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THE ENRON COLLAPSE: IMPLICATIONS TO INVESTORS AND THE CAPITAL MARKETS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

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CONTENTS

	Page
Hearings held on:	
February 4, 2002	1
February 5, 2002	109
Appendixes:	
February 4, 2002	185
February 5, 2002	481

WITNESSES

MONDAY, FEBRUARY 4, 2002

Pitt, Hon. Harvey L., Chairman, U.S. Securities and Exchange Commission	28
Powers, William C., Chairman of the Special Investigative Committee of the Board of Directors, Enron Corporation	69

APPENDIX

Prepared statements:	
Baker, Hon. Richard H.	186
Oxley, Hon. Michael G.	189
Israel, Hon. Steve	191
Kanjorski, Hon. Paul E.	194
LaFalce, Hon. John J.	196
Ney, Hon. Robert	198
Paul, Hon. Ron	199
Royce, Hon. Ed	202
Pitt, Hon. Harvey L.	204
Powers, William C. Jr.	210

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Baker, Hon. Richard H.:	
EITF Abstracts	243
Powers, Willam C. Jr.:	
Report of Investigation	263

WITNESS

TUESDAY, FEBRUARY 5, 2002

Berardino, Joseph F., Chief Executive Officer, Arthur Andersen LLP	119

APPENDIX

Prepared statements:	
Castle, Hon. Michael N.	482
Clay, Hon. William Lacy	483
Berardino, Joseph F.	484

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Oxley, Hon. Michael G.:	
Arthur Andersen L.L.P. letter on the FASB's Exposure Draft, Jan. 16, 1996	501

Page

Sherman, Hon. Brad:
"Enron's Many Strands: Early Warning; '99 Deal Failed After Scrutiny of Enron Books," *New York Times*, Jan. 27, 2002 509

THE ENRON COLLAPSE: IMPLICATIONS TO INVESTORS AND THE CAPITAL MARKETS

MONDAY, FEBRUARY 4, 2002

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 2:10 p.m., in room 2175, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Shays, Cox, Paul, Bachus, Castle, Royce, LaTourette, Shadegg, Weldon, Ryun, Biggert, Ose, Ferguson, Oxley, ex officio; Kanjorski, Ackerman, Bentsen, Sandlin, Maloney of Connecticut, S. Jones of Ohio, Sherman, Inslee, Moore, Gonzalez, Lucas of Kentucky, Crowley, Ross, and LaFalce, ex officio.

Also Present: Representatives Leach, Capito, Tiberi, Frank, Watt, and Jackson-Lee.

Chairman BAKER. I would like to call this hearing of the Capital Markets Subcommittee to order. Today's purpose is to continue the subcommittee's work with regard to the matter of Enron.

In order to prepare for the hearing today, I wish to announce by prior agreement the method by which the subcommittee will proceed with regard to opening statements. After consultation with Mr. Kanjorski and others, we would have a 30-minute block of time for each side, proceeding in regular order, in which Mr. Kanjorski would manage his 30 minutes. I will manage our side, and we would do a similar pattern not only for today's hearing, but for tomorrow as well.

And I make that announcement for those who offer opening statements today; you would not then be subsequently authorized for an additional opening statement tomorrow to give as many Members as is possible the chance to be heard at the outset of today's hearing and tomorrow's hearing. Without objection, that process is adopted for opening statements.

I wish to further acknowledge that Members are in participation today who are not Members of the Capital Markets Subcommittee, but are Members of Financial Services generally; and also to recognize Ms. Jackson-Lee, who is sitting as an additional Member of the panel today to participate as appropriate in the proper order of recognition.

I wish to also announce by way of process for those who will be heard here today with no implication from the citation being sent

inappropriately, except as otherwise provided in this section, whoever in any matter within the jurisdiction of the legislative branch of Government knowingly and willfully falsifies, conceals, covers up by any trick, scheme or device a material fact, makes any materially false, fictitious or fraudulent statement or representation, or makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement shall be fined under this title or imprisoned for not more than 5 years or both. This is to make clear in the record that non-responsive or misleading answers to questions posed by Members of this panel are indeed serious offenses and will be dealt with appropriately.

Chairman BAKER. I yield to the gentleman.

