems? Where was the outside auditors? Where were the lawyers? Where were the regulators? It wants to know why it was that so many of the internal and external checks and balances that were supposed to protect the public failed so catastrophically?

Traditionally, many have thought of accounting as an incredibly dull and arcane subject. The stereotype of the accounting profession has been that it is pretty much a bunch of nerdy geeks with an inexplicable fascination with obscure and abstruse rules and regulations. And let's face, accounting is boring. Unless, of course, you wish to engage in financial fraud. In which case, accounting is an absolutely fascinating subject. Successfully cooking the books is the key to getting away with financial fraud and at Enron and at Arthur Andersen, new and innovative recipes appear to have been devised.

This week the Powers Committee Report was released and provided us with an exhaustive review of Chewco, Raptor and LJM transactions and these transactions' insiders appear to have constantly flouted the rules.

Back in the 1930's Will Rogers said that from what he could tell a holding company was where you hide the money when the cops show up. Today, for Enron and for possibly many other U.S. companies, special purpose entitles are where you hide your debts, disguise your nonperforming assets, boost your earnings, conceal your losses and avoid paying your taxes. And so I think our committee must look at this issue. We are not at—we have not found the iceberg yet, Mr. Chairman. We are at the tip of the iceberg.

When accountants want to keep score and play the game at the same time, we'd all love to do that if we could get away with it. But once you start doing that, you are setting yourself up for big problems.

I thank you for your leadership in conducting these hearings.

Chairman TAUZIN. I thank my friend for his statement. And the Chair is pleased to recognize the gentleman from Nebraska, Mr. Terry, for an opening statement.

Mr. TERRY. Thank you, Mr. Chairman. I want to highlight a couple of points and I'll submit the rest of my statement for the record. And while the statement is chock full of pithy quotes, I sadly have no Star Wars references.

I do want to point out two things, in the role of Omaha, Nebraska in this hearing today. First of all, I welcome a friend and constituent, Mr. David Sokol. Mr. Sokol is an expert in energy policy since that's his life and I think he's world renowned for his knowledge of the industry and we welcome him here today to share his expertise with us. So welcome, Mr. Sokol.

The other, sad, part about Omaha is that in the late 1970's we enjoyed a great company called Internorth and Internorth had arranged a merger with a small Houston company named Enron. Well, as it ended up, the small fish gobbled up the big fish. Mr. Lay moved to Omaha promising great things for our community, all the while secretly plotting its removal from Omaha to Houston. Nonetheless, while hundreds of people were ripped from their jobs and either forced to move to Houston or retire, they did keep a small division in Omaha, their pipeline division. We have about 400 employees in Omaha and several of those people are friends of mine. And I've heard from several people in the Enron Division in Omaha who told me stories about how they had hundreds of thousands of dollars built up for them from their years of service with Enron in their 401(k) and now as they are looking toward retirement, have nothing.

Now Mr. Chairman, it's said that there are two kinds of light. The glow that illuminates and the glare that obscures. Obviously, we thought Enron was a company with an illuminating glow, but we have found out that they have used that glow to obscure their tactics and we're here today to try and uncover those tactics.

Mr. Chairman, I appreciate your outspokeness on behalf of the employees in Omaha, Nebraska and in Houston, because I think it's our duty today to find those tactics, fill the policy void so this can never happen again and make sure that the Justice Department vigilantly pursues those who have broken the law.

I yield back the balance of my time.

[The prepared statement of Hon. Lee Terry follows:]

PREPARED STATEMENT OF HON. LEE TERRY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Thank you Mr. Chairman. Today's hearing will primarily examine the lax accounting practices Andersen employed in its auditing of Enron. I am pleased, though, that we will also hear testimony regarding the status of our energy markets. I think it's worthy to note that although the largest energy trading company in America collapsed, energy prices have remained fairly stable, and I'm looking forward to the testimony of my good friend David Sokol, chairman of MidAmerican.

When I contemplate the Enron saga I am reminded of a line from Shakespeare's *Henry The Eighth,* "Thy ambition, Thou scarlet sin, robb'd this bewailing land."

What I'm concerned about are Enron's accounting practices: are they the exception to the rule, or are they the rule in Corporate America? We've seen the collapse of Enron late last year, and last week Global Crossing declared bankruptcy—who's next?

Enron's story is reminiscent of a Shakespearean tragedy: a hugely successful company responsible for transforming an entire industry engaged in an elaborate scheme of complicated, unprofitable, and possibly illegal business partnerships; a politically connected CEO; a precipitous financial collapse of immense proportions; and the recent tragic death of its former Vice Chairman.

How could a company so well reputed, employing so many hardworking Americans, and with such a prolific stature in Corporate America just crumble?

As we begin to investigate what happened here and why, it's important to keep in mind people's motives. My interest is twofold: first as a member of this Committee, but more importantly because Enron was formed by merging two companies—Houston Natural Gas and Internorth—the latter headquartered in my home district of Omaha, Nebraska.

Enron employs more than 20,000 people, or at least did before this past Fall. 400 or so of those employees are located in Omaha. They joined thousands in trusting Enron's officers to make decisions that were good for the firm's employees, retirees, shareholders, and not merely to enrich its executives' bank accounts. Until late last year, it appeared Enron's expansion knew no boundaries. The company grew to titanic proportions, spanning 40 countries, operating 30,000 miles of pipeline, holding nearly $50 billion in assets, and taking in revenues in excess of $100 billion in 2000 alone. This seemed like a company playing out that fabled American dream, and its employees and shareholders were reaping the rewards.

On Sunday, the Special Investigative Committee of Enron's Board of Directors released the Powers Report, detailing intricate schemes that created assets that never existed, coaxing investors and employees to invest in a retirement future that would never be. For those who have not read the Powers Report, I'd like to read a brief excerpt of how people like Chief Financial Officer Andrew Fastow, Michael Kopper, and others made millions.

> "We were charged with investigating transactions between Enron and partnerships controlled by its Chief Financial Officer, or people who worked in his department. That is what our Report discusses. What we found was appalling.
>
> "First, we found that Fastow—and other Enron employees involved in these partnerships—enriched themselves, in the aggregate, by tens of millions of dollars they should never have received. Fastow got at least $30 million, Michael Kopper at least $10 million, two others $1 million each, and still two more accounts we believe were at least in the hundreds of thousands of dollars.
>
> "Second, we found that some transactions were improperly structured. If they had been structured correctly, Enron could have kept assets and liabilities—especially debt—off its balance sheet. But Enron did not follow the accounting rules."

Now we're here to determine how this charade was allowed to happen. Who dropped the ball? A lot of finger pointing has taken place, and yet no one has come forward to say, "I'm responsible. I was the one making millions of dollars, all the while knowing that what I was doing was illegal, malicious, and a complete breach of public trust." I hope our witnesses here today can shed some light on what happened in the accounting world to have allowed such a corporate calamity to occur.

It has been said that there are two kinds of light—the glow that illuminates, and the glare that obscures. For years, Enron seemed to be that illuminating glow. Today, we seek uncover the tactics they used to glare their investors and obscure the reality of their condition. If the only result of these hearings, though, is placing blame on the appropriate parties, we have not fulfilled our duties. We must seek solutions to the problems exposed by this unfortunate collapse and implement reforms on a bipartisan basis to ensure this does not happen again. Therefore, I look forward to this Committee and others in Congress exploring further the relationship Enron had with Andersen. It may make sense that one firm should never hold the duplicitous roles of both auditor and consultant. Congress may need to closely examine the possibility of closing this loophole.

I hope the issue of reporting earnings, and the practice of restating earnings, is further explored. We must ensure American investors have accurate, transparent, and timely information when making their investment decisions. I am also hopeful we make some meaningful reforms to how 401(k) plans are administered—not knee-jerk reactions, but commonsense, pro-active legislation that creates safe plans for both employers and employees. It's unfortunate that these reforms are too late for some, but hopefully will benefit future American employees and retirees.

In the 1980's there was a popular movie entitled Wall Street. One of the primary characters, Gordon Gecko, while speaking to a group of shareholders proclaims the memorable line, "Greed is Good." However, it should be remembered that greed is one of the seven deadly sins. And unfortunately in Enron's case—it has proved to be prophetic.

Thank you again, Mr. Chairman, and I look forward to the testimony.

Chairman TAUZIN. I thank my friend. The Chair is pleased now to recognize the gentleman from New York, Mr. Towns, for an opening statement.

Mr. TOWNS. Thank you very much, Mr. Chairman. This is a sad day for this committee and the shareholders of Enron and the families that were employed by Enron. It is clear that the leadership of Enron Corporation did nothing to protect their investors, their shareholders or the employees of the company. The executives put their own interest ahead of the workers and their families and the company's shareholders. Unfortunately, they were able to use regulatory loopholes to accomplish this deceit. It appears that they also broke a lot of rules and laws.

We look to the leadership of our present Chairman, Billy Tauzin from Louisiana in guiding our efforts to plug the loopholes and make sure that such an ungodly mess never happens again in this country.

The financial losses resulting from Enron's collusion to defraud everyone except a few executives cannot be understated. While Enron employees lost some $1.6 billion, let me just briefly discuss the impact on some New York institutions. Amalgamated Bank of New York shareholders lost an estimated around $500 million. J.P. Morgan Chase and CitiGroup could lose over $3 billion from loans made to Enron and finally the losses of the New York Common Retirement Fund will lose approximately $58 million. In the past the SEC had argued that budgeting and staffing constraints limited their regulatory capability.

Mr. Chairman, you probably remember, in the 106th Congress I was the first member to propose a fee reduction and pay parity bill for the SEC. I'm pleased to say that the President recently signed into law the legislation which provides pay parity for SEC staff. However, I'm deeply troubled that the President's budget for fiscal year 2003 does not provide funding for either the pay parity to stem the loss of experienced staff or additional resources to hire the staff attorneys, staff accountants, economists and examiners necessary for safeguarding America's investors. Since we can't find the money for the SEC, I cannot understand how all of a sudden we can find funds for Chairman Pitts' new oversight board. That just bothers me. It is up to us, here in the Congress, to ensure that no American investor or employee is ever again victimized by the corporate greed practiced by Enron.

I look forward to hearing from our witnesses today about how we can strengthen our existing regulatory system. I yield back the balance of my time, Mr. Chairman, and thank you for holding this hearing.

Chairman TAUZIN. I thank my friend. Let me interrupt to explain to our witnesses, it is our practice to do these opening statements for several reasons. One is it's the first opportunity for all the members of the full committee to make comments, even those who do not serve on the Oversight Subcommittee that is doing the

investigation, and to give their observations and their perspectives on this issue. That is valuable to the Chair and to the subcommittees who are going to have to produce the legislation, hopefully, to repair some of the damage that has been done, and as many members have said, to see to it that this does not happen again.

Second, I hope it helps the witnesses in terms of understanding either the correct impressions we have or give you a chance to correct any misimpressions we have about the state of some of these concerns. And so I hope it's helpful to both of us.

Again, I apologize that we've kept you waiting, but this is an extraordinarily important part in the way in which our committee hears from one another, understands one another's perspectives and then prepares for the solution phase of our process which is to produce the legislation, hopefully, that will repair this damage.

The Chair now asks if there are members on this side of the aisle who seek recognition for an opening statement. Mr. Deal, are you prepared at this time? The gentleman from Georgia is recognized for 3 minutes.

Mr. DEAL. Thank you, Mr. Chairman, and thanks to the distinguished panel. We look forward to your testimony.

Obviously, there are many points of view that have been and will be expressed during the course of this hearing and others that will follow. As many of us in the legislative branch have always heard, there is an admonition that I think is important here and that is that bad facts sometimes make bad law.

The Enron debacle is bad facts of historic proportions. I think our challenge is not to react to bad facts by tempting to solve the problem with bad law. Certainly those who have violated the existing laws should be prosecuted as those laws provide. If there is a requirement that Congress act to provide further legislative safeguards that, to me, is the thrust of what we need to do and what we need to understand.

Certainly, the confidence of the American public and others in the safeguards and the oversight of the business community in its private capacity has been shaken as a result of these events. Obviously, I think it would be a mistake for us to attempt to pre-empt those by simple governmental action or governmental rules and regulations. But I think we need to have assurances from the private business community that they will take the kind of corrective action that would not make further legislative, detailed legislative action necessary, but that they as a good part of our overall business community are willing to do some of the policing themselves.

I think those are the challenges that we face. I look forward to the testimony of the witnesses.

Thank you, Mr. Chairman.

Chairman TAUZIN. I thank the gentleman for an opening statement. He yields back and the Chair is pleased to recognized the gentleman from New Jersey, Mr. Pallone, for an opening statement.

Mr. PALLONE. Thank you, Mr. Chairman. I want to say that I'm amazed at how many public policy crises are Enron-related. I'd just like to list, for example, campaign finance reform, energy deregulation, SEC reform, bankruptcy protection and pipeline safety measures. And I don't have time to review all these, but the first point

I'd like to make is aimed directly at Enron's political influence. On January 24, USA Today said it best. They said "Enron's aggressive lobbying drove the deregulation of markets for energy and other commodities that allowed it to escape scrutiny and outdistance its rivals." The New York Times noted that "Enron and its executives have been President Bush's most generous contributors." But we aren't hearing much about House Majority Whip Tom DeLay's well-known relationship with Enron and his bold, fundraising campaigns created in part by his former Chief of Staff, turned Enron lobbyist, Ed Buckham.

A Washington Post article from October 1999 noted that "DeLay's fundraising deals are straight forward. A seat at the table to plot legislative and political strategy in exchange for help in passing the Republican's agenda and financial support for GOP candidates."

Well, what was Enron's role when this committee drafted industry-supported energy restructuring legislation that would have provided FERC full authority over all transmission and interstate commerce? According to an Energy Daily article printed October 21, Enron lawyers argued this very issue before the Supreme Court supporting FERC's order opening access to transmission and further arguing that it did not go far enough. Did Enron work with Mr. DeLay in an attempt to undermine the activities of this committee or try to push legislation that would remove consumer protections?

Another point is aimed directly at the SEC and its role in corporate disclosure, 401(k) and pension reform. Enron's collapse caused New Jersey's Public Worker Pension Fund $60 million in loss and 20 jobs in my District in Edison, New Jersey. It wasn't the largest loss, but it's the proof of the impact of Enron's collapse around the country.

Finally, Mr. Chairman, I'd like to mention the need for bankruptcy reform in light of the effects it has on Enron's wholly owned subsidiary, San Juan Gas Company's 1996 pipeline explosion that killed 33 and injured 80 others. In 1996, Enron lobbied in support of the Accountable Pipeline Safety Partnership Act. I didn't support this bill with many of my colleagues and we called upon President Clinton to veto the bill because it gutted pipeline safety laws. Shortly after it became law, Enron's San Juan Pipeline exploded and NTSB reported this explosion noted that Enron knew that the gas company's operations did not comply with pipeline safety requirements and recommended industry practices had knowledge of failure to meet safety standards on this pipeline since 1985.

Today, Enron and its subsidiaries are being held accountable for financial loss, wrongful death, personal injury and post-traumatic stress disorder caused by this pipeline explosion, but according to the January 21 New York Times, "Enron's bankruptcy case has frozen settlement negotiations and the first scheduled trials for hundreds of victims." First, this provides us a clear example of why we must strengthen pipeline safety laws and further ensure improvements and reform in corporate bankruptcy.

I know there are a lot of other issues, but I just wanted to highlight those, Mr. Chairman. Thank you.

[The prepared statement of Hon. Frank Pallone, Jr. follows:]

PREPARED STATEMENT OF HON. FRANK PALLONE, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. Chairman, I want to say that I am amazed at how many public policy crises are Enron related.

ENRON was the Lone Star of Texas, shining blindingly bright. But, in truth, each of the Lone Star's points of light was aimed squarely at the American public like a weapon. Each point represents significant public policy crises that warrant our immediate and thorough attention: campaign finance reform, energy deregulation, SEC reform, bankruptcy protection and pipeline safety measures.

The first point of this Lone Star is aimed directly at Enron's political influence. On January 24, USA Today said it best, "Enron's aggressive lobbying drove the deregulation of markets for energy and other commodities that allowed it to escape scrutiny and outdistance its rivals." The *New York Times* noted that Enron and its executives have been President Bush's most generous contributors giving more than $550,000 to President Bush's various campaigns, the vote recount coffers and the inaugural committee. Enron's political connection to and relationship with President Bush through Mr. Lay, has been tight.

But, when asked about his relationship with Mr. Lay, President Bush's initial reaction was to fib. In a Texas newspaper, the Dallas Morning News, President Bush claimed that Kenneth Lay was "a supporter of Ann Richards" whom he "first got to know" when he decided to retain Mr. Lay as the head of the Governor's Business Council. In fact, according to a 1994 article published in *The Nation,* President Bush lobbied on behalf of Enron in 1988 when he called Rodolfo Terragno, a former Argentine Cabinet Minister and pressured Mr. Terragno to award a contract worth hundreds of millions of dollars to Enron. To what extent has Enron held onto this level of influence with President Bush and been able to influence public policy created by this Administration during the past year?

According to a *Businessweek* report in December 2000, transition scouts were eyeing Ken Lay to serve as Treasury Secretary and just a few months later they reported that Ken Lay was a key Bush advisor on energy and was named a "transition adviser" to the Energy Department.

But, we also aren't hearing much about House Majority Whip Tom DeLay's well-known relationship with Enron and his bold fundraising campaigns created in part by his former chief of staff turned Enron lobbyist, Ed Buckham. A *Washington Post* article from October 1999, noted that DeLay's fundraising deals are straightforward: a seat at the table to plot legislative and political strategy in exchange for help in passing the Republicans' agenda and financial support for GOP candidates. What was Enron's role when Rep. DeLay attempted to undermine the work of this committee last July by drafting industry-supported energy restructuring legislation that in part would have provided FERC full authority over all transmission in interstate commerce? According to an *Energy Daily* article printed October 21, Enron lawyers argued this very issue before the Supreme Court—supporting FERC's order and further arguing that it did not go far enough. Was it Enron that instigated the attempt to undermine the activities of this committee and push legislation that would remove consumer protections?

This ties in very closely with the Lone Star's second bright point, the need to examine energy markets. Did deregulation of the electricity market assist Enron in its ability to operate under the radar of regulatory oversight? The industry maintains that a deregulated electricity market is necessary. However, did deregulation allow Enron's executives more flexibility in what Chairman Wood calls, "questionable non-core business investments"? To what extent do we need to implement more transparency in the electricity trading market?

I think it is also important to keep in mind the expanding web of relationships as well. Last year, Vice President Cheney told Frontline that he did not hear from Mr. Lay regarding FERC appointments. However, the White House last week admitted that it received a letter signed by Mr. Lay that included suggestions for new FERC commissioners. Mr. Lay's suggestions included Pat Wood and Nora Brownell, now the FERC Chairman and a Commissioner respectively. Is this mere coincidence?

The third Lone Star point is aimed directly at the SEC and its role in overseeing accounting and auditing activities, corporate disclosure, 401K and pensions. Enron's collapse caused New Jersey's public-worker pension fund $60 million in loss and 20 jobs in the Edison, New Jersey office—not the largest loss of a state but proof that the impact of Enron's collapse was broad. We need to take action to prevent mega-corporations from undermining the retirement savings of their employees. Employees must have accurate information about the pension benefits they have earned, including employer stock holdings in their plans, and vested employees must have

the right to diversity employer contributions. Employers should also have to provide clear notice before "locking down" pension account, and allowed to do so for only a limited time. Finally, employees must be able to use the Labor Department and the courts to recover losses if their retirement funds are misused. We cannot allow such financial losses to fall upon misinformed workers again.

The fourth and fifth points of the this Lone Star's saga are related, the need for bankruptcy reform in light of the effects it has had on Enron's wholly owned subsidiary San Juan Gas Company's 1996 pipeline explosion that killed 33 and injured 80 others.

In 1996, Enron lobbied in support of the Accountable Pipeline Safety Partnership Act. I did not support this bill and with many of my colleagues and called upon President Clinton to veto this bill—it gutted pipeline safety laws. Shortly after it became law, Enron's San Juan pipeline exploded. An NTSB report of this explosion noted that Enron knew "that the gas company's operations did not comply with pipeline safety requirements and recommended industry practices had knowledge of failure to meet safety standards on this pipeline" since 1985.

Today, Enron and its subsidiary are being held accountable for financial loss, wrongful death, personal injury and post-traumatic stress disorder caused by the pipeline explosion. But, according to a January 21 *New York Times* article, Enron's bankruptcy case has frozen settlement negotiations and the first scheduled trials for hundreds of victims. First, this provides us a clear example why we must strengthen pipeline safety laws to prevent corporate negligence as well as ensure that corporate bankruptcy protection does not undermine the ability of innocent victims to receive compensation for such loss.

Thank you.

Chairman TAUZIN. The gentleman yields back his time and the Chair will recognize Mr. Cox, if he's ready for his opening statement, for 3 minutes.

Mr. COX. Thank you, Mr. Chairman. On September 11, the men and women who worked at the World Trade Center, Wall Street analysts, traders, investment bankers, accountants were heroes. We recognize that among the 3,000 souls who perished that day were some of our best and brightest, extraordinary individuals whose creativity, energy and leadership helped power the economic miracle that is our free enterprise system.

Today, America's men and women of Wall Street are under deep suspicion. The problems at Enron, K-Mart and Global Crossing and at their accounting firms have deeply damaged the credibility of every accountant, every corporate manager, every analyst.

Today, accountancy is in the dock. The essence of the Enron fraud is accounting. According to the Powers Report, the accounting for Chewco was flatly wrong from its inception. The purpose of the many SPEs that Enron created was to keep debt and risk hidden from investors, from regulators and from the public. The audited financial statements were misleading. The only questions that remained are the various levels of culpability and the number of people knowingly involved.

It is my hope that as we explore accounting issues today, we can learn not only how to inform remedial legislation, but also how to inform better regulation, both by the industry and by the Securities and Exchange Commission.

I hope that we also keep uppermost in mind our responsibility to protect the livelihoods of those people who are not guilty of any wrong doing and who participate honestly every day in the business of America at other places of work, in other firms. I hope that we do everything possible to restore the confidence of the investing public, of workers and their own retirements and of people and their own employers so that we can get about the business of America.

I thank you, Mr. Chairman.

Chairman TAUZIN. The Chair thanks the gentleman whose time has expired and the Chair will recognize—who's next? Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

Chairman TAUZIN. You are recognized for 3 minutes.

Mr. BARRETT. I want to thank you for holding this hearing and thank our witnesses for being here today. We should learn lessons about the administration of Enron's 401(k) plan today. As a result of what may prove to be willful deception, thousands of workers lost not only their family supporting job, but also their retirement savings. Those families deserve answers from this Congress.

We should learn lessons about the limits of Wall Street's securities analysis capabilities. Because of America's investment advisor and brokerage houses took Enron at its word, America's families and large institutional investors suffered untold losses. Wisconsin State employees alone lost over $45 million in pension fund assets when Enron stocks held by Wisconsin Investment Board became virtually worthless. Wisconsin employees and participants in other large institutional investment plans have worked hard to earn their pension benefits. And Mr. Chairman, they deserve answers from this Congress.

We should learn lessons about the effectiveness of the accounting and audit system that helps investors and creditors to value one business venture against another. Enron's chief work product appears to have been a web of dummy corporations and mislabeled accounts. With literally thousands such sham devices, the company's wrong doing appears to have been as inconspicuous as a bulldozer at a tea party. But Arthur Andersen signed off on Enron's reports and investors around the world took Enron at its word, in part, because Andersen had looked over the books.

Some of Andersen's reactions to allegations concerning its role in Enron's failure have been disappointing. In comments appearing in the February 3 Washington Post, Andersen spokesman Charlie Leonard responded to Enron's internal audit by setting Enron's failure to provide information about its money-pit partnership Chewco. "We attempted to speak with them and they didn't speak with us" Mr. Leonard told the Post.

Now it's been a while since I worked as a Federal bank examiner, but as I recall when a responsible auditor does not get the information he needs to be satisfied that the numbers add up, he refuses to sign off on the audit. He doesn't rubber stamp it and then complain after the fact that he hadn't gotten all the information.

To borrow a phrase from President Bush, Enron's math was not just fuzzy, it was hairy, wooly, shaggy, downright furry. But whether it was willful complicity or just shoddy work, Arthur Andersen was the watchdog that never barked.

We can take lessons from these failures too. The current system of auditor accountability based on peer review may no longer serve the public interest. I am hopeful that our witnesses will help us consider whether an independent, self-regulatory organization might better safeguard American investors.

We can also take a broader lesson from the Enron debacle about the importance of honest and complete information disclosure. A capitalist economy, like America's, requires a certain basic level of

trust between business associates. One party must believe that information provided by the other is accurate and complete or the system cannot work.

In this case, this was forgotten. We should learn from these failures and assure that America's business transactions are more transparent, more accessible and more responsible than before.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Tom Barrett follows:]

PREPARED STATEMENT OF HON. TOM BARRETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Thank you, Mr. Chairman.

And I want to thank all of our witnesses for appearing today. I expect that we will find your testimony enlightening.

Mr. Chairman, the focus of today's hearings is certainly an appropriate one. We should be looking for lessons from Enron's collapse, because there is a lot at stake.

We should learn lessons about the administration of Enron's 401(k) plan. As the result of what may prove to be willful deception, thousands of workers lost not only a family-supporting job but also their retirement savings. Those families deserve answers from this Congress.

We should learn lessons about the limits of Wall Street's securities analysis capabilities. Because America's investment advisors and brokerage houses took Enron at its word, American families and large institutional investors suffered untold losses. Wisconsin state employees alone lost over $45 million in pension fund assets, when Enron stocks and bonds held by the Wisconsin Investment Board became virtually worthless. Wisconsin employees and participants in other large institutional investment plans have worked hard to earn their pension benefits, and Mr. Chairman, they deserve answers from this Congress.

We should learn lessons about the effectiveness of the accounting and audit system that helps investors and creditors to value one business venture against another. Enron's chief work product appears to have been a web of dummy corporations and mislabeled accounts. The company's wrongdoing appears to have been as inconspicuous as a bulldozer at a tea party. But Arthur Andersen signed off on Enron's reports, and investors around the world took Enron at its word, in part because Anderson had looked over the books.

Some of Arthur Andersen's reactions to allegations concerning its role in Enron's failure have been disappointing, to say the least. In comments appearing in the February 3rd *Washington Post,* Anderson spokesman Charlie Leonard responded to Enron's internal audit by citing Enron's failure to provide information about its money-pit partnership, Chewco. "We attempted to speak with them, and they didn't speak with us," Mr. Leonard told the Post.

Now, it's been a while since I worked as a federal bank examiner. But as I recall, when a responsible auditor does not get the information he needs to be satisfied that the numbers add up, he refuses to sign off on the audit. He doesn't rubber-stamp it, then complain after the fact that he hadn't gotten all of the information.

To borrow a phrase from President Bush, Enron's math was not just fuzzy—it was hairy, woolly, shaggy—downright furry. But whether because of willful complicity or just shoddy work, Arthur Anderson was the watchdog that never barked.We can take lessons from Andersen's failures, too. The current system of auditor accountability, based on peer reviews, may no longer serve the public interest. I am hopeful that our witnesses will help us to consider whether an independent, self-regulatory organization might better safeguard American investors.

We can also take a broader lesson from the Enron debacle, about the importance of honest and complete information disclosure. A capitalist economy like America's requires a certain basic level of trust between business associates. One party must believe that information presented by the other party is accurate and complete, or the system cannot work.

In this case, this was forgotten. We should learn from their failures and ensure that America's business transactions are more transparent, more accessible, and more responsible than before.

Chairman TAUZIN. I thank the gentleman. The Chair recognizes Mr. Blunt of Missouri.

Mr. BLUNT. Enron went down with a bang not a whimper and the ripple effects have been felt in communities nationwide. In my

hometown of Stratford, Missouri—one of the largest employers and you don't have to be a very big employer in Stratford, Missouri, but one of the largest employers—went out of business on Friday because their owner had a contract and a loan with Enron. Enron couldn't hold up their end of the bargain and now 130 Southwest Missourians are looking for work. This is a complicated story with ramifications spilling over into many legislative and regulatory areas. It would be easy for me and for all of us on this panel to propose a mountain of changes to prevent what happened to Enron. Subsequently, what happened to businesses like Midwest Products in Stratford from ever happening again. That's why I'm so pleased that the Mr. Chairman has chosen to hold these hearings so that we, as a committee, can find out what new regulations really are warranted or whether we're simply creating obstacles to solutions in the future.

Much of this mess may have been attributed to illegal business practices or individual misconduct, but we can't, of course, legislate scruples. Some of this bankruptcy could be the result of bad business decisions and we can't legislate good business judgment either. But the true scandal of this case may be cutting bookkeeping tricks and promises of retirement security that ultimately weren't worth the paper they were written on.

It's clear that we need to shine some light on corporate practices and then enforce corporate disclosure requirements. SEC regulations and accounting rules already require disclosure in situations that are likely to have a material effect on a company's financial condition, but in this case, Enron's financial disclosures were vague at best or criminal at worst.

Wall Street continued to overvalue Enron stock based on this pattern of misleading reports. If adequate information had been available about the true state of Enron's finances, Enron employees would have made informed decisions about their financial futures. After all, fully 62 percent of their 401(k)s consisted of Enron stock and that stock plummeted from over $80 a share in January 2001 to less than $.80 a share by January 2002.

They never had a real chance, based on the reassurances they apparently were receiving about the future state of the company. I'm co-sponsoring legislation as many on this panel are. The legislation I'm working on with Congressman Portman and Congressman Carden will be legislation that will help workers avoid overconcentration in stock of their own companies. Enron's been a case in point for enhanced employee control of retirement security. We need to look closely at a bill of rights for retirement security.

Look at all the Enron-related problems that could have been avoided had we had this type of regulation already on the books.

I look forward to the committee's investigation of corporate disclosures at Enron and at all companies. We need to get to the bottom of what changes need to be made and then enforce them so that workers aren't left trading years of service for empty promises and uncertainty in their retirement years.

[The prepared statement of Hon. Roy Blunt follows:]

PREPARED STATEMENT OF HON. ROY BLUNT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. Chairman, I want to thank you for calling these hearings. We have an excellent opportunity to use Enron's collapse to effect some significant change in the way our nation's businesses do business.

Enron went down with a "bang—not a whimper," and the ripple effects have been felt in communities nationwide. In my hometown of Strafford, Missouri, one of our largest employers went out of business on Friday because their owner had a contract and a loan with Enron, and Enron couldn't hold up their end of the bargain. Now 130 Southwest Missourians are looking for work.

This is a complicated story with ramifications spilling over into so many legislative and regulatory areas. It would be easy for me and for all of us on this panel, Mr. Chairman, to propose a mountain of changes to prevent what happened to Enron—and subsequently to businesses like Midwest Products in Strafford—from ever happening again. That's why I'm so pleased that you're conducting these hearings—so we as a committee can find out which new regulations are warranted, or whether we'd simply be creating obstacles to the real solutions.

Much of this mess may be attributable to illegal business practices or individual misconduct, and we can't legislate scruples. Some of this bankruptcy could be the result of imprudent business decisions.

And we can't legislate good business judgment either. But the true scandal in this case may be that which is perfectly legal—cunning bookkeeping tricks and promises of retirement security that ultimately weren't worth the paper they were written on.

It's clear that we need to shine some light on corporate practices and enact, and then enforce, corporate disclosure requirements. SEC regulations and accounting rules already require disclosure in situations that are likely to have a material effect on a company's financial condition, but, in this case, Enron's financial disclosures were vague at best and criminal at worst. Wall Street continued to overvalue Enron stock—based on this pattern of misleading reports.

If adequate information had been available about the true state of Enron's finances, Enron employees could have made informed decisions about their financial futures. After all, fully 62 percent of their 401(k)s consisted of Enron stock, and that stock plummeted from 80 dollars a share in January 2001 to less than 80 cents a share in January 2002. They never even had a chance.

I signed on yesterday to a bill Congressmen Portman and Cardin have introduced to avoid workers' over-concentration in the stock of their own companies. Enron has been a case-in-point for enhancedemployee control of retirement security. This legislation would provide for new diversificationrights, new disclosure requirements and new tax incentives for retirement planning and education. It's a bill of rights for retirement security.

Look at all of the Enron-related problems that could have been avoided had we had this type of regulation already on the books to allow employees to take control of their own financial futures. This bill will prohibit companies from forcing employees to invest in employer stock. It will grant new diversification rights for 401(k) matching contributions in employer stock. The bill will require companies to notify employees within 21 days of so-called "blackout" periods, so they can rearrange their investments if they see fit. And it will require companies to make sure employees know about general investment principles when they enroll in a retirement plan, so they can make knowledgeable decisions about their futures.

Mr. Chairman, I look forward to the Committee's investigation of corporate disclosure—at Enron and in all companies. Let's get to the bottom of what changes need to be made and then enforce them, so that workers aren't left trading years of service for empty promises and uncertainty in their retirement years.

Thank you, Mr. Chairman.

Mr. BLUNT [presiding]. I recognize Ms. DeGette for an opening statement.

Ms. DEGETTE. Thank you, Mr. Chairman. I guess I'll filibuster until everyone else comes back.

Mr. BLUNT. Then we have Mr. Ehrlich to follow you who has to vote as well.

Ms. DEGETTE. I have an opening statement which I will submit for the record, but I have a few comments I'd like to make. I'm privileged to sit on the Oversight and Investigations Subcommittee which has been investigating the Enron mess over the last few

weeks and a few of my observations are as follows: when we started this investigation several weeks ago, we were told that the entire collapse of the house of cards that was Enron was due to just a few bad actors and as we have gotten deeper and deeper into this issue, it has become clear to all of us that the problems go deep and wide, both in Enron and all of its advisors.

Let me give a few examples. First, Enron's auditors, Arthur Andersen. We were told in the Oversight and Investigations Subcommittee that one renegade at Arthur Andersen, David Duncan, the project manager, on his own decided to simply shred documents using an appropriately named company, Shredco. And we were told that he just decided this should be done.

As we went through the hearing it became immediately clear, that the shredding was done with the tacit understanding and the not-so-tacit advice of Andersen's in-house legal department and of Mr. Duncan's supervisors. Mr. Duncan was told to use Andersen's regular policy and destroy all backup documentation. He was told this, even after Andersen and Enron knew of pending litigation.

Second, the limited partnerships. We've heard much today and in the last week about the complex web of limited partnerships and other financial entities which were designed to boost up Enron's balance sheet while at the same time hiding fantastic losses. We were told at first this was just a few greedy individuals. But as we sat through the Oversight an Investigations Subcommittee hearings this week, it became immediately clear that Andersen's senior management and their board were either asleep at the switch or worse.

This is the diagram of the Chewco transaction. You can't see it too well from the witness table, but it doesn't make much difference because this transaction is so complex it's difficult for even fairly well trained lawyers like me to understand what was going on. But the bottom line was to shift Enron's debt off the books to run it through limited partnerships and other entities and in the end to inflate what it looked like the bottom line was. There were thousands of entities not all structured like this. In fact, many structured quite differently than this. This is a diagram of the first financial entity put together which I have an interest in since it was a Colorado company, Rhythms. As you can see, these two are very different transactions. And as we sat there and listened to the web of very complicated partnerships and accounting slight of hand, I could only help but think of one thing, what would a low level Enron employee with all of their 401(k) retirement plan in stocks make of these? The Enron investors relied upon Arthur Andersen, the Board of Directors and senior management of Enron to make sure that all of these transactions were legitimate and that any conflicts of interest were disclosed.

Finally, the huge personal gains made by Enron employees and offices. Again, we were told this was just one or two people making a lot of money. As we sat in the Oversight and Investigations Subcommittee, we realized many senior level employees, several officers were benefiting unbelievably from these. Let me just give a couple of examples. People who invested a few thousand dollars in the limited partnership and received $1 million in compensation 6 months later. People who invested a few tens of thousands of dol-

lars and received $30 million in compensation, just a few months later, all undisclosed. It's clear we must know exactly what happened. How did Enron senior executives and board members hide these losses while getting personal gains like this? What can Congress do? And most importantly, perhaps, what can our society do to protect the small investors who have lost everything while the executives gained.

[The prepared statement of Hon. Diana DeGette follows:]

PREPARED STATEMENT OF HON. DIANA DEGETTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF COLORADO

Thank you, Mr. Chairman. In the past few weeks all of us have been stunned by the revelations surrounding Enron's bankruptcy and the involvement of Arthur Anderson. These hearings may help us get to the bottom of the matter. The arrogant web of lies and deception must be untangled.

We must restore investor confidence, mandate greater transparency, deter other corporations from flimsy fiscal practices, and find just recompense for employees who lost their savings.

Enron was the largest corporate implosion in history. And while those charged with fiduciary duty protected their money, loyal employees and trusting investors were scammed. The American people have lost confidence that Enron will provide the truth. They have learned that Arthur Anderson, which functioned as an auditing safeguard, failed in its duty. Now, the American people are looking to us for an honest accounting. It is our duty to use these hearings to answer the many questions at hand.

We must know exactly what happened. How did Enron's senior executives and board members hide such fantastic losses while themselves realizing some breathtaking gains? How can shell partnerships be created that bury huge losses? How did Enron get away with annual reports filled with half-truths, even lies, omitting key information and transactions? What kind of corporate mentality creates a climate to ignore the law with seeming impunity, especially in an organization that in many ways was so visible?

We know Enron was a hard-charging, rapid-growth company that constantly pushed the envelope. The Powers Report detailed a litany of problems, compounded by a corporate mentality where executives thought that the law was an inconvenience to be over-ridden, not a legitimate public demand for honest practices and transparent dealings.

Arthur Anderson helped Enron, of course. How did a reputable, internationally recognized firm like Arthur Anderson fail to provide a credible, transparent, honest audit of the company? How did Arthur Anderson hope to remain objective and credible when they were receiving astronomical consulting fees?

I am most mindful of the many investors here who have lost their money, and the employees who lost their retirement funds. What can Congress do to protect these employees and shareholders, many of whom have lost their entire retirement savings. We have had two Oversight & Investigation hearings which have provided extensive illumination. I look forward to learning more today so that we may begin to untangle the web which Enron left us.

Thank you.

Mr. BLUNT. The gentlelady's time has expired. The Chair recognizes the gentleman from Maryland, Mr. Ehrlich, for 3 minutes.

Mr. EHRLICH. Thank you, Mr. Chairman. I have a sense of compassion for our witnesses. I'll give you the Cliff Notes version of my opening statement because you all have certainly gotten the spirit of the day.

We all know Enron is the largest corporation in American history to file for bankruptcy. In addition to the type of investor losses the gentlelady just discussed, there was a dramatic and sudden fall in Enron stock prices that stripped retirement accounts of many current and retired Enron employees whose savings were based on Enron's stock.

Our committee colleagues from both sides of the aisle support this committee's efforts to discover whether or not Enron engaged in illegal business practices. We want to understand a lot. We want to understand why executives received large bonuses and compensations during a period of financial decline while other employees were prevented from selling their stock. We want to understand how such a large corporation was able to hide its debt and collapse without any warning from responsible regulatory agencies and auditors.

Yet additional questions must be answered. Did Enron's use of a large number of partnerships contribute to its collapse? Was there a complete failure of Federal regulators? Did Federal regulators have authority to adequately oversee complex commodity trading and financial transactions, the foundation of Enron's rapid growth?

Through your guidance we'll certainly come to some conclusions, hopefully, solid conclusions with regard to these issues.

Chairman Tauzin's efforts to promote dependable, affordable and environmentally friendly production and distribution of energy are well known. Some, and you've heard a sampling here today, but not most members of this committee, may try to confuse deregulation and the need for sound energy policy with illegal and duplicitous actions. I continue to believe that the competitive market protected from potential abuse through proper oversight and the law remains the foundation for a strong economy, the basis for our national security and provides the best products and services for our citizens.

We look forward to what you all have to say and thank you for being here. I yield back.

[The prepared statement of Hon. Robert Ehrlich follows:]

PREPARED STATEMENT OF HON. ROBERT EHRLICH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Thank you, Mr. Chairman. Mr. Chairman, the failure of any business is deeply disappointing. In most cases, employees and their families bear the brunt of this failure with many experiencing a profound sense of loss, anger, and shame. As the failure ripples through related enterprises, rocking businesses and communities—disillusionment and loss is left in its wake. Unfortunately, the tempest of a failed enterprise is in direct proportion to its size, and, accordingly, I applaud your conducting this inquiry of Enron, once our nation's 7th largest company.

On December 2, 2001, energy-giant Enron shocked the energy and financial communities by filing for Chapter 11 bankruptcy. Enron is the largest corporation in American history to file for bankruptcy. In addition to investor losses, the sudden and dramatic fall in Enron's stock price has stripped the retirement accounts of many current and retired Enron employees, whose savings were largely based on Enron stock.

Mr. Chairman, my colleagues and I support the committee's efforts to discover whether or not Enron engaged in illegal business practices. We want to understand why executives received large bonuses and compensation during Enron's financial decline while other employees were prevented from selling their stock. We want to understand how such a large corporation was able to hide its debt and collapse without any warning from responsible regulatory agencies and auditors. Yet additional questions must be answered: Did Enron's use of a large number of partnerships contribute to its collapse? Was there a failure re the performance of federal regulators? Did federal regulators have authority to adequately oversee complex commodity trading and financial transactions—the foundation of Enron's rapid growth? Through your guidance, these and many other questions will be answered.

Mr. Chairman, I applaud your efforts to review accounting standards, practices, and services and their effects in the Enron collapse. If there are flaws in the regulatory system, then the laws must be changed to guarantee that a debacle of this magnitude will never happen again. I agree with President Bush's State of the

Union statement that through stricter accounting standards and tougher disclosure requirements will make corporate America more accountable to employees and shareholders alike. This must be an era of corporate responsibility.

The deliberate destruction of evidence by an employee in an ongoing investigation brings its own State and Federal criminal and civil penalties, as does failure to comply with SEC regulations and directives. Our court system will resolve the many lawsuits seeking justice and compensation. Illegal and duplicitous actions should not and cannot be tolerated. Further, it is clear that some may attempt to use this business scandal that has hurt so many as a tool for petty politics and opinion manipulation. We owe those who have worked hard, played by the rules, and have lost so much a strong, bipartisan investigation, or risk victimizing them a second time.

Mr. Chairman, your efforts to promote dependable, affordable, and environmentally-sound production and distribution of energy are well known. Opponents may try to confuse deregulation with illegal and duplicitous actions. I continue to believe that the competitive market, protected from potential abuse through proper oversight and legal protections, remains the foundation for a strong economy, the basis for national security, and provides the best products and services to our citizens.

Finally, this committee's investigation into Enron's business practices will prevent future business collapses of this nature, determine the effectiveness of Federal oversight and regulatory agencies, and make clear whether changes to Federal law are necessary to protect employees and shareholders. We must and will get to the bottom of Enron's failure, and work to ensure it never happens again.

Thank you Mr. Chairman.

Chairman TAUZIN. I thank the gentleman for his statement. The Chair is pleased to recognize the gentlelady, Ms. McCarthy, for an opening statement.

Ms. DeGette, I was not here to recognize you and I did want to take a moment to personally thank you for the extraordinary work you're doing on the subcommittee and I deeply appreciate the attention you've given that work. Thank you.

Ms. McCarthy is recognized for 3 minutes.

Ms. MCCARTHY. I thank you very much, Mr. Chairman. I thank you for conducting this hearing. I would like the panelists to know that I arrived at 12:15, 2½ hours ago and so I'm going to submit the bulk of my text to the record, but I want to thank you for taking the time to be here with us today. I think what the committee is about is lessons learned and I'm pleased, Mr. Chairman, that that is how you have framed this hearing, because while all of us have been consumed by this in the news, and our committee staff has done 2 months of investigation and they've come up with some very serious determinations for us to look to, I look forward to your presentations because I think you're going to help us understand that many of the things that we feel we might need to fix can be done through regulatory and statutory mechanisms already in place, but that we might need to revisit some of the ideas that former Chairman Levitt and others presented to us over time that might tighten those regulatory processes to avoid this in the future.

I'm particularly interested in hearing your thoughts on how corporate boards can reform themselves because I think they can go a long way toward finding or being part of the solution to this kind of activity so that it doesn't happen anywhere else and I think too, Mr. Chairman, that all of us on this committee can learn from this experience that we're going to have, how we can shape national energy policy that we are working on very diligently, to make sure that we in the Congress also are working together with the regulatory agencies and existing statutory law and the boards to make

sure we have sound energy policy in the future. So I thank you and I will submit my formal remarks for the record.

Chairman TAUZIN. I thank the gentlelady for always very thoughtful comments and she yields back. Are there further requests for time? I believe we have the vice chairman of the full committee, the gentleman from North Carolina, Mr. Burr, who has done such an excellent job for our committee for 3 minutes.

Mr. BURR. I thank the Chair. I don't want to prolong opening statements. I only want to make a comment about the work of this committee. This committee has a long history and certainly in the 7 years that I have been here to tackle tough issues. And even though the Oversight and Investigations Subcommittee has been asked to look at numerous things in those 7 years and prior to that under other leadership, also difficult issues, I personally have not been as challenged as I think we have been so far with the Enron issue, nor do I think we will be any more challenged as we head through this.

This is clearly like peeling an onion and with every layer we see something different. We see something new and in many cases we find something even more ugly than we saw in the last layer. We owe it to the American people to fulfill our commitment of oversight, of understanding, but most importantly, of assurance that we have gotten at the cancer that exists.

I'm confident, Mr. Chairman, under your leadership and with the commitment of all members, and hopefully, hopefully, with the cooperation of more directly involved in this whole issue we can get at the truth and move on to the solution much faster.

I yield back.

Chairman TAUZIN. I thank the gentleman for his statement and the Chair yields to the gentlelady, Ms. Capps, from California for an opening statement.

Ms. CAPPS. Thank you, Mr. Chairman. I'm so pleased the committee is holding this wide ranging hearing about Enron. It's important that we begin now to look into steps Congress, the regulatory agencies and corporate players must take to protect the public from future Enrons. The distinguished panel of witnesses we have here will certainly be helpful in shedding light on this scandal and how we might prevent future ones.

I share the outrage of my colleagues and my constituents over this whole affair. The various actions of Enron and Andersen executives has been inexcusable, immoral and maybe illegal. As we all know, Enron's meltdown has cost thousands of the company's employees some or all of their life savings. It has burned millions more investors across the country. It has highlighted some glaring inadequacies in the accounting profession and its ineffective system of oversight that has allowed and even encouraged corporate shenanigans. And of course, Enron has shown us, once again, the ugly face of greed and dishonesty.

Every day, congressional hearings in the media bring out more details about this sordid affair. We know, for example, that Enron executives set up thousands of partnerships to help the company hide its debts. We know that many of these executives made fortunes through these partnerships. We know that Arthur Andersen was involved in some or all of this and we now know that Enron,

once touted as a management innovator, was apparently not much more than a sophisticated pyramid scheme.

But there's a lot we still don't know. For starters, Mr. Chairman, we still don't know exactly who approved all these complex relationships and what they knew when they did it, who were all the partners and how much money they made. We don't know how deeply Enron may have been involved in the California electricity crisis. These are my constituents. How Enron's actions may have exacerbated that situation? We know there's a strong connection. We still are paying that price and will be paying it for a long time in California.

Until we know answers to these and many other questions our work here will not be complete. So this committee must continue its aggressive investigation and I applaud all of the efforts into doing that.