Mr. KANJORSKI. Mr. Chairman I understand the Chair is attempting to exercise its prerogative, but under clause 2(k)(8) of Rule 11, the subcommittee's prerogative is to decide whether witnesses should be sworn in at a hearing. It is not the prerogative of the Chair. Under those circumstances, Mr. Chairman, I would like to ask unanimous consent that it be the policy of this hearing and all future hearings that all witnesses be sworn in.

Chairman BAKER. I appreciate the gentleman's perspective. We had discussed how we would proceed in advance of the commencement of the hearing today, and it was my recommendation to the subcommittee that we not swear in witnesses today and that we move appropriately through the course of our inquiry in making a determination as to when that requirement may be imposed.

Mr. KANJORSKI. Mr. Chairman, I understand that, but that is the exercise of a prerogative. As I suggested to you under clause 2(k)(8) of Rule 11, that is not the prerogative of the Chair. I have a motion before the subcommittee to make it a rule that all witnesses before this subcommittee be sworn in.

Chairman BAKER. If the gentleman will restate his motion, is it a unanimous consent request?

Mr. KANJORSKI. I make it in the form of unanimous consent, but if that is not satisfactory to pose it that way, I will make a motion that it is the position of the subcommittee. I ask for a recorded vote that all witnesses appearing in this matter before this subcommittee be subject to being sworn in.

Chairman BAKER. I understand the gentleman's point. I would object to the unanimous consent resolution, understanding that the gentleman has now placed before the subcommittee a motion which would require the subcommittee to proceed by the swearing in as it relates to consideration of matters relating to the Enron resolution.

That being the question before the subcommittee, the question now occurs—we need to have a clerk at the desk to record the proceedings here. We have to wait momentarily. We have gotten ahead of ourselves.

Is there somebody that wishes to be recognized?

Mr. INSLEE. Yes.

Chairman BAKER. Mr. Inslee.

Mr. INSLEE. May I be heard on the motion briefly?

Chairman BAKER. Yes, certainly.

Mr. INSLEE. Mr. Chairman, we want to have a bipartisan approach to this, and you have always acted in the spirit of that, so we don't want to get off to a partisan—but I'm trying to understand why the Chair would not think it appropriate in this matter of great public moment to swear witnesses, particularly where quite a number of people who will be testifying to us have potential civil and criminal exposure; and it seems to me that when people have that looming over their heads, if Congress really wants to get down to the truth, it might be better to make sure they are under oath.

Mr. BACHUS. Would the gentleman yield?

Mr. INSLEE. Yes.

Chairman BAKER. If I may respond to the gentleman's question first, and then I will recognize Mr. Bachus, I merely read the statute which acknowledges that it is already inappropriate to misrepresent to a subcommittee of Congress to an extent a 5-year criminal penalty will ensue.

Secondarily with regard to the gentleman, with regard to those individuals who are believed to be participants in the wrongdoing of this matter, I felt it inappropriate where we are getting assistance from others who are not participants—as in the case of the Chairman of the Securities and Exchange Commission, who appears here to help the subcommittee voluntarily and is not a participate in the Enron failure, I felt that that was not an appropriate step in light of the statutory requirements and the distinction between the enforcement of the existing law and the swearing in of a witness.

But that is the answer to the gentleman, and I yield back.

Mr. INSLEE. I will yield to the gentleman.

Mr. BACHUS. I will simply say, bottom line, Chairman Pitt is not under investigation. And the tradition of the House is to swear witnesses in when they or the organization they represent are under investigation, and I don't think at this time that any Member of this subcommittee wants to make a determination or take any action in any regard that indicates that Mr. Pitt is guilty of any wrongdoing. The subcommittee is under——

Chairman BAKER. It is Mr. Inslee's time.

Mr. INSLEE. I yield to Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, I certainly have the highest regard for Mr. Pitt and for many, many of the witnesses that are here. Quite frankly, I do not know who is responsible for the Enron debacle.

I thought the purpose of this hearing was to find out the facts and circumstances. Quite frankly, I am enraged—enraged—with the rush to judgment of the media and some of the Members of Congress, both in the House and the Senate, that I have observed over the last several weeks.