The unanswered questions, however, do not excuse us from taking actions immediately. I would hope that we can look into the idea of limiting the amount of time an accounting firm can do audits for the same company to a set number of years. Perhaps that's worth exploring. The attempt of our former SEC Chairman Arthur Levitt to stop accounting firms from performing auditing and consulting for the same client is now clearly seen as something that should be pursued in Congress. Some have suggested that the stock exchanges be responsible for hiring the accounting firms to audit companies. These ideas should be explored and I would like to hear from our witnesses on these and other ideas.

These kinds of changes may be necessary to give investors more responsible and accurate accounting of corporate books. I think it's important to note, however, that at the bottom of all this are not seemingly mundane accounting problems. At the bottom appears to be simple greed and dishonesty at the highest levels of a corporation. It was Enron executives who were in charge when the company was going to say what was happening regarding its profits and losses. It was Enron executives that chose to stretch and finally break the bounds of propriety. And so it must be the goal of this committee to take whatever steps are necessary to make sure that the next set of executives in Enron or any other of our large corporation or any of our business executives think twice before they do the same thing.

Thank you, Mr. Chairman. I yield back the balance of my time.

[The prepared statement of Hon. Lois Capps follows:]

PREPARED STATEMENT OF HON. LOIS CAPPS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Thank you, Mr. Chairman.

I am pleased the Committee is holding this wide ranging hearing about Enron.

It is important that we begin now to look into steps Congress, the regulatory agencies and corporate players must take to protect the public from future Enrons.

The distinguished panel of witnesses we have here will certainly be helpful in shedding some light on this scandal and how we might prevent futures ones.

I share the outrage of my colleagues and my constituents over this whole affair.

The varoius actions of Enron and Andersen executives has been inexcusable, immoral and probably illegal.

As we all know, Enron's meltdown has cost thousands of the company's employees some or all of their life savings.

It has burned millions more investors across the country who bought Enron stock based on false premises.

It has highlighted some glaring inadequacies in the accounting profession and its ineffective system of oversight that has allowed and even encouraged corporate shenanigans.

And, of course, Enron has shown us once again the ugly face of greed and dishonesty.

Every day Congressional hearings and the media bring out more details about this sordid affair.

We know, for example, that Enron executives set up thousands of partnerships to help the company hide its debts and artificially boost its profits.

We know that many of these executives made fortunes through these partnerships.

We know that Arthur Andersen was involved in either setting up the accounts or approving them or somehow giving some cover to Enron's misdeeds.

And we now know that Enron—once touted as a management innovator—was apparently not much more than a sophisticated Pyramid scheme.

But there is an alot we still don't know.

For starters, Mr. Chairman, we still don't know exactly who approved all these complex partnerships and what they knew when they did it.

We don't know who were all the partners in the partnership, how they became partners, or how much money they made.

We don't know how deeply Enron may have been involved in the California electricity crisis and how its actions may have exacerbated that situation.

And until we know the answers to these and many other questions, our work here won't be complete.

This Committee must continue its aggressive investigation into these questions and many others.

The unanswered questions do not, however, mean that there are no clear actions we should take.

For example, the former SEC Chairman Arthur Levitt's attempt to stop accounting firms from performing auditing and consulting for the same client is now clearly seen as correct.

I think that we should look into the idea of limiting the amount of time an accounting firm can do audits for the same company to a set numer of years is worth exploring.

Some have suggested that the stock exchanges be responsible for hiring the accounting firms to audit companies.

That idea might be worth exploring as well and I would like to hear from our witnesses on all these ideas.

These types of changes may be necessary steps to give investors a more responsible and accurate accounting of corporate books.

However, I think it is important to note that at the bottom of all this are not just seemingly mundane accounting problems.

At the bottom of this mess appears to be simple greed and dishonesty in the highest levels of a corporation.

It was Enron executives that were in charge of what the company was going to say regarding its profits and losses.

It was Enron executives that chose to stretch and finally break the bounds of propiety.

I hope that this Committee can take steps to make sure that the next set of executives think twice before doing the same thing.

Thank you, Mr Chairman.

Chairman TAUZIN. The Chair thanks the gentlelady. The Chair is now pleased to recognize the gentleman from Arizona, Mr. Shadegg, for an opening statement.

Mr. SHADEGG. Thank you, Mr. Chairman. I want to commend you for holding this hearing. I'm pleased that our committee is going to look into these critically important issues.

It simply cannot be stated how important this inquiry is to our Nation and to its free market system. If people do not have confidence in the market place, if they do not have confidence in the financial documents which describe the companies in which they are asked to invest, then we will not have a functioning free market in this country and we will not have the capital to move for-

ward as a Nation and to sustain the lifestyle we have. So I commend you, Mr. Chairman, for holding these hearings.

I think I want to jump off of the point that Ms. Capps just made. There are clearly some things wrong in the system. When I listen to the bureaucratese about special purpose entities and then you go behind those and you discover that they really are off-balance sheet entities which in this instance were used to hide debt and create a false impression about the financial security of this company, it is clear that we need to take a close look at the accounting standards of this country. We need to take a close look at the role for the SEC. We need to take a close look at the role of FASB and whether or not we're doing the right things there. I commend you for bringing in this particular panel of witnesses.

But in our effort to examine this, we need to discern between that which was a regulatory failure where we did not have bright lines in the rules that govern misconduct and as Ms. Capps put it simple greed, because in this instance it looks to me fairly clear that there was a great deal of simple greed. No one I believe reading the documents and studying what happened can fail to recognize that members of the board of directors had to know what was going on, officers had to know what was going on, they had to know that the public was being deceived.

Now someone should have caught that before now and we should make sure that the enforcement mechanisms are there to do so, but we should not just enact new regulations to replace the regulations that failed the last time and thereby burden the economy. This is a critically important inquiry. I commend you, Mr. Chairman, for conducting it.

Chairman TAUZIN. I thank the gentleman. Further requests for statements? Mr. Doyle is recognized for an opening statement.

Mr. DOYLE. Thank you very much, Mr. Chairman, and in deference to our panel members I'll submit my entire statement for the record.

Chairman TAUZIN. Without objection, so ordered.

Mr. DOYLE. And just state that this member, along with all members of this committee and the Nation are not only shocked, but outraged by what transpired here and one of the things we have to make sure of in this committee is that this can never happen again.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Mike Doyle follows:]

PREPARED STATEMENT OF HON. MIKE DOYLE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Mr. Chairman, thank you for providing today's forum to examine issues that demand this Committee's prompt attention; accounting standards reform and auditor oversight.

Malcolm Forbes once said: "Too many people overvalue what they are not, and undervalue what they are."

Some of Enron's top leadership knowingly and systematically reported an income and financial stability that simply did not exist, and thus betrayed consumer trust by portraying a greater value of the company than actually existed. To make this matter all the more onerous, Enron accountants appear to have exploited loopholes in existing law governing the disclosure of relevant material financial information to achieve their deception. I am troubled by the allegations that top management officials with Enron capitalized on the lack of effective and enforceable accounting

standards, and thus bullied their accountants into misrepresenting numbers to public investors to hide the fact management had made terrible business decisions.

The debt incurred by these deals was obscured from investors in special purpose entities, and what real income Enron was realizing from other SPE deals was being pocketed by a select few at the top. Enron officials knew this was occurring, but did nothing to alert the public. Investors took such information in good faith and heavily invested pension plans in Enron stock. The results were catastrophic for working class Americans, as the value of employee pension plans a worker had invested in and counted on for years were wiped out in an instant.

I am very concerned that our current accounting and auditing practices can be manipulated and exploited to hide fraudulent activities. This committee must look at ways to improve and strengthen our accounting standards to prevent intentional circumvention by unscrupulous individuals whose greed overshadows principle. Such individuals are compromising the integrity of their professional and personal reputations, while ruining the trust of a public that relies on information they provide to make investment decisions. If this is the best that accounting industry self-regulation can do, then Congress has no choice but to step in with real regulation.

In my view, allowing the same firm on a company payroll to do the auditing for that company is a practice that is ripe for exploitation, especially when laws prohibiting this exploitation are vague or nonexistent. We must empower the Securities and Exchange Commission with the proper resources and authority to enforce accounting and auditing standards, and I sincerely hope this Committee explores ways to reduce or eliminate this conflict of interest in industry practice.

My colleagues, one of prime directives of this Committee is to ensure that American consumers are protected from harmful goods and services. Clearly, Enron violated the rights of consumers by reporting false or misleading information through the use of "pro-forma" earnings reports, whereby disclosure laws are skirted through the use of creative accounting terms and practices. We must act to reform our ability to regulate and enforce disclosure laws so that investors know and clearly understand the financial shape of a company before making investments.

Chairman TAUZIN. Further requests on this side? Then the Chair is pleased to announced to our very patient panel of witnesses that he's going to recognize the last member on this side of the aisle, Mr. John of Louisiana. We've come full circle.

Mr. JOHN. Thank you, Mr. Chairman. I know that you're very happy that I'm giving an opening statement only because I'm the last one, right? Thank you, Mr. Chairman.

I really appreciate the on-going efforts that you and the other ranking members of O&I have put together to educate the members of this committee, most of which are not accountants nor attorneys, and the public about really what went wrong at Enron and the steps we can take in Congress to prevent employees and investors at other companies from experiencing some of the same problems.

There are many lessons to be learned from Enron's collapse. Some are very simple. But some are very complex. The expert panel that we have today, that you've assembled on auditing and accounting practices will greatly assist us and this committee in distinguishing between what transpired at Enron versus what takes place in corporate America on a day to day basis. The witnesses have made lots of concrete recommendations in your testimony, a lot of which have merit and we're going to discuss them today. And we'll enact, possibly enact, legislation at the end of our investigation.

I think Enron's collapse revealed a complex, corporate web of related party transactions and off-balance partnerships that beg the question: "how could this have happened to a publicly traded company?" The Powers Report of which we had many hours of testimony yesterday reveals a company that was plagued with flagrant conflicts of interest, as he called them walking conflicts of interest

through the doors of Enron, lax oversight of auditing and reporting processes, a complete disregard for their own code of ethics, and collusion among members of senior management to distort the true financial picture of the company in its public filings.

Mr. Chairman, I believe the Justice Department will bring justice to the individuals that played any role in defrauding the millions of investors and for destroying the retirement dreams of thousands of employees, some of whom live in my District in Louisiana.

However, I believe that it is the responsibility of this committee to determine what role the auditing and accounting professions have played in the collapse of Enron. I think that is our role. For example, is there enough self-regulation in the industry to convince investors that accurate and relevant information is being disclosed? Or does Congress need to take legislative action to ensure auditor independence?

I think before we take any legislative action, it's important to be sure that we have not learned the wrong lessons here. We must make sure that we do not harm consumers or investors with our good intentions or the hasty movements of this committee.

I look forward to the testimony with our witnesses here today, and I yield back the balance of my time.

[The prepared statement of Hon. Chris John follows:]

PREPARED STATEMENT OF HON. CHRIS JOHN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. Chairman, I appreciate your ongoing efforts to educate members of this committee and the public about what went wrong at Enron and the steps we can take in Congress to prevent employees and investors at other companies from experiencing the same fate. There are many lessons to be learned from Enron's collapse, some simple and others more complex. The expert panel you have assembled today on auditing and accounting practices will greatly assist the committee in distinguishing between what transpired at Enron versus what takes place every day in corporate America. The witnesses have made many concrete recommendations in their written testimony which merit discussion today and possible legislative enactment at the end of our investigation.

Enron's collapse has revealed a complex corporate web of related-party transactions and off-balance-sheet partnerships that beg the question: how could this happen to a publicly traded company? The Powers Report reveals a company that was plagued with flagrant conflicts of interest, lax oversight of the auditing and reporting process, a complete disregard for their own code of ethics, and collusion among members of senior management to distort the true financial picture of the company in public filings.

Mr. Chairman, the Justice Department will determine which Enron executives should be put on trial for their roles in defrauding millions of investors and for destroying the retirement dreams of thousands of employees. However, it is the responsibility of this committee to determine what role the auditing and accounting profession played in Enron's collapse. For example, is there sufficient self-regulation in the industry to convince investors that accurate and relevant information is being disclosed, or does this Congress need to take legislative action to ensure auditor independence?

However, before we take legislative action, it is important to make sure we have not learned the wrong lessons. We must make sure that we do not harm consumers, investors or businesses with our good intentions. I look forward to the testimony of our panel to ensure we stay on the right track.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman TAUZIN. I thank my friend for yielding and I think we're through with opening statements. I'm sorry, the chairman of the Energy Subcommittee, Mr. Joe Barton of Texas has arrived. I wish to recognize him for an opening statement.

Mr. BARTON. For once I timed it right. I got here right at the end of the opening statements, so I apologize to our panel for having to wade through all of this. I have just a few brief comments. I am very glad that we're holding this hearing. I think the American public needs to understand if it's possible to understand exactly what happened at Enron. I think the accounting practices are paramount to that understanding. I took six different accounting classes in undergraduate and graduate school. And for the first 10 years out of college I could understand an annual report about as well as anybody. I took a look at the Enron annual report and I can't understand it. I spent an hour attempting to really understand what they were doing and it's impossible by a layman reading their annual report.

I am very interested to learn how some of these accounting practices came to be generally accepted. The mark to market accounting seems to me murky at best. How in the world you can book a revenue this year for something you may not get for 10 or 15 years at 100 percent face value is beyond the comprehension of the average American. I also would be very interested if the panel is allowed, to discuss this practice of an audit firm with a consulting arm, both consulting and auditing the same firm. It would seem to me that one pretty straight forward change would be you could do one or the other, but you can't do both.

So again, Mr. Chairman, I thank you for holding this hearing. I have followed very closely the collapse of Enron. I'm one of the stockholders that has now got stock that if I were to trade it would probably be trading at pennies on the dollar, so I want to get to the bottom of this as well as the next person and do whatever we need to do as a committee to prevent this from happening to future companies and future stockholders.

Chairman TAUZIN. I thank the gentleman. I also thank the gentleman for agreeing to examine the energy markets next week at a hearing. I think we've scheduled it for the 13th or 14th, Joe?

Mr. BARTON. The 13th, I think.

Chairman TAUZIN. The 13th, so stand by for that one.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. TOM DAVIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. Chairman, I would like to first thank you for calling this hearing into the Enron collapse and all of the ramifications it holds for our economy and financial paradigm.

To say the Enron situation is troubling is, of course, an understatement. Beyond being another episode of self-enrichment by rogue employees and careless oversight by senior officers and board members, this case has possible severe implications for our capitalist system. This is because the accounting and auditing procedures currently in place are now being questioned. As we have heard over the past several weeks, if the numbers on the financial reports are meaningless, or if there is widespread gimmickry in use to conceal true financial status of an enterprise, then we are in deep trouble. If investors cannot rely upon the information available to them, then the equities markets devolve into little more than games of chance, where smoke and mirrors prevail over reason and rational decision-making.

While it is not the role of Congress to try and convict those charged with wrongdoing, it is the duty of Congress to conduct effective oversight and strengthen regulation to ensure as little chicanery as possible goes on in the marketplace. If, as evidence becomes available and as events unfold, it becomes apparent that the officers and former officers of the Enron Corporation were guilty of gross negligence and/or criminal activity, then it is my personal desire to see them prosecuted to the full-

est extent of the law. If the Powers report is to be believed, it is unfortunately likely that such misdeeds and derelictions of duty did, in fact, occur. What is also troubling—perhaps more so—is the role the auditors of Arthur Anderson, LLP played in this whole affair. Can we believe that simple human error is to blame for the basic accounting mistakes attending the creation of the Special Purpose Entities created by Mr. Fastow in an effort to conceal debts and liabilities of the Enron Corporation? Or was something more sinister at play?

We are now left with the aftermath of this debacle. Recently, doubts have been cast regarding the accounting procedures of other large and heretofore extremely successful companies. While the fluctuations of the stock market should never be used as the basis for policy decisions, the underlying investor doubt in financial reporting is something to take very seriously. Most unfortunate of all, however, are the employees and other innocents who were forced to stay on board the SS Enron while the top officials jumped like rats off the sinking vessel. While it may be impossible to make their retirement accounts whole again, this unseemly episode does give added impetus to thorough review of pension laws so that this does not happen to anyone else.

In summary, there was enough shoddy oversight by all responsible parties, enough self-enrichment, enough complicity on the part of auditors and senior management, to warrant an exhaustive investigation. I look forward to hearing the testimony today and to the ongoing efforts of the committee to bring the actions of the Enron board and executives to light.

PREPARED STATEMENT OF HON. GEORGE RADANOVICH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, today's hearing is a very important step in building confidence in our U.S. capital markets. Without consumer confidence our American market system, based in part on trust, will not operate. While trust is a key, we need to fix the system to abide by the principle tenant of "trust but verify."

We must uncover all the secret Enron partnerships that were designed to enrich top executives and defraud stockholders. The Enron Special Investigation Committee report has uncovered secret and possible illegal dealings between Enron and partnerships controlled by its top executives. We owe a thorough investigation to the people who worked all their lives at Enron only to retire with a handful of change while top executives made millions.

Enron's attempt to trade water rights in my home state of California through their subsidiary Azurix Inc. is a perfect example of Enron's appalling business deals. It is unjust for a company to dissolve losses of $326 million in one transaction alone, while executives who leave just prior to the downfall receive millions in severance pay at the time of their departure. Huge severance payments paid out to former executives played a part in Azurix's downfall and left many Californians broke and unemployed.

Due to the Enron failure and the scandalous events surrounding the company, the accounting profession has also been tarnished. Arthur Anderson has shown that the regulatory model that governs their profession is in dire need of reform. The conflict of interest when auditors provide other services, especially management consulting services, to their audit clients, require changes that are vital to the survival of the industry.

In the end, I hope we collect enough information to determine the real purpose behind the creation of these secret Enron partnerships. And if their purpose was to have a friendly third party with which Enron could engage in various financial transactions in order to improve Enron's balance sheet, those involved should be brought to justice.

For the sake of our markets, our investors, and our pension plans this problem must be fixed. I thank you Mr. Chairman for holding this hearing, and I yield back the balance of my time.

PREPARED STATEMENT OF HON. JOE PITTS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Thank you Mr. Chairman. Before I begin, I would like to thank you, Chairman Tauzin, Chairman Greenwood, the Ranking Members, and your staffs for all the hard work you have been doing on behalf of this Committee.

So far, this Committee's investigation of the Enron collapse has been very thorough and meticulous, thanks to the careful work and long hours put in by your staff.

Mr. Chairman, like all of us, I am disheartened what happened with Enron. It seems that every day reveals new information and evidence about this collapse that makes this case even more serious and complicated.

Enron's collapse is not just about corporate mismanagement, accounting standards, or regulatory failure, but about thousands of American working men and women who lost their jobs and saw their pensions shrivel to nothing.

As we move forward on this investigation, we shouldn't forget them—those whose futures have been affected by this mismanagement.

I am hopeful that this hearing will help us get to the bottom of what happened, and obviously, how we can avoid this from happening in the future.

I look forward to hearing from this panel of experts today about the transactions behind the company's collapse.

Specifically, I am interested in learning more about audit practices and current standards for Audit Committees and whether these standards are adequate to ensure meaningful oversight for shareholders.

I am also hopeful that the witnesses will discuss the current state of corporate disclosure and make recommendations for improvements. Unfortunately, in the case of Enron, it seems there was a failure to communicate essential information about the real risks facing the company to the people who needed it most—the investors.

As I mentioned before, our final goal in this investigation should be to make sure this doesn't happen again, to protect the hard-earned pensions of the American people and to restore their trust.

Mr. Chairman, I believe we should be careful not to rush to legislative responses to the Enron bankruptcy. However, I do look forward to looking into President Bush's plan and others which address federal laws governing worker pensions and 401(k) plans.

I appreciate the witnesses taking the time to share with us today and look forward to hearing their testimony.

I yield back the balance of my time.

PREPARED STATEMENT OF HON. MARY BONO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman: Thank you for holding these hearings.

Enron created more than 3,000 partnerships, restated nearly $600 million of profit over four years and went from one of this country's top companies to a source of controversy and shame.

Seeking to look more profitable, the creation of these 3,000 partnerships allowed Enron to move its debts off its financial statements and out of the public eye. In doing so, the company allegedly sought to mislead investors and shareholders and betrayed the trust and confidence of its very own employees. In fact, Enron officials went beyond keeping quiet about the company's financial woes—top officials allegedly encouraged further investment by its employees when they knew this house of cards would collapse.

It is unfortunate that Congress must now look at enacting safeguards for 401(K) plans not only because a business failed, but because of the callousness of the men and women who ran it.

Another player in this disturbing turn of events is the Arthur Andersen firm. Arthur Andersen seemed to either bless these business practices of Enron or was oblivious to it. But what makes this relationship even more tenuous is the fact that not only was Arthur Andersen Enron's auditor, but also its consultant. Arthur Andersen collected audit fees of $25 million but earned even more for its consulting work.

Therefore, the role played by auditors in our capital markets should also come under scrutiny. The "Big Five" have long served as a sort of "Good Housekeeping" seal of approval for investors in our capital markets. High standards of disclosure and transparency are the keystones to a healthy and vibrant market. Unfortunately, it has become apparent that Congress needs to discuss implementing stricter accounting standards and more thorough disclosure requirements.

But these troubles do not end in the questionable business practices of Enron and Arthur Andersen. It is now apparent that individuals at both firms decided to shred documents after the Security and Exchange Commission launched a formal investigation on October 31, 2001.

Mr. Chairman, I look forward to this hearing and ones to come in order to understand exactly what went wrong and how Congress can address these problems in a responsible and well thought out manner.

PREPARED STATEMENT OF HON. RALPH M. HALL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman and Members of the Committee—I thank you for holding this hearing today on accounting issues and questions that have been raised in the wake of the collapse of Enron. Let me state at the outset that I fully support the Committee's inquiries and investigations of Enron to determine what, if any, laws, rules and regulations have been broken or evaded. While it is important that we understand fully what happened at Enron so that we may carry out our obligations to make whatever changes are needed in law and policy—we should recognize that ultimately the courts and the regulatory agencies will deal with what happened there.

The title of this hearing—"Lessons Learned..." is an appropriate one that is in keeping with our role. However, I suggest that this may be only the first "Lessons Learned'" hearing. As facts continued to be uncovered, obviously there will be a need for more hearings of this type by the Full Committee. The witnesses before us today have a great deal to teach us based on what they have observed thus far, and I trust that we will benefit greatly from their observations and experience. Perhaps we ought to have them back six months from now and ask them how their views may have changed as the Enron saga continues to unfold.

Analysts are telling us that investors are becoming uneasy about the truthfulness and veracity of financial statements issued by major corporations. As corporate securities are more widely held now by individuals than ever before, it is even more incumbent on us to work carefully but fast to find and identify the problems in accounting and reporting and take all actions necessary to remedy them in this Congress. Some people are frightened about the security of their life's savings in 401(k) and similar plans, so we need to work carefully and calmly to ascertain the facts and take appropriate action in order to calm the markets and those who invest in them.

In closing, Mr. Chairman, as a member from the oil patch, let me urge my colleagues not to tar all other energy companies with the Enron brush. There are many, many well-run energy companies that are conservatively managed and treat their creditors, employees and shareholders fairly. Oil, natural gas, and—yes—electricity markets are evolving. But let's be careful that we don't act hastily to undo the progress that these markets have made. As problems are uncovered, let's correct them, but don't throw out the premise that competitive markets are innately bad.

I yield back the balance of my time.

Chairman TAUZIN. It is now time for us to turn to our distinguished panel, again, with my deep appreciation for your patience. I hope you have gathered from all the discussions of the members how deeply members are concerned to find solutions, not just to understand what went wrong in this case, which is our first tour of duty, but also then move on and find solutions. I want to thank again Mr. Dingell and the minority for helping us to assemble this panel who will begin the process of telling us what we might want to do in order to fix these problems and we start with an understanding of what happened at Enron and we move from an understanding of what happened at Enron coming from Mr. James Chanos, who was the first, I think, of the analysts who actually could see this coming. He was recommending a sell while everybody else was recommending a buy. And we move on to experts in the accounting field, Mr. Robert Raber, who is the President and Chief Executive Officer of the National Association of Corporate Directors who first talked to us about the role of directors in a major corporation. What is their responsibility? What is their training? What is their expertise, what might we do to enhance the capacity of directors of America's publicly traded corporations to do a better job than we see was done at Enron? We'll move on to accounting issues and we'll hear from Dr. Roman Weil, who is a Ph.D., Professor of Accounting at the University of Chicago who will talk to us about general accounting issues and we'll move on to special purpose vehicles, the SPEs and the market-to-market accounting

issues that my friend from Texas finds it difficult to follow in an annual report. I think all Americans would find difficult to follow. We will hear from Dr. Bala Dharan who is a professor in the Graduate School of Management at Rice University in Texas. We'll also then move to Mr. Baruch Lev who is the Philips Bardes Professor of Accounting and Finance at the Department of Accounting Taxation and Business Law at the Stern School of Business in New York. I'm told that Mr. Lev is an extraordinarily gifted individual in this area and who can teach us about accounting policy and possible remedies and we look forward to your recommendations, Mr. Lev. We'll move then to governance of accounting. Many suggestions as to how we might oversee the accounting industry, who audits the auditors has been the question raised and we're going to get some recommendations from another witness recommended by the minority, Mr. Bevis Longstreth of New York, who also has some expertise in this area and I would be deeply interested in your suggestions and observations, Mr. Longstreth. Finally, I want to thank David Sokol, Chairman and CEO of MidAmerican Energy Holdings Company for coming to give us a perspective on the energy markets and the energy business and how it reacted to the collapse of Enron and whether or not it worked well as Mr. Largent has indicated in working around the financial collapse and still delivered electricity and gas to customers across the country served by the seventh largest corporation in America as it collapsed. So we get a sense of the effect of the Enron collapse on the energy markets. Indeed, a distinguished panel. We turn to you and we welcome Mr. James Chanos, for your testimony, sir.

STATEMENTS OF JAMES S. CHANOS, KYNIKOS ASSOCIATES, LTD.; ROGER W. RABER, NATIONAL ASSOCIATION OF CORPORATE DIRECTORS; ROMAN L. WEIL, UNIVERSITY OF CHICAGO; BALA G. DHARAN, RICE UNIVERSITY; BARUCH LEV, NEW YORK UNIVERSITY; BEVIS LONGSTRETH, DEBEVOISE & PLIMPTON; AND DAVID L. SOKOL, MIDAMERICAN ENERGY HOLDINGS COMPANY

Mr. CHANOS. Good afternoon, my name is James Chanos. I would like to take this opportunity to thank the House Committee on Energy and Commerce for allowing me to offer my perspective on this tragic Enron story. I'm the president of Kynikos Associates, a New York private investment management company that I founded in 1985. Kynikos Associates specializes in short selling, an investment technique that profits in finding fundamentally overvalued securities that are poised to fall in price. Kynikos Associates employs seven investment professionals and is considered the largest organization of its type in the world, managing over $1 billion for its clients.

Prior to founding Kynikos Associates, I was a securities analyst at Deutsche Bank Capital and Gilford Securities. My first job on Wall Street was as an analyst at the investment banking firm of Blyth Eastman Paine Webber, a position I took in 1980 upon graduating from Yale University with a B.A. in Economics and Political Science. Neither I nor any of our professionals is an attorney or a certified public accountant, and none of us has had any direct dealings with Enron, its employees or accountants.

On behalf of our clients, Kynikos Associates manages a portfolio of securities we consider to be overvalued. The portfolio is designed to profit if the securities it holds fall in value. Kynikos Associates selects portfolio securities by conducting a rigorous financial analysis and focusing on securities issued by companies that appear to have (1) materially overstated its earnings; (2) been victims of a flawed business plan; or (3) that engaged in outright fraud. In choosing securities for its portfolios, Kynikos Associates also relies on the many years of experience that I and my team have accumulated in the equity markets.

My involvement with Enron began normally enough. In October of 2000, a friend asked me if I had seen an interesting article in The Texas Wall Street Journal, which is a regional edition, about accounting practices at large energy trading firms. The article, written by Jonathan Weil, pointed out that many of these firms, including Enron, employed the so-called "gain-on-sale" accounting method for their long-term energy trades. Basically, "gain-on-sale" accounting allows a company to estimate the future profitability of a trade made today and book a profit today based on the present value of those estimated future profits.

Our interest in Enron and other energy trading companies was picked because our experience with companies that have used this accounting method has been that management's temptation to be overly aggressive in making assumptions about the future was too great for them to ignore. In effect, "earnings" could be created out of thin air if management was willing to push the envelope by using highly favorable assumptions. However, if these future assumptions did not come to pass, previously booked "earnings" would have to be adjusted downward. If this happened, as if often did, companies addicted to the crack cocaine of "gain-on-sale" accounting would simply do new and bigger deals—with a larger immediate "earnings" impact—to offset those downward revisions. Once a company got on such an accounting treadmill, it was hard for it to get off.

The first Enron document my firm analyzed was its 1999 Form 10-K filing, which it had filed with the U.S. SEC. What immediately struck us was that despite using the "gain-on-sale" model, Enron's return on capital, a widely used measure of profitability, was a paltry 7 percent before taxes. That is, for every dollar in outside capital that Enron employed, it earned about seven cents. This is important for two reasons; first, we viewed Enron as a trading company that was akin to an "energy hedge fund." For this type of firm, a 7 percent return on capital seemed abysmally low, particularly given its market dominance and accounting methods. Second, it was our view that Enron's cost of capital was likely in excess of 7 percent and probably closer to 9 percent, which meant from an economic point of view, that Enron wasn't really earning any money at all, despite reporting "profits" to its shareholders. This mismatch of Enron's cost of capital and its return on investment became the cornerstone for our bearish view on Enron and we began shorting Enron common stock in November of 2000 for our clients.

We were also troubled by Enron's cryptic disclosure regarding various "related party transactions" described in its 1999 Form 10-

K as well as the quarterly Form 10-Qs it filed with the SEC in 2000 for its March, June and September quarters. We read the footnotes in Enron's financial statements about these transactions over and over again, and like Representative Barton, we could not decipher what impact they had on Enron's overall financial condition. It did seem strange to us, however, that Enron had organized these entities for the apparent purpose of trading with their parent company, and that they were run by an Enron executive. Another disturbing factor in our review of Enron's situation was what we perceived to be the large amount of insider selling of Enron stock by Enron's senior executives. While not damning by itself, such selling in conjunction with our other financial concerns added to our conviction.

Finally, we were puzzled by Enron's and its supporters' boasts in late 2000 regarding the company's initiative in the telecommunications field, particularly in the trading of broadband capacity. Enron waxed eloquent about a huge, untapped market in such capacity and told analysts that the present value of Enron's opportunity in that market could be $20 to $30 per share of Enron stock. These statements are troubling to us because our portfolio already contained a number of short ideas in the telecommunications and broadband area based on the snowballing glut of capacity that was developing in that industry. By late 2000, the stocks of companies in this industry had fallen precipitously, yet Enron and its executives seemed oblivious to this. Despite the obvious bear market in telecommunications capacity, Enron still saw a bull market in terms of its own valuation of the same business, an ominous portent.

In January 2001, we began contacting a number of analysts at various Wall Street firms with whom we did business and invited them to our offices to discuss Enron. Over the next few months a number of them accepted our invitation and met with us to discuss Enron and its valuation. We were struck by how many of them conceded that there was no way to analyze Enron, but that investing in Enron was instead a "trust me" story. One analyst, while admitting that Enron was a "black box" regarding profits, said that, as long as Enron delivered, who was he to argue. It was clear to us that most of these analysts were hopelessly conflicted over the investment banking and advisory fees that Enron was paying to their firms. We took their "buy" recommendations, both current and future, with a very large gain of salt.

Something else that caught our attention was a story that ran in The New York Times about Enron in early February of 2001. In light of the California energy crisis, Enron was invoking a little-noticed clause in its contract with its California retail customers. This clause allowed Enron to directly match its retail buyers of power in California with the power providers with whom Enron had contracted on its customers' behalf. Most of these power providers were in bankruptcy now. In effect, Enron was telling a number of very prominent California companies and institutions "This is now your problem, not ours." This was done despite the fact that Enron was paid by its customers a middleman fee precisely so that Enron would accept what is called counter-party risk, something Enron now backed out of doing. As a result, Enron's credibility in the en-

tire energy retail business began to crumble simply because the company refused to recognize sure losses in California. One of my analysts said at the time, "Gee, it's as if Enron can never admit to a losing trade." Future revelations would prove that remark prophetic.

It was also in February 2001 that I presented Enron as an investment idea at our firm's annual "Bears in Hibernation" conference. As I recounted Enron's story to the conference participants, most of them agreed that the fact pattern and numbers presented were very troubling. Most also agreed that Enron's stock price left no room for error. Following our conference, the short position in Enron reported monthly began to move higher.

In the spring of 2001, we heard reports, confirmed by Enron, that a number of senior executives were departing from the company. Further, the insider selling of Enron stock continued unabated. Finally, our analysis of Enron's 2000 Form 10-K and March 2001 Form 10-Q filings continued to show low returns on capital as well as a number of one-time gains that boosted Enron's earnings. These filings also reflected Enron's continuing participation in various "related party transactions" that we found difficult to understand despite the more detailed disclosure Enron had provided. These observations strengthened our conviction that the market was still is over-pricing Enron's stock.

In the summer of 2001, energy and power prices, specifically natural gas and electricity, began to drop. Rumors surfaced routinely on Wall Street that Enron had been caught "long" in the power market and that it was moving aggressively to reverse its exposure. It is an axiom in securities trading that no matter how well "hedged" a firm claims to be, trading operations always seem to do better in bull markets and to struggle in bear markets. We believe that the power market had entered a bear phase at just the wrong moment for Enron.

Also in the summer of 2001, stories began circulating in the marketplace about Enron's affiliated partnerships and how Enron's stock price itself was important to Enron's financial well-being. In effect, traders were saying that Enron's dropping stock price could create a cash-flow squeeze at the company because of certain provisions and agreements that it had entered into with affiliated partnerships. These stories gained some credibility as Enron disclosed more information about these partnerships in its June 2001 Form 10-Q which it filed in August of 2001.

To us, however, the most important story in August of 2001 was the abrupt resignation of Enron's CEO, Jeff Skilling, for "personal reasons." In our experience, there is no louder alarm bell in a controversial company than the unexplained, sudden departure of a chief executive officer no matter what "official" reason is given. Because we viewed Skilling as the architect of the present Enron, his abrupt departure was the most ominous development yet. Kynikos Associates increased its portfolio's short position in Enron shares following this disclosure.

The events affecting Enron that occurred in the fall of 2001, particularly after October 16, have been recounted seemingly everywhere in the financial press. Kynikos Associates cannot add much to that discussion, but I have tried to provide an overview of what

our firm thought were significant developments and revelations during the preceding 12 months.

And while this testimony is mainly about our firm's assessment of Enron and the basis for that assessment, we would be remiss if we did not share a few observations about what happened.

First and foremost, no one should depend on Wall Street to identify and extricate investors from disastrous financial situations. There are too many conflicts of interest, all of them usually disclosed, but pervasive and important nevertheless. In addition, outside auditors are archaeologists, not detectives. I can't think of one major financial fraud in the United States in the last 10 years that was uncovered by a major brokerage house analyst or an outside accounting firm. Almost every such fraud ultimately was unmasked by short sellers and/or financial journalists.

In addition, a company's adherence to GAAP, generally accepted accounting principles, does not mean that the company's earnings and financial position are not overstated. GAAP allows too much leeway in the use of estimates, forecasts and other inherently unknowable things to portray current results. In the hands of dishonest management, a rapidly growing subset in my opinion, GAAP can mislead far more than they inform. Further, I believe that certain aspects of GAAP, particularly accounting for stock options in the United States, are basically a fraud themselves. Such obvious accounting scams should be ended immediately without any interference by third parties.

While no fan of the plaintiffs bar, I must also point out that the so called "Safe Harbor" Act of 1995 has probably harmed more investors than any other piece of recent legislation. The statute, in my opinion, has emboldened dishonest managements to lie with impunity, by relieving them of concern that those to whom they lie will have legal recourse. The statute also seems to have shielded underwriters and accountants from the consequences of lax performance of their "watchdog" duties. Surely, some tightening of this legislation must be possible, while retaining the worthy objective of preventing obviously frivolous lawsuits.

Our current system of self-monitored disclosure is first-rate in my opinion, with one important exception. In this day and age of EDGAR, the internet and real-time disclosure, our system for disclosing insider stock purchases and sales remains antiquated. Insiders buying or selling shares should disclose such transactions immediately. And esoteric collars, loan/stock repurchase deals and other derivatives that are in the "gray area" of insider disclosure should be treated for what they are, another way to either buy or sell shares. The structure of an inside transaction should never hinder its immediate disclosure.

Finally, I want to remind you that despite 200 years of "bad press" on Wall Street, it was those "unAmerican, unpatriotic" short sellers that did so much to uncover the disaster at Enron and at other infamous financial disasters during the past decade. While short sellers probably will never be popular on Wall Street, they often are the ones wearing the white hats when it comes to looking for and identifying the bad guys.

Thank you very much for this opportunity to tell our story.

[The prepared statement of James S. Chanos follows:]

PREPARED STATEMENT OF JAMES S. CHANOS, KYNIKOS ASSOCIATES, LTD.

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SOME OBSERVATIONS POST-ENRON

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First and foremost, no one should depend on Wall Street to identify and extricate investors from disastrous financial situations. There are too many conflicts of interest, all of them usually disclosed, but pervasive and important nevertheless. In addition, outside auditors are archeologists, not detectives. I can't think of one major financial fraud in the United States in the last ten years that was uncovered by a major brokerage house analyst or an outside accounting firm. Almost every such fraud ultimately was unmasked by short sellers and/or financial journalists.

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Thank you very much for this opportunity to tell our story.

Chairman TAUZIN. Thanks for your patience, Mr. Chanos, it's interesting testimony. We normally limit our witnesses to 5 minutes. You can see I'm being rather generous after you've waited so long, but I would encourage to try to keep it at least within a 10 minute frame if you can.

We'll now turn to Mr. Roger Raber who is the President of the trade association of Boards of Directors, correct, Mr. Raber?

STATEMENT OF ROGER W. RABER

Mr. RABER. Good afternoon, Mr. Chairman. I'm honored to be here as the President and CEO of the National Association of Corporate Directors founded in 1977 to enhance the education and development of corporate directors.

Corporate directors are an important key to the success of our free enterprise system. True, some aspects of our corporate system such as disclosure do require continuous improvements that directors alone cannot accomplished. Directors must work with others such as institutional investors and regulators to ensure this improvement. But improvements to the system are not enough. Good corporate governance requires, above all, the presence of independent informed directors who have the courage and integrity to ask difficult questions.

With such directors, any reasonable system can work. Without such directors, any system, no matter how excellent can and will fail.

NACD was founded in 1977 as a membership organization for corporate directors committed to improving board effectiveness. Today, NACD is still the only membership organization of its kind in this country. At this time, the NACD has more than 10,000 active members and participants. These are individuals or entire boards who read our publications, attend our seminars or receive training in their board rooms. Most of our members and participants are directors, but some are board advisors such as attorneys and accountants. Many distinguished corporate directors add to our knowledge and practice as members of our governing board, advisory board and faculty.

NACD services cover both basic and emerging issues. We promote high board standards and create forums for peer interaction. We have 12 chapters throughout the country where directors meet to learn, discuss and respond to current issues. NACD also conducts research on governance trends, tracking over 100 issue over time and across company sizes and industries.

Now the board of directors has an important place in the corporate systems. Corporations are owned by shareholders. Boards are accountable to shareholders and management is accountable to the board. Corporations are chartered through State corporation laws. Their laws vary by state, but they share some common features. One common feature in State corporation law is the notion of director, duty of care and duty of loyalty. The duty of care says that corporate directors must exercise care in their decisions, just as they would do in their own decisions process. The duty of loyalty says that directors must be loyal to the company, remaining free of any conflicts of interest as they vote on particular matters. A judicial doctrine called the business judgment rule shields directors' decisions from liability as long as the directors exercise care and were free of conflicts of interest.

As companies grow, boards form committees such as an audit committee, a compensation committee and a nominating committee. They may also form special committees to look at sensitive issues. The NACD recommends that these committees be composed of qualified independent directors. Our recommendations have made a difference. For example, today, part of the result of con-

cepts advocated by a member of our board of directors in a blue ribbon committee report to the SEC and stock exchanges, the boards of publicly listed companies must have an audit committee composed entirely of independent directors who are financially literate. This is one of the many reforms NACD has advocated over the past 25 years.

But in closing, I would like to explain how directors can be a solution to the kinds of problems that allegedly occurred at Enron. I believe that there are three keys to board effectiveness: independence, information and integrity, especially the courage to ask tough questions.

Independence. NACD commends the SEC and stock exchanges for requiring independent audit committees. Meanwhile, independent nominating and compensation committees are now on the rise. Unless this beneficial trend continues, we anticipate stock exchange requirements mandating the independence of these committees.

Information. Directors need to be well informed about governance and about the companies and industries they serve. A vital source of information is financial statements. Overall, the financial statements of U.S. companies do a good job of disclosure, keeping up with such new challenges of financial reporting, but we want to make sure that oversight groups for accounting standards remain free from undue influence by any particular constituency.

On-going education for directors is also important if not mandatory. A number of major institutional investors actively encourage director education in their portfolio companies.

Integrity. Last, but not least, there is integrity. Directors should have the duty of curiosity to have difficult questions such as do these numbers reflect our true profitability? What will this policy do for the employees in our 401(k) program? Isn't it risky to have our auditors do some of our internal auditing work? After Enron, more directors will be asking such questions. We will do our part to make sure that they do.

In summary, directors play an important role in the governance of corporations. Whatever actions you recommend as a committee, I ask you to remember that in the long run corporate directors can be an important part in helping your actions succeed.

I thank you for your time.

[The prepared statement of Roger W. Raber follows:]

PREPARED STATEMENT OF ROGER W. RABER, PRESIDENT AND CEO, NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

I am honored to be here today as President and CEO of the National Association of Corporate Directors (NACD), a not-for-profit professional association founded in 1977 to enhance the education and development of corporate boards.

SUMMARY STATEMENT

In my remarks this afternoon I will cover three main subjects.

- First, I will explain the work and mission of the NACD, especially our long-standing commitment to improving board leadership through director education.
- Second, I will define the role of the corporate board of directors, explaining the duty of care, the duty of loyalty, and the business judgment rule, and showing how the board is accountable to shareholders, and management is accountable to the board.

- Third, I will explain how corporate directors can be a solution to the kinds of problems that contributed to the collapse of Enron.

My main point in all of this is that corporate directors are an important key to success of our free enterprise system. True, some aspects of our corporate system—such as disclosure—do require continuous improvements that directors alone cannot accomplish. Directors must work with others, such as institutional investors and regulators, to ensure this improvement. But improvements to the system are not enough. Good corporate governance requires above all the presence of independent, informed directors who have the courage and integrity to ask difficult questions. With such directors, any reasonable system can work. Without such directors, any system, no matter how excellent, can fail.

THE MISSION AND WORK OF THE NACD

NACD was founded in 1977 as a membership organization for corporate directors committed to improving board effectiveness. Today, NACD is still the only membership organization of its kind in the United States. At this time, the NACD has more than 10,000 active members and participants. These are individuals or entire boards who purchase our **publications**, attend our **seminars**, and receive training in their boardrooms. Most of our members and participants are directors, but some are board advisors such as attorneys and accountants. Many distinguished corporate directors add to our knowledge and practice as members of our governing board, advisory board, and faculty.

Through our publications, seminars, and services, which cover both basic and emerging issues, NACD promotes high board **standards** and creates **forums** for peer interaction. We have 12 chapters where directors meet to learn about, discuss, and respond to current issues. Since 1977, our *Director's Monthly* publication has featured "best practice" articles by and for corporate directors—over 2,000 articles to date. Also, for the past decade, NACD has issued annual "Blue Ribbon Commission" reports on issues such as director professionalism and evaluation, executive and director compensation, and the board's role in strategy, among other topics. Furthermore, NACD also conducts **research** on governance trends, tracking over 100 issues steadily over time and across company sizes and industries. Finally, our members, directors, and officers also **communicate** with the media, regulators, institutional investors, and others where needed to improve understanding of board issues.

THE ROLE OF THE CORPORATE BOARD OF DIRECTORS

The board of directors has an important place in the corporate system. Corporations are owned by shareholders. Boards are accountable to shareholders, and managers are accountable to the board. Corporations are chartered through state corporation laws. These laws vary by state, but they share common features.

One common feature in state corporation laws is the notion of director duty—namely the twin duties of care and loyalty. The duty of care says that corporate directors must exercise care in their decisions, just as they would in their own decisions. The duty of loyalty says that directors must be loyal to the company, remaining free of any conflicts of interest as they vote on particular matters. A judicial doctrine called the business judgment rule shields directors' decisions from liability as long as the directors exercised care and were free of conflicts of interest.

Another common feature in state corporation laws is the notion that corporations are "managed under the direction of a board of directors." The nature of this direction varies. A small new corporation may just have a few key officers, who are all directors and owners as well. If a corporation sells stock to the general public, however, ownership shifts to non-managers. These non-manager-owners need protection. This is the role of state and federal securities laws. For example, securities laws require full, timely, and clear disclosure of important ("material") information. Also, securities laws ensure that owners have representation on boards, through voting on nominations of particular directors.

As companies grow, boards often grow, and form committees, such as an audit committee, a compensation committee, and a nominating committee. They also may form special committees to look at sensitive issues. The NACD recommends that these committees be composed of qualified, independent directors. Our recommendations have made a difference. For example, today, partly as the result of concepts advocated by a member of our board of directors, in a Blue Ribbon Committee report to the Securities and Exchange Commission and stock exchanges, the boards of publicly listed companies must have an audit committee composed entirely of independent directors who are (or who will spend time to become) financially literate. This is only one of the many reforms NACD has advocated in the past 25 years.

LESSONS LEARNED: DIRECTORS AS A SOLUTION

In closing, I would like to explain how directors can be a solution to the kinds of problems that allegedly occurred at Enron. (For a detailed response to the specific issues raised in the Enron case, I refer the committee to the January 31, 2002, issue of our newsletter, *DM Extra,* which can be viewed on our web site, nacdonline.org. I include a copy for the record.)

In general, I believe that there are three keys to board effectiveness: independence, information, and integrity—especially the courage to ask the tough questions.

Independence. NACD commends the SEC and stock exchanges for requiring "independent" audit committees. Meanwhile, independent nominating and compensation committees are now on the rise. Unless this beneficial trend continues, we anticipate stock exchange requirements mandating the independence of these committees.

Information. Directors need to be well informed about governance, and about the companies and industries they serve. A vital source of information is financial statements. Overall, the financial statements of U.S. companies do a good job of disclosure, keeping up with new challenges of financial reporting, but we want to make sure that oversight groups for accounting standards remain free from undue influence by any particular constituency. Ongoing education for directors is also important. A number of major institutional investors actively encourage director education in their portfolio companies. The late Jean Head Sisco, in her speech as NACD Director of the Year in 2000, went so far as to suggest that the stock exchanges require newly listed companies to provide evidence of ongoing director education.

Integrity. Last but not least, there is integrity. Directors should have the "duty of curiosity" to ask difficult questions, such as, 'Do these numbers reflect our true profitability?' "What will this policy do for the employees in our 401-k plan?" "Isn't it risky to have our auditors do some of our internal auditing work?" After Enron, more directors will be asking such questions. We will do our part to make sure that they do.