The purpose for this hearing, as I understand it, is to get to the question of what the facts are. What happened? Was there any public policy, rules, regulations or laws that should have stopped this from happening? Were they inadequate? Were there loopholes that need to be closed? Is there any action that we should take in the legislative form?

We are not a grand jury. We are not a trial court. I can tell you that I have made no judgment. I do not know whether the facts

and circumstances will indicate if something went wrong, whether it was wrongdoing, or whether it was criminal or civil liability. I do not know if anything went wrong.

All I want to say is: Anybody who comes in here and gives this subcommittee facts on the record should not, in any way, object to taking an oath. It will assure us that they not only will be subject to the penalties enunciated in the statute that you read from, but they also will be subject to perjury if they do not relate the facts correctly. I think we should implement a policy that everybody coming before this subcommittee will be subjected to an oath, and perhaps even a subpoena if that is necessary. I will support that.

I think what we want to have is a very bipartisan effort not to rush to judgment or conclusion on any matters. But, to suggest that because someone is an official——

Chairman BAKER. The gentleman's time has expired.

Mr. Ose.

Mr. OSE. Thank you, Mr. Chairman. I am curious. Is there an expectation that Mr. Pitt is not going to tell us the truth?

Mr. KANJORSKI. Not on my part.

Mr. OSE. What is the purpose of swearing him in?

Mr. KANJORSKI. If I may respond, I have no expectations that any particular witness who comes before the Congress of the United States does not intend to tell the truth. But, I have had experience over the last 17 years in the Congress, knowing full well that sometimes witnesses have been brought before Congress whose testimony has been questionable. They unfortunately did not quite fall under the standard and the capacity of enforcement as enunciated in this statute, but could have been prosecuted under perjury. If we are going to decide——

Mr. OSE. If I may reclaim my time, this gentleman has been confirmed by the Senate as the Chairman of the Securities and Exchange Commission. My question remains. Is it the expectation of some that he is not going to tell the truth?

Mr. KANJORSKI. Is it not the case that the committees of Congress have had Presidents of the United States, who have been elected by all of the people in the United States, testify before Congress under oath?

Mr. BACHUS. Would the gentleman from California yield?

Mr. OSE. I reclaim my time and yield to the gentleman from Alabama.

Mr. BACHUS. Let me say this. This subcommittee has not traditionally, and it is not our normal practice to swear in witnesses who testify before us. If we are going to start doing that today, then we need to swear in every witness at every hearing, and we need to make a decision if we are going to do that. And if we do that, we will be departing from our tradition, and our tradition is to swear people in when they are under investigation, when there was a question that they may have committed wrong.

That is certainly not the case today. Mr. Pitt is not under investigation. If we swear him in, we will be changing our procedure.

Mr. KANJORSKI. Will the gentleman yield?

Mr. BACHUS. Do you acknowledge that?

Chairman BAKER. It is Mr. Ose's time. He would have to answer.

Mr. OSE. I would be happy to yield to the gentleman from Pennsylvania.

Mr. KANJORSKI. I just want to say I do not know how many Members of the subcommittee have been here as long as I have. Sometimes I have the assumption that everybody has been here as long as I have. But, I went through the Whitewater hearings, and to the best of my recollections, I remember that we did swear in all witnesses regardless of who they were, where they came from, or who were their appointing authorities.

I do not want to, in any way, suggest that I do not expect Mr. Pitt will be truthful. He is an honorable man. He is a lawyer. How could he be anything other than an honorable man?

Mr. OSE. If I could reclaim my time, two out of three isn't bad.

Mr. BACHUS. We swear in witnesses for investigative hearings. This, as such, is not an investigative hearing.

Mr. KANJORSKI. We are not investigating?

Mr. BACHUS. It is not an investigative hearing. It can be, but it is not.

Mr. KANJORSKI. What type of hearing is this, may I ask? Maybe I prepared incorrectly.

Mr. BACHUS. The House has its definition and rules and this does not fall into that category.

Mr. OSE. If I may reclaim my time.

Chairman BAKER. You have 2 minutes and 15 seconds, if you would be happy to share with me.

Mr. OSE. I would be happy to share with the Chairman.