In summary, directors play an important role in the governance of corporations. Whatever actions you recommend as a committee, I ask you to remember that in the long run, corporate directors can be an important part in helping your actions succeed.

I thank you for your time.

Chairman TAUZIN. I thank you.

The Chair is now pleased to recognize Dr. Roman Weil, Ph.D. from Chicago School of Business for his testimony.

Dr. Weil?

STATEMENT OF ROMAN L. WEIL

Mr. WEIL. Thank you, Mr. Chairman. I have been privileged to receive a fine education and I'm privileged to be a member of the Graduate School of Business at the University of Chicago Faculty for 35 years or so and it's a privilege to be here today. I thank you very much.

Chairman TAUZIN. Thank you, sir.

Mr. WEIL. This is not a place I can tell for subtlety. I am going to give you my broad brush view of what I think and I'll be glad to meet with your staff later to talk about the subtleties because there are a lot of subtle issues here.

I have some testimony that's been distributed here and some of my co-authors who have looked at this in the last day or so say I left some things out, so I brought a new version with me today and I'll tell you what Congress has done well as well as the accounting profession and what the SEC has done wrong as well. So if you have the February 3 version, you don't have the places with Congress in it. There's a February 5 version with Congress.

Chairman TAUZIN. Did you shred the last copy?

Mr. WEIL. It's been turned over to your staff and if they shred it, they're following standard document retention policies, but I don't know.

What can I do here today in this unsubtle forum? Let me tell you what I think the basic problem is in accounting. I'm not here as an expert on the details of what Enron did or what the auditing firm did. I don't know. But I do know, I believe, what the underlying cause of getting us to where we've been is and I think I know something to do about it. I agree a lot with what Mr. Raber's done. I teach directors' college at the University of Chicago where we ask directors to come to school for a day or two and learn how to do their jobs better.

It is okay for Enron to bet the farm and lose. We don't want to regulate within wide ranges what businesses do and their business models. If they want to gamble and lose that's okay. But we'd like to know, as shareholders, as outside investors, as regulators when such bets are being undertaken and what are the consequences of the outcomes. Now I think the problem that we get here is a result of a process that started about 1940 and got a boost in 1980 and the direction in which accounting reports. When we first got the message from the Securities and Exchange Commission back in the late 1930's to begin regulating accounting, there were two paths that could have been taken. The path not taken would be the path based on axioms, principles the way we did it in geometry in high school, the 12 Euclidian axioms. Here's what you can derive from it. Accounting could have said here's what an asset is. My students know what an asset is. Here's what an revenue is. My students know what a revenue is, and derive the fundamental accounting principles from those. Instead, we didn't do it that way. We said we've got these myriad accounting problems, let's write rules to deal with specific problems.

Now the first page of my testimony I've given you an example. It's got nothing to do with Enron, but is the quintessence of what this problem is all about. Let's look at this. It's only two paragraphs long.

Imagine an asset, for the moment think of rights to use a patent on a drug that defeats anthrax. Purchased by a dozen different companies for a total of $500 million. Now suppose that the Congress passes laws saying that any other company who so chooses can use that patent to produce the anthrax defeating drug, free of royalty to the owners. What do you suppose the accountants for the firms who had purchased those patents for $500 million would do? They would write off the assets to zero, recognizing a collective loss of $500 million before taxes on their income statements. Would you suppose that accountants would need to look into their GAAP rule books to find out if that write down were necessary. Well, I wouldn't think it was necessary. What do you think? It seems obvious to me. If they did look and couldn't find such guidance, do you think they'd write off the assets anyway, recognizing the attendant losses? Well, of course.

What has this got to do with the current situation? A lot. Back in 1980, events paralleling those of the story I've just told you actually occurred. The Congress passed deregulating legislation liberalizing the granting of trucking rights, effectively giving any truck

the right to carry any commodity from one place to another. Prior to that deregulating legislation, Congress acting through the Interstate Commerce Commission had limited those rights. People bought them in the marketplace, traded them, had them on their balance sheet.

When Congress effectively destroyed the value of those rights by allowing any trucker the right to carry the goods previously protected by the monopoly rights, what did the accountants of the trucking firms do? They wrote off the value of those rights on the balance sheet, recognizing a loss. Do you suppose trucking firm accountants needed a rule to tell them to do that? You've got an asset. It's gone. Write it off.

But the Financial Accounting Standards Board felt compelled to pass such a rule. It was a statement of Financial Accounting Standards No. 44, passed in 1980 saying just that. That was an important step along the road to where we are today. We are getting evermore specific rules to deal with evermore specific transactions. And it leads managements to say there are these rule books out there. It's now this thick. Let me see where there's a transaction that's not covered in the rule book. And I'll invent one. I'll make one up. You can be sure that however smart we accountants are, the investment bankers who make 30 to 40 times as much as we do each year, they're smarter, they're nimbler. As fast as we can write rules, they can get around it.

And so the investment banker and the manager will devise a new transaction and devise the accounting for it and say to the accountant show me where it says I can't? If you can't show me where this is forbidden, I'm going to do it and the auditor has found that management has got a lot of power in this, the power to go elsewhere with the business. The auditor goes to the accounting rulemakers and says give me a rule, give me a rule to forbid this and so we get some rules.

But the rules don't come fast enough to deal with the transactions. I think it would be a mistake to ever think we could get there. I do not believe that you want to pass laws that lead to legislation attempting to govern the details of accounting because the investment bankers are smarter than you are. Smarter than I am. They're going to figure it out.

Now the SEC has had a hand in this. The SEC says we've got this big rule book. If you want to do something, you show me where it says you can and now accountants are afraid to do a transaction without going to the SEC, without getting preclearance for some transaction. We're bogged down in rule books.

No speaker ever angered the audience by talking too short of time on the appointed subject. I'll stop now, but I have more stories for you, if you have time.

[The prepared statement of Roman L. Weil follows:]

PREPARED STATEMENT OF ROMAN L. WEIL, GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF CHICAGO

Enron bet the farm and lost. It's OK to gamble, but shareholders should know about the size and risk of bets undertaken as well as how the nature of bets changes over time. Why didn't the accounting for Enron's activities do a better job of alerting shareholders to the risks and changes in them?

FUNDAMENTAL PROBLEM

Imagine an asset (for the moment think of rights to use a patent on a drug that defeats anthrax) purchased by a dozen different companies for a total of $500 million. Now, suppose that the Congress passes laws saying that any other company who so chooses can use that patent to produce the anthrax-defeating drug free of royalty to the owners.

What do you suppose the accountants for the firms that had purchased those patents for $500 million would do? They would write off the assets to zero, recognizing a collective loss of $500 million, before taxes, on their income statements. Would you suppose that accountants would need to look into their

GAAP rule books to find out if that write-off were necessary? (Not necessary, wouldn't you think—it's obvious.) If they did look and couldn't find such guidance, do you think they'd write off the assets anyway, recognizing the attendant losses? (Of course.)

What has this to do with the state of accounting reflected in the current Enron/Andersen shambles? A lot.

In 1980, events paralleling those of the imaginary two paragraphs happened: Congress passed de-regulating legislation liberalizing the granting of trucking rights, effectively giving any trucker the right to carry any commodity between any two points. Prior to that de-regulating legislation, Congress, acting through the Interstate Commerce Commission, had limited those rights. The issued rights traded in the market place and, once purchased by a trucking firm, appeared on the firm's balance sheet at cost. When Congress effectively destroyed the value of those rights by allowing any trucker the right to carry the goods previously protected by monopoly rights, what did the accountants at trucking firms do? They wrote off the value of the trucking rights on the balance sheet, recognizing an amount of loss equal to their then-current book value.

Did the trucking company accountants need a specific accounting rule telling them to write off those trucking right assets? You wouldn't think so, would you? But the Financial Accounting Standards Board (FASB) felt compelled to pass a rule (*Statement of Financial Accounting Standards No. 44,* 1980) saying just that. Accounting rule makers took a first step on the road to the Enron accounting debacle.

Since the early 1980's, an aggressive company's management engages in a transaction not covered by specific accounting rules, accounts for it as it chooses, and challenges the auditor by arguing, "Show me where it says I can't." The auditor used to be able to appeal to first principles of accounting. Such principles suggest, for example, that post-deregulation trucking rights are no longer assets. Now, the aggressive management can say, "Detailed accounting rules cover so many transactions and none of them covers the current issue, so we can devise accounting of our own choosing." And they do.

Accounting rule making has become increasingly detailed as auditors plead with standard setters for specific rules to provide backbone: "Dear FASB or EITF [Emerging Issues Task Force, created by the SEC and the FASB], Give us a rule for this new transaction."

So, Enron transfers assets, reporting current profit and debt,[1] then challenges its auditor to "Show me where it says I can't." The auditor can't. The auditor considers nixing the profit recognition but simultaneously considers the consequences of saying, "No" to aggressive management: "We might lose this client."

The near-majority of the rule-setting FASB comes from high-powered audit practice. These members bring to the Board a mindset that the accounting profession needs, and wants, specific guidance for specific transactions. Three of them can meet privately and can effectively, if not formally, guide, perhaps even set, the agenda for the Board. A minority of the Board has spent careers dealing with fundamental theory. This minority, with more faith in the conceptual basis for accounting, appears to prefer to derive broadly applicable rules from first principles of accounting, which the FASB developed in the early 1980s in its conceptual framework. The majority, the members from auditing practice, less interested in deriving rules from conceptual principles, appears to win most of the battles.

The emphasis on specific rules for specific issues gets more pronounced over time. I concede that these specific rules for specific issues leads to more uniform reporting of the covered transactions—all else equal, a good thing. That uniformity comes at

[1] In addition, Enron appears to have promised to give Enron shares to the purchaser if the transferred assets later turn into losers. If this were true and the auditor knew about the additional contingency, I suspect the auditor would have not allowed Enron's accounting. I am less confident of these next two: it appears that Enron may have strong-armed the auditors into avoiding the equity method of accounting for investments and into questionably treating some of its derivative transactions as hedges.

the cost: practicing accountants have less need for informed intelligence and judgment. I concede that part of the pressure on standard setters for specific rules for specific transactions comes from the current litigation environment. Auditors, in a rational pursuit of a full purse, want unambiguous rules to stand behind when, inevitably, the trial lawyers sue them for accountant judgments and estimates, made in good faith, that turn out to miss the target.

That some good results from specific rules for specific transactions doesn't make such rules a good idea. These rules have a cost: "Show me where it says I can't," demands management. "Give me more rules for these new transactions," pleads the auditor, "so I can combat aggressive management." This cycle continues: the increasing number of specific rules for specific transactions strengthens aggressive management's belief that if a rule doesn't prohibit it, then it's allowed. This, in turn, increases the auditor's dependence on specific rules.

WHAT TO DO?

I want accountants to rely on fundamental, first principles in choosing accounting methods and estimates. I want accountants not to hide behind the absence of a specific rule. Whatever the detailed rules accountants write, smart managers can construct transactions the rules don't cover.

You might now think about the parallels of the above with our tax collection system, where principles alone cannot suffice. The principle: tax income. The principle requires 40,000 pages of tax code, regulations, and court decisions to implement. Can financial accounting be different? I think yes. The tax collector and the taxpayer play a zero-sum game—what one pays, the other gets. Financial accounting doesn't have that property and in addition has the auditor to interpret the rule book.

What else, besides more spine in the auditor, do we need to reduce the likelihood of more accounting debacles?

Reduce Conflict of Interests

In recent weeks, we hear about reducing conflicts of interest—two recent ones: reduce the opportunities of the auditor to do consulting and forbid the auditor from going to work for the audited company.

The basic conflict occurs because the audited pays the auditor and, in practice, selects the auditor. In my opinion, everything else has lesser effect.

Auditor Term Limits

First, let's mandate auditor rotation—term limits for auditors. Seven years ought to do it, maybe five. Let the auditor know that, no matter what, another auditor will take over the job in a few years and will have the incentive to expose a predecessor's carelessness.[2] Mandatory auditor term limits have a cost—audit costs might triple. Not just the actual audit bills, but the costs the audited company incurs to show the new auditor where the inventory records lie in the second file drawer of the cabinet two to the left of the green door in the third room on the right of the outside corridor.

I imagine that known term limits will induce the Audit Committee to begin the search for the subsequent auditor 18 months or so before the engagement will start and will be able to bring that new auditor into on-board, learn-from-observation mode early in the process. Those who argue against mandatory auditor rotation adduce large transition costs. Suddenly changing auditors does cause surprise costs that anticipated, orderly transitions will reduce.

Prod the Audit Committee

Then, we need audit committees to exercise the power the SEC has given them. Thirty years ago, Rod Hills, then Chairman of the SEC, conceived the powerful modern audit committee. He has written that the audit committee's most important job is to make the independent, attesting auditor believe that the auditor's retention depends *solely* on the decision of the audit committee. Most often, it doesn't work that way.

Most audit committees consist of independent, smart, but financially illiterate, members, with rarely more than one financial expert.[3] (If you don't believe me, look at the accounting qualifications of the audit committee of any large company you follow. Then, look at how seldom the large corporations change auditors.) Audit Committees usually depend on management to recommend the independent auditor

[2] Talk about professional peer review. This will be real peer review, not the pap we get now.

[3] How do I know they are often illiterate? Because I teach them in Directors' College classes where I start with pop quizzes.

and changes in the auditor. The auditor learns to take its guidance from management, not from the audit committee. The SEC has provided power to the audit committee; now, it can help empower the audit committee by mandating auditor term limits and having the audit committee report on its independent search to find the replacement and its independent contacts with the auditor after engagement.

Some of my colleagues doubt that the country has enough independent, knowledgeable people to staff corporate America's audit committees and ask them to do the job Rod Hill set for them.[4]

Consulting Conflicts

Management typically views audits as adding no value, purchased merely because regulation requires them. Hence, management typically wants the most cost/effective job it can get to satisfy the regulations. This doesn't mean the cheapest audit. Capital markets will guide a company in the S&P 500 not to hire me to do its audit, but to hire one of the Big Five, because the resulting savings in the cost of funds more than offsets the higher invoice cost. Once that firm decides it needs a Big Five auditor, its Chief Financial Officer will prefer to spend less, not more, for the service. The audit committee worries less about a smaller audit bill.

The audit committee could say, "We're going to pay top dollar for a high quality audit." To the auditor it could say, "Make a decent profit on the audit; don't count on consulting fees to make up for thin margins on the audit." This will drive up the cost of both the audit and the consulting services, because the outside consultant will not have the head start in understanding the client's specifics that the auditor has. Management will not like this. The audit committee, charged to be concerned primarily with the audit, should be unconcerned about the higher cost of consulting fees. When did you last hear of an audit committee asking for a higher-priced audit?

Does this require a regulation forbidding the auditor from consulting? No, we already have regulations empowering the audit committee to act, independent of management. Now, we need the audit committee to act.

In the current environment, it's heresy to suggest that we need not to forbid auditors from also providing consulting services. Despite this pressure, I suggest to the Committee that mandatory auditor rotation, with auditors chosen and beholden to the audit committee, will solve the conflict of interest problem.

Another advantage to term limits for auditors is the ease of specifying and enforcing the rule. All proposals to divorce auditing from consulting contemplate exceptions. For example, the auditor can be the most cost-effective preparer of income tax returns. I, and others, see no need to waste resources by having firms different from the auditor do the tax return. Where to draw the line? Let's don't mandate one, but let the audit committee decide. I can imagine that the auditor will prefer shorter terms to longer because the sooner the audit is done, the sooner it can undertake consulting engagements.

Chairman TAUZIN. I think I would have enjoyed your classes, Professor. Thank you very much.

The next witness is Dr. Bala Dharan who is Professor of the Graduate School of Management at Rice University in Texas. By the way, my neighbor at law school was Daria Dharan, same spelling. We welcome you, sir, and you're going to speak to us about the special purpose vehicles and the market-to-market accounting, all these new developments. We welcome your testimony.

STATEMENT OF BALA G. DHARAN

Mr. DHARAN. Thank you, Mr. Chairman, and members of the committee for inviting me to present my analysis of the accounting issues that you just mentioned that led to Enron's downfall. I am very honored to be given this opportunity. Thank you again.

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[4] At this point, I have three suggestions, all blatantly self-serving. In earlier drafts of this testimony, I failed to flag these as tongue-in-cheek and my friends called me to task for that. Let's consider increasing the pay differential between audit committee board members and the others. Let's encourage potential audit committee members to attend Directors' College at the University of Chicago. Let's educate audit committee members to demand of management a budget to hire its own accounting consultants, such as professors from the University of Chicago, to teach the accounting issues for the company's operations and financial structure.

I am a professor of accounting at Rice University. I've also taught at Harvard Business School and University of California, Berkeley and along with Roman Weil, I'm also a Ph.D. from Carnegie Mellon, so I think we should mention those.

Given the limited time that you have given us for the oral testimony, even though I have a big temptation to give a long lecture, which we all do, as you know, I'm going to really restrict myself and give mainly the summary of my findings.

My written testimony which has been submitted to the committee contains extensive discussions of both special purpose entities as well as mark-to-market accounting.

Chairman TAUZIN. Could you move the mike a little closer, Dr. Dharan? Thank you, sir.

Mr. DHARAN. The Enron debacle will rank as one of the largest securities fraud cases in history. Evidence to date points to signs of accounting fraud involving false valuation of assets, misleading disclosures and bogus transactions to generate income. This failure is a result of an unparalleled breakdown at every level of the usual system of checks that investors, lenders and employees rely on.

Let me start with broken or missing belief systems and boundary systems that companies need to have to govern the behavior of their senior management. Weak corporate governance by board of directors and its audit committee, and compromised independence in the attestation of financial statements by external auditors. As per your request in my testimony I'll focus mainly on the accounting issues on the Enron use of special purpose entities and mark-to-market accounting.

My analysis of the Enron debacle shows that while Enron's fall might have been initiated by a flawed and failed business strategy which many people have pointed out, it was ultimately precipitated by the company's pervasive and sustained use of aggressive accounting tactics to generate misleading disclosures intended to hide bad business decisions from the shareholders. As Dr. Weil pointed out, it's okay to bet the farm and lose it, but it's not okay to mislead the investors about what you are trying to do.

Enron's corporate strategy itself was flawed. Let's focus on that for a second to see how they elected the accounting problems. The strategy was to be an assetless company that would buy and sell risk positions. This strategy when you really think about it is virtually devoid of any boundary systems that tell you what not to do. Essentially, the management, the senior management gave its managers a blank order to just do it, to do any deal origination that generated a desired rate of return. And as Mr. Chanos pointed out, even those returns were not adequate. This flawed business strategy led to colossal investment mistakes in virtually every new area that the company tried to enter. However, again, it's important to remember that while bad business strategy can contribute to a company's fall, it's often a company's desperate attempt to use accounting tricks to hide bad business decisions that seals its fate.

Confronted with normal business problems, a corporation can generally use the right decisions to extricate itself out of those problems. But when a firm loses their trust and confidence of the investing public because of discoveries of accounting wrongdoings,

the net result on the stock prices is mostly devastating and long lasting. This is what happened in the case of Enron.

Let me start with the loss of investor faith and just give an example of that to really illustrate this point. They had their quarterly earnings release on October 16, 2001. This release claimed a pro forma profit while the company was actually losing money. Bad news to the tune of $1 billion was conveniently labeled as nonrecurring. As earnings releases go, this one must rank as one of the most misleading. Accounting research suggests that the adoption of this pro forma earnings reporting is often a company's desperate response to hide underlying business problems. To prevent future Enrons from hiding under similar pro forma reporting, we need to ensure that the misleading pro forma disclosures are halted all together.

The Securities and Exchange Commission should recognize all pro forma disclosures for what they really are, a charade. The SEC, the New York Stock Exchange and the NASDAQ should adopt new rules restricting the format and the use of pro forma reporting. The use of terms such as one time or nonrecurring about past events, in earnings communications, in place certain promises about the—to the investors about future performance of the company and therefore should not be allowed to be used in earnings communications, except in rare cases.

Enron's internal report released on February 1, 2002 makes clear that Enron used dozens of transactions with special purpose entities. While not all SPEs are bad, in Enron's case, special purpose entities are mainly used in the last 5 years to achieve dubious accounting goals, rather than genuine business purpose. The accounting effects can be summarized in the following four categories: (1) hiding of debt from the balance sheet; (2) hiding of poor-performing assets with some of your members mentioned also; (3) earnings management which is reporting gains and losses when desired; and (4) quick execution of transactions at desired prices. For example, Enron used its own senior managers as part of special purpose entities so that they could execute those transactions whenever they desired at short notice.

To prevent the continued use of SPEs, the accounting profession and the SEC need to act quickly to enact several changes in the existing set of accounting rules. The Financial Accounting Standards Board needs to accelerate its current project on consolidation accounting and in particular fix the consolidation rule for special purpose entities. The current rules which includes the infamous 3 percent rule for consolidation needs to be abandoned in favor of rules that emphasize economic control, rather than specific numbers that can be easily violated. Economic control should be assumed, unless management can prove otherwise.

In the U.S. financial assets are reported under a method that we call mark-to-market accounting. The values are reported at current prices rather than historical costs. Normally, mark-to-market accounting works, but we also use mark-to-market accounting not just for assets that have readily determinable market prices, but also for assets such as financial derivatives that don't have traded market values. The bottom line when you allow mark-to-market accounting for financial contracts is that the mark-to-market account-

ing rule essentially allowed, in the case of Enron for example, to pick its own market value estimates and report them as gains to shareholders, estimates that were supposed to be checked by external auditors, but are hard to verify for anyone outside the firm.

The mark-to-market methodology is theoretically sound, but it needs to be modified in the light of what we have learned from the use of mark-to-market accounting by Enron. Traditional revenue recognition rules anchored in conservatism principle should be extended to recognition of gains and losses from mark-to-market accounting. As several of your members pointed out, it really is very hard to understand how we could report gains from transactions that are going to happen 20, 30 years from now.

Mr. Chairman, the Enron meltdown is the result of massive failure of corporate control and governance, out of focus mainly on the accounting issues, and in particular on the possible changes we need to make and the lessons we can take.

I'll be glad to answer questions from you and the committee members and elaborate on my analysis. Once again, thank you for giving me the opportunity.

[The prepared statement of Bala G. Dharan follows:]

PREPARED STATEMENT OF BALA G. DHARAN, PHD, CPA, PROFESSOR OF ACCOUNTING, RICE UNIVERSITY

Mr. Chairman and members of the Committee, I want to thank you for inviting me to present my analysis of the accounting issues that led to Enron's downfall. I am honored to be given this opportunity.

I am Bala Dharan, professor of accounting at the Jesse H. Jones Graduate School of Management, Rice University, Houston. I received my PhD in accounting from Carnegie Mellon University, Pittsburgh. I have been an accounting professor at Rice University since 1982. In addition, I have taught accounting as a professor at Northwestern University's Kellogg School of Management, and as visiting professor at the Haas School of Business at University of California, Berkeley, and the Harvard Business School. I am also a Certified Public Accountant and a Registered Investment Advisor in the state of Texas. I have published several articles in research journals on the use of financial accounting disclosures by investors.

The Enron debacle will rank as one of the largest securities fraud cases in history. Evidence to date points to signs of accounting fraud involving false valuation of assets, misleading disclosures and bogus transactions to generate income. I have had several invitations to speak on Enron's accounting issues over the last few months. In my talks and lectures, I am asked two questions most frequently: One, how could this tragedy have happened while the company's management, board of directors and outside auditors were supposedly watching over for employees and investors? Two, what can we learn from this debacle so that we can avoid future Enrons? Undoubtedly the first question will be the focus of the many investigations currently under way, including your Committee's efforts. In my testimony, I will focus on what we can learn from the accounting issues related to Enron's use of mark-to-market (MTM) accounting and special purpose entities (SPEs). These two issues are very closely related, especially as they were practiced by Enron. In addition, I will address the related accounting issue of pro-forma disclosures, and also how Enron's failed business strategy contributed to the accounting errors. I hope other invited panelists addressing before this Committee will talk about the critical roles played by Enron's management, board, auditors, lawyers, consultants, financial analysts, and investment bankers in Enron's fall. I conclude with recommendations for regulatory changes and improvements in the accounting and auditing rules governing special purpose entities, mark-to-market accounting, and financial disclosures in general.

1. LOSS OF INVESTOR TRUST

My analysis of the Enron debacle shows that Enron's fall was initiated by a flawed and failed corporate strategy, which led to an astounding number of bad business decisions. But unlike other normal corporate failures, Enron's fall was ultimately precipitated by the company's pervasive and sustained use of aggressive ac-

counting tactics to generate misleading disclosures intended to hide the bad business decisions from shareholders. The failure of Enron points to an unparalleled breakdown at every level of the usual system of checks that investors, lenders and employees rely on—broken or missing belief systems and boundary systems to govern the behavior of senior management, weak corporate governance by board of directors and its audit committee, and compromised independence in the attestation of financial statements by external auditor.

Enron started its transformation from a pipeline company to a "risk intermediation" company in the 1980s. It adopted a corporate strategy of an "asset-less" company, or a "frictionless company with no assets." The company's Chief Financial Officer said in a 1999 interview to a management magazine (which awarded him "CFO Excellence Award for Capital Structure Management") that the top management transformed Enron into "one engaged in the intermediation of both commodity and capital risk positions. Essentially, we would buy and sell risk positions." What this description of the company implies is that unlike any other major company in the US, Enron's corporate strategy was virtually devoid of any boundary system that defined the perimeter of what is an acceptable and unacceptable investment idea for managers to pursue. Since any business investment basically involves some risk position, this strategy is not really a strategy at all but an invitation to do anything one pleases. Enron's top management essentially gave its managers a blank order to "just do it", to do any "deal origination" that generated a desired return. "Deals" in such unrelated areas as weather derivatives, water services, metals trading, broadband supply and power plant could all be justified and approved by managers under this concept of an asset-less risk intermediation company. The company even briefly changed its tagline in a company banner from "the world's leading energy company" (which implies some boundary system for investments) to "the world's leading company." It is no wonder that this flawed business strategy led to colossal investment mistakes in virtually every new area that the company tried to enter.

While bad business strategy and bad investment decisions can and do contribute to a company's fall, it is a company's desperate attempt to use accounting tricks to hide bad decisions that often seals its fate. My analysis of cases of major stock price declines shows that when news of an unanticipated business problem, such as a new product competition or obsolescence of technology, is released to the market, the company's stock price does take a hit, but it often recovers over time if the company takes appropriate and timely management actions. However, when a company loses the trust and confidence of the investing public because of discoveries of accounting wrongdoings, the net result on the company's stock price and competitive position is mostly devastating and long-lasting. This is because accounting reports are the principal means by which investors evaluate the company's past performance and future prospects, and a loss of trust effectively turns away investor interest in the company.

My analysis also suggests that it is not possible to recover from a loss of investor confidence by some quick management actions. Before re-admitting the company to their investment portfolios, investors would demand and seek evidence that the accounting numbers are again reliable, and this process of rebuilding of trust often takes place through several quarters of reliable financial disclosures. If the company's finances are not fundamentally sound to begin with, then it is quite likely that the company would not survive this long trust-recovery phase intact. This is exactly what happened in the case of Enron. Burdened with dozens of failing investments and assets hidden in special purpose entities whose very existence and financing often depended on high stock price of Enron's shares, the company quickly entered a death-spiral when investors questioned its accounting practices and pushed its share price down to pennies.

2. USE OF PRO-FORMA EARNINGS

Enron's loss of investor faith started with the company's 2001 third quarter earnings release on October 16, 2001. As earnings releases go, this one must rank as one of the most misleading. The news release said in an underlined and capitalized headline, "Enron Reports Recurring Third Quarter Earnings of $0.43 per diluted shares." The headline went on to reaffirm "recurring earnings" for the following year, 2002, of $2.15 per share, a projected increase of 19% from 2001. But an investor had to dig deep into the news release to know that Enron actually lost $618 million that quarter, for a loss of ($0.84) per share. A net loss of $618 million loss was converted to a "recurring net income" of $393 million by conveniently labeling and excluding $1.01 billion of expenses and losses as "non-recurring".

The practice of labeling certain earnings items as non-recurring or "one-time" has unfortunately become widespread in the US, and has corrupted corporate disclosure

environment to the detriment of investors and the public. Companies ranging from General Motors to Cisco mention some form of pro-forma earnings in their earnings disclosures. Of course, there is nothing "one-time" or "non-recurring" about the $1.01 billion of expenses and losses that Enron chose to label as such in its 2001 third quarter earnings release. In other words, neither accountants nor managers could assure that what they call non-recurring would not recur.

My ongoing research also shows that the adoption of pro-forma earnings reporting is often a company's desperate response to hide underlying business problems from its investors. As an example, Enron did not always use pro-forma earnings in its news releases. Its earnings release as late July 24, 2000, for 2000 second quarter, did not contain any reference to recurring earnings. In its 2000 third quarter earnings release on October 17, 2000, Enron started using the recurring earnings in the body of the news release. We know from the Enron board's internal report dated February 1, 2002, that this was also the time when the senior management started worrying about the declining value of many of their merchant investments. By the following quarter, recurring earnings had been elevated by Enron to news headline.

Not all companies, of course, use pro-forma earnings or use them in blatantly misleading way. Companies like Microsoft do report their earnings without having to resort to misleading pro-forma disclosures. However, we need to ensure that misleading pro-forma disclosures are halted altogether. In a recent speech, the chairman of the Securities and Exchange Commission has warned companies that pro-forma earnings would be monitored by the SEC for misleading disclosures. However, this does not go far enough. The SEC should recognize all pro-forma disclosures for what they really are—a charade. They may differ from one another in the degree of deception, but the intent of all pro-forma earnings is the same—to direct investor attention away from net income measured using generally accepted accounting principles, i.e., GAAP earnings.

Enron's 2001 third quarter earnings press release on October 16, 2001, contained another major shortcoming—lack of information about its balance sheet and cash flows. While the company's press release provided information on net income, the company failed to provide a balance sheet. This is inexplicable—we teach in Accounting 101 that the income statement and the balance sheet are interrelated ("articulated") statements. This essentially means that we cannot really prepare one without preparing the other. Not surprisingly, almost every major company's earnings release contains the balance sheet along with its income statement. Financially responsible companies would also provide a cash flow statement. Analysts and investors puzzled with Enron's lack of balance sheet disclosure had to wait until after the markets closed on October 16, 2001, when the senior management disclosed in response to a question during the earnings conference call that it had taken a $1.2 billion charge against its shareholders' equity (a balance sheet item), including what was described as a $1 billion correction of an accounting error. The experience suggests that along with reforms on pro-forma earnings usage, we should mandate a fuller, more complete presentation of financial statements in the earnings news releases so that investors can truly be in a position to interpret the quality and usefulness of the reported earnings numbers.

3. SPECIAL PURPOSE ENTITY ACCOUNTING

3.1. Business Purpose of SPEs

Enron's internal report released on February 1, 2002, makes clear that Enron used dozens of transactions with special purpose entities (SPEs) effectively controlled by the company to hide bad investments. These transactions were also used to report over $1 billion of false income. Many of these transactions were timed (or worse, illegally back-dated) just near end of quarters, so that the income can be booked just in time and in amounts needed, to meet investor expectations. However, SPEs were not originally created as mere tools of accounting manipulation. Surprisingly, the SPE industry did start with some good business purpose. Before discussing the accounting issues related to Special Purpose Entity (SPE) accounting, it would be useful to have a brief description of what these entities are and how they arose.

The origin of SPEs can be traced to the way large international projects were (and are) financed. Let's say a company wants to build a gas pipeline in Central Asia and needs to raise $1 billion. It may find that potential investors of the pipeline would want their risk and reward exposure **limited** to the pipeline, and not be subjected to the overall risks and rewards associated with the sponsoring company. In addition, the investors would want the pipeline to be a self-supported, independent entity with no fear that the sponsoring company would take it over or sell it. The investors are able to achieve these objectives by putting the pipeline into a special

purpose entity that is limited by its charter to those permitted activities only. Thus a common historical use of SPE was to design it as a joint venture between a sponsoring company and a group of outside investors. The SPE would be limited by charter to certain permitted activities only—hence the name. Such an SPE is often described as brain-dead or at least on auto-pilot. Cash flows from the SPE's operations of the project are to be used to pay its investors.

In the US, the use of SPEs spread during the 1970s and 1980s to financial services industry. In the early 1980s, SPEs were used by the financial services firms to "securitize" (market as securities) assets that are otherwise generally illiquid and non-marketable, such as groups of mortgages or credit card receivables. Because they provide liquidity to certain assets and facilitate a more complete market for risk sharing, many SPEs can and do indeed serve a useful social purpose.

3.2 Accounting Purposes of SPEs

These examples illustrate that SPEs can be motivated by a genuine business purpose, such as risk sharing among investors and isolation of project risk from company risk. But as we have seen from the Enron debacle, SPEs can also be motivated by a specific accounting goal, such as off-balance sheet financing. The desired accounting effects are made possible because of the fact that SPEs are not consolidated with the parent if they satisfy certain conditions. The accounting effects sought by the use of SPEs can be summarized into the following types:

1. Hiding of Debt (Off-Balance Sheet Financing). The company tries to shift liabilities and associated assets to an SPE. The main purpose of forming the SPE in this case is to let the SPE borrow funds and not show the debt in the books of the sponsoring entity. The so-called "synthetic leases" are examples of this type of SPEs. In the 1980s SPEs became a popular way to execute synthetic lease transactions, in which a company desiring the use of a building or airplanes tries to structure the purchase or use in such a way that it does not result in a financial liability on the balance sheet. Though Enron's earlier use of SPEs may have been motivated by this objective, the key SPEs formed by Enron since 1997, such as Chewco, LJM1 and LJM2, were intended more for the other accounting objectives described below.

2. Hiding of Poor-Performing Assets. This objective has a major factor in several SPE transactions of Enron. For example, Enron transferred poor-performing investments such as Rhythms NetConnections to SPEs, so that any subsequent declines in the value of these assets would not have to be recognized by Enron. In 2000 and 2001 alone, Enron was able to hide as much as $1 billion of losses from poor-performing merchant investments by these types of SPE transactions.

3. Earnings Management—Reporting Gains and Losses When Desired. This accounting objective has also been a fundamental motivation for several of the complicated transactions arranged by Enron with SPEs with names such as Braveheart, LJM1 and Chewco. For example, Enron was able to transfer a long-term business contract—an agreement with Blockbuster Video to deliver movies on demand, to an SPE and report a "gain" of $111 million.

4. Quick execution of Related Party Transactions at desired prices. Enron's use of SPEs such as LJM1 and LJM2, controlled by its own senior managers, was specifically intended to do related party transactions quickly and when desired, at prices not negotiated at arms length but arrived at between parties who had clear conflicts of interest. For example, the above Blockbuster deal was arranged at the very end of December 2000, just in time so that about $53 million of the "gain" could be included in the 2000 financial report. (The rest of the gain, $58 million, was reported in 2001 first quarter.) The purpose of this and several similar transactions by Enron seems to have been to use these transactions with SPEs controlled by its own senior executives to essentially create at short notice any amount of desired income, to meet investor expectations.

There are three sets of accounting rules that permit the above financial statement effects of SPEs. One deals with *balance sheet consolidation*—whether or not SPEs such as synthetic leases should be consolidated or reported separately from the sponsoring entity. The second deals with *sales recognition*—when should the transfer of assets to an SPE be reported as a sale. The third deals with *related party transactions*—whether transfers of assets to related parties can be reported as revenue. Of these, the accounting problem that needs immediate fixing is the one dealing with consolidation of SPEs. This is addressed next. With respect to sales recognition rules and related party transaction rules, the problem may lie more with Enron's questionable accounting and corresponding auditor errors, rather than the rules themselves. However, Enron's revenue recognition from SPE transactions often depended on the so-called mark-to-market accounting rules which gave Enron the ability to assign arbitrary values to its energy and other business contracts.

These rules do have certain problems that need fixing, and this issue is addressed in section 4.

3.3. Consolidation of SPEs

Despite their potential for economic and business benefits, the use of SPEs has always raised the question of whether the sponsoring company has some other accounting motivations, such as hiding of debt, hiding of poor-performing assets, or earnings management. Additionally, the explosive growth in the use of SPEs led to debates among managers, auditors and accounting standards-setters as to whether and when SPEs should be consolidated. This is because the *intended accounting effects of SPEs can only be achieved if the SPEs are reported as unconsolidated entities* separate from the sponsoring entity. In other words, the sponsoring company needs to somehow keep its ownership in the SPE low enough so that it does not have to consolidate the SPE.

Thus consolidation rules for SPEs have been controversial and have been hotly contested between companies and accounting standards-setters from the very beginning. In the US, the involvement of the Financial Accounting Standards Board (FASB), the accounting standards-setting agency, in SPE accounting effectively started from 1977 when it issued lease capitalization rules to control the use of off-balance sheet financing with leases. Corporate management intent on skirting around the new lease capitalization rule appeared to have led to the rapid development of SPEs to do the so-called "synthetic leases". In the first of several accounting rules directed at SPEs, in 1984 the Emerging Issues Task Force (EITF) of the FASB issued EITF No. 84-15, "Grantor Trusts Consolidation." However, given the rapid growth of SPEs and their ever-widening range of applications, standards-setters were always a step or two behind and were being reactive rather than proactive in developing accounting rules to govern their proper use.

The question of whether a sponsoring company should consolidate an SPE took a definitive turn in 1990 when the EITF, with the implicit concurrence of the SEC, issued a guidance called EITF 90-15. This guidance allowed the acceptance of the infamous "3 percent rule", i.e., an SPE need not be consolidated if at least 3 percent of its equity is owned by outside equity holders who bear ownership risk. Subsequently, the FASB formalized the above SPE accounting rule with Statement No. 125, and more recently Statement No. 140, issued in September 2000.

An analysis of the development of the 3 percent rule suggests that the rule was an ad-hoc reaction to a specific issue faced by the FASB's Emerging Issues Task Force and was intended as a short-term band-aid, but has somehow been elevated to a permanent fix. More importantly, the rule, in many ways, was a major departure from the normal consolidation rules used for other subsidiaries and entities. In the US, we generally require full consolidation if a company owns (directly or indirectly) 50 percent or more of an entity. Thus the 3 percent rule is a major loosening of the normal consolidation rule. The motivation for this seems to have been that the SPEs were restricted in their activities by charter and thus the parent company could claim lack of control. The parent company only had to show that some other investors did indeed join the SPE venture with a significant exposure (signified by the 3 percent rule) in order to make the SPE economically real and thus take it off the books.

Clearly the accounting for SPE consolidation needs to be fixed, starting with the abandonment of the 3 percent rule and its replacement with a more strictly defined "economic control" criterion. The need to fix consolidation rules has also been amply recognized by the FASB, which has been working for several years on a comprehensive "consolidation" project. However, the Enron debacle should give our standards-setters the needed push to rapidly complete this critical project and issue new rules for the proper consolidation of SPEs whose assets or management are effectively controlled by the sponsoring company. The rules should emphasize economic control rather than rely on some legal definition of ownership or on an arbitrary percentage ownership. Economic control should be assumed unless management can prove lack of control.

4. MARK-TO-MARKET ACCOUNTING AND EARNINGS MANAGEMENT

In the US, financial assets, such as marketable securities, derivatives and financial contracts, are required to be reported on the balance sheet at their current market values, rather than their original acquisition cost. This is known as mark-to-market (MTM) accounting. MTM also requires changes in the market values for certain financial assets to be reported in the income statement, and in other cases in the shareholders' equity as a component of "Accumulated Other Comprehensive Income" (OCI), a new line item that was required for all public companies by FASB Statement No. 130 from 1997.

MTM was implemented in FASB Statement No. 115, issued in 1993, for financial assets that have readily determinable market values, such as stocks and traded futures and options. In 1996, FASB Statement No. 133 extended MTM to all financial derivatives, even those that do not have traded market values. For some derivatives, a company may have to use complex mathematical formulas to estimate a market value. Depending on the complexity of the financial contract, the proprietary formulas used by companies for market value estimation may depend on several dozen assumptions about interest rate, customers, costs, and prices, and require several hours of computing time. This means that it is hard, if not impossible, to verify or audit the resulting estimated market value. Of course, a consequence of this lack of verifiability is that MTM accounting can potentially provide ample opportunities for management to create and manage earnings. Thus MTM accounting represents the classic accounting struggle of weighing the trade-off between *relevance* and *reliability*—in this case the relevance of the market value data against the reliability of the data. In the end, the accounting standards-setters took the position that the increased benefit from reporting the market value information on the balance sheet justified the cost of decreased reliability of income statement and the earnings number.

It will be useful to consider an example of how Enron recognized with MTM accounting, in order to understand how MTM can be easily manipulated by a company to manage earnings, especially with respect to financial contracts that do not have a ready market. Assume that Enron signed a contract with the city of Chicago to deliver electricity to several office buildings of the city government over the next twenty years, at fixed or pre-determined prices. The advantage to the city of Chicago from this "price risk management" activity is that it fixes its purchase price of electricity and allows the city government to budget and forecast future outlays for electricity without having to worry about price fluctuations in gas or electricity markets.

Enron sought and obtained exemptions from regulators to allow it report these types of long-term supply contracts as "merchant investments" rather than regulated contracts, and obtained permission from accounting standards-setters to value them using MTM accounting. Without MTM, Enron would be required to recognize no revenue at the time the contract is signed and report revenues and related costs only in future years for actual amounts of electricity supplied in each year. However, MTM accounting permits Enron to estimate the net present value of all future estimated revenues and costs from the contract and report this net amount as income in the year in which the supply contract is signed. The idea for such an accounting treatment seems to be based on the notion that the financial contract could have been sold to someone else immediately at the estimated market value, and hence investors would benefit from knowing this amount in the balance sheet and correspondingly in the income statement. Enron used similar MTM procedures to not only value merchant investments on its books but also to determine the selling price, and hence gain on sale, for investments it transferred to the various SPEs it controlled.

A major problem with using MTM accounting for private contracts such as the one described above is that the valuation requires Enron to forecast or assume values for several dozen variables and for several years into the future. For example, the revenue forecasts may depend on assumptions about the exact timing of energy deregulation in various local markets, as well as 20 years of forecasts for demand for electricity, actions of other competitors, price elasticity, cost of gas, interest rates, and so on.

While there are strong conceptual reasons to support MTM accounting, the Enron crisis points to at least some need to revisit and revise the current accounting rules for reporting transactions and assets that rely on MTM values. In particular, MTM rules should be modified to require that all gains calculated using MTM method for assets and contracts that do not have a ready market value should be reported only in "Other Comprehensive Income" in the balance sheet, rather than the income statement, until the company can meet some high "confidence level" about the realization of revenue for cash flows that are projected into future years. Normal revenue recognition rules do require that revenue should be recognized after service is performed, and moreover that revenue should be "realized or realizable", meaning that *cash flow collection should be likely*. In the absence of satisfying this condition, revenue rules (such as those explained in SEC Staff Accounting Bulletin 101) normally compel a company to wait until service is performed and cash collection probabilities are higher. Extending this logic to MTM accounting would protect the investing public from unverifiable and unauditable claims of gains being reported in the income statement.

5. RECOMMENDATIONS

The Enron Meltdown is a result of massive failure of corporate control and governance, and failures at several levels of outside checks and balances that investors and the public rely on, including an independent external audit. In my testimony, I have focused on the accounting issues, and in particular on the possible changes we need to make in these areas in order to prevent future Enrons. My recommendations are summarized below.

1. The SEC, the New York Stock Exchange (NYSE) and the Nasdaq should adopt new rules severely restricting the format and use of pro-forma earnings reporting. All earnings communications by companies should emphasize earnings as computed by Generally Acceptable Accounting Standards. Any additional information provided by the company to highlight special or unusual items in the earnings number should be given in such a way that the GAAP income is still clearly the focus of the earnings disclosure.
2. Companies should be reminded by regulators and auditors that the use of terms such as "one-time" or "non-recurring" about past events in earnings communications implies certain promises to investors about future performance, and therefore should not be used except in rare cases.
3. Companies should present a complete set of financial statements, including a balance sheet and a cash flow statement, in all their earnings communications to the general public, in order to permit investors evaluate the quality of the reported earnings numbers.
4. The FASB needs to accelerate its current project on consolidation accounting, and in particular, fix the consolidation rules in the accounting for Special Purpose Entities to prevent its continued abuse by corporations for earnings management. The current consolidation rules, including the "3 percent" rule for SPEs need to be abandoned and replaced with an "economic control" rule. The new rules need to emphasize economic control rather than rely on some legal definition of ownership or on an arbitrary percentage ownership. Economic control should be assumed unless management can prove lack of control. Similar rules should be extended to lease accounting.
5. The FASB and the SEC need to consider requiring new disclosures on transactions between a company and its unconsolidated entities, including SPEs. In particular, more detailed footnote disclosures on the sale or transfer of assets to unconsolidated entities, recognition of income from such transfers, and the valuation of transferred assets should be required.
6. The mark-to-market accounting methodology, while theoretically sound, needs to be modified in the light of what we have learned from the Enron meltdown. Traditional revenue recognition rules, such as the realization principle, should be extended to the recognition of gains and losses from MTM accounting. Forecasted cash flows beyond two or three years should be presumed to have a low level of confidence of collectibility. Gains resulting from present values of such cash flows should be recorded in the Accumulated Other Comprehensive Income in the balance sheet, rather than the income statement, until the confidence level increases to satisfy the usual realization criterion of collectibility.

Chairman TAUZIN. Thank you, Dr. Dharan.

Now we turn to someone whom I'm told by the staff if they did have a Nobel Prize for accounting, would be a recipient of the Nobel Prize. In fact, Dr. Lev, the staff affectionately called you the Britney Spears of accounting.

We welcome your testimony, sir.

STATEMENT OF BARUCH LEV

Mr. LEV. Thank you very much, Chairman. I'm deeply grateful to be here. I was asked to speak about reforming accounting auditing systems. I would like to state at the outset that my ideas, concepts, suggestions that are included in my written testimony were not shaped by Enron or Arthur Andersen. They were shaped by more than 25 years of experience, observations and extensive reach. Enron basically provides with, I think, a great opportunity to do a much needed over due, overhaul of the system.

I draw your attention to my testimony, the first two pages provide diagrams of what I see as the problem. The second one what I see as the solution, followed by 9 pages of elaborations and then followed a quiz.

Starting with the problem, the first diagram, there is a nexus there of three elements. I'm almost tempted to borrow a phrase and call it an "evil axis" here and we have financial reports, we have auditing and we have enforcement and I characterize those financial reports by too narrow auditing, it's too cozy and enforcement is too little, too late and too opaque. Let me say a word about each of the three.

Financial reports, I'm sure that the gentleman that took six accounting courses will agree with me, accounting is very good at recording or portraying simple transactions like sales, purchases, borrowing. Accounting is terrible in reporting more complex things that are not regular transactions like unexecuted obligations, for example, promises that Enron gave to the special entities to cover losses if there will be losses. All those things are to a large extent not reported, not recorded in accounting.

Accounting does not portray the myriad network of alliances, joint ventures, partnerships that corporations have, most of them for legitimate, good economic reasons, but they are not portrayed in accounting. Accounting is terrible in portraying intangible assets like patents, like brands, like human resources. Intangible assets now count for more than 80 percent on average of the values of companies and accounting is completely useless in portraying the risk that the company is exposed to, so we are speaking here about a really outmoded, to a large extent, useless information system.

If I turn to auditing, you heard a lot about auditing. It's basically an "all-in-the-family" affair. You heard about the consulting and the revolving door and everything. Let me just add one nugget here. Even the auditing standards which are called generally accepted accounting standards, the rules that auditors follow and on which they rely in their report are basically set by their own trade association, by the American Institute of Certified Public Accountants.

Enforcement, as I said before, too low, too slow. Let me just quote form the Journal, it was the Journal yesterday to speak about Global Crossing and they say the SEC tries to determine whether accounting rules were violated. The decision whether to bring a case can take at least 1 or 2 years. We are speaking about the company that went bankrupt last week.

If I turn to the solution which is the next exhibit that you have, speaking about financial reporting, we have to move from the very narrow, as it is called financial reporting, to the exclusion of everything else to a very broad, comprehensive disclosure, to open a net which will capture and report alliances and joint ventures and partnerships and all obligations and intangible assets and will portray the risk position or exposure of the company. This is a tall order. It's not an easy thing to do, but it can be done.

When I turn to auditing, given my time limitation you heard a lot about auditing. Let me just mention a couple of things. It's not a secret that auditors for all practical purposes are selected, chosen and reappointed by managers. We all know about the board and

the audit committee of the board, but board members are also for all practical purposes chosen and selected by managers. We have to break this link, this dependency of auditors on managers and the only way I see that this can be done is that auditors will be chosen, once in 5 years, by shareholders. What a novel idea. Those that have to receive the information are choosing the auditors and not the auditees.

Now I hear from people that it's not practical and a condescending thing that shareholders don't know and they cannot choose auditors. This is, excuse me, this is nonsense. We have a very solid process which is called a contest, a proxy contest which is used quite frequently to select, to change board compositions, to change management, to change policies and this can be used to select auditors, once in 5 years. Next month shareholders of two giant companies, Hewlett Packard and Compaq will vote on the largest acquisition ever in the high tech sector. If they know how to do that, they will now how to select auditors.

This will open the audit markets to competition. There will be bids every 5 years. New teams will come with expertise, something like auditors with expertise in energy trading, something like that and if they won't perform, they'll be thrown out. In this case, it will break this dependence between managers and auditors.

The second element that was not discussed, at least extensively is the audit report. The audit report is a meaningless piece of paper with just one sentence and lots of hedging and pushing, transferring the information to other parties like the financial reports, the responsibility of managers and we follow auditing standards and accounting standards and so on and so on. We have to discard this report for an open-ended report in which auditors will tell, sometimes at length, to shareholders what is going on in the company. I read that Mr. Berardino, the CEO of Arthur Andersen yesterday even came close to these suggestions when he said the current past/fail system, this qualified/nonqualified lets companies get away with barely adequate accounting. I will say it gets away with much less than that and he provides some kind of suggestions for a rating.

Last thing I would say is about enforcement. I am for the ideas that were raised by several people including Lynn Turner of setting up, and it's the only body that I think has to be set up, an investigatory body that will be mandated to investigate and quickly, relatively quickly release results with respect to failures and failures are not just Enron. Failures, for example, are large restatements of earnings that are now numbering in the hundreds per year.

All I can add to this is perhaps a novel idea about funding. I don't want the funding for this body to come from accounting firms which again will create dependence, all from corporations. I calculated that if you'll charge every 100 shares traded one penny, just one penny which is really a minuscule charge, you'll raise more than $70 million which probably will be sufficient to fund such a body. The budget of the National Transportation Board has year was $57 million. I'm coming to a close.

I agree with the first speaker here that we have to change completely the rules of disclosing insider trading. This is incredibly important information to shareholders what insiders do. Currently,

you have to report to the SEC on the tenth day or no later than the tenth day of the following month which means a lag of 20 to 25 days. This is intolerable. This has to be reported no later than the following day after the trade.

In closing, I think we have a great opportunity here. I think we have really a moment of grace to initiate change because what we are dealing with here is not just Enron and Arthur Andersen. The problems afflict hundreds, to varying degree, hundreds if not thousands of corporations in the United States. You will soon hear from the awesome forces of the vested interest of the status quo that the changes that will be proposed can't be done, they're too radical and they really are not needed. They are wrong and I hope you rise to the occasion.

Thank you very much.

[The prepared statement of Baruch Lev follows:]

THE REFORM OF CORPORATE REPORTING AND AUDITING

Testimony of
Baruch Lev*

Before the House of Representatives Committee on Energy and Commerce
(February 6, 2002)

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THE PROBLEM

FINANCIAL REPORTING

TOO NARROW

Reflecting:
Financial Aspects of Executed Transactions

Missing:

- Most Networking Activities
- Unexecuted Obligations
- Intangible (Knowledge) Assets
- Comprehensive Disclosure of Risk Exposure

AUDITING

TOO COZY

Due to:

- Auditors Effectively Appointed/Paid by Management
- Low Rotation, Excessive Consulting, and Jumping Ship
- Information-Challenged Auditor Report
- Auditing Standards Promulgated by Industry (AICPA); Peer Review Oversight

ENFORCEMENT

TOO LATE & OPAQUE

- Disclosure/Audit Failures Not Fully and Promptly Investigated
- Delayed Reporting of Trade by Insiders
- Investigative Material Largely Unreleased
- Litigation Settlements Kept Secret

THE SOLUTION

COMPREHENSIVE DISCLOSURE

Comprehensive Reports, Reflecting Financial & Nonfinancial Information Concerning:

- Executed Transactions (current system)
- Network Activities
- Unexecuted Obligations
- Intangible Assets
- Risk stress-tests

INDEPENDENT ASSURANCE

- Auditors Appointed by shareholders for a 5-Year Term
- Open-Ended Audit Report on Key Issues
- Consulting Capped at 25-30% of Audit Fees
- 1-Year Cooling-Off Period for Engagement partner
- A Joint Accounting-Auditing Standard Setting

QUICK-REPSONSE, TRANSPARENT INVESTIGATIONS

- Mandatory and Prompt Investigation of "Failures" by a New Body
- Transparency of Investigatory Correspondence and Findings
- Prompt Reporting of Insider Trading

ELABORATIONS

I. Corporate Disclosure: From Financial Reporting to Comprehensive Disclosure

21st century business enterprises are fast changing; involved in a complex network of alliances, joint ventures, partnerships and other related entities; and derive their value and growth primarily from intangible assets (patents, brands, knowhow, unique organizational designs).

The traditional accounting system, and its major product—the publicly-released financial reports—essentially reflect past transactions (sales, purchases, borrowing, etc.) only, and recognize physical and financial assets (plant and equipment, securities), to the exclusion of most intangible assets. Such narrowly-based, backward-looking corporate reports are ill-suited to provide the information needed by investors, creditors, and policymakers (e.g., for national accounting measurements). Primarily missing from current financial reports are:

1. Networking activities

A hallmark of the modern corporation is its involvement in a wide range of corporate activities conducted through alliances, joint-ventures, partnerships, and special purpose entities. For example, pharmaceutical, biotech, and chemical companies are conducting much of their R&D and marketing activities through alliances and joint ventures, as do software developers, and special purpose entities are often used to shift and optimize ownership and risk. There are solid economic reasons for most of these networking activities, although occasionally they are abused.

Most of these wide ranging activities are either ignored or improperly reflected in corporate financial reports, adversely affecting the information available to investors and creditors, and creating incentives for misrepresentation and fraud.

2. Unexecuted Obligations

The current, transaction-based accounting system practically ignores most unexecuted obligations and contractual arrangements, despite the fact that they can create major liabilities in the future.[2] Thus, for example, Enron's alleged obligations to cover SPE's losses were not reflected in its financial reports.

More broadly, firms' myriad unexecuted obligations to and contractual arrangements with alliance partners, suppliers, and financial institutions (e.g., debt securitzation) are deficiently reported, if at all. This creates significant incentives to misrepresent the true obligations profile of the company, and distorts the true economic situation of the enterprise.

3. Intangible Assets

In today's economy, physical and financial assets are largely commodities (i.e., competitors have equal access to them, such as Merck and Pfizer's access to the best lab equipment and information technology). Value and growth, of both corporations and nations, is primarily derived by unique intangible assets, such as patents, brands, and trademarks, as well as unique organizational designs (e.g., supply chains) and knowledge management systems.

The current, industrial era-based accounting system regards most intangibles as expenses, as if they were devoid of future benefits, thereby introducing serious biases to corporate balance sheets and income statements.[3] It has been empirically shown that these reporting deficiencies cause serious social harms, such as excessive cost of

[2] An obligation is recognized in GAAP (generally accepted accounting principles) as a liability, only when a transaction (e.g., a purchase or a borrowing), or an event (a legally-binding fine) has already occurred.
[3] Particularly revealing in this respect is the fact that the current average market-to-book ratio (ratio of market value of companies to their net assets on the balance sheet) for the S&P 500 companies is over 5.0, implying that of every $5 of market value, only $1 appears on the balance sheet.

capital, large insider gains, and manipulation of financial reports.[4]

4. Risk Exposure

The traditional accounting system, focusing on assets/liabilities and the outcomes of operations (income, cash flows) essentially ignores the risk exposure of business enterprises.

The fast growth of financial innovations in the last 20 years (derivative instruments for hedging and speculation, debt and other assets' securitization, employee stock options, etc.) expose companies and their shareholders to considerable and difficult to quantify risks. In the early 1990s, the SEC instituted various requirements for risk disclosure in prospectuses and financial statements. These, however, resulted in extensive yet largely meaningless boilerplate statements enumerating every possible risk "under the sun," and insufficient specific risk disclosures.

Particularly missing are results of comprehensive risk-related stress-tests, informing investors of the earnings and asset/liabilities consequences of expected changes in interest rates, foreign exchange rates, commodity (e.g., oil) prices, or changes in the economic conditions of countries where the company has major operations.

The Solution:

Current financial reports should be expanded to comprehensive disclosures, portraying in addition to the consequences of past transactions (the current system), a fair representation of the networking activities of the company, the obligations undertaken (executed as well as unexecuted), and its risk profile. Assets should include both tangible and intangibles. This is, of course a major endeavor, but a possible one, if such a comprehensive disclosure will be placed on the top of standard-setters (FASB, SEC) agendas.

[4] For elaboration on intangible assets, their sources and impact, as well as the reporting deficiencies and social consequences, see Baruch Lev, Intangibles: Management, Measurement and Reporting (Brookings Institution Press, 2001).

It is important to emphasize, particularly in the current Enron-intensive climate, that the major benefit of the proposed comprehensive disclosure system is to improve resource allocation in the economy and enhance the integrity of capital markets. The rooting of occasional misrepresentation and fraud is an important, yet secondary objective.

II. Auditing

The auditing of public companies by external auditors is in many cases an "all in the family" affair. Auditors are in too many companies effectively appointed and reappointed by managers, who also have a significant say in the audit fees.[5] Auditors' rotation is very low; quite frequently auditors serve the same company 10-20 years, or more (much of the auditors' rotation, as is, is due to frequent mergers and acquisitions by companies rather than to inadequate service.) Cases in which auditing personnel switch without a cooling off period to work for clients proliferate, as are cases in which auditors engage in lucrative consulting with audit clients. Such close arrangements and relationships between auditors and auditees are manifestly inconsistent with independent, effective and high quality auditing services.

Yet another dimension of the "all in the family" is the fact that the auditors' trade association—the American Institute of Certified Public Accountants (AICPA)—is in charge of promulgating auditing standards (GAAS), on which in turn, the audit report relies. This uniform report is long on hedging (e.g., "the financial statements are the responsibility of the Company's management") and short on information relevant to investors and creditors. To top it all, the industry oversight is performed by "peer reviews" conducted by other auditing firms. It was widely reported in the media that in the last two decades this peer review did not publicly sanction a single "big five" accounting firm.

[5] Formally, the board's audit committee is primarily involved in auditors' appointment, and their reappointment is approved in the annual shareholders' meeting. In many corporations, however, these are just formalities.

The Solution: A substantive revamp of the auditing industry along the following lines.

- Auditor selection by shareholders. This is a drastic change from the current procedure, where managers and board members effectively select and reappoint auditors. Shareholders, using a process similar to the frequently used "proxy contest," will be asked to appoint auditors, based on competitive bids, for a five-year term. Only such an appointment will effectively sever managers-auditors link. Some argue that this can be achieved by the board's audit committee. But board members are also selected by managers.

  It's easy to dismiss this proposal by saying that shareholders don't have the required information to make auditor choices. Such a condescending approach ("we know, but owners don't") is flawed on its face. In addition, Hewlett Packard (H-P), for example, will soon put to a shareholder vote the largest acquisition ever in the high tech sector (Compaq). If shareholders can be trusted to make such a complex decision, why can't they be trusted to choose auditors. Of course, the main choice will be made by the generally well-informed institutional investors who are holding large blocks of shares, in most companies.

- Consulting to audit clients. It's attractive in the current climate to demand a complete ban on consulting to audit clients. I prefer a consulting cap of 25-30 percent of audit fees. The reason: As an educator, I can testify to the considerable difficulties accounting firms encounter in attracting young, qualified personnel. Put plainly—it's not very attractive to work for accounting firms, particularly post-Enron. It is, therefore, important to retain elements of challenge and excitement in the accounting career. Consulting provides such an element.

- Jumping ship. Engagement partners (the people in charge of the audit) should not be allowed to switch employment to clients, without a cooling-off period of a year, at least.

- An expanded audit report. The current, information-challenged audit report should be replaced with an open-ended document, where auditors report to shareholders and creditors on various key subjects, in addition to the conformity of financial statements with the company's financial position (the current report). Such key issues include the adequacy of corporate governance systems and internal controls, unusual risks facing the company, and questions and suggestions raised by auditors in the audit process, but left unanswered by management. Of course, if auditors will be selected by shareholders, additional tasks can be placed on them (e.g., report on the consequences of mergers and acquisitions).

- Joint accounting-auditing standard setting. Accounting standards are set by the FASB, and auditing standards by the Auditing Standards Board (ASB), affiliated with the auditors' trade group—the AICPA. Since financial reporting (accounting) and auditing issues are intertwined, it makes sense to combine these activities in one standard-setting body.[6] Such a joint standard-setting process will have the added advantage of detaching the setting of auditing standards from the industry.

- A need for oversight? The peer review oversight of audit firms is currently much maligned. What should replace it? Perhaps nothing. The above mentioned proposals, if instituted, will create a vibrant, truly competitive and independent auditing profession, that probably does not require a formal oversight beyond the current SEC, courts, and shareholders having a real power to remove auditors.

III. Enforcement

Two important elements are currently missing, in my opinion, from the auditing-accounting enforcement systems: a quick-reaction investigatory body and transparency.

[6] For example, the FASB has recently added to its agenda the "intangibles disclosure" item. Surely, questions concerning the disclosure of intangibles (e.g., the value of a patent portfolio), depend in part on the auditability of the disclosed items.

- Quick-reaction investigation body. This suggestion was raised by several commentators on the Enron case. The proposal is to establish an organization that will promptly and thoroughly investigate corporate accounting/auditing failures, and make the findings publicly available. I strongly endorse this suggestion, and add several elements. Investigation cases should not be limited to "post mortems," such as Enron. They should start much earlier in the process and thereby retain the important preventative element. For example, every case of significant restatement of earnings (numbering in the hundreds each year) should be investigated. Also, employees, like Enron's Ms. Watkins, could ask for this body's investigation.

  I propose that this investigative body be independent of the SEC, and funded by a miniscule levy on stock trade. After all, investors will be the main beneficiaries of this body. An idea for funding: Total number of shares traded in the U.S. during 2000 was 718 billion shares. A levy of 1 cent per 100 shares will raise $71 million a year, sufficient to fund an active and efficient investigative body (the National Transportation Safety Board's recent annual budget was $57million).

  Transparency. Much of the examinations and investigations currently conducted with respect to financial reporting and auditing issues is not open to the public. Consequently, such investigations contribute little to learning and deterrent in capital markets, in corporate boards and accounting firms. For example, most of the correspondence between the SEC and public companies is closed to the public, as are securities litigation settlements (over 90% of securities lawsuits).

  I propose to thoroughly review the SEC disclosure procedures, and increase significantly the transparency of correspondence and investigatory material, unless it is highly likely harmful to companies and their shareholders.

  Not directly related to accounting/auditing, but very important nevertheless is a prompt reporting of insider trading. Currently there is a lag of 20-25 days on average, between trade and reporting to the SEC. There is absolutely no justification for such a long

delay. Insider (e.g., corporate officers and board members) trading should be electronically reported to the SEC and made public no later than the day following the trade. This will alert investors and creditors in real time to important information available to managers.

IV. Postscript

The analysis, proposals and suggestions outlined in this document are not just aimed at preventing future Enrons and its audits. More broadly and importantly, they are aimed at enhancing corporate disclosure and the effectiveness of audits, which are necessary conditions for a fast growing economy, well-functioning capital markets, and ethical and equitable corporate behavior. The pursue of these high level social goals, is the major purpose of the proposed corporate reporting and auditing reforms.

Chairman TAUZIN. Thank you very much, Mr. Lev. Excellent testimony.

We turn now to Mr. Bevis Longstreth and Mr. Bevis Longstreth is with the firm, this is a tough pronunciation, Debevoise & Plimpton, right, in New York.

Mr. Longstreth.

STATEMENT OF BEVIS LONGSTRETH

Mr. LONGSTRETH. I pronounce it Bevis.

Chairman TAUZIN. I'm sorry.

Mr. LONGSTRETH. That's okay.

Chairman TAUZIN. And you will give us some idea about your thoughts on the governance of accounting and auditing.

Mr. LONGSTRETH. Yes. I'm going to cover some material that my colleague to the right covered. Let me give you a little background about my qualifications to be here. I have spent most of my professional life at Debevoise & Plimpton, a New York law firm, which I retired from about 8 years ago. I served as an SEC Commissioner for 3 years, 1981 to 1984.

Chairman TAUZIN. That was during the Reagan Administration, correct?

Mr. LONGSTRETH. It was. I was appointed twice by President Reagan and being a registered Democrat, I felt that I could serve both sides of the aisle.

Chairman TAUZIN. And serve there with distinction.

Mr. LONGSTRETH. Recently, I was a member of the panel on Auditors——

Chairman TAUZIN. Sir, Mr. Dingell, wanted to add that you served there with great distinction as well.

Mr. DINGELL. I just observe that you served there with distinction.

Mr. LONGSTRETH. Thank you. I recently served on the Panel on Audit Effectiveness which published a report in 2000 which vanished from sight as did the panel. The panel was appointed by the POB, the Public Oversight Board, the group that recently resigned en masse as a result of some suggestions coming out of the SEC.

For 5 years after I retired, I taught a course on the regulation of financial intermediaries at Columbia Law School and presently I'm the chair of an audit committee of a large public company. So those are the qualifications that bring me here to talk to you.

What I want to say starts really with the leading role in capital formation that is served by the audit and just to get a definition down, the audit is, as you all know, the critically important process by which a public company's financial condition is vouched for by a firm of certified public accountants as being worthy of the investing public's trust. And a fundamental importance to the audit function is an iron clad assurance that the auditor is independent of the client, both in fact, and in appearance.

Now I'm going to invite you to consider two notorious fictions that for years leaders of the auditing profession have staunchly maintained and thereby have deflected efforts over the years at any serious reform.

The first fiction is the claim that payment by an audit client to its auditor for consulting another nonaudit services no matter how

large, will never impair independence, that is, it will never have an adverse effect on the quality of the audit or be seen to have such an effect in the eyes of the investing public. Because of the rule that the SEC wrote a couple of years ago requiring separate disclosure of audit and nonaudit fees paid to its auditor, the public has recently discovered how important nonaudit fees have become to an auditor's bottom line. On average in the year 2001, nonaudit services represented an astounding 73 percent of total fees paid to auditors by their audit clients.

It just defies common sense to claim that large payments for nonaudit services which management could easily purchase or threaten to purchase from service providers other than its auditor do not function as a powerful inducement to gain the auditor's cooperation on how the numbers are presented.

One of the Big Five in explaining to its clients these SEC new rules that were published a couple of years ago, carried the fiction I'm describing to a breathtaking extreme. In the published and widely distributed pamphlet on the rule, sent to all its clients, and presumably prospective clients, the firm wrote that the size of nonaudit fees paid by a single company are relevant to the question of independence only if those fees reach 15 percent of that auditor's total revenues from all sources. Now in 2001, the smallest of the Big Five had total revenues of over $9 billion. In other words, using the 15 percent rule threshold of concern, a Big Five firm was claiming that a single client could pay annually at least $1.35 billion to that audit firm before the audit committee of the firm, of the company, the SEC or anyone else need trouble himself over independence. In a practical sense, the statement was "there's no limit at all."

Audit account partners are expected by their firms to establish close relationships with the managements they serve. They are expected to cross market to management as full a range of services as they can and they are compensated by their firms on how much revenue they produce from these audit clients. Their stake in maximizing revenue from these clients through cross marketing of nonaudit services is as natural and compelling as any financial reward could be. To claim these incentives have no adverse impact on independence is a fiction, pure and simple.

The second fiction that I wish to address is the profession's threefold claim: (1) that it has the ability and motivation to regulate itself voluntarily; (2) that it has done so effectively over the past several decades; and (3) that there is no need for a legislatively empowered regulatory body led by persons independent of the profession and who are charged to regulate the profession and post discipline where it's warranted.

In fact, the profession's voluntary scheme of self-regulation is an oxymoron. It is a bewildering maze of overlapping committees, panels and boards, piled one on top of the other that collectively has failed in protecting the investing public.

Even with the best intentions, these voluntary arrangements would be incapable of achieving anything close to effective self-regulation. The list of defects is long, but among them is (1) lack of public representation; (2) lack of transparency; (3) lack of assured

funding; (4) lack of any credible system for imposing discipline, and overall, a lack of any accountability.

Enron makes it perfectly clear that these two fictions can no longer be permitted to carry this once proud profession away from its core responsibilities to the investing public and those are responsibilities that are under our Nation's licensing laws at the State level and the securities laws at the Federal level, are reserved exclusively for this profession to discharge. Any enterprise that has market exclusivity is a blessing, but the blessings have to come with some burdens that would flow from essentially a monopoly.

To address the conflicts of interest that are masked by these two fictions, reform is necessary and I'm not a great believer in writing law to solve every ill. In fact, I'm a great believer that that's a mistake. But I am convinced that legislative reform and nothing short of legislative reform will meet this need because the profession has been enormously effective in overwhelming efforts at reform by the SEC and others. Indeed, its lobbying largesse has been so abundant here on Capitol Hill that protective legislative voices have repeatedly over the decades been raised whenever the SEC has tried to effect serious reforms.

Now, on the back of the Enron disgrace, with public investors, small and large, suffering deeply their losses, this Congress has a wide open window of opportunity to do something of lasting and immense value to the Nation and that something is actually quite something. Only two reforms in my judgment are needed. First, an effective rule preventing an auditor from rendering nonaudit services to its audit clients. I describe such a rule at page 18 to 19 of my written testimony. Second, an effective legislatively empowered system of self-regulation and I describe that and the essential elements of it at pages 31 to 35.

One final point if I may be permitted. In the wake of the Great Depression with the failure of an immense number of banks and the loss, huge losses to depositors, the Congress recognized that the public's confidence in the Nation's banking system had been badly shaken. Through hearings before this House and the Senate it became clear to the Congress that the public's earnings, when deposited in banks, simply had to be safe and the public had to believe their deposits were safe. And to meet this goal, of course, as you all know, the Congress created the FDIC and the system of deposit insurance which has stood the test of time down to today.

Since 1933, the public's earnings have gradually migrated from the banking system to the capital markets, from bank deposits to money market, mutual funds and increasingly to equities. With this shift in how the public saves its earnings must come a shift by lawmakers in fashioning the kinds of protections these public investors need. The Congress should not, of course, create a safety net to protect public investors in equities against any loss. To do that would be to do more harm to our system of capital formation than good. But the Congress should act to ensure that the system by which our corporations present their financial condition to the public is worthy of trust. The auditors, often referred to as gatekeepers, are simply the last line of defense against management's inclination to fudge the numbers and in recent years with increas-

ing and disturbing frequency to present false and misleading numbers.

Legislative action is needed now because with the growing number of audit failures in recent years, culminating with Enron, I hope culminating with Enron, the public's confidence has again been badly shaken, just as in the Great Depression. However, this time the loss of confidence is by the public in its capacity as investors, not depositors, and its loss of confidence is directed at the reliability of financial data certified by auditors.

I hope that the Enron hearings will convince the Congress that the public's confidence in the auditing system should be restored by prompt and forceful legislative intervention, just as the public's confidence in the banking system was restored by forceful congressional action in 1933. The two reforms I've summarized will do the job. My written testimony develops the case for each in some detail. I thank you for your attention and the opportunity to be here and I'm happy to answer any questions you may have.

[The prepared statement of Bevis Longstreth follows:]

PREPARED STATEMENT OF BEVIS LONGSTRETH

My name is Bevis Longstreth. I am a retired partner of the New York law firm, Debevoise & Plimpton, where I spent the bulk of my professional career. From 1981 to 1984, I served as a Commissioner of the SEC, a post to which I was appointed twice by President Reagan. Recently, I served as a member of the Panel on Audit Effectiveness, which released its final Report and Recommendations in August, 2000. For five years following retirement from law practice, I taught a course on the regulation of financial institutions at the Columbia Law School.

I welcome this opportunity to address the Committee on the subject of reforming the audit profession. I am here because my professional experience and background give me some basis for contributing to your treatment of this urgent need for reform. I represent only myself, but in so doing, I hope to offer opinions that will resonate with other public investors in our nation's securities markets.

I want to speak about the audit profession, a once proud profession now greatly in need of reform.

My thesis is simple. The profession needs reform in two major respects:

1. An effective rule preventing the delivery of non-audit services to audit clients; and
2. An effective system of self-regulation.

Despite the SEC's adoption of Rule 2-01, the threat to an auditor's independence from performing non-audit services allowed by the Rule remains palpable.

Despite the enlarged charter of the Public Oversight Board, until recently the most promising vehicle for improving self regulation, an effective system of self-regulation for the profession does not exist and can not be achieved without legislative reform. No greater proof of this fact could be found than the POB's unanimous vote on January 20, 2002 to terminate its existence in reaction to the efforts of the profession's trade association and the CEOs of the Big Five, in private meetings with the new Chairman of the SEC, to circumvent the POB by proposing still another voluntary oversight entity.

While the reforms I advocate offer no guarantee against audit failures, they should sharply reduce their size and number, without impairing the ability of audit firms to prosper. Indeed, I believe that, without these reforms, the profession, which has been its own worst enemy, will continue to abuse its public trust, spiraling downwards until legislation denies it the exclusive economic franchise on which its success was built from the beginnings of the securities laws in 1933 and 1934.

THE NEED FOR AN EXCLUSIONARY RULE FOR NON-AUDIT SERVICES

Arthur Levitt, with strong assistance from Lynn Turner, his Chief Accountant, showed boldness in their efforts to achieve a lasting solution to the vexing problem of independence. In the SEC's Proposing Release, they invited comment on a simple rule excluding an auditor from providing non-audit services to audit clients. To many people away from the narrow corridor extending from the financial capital of the world that is still New York City to the separated powers of government in

Washington, the idea that boldness, and even personal courage, would be required for a governmental powerhouse such as the SEC to propose such an obvious, and widely supported, rule is strange. Yet, I am positive that it took both boldness and courage to issue the Proposing Release. That's because, by so doing, the SEC knowingly unleashed an unprecedented attack from those it was seeking to regulate, as it was charged by Congress to do, for the protection of the investing public and otherwise in the public interest. The ensuing battle, and it was clearly a battle, pitted a legally created monopoly, dominated by five global accounting firms, against the SEC. Three of the five, representing solely their private business interests, rejected any meaningful restrictions on the free play of those interests. Despite the profession's multi-pronged assault, the SEC, acting upon the need for greater independence, a need long recognized by virtually every group that's considered the issue (and there have been many), went ahead with its proposals, inviting comment and conducting four days of public hearing.

There were almost 3000 comment letters. One hundred witnesses testified for about 35 hours. The battle raged far beyond the frontlines at 450 5th Street N.W. Given the sharpness of the debate, and the transparency of the private vs. the public interest, there was more at stake in the outcome than just the independence of auditors. The independence of the SEC, itself, was being challenged as the accounting firms did all they could, on Capitol Hill and throughout the business and legal communities, to bring political pressure to bear against a proposal, the exclusionary rule, that could not be defeated by argument on the merits. At an informal meeting during the pendency of the rule proposal, involving representatives of the SEC and the POB, I was told by a veteran Washington insider that there wasn't a significant law firm in DC that hadn't been lined up by the profession to assist in its battle.

In the tumult of the moment, many leaders of the accounting profession—and here I must say I am not including leadership of the POB—forgot their profession's origins as one granted exclusive rights, and reciprocal duties, to perform a vital public service. Although affected by the public interest as much as, or more than, any public utility, these leaders were demanding freedom from serious oversight or constraint. From my vantage point as a member of the Panel on Audit Effectiveness who had a career of experience working closely with literally hundreds of responsible public accountants, I became increasingly convinced that the leadership of the profession was seriously, perhaps disastrously, disserving a worthy profession.

A rule on independence was adopted on November 21, 2000, shortly before Arthur Levitt's term expired. The adopting release was 212 pages long. It was meticulously detailed. In that detail a careful reader can discern the parry and thrust of the battle that raged over each principle sought by the SEC and every word and sentence by which each surviving principle was to be expressed. I'm sure if Lynn Turner bared his back and shoulders, we would find more wounds than we could count, inflicted by a profession in the hands of hostile and short-sighted people.

The release acknowledges in several places that, in the SEC's view, the final rule struck a reasonable balance among the commenters' differing views. The release also claims the rule achieves the SEC's important public policy goals. I wish these statements were true. But, it is my firm opinion they are not. There is a large gap between the sound policy goals sought by the SEC and the actual accomplishments that can realistically be anticipated by the rule. When the smoke had cleared, it was apparent to this observer that the profession had won the battle. Importantly, however, it was just one battle in a war the outcome of which, when it comes, sooner or later, will be different.

About the rule, let me be clear. I am not saying that, on balance, we would be better off without the rule. It is useful, despite its breath-taking complexity, which has proven very costly for the best intentioned issuers. I speak here as Co-Chair of the Audit Committee of a large public company that is continually struggling to understand the rules and assure that both it and its auditor are in compliance.

The rule is not even "half a loaf;" nonetheless, it is a step in the right direction. I say that for three reasons. First, because it was a bold and honorable battle hard fought by the SEC. In future battles this effort will count for a lot, despite the many compromises. Second, because the policy goals elaborated in both releases, and supported by abundant testimony and comment, provide a compelling foundation for carrying the battle forward in the halls of Congress, where, it has become clear, the fight must now be taken. And third, because the disclosure requirement is proving of particular use in focusing public attention, not to mention the attention of audit committees, on the amazing growth in non-audit fees paid to their auditors.

In thinking of the disclosure requirement, it is important to remember that the SEC in 1978, based on what it then saw as a growing amount of non-audit services being performed for audit clients, adopted a very similar disclosure rule, ARS 250, which was swiftly repealed in 1982 as the consequence of massive pressure from a

profession that was beginning to be adversely impacted by disclosure. Since then, as we now know, non-audit services have increased exponentially.

So, what's wrong with the rule? I want only to address one big problem. Here's what I'm talking about. The SEC adduced strong and abundant evidence in the rule-making process, as summarized in III(c)(2)(a) of the Adopting Release, that providing to one's audit client non-audit services of any kind or kinds, if large enough in terms of fees paid, may impair independence. Despite this powerful predicate for rule-making, the rule adopted fails absolutely to address this concern.

The SEC describes the rule as implementing a "two-pronged" approach:

1. Requiring separate disclosure of audit fees, financial information-related service fees and other non-audit fees.
2. Prohibiting nine specific non-audit services believed by the SEC to be, by their very nature, incompatible with independence.

Economic incentives derived from non-audit work, no matter what their magnitude, were not defined as being, by their very nature, incompatible with independence. In failing to address this matter, the SEC ignored a mountain of persuasive argument.

It defies common sense to claim that large payments for non-audit services, which management could easily pay to service providers other than its auditor, do not function successfully in many cases as an inducement to gain the auditor's cooperation on matters of financial presentation.

Audit account partners are expected by their firms to establish close relationships with the managements they serve. They are expected to cross-market to management as full a range of non-audit services as possible. And, they are compensated by their firms on the basis, among others, of how much revenue they produce from their audit clients. Their stake in maximizing revenue from these clients through cross-marketing of non-audit services is as natural and compelling as any financial reward could be. To claim these incentives have no adverse impact on both the fact and appearance of independence is a fiction, pure and simple.

To be fair, I should point out that the rule contains a general standard, 2.01(b), that declares an accountant not independent if, in fact, or in the opinion of a fully informed, hypothetical "reasonable investor," the accountant is not capable of exercising objective and impartial judgment. Absent a "smoking gun," this "capability" test would seem to create a virtually insurmountable hurdle for the SEC.

The disclosure requirements of the rule, which enjoy the truth-eliciting feature of proxy rule sanctions for misstatements, have already illuminated the seriousness of the economic incentive problem. On average, for every dollar of audit fee paid, clients paid their auditors $2.69 in fees for non-audit services. In other words, non-audit fees represent, on average, 73% of total fees paid to auditors. This percentage is astoundingly large, even when one discounts it for lumping together audit-related services such as work on financials in registration statements. Of course, this is just the average. As The Washington Post reported in a June 13, 2001 editorial: "KPMG charged Motorola $39 million for auditing and $623 million for other services. Ernst & Young billed Sprint Corp. $2.5 million for auditing and $63.8 million for other services."

If Rule 2-01 with all of its promise and detail, allows non-audit service fees, as a percentage of total fees, to represent even a fraction of the 73% average that we now know prevailed on the eve of the rule's adoption, the rule must be counted a failure. Given the compromises reached in defining the "terrible nine" services that may not be provided, I am afraid the percentage will not be substantially lessened by these so-called "bright line" exclusions. Of course, there remains the often powerful effects of disclosure on corporate behavior and, in this case, on the behavior of the audit committees.

Disclosure might encourage the growth of "best practices," as exemplified by TIAA/CREF, for example, which denies its auditor any non-audit business. Over some period of years, the rule's disclosure could cause a growing number of audit committees to back away from using their auditors for any significant amounts of non-audit work.

But I wouldn't bet on it. I fear Rule 2-01 will turn out to be the Maginot Line for Independence, crisscrossed with trenches, barbed wire and gun emplacements, all pointing in one direction only, capable at will of being thoroughly outflanked.

One indication of the rule's effectiveness can be found in the way the Big Five presented it to their audit clients. I have been exposed to only one sample, which I suspect may be illustrative of what others did. Overall the message of this firm's booklet on the rule, provided to audit committees and the managements of its audit clients, is that the rule changes almost nothing. In the sweep of its misleading characterization of what the SEC was seeking to accomplish, it leaves an informed read-

er amazed at the firm's audacity. I want you to hear only one statement taken from this document. It appears twice with only slight variations. Here's one version:

"The real issue for audit committees is the nature of the work performed, not its cost. The rules do not indicate that fees of any magnitude alone impair independence. Nor did the SEC cite specific ratios of audit to non-audit fees as being "good" or "bad."

"Historically, the size of non-audit fees paid to an audit firm has been relevant to SEC independence considerations only to the extent that the total fees earned from one client represent a disproportionate percentage of the audit firm's total revenues. SEC guidance on this point has established 15 percent of an audit firm's total fees as a threshold of concern."

In 2001, the smallest of the Big Five's total revenues was reported in *The New York Times* to have been more than $9 billion. Using the 15% "threshold of concern," a client could pay its Big Five auditor at least $1.35 billion dollars per year in non-audit fees before the audit committee or anyone else need trouble itself over independence. In practical terms, there was no limit.

How any professional firm, let alone a closely regulated firm of auditors, could so blatantly, so laughably, so absurdly, deceive its audit clients in this way defies common sense. For me the only plausible answer is that it's a reflection of the contempt that a victor sometimes directs against the vanquished.

The Big Five surely know that the 15% "threshold" came out of a 1994 no-action position taken by the Office of the Chief Accountant to address non-audit fees proposed to be paid to a very small auditor to allow that auditor to take on as a client its first SEC registrant. They know as well that this ruling was limited to its special facts and contained no suggestion of being an authoritative statement with regard to independence generally.

The basic problem with non-audit fees, which exists regardless of their magnitude but grows more serious as the fees grow larger, is conflict of interest. This conflict derives from the fact that, in performing both audit and non-audit services, the audit firm is serving two different sets of clients:

1. *management*, in the case of non-audit services, which typically are commissioned by, and performed for, management, and
2. *the audit committee*, in the case of audit services, which now are by rule commissioned by the audit committee and performed for that committee, the shareholders and all those who rely on the audited financials and the firm's opinion in deciding whether to invest.

The audit firm is a fiduciary in respect to each of these two very distinct client groups, duty-bound to serve each with undivided loyalty. It is obvious, and a matter of common experience, that in serving these different clients the firm will be regularly subject to conflicts of interest. These conflicts tear at the heart of independence. What is independence? It is the absolute freedom to exercise undivided loyalty to the audit committee and the investing public. When other loyalties tug for recognition, and especially when they come from those in a position to enlarge or shrink one's book of business, on which depends one's partnership share, the freedom necessary to meet one's professional responsibilities as an auditor is curtailed, and sometimes eliminated altogether.

Paul Volcker, in testimony on the rule, given in New York City on September 13, 2000, made the same point:

"The extent to which the conflict has in practice actually distorted auditing practice is contested. And surely, instances of overt and flagrant violations of auditing standards in return for contractual favors—an auditing capital offense so to speak—must be rare. But more insidious, hard-to-pin down, not clearly articulated or even consciously realized, influences on audit practices are another matter."

To highlight the size of the hole in the rule, consider that, in addressing disqualifying financial and business relationships between an accountant and its audit client, the rule declares in absolute terms that an audit firm lacks independence if there exists (a) any investment in the client, however small, by the firm or personnel involved in the audit, or (b) any direct business relationship with that client, however insignificant. Explicitly excluded from the term "business relationships," is the provision of non-audit services by the audit firm to its audit clients. Thus, one faces the absurdity of a rule that is absolute in banning financial and business relationships that are utterly inconsequential while appearing to permit any level of non-audit fees to be paid to the audit firm.

My point is not to suggest that the finely textured concerns of the SEC over the independence-impairing effects of various financial and business relationships are misplaced. They reflect legitimate, albeit immeasurable, concerns. But the important point is that they pale in significance when compared to the potential for impairment that comes from the financial and business stake that an audit firm, de-

spite the rule, is still free to develop in an audit client through provision of a very wide variety of permitted non-audit services.

This brings me to argue for a simple exclusionary rule covering virtually all non-audit services, in place of the deeply complex, existing rule that I hope, by now, to have convinced you is ineffective.

This rule would define the category of services to be barred as including everything other than the work involved in performing an audit and other work that is integral to the function of the audit. In general, the touchstone for deciding whether a service other than the straight-forward audit itself should be excluded from non-audit services is whether the service is rendered principally to the client's audit committee, acting on behalf of investors, to facilitate, or improve the quality of, the audit and the financial reporting process rather than being rendered principally to provide assistance to management in the performance of its duties.

This exclusionary rule could include a carefully circumscribed exception to permit certain types of non-audit services to be rendered by the audit firm to its client where special circumstances justify so doing. Use of such an exception should require at least the following:

(a) Before any such service is rendered, a finding by the client's audit committee that special circumstances make it obvious that the best interests of the company and its shareholders will be served by retaining its audit firm to render such service and that no other vendor of such service can serve those interests as well.

(b) Forthwith upon the making of such finding by the audit committee, submission of a written copy thereof to the SEC and the SRO having jurisdiction over the profession.

(c) In the company's next proxy statement for election of directors, disclosure of such finding by the audit committee and the amount paid and expected to be paid to the auditor for such service.

The rule would be refined, administered and enforced by the legislatively empowered SRO that is the subject of my second recommendation for reform (discussed below).

The fundamental argument for exclusion is the avoidance of conflicts of interest. Beyond that, however, there are a number of other points to be made. I summarize them below:

1. Given the conflict of interest, it is not realistic to expect the firm, itself, to decide convincingly on its own independence. Given its self-interest in the outcome, the credibility of this process is highly suspect.
2. Nor is it feasible to expect independence to be assured by approval of the audit committee. It is impossible for that committee to identify when the problem exists. To challenge the auditor's judgment on the matter is to challenge its integrity, something audit committees are most unlikely to do. Independence is a state of mind, necessary to maintain the skepticism and objectivity that long have been the hallmarks of the accounting profession. Being subjective and invisible, independence is not something an audit committee can apply any known litmus test to determine.
3. No one has suggested that the audit committee can be a substitute for clear rules where the problem of conflicts is most serious. Thus, for example, there is no suggestion that the audit committee be accorded discretion to assess independence despite the existence of financial or business interests between the audit firm and its client. Stock or other financial interests in one's audit client, for example, have long been viewed as creating too clear a conflict of interest to become the subject of discretion, even if exercised by an audit committee composed only of outside directors. The need for an exclusionary rule is rooted in the same ground: prospective revenues from the provision of non-audit services, extending into the future, create precisely the kind of financial stake that produces a conflict of interest capable of impairing independence.
4. An exclusionary rule is easy to administer. It does not preclude an audit firm from engaging directly or through affiliates in non-audit services of any kind. All business entities other than its audit clients are available for business. Since the rule would apply to all audit firms, for each audit client put out of bounds for non-audit services, many more clients of other audit firms become available.
5. An exclusionary rule should correct the current system of compensation, which was found by the Panel on Audit Effectiveness to fail in giving adequate weight to performing the audit function with high levels of skill and professionalism. This situation adversely affects audit effectiveness. Success in cross-marketing an audit firm's consulting services is a significant factor in the compensation

system. The skills that make one successful in marketing non-audit services to management are not generally consistent with the professional demands on an auditor to be persistently skeptical, cautious and questioning in regard to management's financial representa-tions. As long as the marketing of non-audit services by auditors to their audit clients is encouraged, expected and rewarded, there will exist a tension counterproductive to audit excellence. An exclusionary rule would eliminate both this tension and its harmful effects.

6. An exclusionary rule would be effective in rewarding those audit firms most sensitive to the independence issue and most scrupulous in seeking to avoid a real problem or even the appearance of a problem. Exhortation and even disclosure, by itself, often encourage those willing to sail close to the line, or even cross over it. This result has the real and perverse impact of hurting the competitive position of the most sensitive and scrupulous audit firms, and in time encourages even those firms to drop their guard, and exploit the laxness in standards as well.
7. Independence is given important meaning in many analogous situations where potential conflicts, while not always certain to impair independence, nonetheless are prohibited in the interest of avoiding the problem entirely. For example, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees determined that, for a director to be independent for purposes of meeting the membership requirements of the audit committee, he or she must not accept compensation from the corporation for any service other than service as a director and committee member. The Blue Ribbon Committee noted that "...common sense dictates that a director without any financial, family or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices." The common sense parallel to the auditor is both exact and compelling. Compensation for any service other than the audit would impair the auditor's independence.
8. An exclusionary rule is a low cost premium on an important insurance policy for the whole profession, against governmental intervention to deny audit firms the right to do any non-audit work. In the Panel report we wrote, as of August 31, 2000, that "an exclusionary rule would go far toward eliminating the possibility of a major audit failure being linked to the influence of non-audit service business on the audit firm's diligence and skepticism, an event that would provide a basis, and possibly the momentum, for some radical solution like a total ban." Enron could turn out to be the failure we were imagining.

THE NEED FOR A LEGISLATIVELY EMPOWERED SELF-REGULATORY ORGANIZATION

The present form of self-regulation of the auditing profession reminds one of military music, military intelligence or even, some might argue, corporate governance—a classic oxymoron. Having looked closely at the system of governance within the auditing profession, I'm not prepared to be quite so simplistic. But, having studied the matter, I am quite certain that the governance of this vitally important profession is in an entirely unsatisfac-tory state. Moreover, this is no trivial matter.

Overview of Governance. Today, governance is exercised from three sources:

1. State boards of accountancy, which have licensing powers.
2. The SEC, which exercises potentially broad powers over those who audit reporting issuers.
3. Private organizations of the profession, of which there are at least seven important ones.

The profession claims that, through its various organizations, effective self-regulation is achieved. Having looked closely at this claim, I believe it to be false. The organizations are characterized by complexity and ineffectiveness in matters of central importance to any effective system of self-regulation.

Among the short-comings of the present system are the following:

1. Lack of any public representation.
2. Lack of unified leadership over the seven organizations.
3. Lack of transparency.
4. Fuzzy and often over-lapping areas of responsibility.
5. Conflict between self-interest (as in the American Institute of Certified Public Accountants (AICPA), which is a trade organization parading as an SRO) and protection of the public interest.
6. Lack of any credible system for imposing discipline.
7. Lack of assured financing.
8. Overall, a total lack of accountability to anyone.

Given its importance, a further word on discipline. Here's all there is. The Quality Control Inquiry Committee of the SEC Practice Section of the AICPA (QCIC) is charged with investigating alleged audit failures involving SEC clients arising from litigation or regulatory investigations. However, it is only looking to see if there are deficiencies in the firm's system of quality control. It is not involved in assessing guilt, innocence or liability of the firm or any individual. And its report is only prospective in its impact.

The Professional Ethics Executive Committee of the AICPA (PEEC) is charged with such responsibility for discipline as exists. It is supposed to pick up cases from the QCIC. However, out of alleged "fairness," at the firm's request, the PEEC will automatically defer investigation until any litigation or regulatory proceeding has been completed, often many years later. This system results in long delays in investigation and, as a practical matter, renders the disciplinary function a nullity in almost all instances.

It was the Panel's hope to recast the POB as the central overseer of self-regulation, with power and responsibility to effect changes necessary to make self-regulation effective. With a new and energetic chairman in Chuck Bowsher, this idea seemed achievable. As conceived by the Panel, the POB would have had these new elements:

1. Public members, independent of both the profession and the SEC, would constitute a majority of the board.
2. "Strings attached" funding would be provided by the profession in amounts sufficient to carry out the POB's mission.
3. Absolute control over the nature of its work and the budget necessary to carry out that work.
4. Power to oversee all of the profession's governance organizations.
5. Power of approval over appointments to the various organizations and over hiring, compensation, evaluation and promotion decisions by AICPA in respect of employees of key organizations.
6. Term limits for board members.
7. Nominating committee for selection of board members, composed of representatives of public and private institutions especially concerned with the quality of auditing and financial reporting.
8. Advisory council, composed similarly to the nominating committee, responsible for annually reviewing the work agenda for the POB.

The new charter for the POB was the result of heavy negotiation among the Big Five, the AICPA and the SEC. It fell short of the Panel's recommendations in several important respects:

1. No POB approval over membership of governance organizations. Concurrence rights over Chairs.
2. No oversight over PEEC's standard setting activities.
3. No nominating committee or transparency for POB board membership.
4. No oversight of staff of key governance organizations.
5. No power to change POB charter.

The POB believed it could work around its charter limitations by the threat of going public with disagreements. A whistle-blower technique. At the time I thought this a slim possibility. Making the POB the central, responsible and empowered regulator of the profession, which was the Panel's goal and similarly the goal of the SEC under Chairman Levitt, was powerfully and effectively resisted by the AICPA. Again, the battle was waged. Again, the AICPA and the big firms asserted their immense power on behalf of unchecked self-interest. And again, the profession's leaders came out on top.