I would be happy to swear Mr. Pitt in if I have some evidence that he is not going to tell the truth, but if he is going to tell the truth, I am not so sure that I need to swear him in.

Chairman BAKER. Would the gentleman yield?

Mr. OSE. Certainly, I would be happy to yield.

Chairman BAKER. Thank you, Mr. Ose.

To try to get us on point here, this hearing at the outset was to be a solution to the systemic problems created by the Enron failure. It is not, as Mr. Kanjorski noted, a criminal proceeding nor are we in a prosecutorial setting. The gentleman has made the absolute correct observation that we are assuming that people are innocent until they are proved guilty here; and to that end, we are only to require, at my suggestion, those who have some clear, defined role in the events of the Enron failure potentially to the swearing-in requirement.

In light of the fact there exists a statute which says, if you sit in front of that microphone and say something that is not true, you can go to jail, now, that is pretty clear; so I am hoping that that level of confidence will instill the subcommittee for us to move quickly to resolution, since I have now expired your time, Mr. Ose. And I appreciate your courtesy.

Mrs. JONES. Mr. Chairman.

Chairman BAKER. If I may move next to Mr. LaFalce, and he can decide the time. You are recognized for 5 minutes, sir.

Mr. LAFALCE. I thank the Chair, and I am going to suggest a compromise, because I think it is important that our subcommittee proceed in a very bipartisan fashion. And the Chairman of the subcommittee has exercised his prerogative and the Ranking Member

has exercised his prerogative to have it the way he thinks would be best, but what is most important is that we proceed to discern not just the Enron problem, but the systemic problems that gave rise to Enron, and we devise some legislative regulatory scheme that can prevent future Enrons.

A year ago, as you recall, I opposed strongly the reduction in the SEC fees bill, because I thought and called for an increase in the budget of the SEC of some 300 percent. Had we given more time and attention to the systemic problems that I was pointing out at that time, perhaps Enron would not have happened, but that is history.

What I am going to suggest is that with respect to the Chairman of the SEC, he be asked if he realizes the existence of the law that the Chairman of the subcommittee just read off, and if he realizes that any wrongful testimony would subject him to the laws of perjury just the same as the swearing-in would; and that with respect to private sector parties who might not be as aware of the law, that they be sworn in if their testimony relates to the Enron situation.

So we would distinguish between public officials and private sector parties, so that Mr. Pitt would not have to be sworn in, but he would acknowledge that he understands the law and that any deliberately willful testimony of his would subject him to the laws of perjury; and that all the other future witnesses would be sworn in.

I offer that as I compromise, Mr. Chairman.

Chairman BAKER. I thank the gentleman for his offering.

Does Mr. Kanjorski wish to opine?

Mr. KANJORSKI. May I have some time to respond?

Chairman BAKER. Yes.

Mr. KANJORSKI. I love my Chairman and my Ranking Member. I believe compromise is excellent, but this is not the reason for my asserting the right to have a motion to swear in witnesses that appear before us.

This individual is among the first witnesses that will appear before this subcommittee over months and months in the future. We do not know who the others will be or what offices or authorities they might come from. It just seems to me that to the maximum extent possible we ought to treat them all uniformly. There is no more reason not to swear in Mr. Pitt than there is reason to swear in Mr. Powers.

Are we suggesting that if you are an expert and dean of a law school that your understanding of the law, or intention to avoid it, is any greater than if you are a public official? I do not believe so. Rather than us making predetermined conclusions as to the veracity of potential witnesses, all we should do is protect ourselves by uniformly making the rule that all witnesses in this matter, who come before the subcommittee to give testimony and will ultimately be publicized across America, be subject to being sworn in.

I think that is the most rational conclusion. Quite frankly, this motion is not intended in any way to be a partisan effort. I am putting this idea forward based on my own experiences. I have gone through the Whitewater hearings, in this committee and the Government Reform Committee, that stretched over 2½ or 3 years. Never did I suggest that a witness in those matters should not have been sworn in. They all were, and properly so.

Moreover, when the Energy and Commerce Committee had hearings on the tobacco matter, it had five or six presidents from some of the major corporations in America. It was very embarrassing, but they were sworn in. I find nothing wrong with that. Ultimately that proved very important that they subjected themselves to an oath, because if they had not, the question of whether or not they could have been prosecuted in that matter would have been compromised.