However well intentioned Chuck Bowsher and his board might have been, and I know they were well intentioned, there was no way they could have achieved effective self-regulation of this profession under the POB's charter as negotiated in 2000. Even if they had gotten all that the Panel advocated, it wouldn't have worked. The reason is quite simple. Like many other businesses, the profession, and particularly its current leaders, apart from the POB, don't want self-regulation. They want the shield of apparent self-regulation. But not anything close to the real thing.

Now, as you know, the POB members have all resigned in protest over the actions taken by the Big Five CEOs and the AICPA, in cooperation with the new SEC Chairman and in complete disregard of the Panel's recommendations and the modest efforts taken so recently to strengthen the POB. The five members of the POB did, indeed, become whistle-blowers, having no other choice even in the face of a palpable crisis to the profession.

Whatever the explanation for the profession's nearly suicidal attempt to evade the POB, which was the only plausible entity capable of some self-regulation, and what-

ever the SEC Chairman's motives in lending support to this effort, it will not stand scrutiny. On the back of Enron, real reform will come at the legislative level. It must emerge from the lawmakers on Capitol Hill not only because the SEC appears unwilling to lead. In regard to an SRO, only legislation can arm an SRO with the necessary powers to do the job. A review of the essential elements common to all the existing SROs will explain why this is so. Here they are:

1. Creation by legislation or by governmental agency pursuant to legislation, with clear powers to write rules and conduct enforcement and disciplinary proceedings.
2. Supervision by government agency, including registration with that agency to operate as an SRO, agency approval of all rules adopted by the SRO and agency power to adopt rules for the SRO.
3. Power in the supervising agency to sanction the SRO for failure to perform its responsibilities, as, for example, failure to comply with its self-governance rules or to enforce the rules it imposes on those it has the chartered duty to regulate.
4. Requirement that all participants in the profession or industry being regulated (e.g., brokers and dealers) become subject to the SRO's jurisdiction and powers.

It will be instructive to examine further the workings of the NASD's SRO, whose most important public duty is that of policing the rules of financial responsibility, professional conduct and technical proficiency. In carrying out this charge, the SRO is given essentially the same range of sanctions available to the SEC, which must be applied by the SRO in cases where a broker-dealer or its employees have violated the securities laws or SEC-enacted rules or the rules of the SRO. Of particular importance in achieving wide-spread compliance with the rules of professional conduct is the power of both the SEC and the SRO to discipline either or both the supervisory personnel and the firm for a failure to supervise employees who misbehave. To avoid sanction the firm must have in place procedures to deter and detect rule violations and a system for the effective implementa-tion of those procedures. It is hard to exaggerate the importance of this "duty to supervise" in respect of its prophylactic effects.

To facilitate speedy investigation by the SRO of alleged violations, and speedy judgment and imposition of sanctions where warranted, the SRO has one critically important tool that it uses to gain the cooperation of those it regulates, even those who are targets of an investigation. Its rules require each of its registered firms and individuals to turn over all requested documents and other information, and to appear and testify, in connection with an SRO investigation. Failure to cooperate in this way can result in expulsion from the industry. Courts have held the Fifth Amendment privilege against self-incrimination inapplicable to sanctions imposed by an SRO. Thus, as a practical matter, those regulated by the SRO, including the target of an investigation, must cooperate or lose their right to be in the industry.

As a result of being vested with law enforcement powers in combination with close supervision from a governmental agency, an SRO is widely believed to possess three significant protections that typically are only enjoyed by governmental agencies in the exercise of enforcement powers. They are:

1. Immunity from suit.
2. Privilege from discovery of investigative files. It is important to note here that this privilege is generally understood to operate only during the investigation. This limitation holds for the SEC too.
3. Protection from antitrust violation for group boycott or other activity violative of antitrust principles.

These protections proceed from the fact, as reflected in Congressional committee reports, that an SRO is delegated law enforcement powers subject to supervision by the governmental agency from whence those powers came. Effectiveness compels the delegation of these protections as well.

From the foregoing brief summary of the common elements of an SRO, it can be seen that a private organization such as the POB, voluntarily organized by the accounting profession to self-regulate itself, cannot do the job, no matter how well-intentioned its leaders might be.

To reiterate: the SROs are effective because they are accountable to a governmental agency and derive from their relationship with that agency immunity from suit and important protections against discovery and antitrust laws, while at the same time preserving their private status enough to avoid the Fifth Amendment's protections for those it regulates.

The inescapable conclusion from this analysis is that, unless and until a real, legislatively supported SRO is put in place to regulate the accounting profession, little, if any, progress toward an effective disciplinary system for accountants practicing before the SEC can be made outside the SEC itself.

Chairman TAUZIN. Thank you very much, Mr. Longstreth.

Our final witness who will testify on the issues of the energy markets themselves and the effect of the Enron collapse on those markets and he is Mr. David Sokol, Chairman and CEO of MidAmerican Energy Holdings Company of Des Moines, Iowa.

Mr. Sokol.

STATEMENT OF DAVID L. SOKOL

Thank you, Mr. Chairman. I am for the record a registered professional engineer and then an accountant. MidAmerican Energy Holdings is a privately held company with about $13 billion in assets and our largest investor and roughly 75 percent investor is Berkshire Hathaway.

Mr. Chairman, the Enron disaster is inexcusable and your efforts to fully explore it is essential to restoring the credibility in the U.S. capital market system. I believe what you'll find is arrogance, greed, accounting fraud and poor governance.

As a chairman, president and CEO of a public company for the last 16 years, I have seen on balance how well and how terrific the U.S. capital markets are, but I've also been witness to how badly people can misuse them. Some people ask the question why—or someone once said why do people rob a bank and someone answered because that's where the money is. And the capital markets are where the money is today and they're what Enron took advantage of.

But I think we have to be honest as we look back and say that the past 8 years have been a period not only of irrational exuberance by investors in the market, but also of irrational expectations by stock analysts and of poor performance by auditors, rating agencies and management of companies. That irrational exuberance throughout that period has created a loosening in the quality of our reporting systems and a loosening in management's attention its obligations.

Accounting, as I was taught it, was to reveal information on a fair and consistent basis for investors to make informed decisions. Accounting today is about concealing information. It's about keeping debt off balance sheets. It's about hiding obligations called contingent obligations. That's a severe twist to what accounting is supposed to be for America's corporations and we have to fix it.

I would offer to you having turned in a corporation to the SEC for breaking the rules, that one way you help solve this problem in addition to many of the ideas given by this panel is to enforce the rules against senior executives and against auditing firms.

I watched a chief executive officer and a CFO get a slap on the wrist by causing a very large U.S. corporation to go into bankruptcy with over 6 years of accounting fraud and manipulation of earnings. The investors lost their money, employees lost their jobs, but senior executives often don't go to jail and don't pay significant restitution and that needs to change. We don't tell youngsters when they rob a convenience store that if they give half the money back we'll let them go, but that has been how we've treated executives when they steal in the public markets.

And auditing firms have to be held liable for not doing their job. Any CEO today will tell you that we spend more time negotiating

the audit engagement letter than we do spending times with the senior management of auditing firms about what they're actually going to do. And that auditing letter spends very little time saying what the auditor is going to do to audit the company. It spends a lot of time expressing what they're not going to be liable for. And we need to change those activities.

Directly in regard to the energy markets, I think it's most enlightening to notice that through the Enron debacle, a catastrophe of giant proportions in any measure, the energy markets have continued to function. Electricity has flowed, natural gas has flowed, the lights have stayed on and most importantly, consumer prices have not been affected by the Enron wholesale—the Enron debacle in the wholesale market. It is, and I think it's fair, that people have asked questions about whether or not Enron may have attempted to manipulate wholesale markets in certain regions of the country. I don't know if that occurred. If it did, again, it's another law they've broken and they should be punished, but it's important to recognize that some have estimated that Enron managed 25 percent or trade 25 percent of the U.S. electrical and gas wholesale industry, and there's not a single period you can find from September through December of last year where those markets were dislocated even while Enron went bankrupt. So it's a real tribute to the energy markets.

Another, I think, misnomer that's been raised is that somehow Enron purportedly was trying to skirt the Public Utility Holding Company Act and perhaps create an Insull-like utility of the 1930's and that's just not the case. In fact, Enron is not about the energy markets. It's about fraud, corruption and poor governance. The Public Utility Holding Company Act in many ways is actually today, if anything, harming Portland General Electric which was the only electric utility subsidiary Enron had and the reason it's harming it is because Enron has been trying to sell it for 2½ years. We wanted to buy it 2 years ago and we can't because Berkshire Hathaway, even though they're a AAA-rated company, cannot make another investment in the U.S. utilities sector because of PUHCA. What that's requiring Enron today to do is to sell Portland General Electric to Northwest Natural Gas, a company roughly one third its size, in Portland, Oregon, and they're having to leverage up using junk bonds to buy the utility from Enron. The chairman of the Oregon Public Utility Commission testified this morning in front of the Senate that Enron's bankruptcy has caused no strain and no cost to consumers of Portland General Electric, but that, in fact, PUHCA is today making it more difficult for them to actually get another owner in place of that utility. The energy markets continue to work fine. We would mention that perhaps in the wholesale energy markets that those markets should be overseen perhaps by the CFTC going forward, but again it's important to recognize that Enron didn't collapse because it was in the wholesale trading market. It collapsed because of accounting fraud and manipulation of earnings.

Last, we feel it's important to mention that this issue is very much a bipartisan issue. It's about the trust and the confidence in the United States capital markets. The integrity of our capital markets underpin the great economy of the United States and it's not

about campaign reform. That may be necessary. But this issue with Enron and the follow-on effects of now the tightening, the proper tightening of accounting and oversight, do draw to the credibility of our markets and we must protect them and I think it's a very important function for both Congress and us and industry to make sure that we don't undermine those capital markets.

Thank you.

[The prepared statement of David L. Sokol follows:]

PREPARED STATEMENT OF DAVID L. SOKOL, CHAIRMAN AND CEO, MIDAMERICAN ENERGY HOLDINGS COMPANY

Thank you, Mr. Chairman. MidAmerican Energy Holdings Company is a diversified, international energy company headquartered in Des Moines, Iowa with approximately $13 billion in assets. Our largest investor is Berkshire Hathaway, one of the only AAA-rated companies in the United States.

The company consists of four major subsidiaries: CE Generation (CalEnergy) a global energy company that specializes in renewable energy development in California, New York, Texas and the West, as well as the Philippines; MidAmerican Energy Company, an electric and gas utility serving the states of Iowa, Illinois, South Dakota and a small part of Nebraska; Northern Electric, an electric and gas utility in the United Kingdom; and HomeServices.com, a residential real estate company operating throughout the country.

I would like to commend you for your persistence in working with Energy and Air Quality Subcommittee Chairman Barton to push for energy legislation, including electricity modernization provisions. We cannot pass a national energy plan for the new century while leaving in place a regulatory system that was already outdated at the end of the last. Your bill, H.R. 3406, does not seek to do everything, but it does critical things that only Congress can do, and it will result in a modernized electric infrastructure that will benefit consumers while providing for fair competition.

As the American economy begins to recover, demands on our electric system will increase once again, and if we have not moved forward with the critical elements of market modernization, consumers may once again pay the price for an outdated system. At the same time, we should recognize that the pending recovery is tenuous and take steps to encourage the markets and American consumers that there is bipartisan support for positive, pro-investment initiatives.

My testimony this morning will focus on the Enron scandal's impact on energy policy issues, specifically the relationship, if any, between Enron's activities and the Public Utility Holding Company Act of 1935, or PUHCA, including issues of consumer protection, barriers to investment and market entry, and appropriate forums for regulatory oversight.

These three issues are unavoidably linked. Ten years ago, Congress passed the Energy Policy Act of 1992 in order to create open, competitive wholesale electricity markets so that investors, not consumers, would bear the risks associated with capital-intensive, electric generation investment. That is when PUHCA changed from being primarily a nuisance for companies to a burden for consumers.

By keeping investment dollars out of the industry and perpetuating market fragmentation, PUHCA contributed to the failure of our electric infrastructure to keep pace with the demands of the growing competitive wholesale market. MidAmerican's largest investor, Warren Buffett, has publicly announced his intention to invest as much as $15 billion in the industry once PUHCA is repealed. However, PUHCA's barriers to entry prevent him from making these investments, particularly in transmission and distribution assets.

Last year, I testified in both the Senate and the House as to how PUHCA blocked MidAmerican from making major investments in the California utilities that could have helped stabilize their financial positions during the early part of the energy crisis. PUHCA's ownership limitations and physical integration requirements stood in the way.

PUHCA is also complicating attempts by the company to make a major expansion of our geothermal development in the Imperial Valley in Southern California. While we have begun a smaller project, we cannot undertake any expansion that would require us to build significant new transmission facilities to bring this power to the grid without potentially running afoul of PUHCA.

Some have claimed in recent contacts to the SEC that one cannot invest in a regulated utility asset and also make good non-utility investments. No law can make a

good investor or a bad investor. Nor should any law determine that a person who invests in one industry should not be able to invest in another provided there are no conflicts of interest. And I can tell you about one investor who has done pretty well in both arenas. His name is Warren Buffett, and his record speaks for itself.

PUHCA and those who support its predetermined limitations on who can invest in this industry take a shortsighted approach. The way to protect consumers is not to maintain a Chinese wall around investment in this industry it is to maintain effective separation of the financing and rate structures of regulated utilities and their assets and any affiliated operations.

There has not been much good news in energy markets in recent months, and even conservatively managed traditional utilities are feeling financial pressure. This will make it harder than ever for the industry to raise capital and build new infrastructure. And, as consumers in California and the West experienced in recent years, market failure is the ultimate anti-consumer result.

PUHCA is not and never was designed to be primarily a consumer protection statute. The overwhelming focus of the law is on preventing corporate malfeasance that harms investors. By eliminating financial abuses, Congress certainly expected that consumers would benefit, but PUHCA does not address rates, and the implementing agency, the SEC, has no rate setting function or expertise.

Simply put, if the issue is protecting consumers from unfair rates, FERC and the states have developed the expertise over almost seventy years to perform these functions. The SEC has absolutely no rate-setting function and has emphasized this fact on many occasions before Congress.

On the issue of cross-subsidies, the appropriate protection against cross-subsidization is the books and records access provided in the bill. Using my own company as an example, if the state of Iowa had concerns that MidAmerican Energy was inflating rates in our retail electric or gas tariffs to support a competitive business in some other state, under the bill, state regulators would have an explicit right in federal court to gain access to the books and records of any affiliated business in any other state that had conducted business with the utility.

At the same time, the Committee should be wary of attempts to make FERC some type of super-regulator of retail rates in all fifty states in the name of stronger protections against cross-subsidization. FERC's expertise is wholesale rates. State commissions are closest to the details of retail rate-setting and capital structure decisions. Muddying the water on this fairly clear distinction would be a recipe for disaster. We've already seen during the California crisis the debilitating impact that finger-pointing between Washington and the states can have on effective regulation. We should not go down that road.

The only rate-related provision of PUHCA relates to "at cost"' pricing. While the law seeks to ensure that utilities and their affiliates do not engage in inter-affiliate pricing schemes to inflate consumer costs, the "at cost" requirement in the PUHCA law actually limits the ability of state and federal regulators to require registered holding companies to price some goods and services at the lower of "at cost" or market rates.

Much of this ground has been well-covered in recent years. That is why the PUHCA provisions included in this bill have been part of virtually every electricity modernization bill introduced in the last several Congresses, have enjoyed the support of the last four Administrations and the regulatory agencies that enforce the laws, and passed the Senate Banking Committee last year by a 19-1 vote.

What has changed then?

We are here this morning because a few long-time opponents of updating the PUHCA law have made new claims arising from the Enron collapse. It's worth noting that one of these advocates stated last December that he could support the electricity provisions of this bill in its present form. But, I suppose that Enron fell, and opportunity knocked.

There are really two stories before this Committee today. The first is the story of what actually happened to energy markets as a result of the Enron collapse. These events should reassure the Committee that you should move forward with this legislation.

The second story is the one spun by those who have long opposed market modernization measures. It poses a series of events that did not happen and attempts to force supporters of PUHCA legislation to prove that these events could not have happened. Taken to its logical conclusion, this "expand PUHCA" agenda would require Congress, FERC and the states to unravel more than a decade's efforts to create open, vibrant and transparent energy markets.

The reason why this is so is instructive. Virtually every element of modern competitive electricity markets exists either as an explicit statutory exemption from

PUHCA or as a result of regulatory determinations that gave flexible interpretations to PUHCA.

A "fundamentalist" view of PUHCA, that every electric or gas company that sells on the grid should be registered, would result in complete market concentration, elimination of the marketing industry and gutting of the EWG exemption since almost all EWGs rely on either an affiliated marketing company or independent marketers to sell competitive electricity.

LET'S START WITH THE FIRST STORY. WHAT HAPPENED TO ENERGY MARKETS AS A RESULT OF THE ENRON COLLAPSE?

Energy markets responded to the Enron collapse with little, if any, disruption. The lights stayed on, natural gas flowed, and consumer prices did not rise. This is true not only for the markets generally, but also for wholesale and retail customers of Enron's subsidiary, Portland General Electric.

In December, all four FERC Commissioners testified before your Energy and Air Quality Subcommittee that electric and gas markets had responded to the Enron collapse with remarkable resiliency. Chairman Wood repeated that assessment before the Senate last week, along with independent market analysts, market participants and a representative of the state regulators.

In fact, the situation of the customers of Enron's retail electric and gas pipeline subsidiaries proves the argument that PUHCA legislation supporters have been making for almost twenty years, which is that aggressive, effective state and federal regulation are the true keys to consumer protection, not a statute that deals primarily with details of corporate structure.

It's hard to imagine a company collapsing more swiftly or more completely than Enron, yet the customers of Portland General have been unaffected by the bankruptcy, because its PGE's assets and operations have both regulatory and contractual safeguards. This is the result of effective state and federal rate regulation and the ability of state commissions to oversee issues of utility financing and cost recovery. This is where real consumer protection occurs in electric and gas markets.

In December, I met with members and staff on both sides of the aisle of this Committee and shared my view that if there was any part of Enron's energy assets that had the potential for abuse, it was that company's domination of the "mark-to-market" exchange.

The allegations that Enron may have manipulated forward markets are troubling, and I encourage the Committee to pursue these further.

However, I am not aware of any way these issues could be linked to PUHCA. For those who argue that this shows that the Enron collapse did impact energy markets, I would respond that, if these allegations are proven true, it appears to have affected them in a positive direction for consumers.

LET'S NOW LOOK AT THE SECOND STORY, WHAT DID NOT HAPPEN.

1. Enron was not working to build a multi-state Insull-like utility empire.

To the contrary, it was looking to sell Portland General. In fact, Enron probably would not even have been in the regulated utility business at the time of its collapse if PUHCA had not hampered its efforts to exit that business.

Why? PUHCA artificially and materially limits the number of potential buyers of any utility to those utilities who can meet the law's physical integration provisions, which requires that two utility systems must be capable of interconnection to be legally combined under PUHCA. This is one of the core problems of PUHCA. It serves as a barrier to entry and investment and results in market concentration.

2. Enron did not lobby for PUHCA repeal.

It was a leading opponent of stand-alone PUHCA legislation and testified before Congress that it would only support PUHCA repeal as a trade-off for concessions it wanted.

Enron's overall policy position with regard to traditional utilities can perhaps best be described as disqualify and dominate: Work to keep asset-backed utilities out of emerging energy markets, then dominate those markets.

The Committee should also be aware that in its most recent congressional testimony on electricity policy, Enron opposed enhanced access to books and records, provisions that we have long favored.

On July 22, 1999, Enron's Executive Vice President Steven J. Kean testified before the House Energy and Power Subcommittee, "we have concerns that H.R. 2363 creates unneeded regulatory oversight of affiliated companies that have no need for additional regulation of their books and records."

Supporters of PUHCA modernization and reform want more competitors in the marketplace, not fewer, and support giving federal and state regulators more tools to protect consumers.

3. Enron did not receive special exemptions from PUHCA.

Enron received two PUHCA exemptions from the SEC. Both were clear cases under the law.

The first was a statutory exemption provided to more than 50 other holding companies whose utility operations are primarily located in a single state.

The second exemption concerned the question of whether a power marketer should be considered a "public utility" under PUHCA. PUHCA defines an "integrated public-utility system" as, "a system consisting of one or more units of generating plants and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of interconnection."

The claim that the "no action" letter Enron received for Enron Power Marketing Inc. constituted a special exemption for Enron that ultimately allowed the company to escape regulatory scrutiny is the entire basis for the claim before the Committee today. However, for the SEC to have found otherwise would have required it to find that the assets of marketers—office equipment, paper contracts, and computer data—are "facilities" of public utilities comparable to generating plants and transmission lines.

This raises the interesting question of how these types of "facilities" could meet PUHCA's "physical integration" requirement. Obviously, they could not, and no other decision by the SEC seems supportable under either the facts or the clear definition in the law.

More importantly, had the SEC decided otherwise, the entire power marketing industry would probably not have developed.

It's hard to think of any single decision that would have had a more negative impact on consumers and competitive wholesale markets.

4. What about the other exemption mentioned in the January 23, 2002 New York Times article?

This exemption, to the Investment Company Act of 1940—not PUHCA—is the exemption that some have claimed allowed Enron to engage is some activities that played a significant role in the company's collapse.

This appears to raise some genuine issues—but these issues have nothing to do with PUHCA, and attempts to use the Investment Company Act exemption as a way to derail electricity modernization are clearly opportunistic.

5. But couldn't the Enron collapse have been prevented had Enron somehow been subjected to PUHCA?

Since it's clear Enron should not have been considered a registered holding company, this could only be true to the extent that Congress would apply PUHCA-like financial regulations to every other publicly-traded company, energy or non-energy. There is nothing unique about the energy industry concerning Enron's financial activities.

If, as has been reported, a company is willing to risk violating the '33 and '34 Securities Acts, shred congressionally requested documents, engage in highly questionable accounting practices, knowingly mislead investors, and ultimately drive itself into bankruptcy, why would we believe that PUHCA would somehow protect its shareholders.

Congress can and should conduct a thorough review of all the accounting, bookkeeping, pension and corporate governance issues raised by this scandal. In some cases, laws and regulations may need to be strengthened. But these changes should be applied to all publicly-traded companies, not to a small subset of companies in one industry. At the same time, it may be appropriate to address oversight of energy futures trading.

FERC Chairman Wood is moving aggressively to bring the wholesale electric energy market to an end-state of transparency and vibrant competition. Some are concerned that he is moving too quickly; others may believe he is moving too slowly. Few would disagree with his goal of achieving that end-state or the benefits that consumers will gain when we get there.

In his testimony before the Senate Energy and Natural Resources Committee last week, he said, "If Congress' policy goal is to promote wholesale energy competition and new infrastructure construction, then reform of the Public Utility Holding Company Act of 1935 (PUHCA), supplemented with increased access by the Commission to the books and state regulators to certain books and records, will help energy consumers. Energy markets have changed dramatically since enactment of PUHCA,

and competition, where it exists, is often a more effective constraint on energy prices. In the 65 years since PUHCA was enacted, much greater state and federal regulation of utilities and greater competition have diminished any contribution PUHCA may make toward protecting the interests of utility consumers."

This is not just the view of Chairman Wood, but also all the members of the Commission, and all his predecessors in the last decade. They have understood that this market will never achieve the depth, transparency and level of competition we all seek if PUHCA's barriers to entry and investment remain in place. The reasons why you must eliminate the anti-competitive and anti-consumer aspects of PUHCA are simple:

PUHCA's arbitrary limitations hurt consumers. Just last month, The D.C. Circuit Court of Appeals remanded the SEC's approval of a large utility merger that would provide consumers and the companies involved more than $2 billion in savings, based solely on concerns related to PUHCA's single region and physical integration requirements.

While some have claimed that this decision represented some form of victory for consumer interests, I disagree. Quoting from the ruling, the Court wrote, "According to Petitioners, the Commission erred in accepting (*the two companies'*) projections that the proposed merger would produce approximately $2.1 billion in cost savings. We disagree. We owe considerable deference to the Commission's assertion that it 'reviewed the assumptions and methodologies that underlie' the projections and found them 'reasonable and consistent with . . . precedent.' Moreover, Petitioners point to no evidence or expert testimony supporting their assertion that the companies' calculations were flawed."

The law's ownership restrictions keep capital out of one of this country's most critical industries at a time when needs in the transmission sector alone will require tens of billions of dollars in new investment. As I mentioned before, Mr. Buffett has publicly stated his intent to invest as much as $15 billion in the industry if PUHCA is repealed.

The law's counterproductive requirements of interconnection and geographic proximity foster regional concentration, directly counter to 50 years of antitrust law. As I mentioned during testimony in the House last year, one of the ironies of PUHCA is that the only other utility that MidAmerican could purchase without running afoul of the Act are the utility assets of the only other investor-owned utility in the state.

As representatives of FERC have testified on numerous occasions, PUHCA hinders their ability to establish large, multi-state regional transmission organizations.

PUHCA also provides foreign companies which are not restricted by the physical integration standard an advantage on their "first bite" entry into the U.S. market and, at the same time, sends overseas American dollars that could be invested here. In view of the series of negative events that have buffeted this sector beginning with the crisis in California and the West, the overall economic downturn and the negative financial impact of the Enron collapse on much of the sector, I believe we could see a substantial increase in this trend in the next several years.

Congress cannot fix PUHCA by tinkering around its edges. The SEC concluded in 1995 that PUHCA had accomplished its goals by 1952, fifty years ago. It is time to repeal this law's antiquated and arbitrary physical integration requirement and ownership limitations. At the same time, you can replace PUHCA with enhanced books and records authority and the other consumer protection measures that are contained in H.R. 3406 and move the country forward toward a competitive, pro-consumer market.

Chairman TAUZIN. Thank you very much, Mr. Sokol.

Now it's our function at this point to allow members a round of questions and the Chair recognizes himself very briefly.

Let me say first of all, Mr. Chanos, I hope someone gets into the question of why it is that you could see insider selling of stock. You could see all these problems when the accountants couldn't see it and the SEC was not seeing it in their oversight function of looking at the Enron disclosures. I won't have time to get into that, but I hope someone will get into that. I think they will.

And Mr. Raber, I would love to get into a lot of questions with you about how it is that you can expect any member of a board of directors, outside board of directors who comes on and is paid

$250,000 to $350,000 to serve on that board of directors to truly be a tough questioner, a tough insider, sort of the whistle blower that we saw in Ms. Watkins, for example, an employee who saw everything going wrong and tried to bring it to senior management attention at Enron. How is that possible when it might jeopardize their position on the board? I believe that will come up in some questions too, so you might get ready for that.

What I want to focus on, however, is the substance of the questions of how we somehow fix the failure of disclosure of relevant information to investors that might have encouraged investors to make different decisions about Enron, rather than seeing its stock inflated with this unreal value for so long that it caused such a problem to so many people. In that regard, I had a discussion this morning, very much in the line, Professor Weil, of your comments that on whether or not we ought to have rules, specific rules, a whole cast of them as complicated as the IRS rules are today for the accounting profession, or whether they ought to be principles, generally, that the accounting profession follows, whether, for example, that 3 percent rule is a good rule or we ought to just have a principle that you ought to look to see who really controls the outside entity, who is really in charge of it as opposed to these very specific rules that say whether or not it fits the categories that allow you to hide debt into that entity or to make up income as we see in this case.

Here's a question I want you all to think about and answer for me. We have been debating the question of whether or not we should separate the consulting function from the audit function. That came up several years ago. It certainly is before us again today. What the SEC Chairman did several years ago was to require disclosure as you pointed out, Mr. Longstreth of the amount of monies being paid, for one function as opposed to the other, as an indicator of whether the possibilities of something going wrong might be to the short sellers or anyone else who might say well, there's too cozy a relationship between the consultant function, too much money in there to trust those numbers, trust that audit in the end. But the recommendation is now much stronger to separate those two functions. Some of the accounting firms are voluntarily saying they're going to get rid of one of those functions or separate those functions. Disney, I think, announced today they wouldn't hire the same auditors today to do both the auditing function and the consulting function any more. I suspect other corporations are going to make similar conclusions.

But here's the question, if we move toward general principles rather than a whole host of specific rules by which the accountants try to give us accurate information, and even if Mr. Lev, we take your recommendations and broaden that disclosure to include intangibles and all the other much more, if you will, filled net of information, and then we leave it to that consulting function, that ongoing sort of advice to the company about how to structure its special purpose entities and its partnership, everything else it does, only to have some third entity come in and judge later on whether they did it right, do we open the door to two very subjective conclusions? On the one hand the first set of accountants counseling with the company under general principles that we think you can do

this, so go ahead and do it, and then someone entirely different coming in and saying no, man, they gave you terrible advice, our subjective interpretation of those general principles says you can't do that. Now you have to go back in and restate your earnings and declare debt that you didn't declare before and is that going to create confusion for the investing community, the investment community? Is that going to do more harm than good is what I'm asking? Second, if we did move to that kind of a frame and we may be moving to that sort of a frame, will it create friction if, in fact, as you point out, Mr. Longstreth, the counseling part of this, the consulting part it is where the real money is and it seems to be, 73, 75 percent of where the money is. If I'm hired as the auditor and you've been hired as the consulting firm, isn't it in my interest then to make you look as bad as I can in the hopes that they'll fire you and hire me to the new set of counselors? Is that going to create that sort of a friction that is going to lead to more confusion and more contradictory statements to the American investors? I don't know. Give me some thoughts on that real quickly. That's what troubled us throughout this period of discussion and frankly, that's why we urged Arthur Levitt to have public hearings where corporations could come in and accountants can come in and we can have a full discussion of that. Perhaps it's time to have that now. Let's start, any one of you.

Dr. Weil?

Mr. WEIL. Consulting comes in a wide variety of cloaks. One of the things we're trying to do is to conserve society's resources. There is nobody better able to prepare a corporation's tax return than its accountant. If you say to the accountant, the auditor can't do the tax return, we're going to waste resources.

A company decides they want to do just in time inventory system. Nobody's better able to help them design it than someone who knows where the inventory records are kept in the green filing cabinet next to the door. We will waste society's resources if we absolutely forbid that.

There's some place to draw a line. I think the heavy hand of legislation is not the right way to draw the line. I disagree with Mr. Longstreth. I think Mr. Raber has got the right idea which is we need independent audit committees making the decisions of their companies who should be the auditor, how quickly we should rotate them out and I think we should consider mandatory audit rotation. That's the kind of legislative or regulated thing that you can do, and we can talk about hiring the way Baruch Lev says, the new audit committee via vote, but we can have overlapping terms so the new person is learning as the old person is winding up. But if the audit committee is independent and feels the responsibility that we want the audit committee to have and haven't had, they can make a reasoned judgment about when it makes sense to hire the auditor. The most important thing is to have the auditor believe that his retention, her retention as auditor is a function of the audit committee's judgment, not the CFO's judgment.

Chairman TAUZIN. Yes, I'd like you to reply, Mr. Longstreth. If anyone else wants to make a brief comment, then I've got to move on.

Mr. LONGSTRETH. Well, I think just to pick up on the last comment, I think the critical analysis of consulting on the one hand and the audit function on the other is to realize that when an audit is performed, the client for the auditor are really the shareholders and the investing public. The surrogate for that body is the audit committee and so the audit committee, acting as a surrogate for the shareholders is the client of the auditor.

When the nonaudit services are undertaken, they are undertaken for a different client, management. Management retains the auditor to perform this range of services. And maybe lots of times you can serve both those clients and not get into trouble, but not always.

Chairman TAUZIN. Not always.

Mr. LONGSTRETH. And it's a dangerous situation. I think that in coming to what can be legislated and what can't be or shouldn't be, obviously Congress can't legislate generally accepted accounting principles.

Chairman TAUZIN. That's correct.

Mr. LONGSTRETH. And they shouldn't regulate or try to write laws for auditing principles, but there is a need for a clean break between the audit function and the consulting function.

Chairman TAUZIN. But I wanted to know what unintended consequences might result when we do it.

Dr. Lev, I want to give you a chance and Dr. Dharan and then I've got to move, please.

Dr. Lev.

Mr. LEV. Mr. Chairman, let me say something about rules, you mentioned it. I don't think anybody has in mind getting rid of all the rules. It's just impossible, but the current system that we have now in accounting is really completely crazy. You mentioned the IRS. It's much more complicated than IRS. I brought you an example of the accounting rules in the United States for just one item which is leasing, perhaps even not the most important, there are 452 pages and they also add a CD ROM to it. This is a system run amok. There is no doubt about this. There's no doubt that we can do with much less. The UK is doing with much less rule, more flexible, more general system, financial markets operating well, but let me give you an example. We are speaking in abstract terms. Let me give you just one simple example, but an important one. The whole issue of consolidation.

Chairman TAUZIN. Yes.

Mr. LEV. Which relates to the networking activity of software companies. I mean pharmaceutical companies like Merck, like Pfizer have hundreds of R&D marketing alliances, joint ventures, most of them for very good reasons. Accounting is bogged down with how to consolidate and if to consolidate these things with all kinds of absurd rules like if you have more than 50 percent, then it should be consolidated so they do it with 49.9 percent. If you have control, no one knows what is control. You can have a simple rule which says you have to consolidate everything based on proportion consolidation which means that if you have a share of 10 percent in an alliance and joint venture, you take 10 percent of the asset and the liabilities and the profits of the alliance, period. In

this case and everything will be consolidated in this case. This can be done.

Let me say a word about consulting and then I'm not going to be very popular here. I'm, like my colleagues here, from the point of view of an educator. It's not a secret that it's not very exciting to work for accounting firms.

Chairman TAUZIN. That's right.

Mr. LEV. And it's extremely difficult to get young, talented, capable, venturesome, intellectually curious people to work for accounting firms. We don't want to make accounting firms even less attractive than they are now by putting all kinds of restrictions and other things. Consulting is an opportunity for an accounting firm—and they say it and in many cases they even do it—to tell young people, our graduates, telling them you know you start, you work 2 years in auditing, we'll switch you to consulting work, and switch you back. We have to be sensible here. I think and that's a suggestion that I put in my testimony, if we kept consulting no more than 25 to 30 percent, let's say, the total of consulting fee, no, we can argue about it, maybe 15 to 20 percent, it will—they'll have something. It will not create significant independence problems in this case, but you don't want to really, as I said before, make auditing firms incredibly unattractive. We won't have the quality of work that we need.

Chairman TAUZIN. My time has grossly expired. So let me just move in. We'll get into some more of this as we move along. Let me recognize the ranking minority, Mr. Dingell, for a round.

Mr. DINGELL. This has probably harmed investors more than any other piece of legislation. I take it you're advising the Congress to revisit the law and the assumptions about corporate professional behavior that underlies the Act, is that correct?

Mr. CHANOS. I think that's accurate, Congressman. Just preceding remarks about auditors and the focus here. I would point out in the financial crime that is Enron, the auditors were driving the getaway car, but I don't think they were committing the crime.

I would point your attention to a Business Week article in the summer of 1998 in which they held a conference for Chief Financial Officers and they asked slightly under 200 of these Chief Financial Officers of major corporations anonymously, if they had been ever asked to knowingly misrepresent financial results and if they did so.

Fifty-five percent answered yes, they had been asked to misrepresent financial results, but declined to do so; 12 percent answered yes, and they had done so; and 33 percent said they had not been asked to do so and therefore hadn't done so. Two-thirds of these corporate CFOs had been asked to misrepresent financial results in this survey. Well, by whom are they being asked? It's corporate management. My view on accountants is they're generally very cautious and even when something controversial comes up before a company and the way a transaction can be accounted for, almost every accountant I've ever dealt with will present you with a palette of options and say here is the most conservative, here is the most aggressive. In the most controversial situations that happens and yet it is management teams that generally impose their will in these situations and whether the accountants go

along because of the consulting or not is beyond my area of expertise.

The Safe Harbor Act, I think, has only made these things worse. In my practice of listing the conference calls, I've seen a noticeable uptake since 1996 of companies that were saying everything was fine in response to questions about the current outlook, of things that they might know about and then shortly thereafter news came out from the corporations that turned out for that not to be the case. I think that the Safe Harbor Act did a lot of admirable things, I really do on behalf of frivolous lawsuits and other things. There's got to be some middle ground here that I think could be reached to protect investors.

Mr. DINGELL. Thank you. Now you stated that you invited a number of Wall Street analysts that followed Enron to discuss the warning signs that you and the Wall Street Journal, Texas edition, identified. Who are these analysts and which financial institutions did they represent?

Mr. CHANOS. The sell side analysts represented a number of Wall Street firms, most of the largest ones. These were firms such as Goldman Sachs Solomon Smith Barney, C.S. First Boston, I believe, who represented the main force of these analysts and they were all bullish on the company and generally remained so throughout 2001.

Mr. DINGELL. Now did these investment banks invest in any of Enron's partnerships?

Mr. CHANOS. I'm not an expert on this, Congressman. I think there's been some reports in the press as to whether or not they were investors.

Mr. DINGELL. They are not barred from being investors in Enron's partnerships, are they?

Mr. CHANOS. To my knowledge, no.

Mr. DINGELL. Did any of these investment banks have buy recommendations on Enron stock?

Mr. CHANOS. They all had buy recommendations on Enron stock.

Mr. DINGELL. Even after your presentation?

Mr. CHANOS. Yes.

Mr. DINGELL. What was their reaction to your presentation?

Mr. CHANOS. These analysts were not stupid people. As I mentioned in my testimony, they saw some troubling signs. They saw some of the same troubling signs we saw. It was, with the benefit of hindsight, I mean some of these things look very clear now, but a year ago management had very glib answers for why certain things looked troubling and why one shouldn't be bothered by them. Basically, that's what we heard from the sell side analysts. They sort of shrugged their shoulders. As I mentioned in my testimony, one analyst said look, this is a trust me story. One analyst even went further and said he thought that Enron was hiding reserves that they were understating their earnings which we found a little bit remarkable, but that's what he said. So I think that we take these sell side analysts with a grain of salt from our side of the table. We've seen too many of them just ignore obvious financial discrepancies or problems or funny accounting. They're just hopelessly conflicted because of the fees that their firms get on the

investment banking side and then I think a lot of investment professionals, maybe not retail investors, feel the same way.

Mr. DINGELL. Now in Mr. Longstreth's testimony with which I happen to agree in large part, he says unless and until a real legislative supported SRO is put in place to regulate the accounting profession, little, if any progress toward effective disciplinary systems for accountants practicing before the SEC can be made outside the SEC itself. Starting with you, Mr. Chanos and then going down the table, do you agree with this just—and I apologize to this gentleman, but I have very limited time and I'm not going to be able to ask many questions. Do you agree or disagree with this statement, starting with Mr. Chanos?

Chairman TAUZIN. The gentleman's time is expiring, so if you'd all take a turn at answering.

Mr. DINGELL. Just give a yes or no response, if you please, sir?

Mr. RABER. Yes.

Mr. WEIL. I don't have an expert opinion on that subject.

Mr. LEV. I'm not sure about the statement. Can you rephrase the statement?

Chairman TAUZIN. Will you restate the question?

Mr. DINGELL. Yes, the question, in Mr. Longstreth's testimony with which I happen to agree, it says that unless and until a real legislatively supported SRO is put in place to regulate the accounting profession, little, if any progress toward an effective disciplinary system for accountants, practicing before the SEC can be made outside the SEC itself. Do you agree with that, sir?

Mr. LEV. I don't think we need significant more regulation on accounting, no.

Mr. DINGELL. And I know, Mr. Longstreth, you agree with it. The next gentleman, if you please?

Mr. SOKOL. As an engineer, I'm probably not qualified to comment on it.

Mr. DINGELL. Gentlemen, Mr. Chairman, with your leave, this has been a very fine panel. Gentlemen, you have my congratulations and appreciation. Thank you.

Chairman TAUZIN. Thank you very much, Mr. Dingell. The Chair now recognizes the chairman of our Health Subcommittee from Florida, Mr. Bilirakis.

Mr. BILIRAKIS. Yes, and we're talking about a very unhealthy part of our society here, are we not?

Mr. Raber, very quickly, I commend and respect your support of the corporate director community. You made the comment that they play a leading role in the governance of corporations. I'm not going to ask you a question in that regard, sir, because of time limitations, but I would say it has been pointed out here that due to the fees that have been given, in theory you're right, they should play a leading role. In practice, frankly, it's been my limited experience that they don't because certain people are chosen to be directors. It's an honor to be a director. There's money and other things of that nature involved, and you pretty well go right on down the line. If I have time maybe I'll ask you to respond to that.

But in the meantime let me get to Mr. Chanos. Sir, in the poll to which you referred, of the approximately two thirds of the auditors who indicated that they were requested by CEOs or by man-

agement to come out with false statements or false information, how many of those would you say received substantial nonauditing fees?

Mr. CHANOS. It was not auditors. It was chief financial officers who were asked that question. These were actual members of corporate management.

Mr. BILIRAKIS. But we don't have any similar information regarding auditors?

Mr. CHANOS. Not to my knowledge. This was a Business Week poll, again in 1998, following their summit of CFOs, so they might have that, but I don't.

Mr. BILIRAKIS. It sure would be interesting to know the answer to that question and how many of them actually receive substantial nonauditing fees. I suppose a logical, reasonable person would assume that if you have received substantial nonauditing fees, you're probably going to be more likely to be cooperative. So it would be interesting to know that.

Mr. Dingell already asked the question that I had planned to ask you on the Safe Harbor. I wonder if you could, for the benefit of the committee and for the benefit of the people who are tuning in, take an illustration of how safe market has hurt investors and has hurt employees as is the case here.

Can you give us an illustration? Tell us briefly about the Act. How does it protect these people who do something wrong?

Mr. CHANOS. Well, we have disclaimers that are given by corporate managements before they make presentations publicly or in publicly open conference calls discussing earnings and outlook and the disclaimer basically holds, tells investors that they're about to make forward looking statements and can therefore be shielded under the Act, my interpretation of the Act from any legal liability when making such forward looking statements.

Chairman TAUZIN. Would the gentleman yield a second?

Mr. BILIRAKIS. Yes, of course.

Chairman TAUZIN. I wanted to correct something on the record. Mr. Chanos, you said something like everything is okay, is covered by this, it's Safe Harbor, if the company says everything is okay. That's a current statement, not a forward looking statement not covered by the Safe Harbor, is that correct?

Mr. CHANOS. Well, forward looking statement would be in response to the current outlook. Often managements talk about earnings guidance and they would say we are okay with current earnings guidance.

Chairman TAUZIN. But we were very specific in the legislation, if the gentleman will continue to yield, I will make time for him. The legislation says only that forward looking statements, that is, projections can only be safe harbored if they are forward looking, No. 1, not statements of current condition and second, if they contain statements of all the elements that might make the forward looking projection wrong if those elements are present. Isn't that correct?

Mr. CHANOS. Again, I'm not an attorney, Congressman, but that sounds correct to me.

Chairman TAUZIN. I thank the gentleman for yielding. Please proceed, sir.

Mr. CHANOS. Well, the game that I see being played on Wall Street regarding safeguard, current guidance and forward looking statements often has to do with managements discussing the period that they are in currently. Now that would be an earnings that would be reported in the future for the period they are in and for the fiscal year that they are in, which is also by definition in the future. My problem is is that we have a situation where people who often want to ask questions of management in this area about these forward looking statements and what colors their input to make such forward looking statements are often excluded from these conference calls. They may listen, but they may not ask. And again, I don't think that's in the spirit of the Safe Harbor Act and what people were trying to do to protect investors.

We've also seen a number of cases where managements have reversed themselves rather abruptly following conferences or conference calls to discuss earnings and accounting issues. And again, it's hard for me from my vantage point on Wall Street to believe that they didn't know days before revealing bad news publicly when speaking to Wall Street analysts and investors that they might not have known at that point.

Again, I think a lot of what this Act did was admirable regarding frivolous lawsuits which I'm not fan of. I think there's a middle ground somewhere.

Mr. BILIRAKIS. Well, all of you have made recommendations to us in your written statements. When I conduct our hearings I always ask the witnesses to furnish to us in writing recommendations, the changes that they would suggest to us, and I'm sure Mr. Tauzin is going to do the same thing. I would be very much interested in your recommendations regarding the Safe Harbor Act.

Mr. Raber, just very quickly, forgive me for picking on you. Time won't allow me to go into it, but I would like to see that, in fact, your confidence in the corporate director is something that we can really live with and all have the same confidence in. You might want to furnish us, and I certainly would love to see them, some ideas that you might have and what we can or should do, if, in fact, we should address it legislatively, so that we might have a higher level of confidence. Frankly, I don't have that much confidence. I know I was selected years ago to be a director of a bank, and it was a piddling amount, a couple hundred dollars for meetings or something like that. But I was selected because I was probably going to go along with any of the things that the management wanted to go along with, as well as some of the prestige.

Mr. RABER. Congressman, more and more directors are sitting on fewer boards. It's quickly disappearing where directors are sitting are 8, 9, 10 boards. What's happening is that when a director looks at a particular company where the person is being nominated to sit on that board, the more astute director will say I know it's well beyond the number of board meetings, committee meetings. It's going to be phone calls and e-mails back and forth and you see more and more companies they say well my expectation is 200 hours or 250 hours, so there's a realization, it's a commitment beyond the board meetings and the committee meetings and it's also a sense, "Do I know enough about this industry and this company?" That's key these days. And third is disclosure.

Mr. BILIRAKIS. My time is up, but I still think, with all due respect, that you're talking more theory than you are realism and I wish I were wrong.

Chairman TAUZIN. Thank you, gentlemen. His time is expired. I wanted to point out to Mr. Chanos for the record that Arthur Levitt endorsed legislation on security litigation reform. He supported the Safe Harbor positions as they were written in the bill, as we negotiated with him and others in that language. Now if they can be improved, we'd love to hear from you and others how we might improve them.

Let me make that a general request, by the way, because I threw a question at you that I'm not sure you all had a chance to think about an answer. We will give you specific questions like that, all of you, Dr. Weil, Dr. Dharan, if you might respond in writing, we'd deeply appreciate it as we go forward.

The gentleman from New York, Mr. Engel is recognized for a round of questions.

Mr. ENGEL. Thank you, Mr. Chairman.

Chairman TAUZIN. Am I missing seniority? Is Mr. Sawyer—I think I'm correct, Mr. Engel is next, yes.

Mr. ENGEL. I'll sit and listen to his questions also. Thank you, Mr. Chairman.

Mr. Chanos, you stated in your testimony and I'm going to quote you, "certain aspects of GAAP, particularly accounting for stock options in the United States are basically a fraud themselves." And then you refer to them as "accounting scams" later on your testimony. That's a pretty strong statement and I'd like you to please elaborate on it and why you say that and what Congress can do or should be doing to change the situation.

Mr. CHANOS. Mr. Sokol has as his investor Warren Buffet who said it far better than I ever could about stock option accounting and I'm paraphrasing, but if stock options aren't compensation, what are they? If compensation isn't an expense, what is it? And if expenses shouldn't go into the calculation of profit and loss, what should? And again, I'm paraphrasing from the master, Mr. Buffet, but I agree with that whole heartedly.

Stock options increasingly have skewed the risk/reward for corporate managements in the United States today to basically heads I win, tails, the shareholders lose, so we talk about the rise in agency risk in investing in the United States. It used to be that you were in the same boat with your corporate management. They were shareholders as well, they were stewards of your capital. They served at the board of directors' pleasure. And now it seems as if the agency risk that's risen is how can we enrich ourselves if the opportunity presents itself without harming our earnings per share and therefore our stock price?

Well, one way to do it is innovative compensation schemes using stock options because as you know, stock options are not calculated, the present value of stock options are not calculated as an expense in the profit and loss statement of U.S. corporations. No matter how lavish they are, no matter how enormous the grants might be, they are contained in the footnote to the financial statements as to what their value would be under reasonable assumptions in terms of their valuation and people can look through that

and find out what that number is. We do it automatically to figure out what the real profitability of a company is if they expense their stock options, but it's just simply not run through the P&L statement. We see no reason why they shouldn't be. It's an expense. It is compensation. And corporations are allowed a tax deduction when the options are exercised by their executives. Now it's not revenue neutral because the executives pay tax when they exercise, but from an accounting point of view and I'd be very curious to see what the accounting experts on my left have to say, there is no reason that some attempt to value these options at market prices should not be an expense item when they're granted.

Mr. ENGEL. I see Dr. Weil would like to comment.

Mr. WEIL. Thank you. The fault is your predecessors. The Financial Accounting Standards Board wrestled with this problem in the early 1990's and had a rule that would do just what Mr. Chanos wants. It wasn't the best measurement technique, but it allowed some good measurement techniques and the lobbying was so intense from your constituents that you, your predecessors came to the FASB and said you can't pass that rule.

The Chairman of the SEC at that time told the FASB to back off. He later admitted that was a mistake. This is the time, the first worst in my opinion, interference with accounting standards from Congress. All you have to do is go back to the rule that was about to be passed in 1994 and get it going again. That was a good rule and I don't think there's going to be a single accountant, accounting theorist who is going to disagree with that. We had it and you took it away from us, your predecessors.

Mr. ENGEL. Thank you. Mr. Raber, have you read the Powers Report?

Mr. RABER. I'm sorry?

Mr. ENGEL. The Powers Report?

Mr. RABER. Yes, I read the Powers Report.

Mr. ENGEL. In your opinion, did the Board do its job in overseeing the financial situation of Enron?

Mr. RABER. I think that the Board did not fulfill its oversight obligations completely and I think they should have asked more probing questions.

Mr. ENGEL. In the report it states that the Board approved, the Enron board approved Mr. Fastow's waiver from the corporate code of conduct and allowed him to serve as a general partner in partnerships that participated in significant financial transactions with Enron. Is it common for a board to allow an officer of a company to be the manager of another?

Mr. RABER. This to me, is unconscionable for that to happen and that gets back to disclosure and some of the conflict of interest that I talked about in my testimony and I'm sure people here would have other comments as well.

Mr. ENGEL. Mr. Longstreth, as I mentioned in my opening statement, Andersen does not believe that it violated the AICPA's code of professional standards, but instead they say they committed a gross error. Do you agree with this?

Mr. LONGSTRETH. Well, I don't think I know what standard they think they did not violate, so I really can't answer that question. They've admitted to a gross error.

Mr. ENGEL. Do you think that AICPA is monitoring, policing its members properly, or do you think they failed in that regard?

Mr. LONGSTRETH. No, I said in my testimony, they are a trade association and a lobbying vehicle for the profession and to put, to charge them with writing and enforcing standards of professional conduct is really expecting too much of an organization that is chiefly designed to advance the bottom line of the industry.

Mr. ENGEL. Well, then should the government play a greater role in overseeing the industry?

Mr. LONGSTRETH. What is needed is an adequately empowered self-regulatory body in my judgment. You should understand that the SEC has powers to discipline the accountants, but it's never been a high priority for the SEC, so I think one needs something comparable to the NASD. The reason the NASD works, it hasn't worked perfectly over the years, but it's working better recently, the reason it works is it has subpoena power, it has disciplinary power. It has rulemaking power and it has the power to tell every one in the industry when something happens, turn over your documents, all your documents, come, appear, testify. You have no fifth amendment rights and if you don't, you're out of the industry. We bar you forever. That power is essential for an SRO to function effectively.

Chairman TAUZIN. The gentleman's time has expired and the Chair recognizes the gentleman from Texas, Mr. Barton.

Mr. BARTON. I thank the chairman. Just to let the record show, my graduate degree is in management from Purdue in the 1970's, but I have a son who has got a graduate degree in business from Stanford in the 1990's, so about 1½ or 1 year ago, I kept reading all these stories that Enron had found a new way to make money and it was the new way and I couldn't understand it, but I asked my son to evaluate it because he was working for a company that did venture capital analysis for a group in Texas and he routinely had to review deals and he came back to me after about a week and said don't touch it. I said what do you mean don't touch it? Everybody on Wall Street is for it. He said they don't have any assets. I don't understand what they're doing, but sooner or later they're going to head south and they're going to head south in a big way. So my degree was 20 years old and I couldn't understand it, but my son's degree is a little more recent and I was going to put some money into Enron and my son told me not to. Eventually, I did, anyway. As it headed south, I figured it can't go any lower and of course, every time I bought it, it immediately went lower, so anyway, that's that.

I lost everything, but fortunately for me everything for me is not a lot so that's a good deal.

I want to try to put this in some sort of perspective because never has a more important subject been presented in a more boring fashion and we really need to kind of understand this. So I'm going to use the analogy of me as an entity and the old economy and the new economy. The old economy, I'm Congressman Barton and I have an annual salary after taxes of about $100,000 a year and I get that about $8,000 a month and out of that I pay my household expenses and I try to save some money and I have some assets, a savings account and a stock—some thrift savings that we

can join in. But I know every month how much money is coming in and I know every month how much money is going out. Now most of the money that's going out is to my kids. I have a son who is now running for Congress, fortunately, I'm limited to a $1,000 that I can give him, so I've got a limit on that, a mandatory, Federal limit. I have a daughter to who is about to be married. There is no limit on that.

And I have another daughter who is in college and in a sorority who wants to study overseas next year and there's no limit to that. Okay? So that's my outgo.

So in the old economy I know how much money is coming in and I know how much money is going out and where it's going and I have to balance the books at least once a month, unless I go to my banker in which case I can balance once a year, but I'm tired of that. So I decide to develop TexasCon.com and I like these new accounting rules that generally accepted, which means if you can get away with it, do it. So I decide to go to somebody and create a special entity, an SPE and I look around and I see that former Congressman Livingston is making lots of money and former Congressman Brewster and McCurdy and a lot of our colleagues are making a lot of money. So I go out and say if you'll put up 3 percent net equity and where that number comes from I don't know, but we can go and say 5 years from now I'm going to be making $1 million a year. So if you'll put up 3 percent of that which is what, $150,000, I guess, then I can create a special purpose entity and I can book that as revenue right now and then my children's outgo, I want to limit liability so I create an SPE for each of them, you know, and so I can take those liabilities off my balance sheet and all of a sudden stodgy old Congressman Barton who has got an income of about $8,000 a month, an outgo of about $8,500 a month, all of a sudden I've got this mark-to-market of this revenue stream in my special purpose entity of $5 million and I can book right now, even though I haven't got it, and I can take that to the bank and borrow money and I don't have any problems, as long as nobody calls me on it. And as long as I can sell my stock on the market and make my accounting and my annual report so confusing that nobody understands it.

Chairman TAUZIN. Will the gentleman yield before you ask the question Mr. BARTON. Yes, I'm going to ask a question. I've set it up now. I'm about to ask the question.

Chairman TAUZIN. Go ahead and ask it.

Mr. BARTON. My question of you guys is which is better, the old way where I'm stodgy and everybody understands it, or the new way where I'm very unstodgy and I'm very hip and it's all a mirage?

Mr. Sokol, you're a straight shooter, which way do you prefer?

Mr. SOKOL. The old way.

Mr. BARTON. The old way. Mr. Longstreth?

Mr. LONGSTRETH. Yes, I'm convinced by your rhetoric.

Mr. BARTON. Okay, how about Mr. Lev?

Mr. LONGSTRETH. I like the old way.

Mr. BARTON. Does anybody like the new way?

Mr. LEV. I like the new way.

Mr. BARTON. Which way? Mr. Lev likes the new way. Why do you like the new way?

Mr. LEV. Let me first say that you really put some life into the discussion of accounting and——

Mr. BARTON. It's hard to do, but——

Mr. LEV. I commend you for this. I commend you for this, but there is a new economy and the new economy is a place in which there are many assets which are not old assets. If you ask yourself what are the assets of Merck or Pfizer, these are not old assets, these are not buildings or lab equipment. It's patents and minds of people.

Mr. BARTON. Well, there's always been minds of people, there's always been ideas. Now Dr. Weil, he said that his students understood what a revenue is. I think I understand what a revenue is. It's something that comes in, somebody pays me money.

Mr. WEIL. I think you're confused. You think you know what a receipt is and you have no idea what a revenue is, but a revenue isn't necessarily a receipt.

Baruch here, Professor Lev, is getting to the right thing. Your old economy is easy to account for because it's cash-flow, it's cash in, cash out. There are enormous numbers of assets like the patents of the drug companies where you spend the money today, but you don't know for a year, or two or three, whether there's going to be cash inflow and between now you spend the money and later you might get it. We've got uncertainty.

Mr. BARTON. Well, I'll go with you, if you have a patent you have a certain monopoly or a royalty right because of that patent, but you don't necessarily have a revenue because you have the patent, isn't that correct?

Mr. LEV. You can always license a patent.

Mr. BARTON. But somebody has to buy it. Somebody has to pay you money.

Mr. LEV. Yes, in the future.

Mr. BARTON. I have three real questions here, everybody else has had 10 minutes. Now you're not going to hold me——

Chairman TAUZIN. You made 3 percent of $1 million at $150,000, I think that was pretty innovative. So I'll give you a couple of minutes.

Mr. BARTON. Here are my questions, the first one is to Dr. Dharan who gave quite a bit of testimony about mark-to-market. What if we just prohibit mark-to-market?

Mr. DHARAN. I don't think that's a good idea at all. Again——

Mr. BARTON. Okay, you just say no.

Mr. DHARAN. I say no.

Mr. BARTON. What about instead of having an independent audit committee like one of the gentlemen said, what if we just eliminate the whole idea of an independent audit committee but say it has to be internal and you're liable for it?

The companies have to do the audits, but they're liable for the audits instead of going through this outside independent audit firm who's really not liable and it's based on generally accepted accounting principles which have been stretched like rubber bands for the last 20 years, why not just say you've got do a real audit internally and you are liable for it. What's wrong with that idea?

Mr. RABER. You have to have, at least from our perspective, you should have an independent external auditor that has no problems with some of the independence issues that—you're looking at it objectively. You're bringing in the best people insofar as skills and experience and that independent judgment, independent from management, independent from the internal auditor, that person needs to take a look and make an objective assessment insofar as the audit.

Mr. LONGSTRETH. The laws we have today would make the company liable if they put out false statements, so we've got that. I think the point is we've felt it necessary to have an independent verifying process.

Mr. BARTON. But you're really not independent because some of these companies are so big you can't say no to them.

Chairman TAUZIN. The gentleman's time has expired.

Mr. BARTON. The auditor of Enron could not say no to Enron.

Chairman TAUZIN. All right, Joe, got to move on. The Chair recognizes the gentleman from Ohio, Mr. Sawyer, for questions.

Mr. SAWYER. Thank you very much, Mr. Chairman. I've got a couple questions of corporate governance I'd like to pose. In the Enron case, we had both an independent board and a common law fiduciary duty imposed on that board. Do we need to have a statutory fiduciary responsibility on investment retirement plan administrators, similar to that which we have in ERISA?

Mr. RABER. That's part of the responsibility of the audit committee is do what needs to be done to make sure the pension plans are being dealt with appropriately, so you—that's part of the risk audit of an audit committee, so I don't know if that answers your question, but that's part of the due diligence you do there is similar to what you do in other areas of risk in the company.

Mr. SAWYER. In Federal pension plans, fiduciaries have a responsibility, I quote "to diversify the investments of the plan so as to minimize the risk of large losses." Do we need a similar kind of standard for 401(k) administrators?

Mr. RABER. I'd rather look to some of the accountants here that may be able to give a judgment on that insofar as that is concerned.

Mr. SAWYER. Anybody?

Mr. WEIL. Well, here we go. Your predecessor did that one to us too, back in the 1970's when you started with employee stock ownership plans, employee stock ownership trusts, you sort of forced the investments in your own company's stock. We need diversification. You don't want to put all your eggs in one basket. It's been a well-understood principle of financial economists for decades and anything you can do to help the shareholder diversify retirement funds is a good idea. I'm not sure what the details needs to be, but the nondiversification started with your predecessor's rules. Let's fix them.

Mr. SAWYER. Mr. Sokol, I was really interested in the last page of your written testimony where you talked at some length about a topic that is—I bored my colleagues to death with over the last several years and that's the problems of capital formation around truly modern regionally built markets supported by a modern transmission system. And you talk about PUHCA and how it can't

be fixed by tinkering around the edges, that it's 50 years out of date. I have some appreciation for that. However, you don't talk in your testimony about elements from PUHCA that need to be retained or transposed into other settings in order to continue to preserve the protections that they provide. Could you elaborate on that for me.

Mr. SOKOL. Yes, it's a very good point, Congressman. PUHCA was established in 1935, known as the 1935 Act to deal with two sets of issues, a set of issues that are gone that the SEC has said since the 1950's are gone and then a set of issues that continue today which are consumer protections which I think that's what you're speaking to. We strongly endorse and I think the industry strongly endorse, although Enron opposed that. When PUHCA is reformed, similar to Senate Bill 1766 currently in front of the Senate, that the books and records for State regulators, Federal regulators have to be enhanced for all not only monopoly utilities, wires or pipes, but any affiliates of those, so that any affiliate abuses or other transactions can be properly monitored. We strongly agree with that because really—and Enron is a good example of this. The consumers, a problem with General Electric, which was owned by Enron, an intrastate-exempt utility holding company, were protected by the State of Oregon, the Public Utility Commission of the State of Oregon and they did an excellent job, as almost every State today does. It fences a utility within its State so that other corporate activities cannot affect that activity. And that's the situation. The reality is there's well in excess of 5,000 State regulators, professional regulators in the United States. There's 22 employees of the SEC that oversee PUHCA. And so we really strongly endorse both the consumer protections and enhanced protections be moved both to the FERC and to the State regulatory bodies.

Mr. SAWYER. Thank you very much.

Chairman TAUZIN. Does the gentleman yield back the balance of this time? The Chair recognizes Mr. Stearns of Florida.

Mr. STEARNS. Thank you, Mr. Chairman. One of the purposes of this hearing is not just to go into some of the details as my good colleague from Texas talked about so that it just gets so boring that no one can follow it, but we're trying, as Members of Congress, to give confidence to the investor so that the investor has full disclosure and can understand what he or she is purchasing. And so the whole purpose is somehow to come out of this Enron not necessarily with huge reregulation, but to come out with some kind of platform in which we can say to America, these Enrons won't continue. One of the gentleman here has mentioned that the special purpose entities has been going on for at least 5 years and I suspect other corporations are using this and I suspect there will be a lot of people including the people at the table here that would argue that it's acceptable to use that if it's done in a proper way and we don't have a conflict of interest. But I would like to get at the heart of the problem which is the American people are saying, "What confidence will I have that when I go to invest in any corporation today, there's not similar type of chicanery or hiding smoke and mirrors of the debt and the revenue is inflated?"

Now Dr. Weil, you're teaching MBAs at the University of Chicago, Graduate School of Business. I could simply say to you when

you have a graduate from your MBA school, shouldn't he or she be able to discern that Enron's books were bad? And I think I would just ask you just plainly and I probably also should ask this to Mr. Dharan at the Graduate School of Management at Rice University. I mean these MBA graduates should be able to understand this. Could they today pick up the Enron P&L statement and understand it? Just give me a brief answer, the two of you.

Mr. WEIL. My co-author Clyde Stickney who is a Professor at Dartmouth College, we've written a book for 30 years on this, spent over a week dealing with the Enron financial statements to write a case that he can use to teach the students. Mr. Stickney is a pro and it's taken 40 man hours to get to the bottom of things and he's not 100 percent to the bottom because there's not full disclosure, but an MBA graduate is not going to be able to do it.

Mr. STEARNS. So the Tucker School of Management, Dartmouth, one of the premiere guys could not understand it after weeks, okay?

Mr. DHARAN. Congressman, I agree with it totally and I think the problem has to do with the way Enron reported the numbers, not it's accounting itself. It was very misleading.

Mr. STEARNS. Okay, so your MBA graduates couldn't understand it either. Okay, so then the average person couldn't understand it. So this goes to the main question of this hearing, could FASB, the Financial Accounting Standards Board, could they by themselves provide enough rules to clean this up and put it in place without Congress doing anything?

Mr. WEIL. I believe, yes, they could.

Mr. STEARNS. Yes, they could.

Mr. WEIL. Here is the rule that they proposed in 1999 that was essentially all but passed, that would have solved the problem and it was put aside for various——

Mr. STEARNS. Is that the majority of the consensus? Let me just go down the line, if you would, from left to right. Could FASB on itself clean up this through accounting rules without Congress. Just yes or no.

Mr. CHANOS. Yes.

Mr. RABER. Not sure.

Mr. STEARNS. Dr. Weil, you say yes?

Mr. WEIL. Yes.

Mr. DHARAN. I would say no, but if I could take a second to explain why.

Mr. STEARNS. I just want a no or yes. The chairman is going to be ruthless with me here. Yes or no?

Chairman TAUZIN. I'm not going to be ruthless with my fellow Texan.

I'll give him all the time he wants.

Mr. STEARNS. Is that a yes then?

Mr. DHARAN. If I want to say no, I need to have a minute or 2 to explain why.

Mr. STEARNS. Okay, I have a follow-up question, so let me just go down to the rest of the fellows, yes? Yes or no.

Mr. LONGSTRETH. No.

Mr. SOKOL. No.

Mr. STEARNS. Okay, this comes down to the next great concern we have is that the Chairman of the Securities and Exchange Commission has come out and has indicated that we're going to have to go ahead and have an accounting industry oversight board and I think Mr. Dingell mentioned on this that he asked you this question already, but I judge from what you say is we cannot expect FASB to do this by themselves. There's some mixed reaction here. So what is the American public supposed to do with the Financial Accounting Standards Board cannot come up with a solution and provide enough disclosure and your MBA, as it presently exist, cannot even understand those reports and the man at Dartmouth spent weeks and he couldn't understand it. So what are we supposed to do? And I just would close, Mr. Chairman, by just asking them again to answer this question that Mr. Pitt from the Securities and Exchange Commission said, should there be a congressionally mandated self-regulatory organization, an SRO like the National Association of Security Dealers for accountants to give government direct oversight of the accounting industry and just yes or no?

Mr. CHANOS. No.

Mr. RABER. There should be an oversight and it should be strengthened. I'm not so sure what it should be though, whether it should be the regulator or some sort of a public oversight board.

Mr. STEARNS. Dr. Weil?

Mr. WEIL. I think there's a better way, but I don't have time to tell you about it now.

Mr. STEARNS. Okay.

Mr. DHARAN. I think there should be an oversight board. Again, I'm not very sure about the specifics of SRO that was proposed.

Mr. LEV. We are really mixing two things here and we are making disservice to the subject by having to answer yes or no.

Mr. STEARNS. In all deference to you, in my job I have to simplify things day in and day out. I do 800 to 900 votes a day. I could sit and talk about each vote for 3 hours.

Mr. LEV. I respect it, but you started speaking of accounting rulemaking, the FASB, and then you switch to the SEC chair who spoke about oversight of the auditing profession.

Mr. STEARNS. Right.

Mr. LEV. These are two entirely different things.

Mr. STEARNS. Okay, I'll take your word for it, yes, okay, and your answer should there be this congressionally mandated self-regulatory organization over the accounting industry?

Mr. LEV. Yes.

Mr. STEARNS. And last?

Mr. SOKOL. I think it misses the bulk of the point.

Mr. STEARNS. Okay. Mr. Chairman, I think that if any one of the members would like to send a letter to outline more specifically how they feel about it, we'd be more than happy to, but I only have 5 minutes and as I say I have to scintillate all this down, so at least the American public can have a better appreciation for what we're talking about.

Thank you, Mr. Chairman, for your indulgence.

Chairman TAUZIN. Thank you. It is a serious subject. I would, before we go to Mr. Greenwood, like to Dr. Dharan and Mr. Lev, it

is a serious subject, all joking aside, if you want to elaborate a little on Mr. Stearns. He didn't use as much time as the other members.

Mr. STEARNS. Mr. Chairman, if I still have time, I would certainly offer them——

Chairman TAUZIN. I'll give them a time to elaborate. We need a full hearing record and this is an important subject.

Mr. DHARAN. Thank you, Congressman. I think the question was, "Could the FASB in and of itself clean up the reporting and disclosure rules?" and the answer is no, because the FASB, as was pointed out, only sets the accounting rules. It does not enforce them. And we really need a combination of both good accounting rules and good enforcement. The reliability of accounting numbers comes from the enforcement system, not from the accounting rules themselves, so that's why it really is important to have a support function that really does the best job of enforcement. That's really why FASB by itself cannot do this.

Mr. STEARNS. So enforcement is the key in your mind?

Mr. DHARAN. Enforcement is the key, along with good rules. Enforcement cannot make up for bad rules. And good rules cannot make up for lack of enforcement.

Mr. STEARNS. And FASB couldn't provide the enforcement?

Mr. DHARAN. FASB has absolutely no power of any kind to do enforcement. It's just a private group. It sets accounting standards, but it does not enforce them.

Mr. STEARNS. Okay. Mr. Lev, you are certainly welcome.

Mr. LEV. Let me just say about the FASB, the rulemaking body for accounting. A group of good people basically moving in the right direction, but too slow, too timid, they are now working about 10 years on consolidation and still we don't have really good rules in this case. In my opinion they need, maybe not new regulations, they need some kind of a push or a shove by the SEC or someone to get the act together. Regarding the oversight of the auditing profession, I don't think we need any oversight in this case. I think that if we get—we in competition, in the auditing industry, along the line that I mentioned before, that auditors will be chosen by shareholders for a 5-year period, then you don't need any oversight. They'll act and if they don't act, they'll be kicked out like any other service providers. We don't need another regulatory body.

Mr. STEARNS. How do you get enforcement then?

Mr. LEV. On what?

Mr. STEARNS. When you said they need a push or a shove, is that an enforcement mechanism or is that just a house resolution from Congress?

Mr. LEV. I'm not even sure if—I'm not a lawyer, I'm not sure if a resolution is needed, but the little I know about laws, the SEC, according to the 1933 and 1934 laws was in charge and still is in charge of setting accounting standards. They delegated it to the FASB and from time to time they have to provide an oversight whether the job is done well, in the right pace, the right direction, the right speed and I think they should do it.

Mr. STEARNS. Thank you, Mr. Chairman.

Chairman TAUZIN. Thank you. The gentleman from Pennsylvania, Mr. Greenwood, is recognized for 5 minutes.

Mr. GREENWOOD. Thank you, Mr. Chairman, and thanks to all of the panel members for a very long day.

I'd like to address a question to those who have the expertise in accounting and I want to think about board members and particularly the board members who are on the audit committee. Now I haven't—I was just talking to the staff to try to get a sense of the magnitude of the compensation that the board members at Enron were getting. My understanding was it was pretty nice. I've heard numbers of $400,000, in this vicinity. When you look at the cash that they're given, you look at the stock they're given, you look at the stock options that they're given and then they fly them around first class and put them in fancy hotels and all this stuff, and it's been my experience and I don't know a whole lot about this, but it's been my experience that board members are not necessarily chosen by companies because of their great expertise in the business that the company is engaged in. They're picked because they've got some political juice or they've got some stature or wisdom, but they don't necessarily know about all of the intricacies of the business that the company is in.

Now when you're getting this kind of compensation and you know that you serve fundamentally, I think one of you said earlier at the behest of the CEO, you very likely don't want to rock any boats because you can go. You can go pretty easily.

One question I have is should giving the board members stock and stock options, is that a good idea because it's a way of saying so the governance that you provide to this corporation will affect the value of your stock and so this is an inducement for you to really care about the value of the stock, or does it, in fact, create a conflict, certainly if I were on the board of directors of Enron and I had a lot of stock in Enron or stock options in Enron and I knew that my being deadly honest about the audit, that that might cause the stock to drop, I might be in the same, put me in the same boat as some of the management team that had stock and didn't want to see its value drop. What do you think about that specific question? Should board members—is it a good idea for board members to be compensated with stock and stock options?

Mr. RABER. If I could comment on that since we track it with public companies and we firmly believe and recommend that 40, 50, 60 percent of your compensation should be in equity, the rest in cash. They are looking at that you're paid in equity, you get the chance to feel the pain or the gain that the shareholders feel. We want to pay you in cash to a certain extent, so you take the long run, the long look at things, rather than maybe the incentive would be if we were paid entirely in stock, we have more of a short term perspective. These are safeguards. But the practice is between 40 to 60 percent is in stock if you look at all public institutions, with the larger institutions similarly paying more in stock. Now we're also encouraging, again this is part of a principal of good corporate governance that when you come on the board it's a good idea to purchase outright stock and some companies do that. I know when I first got on my board back in 1980, I had to make a purchase of X amount of stock and again there, if the governance principle is you represent the shareholders, you should feel the pain that the shareholders feel.

I also find, because we do a lot of education of directors, this area is the area we spend the most time is on audit committees and what I wanted to say before, getting behind the numbers. There's no doubt you're seeing a lot more focus on audit committee quality and independence by audit committees. You're also seeing a lot more focus on enhancing their financial competencies. So we're seeing a lot more focus on tackling those issues, realizing longer days, longer hours——

Mr. GREENWOOD. What about the observation that had the audit committee at Enron forced the issue and pushed these off-book numbers back on book that the stock might have dropped as a result of that.

Mr. RABER. I've got to tell you that the impact of Enron, among other things, is to look at those off balance sheet transactions, not that they haven't been in the past, again, a lot of the people that belong to my organization are more enlightened and more engaged in good governance practices, but there's no doubt the implication of off balance sheet transactions is going to take a heightened interest among audit committees.

Chairman TAUZIN. Would the gentleman yield?

Mr. GREENWOOD. The gentleman will yield.

Chairman TAUZIN. I'd just like an explanation of the public good of allowing off budget entities in this new market economy. Why allow that if it hides the real value of the company?

Mr. RABER. I agree with you. To get back to your question before about the old and the new and if you can't understand it and say you're an MBA, you have a certain amount of financial sophistication and you have a finance background and you're sitting on a board or an audit committee and you can't understand it, that means you can't govern it and something has to change.

Chairman TAUZIN. Well, Enron was pretty up front to the analytical community that the purpose of these SPEs was to provide a hedge against volatility both on the upside of the asset and the downside—they were pretty up front that that's why they were creating the entity. So that wasn't a secret and that wasn't buried in a footnote. Now how they funded them and the equity they put in was confusing, but the purpose was to protect the parent company balance sheet which would seem to me to be contrary to general accepted accounting principles that you want transparency and understandability.

Is the gentleman through with his questions?

Mr. GREENWOOD. I'm through questioning, but I would like anyone who wanted to respond to my question to respond.

Mr. LONGSTRETH. I'd like to respond to the, if I could respond to the question you put, Congressman Greenwood, about options for directors.

I think that they're not a particularly good idea. I think the idea of having directors paid in whole or in significant part as my colleague here has suggested ought to be done is a very good idea because it aligns the director with the shareholder and he pays for it in effect through the director's fee. But options is it's a heads I win proposition. And in England, options for directors are prohibited.

Mr. WEIL. There's a tradeoff here where economists, if you own an ownership interest, you go down with the ship. You have interest in going forward and the company doing well. If you have too much of your wealth in it, you're going to be tempted to hide bad news to protect your own wealth. There is some place in there where you want to draw a line, but it's probably not at zero. Whether the compensation should be in options and shares, we can equilibrate that and make them equivalent. That's not an important distinction in my mind, but it is a good idea for the director to care about the health of the company. It is not a good idea for the director's entire wealth to be at stake on the good of the company. It's a tradeoff. It's a most simple answer.

Mr. DHARAN. I just have a small comment to add. We have the concept of independent directors and we always think of that concept in terms of whether the director is part of management or is the director coming from outside the company. I think we should also start thinking in terms of the independence of the director with respect to the stocks that he or she holds in the company, so the director that's holding a huge amount of stock that is a percentage of his or her wealth very significant, then at that point to call the director independent is really very difficult to convince in terms of the downside risk he or she faces in exposing problems. So I think your point is excellent. I think we really should think about what portion of the wealth should be held in the director's portfolio of the company.

Chairman TAUZIN. The gentleman from Iowa is recognized. We're going by seniority, just to let Mr. Shadegg know. Mr. Ganske has got seniority on Mr. Shadegg. I was told to do that.

Mr. GANSKE. Thank you, Mr. Chairman. I think the—I've enjoyed the panel a lot and there are a lot of strong personalities on this panel. I think it gives lie to the old saying that you become an accountant if you lack the charisma of an undertaker. But then maybe we have some accountant teachers here on this Board as well.

You know, I'm thinking about a gentleman who lives on the western edge of my District. His name is Warren Buffet, just across the river from Council Bluffs and for a long time while that high tech economy was rolling along, Mr. Buffet was kind of viewed as being a stodgy guy because he said you know, I just can't figure out how to evaluate those companies and what a true evaluation. And we've talked a lot today about some of the problems with accounting in terms of determining what the actual worth is of some of those intellectual property ideas that maybe yeah, aren't realizing any gains.

I don't know that we'll get into that in terms of Congress looking at the rules. There very well may be criminal prosecutions that arise out of this. The Justice Department is looking at this. I share the feelings of some of the members on this committee who have expressed frustration, for instance, that the person who robs a convenience store gets put in jail and isn't given the option of staying out of jail if he returns half of what he stole. And I appreciate Mr. Sokol's comments on this issue. We really, the Nation's attention will be spotlighted on this, on the Justice Department probe.

We're sort of looking at what can we do right now to try to shore up investor confidence because just looking at all sorts of things that are going on Wall Street in terms of Global Crossings, Tyco, bankruptcies, all up and down, and people worrying whether, you know, their investments in particular stocks haven't been reported accurately and that there's all sorts of offshore entities going on. I think Congress does need to do something like that. Several years ago I was sympathetic to Arthur Levitt's proposal to somehow or other deal with the potential, at least the potential conflict of interest between entities that are doing the accounting and those that are getting high fees for consultation. I guess I'm reading that the Big Five now, if they haven't already, they're spinning off their consulting services.

You know, when I ran my medical practice, I was running a small business and I had a professional manager that helped me. He was an accountant, kept my books, also did my tax prep. You know, but that's a whole lot different entity. I wasn't a publicly traded company. People weren't investing in my business. And I do think that we need to go back, look at the FASB rules. We need to go back and look at possibly strengthening and going back to Mr. Levitt's original proposition. I am not so worried about accounting firms being able to or businesses being able to get the type of consultation because you know, look, you hire one firm to do your accounting and you get another firm to do your, of some type to do your consultation. The specter was that maybe they would be at odds with each other. Maybe they would badmouth the other. I think you could also wonder whether they would be in collusion with each other, since there may not be that many large entities. I think the competition would be helpful and would help restore some confidence in these companies that we're dealing with.

I guess I don't have any particular questions right now, except I do want to thank you for the indulgence, patience that you've shown when all of us up here in Congress, up here on the bench had our long statements. It's been a long day for you. I look forward to going over in more detail the suggestions that you submitted in your writings. Thank you very much.

Chairman TAUZIN. We're going by order of seniority which would give Mr. Deutsch the opportunity before Mr. Stupak, although Mr. Stupak appeared before Mr. Deutsch. So Mr. Stupak will be recognized.

Mr. STUPAK. Well, thank you, Mr. Chairman, and thank you, Mr. Deutsch.

Mr. Chanos, I did have a chance to read the article in Barron's there and on the last page of that article that was on our desk here it said that your correct prediction of Enron's demise, it is reported that you suspected more will be discovered. Specifically, the article says that you suspected other Enron partnerships were used and I'm going to quote now "to boost Enron profits by acting as a dumping ground for losing trades, bad long-term investments and busted Enron investment banking deals." The article also says that you think "once Enron's long-term energy trades are properly marked to the market, other profits will simply melt away."

Can you give us just a little bit more of what's the basis for your concluding this in this article?

Mr. CHANOS. Well, again nothing other than a pattern that we saw which leads us to believe that if Enron was going to great lengths to basically hide losses in its merchant banking and other areas through the use of SPEs, it seemed to—and I read the report that the company put out, just a simple violation of accounting rules, well, why wouldn't they also gain in the great, gray morass of the mark-to-market or gain on sale area that we discussed a little earlier, be perhaps a little bit too aggressive.

One note I point to there is in the now infamous or famous Watkins memorandum that came out. She referred the use of partnerships to—and again, I'm going from memory here, but to act as a repository for EESMTM positions was, I believe, the line she used and we took that to mean Enron Energy Services mark-to-market positions. So that's one internal person who seems to also believe that may indeed have happened.

Mr. STUPAK. Well, let me ask you this, I mentioned the 1995 so-called Security Reform Litigation Act, one that I strongly disagree with and when you talk about safe harbors for forward-looking statements that Congress enacted as part of that so-called reform in 1995, in what ways does that provision prevent investors such as yourself from really obtaining accurate information about a company's current and future prospects, how are corporate insiders using this provision to avoid meeting their duty of public disclosure responsibilities?

Mr. CHANOS. How does this prevent us from getting information?

Mr. STUPAK. Right.

Mr. CHANOS. I don't know how it prevents us from getting information, Congressman. I think the problem I have with it is on the back end of it. What happens when the system fails and when you're providing some sort of umbrella against litigation for the watchdogs for these kinds of things and for managements that knowingly try to deceive their shareholders. That's the problem I have with it. I'm going to still be able to do my job. We're going to go through the footnotes and we're going to ask questions and we're going to do everything we possibly can on behalf of our investors which I have fiduciary responsibility to, but my concern is more to other investors who don't have the resources we do or the experience we do and have been wronged where there's this asymmetric risk/reward for corporate managements as we've talked about. If I give back half, will you let me go free? I just don't think at the end of the day that's fair.

Mr. STUPAK. With these forward-looking statements, the 1995 reform, sort of use your words, "provides an umbrella of protection" and in fact, I think 1995 reform goes so far as saying even misleading statements in a forward looking statement is not actionable after 1995. Is that correct?

Mr. CHANOS. That's my understanding.

Mr. STUPAK. I know of others and I've prepared some legislation that would restore the joint and severable liability for accountants that also provide consulting services to the same clients and eliminate the current Catch-22 situation which plaintiffs can't get discovery against the accountants needed to pursue claims against them and restore liability for aiding and abetting securities fraud.

Would you support these types of reform or restoration of the action that we had before this 1995 reform went in?

Mr. CHANOS. I'd like to see some middle ground. I would not like to see wholesale abolishment of that act because I do think it accomplished some very good things on one end about frivolous lawsuits that are filed and were filed prior to the act.

I don't want to comment on the specifics of the joint and severable question because I'm not an expert there. I just think that to fall back to what I've said, there's got to be a middle ground here to protect corporations and protect the managements from making honest statements about what they know about and not be sued and not be found liable and yet punish those that use this as a way to defraud investors of the marketplace. It's got to be better than all or nothing.

Mr. STUPAK. When this whole thing shakes out, this whole Enron, whether Enron aided and abetted Arthur Andersen or Arthur Andersen aided and abetted Enron, under the 1995 reform, again, that umbrella gives them protection that they did not have before which help leads to this cavalier attitude that we see at least in Enron and hopefully not in other corporations, but possibly in other corporations too, according to your article in Barron's. Is that a true statement?

Mr. CHANOS. I think it's an accurate interpretation. I would agree with it.

Mr. STUPAK. Professor Dharan, some of the infamous Enron partnerships apparently ran afoul of accounting standards which used a so-called special purpose entities, the SPEs, to have at least 3 percent outside equity. Now to me, that doesn't make a lot of sense to have a 3 percent equity. That was not what it was set up for. Before in accounting standards you always had to have at least 50 percent before it triggered an accounting standard. Would you be in favor of repealing this 3 percent rule?

Mr. DHARAN. Yes, I would be. The 3 percent rule as I indicate in my written testimony really came about in a very ad hoc accidental way. There was not really a whole lot of discussion. It came about not even in the primary rulemaking group, the FASB, but one of its emerging issues task force group. I think in hindsight, it was pushed by the industry group that benefited most from it, rather than any kind of a good accounting analysis, so I would certainly support repealing that.

Chairman TAUZIN. Would the gentleman yield on that?

Mr. STUPAK. Yes, I would, Mr. Chairman.

Chairman TAUZIN. What industry groups benefited from such a low equity requirement?

Mr. DHARAN. I think definitely the companies that were sponsoring them needed to have a very low threshold. They don't have to report those partnerships and the industry groups that would have supported them would be the liars in the accounting firms that are supporting the companies to form those special——

Chairman TAUZIN. So would you agree that the people that pushed the rule were people that just wanted to have a leverage transaction and not necessarily really have a true partnership?

Mr. DHARAN. I think so. I mean definitely that's my judgment, looking at the history of the 3 percent rule.

Mr. STUPAK. This 3 percent rule, just so the record is clear was really developed by the Financial Accounting Standards Board, is that correct? And that gives advice to the SEC. It wasn't something Congress created.

Mr. DHARAN. That's correct. It was created by a group of the FASB called the Emerging Issues Task Force.

Mr. STUPAK. When you do a statement, a corporate statement profit/loss, is it your impression all profit/all loss which can be attributable to a company should be listed, even if there's these partnerships? How would you list it?

Mr. DHARAN. I think the answer if I control the partnership, I should also report the gains and losses from the partnership, but also we need to look at the collectability, and what's the quality of these numbers? Do we have any confidence that we are going to get the gains or are these gains completely self-estimating numbers that cannot be verified? If the gains are fairly reliable and there's a high degree of probability that I can get the money, then it makes sense for the company to report those gains. Currently, we don't have that system in place.

Mr. STUPAK. And in this case, these SPEs, because Enron pledged its stock to secure the loans and everything else, they had basically control of these and they should have put their profits/loss there for——

Mr. DHARAN. I think so.

Mr. STUPAK. I guess it goes back to what Mr. Raber says. I guess it's independence information and integrity and until we get that, we're going to continue to have problems like Enron.

Chairman TAUZIN. The gentleman's time has expired. I thank the gentleman and the Chair recognizes the gentleman from Arizona, Mr. Shadegg for a round of questions.

Mr. SHADEGG. Thank you, Mr. Chairman. Gentlemen, let me start by saying I've spent now 3 days in Enron hearings. I began Tuesday afternoon, where we heard testimony from the head of SEC and we also heard Dean Powers' Report. I then spent hours yesterday with the head of Arthur Andersen and I want to tell you by far and away this has been in terms of solving the problem, that is, giving us help and guidance in what we should do going forward, the most useful panel.

I also want to say that I strongly concur with Mr. Sokol and Mr. Barton in contending that this is incredibly important. I believe, indeed, the economy of the Nation and damage to the economy of the world depends upon how this issue gets resolved. If we do not have clear and understandable rules, if people cannot rely on our markets as honest and fair, then we are in serious trouble in a world economy. And so I do think this is—Joe said he'd never seen a more important subject dealt with in a more boring way. I do, in fact, think it's the most important subject that I've heard while we've been here. I'm not certain that it's the most boring way. I am convinced that it's the most confusing way because you are all competing with each other and giving different answers to the questions that we have and I'm trying to get to some bottom lines and I don't know if I'll have time to get to all of them.

First, some of the things in here are incredibly confusing to me and Joe's simple analogy of the old economy and the new economy,

I'm really old economy, like Joe Barton, only instead of $8,000 income and $8,500 outgo in my family, it's about $8,000 income a month and $9,000 a month out. So my family and I are struggling to get to where Joe and his family are.

Chairman TAUZIN. You need one of those special purpose entities.

Mr. SHADEGG. Well, I'm going there. When I began my study of this topic and read special purpose entities and then I realized they were off balance sheet entities, as I said in my opening statement, I thought well, gee, Shirley and I need to create an off balance sheet entity. We'll put all our debt over there, then we can qualify to buy to move to a much larger mortgage to build the house we'd like to build. And really, my initial reaction was why in the world should there be any off balance entities? Why shouldn't all balance sheets be completely consolidated. I've now come to the conclusion that that's a too simplistic approach and that indeed there might be circumstances under which you need a special purpose or off balance sheet entity. But I am troubled by this. It seems to me on the one hand if you don't set bright rules and you instead use judgment which is the argument that I believe Dr. Dharan you made for saying you shouldn't have a 3 percent rule, obviously, too arbitrary; you need a judgmental rule about control. The problem that I have with that is that when you listened yesterday to the head of Arthur Andersen and you realized that—and he made the same argument—we should use judgment as to whether these really should be off balance sheet. The problem is that the money involved, the amount of money that the accounting firm gets to make this judgment call of whether it's a bonafide or not a bonafide off balance sheet entity, makes it I think, quite frankly impossible for those individuals to be expected to make a fair call. So that gives me serious trouble.

And then we get down into the next step of detail, let's talk about FASB. FASB was involved in setting the 3 percent rule and I think I completely agree with one thing here trying to distill it. It seems to me that FASB is not, as I think several of you have said, doing its job. It is not up to speed. It is not performing its task quickly enough or aggressively enough. Is there anybody here that disagrees with that?

Okay, good, we got a—Mr. Sokol?

Mr. SOKOL. Congressman, just can I make a statement to that? The accounting issues are complicated in some ways but rather simple. The real issue is the misuse of accounting principles to deceive investors and to deceive a balance sheet.

Mr. SHADEGG. Okay, I agree with you there. There is misuse and there is fraud and somebody ought to catch that and somebody needs to supervise and we're going to get just a minute to SEC's enforcement of the FASB rules, but I think I just got agreement on everybody that the FASB rules aren't up to speed, the 3 percent rule was ad hoc, it's out of date. I think somebody mentioned that they're working on a consolidation rule. I'm having real trouble with how anybody can have any faith in this market if there isn't a clear set of rules on what has to be consolidated on your financial statement and what doesn't. And so again, I think FASB needs to be kicked and moved forward and that seems to me that's one of

the things that comes out of this process and I assumed everybody agreed.

Okay, second, Mr. Longstreth, you said SEC has enforcement powers and I think it does have enforcement powers, but I think everybody agrees that SEC is not aggressively enough enforcing, using its enforcement power. That would certainly be your position, would it not?

Mr. LONGSTRETH. Yes, it is my position. Over the years, they have not used those powers as effectively and as aggressively as they should have.

Mr. SHADEGG. So as a group, is there anybody on the panel that disagrees with that and says no, SEC has been adequately aggressive in its use of its enforcement powers? Nobody disagrees with that.

One of the things I worry about and lose sleep over is that we can—somebody said here already we screwed up a couple of things in Congress by interfering in these things. We have no direct control over FASB. The question is should we get involved—should government take over FASB? I don't think so. We have some control over SEC, but it is an independent entity and we have some authority to help encouraging it to use its oversight power. But I am most intrigued, Mr. Chanos, by the point you made and that is in all of time or maybe you just said in the last 10 years, you don't know of a single instance where an inside auditor or any regulatory entity discovered at the initial stage fraud or one of these problems and you said it's always been discovered by either the press or short sellers. And I'm fascinated by that because that basically says look, the market is the answer here and the market will solve these problems and I see that happening. I mean the selldown that occurred the day before yesterday shows a little bit of that right now. And I guess I'd like you to expand on how we can use that, not to create more regulation, but is there some way that we can rely on short sellers? Is there—should the SEC have a rule that says if there's a certain level of short selling that should trigger an investigation? How do we take advantage of the market scrutiny that short sellers are performing to catch this kind of problem?

Chairman TAUZIN. The gentleman's time is expiring, but please answer the question.

Mr. CHANOS. I'm not so sure how you would do that. I made the point that Wall Street analysts and accountants were not the—I can't find any instance where they were uncovering these things. I don't know. It's—I think that the free market does work. I'm a free market person myself. I think that there was an editorial in the Journal today, Wall Street Journal today about short selling in the free market, that I would commend you all to read. I think it does provide an admirable function, watchdog in its own free market way by pointing these kinds of things out, but having said that, I think that I'm also in favor of full and free disclosure so that any investor not just people with our resources and expertise can go in and look at the financial statements and make informed decisions and I just feel that we're still falling short there.

Mr. SHADEGG. Well, we're clearly falling short there and I completely agree and I think consolidation of balance sheets is a huge

part of that. I think abuse of special purpose entities is a huge part of that.

Mr. Chairman, I don't have any other questions, but everybody else took a great deal of time. I do have one request of each of you. As I said, I think in terms of what we do as a Congress going forward and how not to overregulate, but how to try to solve some of these problems is extremely important.

I'd like to make a request of you. I'd like each of you to submit to me and to the committee a list of the three or four specific things you believe Congress should do in response to what has occurred here and the one or two things you think Congress absolutely should not do. For example, everybody I think on this topic so far has said well, we ought to separate auditing and consulting. And yet here today I heard some intelligent discussion of how doing that arbitrarily may not be a prudent idea. So if you could just each take the time to give us three or four suggestions of what you think we ought to do and one or two suggestions if you have them of what we absolutely should not do, would cause a problem, I would greatly appreciate it.

Chairman TAUZIN. And I'm particularly interested when you do that, Dr. Lev, that you identify for us your projection, your forward looking statements on consequences, if you will, if you could do that.

Mr. SHADEGG. Thank you, Mr. Chairman.

Chairman TAUZIN. If you want to make some comments——

Mr. SOKOL. Congressman, if I could make a comment about the notion that no internal auditors and no internal managements have ever uncovered fraud within their company and turned them forward other than the press and short sellers. That's nonsense. I think that's an offense to the best capitalist system in America. In our own company last year, we found an accounts payable person in a title business, had embezzled $1.7 million and it was found internally, it was dealt with. She's being prosecuted and a good portion of the money has been recovered. That goes on every day. The internal audit function of a corporation is essential and to say that it has never functioned properly is wrong.

Enron is a graphic example of the misuse of the system and I think there again people need to be punished, but it would be imprudent for me to sit here and say that there's no function for an internal audit organization——

Mr. SHADEGG. Well, by no means did I intend to imply nor do I think that Mr. Chanos said there's no——

Mr. CHANOS. That's not what I said. My statement said that there hasn't been one major financial fraud in the United States in the last 10 years that was uncovered by a major brokerage house analyst or an outside accounting firm.

Chairman TAUZIN. I've got to move on, but I should tell you all that in our investigation we discovered that Arthur Andersen did discover problems and unfortunately perhaps didn't report it, timely or properly, but they did uncover the fact that the first Chewco had not been capitalized correctly and therefore they had to restate the earnings. I think this came from the accounting firm at some point.

Mr. SHADEGG. My only point was as a foundation I think short sellers are something we ought to also be looking to.

Chairman TAUZIN. I thank the gentleman. The Chair recognizes the gentleman from Florida, Mr. Deutsch. While I do that, I want you all to know that the Subcommittee on Oversight and Investigations meets tomorrow with all the principals at Enron invited, some of whom will take the fifth, some of whom will testify and Jim Greenwood, the chairman of that subcommittee, and his ranking member, Mr. Deutsch, have done a fabulous job of bringing these facts to the attention of the committee and I wanted to commend him for his excellent work with Mr. Greenwood.