So, rather than making this a big to-do, I have made my motion. It is not the prerogative of the Chair to make this decision, but it is the prerogative of the full committee. Mr. Chairman, I suggest we call a vote on the full committee and those who do not want people sworn in, vote against it. I feel very secure in saying to everyone out here and every future witness, I hold no ill-will against anyone. I think you all intend to do the best and tell the truth, but I still like the protections of your testimony under oath.

Chairman BAKER. I thank the gentleman.

Mr. Chairman, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

I would simply point out, when we had the first hearing in the Congress on Enron in December, the witnesses were not sworn in; and that was a joint hearing, if you will recall, between your committee and the Oversight Committee. And if there is ever a committee that probably ought to have the ability to swear witnesses in, it would be the Oversight Committee, as opposed to a Legislative committee.

With that, Mr. Chairman, I move the previous question.

Chairman BAKER. We have a motion for the previous question. Is there objection?

Mrs. JONES. Yes.

Chairman BAKER. Objection having been heard, now the question occurs on the previous question.

All in favor of moving the question?

All those opposed?

Roll call. I say the ayes have it.

Mrs. JONES. Roll call.

I think that I ought to have an opportunity to be heard, as everybody was, Mr. Chairman; and I raised my hand and asked to be heard, and so that is the only reason I am asking. All I want is a minute-and-a-half, gentlemen and gentleladies.

Chairman BAKER. Without objection, the motion is withdrawn and the gentlelady is recognized for 5 minutes.

Mrs. JONES. Maybe 2.

Chairman BAKER. OK, great, 2.

Mrs. JONES. Thanks, Mr. Chairman, subcommittee Members.

Because of the importance of this issue to the American public, it seems to me that we are treading on an area that we could very easily erode by allowing all the witnesses to be sworn in. Having served as a judge and prosecutor, I understand the import of having someone take an oath, and it would at least give to the public, who is sitting here on the edge of their seats trying to figure out what exactly happened in this instance, that if we had the witnesses sworn in, at least that would add some additional belief that we, the Members of Congress, are attempting to get to the issues

in this case. And I am confident that if you asked Mr. Pitt, he wouldn't care whether we swore in him or not. He would probably voluntarily say, I will be sworn and we could get on.

I yield back the balance of my time.

Chairman BAKER. I thank the gentlelady for yielding.

Mr. Bachus.

Mr. BACHUS. Mr. Chairman, I think we all know and everybody in this room knows that there were illegalities, there was misconduct and there were non-disclosures, but no one has even made a suggestion that this witness is involved in any way whatsoever. To change the rules of this House and to swear in this witness without any discussion, to start this hearing with that is the wrong thing to do.

If anyone on the Democratic side says that there is suggestion of an illegality by the Securities and Exchange Commission that might change my mind.

Mr. KANJORSKI. Mr. Chairman, will you yield?

Mr. BACHUS. Well, I've said what I have said. Again, I am going to say, bottom line, Chairman Pitt is not under investigation. He's not under investigation.

Mr. KANJORSKI. Will you yield for a response?

Mr. BACHUS. I will yield.

Mr. KANJORSKI. First of all, I want to assure you that I do not suggest he is under investigation for anything that I have remotely heard about. I want to exclude myself from your all-inclusive statement.

This is one Member that does not know whether any illegality occurred at Enron or whether there was any corruption. I do not know what happened at Enron. The reason I came here to this hearing is to begin to find out what happened. What I am suggesting to you is, too many in the Congress and in the public have jumped to conclusions and judgments that may be——

Mr. BACHUS. Let me reclaim my time. I have about 20 seconds, but I don't in any way discount what I said. I will say it again.

There were illegalities in the Enron case, there was misconduct and there were non-disclosures, and if anyone on this panel hasn't figured that out by now, they should have. They should also realize and use discretion that there is no suggestion that this witness is involved in any way whatsoever.

Chairman BAKER. The gentleman's time has expired.

Mr. ACKERMAN. Mr. Chairman.

Chairman BAKER. Mr. Ackerman.

Mr. ACKERMAN. Thank you.