Mr. Deutsch?

Mr. DEUTSCH. Thank you, Mr. Chairman, and again, I apologize for not being here the entire day, but having sat through an entire day yesterday I'm looking forward an entire day tomorrow. My staff has been here and I've read some of the testimony. I want to focus on two very specific questions and just in a general way, this is an issue, this is my twentieth year as an elected official, my tenth year in Congress. As a policy issue, I have been sort of fascinated in many ways, but one is just the public's just absolute fascination, intense interest in this and that's one of the reasons why we're driven to some extent by not just issues, but really what our constituents want us to look at. I think part of that is in the real world people just see this as an incredible injustice what's occurred and that really at the end of the day we don't know how many, but probably thousands of people who lost their retirement savings and are in terrible situations and people can relate to that. I guess what I want to specifically focus in on is that in the accounting profession, my understanding is that when the accountant signs off on the audit, they say that it fairly represents what is going on in the company. That's my understanding what they're actually signing. And I think by anyone's normal definition, that that was not, the books did not fairly represent what was going on in Enron. And I'm not convinced at this point that that Andersen violated the law or violated accounting rules in terms of what they did, but I think what they did by any normal definition is that it did not fairly represent what was going on.

And I guess what I'd like to focus on is maybe there's another way of looking at that. If, in fact, audits fairly represented what was going on, then Enron wouldn't have happened and obviously our concern is how many other Enrons are there out there because if people are living on the edge and gaming the system as obviously occurred here, I mean if you can, if any of you could try to elaborate on that, that in the existing rules, it should not have happened by normal definitions, but obviously it did.

Dr. Chanos, you're nodding, so I welcome your comments.

Mr. DHARAN. I could probably spend a second on that. The existing rules do a fairly good job insofar as some problem areas that I have pointed out earlier such as the extensive use of mark-to-market accounting for items that really should not have been applied to, and also the use of special purpose entities.

Mr. DEUTSCH. I guess what I'm saying though that general statement of fairly represent, that is something that Andersen signed.

They said that it fairly represents and how by any normal definition it obviously didn't.

Mr. DHARAN. I agree. I think they said two things and typically this has been argued in courts quite a bit and again, I'm not a lawyer, but there are two phrases that auditors use. One is "fairly." And then very next couple of words later they say "in conformity with generally accepted accounting principles."

Mr. DEUTSCH. Right.

Mr. DHARAN. And surprisingly, Congressman, there is no in between clause like "and" or "or" or "except for" so when they say "fairly" and "in conformity with generally accepted accounting principles" there's no real "and" there. So they hang on to that accepted accounting principles. The investor, the public, you are absolutely right, should be looking at the word "fairly" in a different way, but I don't think my understanding is that's not the way the courts look at it.

Mr. DEUTSCH. I guess what I'm struggling with is that's really what the expectation is. That's what the system working is that there's transparency, that it is fair. And obviously, the big concern, the big policy issue that we're looking at is if we lose investor confidence, the system that exists which is by far the greatest economic system ever created and brings us such positive things as a society, is challenged. It is being challenged today and we're challenging it. That is really what we're trying to get. And I don't know—I mean our job is to legislate and try to figure out how to get to that point, but it goes back to that's what people want. They want that transparency. The accounting firms are saying that it fairly represents and yet, it's not occurring.

Did anyone else want to comment I mean just about that?

Mr. LEV. I can make a comment on that. I mentioned it before in my testimony. This report I have here an example of the uniform report. It's filled with hedging. It starts by saying "this financial statement is the responsibility of management", hedging No. 1. Hedging No. 2, "we conducted our audits in accordance with auditing standards generally accepted in the United States" which means someone else directed us to do what we do. And third one is what Professor Dharan mentioned, "represents fairly in conformity with accounting principles generally accepted in the United States." This, in my opinion, is not an informative report and it definitely has to be replaced by an open ended report which will provide information, which auditors will tell you what they found, what they didn't find, what's their opinion on their internal controls in the company, what's their opinion on the corporate governance. Questions, something very important, questions that they put to management and were not answered; suggestions that they made that were not implemented. This has to go out. And then people will have some degree of comfort that you Congressmen are looking for.

Mr. DEUTSCH. In terms of suggestions, so obviously that changes dramatically the way the public accounting system is set up today?

Mr. LEV. Yes.

Mr. DEUTSCH. Is that specifically, I mean recommendations that you will be providing us or that we're looking at at this point? I mean——

Mr. LEV. I already provided it. I wrote about it and I strongly believe in this. This is not a statement that is worth much.

Mr. DEUTSCH. The one final question that I wanted to at least offer the opportunity for you is again this sort of common sense uses and it's on the security side in terms of fraud. I mean as we—in the hindsight that we have now, I mean we look at what Enron did, I mean at so many different levels, that by any common usage would be fraud. And again, it ultimately might be determined either through prosecution, through SEC work, of actual criminal fraud.

But I guess the question is and I'm reminded, the thing that I keep coming back to personally, as I'm looking at what happened with Enron is a scene in the Godfather movie where the attorney, Tom Hanks, comes to the Godfather and the Godfather says to him I want you to always remember you can steal a lot more with a briefcase than a gun. And when I look at this whole episode of Enron, I mean we can add up how much they stole, but it looks like they stole maybe as much as $4 billion, I mean which is an incredible amount of money and obviously, I can't think of a violent crime with a gun where anyone could conceive of stealing that much money. And it was at that level in terms of what they were doing day by day. And that, a very creative, very, very bright people, but really almost evil people because every dollar they were stealing, they were stealing from someone else. It wasn't a value added business. We've gone through enough stuff at this point that it really was not value—I mean there's lots of people in America, thank God, who have made billions of dollars, who have come up with some great ideas and some investors or maybe even some shortsellers who have been able to figure out the market through work of their own, but in this case, I think we know enough now that basically the money was stolen from other people Go ahead.

Mr. RABER. It's interesting and talking to some of our directors who are reacting to Enron, there's an consensus that many times throughout their life as a corporate director something didn't smell right, something bothered them. And we're starting to see more and I don't know enough about Enron to know what happened, but I suspect that those board meetings and committee meetings there were some board members who felt something is wrong here. Now what's happening insofar as corporate directors, they're going to be a lot more aggressive in asking questions. And I also see, to go back to your comment about audit committees. Audit committees want more than just a testing, that this has been done appropriately, this particular audit. They want it raised to quality and independence. As a result of that, we're trying to provide guidance to them about red flags, questions to ask and I have to say that's the courage and integrity I talked about in my testimony is that were there times during Enron board meetings and audit committee meetings there was a sense that something was wrong here. And go back to some of the fraudulent areas, we know that outside board members, if they sense something is wrong, that's where they refer to a special committee. Let's take it the next step. It doesn't mean that there is something fraudulent, but when something like that starts bothering you, even though you may not have

a sophistication in financial areas, you should have enough to know this does not ring right.

Chairman TAUZIN. The gentleman's time has expired. And I might point out that we'll have tomorrow at our O&I hearing, individuals who worked for Enron who did smell something wrong and tried to do something about it. Stay tuned.

The gentleman, Mr. Shimkus, is recognized, for 5 minutes.

Mr. SHIMKUS. Thank you, Mr. Chairman, and I appreciate you putting in a long day. Obviously, we are all very disheartened and frustrated, but I want to talk about—I only have one question and it kind of refers to the man on the street, the individual who given clear and concise information can then make decisions and be held accountable for the success of those decisions or the failure of those decisions. When it's disassociated through false information that's what's brought us here today. Folks are—they had made the personal decision of putting money in a gold mine, then they would say oh, I made a stupid decision, but someone was managing this for them.

So I have a question for the folks who are addressing questions on the accounting issues, Mr. Weil, Mr. Dharan and Mr. Lev and Mr. Longstreth. And it deals with this whole issue of pro forma disclosures and are they really useful? Are they abused? I mean we understand spin here in Washington. The question is are pro forma statements used more for spin or are they used, or are they really an important accounting vehicle to let the individual consumer know what's going on and then if you would just try to answer that and give me your—and then if anyone else wants to jump in, but that's how I'm going to use my time——

Chairman TAUZIN. Would the gentleman yield?

Mr. SHIMKUS. Yes.

Chairman TAUZIN. The gentleman is talking about the statement by Enron, for example, that the billion dollars was a nonrecurring problem, was that spin, did that help anybody? What's the story on that?

Mr. WEIL. Let me work on this and it dovetails with the previous gentleman's questions. We used to have a free market in accounting. There were no regulations. Companies went out voluntarily and hired accountants to do a report and we got pro's statements of what was going on which is what Professor Lev would like to see us have now. I don't see how to legislate people using judgment. You invite them to do it.

Pro forma earnings have that characteristic. They're not governed, they're not regulated. Some people find them useful. Some think they're silly. My colleague professors who studied these things scientifically are not persuaded of the information merit therein, but I don't see that they do any harm because you're alert of what it is. It's the company spin. I think you've got the right adjective and I don't see anything wrong with it. People get to do what they want to do and the analysts get to decide what makes sense.

Mr. SHIMKUS. Just go down the table then, Mr. Dharan?

Mr. DHARAN. I happen to disagree with that entirely, unfortunately. I think the problem with pro forma earnings is that we have a whole system we are trying to fix here which is the gen-

erally accepted accounting principles. We want companies to be able to properly calculate earnings and report it and we want investors to be able to understand it, but as soon as we allow companies to report in addition to their pro forma earnings, the entire focus shifts to pro forma. So the entire, the effort that we are all trying to do to strengthen the system is completely taken away. It gets diluted. And there's no reason to talk about lack of regulation for pro forma earnings because these earnings releases should be looked at by auditors, should be looked at by lawyers. These are numbers that are being communicated to investors and they should be regulated just like 10(k)s and 10(q)s because in the old days you got the 10(q) in the mail and you read it and you decided. Today, you look at the press release, you look at the internet and the analysts look at it, the market reacts instantly. And if you don't regulate this, we are simply ignoring the reality that information is going out through these numbers more than the 10(q)s.

Mr. SHIMKUS. Mr. Lev?

Mr. LEV. I don't have very strong feelings about pro forma. I tend to agree with Roman Weil that I definitely don't think they should be banned. As long as you get earnings or some kind of regulated earnings, I don't' see any problem when managers are saying that they think that there is another measure which reflects better. They don't believe them. They don't look at this measure. They don't use this measure. I don't think this is a major problem here.

Mr. LONGSTRETH. I think it's a problem of you can lead a horse to water, but you can't make him drink. The earnings, according to GAAP are filed by the corporations. They're available to the analysts. The analysts call in the first call or IBIS and give their estimates. The problem is that the analysts have not bothered to look much at the earnings according to GAAP. They prefer to take the advice from management of what operating profits are going to be with very substantial freedom on the part of management to define that the way they want to define it. Then they pass it on to first call and it gets cooked into the system and everyone says well, the companies—the S&P 500 is going to grow at a certain rate. The Wall Street Journal did kind of an exposé comparing the P/E ratios based on earnings as reported according to GAAP compared to operating profits that were reported and cooked into the first call estimates and it was a spread of something like 23 times earnings for the—on the basis of the operating profits and about 40 times earnings on the basis of the filed earnings. So I don't know, I think the private sector has got to get a little more realistic in using the data. I don't think there's anything to do there with rulemaking.

Mr. SHIMKUS. And Mr. Chairman, I yield back my time, thank you very much.

Chairman TAUZIN. I thank the gentleman. The Chair recognizes the gentleman from Texas, Mr. Green, for a round of questions.

We're coming to the end of this long afternoon and evening and I want to thank you again for your patience, gentlemen.

Mr. Green.

Mr. GREEN. Dr. Weil, and frankly for everyone who has experience in accounting, I've reviewed your testimony and I have a question that's come up. Are you conceptually familiar with the practice used by some law firms in our country to shop around opinions, for

example, that they find new loopholes or what they think are loopholes in the tax law and that allows companies to lessen their tax burden so they'll shop that opinion around?

Is that something you're familiar with?

Mr. WEIL. We have a phrase, "opinion shopping" in accounting, but the SEC went after that a decade or two ago and it's a lot less problem than you might think because if you go opinion shopping and decide to get rid of this auditor and pick that one, you've got to send a letter explaining why you fired the first one.

Mr. GREEN. Well, let me—I've met with a former Arthur Andersen employee who worked in the Houston office and he told me that Andersen had a similar practice, they pitched for new business development. I was told that the Houston office of Arthur Andersen had something called the book of ideas and this book was described as containing accounting suggestions that while technically in compliance with Financial Accounting Standards Board, was actually a manual for aggressive accounting and like my other colleague from Texas I was a business major and I think I took 12 or 18 hours in accounting as an undergraduate. But I was wondering if this is a type of material commonly compiled by our Big Five accounting firms to encourage aggressive accounting?

Mr. WEIL. I don't know and it would be dangerous to speculate about that one.

Mr. GREEN. Someone never has heard of something similar that maybe a firm, and again, I had up until Enron, I had probably the highest respect for Arthur Andersen.

Mr. DHARAN. I have never heard of this before, but it does sound like it is pushing aggressive accounting in some way, if it is true.

Mr. GREEN. Mr. Chairman, this information wasn't available when our subcommittee had the Arthur Andersen folks, but I would sure like to subpoena their records or maybe we can make that available, that former staff member to our committee.

Chairman TAUZIN. If the gentleman will yield. Will you make the information available to our investigators and we'll chase it down for you, obviously, we are going to have, as you know, a FASB hearing and it might be appropriate to have that information available for that hearing.

Mr. GREEN. Okay, thank you, Mr. Chairman. Mr. Chairman, I have no other questions. It's been a long day for our witnesses and I thank them for their time.

Chairman TAUZIN. I thank the gentleman and for the last round of questions, I'm pleased to recognize my friend from Nebraska, Mr. Terry.

Mr. TERRY. Thank you. You should be glad to know we go by order of seniority and I have the least which means I'm the last.

Mr. Sokol, you haven't participated much, mostly because you offer an expertise in energy market and business practices, but you stated something in your testimony that has gnawed at me, even before you came here today. You said that Enron trades 25 percent of the natural gas, but yet you testified there were no effects on the market, including especially to consumers. Why? What went right in the market specifically that protected the market, protected the consumers. You would think that an entity that controls 25 percent of the trading market of natural gas that there would

be catastrophic effects. Certainly we heard news reports that Kenneth Lay was projecting that there would be catastrophic effects if someone didn't ride to the rescue.

Mr. SOKOL. Well, first, Congressman, both natural gas and electricity was estimated at about 25 percent market share in Enron's trading activities. I think the important point first is that they didn't control it. They traded it. They did not control the flow. They controlled the trading or they were participants in that amount of trading.

What really occurred and what has shown itself to be, frankly, I think surprising to all of us is the incredible depth of the energy trading markets. Basically, within a 24-hour period when it was pretty clear that Enron on-line was going to be going off-line, the rest of the marketplace picked up all those trades. What it really tells and actually it's probably a point that Mr. Chanos would recognize as well, that Enron really wasn't making very much money in those trades because if they were, there would have been a significant dislocation for at least a short period of time as all those trades shifted to other people that wouldn't make them. The reality was many of us believe they were kind of a trader of last resort almost, just to have the volume because literally when you're talking about billions of dollars of trading and the market doesn't move a fraction of a percent when the largest trader goes under, that can't happen if they're a large market maker and so it's—I think it is a tribute to the depth of the wholesale trading markets that are out there and frankly, I don't think we're likely to see anyone else even approach that level of involvement in the market now because it's recognized that it's not necessary.

Mr. TERRY. Interesting. One other aspect that you touched on, but not as much as I expected, is PUHCA. One of the issues that I want to ask you about today is one I've heard about from some of my colleagues, especially, that Enron's failure symbolizes why we shouldn't move forward with deregulation. Within that deregulation genre, I've heard specifically PUHCA and frankly, I don't understand any connection here to PUHCA in Enron's failure. I want you to expand on whether you feel that there's a connection. And second, there have also been accusations that Enron has received exemptions from PUHCA and other regulatory requirements that have led to its demise.

Do you have an opinion on whether or not there's a causal link?

Mr. SOKOL. I have a tough time staying in your timeframe. First, in the testimony I think I do hit those points, but there really is no relation to PUHCA. In fact, I would make two points to the chairman about what you're doing here. One is that energy modernization regulation has to continue forward. The Senate is moving forward, hopefully House 3406 will move forward because the Enron problem cannot stop us from crossing the street. We're about halfway across it from 1992 when the wholesale markets were opened and we need to modernize the regulation for natural gas and electricity. That needs to proceed.

What you're doing in regard to Enron is hugely important, but I think important that these gentleman are making. There is no simple fix to what happened to Enron. Enron, to me, taking into account the criminality is the culmination of the excesses of the

1990's. Now again, with criminality. It's not to say by any means even a significant portion of corporations are doing what they were doing. But it does, I think, cause all of us including Congress to take pause and say can we do better? These gentlemen who have much more expertise, obviously, in the accounting side have numerous ideas. I mean proportional accounting. Why should executives be allowed to sell stock and report it 30 days later? Compensation accounting for options. There are serious abuses out there and they need to be fixed, but there's no single answer and I think holding hearings, asking expert testimony and ideas is the only way you get to fix the problems and move forward, but we would certainly urge you in the energy industry not to slow down with energy regulation modification because it's essential to keep that part of our economy moving forward.

Mr. TERRY. Thank you. That's all, Mr. Chairman.

Chairman TAUZIN. If the gentleman, Mr. Terry, will yield?

Mr. TERRY. Yes, I yield.

Chairman TAUZIN. I think it's important to point out that the work that has been done by the subcommittee by Mr. Joe Barton's subcommittee on the energy markets, particularly the work he's done in helping to ensure transmission facilities are adequate and that there's adequate supplies in the marketplace for it to function is going to go on and what's interesting about the product he's got is that it doesn't contain the Enron recommendations. It's very different from what Enron asked for and wanted, but it is essential, Mr. Sokol, that you were here today and it's essential that Joe have this hearing this week, that we can literally elaborate on the Enron effect on those markets. Get a clear picture of them so that Mr. Barton's subcommittee has that as a background to its work, as it continues its work toward making sure those markets are sound and we don't have California-like problems in the rest of the country. We're not going to stop that work. We simply want to make sure with this Enron situation that they're not at loose ends that need to be covered in that legislation as well.

I thank the gentleman for yielding. The gentleman is complete, then I thank the gentleman for his time.

Let me conclude, first of all, just you and I, let me make the point that 4 years ago if you had told me that we could have 40 members of my committee attend so serious a session to listen to a bunch of accounting professors talk to them about these esoteric kinds of issues and that four cameras would be here to cover this, I would have laughed. In fact, years ago, several years ago when we talked about having public hearings on the issue of separating the auditing functions and accounting functions and there was not any takers, nobody was willing to come to those public hearings and debate them and discuss them.

The Enron situation has caused us all now to take this much more seriously and to take your advice seriously. The record will stay open for 30 days. Several members have indicated they'd like you to respond in writing to some specific requests for information. I have raised the question. I have not gotten an answer to yet and I would love for you to respond to it. That specific question is whether or not if we go to general principles as opposed to specific rules do you have a problem with two different accounting firms in-

terpreting them so differently that it causes friction and confusion rather than clarity for American investors? I'd love you to think about that and come back to us with some description.

Most importantly, when you do write recommendations to us, 1, 2, 3, 4 things we ought to do legislatively which is where we're going to try to get to as rapidly as we can, I'm most interested in you thinking through the unintended consequences of changes we make. One of the things I have cautioned the subcommittees who will be working on these issues is that if we make too drastic a change in the way in which this is reported and the way in which accountants have to classify income and debt and the way companies have to report them, that we might have some unintended consequences of making it appear as though companies who have legitimately used devices like special purpose entities and other alliances and partnerships, we may make them look like they were doing something wrong when they were not and therefore undermine integrity and confidence in the marketplace. Those are serious kinds of concerns for me. I hope you will think about those, give us some advice, for example, as to transition, moving from this current way in which we interpret an audit report, what's included in it. How do we transition into a different kind of system? How do we move from that forum, Professor Lev, you said is worthless to one that's much more worthy of informing people and do it in a fashion that doesn't shake the world of investment in the meantime. Those are serious concerns I have for our committee as we move forward. You have been extraordinarily patient. I thank you for that. This has been, believe it or not an extraordinarily interesting session for me and I know for many members and I thank you for that.

The hearing stands adjourned.

[Whereupon, at 6:28 p.m., the committee was adjourned.]

[Additional material submitted for the record follows:]

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON ENERGY AND COMMERCE
February 19, 2002

Mr. BARUCH LEV
Philips Bardes Professor of Accounting and Finance
Vincent C. Ross Institute of Accounting Research
Stern School of Business, NYU
40 West Fourth Street, Suite 312, Tisch Hall
New York, NY 10012

DEAR MR. LEV: Thank you for appearing before the Committee on Energy and Commerce to present testimony on Accounting Issues.

Congressional hearings are used to build a record to assist with the Committee's legislative initiatives. I would greatly appreciate the benefit of your expertise in responding to some follow-up questions surrounding issues raised at the hearing. So that your answers may be included in the hearing record, please respond in writing to the attached questions by March 4, 2002.

1. Your testimony regarding corporate disclosure points out that the system only reflects past transactions. The Chairman of the SEC, Mr. Pitt, recently spoke about supplementing disclosure with "current disclosure" of significant information as it arises? Please comment on the Chairman's proposal.

2. You testified that the reporting of unexecuted obligations is deficient. What are the reasons for the deficiency in disclosure and how would you remedy the deficiency?

3. You stated that our current system of accounting is geared for an industrial era based economy of tangible assets and that it largely ignores or misrepresents the value of intangible assets. Please discuss the consequences of the current system and recommendations for improvements.

4. You testified that the current disclosure of specific risk exposure is insufficient. How would more accurate information or disclosure benefit investors? How do you balance necessary disclosure with a company's desire to keep secret its stragetic information?

5. The number of earnings restatements each year is in the hundreds. Is this a recent phenomenon? Why is it occurring and what can be done to curb errors that cause restatements?

6. You suggest mandatory auditor rotations every five years. What are the costs and benefits of such a system? Please compare them to the costs and benefits of the current system.

7. You suggest restricting audit firms to performing consulting on a limited basis—25-30% of audit fees. Do you believe it is necessary to limit the consulting to specific types of services? If so, which services should definitely be excluded? Which should definitely be included?

8. Under a regime that forecloses an auditor from performing consulting work for an audit client, will there be perverse incentives for the auditing firm to provide a poor opinion of the consulting firm's work in the hope of replacing its own auditing contract with the client's more lucrative consulting contract?

Sincerely,

W.J. "BILLY" TAUZIN
Chairman

NEW YORK UNIVERSITY
LEONARD N. STERN SCHOOL OF BUSINESS
March 4, 2002

Representative W.J. "BILLY" TAUZIN, CHAIRMAN
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515-6115

Re: Response to your questions (from February 20, 2002), concerning my testimony before your committee (February 6, 2002).

DEAR CHAIRMAN TAUZIN: The order of my answers follows your questions.

1. Concerning SEC Chairman Pitt's comments about "current disclosures." In general, the more current and timely the disclosure to capital markets, the more efficient and fair will these markets be. So, I definitely encourage quick and unbiased (e.g., not only good news) disclosure of business events.

This, however, differs from my testimony about a major limitation of the accounting and financial reporting systems—the reflection of *past transactions* only (with few exceptions). Thus, for example, "unexecuted obligations," such as loss guarantees to special purpose entities, or provisions for future availability of raw materials and other inputs (known as "take-or-pay contracts," or "throughput arrangements"), create obligations which are not reflected as liabilities in the financial reports. (Unexecuted obligations arise from agreements related to future transactions).

In my testimony, I strongly urged accounting standard-setters (SEC, FASB) to expand the scope of financial reports to include most unexecuted obligations. This can be done effectively and expeditiously in my opinion.

2. Response include in (1), above.

3. The issue of intangible (intellectual) assets, which are by and large not reflected in financial reports, is broad and obviously beyond the confines of this response. It is, however, thoroughly presented and analyzed in my recent book—Intangibles: Management, Measurement, and Reporting (Brookings Institution Press, 2001).

For the record I will note that various estimates indicate that intangible assets (e.g., discoveries, patents, brands, unique organizational designs and processes, etc.) currently constitute 60-75 percent of corporate value, on average.

The socially harmful consequences of the failure to account properly for those assets (which are mostly expensed immediately by the accounting system), and disclose their attributes are numerous and very consequential. They include: using intangibles (e.g., in-process R&D) for widespread manipulation of financial information, excessive gains to corporate insiders from trading the stock of their companies, high volatility of stock prices, and not the least—excessive cost of capital to intangibles-intensive companies, hindering innovation and growth. (Elaboration on these social harms can be found in my book, referenced in (1), above, Chapter 4.)

The accounting and financial reporting systems can, and should be significantly modified—for example GAAP rules for asset recognition—to reflect vital information about investments in intangible assets and their consequences. At the minimum,

corporations should be required to routinely disclose information on their investment in key intangibles—brands, human resources, information technology, major business processes, and breakdown of R&D—and the consequences of such investments. Investors should be able to assess the desirability and productivity of such investments.

4. Concerning risk exposure. The SEC required in the early 1990s some disclosure by corporations of risk exposure. This was a step in the right direction, but a very modest step which was not pursued vigorously.

A system of "stress tests" should be developed, to reflect the consequences of foreseeable events on the company's operations and economic condition. Thus, for example, a globalized corporation exposed to foreign exchange fluctuations of the Euro or the Yen (relative to the U.S. dollar), should be required to provide information on the consequences of expected changes in the value of these currencies. For example, the consequences of changes of plus/minus 2%, 5%, 10%, relative to the exchange rates at the end of the year. Similarly, a company exposed to interest rate fluctuations, should report the results of "stress tests," reflecting the consequences (gains/losses, changes in assets/liabilities) of expected changes in interest rates of 0.25,0.5,1.0 percents.

Similar risk-related information is currently requires from financial institutions. I favor expansion of such requirements to include non-financial enterprises.

Concerning your questions about secrecy of strategic information, I sincerely doubt that results of stress tests will harm the competitive position of the corporation. To the contrary, I believe that a requirement to publicly report risk exposure will focus the attention of mangers and board members on a vital aspect of operations (i.e., risk) currently neglected in many corporations, as a result of the failure of the accounting system to reflect risk.

5. You are perfectly right that the number of earnings restatements has mushroomed in recent years. New York University Ph.D. candidate, Ms. Min Wu, documented a sharp increase in restatements during 1998-2001 (see attached graph from her dissertation).

The major reasons for the increase in restatements in the late 1990s are: the rise in uncertainty/volatility of the business environment in the late 199s, and the pressure from Wall Street to meet or beat the earnings forecast of financial analysts (the "earnings game"). These reasons led many executives to "manage" their volatile earnings toward meeting the forecasts. Ultimately, however, reality catches up with such managers, leading to restatements, and in extreme cases to bankruptcies.

Restatements of earnings are just a symptom of the futile but pervasive "earnings game" played by managers and analysts to the detriment of investors and the economy. Fundamentally, the earnings game, with its focus on short-term profits and a superficial concept of companies' operations (undue focus on accounting earnings), should stop. This is not an easy task, but expansion of the disclosure of relevant information—a central theme of my testimony—should lessen the adverse impact of the earnings game.

6. Regarding auditors' rotation. I suggest not only a rotation of auditors, but mainly their selection and reappointment by shareholders every five years. (See my testimony). If shareholders are satisfied with the performance of auditors, they will reappoint them. So, auditors will not necessarily be changed every five years. What will happen every five years is a serious examination of auditors' performance, and an opportunity for competitor auditors to publicly bid for the audit engagement.

While I have no reliable cost estimates for the proposed system, I doubt whether it will result in a significant cost increase. I am familiar with the argument that there are some "learning" advantages from repeating the audit over several years, but I am not familiar with any estimates of the magnitude (cost savings) of such learning. The benefits of my proposal in increased auditor diligence, knowing that their performance will be seriously evaluated every few years, and in the occasional dismissal of negligent auditors, will in my opinion far outweigh the additional costs, if any.

7. Regarding consulting activities. I believe that if revenues from non-audit activities will be limited to a reasonable fraction of audit fees (I suggest 25-30 percent), then there will be no need to specify which services should be excluded—a difficult task at best.

8. You ask: "...will there be perverse incentives for the auditing firm to provide a poor opinion of the consulting firm's work...?" I doubt it. In general, auditors don't opine on managerial issues (e.g., effectiveness of operations, quality of the product, etc.), only on the faithful representation of financial reports. Most consulting engagements, in contrast, deal with management issues (e.g., improving information technology, streamlining human resource practices, etc.). Accordingly, I

don't see a significant opportunity for auditors to criticize consulting engagements by other firms.

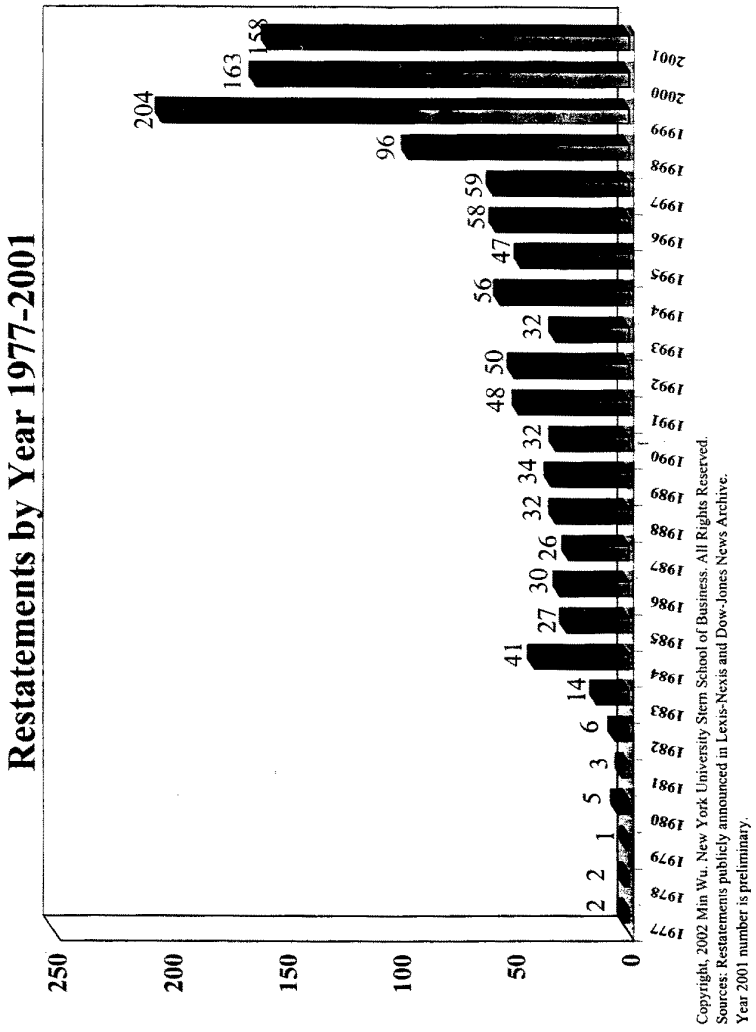
Concluding Comment

The above responses are by necessity brief and hopefully concise. I will be happy to elaborate, in person, on any issue of concern to your legislative activities (within my range of expertise, of course).

My best wishes,

BARUCH LEV

BARUCH LEV



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March 8, 2002

The Honorable William J. Tauzin
Chairman, The Committee on Energy
and Commerce
United States House of Representatives
Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Tauzin:

On February 6, 2002, I testified before The Committee on Energy and Commerce ("Committee") in its hearing "Developments Relating to Enron Corporation" ("Hearing").[1] At the conclusion of the Hearing you requested that each of the witnesses supplement his testimony with a written statement recommending legislative changes that he believes Congress should enact. This letter responds to your request. Please bear in mind that I am not an attorney. My suggestions as to changes in the law therefore are offered from a layman's perspective.

While there surely are additional steps that should be taken to ward off recurrence of the facts presented in the case of Enron, I have only two specific suggestions, both signaled in my testimony. Stated simply, I believe that Congress should amend the safeharbor now afforded to corporate managers when they make "forward-looking statements" accompanied by a "meaningful cautionary statement" by Section 21E of the Exchange Act. I also believe that Congress should amend Section 16 of the Exchange Act to require that insiders of a company publicly disclose, as promptly as practicable, but no later than the close of the next business day, any transaction in which they engage that has the economic effect of a purchase or sale of that company's stock.

With regard to the safeharbor for forward-looking statements ("Safeharbor"), Congress should:

(1) require persons who make a forward-looking statement to believe in good faith at the time the statement is issued that there is a reasonable basis for the statement;

---

[1] Testimony of James S. Chanos, Kynikos Associates, Ltd., Concerning Enron Corporation before The Committee on Energy and Commerce, United States House of Representatives (February 6, 2002). Please include in the Hearing record this letter and Attachment A, which highlights suggested changes to Sections 16 and 21E of the Securities Exchange Act of 1934.

(2) not shield from liability a person who makes a false or misleading forward-looking statement if that person knew or should have known that such statement was false or misleading;

(3) state that the term "meaningful," as it applies to cautionary statements for purposes of Section 21E is to be determined by reference to the extent to which the cautionary statement relates directly to the forward looking statement made and applies specifically to one or more assumptions underlying such statement;

(4) require persons who make a forward-looking statement orally to provide contemporaneously a meaningful cautionary statement (rather than merely refer to a document containing such as statement);

(5) require that any forward-looking statement made and any meaningful cautionary language accompanying it be updated within two business days after the issuer to whom the forward-looking statement or the cautionary statement pertains learns or should have learned of facts that, had they been known at the time either statement was made, would have made either statement materially false or misleading; and

(6) provide that no forward-looking statement shall be deemed to have defrauded any investor after a specified number of months have elapsed (*e.g.*, three months since issuance of the statement) after issuance of the statement.

The statutory changes I suggest are attached as Exhibit A to this letter, with brackets around italicized language that I would delete and new language that I would add indicated by underlining.

Proposed Changes to Section 21E

1. <u>Good Faith Belief in Reasonable Basis</u>

Congress should add to the preamble to paragraph (A) of subsection (c)(1) of Section 21E the new language indicated by underlining below:[2]

> IN GENERAL.— Except as provided in subsection (b), in any private action arising under this title that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) shall not

[2] Underlining is used in quotations of proposed new statutory language throughout this letter to indicate language that I suggest adding or substituting for existing language.

> be liable with respect to any forward-looking statement, whether written or oral, if such person believed in good faith at the time such statement was made that there was a reasonable basis for such statement, if and to the extent that . . . .

In my view the Safeharbor should only protect statements made by a person who believes in good faith that there is a reasonable basis for the statement.

2. Removal of "Actual Knowledge" Test

Congress should confine availability of subparagraph (i) of subsection (c)(1)(B) to natural persons not serving as directors or employees of the issuer to which a forward-looking statement applies — because a more demanding test should apply to persons who do serve as directors or who are employees — and should change the "actual knowledge" test to a "knew or should have known" test. Thus, I would, first, add immediately after "natural person" in subsection (c)(1)(B)(i), the phrase "not serving as a director of or employed by the issuer to which the statement pertains"; and, second, delete the phrase "was made with actual knowledge by that person that the statement was" as it appears in that subsection and substitute instead the phrase "was known or should have been known by such person to be." As amended, subsection (c)(1)(B)(i) would state:

> (i) if made by a natural person not serving as a director of or employed by the issuer to which the statement pertains, was known or should have been known by that person to be false or misleading; or

Likewise, I would change subsection (c)(1)(B)(ii) by, first, adding immediately after "business entity" the words "or on behalf of such entity by a person serving as a director of or employed by such entity"; and, second, by deleting from clause II of that subsection the words "with actual knowledge by that officer that the statement was" and substituting the words "and was known or should have been known by such officer to be." As amended, subsection (c)(1)(B)(ii) of Section 21E would state:

> (ii) if made by a business entity or on behalf of such entity by a person serving as a director of or employed by such entity, was—
>
> (I) made by or with the approval of an executive officer of that entity; and
>
> (II) made or approved by such officer and was known or should have been known by such officer to be false or misleading; or

These changes would force persons who make forward-looking statements to inform themselves concerning issues affecting the reliability of such statements. The existing "actual knowledge" standard represents an almost insuperable barrier to efforts to hold persons making false or misleading forward-looking statements accountable.

3. Limit on Accrual of Right of Action

To limit claims based on defective forward-looking statements whose effect I believe should dissipate over time (and which, in any event, my further suggestion below regarding updating should help correct), I propose to make a change that would state that a cause of action based on such a defective statement will not arise from and after three months — or some other number that you deem appropriate — from the date the statement was issued, by which time it should have been either repeated, corrected or superseded by a quarterly or annual financial report. To do this, I would add a new subsection (c)(1)(B)(iii) requiring a plaintiff to prove that the forward-looking statement

> (iii) was made less than three months prior to the accrual of a cause of action arising under this title that is based on an untrue statement of material fact or omission of a material fact necessary to make the statement not misleading contained in such forward-looking statement.

4. Oral Cautionary Statements

Congress should eliminate subsections (A) and (B) of Section 21E(c)(2), as well as subsection 21E(c)(3), and add the statement "must be satisfied" after the phrase "the requirement set forth in paragraph (1)(A)" that is currently used in Section 21E(c)(2).[3] As amended, subsection (c)(2) would state in its entirety:

> (2) In the case of an oral forward-looking statement made by an issuer that is subject to the reporting requirements of section 13(a) of this title or section 15(d) of this title, or by a person acting on behalf of such issuer, the requirement set forth in paragraph (1)(A) must be satisfied.

Persons making oral forward-looking statements thus would be forced to orally provide a contemporaneous meaningful cautionary statement.

5. Updating

Congress should remove from subsection (d) of Section 21E the sentence, "Nothing in this section shall impose upon any person a duty to update a forward-looking statement." In its place, Congress should add, "A forward-looking statement and any cautionary statement accompanying such forward-looking statement made by or on behalf of a person referred to in subsection (a), and known by the issuer to whom the statement pertains or by an executive officer of such issuer to have been made, must be updated by or on behalf of such issuer within two business days after such issuer or officer learns or should have learned of facts that, had they been known at the time either statement was made, would have rendered the statement materially false or misleading." As amended, subsection (d) of Section 21E would state in its entirety:

---

[3] Subsection (4) of Section 21E(c) would be renumbered as subsection (3).

> (d) A forward-looking statement and any cautionary statement accompanying such forward-looking statement made by or on behalf of a person referred to in subsection (a), and known by the issuer to which the statement pertains or by an executive officer of such issuer to have been made, must be updated by or on behalf of such issuer within two business days after such issuer or officer learns or should have learned of facts that, had they been known at the time either statement was made, would have rendered the statement materially false or misleading.

A forward-looking statement that subsequently becomes materially false or misleading is just as damaging as one that is materially false or misleading when made if it is not corrected.

6. Definition of "Meaningful"

Finally, Congress should add a new subsection (6) to Section 21E(i), which would state:

> (6) The term "meaningful," when used to modify the words "cautionary statement" in this section, shall be defined in each case by reference to the extent to which the cautionary statement relates directly to the forward-looking statement made and applies specifically to one or more assumptions underlying such statement.

This amendment is designed to ensure that the term "meaningful" in this context is construed in an appropriate way to preclude the use of "boilerplate" cautions.

Proposed Changes to Section 16

1. Immediacy and Coverage

I would reformulate Section 16 of the Exchange Act in three ways. First, I would change subsection (a) to read in full as follows:

> (a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g) of this title, or as promptly as practicable and in no event later than one business day after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner and any other interest in such security, and, if there has been a change in such ownership or if such person shall have directly or

> indirectly engaged in any transaction involving any other interest in such security or purchased or sold a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving such equity security, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the time of the change in beneficial ownership or any transaction directly or indirectly involving any other interest in such security and such changes in his ownership of such security as well as any other interest in such security and such purchases and sales of such security based swap agreements as have occurred.

2. **Reach of Section 16**

I would add a new subsection (h) to Section 16 that would state:

> (h) Solely for purposes of Section 16 of this title, "any other interest in such security" shall mean any direct or indirect pecuniary interest which derives its value from, or whose value is otherwise related to, an equity security within the scope of subsection (a) of this section.

3. **Availability of Reports**

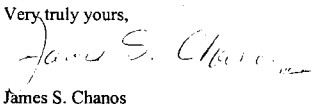
Finally, Congress should add a new subsection (i) to Section 16 that would state:

> (i) The Securities and Exchange Commission shall make statements filed with it under this section publicly available in accordance with the requirements of this title including, but not limited to, Section 35A of this title.

I believe, as I testified, that investors have a right to know when a company insider alters his exposure to the performance of his company so that they can assess in a timely way what that change might signify as to changes in the company's prospects. That is, investors have a right to know if a company insider engages in any transaction that modifies the degree of fundamental economic risk associated with holding the company's equity securities. The continuous development of exotic new financial instruments and strategies such as "collars" or "synthetic securities" has created new ways for corporate insiders and other persons to modify their exposure to a company's equity without actually purchasing or selling an equity security and promptly reporting that change in exposure. Transactions involving these strategies should be immediately disclosed. My proposed changes would assure that investors know at once when insiders buy or sell their companies' stocks directly or by any other means.

I hope the Committee finds these recommendations to be useful as it considers a legislative response and thank you for providing me the opportunity to participate in the legislative process.

Very truly yours,



James S. Chanos
President, Kynikos Associates Ltd.

cc: Consuela Washington
Senior Counsel, Committee
on Energy and Commerce

David L. Cavicke
Counsel, Committee on
Energy and Commerce

Andrew M. Klein
Schiff Hardin & Waite

26085v10

ATTACHMENT A

Words in italics and brackets deleted. Words underlined added.

SEC. 21E. APPLICATION OF SAFE HARBOR FOR FORWARD-LOOKING STATEMENTS

(a) **APPLICABILITY.** — This section shall apply only to a forward-looking statement made by —

(1) an issuer that, at the time that the statement is made, is subject to the reporting requirements of section 13(a) or section 15(d);

(2) a person acting on behalf of such issuer;

(3) an outside reviewer retained by such issuer making a statement on behalf of such issuer; or

(4) an underwriter, with respect to information provided by such issuer or information derived from information provided by such issuer.

(b) **EXCLUSIONS.** — Except to the extent otherwise specifically provided by rule, regulation, or order of the Commission, this section shall not apply to a forward-looking statement--

(1) that is made with respect to the business or operations of the issuer, if the issuer--

(A) during the 3-year period preceding the date on which the statement was first made—

(i) was convicted of any felony or misdemeanor described in clauses (i) through (iv) of section 15(b)(4)(B); or

(ii) has been made the subject of a judicial or administrative decree or order arising out of a governmental action that—

(I) prohibits future violations of the antifraud provisions of the securities laws;

(II) requires that the issuer cease and desist from violating the antifraud provisions of the securities laws; or

(III) determines that the issuer violated the antifraud provisions of the securities laws;

(B) makes the forward-looking statement in connection with an offering of securities by a blank check company;

(C) issues penny stock;

(D) makes the forward-looking statement in connection with a rollup transaction; or

(E) makes the forward-looking statement in connection with a going private transaction; or

(2) that is —

(A) included in a financial statement prepared in accordance with generally accepted accounting principles;

(B) contained in a registration statement of, or otherwise issued by, an investment company;

(C) made in connection with a tender offer;

(D) made in connection with an initial public offering;

(E) made in connection with an offering by, or relating to the operations of, a partnership, limited liability company, or a direct participation investment program;

(F) made in a disclosure of beneficial ownership in a report required to be filed with the Commission pursuant to section 13(d).

(c) **SAFE HARBOR.** —

(1) **IN GENERAL.** — Except as provided in subsection (b), in any private action arising under this title that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading, a person referred to in subsection (a) shall not be liable with respect to any forward-looking statement if such person believed in good faith at the time such statement was made that there was a reasonable basis for such statement, whether written or oral, if and to the extent that--

(A) the forward-looking statement is—

(i) identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement; or

(ii) immaterial; or

(B) the plaintiff fails to prove that the forward-looking statement—

(i) if made by a natural person not serving as a director of or employed by the issuer to which the statement pertains, [*was made with actual knowledge* by *that person that the statement was*] was known or should have been known by such person to be false or misleading; or

(ii) if made by a business entity or on behalf of such entity by a person serving as a director of or employed by such entity, was—

(I) made by or with the approval of an executive officer of that entity; and

(II) made or approved by such officer [*with actual knowledge by that officer that the statement was*] and was known or should have been known by such officer to be false or misleading; or

(iii) was made less than three months prior to the accrual of a cause of action arising under this title that is based on an untrue statement of a material fact or omission of a material fact necessary to make the statement not misleading contained in such forward-looking statement.

(2) **ORAL FORWARD-LOOKING STATEMENTS.** — In the case of an oral forward-looking statement made by an issuer that is subject to the reporting requirements of section 13(a) or section 15(d), or by a person acting on behalf of such issuer, the requirement set forth in paragraph (1)(A) must be satisfied.

*[(3) **AVAILABILITY.** — Any document filed with the Commission or generally disseminated shall be deemed to be readily available for purposes of paragraph (2).]*

[(4)] (3) **EFFECT ON OTHER SAFE HARBORS.** -- The exemption provided for in paragraph (1) shall be in addition to any exemption that the Commission may establish by rule or regulation under subsection (g).

(d) **DUTY TO UPDATE.** — [*Nothing in this section shall impose upon any person a duty to update a forward-looking statement.*] A forward-looking statement and any cautionary statement accompanying such forward-looking statement made by or on behalf of a person referred to in subsection (a), and known by the issuer to which the statement pertains or by an executive officer of such issuer to have been made, must be updated by or on behalf of such issuer within two business days after such issuer or officer learns or should have learned of facts that, had they been known at the time either statement was made, would have rendered the statement materially false or misleading.

(e) **DISPOSITIVE MOTION.** — On any motion to dismiss based upon subsection (c)(1), the court shall consider any statement cited in the complaint and any cautionary statement accompanying the forward-looking statement, which are not subject to material dispute, cited by the defendant.

(f) **STAY PENDING DECISION ON MOTION.** — In any private action arising under this title, the court shall stay discovery (other than discovery that is specifically directed to the applicability of the exemption provided for in this section) during the pendency of any motion by a defendant for summary judgment that is based on the grounds that —

(1) the statement or omission upon which the complaint is based is a forward-looking statement within the meaning of this section; and

(2) the exemption provided for in this section precludes a claim for relief.

(g) **EXEMPTION AUTHORITY.** — In addition to the exemptions provided for in this section, the Commission may, by rule or regulation, provide exemptions from or under any provision of this title, including with respect to liability that is based on a statement or that is based on projections or other forward-looking information, if and to the extent that any such exemption is consistent with the public interest and the protection of investors, as determined by the Commission.

(h) **EFFECT ON OTHER AUTHORITY OF COMMISSION.** — Nothing in this section limits, either expressly or by implication, the authority of the Commission to exercise similar authority or to adopt similar rules and regulations with respect to forward-looking statements under any other statute under which the Commission exercises rulemaking authority.

(1) **DEFINITIONS.** — For purposes of this section, the following definitions shall apply:

(1) **FORWARD-LOOKING STATEMENT.** — The term "forward-looking statement" means —

(A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;

(B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;

(C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission;

(D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C);

(E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or

(F) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the Commission.