The remarks of the previous gentlemen are really why I believe we must swear in every witness, because if everybody agrees that the first witness is not guilty of anything and therefore we don't swear him in, then, by inference, everybody we swear in after that is going to be considered guilty because we have made a decision not to swear him in, because that becomes the criterion.

I don't know why this is a partisan issue, and it shouldn't be, and we shouldn't divide this on party lines. I would think everybody here wants to make sure that everybody who testifies before the subcommittee is telling the truth and that they are subject to the full implication of the weight of anything legal we could put on

them while they are testifying. Otherwise, it is like saying, let's just swear the guilty people in. And if that is what we are going to do, let's vote ahead of time who is guilty, and then we will swear those people in.

I don't know how you are going to do it if you don't swear everybody in, because you are tainting certain people.

I will be glad to yield to the gentleman.

Mr. BACHUS. I will just say on many occasions when there has been at least some discussion before a hearing that I have chaired, should we swear someone in, there was holy heck on the other side over the mere suggestion.

So we are changing our procedure today if we start swearing in these witnesses; and there has been at least some suggestion that I have heard from the other side that we ought to start swearing in all witnesses at all hearings. That is a change of policy, and to ambush this subcommittee with such a suggestion without any notice has already delayed this hearing for an hour.

Mr. ACKERMAN. I think the motion before us is just to swear in witnesses with regard to the matter before us on this particular issue, not every issue that comes before us. Those decisions could be made——

Chairman BAKER. Would the gentleman yield?

Mr. ACKERMAN. I would be glad to yield, Mr. Chairman.

Chairman BAKER. I would make the point that the gentleman's motion would be as to the subcommittee activities. It would not preclude at a full hearing of the full Financial Services Committee, after we do the preparatory work, the Chairman's swearing in anyone deemed advisable. I just don't think we are giving away any rights, and I would certainly hope we could bring this matter to conclusion. Even if there are differing opinions, let's try to get it to the point where we close the debate, if we may.

Mr. ACKERMAN. I just think that it has nothing to do with the full committee or the subcommittee. At the full committee level, that decision could be made upon the recommendation of the Chairman with the prerogatives of the full committee being observed as they are here.

I yield back my time.

Chairman BAKER. The gentleman yields back his time.

Mr. Castle.

Mr. CASTLE. It seems to me that the distinction between what is in the rule and what is being stated here is not that great, and I tend to agree with what the Ranking Member of the full committee, Mr. LaFalce, has suggested.

I think we should resolve this question, so I would move the previous question.

Chairman BAKER. The question has been called for. Is there an objection to the question?

Without objection, the previous question is ordered. Therefore, those who are in favor of the Kanjorski motion, which is to swear in all witnesses appearing before this subcommittee with regard to the Enron matter would vote yes; those opposed to that motion would vote no.

The clerk will call the roll.

The CLERK. Mr. Ney.

[No response.]
The CLERK. Mr. Shays.
Mr. SHAYS. No.
The CLERK. Mr. Shays, no.
Mr. Cox.
Mr. COX. No.
The CLERK. Mr. Cox, no.
Mr. Gillmor.
[No response.]
The CLERK. Mr. Paul.
Mr. PAUL. No.
The CLERK. Mr. Paul, no.
Mr. Bachus.
Mr. BACHUS. No.
The CLERK. Mr. Bachus, no.
Mr. Castle.
Mr. CASTLE. No.
The CLERK. Mr. Castle, no.
Mr. Royce.
Mr. ROYCE. No.
The CLERK. Mr. Royce, no.
Mr. Lucas of Oklahoma.
[No response.]
The CLERK. Mr. Barr of Georgia.
[No response.]
The CLERK. Mr. Jones of North Carolina.
[No response.]
The CLERK. Mr. LaTourette.
Mr. LATOURETTE. No.
The CLERK. Mr. LaTourette, no.
Mr. Shadegg.
[No response.]
The CLERK. Mr. Weldon of Florida.
Mr. WELDON. No.
The CLERK. Mr. Weldon, no.
Mr. Ryun of Kansas.
Mr. RYUN. No.
The CLERK. Mr. Ryun, no.
Mr. Riley.
[No response.]
The CLERK. Mr. Fossella.
[No response.]
The CLERK. Mrs. Biggert.
Mrs. BIGGERT. No.
The CLERK. Mrs. Biggert, no.
Mr. Gary G. Miller of California.
[No response.]
The CLERK. Mr. Ose.
Mr. OSE. Aye.
The CLERK. Mr. Ose, aye.
Mr. Toomey.
[No response.]
The CLERK. Mr. Ferguson.
Mr. FERGUSON. No.