(2) **INVESTMENT COMPANY.** — The term "investment company" has the same meaning as in section 3(a) of the Investment Company Act of 1940.

(3) **GOING PRIVATE TRANSACTION.** — The term "going private transaction" has the meaning given that term under the rules or regulations of the Commission issued pursuant to section 13(e).

(4) **PERSON ACTING ON BEHALF OF AN ISSUER.** — The term "person acting on behalf of an issuer" means any officer, director, or employee of such issuer.

(5) **OTHER TERMS.** — The terms "blank check company," "rollup transaction," "partnership," "limited liability company," "executive officer of an entity," and "direct participation investment program" have the meanings given those terms by rule or regulation of the Commission.

(6) **"MEANINGFUL".** — The term "meaningful," when used to modify the words "cautionary statement" in this section, shall be defined in each case by reference to the extent to which the cautionary statement relates directly to the forward-looking statement made and applies specifically to one or more assumptions underlying such statement.

SEC. 16. DIRECTORS, OFFICERS, AND PRINCIPAL STOCKHOLDERS

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g) of this title, or [*within ten days*] as promptly as practicable and in no event later than one business day after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner and any other interest in such security, and [*within ten days after the close of each calendar month thereafter*], if there has been a change in such ownership or if such person shall have directly or indirectly engaged in any transaction involving any other interest in such security or purchased or sold a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving such equity security [*during such month*], shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the [*close of the calendar month*] time of the change in beneficial ownership or any transaction directly or indirectly involving any other interest in such security and such changes in his ownership of such security as well as any other interest in such security and such purchases and sales of such security based swap agreements as have occurred [*during such calendar month*].

. . .

(h) Solely for purposes of Section 16 of this title, "any other interest in such security" shall mean any direct or indirect pecuniary interest which derives its value from, or whose value is otherwise related to, an equity security within the scope of subsection (a) of this section.

(i) The Securities and Exchange Commission shall make statements filed with it under this section publicly available in accordance with the requirements of this title including, but not limited to, Section 35A of this title.

Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116 | 203-847-0700
Ext. 312
Fax: 203-847-6030

EDMUND L. JENKINS
Chairman

December 18, 2001

DEC 18 2001

The Honorable Cliff Stearns
United States House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Thank you for your letter of December 4, 2001, regarding Enron Corp. As we discussed at our meeting on December 5, 2001, the recent public filings of Enron Corp. include a description of the "restatement" referenced in your letter. That description reveals that Enron *did not comply with the existing accounting requirements* for consolidation of certain special-purpose entities ("SPEs"). If the existing requirements had been initially complied with, the debt of the SPEs would have been transparent to investors because that debt would have been reported on the face of Enron Corp.'s balance sheet.

As we also discussed, the Financial Accounting Standards Board ("Board") has an active project on its agenda relating to consolidation policy. One purpose of that project is to determine whether the accounting for consolidations should be improved. The Board's current efforts include public deliberations focusing on developing a proposed new standard that would provide guidance addressing the following issues:

- So-called strawman situations
- Entities that lack sufficient independent economic substance
- Convertible instruments and other contractual arrangements that involve latent control
- The distinction between participating and protective rights.

Effective guidance for those situations would resolve many of the accounting issues relating to consolidation policy encountered in present practice including issues relating to special-purpose entities.

The Board intends to move forward on these issues as expeditiously as it can, consistent with maintaining our open due-process, including considering the views of all of our constituents.

If you have any further questions, please feel free to contact me directly, or our Washington, DC representative, Jeff Mahoney, at 703-243-9085.

Sincerely,

DM VA

www.washingtonpost.com/kidspo

KidsPost

WASHINGTON POST, WEDNESDAY, JANUARY 30, 2002

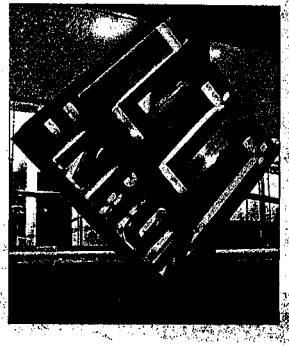
These pictures are clues to this question:
What's a nice summer treat?
(See answer below Today's News.)

TheBIGStory *An Occasional Look at Stories Everyone Is Talking About*

Greedy Liars? The Enron Scandal

DID THIS MAN GET RICH . . .

Former Enron chairman **Kenneth Lay** *told employees last October that the company was doing fine.*



PHOTOS BY ANDREW FRANCE-PIERCE GUTT AND CENTER AND JUSTIN KENDALL FOR THE WASHINGTON POST

. . . WHILE THESE PEOPLE GOT POOR?

Former Enron employee **Wayne Stevens** *and his wife,* **Cathie,** *lost their life savings when Enron collapsed.*

The Watchdog Doesn't Bark

Accountants don't have the most glamorous job in the world. Their days are spent closely examining piles of paperwork to make sure companies are following the rules. But they can be heroes, especially if they uncover lies.

Unfortunately, Enron's accountant doesn't appear to be very heroic. It was a firm called Arthur Andersen. Instead of telling the public that there was something unusual about Enron's finances, Andersen kept quiet. Even worse; Andersen's bosses say a top Andersen accountant named David Duncan ordered his workers to destroy documents that might have made it easier to figure out what was really going on. The documents were destroyed by putting them into shredding machines that sliced the paper into tiny, unreadable pieces.

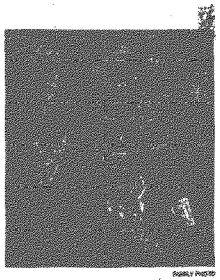
Congress wants to know what Duncan knows, but so far he isn't talking.

Some Heroes

Last year Bethany McLean, a reporter for Fortune magazine, decided to take a hard look at Enron. She had a question: How exactly did Enron make its money? Enron's bosses wouldn't answer her. One hung up when she called. Another called McLean's boss to complain.

Some Enron executives apparently tried to do the right thing. Sherron Watkins is an Enron vice president. Last year she sent a six-page letter to Enron chief Kenneth Lay warning him that Enron wasn't doing well and that it might "implode in a wave of accounting scandals."

As it turned out, that's exactly what happened. But Lay and others decided there was no reason to heed Watkins's warning.



SGIRLY PHOTO

Sherron Watkins: She says it sounding.

Last year Enron was the seventh largest U.S. company. Today it's bankrupt. Thousands of Enron workers have lost their jobs. Some have even lost their life savings. And maybe it didn't have to happen.

What went wrong? It's a story so complicated that investigators have just started unraveling the mystery. But lots of people think there's something pretty simple at the bottom of the Enron mess: lies and greed. **John Kelly** takes a look at the scandal.

The Birth of Enron

Enron started life in Texas as a company that owned underground pipes and sold natural gas to power plants. Then Enron expanded into all sorts of other businesses. It sold natural gas, electricity, Internet connections and more. It bought other companies and grew larger and larger.

Enron looked like a success, a company people wanted to work at and invest in. But then . . .

Secrets & Lies

Companies are allowed to keep some secrets—the recipe for a best-selling soft drink, for example. But there are some secrets they can't keep, especially if they're a "publicly held" company.

Publicly held means that the public can buy stock, or ownership, in the company. When the company does well and makes a profit, the value of the stock goes up. But when a company is badly run, the stock value goes down. By studying information provided by a company, people can decide which stocks they should buy and which ones they should sell.

For years everyone thought Enron was one of the best companies in the United States. If you bought one piece—or "share"—of Enron stock in January 1998 it cost you about $20. By September 2000 that same share was worth nearly $90.

"NO, WE'RE ENRON—WE ROB FROM THE POOR AND GIVE TO OURSELVES!"

BY DOUG MARLETTE—TRIBUNE MEDIA SERVICES

Enron's secret, officials say, is that it *wasn't* a well-run company. It was losing money, not making money. And to hide that fact it created dozens of partnerships. These secretive side deals allowed Enron to hide its debt. The idea seemed to be to convince people that it wasn't *Enron* that was in trouble, it was these *other* groups. The problem: Those other groups *were* Enron. And Enron was like a shaky building about to collapse.

Rich Bosses, Poor Employees

As Enron's stock increased in value, the people who ran the company got richer and richer. They often were paid in stock, in addition to their salaries. Regular employees did well too—at least on paper. They were allowed to buy Enron stock to save for retirement. In fact, it was encouraged: Last October, Kenneth Lay, the head of Enron, sent an e-mail to workers saying that the stock was a great deal and the company was going strong.

But it wasn't going strong. And Enron's bosses seemed to know that. For years they'd been selling some of *their* stock. It was almost as if they knew the value was going to drop. And it did drop. Last fall, when Enron announced that it had earned $586 million *less* over the past four years than it had said at first, the stock value plummeted. It was a good time to sell Enron stock.

At around that time, though, Enron employees weren't allowed to sell their stock. They were frantic as they watched their life savings drip away. But company bigwigs were allowed to sell their stock.

Today stock once valued at about $90 a share is worth about 45 cents.

Politicians' Problems

Enron didn't only spend money buying pipelines and other companies. It also donated money to Republicans and Democrats to help those politicians pay for their election campaigns. This is legal, but a lot of people think it smells fishy. They worry that a senator or representative who got a lot of money from Enron might hesitate to do anything that would upset the huge company.

Think about it this way: If someone gave you a $10,000 "gift," would you think they expected something in return?

President Bush received money from Enron. So did Attorney General John Ashcroft while running for re-election to the U.S. Senate. (Ashcroft, now in charge of prosecuting companies that cheat the public, has said he won't be involved in the Enron investigation.)

Because of these connections, and the fact that such a big company failed and so many workers lost their jobs and their money, people are wondering what the Enron investigation will reveal.

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Wednesday, December 5, 2001

A Section

After Enron, New Doubts About Auditors
David S. Hilzenrath
Washington Post Staff Writer

First of two articles

The collapse came swiftly for Enron Corp. when investors and customers learned they could not trust its numbers. On Sunday, six weeks after Enron disclosed that federal regulators were examining its finances, the global energy-trading powerhouse became the biggest bankruptcy in U.S. history.

Like all publicly traded companies in the United States, Enron had an outside auditor scrutinize its annual financial results. In this case, blue-chip accounting firm Arthur Andersen had vouched for the numbers. But Enron, citing accounting errors, had to correct its financial statements, cutting profits for the past three years by 20 percent -- about $586 million. Andersen declined comment and said it is cooperating in the investigation.

The number of corporations retracting and correcting earnings reports has doubled in the past three years, to 233, an Andersen study found. Major accounting firms have failed to detect or have disregarded glaring bookkeeping problems at companies as varied as Rite Aid Corp., Xerox Corp., Sunbeam Corp., Waste Management Inc. and MicroStrategy Inc.

Corporate America's accounting problems raise the question: Can the public depend on the auditors?

"Financial fraud and the accompanying restatement of financial statements have cost investors over $100 billion in the last half-dozen or so years," said Lynn E. Turner, who stepped down last summer as the Securities and Exchange Commission's chief accountant.

The shareholder losses resulting from accounting fraud or error could rival the cost to taxpayers of the savings-and-loan bailout of the early 1990s, he said. Enron investors, including employees who held the company's stock in their retirement accounts, lost billions.

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Accounting industry leaders deny they are to blame. They say that the number of failed audits is tiny in relation to the many thousands performed successfully, and that it's often impossible for auditors to see through a sophisticated fraud.

"The industry's record is strong," said Stephen G. Butler, chief executive of KPMG LLP. "I think the fundamental question is: Will you ever get to the point where there are not audit failures? In my view, you won't, just as you won't get to a point where there are no airplane crashes or no automobile crashes, no matter what the safety design or procedures."

The federal government gave the accounting industry the valuable franchise to audit companies that sell shares to the public after the stock market crash of 1929. In return, auditors are supposed to do their best to make sure investors can trust corporate financial statements.

With more than half of the nation's households owning stocks -- directly or through pension or mutual funds -- and a stagnant economy depressing stock values, the investing public has never needed a diligent accounting profession more.

The American system of accounting is still the gold standard for the world. In recent years, the U.S. accounting industry has changed markedly, consolidating into a handful of firms that have become global financial consultants. Known as the "Big Five," Arthur Andersen, Deloitte & Touche LLP, Ernst & Young, KPMG and PricewaterhouseCoopers audit most of the companies whose shares trade on the nation's stock markets.

Licensed professionals are expected to do more than just make sure the numbers add up. They are supposed to check inventory, contact customers and perform other tests before putting their stamp of approval on reports that fairly present the company's financial results.

Increasingly, the way these firms do business is at odds with the accounting industry's public watchdog mission.

* Major accounting firms often make more money from selling clients advice than they do from auditing their books. The accounting firms help businesses pick computer systems, lobby for tax breaks, even evaluate takeover targets. Auditors have been graded and rewarded based on how much other business they win from their audit clients. Arthur Levitt Jr., the former chairman of the SEC, which polices public companies, has argued that such incentives could tempt accountants to go easy on an audit.

* Auditors frequently leave their watchdog positions for jobs at the companies they audit. This career path can encourage auditors to make

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improper compromises, the SEC has warned. The route is so popular that auditors often find themselves dealing with former colleagues who are now their clients' executives.

* The profession has sought to insulate itself from responsibility for false or fraudulent accounting. When things go wrong, firms typically decline to answer for their work, invoking client confidentiality.

* The system can discourage thoroughness. The fees companies pay their auditors are often set in advance, so the accounting firms' profit margins can diminish as their efforts increase. There are signs that accounting firms are putting fewer resources into audits, using inexperienced staff or skimping on records checks.

These developments compound the more basic, underlying conflict: The auditors are hired, fired and paid by the companies they are responsible for auditing.

"Too often, they operate under the principle that the customer is always right," said Nell Minow, an activist money manager and editor of the Corporate Library, a Web site on corporate governance. "They will give the answer that the customer wants . . . so they can continue to get the fees."

Investment billionaire Warren E. Buffett put it this way in 1999: "Though auditors should regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay." Buffett quoted a proverb: "Whose bread I eat, his song I sing."

The new SEC chairman, Harvey L. Pitt, a lawyer who has represented the accounting industry, dismissed Buffett's observation as "a good sound bite" and "a nice thing for people who want to attack a profession to say." What prevents such obsequiousness, he said, is that "if an accounting firm has a reputation for being independent, for being professional and for doing its job, then everybody will flock to that firm."

Robert Kueppers, head of Deloitte's national office, said he and his colleagues know their highest priority: "The culture that I grew up with 25 years here is, your first responsibility is to get the audit done and get it done right."

Last year, an industry panel on audit effectiveness found that "both the profession and the quality of its audits are fundamentally sound."

Accounting firms cite a number of reasons for the rise in corrections. It's tough to apply standards that are nearly 70 years old to the modern economy, they say. And the SEC has made matters worse by issuing new

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interpretations of complex standards. "The question is not how does this reflect on the auditors," Arthur Andersen said in a written statement. Instead, the firm asked: "How is it that auditors are able to do so well in today's environment?"

'Public Watchdog' Function

In a 1984 ruling, the Supreme Court declared that auditors have an overriding duty to protect the public interest. "This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust," the court said.

The leading industry trade group, the American Institute of Certified Public Accountants (AICPA), encouraged auditors to take a broad view of their role in a 1999 publication titled "Make Audits Pay: Leveraging the Audit Into Consulting Services." The book says the auditor should think of himself as a "business adviser" and promote his accounting firm's consulting services because "intense competition has reduced the audit to a mere commodity that is distinguishable to the consumer only according to price."

The book notes that "conflicts may arise" in asking the auditor to perform two roles that are inherently at odds. "The business adviser is a client advocate," responsible for "acting in the owner's best interests." That is "completely different from the professional skepticism required of the auditor," the book says. But it suggests the conflicts are manageable if the auditor errs on the side of looking out for the public interest.

A case study posted on Arthur Andersen's Web site under "Success Stories" shows how the firm sees itself. As auditor for TheStreet.com Inc., a financial news service, Arthur Andersen said, it helped its client prepare for an initial public offering of stock, develop a global expansion strategy and secure a weekly television show through another client, News Corp.

One of Arthur Andersen's "greatest strengths . . . is developing full-service relationships with emerging companies and then using all of our capabilities to find inventive ways to help them continue to grow," auditor Tom Duffy is quoted as saying.

TheStreet.com chief executive Thomas J. Clarke Jr. said the accounting firm "become[s] a business partner because they're right there with you." He said the auditors answer to a committee of outside board members, not TheStreet.com executives, to provide checks and balances.

Within the accounting business, consulting is widely viewed as more glamorous and lucrative than auditing. The SEC's Pitt said the

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profession has faced "some difficulties in attracting the best and the brightest."

Among the Big Five firms, U.S. consulting revenue totaled more than $15 billion in 1999 -- about half the firms' total revenue -- the SEC reported last year. That was up from 13 percent in 1981.

The AICPA has described the "certified public accountant" designation as a marketing liability. "The marketplace says the worst thing we have going for us is the 'A' in CPA," Barry Melancon, the trade group's president, wrote in 1998, referring to the word "accountant."

To reflect the variety of services accountants offer, AICPA leaders this fall proposed creating a new credential for "strategic business professionals," and AICPA members have been given until Dec. 28 to vote on the idea.

Fees for non-audit services often eclipse those for audits, according to disclosures corporations were require to begin filing with the SEC early this year. KPMG billed electronics manufacturer Motorola Inc. $3.9 million for auditing and $62.3 million for other services. Ernst & Young billed long-distance phone company Sprint Corp. $2.5 million for auditing and $63.8 million for other services. AT&T Corp. paid PricewaterhouseCoopers $7.9 million for auditing and $48.4 million for other services.

No one has suggested the financial statements of those companies are inaccurate or misleading.

Rite Aid shareholders alleged that consulting fees figured in KPMG's relationship with the drugstore chain, according to their class-action lawsuit against the accounting firm.

Rite Aid acknowledged last year that it had overstated earnings by more than $1 billion over two years. Audit fees were less than 20 percent of what Rite Aid paid KPMG over a 2 1/2-year period in the late 1990s, the suit alleged.

At one point, the suit alleged, Rite Aid's then-chairman, Martin L. Grass, awarded KPMG consulting engagements worth more than $1.5 million "as a sweetener and to ensure the accounting firm's continued cooperation."

An attorney for Grass said the allegations were "wrong" and "grossly unfair." KPMG was given a contract to address weaknesses in Rite Aid's inventory-tracking system, not to ensure cooperation, lawyer Andrew Weissman said.

KPMG said that it was "victimized by company management" and that the

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consulting it did for Rite Aid was "insignificant to the overall professional relationship."

The pressures on individual auditors to be "rainmakers," luring new business, as well as to be watchdogs, is apparent from documents in another lawsuit, which was decided in 1996. The case involved Coopers & Lybrand accountant Gregory Finerty's work as auditor for another drugstore chain, Phar-Mor Inc., in the late 1980s. When he didn't bring in enough consulting revenue to please his employer, Finerty's performance review and compensation suffered, the documents showed. "Greg was skipped last year . . . but he got the 'message,' " a superior wrote in one review. The next year, the reviewer added, "he bounced back and . . . cross sold over $900,000 of business."

As Finerty sold more consulting services, his reviews improved. "WOW!!! Greg cross-sold $2.5 million in Special Services to his client," his 1991 review said.

"He penetrated 18 of his 21 clients and sold every service line."

Then, massive accounting fraud at Phar-Mor was exposed. The company filed for bankruptcy protection and its chief executive was convicted of felonies.

In 1996 a jury found that Coopers committed civil fraud. Coopers then settled with plaintiffs for an undisclosed amount.

PricewaterhouseCoopers, formed by the 1998 merger of Coopers and Price Waterhouse, told The Washington Post, "We were the victims of a massive, collusive fraud perpetrated by the former management of Phar-Mor."

Finerty, who is no longer with the firm, declined to comment.

Accounting executives say providing consulting services actually improves audits because it helps an accounting firm get to know a client's business better.

"There is no conflict between the auditor's responsibilities and his calling to the client's attention certain other services that may benefit the client," PricewaterhouseCoopers said in a written reply to questions from The Washington Post.

A document from another lawsuit shows that PricewaterhouseCoopers was still monitoring the amount of non-audit services partners generated last year.

Personnel records of Warren Martin, who oversaw the firm's audits of Virginia software maker MicroStrategy, showed he brought in nearly $3.6 million of "other service line revenues" during the 10 months that ended

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April 30, 2000, compared with a $2 million target for the year.

PwC said it would not comment on personnel matters.

Trust and Discretion

"CPAs must never forget that the 'P' in 'CPA' stands for public -- serving the public and maintaining their trust," former SEC chief accountant Turner said.

Accounting firms say they have not forgotten their public duty and note they have dropped clients or been fired over disagreements with them. They have also forced clients to publicly correct errors.

Last year, Gene Logic Inc., a Gaithersburg biotechnology firm, fired Arthur Andersen, saying it was disappointed with the outside auditor's level of service and cost. Andersen said in a letter included in an SEC filing that, before Andersen was fired, the accounting firm had told the company it thought it was trying to book $1.5 million of revenue from new contracts prematurely. Gene Logic spokesman Robert Burrows said the revenue disagreement had nothing to do with the auditor's dismissal.

Arthur Andersen said it quickly resigned or refused to accept more than 60 auditing jobs last year after its background checks turned up questions about the integrity of the clients' management.

"There have been innumerable cases . . , where people have stood up and refused to go along with improper conduct," SEC Chairman Pitt said.

Accounting firms say their duty to protect client confidences, based in state law and the profession's code of ethics, prevents them from discussing specific instances where they stood up to their clients and put an end to accounting manipulations.

Citing the same client confidentiality requirements, firms generally refrain from giving a public explanation when a financial blowup leaves investors in free fall.

The board of franchising conglomerate Cendant Inc. commissioned an investigation by outside lawyers and accountants of irregularities at CUC International Inc., one of two companies that merged to form Cendant in 1997. The investigators' 1998 report concluded that CUC had inflated operating income by $500 million over a three-year period, and it accused several insiders of participating in the deception.

But the report made no judgments about the company's longtime auditor, Ernst & Young. As a condition of cooperating, Ernst & Young insisted that the investigation remain silent on the question of whether it had violated professional standards, according to a legal brief filed on

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behalf of investors.

Ernst & Young later paid $335 million to settle with CUC shareholders who had sued it. Two former CUC executives who previously worked for Ernst & Young pleaded guilty to criminal charges.

The accounting firm said it was "the victim of intentional, collusive fraud on the part of CUC's management." The $335 million payment was not an admission of wrongdoing, the firm added, saying such settlements are "sometimes the only realistic option."

The accounting industry has long resisted the idea that auditors should be responsible for exposing fraud.

"We don't want to be in the business of being fraud detectors," Philip Laskawy, who retired in June as chief executive of Ernst & Young, told The Washington Post in the mid-1990s. "What we would like to believe . . . is that you're dealing with honest and reliable people."

A standard adopted by the profession since then requires auditors to assess the risk that fraud is occurring and tailor their audits accordingly.

Since 1995, auditors are also required to notify the SEC if they learn of illegal acts that corporate managers have failed to remedy. Then-SEC enforcement director Richard H. Walker said in a speech last December that the agency received "fewer than five" such notices during the preceding year and fewer than a dozen before then.

Rep. John D. Dingell (D-Mich.), who has sparred with accounting firms before, wondered if the sparse reports meant the auditors are "missing in action." Accounting firms said they expected only a small number of reports, partly because the requirement is triggered only if, in their opinion, an illegal act has "a material impact on the financial statements."

Though investors may interpret an auditor's certification as a sign that financial statements are accurate, accounting firms say their audits are intended to provide only "reasonable assurance" that financial statements are free of "material misstatement."

Over the years, auditors have overlooked a variety of problems and warning signs on the grounds that they were not big enough to be considered "material."

For example, while auditing CUC International, Ernst & Young concluded that after-tax income for one month was overstated by $23 million. But the auditor concluded that the $23 million problem and other discrepancies were not material, according to a report Cendant filed

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with the SEC. In answer to questions from The Post, Ernst & Young responded generally that even the best audits cannot detect fraud.

Later, after CUC merged with HFS Inc. -- the company behind such famous brands as Avis, Days Inn and Century 21 -- the leadership of the new corporation announced that it had discovered "potential accounting irregularities" and that previously issued auditors' reports "should not be relied upon." The value of the combined company's stock sank by billions of dollars.

Standards and Practices

The basic requirements of an audit include checking a company's inventory and verifying transactions with a sampling of customers. But professional standards, set by an AICPA board, give accountants broad discretion as to what to do in an audit.

"The auditing standards are so general that, as a practical matter, it's difficult to hold anyone accountable for not following them," said Turner, the former SEC chief accountant.

Even so, a report by an accounting industry review panel last year cited a "gap" between auditing standards and "what actually transpires in practice."

The Panel on Audit Effectiveness, which was led by a former chairman of Price Waterhouse, warned that "audit firms may have reduced the scope of audits and the level of testing." The panel called for heightened testing to better detect fraud.

While accounting firm managers constantly send their auditors messages on topics such as client service, client relationships and profitability, such guidance "often only indirectly infer that quality audit work is an integral part of quality client service," the panel said.

When CFO magazine, a publication for financial executives, surveyed 75 chief financial officers last year, 18 percent called their auditors "extremely thorough," but 23 percent rated them "not thorough enough."

Some industry veterans say audits have become loss leaders -- a way for firms to get their foot in a client's door and win consulting contracts.

Arthur Andersen disagreed, telling The Post that audits are among the more profitable services the firm provides, adding that "lower pricing in some years" is "made up over time."

Indeed, accounting firms say that if the audit becomes more complicated than initially expected, their contracts generally allow them to go back

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to their clients and adjust the fee.

In a long-running lawsuit, Calpers, the giant pension fund for California public employees accused Arthur Andersen of doing such a superficial job auditing a finance company that the "purported audits were nothing more than 'pretended audits.' "

Andersen assigned a young, inexperienced auditor "who has candidly testified he did not even know what a Contract Receivable was, then or now," consultants for Calpers wrote in a September 2000 report prepared in support of the lawsuit.

Andersen didn't test any of those accounts while the unpaid balances soared, and it failed to recognize that a substantial amount was uncollectible, the report said.

Andersen declined to comment on the case, which was settled confidentially.

Potential Conflicts

Just as government officials often take jobs in the industries they are responsible for regulating, outside auditors often go to work for their clients.

The AICPA board of directors in 1993 proposed a cooling-off period before lead auditors could go to work for their clients, but the SEC last year decided that approach "unnecessarily restricts . . . employment opportunities."

Investors in MicroStrategy lost billions of dollars, at least on paper, when the Northern Virginia software company announced in March 2000 that, contrary to years of audited financial statements, it had been losing money rather than making a profit.

Months before the correction, while serving as senior manager on the MicroStrategy audit, a PricewaterhouseCoopers accountant sought a job as chief financial officer of a MicroStrategy subsidiary, according to a report filed by plaintiffs in a shareholder lawsuit against the accounting firm. The report cited an Aug. 6, 1999, e-mail from the auditor to a MicroStrategy executive, saying, "As we discussed I would really appreciate the opportunity to have a shot at the CFO spot in the new company."

PricewaterhouseCoopers said this had "no impact on the quality or integrity of the audit." The accounting firm denied wrongdoing and said it agreed to pay a $51 million settlement "to avoid the further costs and uncertainties of protracted litigation."

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Few cases illustrate the potential conflicts in the accounting business as vividly as the one involving Arthur Andersen and Waste Management.

Many investors may not realize they were victims because they held Waste Management stock indirectly, through mutual funds and retirement plans. Lolita Walters, an 80-year-old retired New York City government employee who suffers from diabetes and a heart condition, can count what she lost -- more than $2,800, enough money to pay for almost a year of prescription drugs.

"I think it's unconscionable," Walters said of Andersen's role.

According to the SEC, Andersen lent its credibility to Waste Management's annual reports even though it had documented that they were deeply flawed.

Waste Management eventually admitted that, over several years, it had overstated its pretax profits by $1.4 billion.

In a civil suit filed in June, the SEC accused Arthur Andersen of fraud for signing off on Waste Management's false financial statements from 1993 through 1996. For example, during the 1993 audit, the SEC said, the auditors noted $128 million of cumulative "misstatements" that would have reduced the company's earnings, before including special items, by 12 percent. But Andersen partners decided the misstatements were not significant enough to require correction, the SEC said.

An Andersen memorandum showed the accounting firm disagreed with the approach Waste Management used "to bury charges" and warned Waste Management that the practice represented "an area of SEC exposure," but Andersen did not stop it, the SEC said.

An SEC order noted that, from 1971 until 1997, all of Waste Management's chief financial officers and chief accounting officers were former Andersen auditors. The Andersen partner assigned to lead the disputed audits coordinated marketing of non-audit services, and his compensation was influenced by the volume of non-audit fees Andersen billed to Waste Management, the SEC said.

Over a period of years, Andersen and an affiliated consulting firm billed Waste Management about $18 million for non-audit work, more than double the $7.5 million it was paid in audit fees, which were capped, the SEC said. Andersen said some of the non-audit work was related to auditing.

Andersen, which continues to serve as Waste Management's auditor, agreed to pay a $7 million fine to the SEC, and joined with Waste Management to settle a class-action lawsuit on behalf of shareholders for a combined $220 million. Andersen did not admit wrongdoing in either

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settlement.

"There are important lessons to be learned from this settlement by all involved in the financial reporting process," Terry E. Hatchett, Andersen's managing partner for North America, said in a statement after the SEC action. "Investors can continue to rely on our signature with confidence."

Staff writer Sandra Sugawara and researcher Richard Drezen contributed to this report.

Tomorrow: The accountants' accountability

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Thursday, December 6, 2001

A Section

Auditors Face Scant Discipline; Review Process Lacks Resources, Coordination, Will

David S. Hilzenrath
Washington Post Staff Writer

Second of two articles

John A. LaBarca was supposed to look out for the investors.

Starting in the mid-1980s, he oversaw the outside audits of JWP Inc., an obscure New York company that bought a string of businesses and transformed itself into a multibillion-dollar conglomerate. The job required LaBarca, a partner at the big accounting firm Ernst & Young LLP, to scrutinize the work of JWP's chief financial officer, Ernest W. Grendi, a running buddy and former colleague.

In 1992, a new president at JWP discovered rampant accounting manipulations, and the company's stock sank. When the numbers were corrected, the 1991 earnings were slashed from more than $60 million to less than $30 million.

After hearing extensive evidence in a bondholders' lawsuit, a federal judge criticized "the seeming spinelessness" of LaBarca.

"Time and again, Ernst & Young found the fraudulent accounting at JWP, but managed to 'get comfortable' with it," Judge William C. Conner wrote in a 1997 opinion. "The 'watchdog' behaved more like a lap dog."

Today, LaBarca is senior vice president of financial operations and acting controller at the media conglomerate AOL Time Warner Inc., where his duties include overseeing internal audits.

The Securities and Exchange Commission filed and settled fraud charges against Grendi but took no action against LaBarca. Neither did the American Institute of Certified Public Accountants (AICPA), a 340,000-member professional organization charged with disciplining its own, or the state of New York, which licensed LaBarca.

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LaBarca declined to discuss the JWP case but maintained during the trial that the accounting was "perfectly within the guidelines."

An Ernst & Young spokesman said the firm was confident it upheld a tradition "of integrity, objectivity and trust." Grendi declined comment.

A Washington Post analysis of hundreds of disciplinary cases since 1990 found that, when things go wrong, accountants face little public accountability.

"The deterrent effect that's necessary is just not there," said Douglas R. Carmichael, a professor of accountancy at the City University of New York's Baruch College. That "makes investing like Russian roulette," he added.

In theory, the system has several complementary layers of review. In practice, it is undermined by a lack of resources, coordination and will.

The SEC can bar accountants from auditing publicly traded companies for unprofessional conduct. The agency, however, has the personnel to investigate only the most egregious examples of auditing abuse, officials say. It typically settles its cases without an admission of wrongdoing, often years after the trouble surfaced.

Between 1990 and the end of last year, the SEC sanctioned about 280 accountants, evenly divided between outside auditors and corporate financial officers, The Post's review found.

The AICPA can expel an accountant from its ranks, which can prompt the accountant's firm to reassign or fire him. The trade group took disciplinary action in fewer than a fifth of the cases in which the SEC imposed sanctions, The Post found. About one-third of the accountants the SEC sanctioned weren't AICPA members and thus were beyond its reach.

Even when the AICPA determined that accountants sanctioned by the SEC had committed violations, it closed the vast majority of ethics cases without disciplinary action or public disclosure.

President Bill Clinton's SEC chairman, Arthur Levitt Jr., a frequent critic of the industry, said the AICPA "seems unable to discipline its own members for violations of its own standards of professional conduct."

The membership group works as a lobbying force for accountants and often battles SEC regulatory efforts.

State regulators have the ultimate authority. They can take away an

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accountant's license. But some state authorities acknowledge that their efforts are hit-or-miss.

"We only find out about violations on the part of regulants [licensees] in two ways: One, somebody complains, or two, we get lucky," said David E. Dick, assistant director of Virginia's Department of Professional and Occupational Regulation, which until recently administered discipline for the state's accountants.

When the SEC settles without a court judgment or an admission of culpability, state authorities must build their case from scratch, said regulators in New York, where many corporate accountants are licensed.

"You could probably fault both state boards and the SEC for not having worked cooperatively enough with one another over the years," said Lynn E. Turner, who stepped down this summer as the SEC's chief accountant. He added that the agency has tried harder over the past year and a half to share investigative records with state regulators.

As of June, the state of New York had taken disciplinary action against about a third of the New York accountants The Post culled from 11 years of SEC professional-misconduct cases.

While prosecutors occasionally file criminal charges against corporate officials in financial fraud case, they hardly ever bring criminal cases against independent auditors, in part because the accounting rules are so complex. The AICPA's general counsel could recall only a handful of prosecutions.

"From my perspective, this was very hard stuff," said a federal prosecutor who investigated a major accounting fraud. "The prospect of litigating a case against people who actually do this stuff for a living and at least in theory are the world's experts . . . is a daunting prospect."

Investor lawsuits sometimes lead to multimillion-dollar settlements. But they rarely shed light on the performance of individual auditors because accounting firms generally get court records sealed and settle before trial, limiting public scrutiny.

The accounting firms say they discipline those who violate professional standards, including removing them from audits or terminating their employment.

Barry Melancon, president of the AICPA, said "you cannot look at discipline alone" when assessing accountability in the accounting profession.

The profession's emphasis is on preventing rather than punishing

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mistakes, he added. Thus, it invests heavily in quality-control efforts, such as periodic "peer reviews" of the paperwork accounting firms generate during audits.

In disciplinary cases, the AICPA's goal is to rehabilitate accountants, not to expel them, officials said. "While it may feel good and it may give somebody something to write about when somebody is disciplined, the most important thing is whether or not this profession does a good job doing audits or not," Melancon said.

The AICPA puts its investigations on hold until SEC enforcement actions and other litigation have run their course, which can take several years.

Acknowledging one of the system's historic weaknesses, the AICPA this year began requiring accounting firms to, at a minimum, supervise senior auditors' work more closely while they are the subject of a pending AICPA ethics case.

"The profession's self-disciplinary process . . . taken as a whole, is reasonably effective in protecting investor interests," the accounting firm Arthur Andersen LLP said in a statement. "As with any system, it can be improved."

A Critic of the SEC

No one has been more critical of the SEC's slow-moving enforcement process than the agency's new chairman, Harvey L. Pitt, a lawyer with long experience defending clients against the SEC.

"If you bring a case six years after a company goes down the tubes, after all of the money has been squandered and dissipated, you are not helping investors," Pitt said.

Pitt is offering leniency in return for prompt cooperation and restitution. He said that could mean forgoing enforcement action in rare cases. But he also said, as violations warrant, "we are going to be every bit as tough as the SEC has ever been, and maybe even tougher."

SEC penalties for unprofessional conduct include temporarily or permanently barring someone from auditing companies whose shares trade on stock markets.

Negotiated settlements remain central to Pitt's enforcement strategy. "There are not enough lawyers in the country for us to hire if we have to litigate all of our cases," he said.

Richard Walker, the SEC's director of enforcement until earlier this year, said before he left that about 70 SEC accountants were working on

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about 250 enforcement cases involving accounting and financial reporting, and the agency lacked the capacity to pursue every violation.

"We just simply don't have the resources to do that, so we have to be selective and . . . choose cases that have the greatest importance," Walker said.

But even when the agency focuses on a high-priority case, its actions can send mixed signals. In June the SEC alleged that a former managing partner of Arthur Andersen allowed persistent misstatements in Waste Management Inc.'s financial reports to go uncorrected, but the agency took no action against him.

The accounting firm and three lower-ranking Andersen personnel settled SEC fraud charges, without admitting wrongdoing. The firm agreed to pay $7 million; the individual accountants, a total of $120,000.

Walker said the SEC took no action against the former managing partner, who wasn't identified by name, because the agency didn't think he had the "requisite state of mind" or knowledge.

Asked for comment, an Andersen spokesman replied, "The record speaks for itself."

With or without an admission of wrongdoing, an SEC enforcement action for professional misconduct "is the closest thing as you get to a death penalty in the accounting profession," said Charles D. Niemeier, chief accountant in the SEC's enforcement division.

"If the person is a partner in a Big Five firm, they're gone," and "most major companies would not hire a person in any key position" who has an SEC enforcement action on their record, Niemeier said.

That wasn't the case after the SEC ordered Thomas J. Scanlon, a Price Waterhouse LLP partner, to "cease and desist" from violating securities laws in 1999. The agency found that he knew a W.R. Grace & Co. subsidiary had manipulated numbers but failed to insist on proper disclosure.

PricewaterhouseCoopers, as the firm is now known, said the SEC action "speaks for itself."

The order essentially meant that "you don't admit you did anything wrong but you agree that you will not do it again," as Scanlon put it in an interview. Until early this year, Scanlon, now retired, remained the lead PricewaterhouseCoopers partner on the W.R. Grace audit.

Self-Regulator

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The accounting profession has long championed its ability to regulate itself, from setting auditing standards to reviewing how well accounting firms follow those requirements. The AICPA, with an ethics division and various oversight committees, stands at the center of that effort.

As early as the 1970s, that effort was under fire. A congressional report in 1977 called for stronger government oversight of accounting, citing an "alarming lack of independence and . . . dedication to public protection."

The report also noted that the AICPA cleared former Nixon administration official Maurice H. Stans of professional ethics charges after he pleaded guilty to criminal charges in the Watergate scandal. Stans had been president of the AICPA and senior partner of a major accounting firm.

The same year an AICPA advisory commission called on the trade group "to conduct the profession's disciplinary actions 'in the sunshine,' " but the AICPA rejected that proposal, according to a history by its past president, Wallace E. Olson.

In 1985 Price Waterhouse, citing a "crisis of confidence in the auditor's effectiveness," broke ranks with other major firms and called for creation of an SEC-supervised self-regulatory organization "with credible disciplinary authority."

Other big accounting firms were furious. "They couldn't believe that [Price Waterhouse] was selling them out, that here was a firm ready to jump in bed with the enemy," said Wade S. Williams, a former lobbyist for the AICPA and Deloitte & Touche LLP. The proposal died.

Most of the AICPA's ethics work is invisible to the public. When the group finds violations, it routinely resolves cases by issuing confidential letters directing accountants to take "corrective" steps such as courses providing "continuing professional education."

Such private letters have outnumbered by 5 to 1 the suspension or expulsion of members, according to a 1999 AICPA memo to the SEC obtained through the Freedom of Information Act. The memo covered the most recent 108 cases that had been resolved by an AICPA disciplinary panel after SEC action. More extensive data the AICPA gave The Post showed the same pattern.

The AICPA lacks the power to restrict an accountant's practice. But, indirectly, its disciplinary actions can have consequences. If a firm continued to employ a partner expelled from the AICPA, the firm itself could face expulsion, and that could disqualify it from auditing companies listed on the Nasdaq Stock Market and the American Stock Exchange, AICPA officials said.

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The Post analysis of AICPA data shows that about 60 percent of the more that 500 members expelled between 1990 and the end of 2000 were ousted automatically, in cases, for example, where they had already been convicted of a crime or stripped of a state license. In more than a quarter of the expulsion cases, members were ousted for refusing to cooperate with AICPA investigations or comply with its remedial orders.

Only about a quarter of the AICPA's disciplinary actions explicitly involved auditing. Others involved such unrelated offenses as failing to file personal tax returns or embezzling from clients.

The main reason the AICPA refrains from disciplining accountants the SEC has punished is that it lacks the power to subpoena evidence, said Norman R. Walker, former chairman of an AICPA disciplinary panel. "Basically we're confined to looking at the [public] record and the information that the [member] is able to provide and willing to provide," he said.

Besides, AICPA officials added, when accountants settle SEC charges without admitting wrongdoing, the enforcement actions don't prove they did anything wrong. The SEC does not share confidential investigative files with the AICPA.

The AICPA allows accountants to put off disciplinary proceedings while other litigation or regulatory actions are pending. The group postpones action because "if we found something, the plaintiff would use it against our member," said Richard I. Miller, the group's general counsel. "We don't think that that's fair."

The postponements have taken an average of nearly three years, and as long as a decade. It has then taken about a year and half, on average, to conclude a case, according to an AICPA memo to the SEC.

An industry review panel led by a former Price Waterhouse chairman reported last year that the profession's disciplinary system "suffers from a number of limitations," adding that AICPA investigations "typically commence and conclude long after the public's memory of the matter has faded."

The case of Samuel George Greenspan shows how long the process can take.

Greenspan was retained by ZZZZ Best Corp., a California carpet cleaner, to audit financial statements in the mid-1980s. Greenspan relied on a report by a prior auditor named Richard Evans, which ZZZZ Best's management gave him, regulators alleged. But, according to the SEC, the report was a fabrication.

Had Greenspan checked, he would have discovered that Evans didn't

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exist, the SEC said. Had he bothered to inspect the eight-story building described in the company's second-largest contract, he would have learned that it didn't exist, either, the SEC said. Greenspan never visited any of ZZZZ Best's 15 purported job sites, the agency alleged when it permanently barred him from auditing public companies in 1991.

After Greenspan's audit, ZZZZ Best sold stock, which plummeted when the company was exposed as being rife with fraud.

"I wasn't hired to detect fraud," Greenspan said in an interview. "I was hired to do an audit."

Greenspan said he didn't have the funds to fight the SEC, "but it may be of interest to you that I was also investigated by the American Institute of CPAs and I was exonerated completely." He provided a copy of a 1998 letter in which the AICPA said it found "no prima facie evidence" that he violated its code of conduct and was closing its investigation.

The states of New Jersey and New York, which licensed Greenspan, also said they have taken no disciplinary action against him.

The disciplinary notices the AICPA issues to the public do not include the name of the accountant's firm or the name of the company the accountant was auditing.

A February 1998 report, for instance, listed the names of 15 individuals. It said a trial board had found them guilty of violating the rule that requires auditors to be independent from their clients. Then it concluded, without explanation: "The hearing panel voted there should be no sanctions."

Boards Ill-Equipped

The state licensing boards hold the most power over accountants, but many are ill-equipped to police the profession. "There are a number of state boards that just don't have the financial resources to take on big firms," said Dennis Spackman, past chairman of the National Association of State Boards of Accountancy (NASBA).

For the most part, "the state boards of accountancy are ineffective," said Lloyd "Buddy" Turman, who is executive director of the Florida Institute of Certified Public Accountants, a professional society.

Members of the accounting industry backed legislation in Virginia this year to create a separate state agency for the supervision of the state's 14,000 accountants and remove that function from a department that oversees a variety of professions.

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Gov. James S. Gilmore III (R) vetoed the bill, arguing that, "to avoid conflicts of interest, regulatory agencies cannot be dedicated to individual professions." The legislature overrode Gilmore's veto.

Ellis Dunkum, a retired PricewaterhouseCoopers partner who is chairman of the Virginia state board, said the new agency, which operates on a smaller budget, is more efficient because its staff can concentrate on being knowledgeable about one set of regulations.

In Maryland, Dennis Gring, executive director of the state board, said he spends most of his time monitoring the state's 14,000 active accountants. He said he also works for boards regulating foresters, precious metal dealers, sports agents and heating and ventilation contractors.

The AICPA has urged state licensing authorities to let it investigate disciplinary cases on their behalf, partly to avoid duplication of effort. Four states -- Illinois, West Virginia, Rhode Island and Connecticut -- have accepted the group's offer, at least in principle.

AICPA disciplinary notices often give the licensing authorities in Connecticut "our first inkling" of a possible problem, said Michael T. Kozik, staff attorney for the Connecticut board. The board's staff consists of a director, three clerical workers and himself part time -- when he isn't handling election-law matters for the state, Kozik said.

Under the Connecticut-AICPA cooperative agreement, which has been used in only one or two cases, the group shares the results of its investigation and the state makes its own decision, Kozik said. In complicated cases, "it saves us the time and the expense of . . . hiring experts," he said.

The state of New York, which had the most accountants sanctioned by the SEC, as of June had disciplined 17 of 49 New York accountants The Post culled from more than a decade of SEC enforcement actions.

New York regulators said they lack legal authority to discipline accountants who engage in misconduct as corporate officers rather than independent auditors. When an accountant licensed in New York is suspected of committing offenses in another state, New York may wait until the other state investigates, said Daniel Dustin, the board's executive secretary.

California regulators disciplined a large majority of the accountants licensed there who were sanctioned by the SEC, though it wasn't unusual for the penalty to be probation.

The association for state accountancy boards maintains a national database of the disciplinary actions its member boards take. But, like a

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federal database of sanctioned physicians, it is not accessible to the public.

The database was created for state boards to consult when reviewing license applications from accountants already certified in other states. Denise Hanley, NASBA's director of information services, said members of the public can get information about individual accountants from state boards.

A spokeswoman for the District's board, which supervises 1,100 accountants, said it hasn't revoked an accounting license in the past 15 years. Maryland's Gring said records show nine CPAs lost their licenses since 1990, with a 10th about to be made public. Nancy Taylor Feldman, executive director of the Virginia board, said two licenses have been revoked this year.

Liability Limited

Like other professionals, accountants can be sued, and there have been a series of large settlements involving Big Five firms in recent years. But the industry has lobbied hard and successfully to limit its liability.

Sometimes, even when courts find that auditors knowingly misrepresented a company's finances, damages aren't awarded.

In the JWP case, for instance, LaBarca's firm, Ernst & Young, paid $23.4 million to settle with shareholders -- which the judge called "an extravagantly expensive education in auditing ethics."

But a group of insurance companies that lost about $100 million on JWP bonds has come up empty so far.

When the outside auditors confronted JWP management on accounting questions, Judge Conner wrote, "Grendi almost invariably succeeded in either persuading or bullying them to agree that JWP's books required no adjustment."

"Part of the problem was undoubtedly the close personal relationship between Grendi and LaBarca," who trained together for the New York City Marathon, the judge wrote.

In its defense, Ernst & Young argued that LaBarca and his associates were ultimately convinced that JWP's accounting positions were reasonable or that the earnings overstatements were so small as to be immaterial, the judge wrote.

For all his criticism, Conner found that the accounting distortions were not the reason JWP defaulted on its bonds. In legal jargon, he

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found no "loss causation."

The insurers have appealed. Lawyers who represented Ernst & Young cited their victory in a law journal article titled "Loss Causation: A Defendant's Secret Weapon." Such arguments, they noted, "can brush aside even the most difficult set of facts against a defendant."

Database editor Sarah Cohen, staff researcher Richard Drezen and research assistant Eddy Palanzo contributed to this report.

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