The CLERK. Mr. Ferguson, no.
Ms. Hart.
[No response.]
The CLERK. Mr. Rogers of Michigan.
[No response.]
The CLERK. Mr. Oxley.
Mr. OXLEY. No.
The CLERK. Mr. Oxley, no.
Mr. Kanjorski.
Mr. KANJORSKI. Aye.
The CLERK. Mr. Kanjorski, aye.
Mr. Ackerman.
Mr. ACKERMAN. Aye.
The CLERK. Mr. Ackerman, aye.
Ms. Velázquez.
[No response.]
The CLERK. Mr. Bentsen.
Mr. BENTSEN. Aye.
The CLERK. Mr. Bentsen, aye.
Mr. Sandlin.
Mr. SANDLIN. Aye.
The CLERK. Mr. Sandlin, aye.
Mr. Maloney of Connecticut.
[No response.]
The CLERK. Ms. Hooley of Oregon.
[No response.]
The CLERK. Mr. Mascara.
[No response.]
The CLERK. Mrs. Jones of Ohio.
Mrs. JONES OF OHIO. Aye.
The CLERK. Mrs. Jones, aye.
Mr. Capuano.
[No response.]
The CLERK. Mr. Sherman.
Mr. SHERMAN. Aye.
The CLERK. Mr. Sherman, aye.
Mr. Meeks of New York.
[No response.]
The CLERK. Mr. Inslee.
Mr. INSLEE. Aye.
The CLERK. Mr. Inslee, aye.
Mr. Moore.
Mr. MOORE. Aye.
The CLERK. Mr. Moore, aye.
Mr. Gonzalez.
Mr. GONZALEZ. Aye.
The CLERK. Mr. Gonzalez, aye.
Mr. Ford.
[No response.]
The CLERK. Mr. Hinojosa.
[No response.]
The CLERK. Mr. Lucas of Kentucky.
Mr. LUCAS OF KENTUCKY. Aye.
The CLERK. Mr. Lucas, aye.

Mr. Shows.
[No response.]
The CLERK. Mr. Crowley.
Mr. CROWLEY. Aye.
The CLERK. Mr. Crowley, aye.
Mr. Israel.
[No response.]
The CLERK. Mr. Ross.
Mr. ROSS. Aye.
The CLERK. Mr. Ross, aye.
Mr. LaFalce.
Mr. LAFALCE. Aye.
The CLERK. Mr. LaFalce, aye.
Mr. Chairman.
Chairman BAKER. No.
The CLERK. Mr. Chairman, no.
Chairman BAKER. The clerk will report.
The CLERK. Mr. Chairman there are 14 ayes and 13 nays.
Chairman BAKER. The motion prevails. Therefore, the subcommittee will proceed to swear in each witness as they appear in accordance with the subcommittee decision.
I have a further piece of business which I think, or hope, will be received in a bipartisan matter. Given the events of the last 24 hours, the Chair would like to place a motion before the Members of the subcommittee that requires unanimous consent because of Rule 2(b) of the rules requiring prior notice.
I would ask the clerk to report the motion.
The CLERK. A motion offered by Mr. Baker of Louisiana: Mr. Baker of Louisiana moves that the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises authorize the issuance of a subpoena ad testificandum to Mr. Kenneth Lay for testimony before this subcommittee at a date and time to be determined by the Chairman and Ranking Minority Member.
Chairman BAKER. The Chairman is recognized for as such time as he may consume to explain the motion.
Under House procedure, we, as a subcommittee, in the effort to subpoena witnesses must do so with the request of the Chairman of the full committee. This motion only permits the Chair to make such request of Mr. Lay should at such time appropriate for committee's work that Mr. Lay be asked to appear before the committee. The decision is not made at this time that he will be subpoenaed, only authority being granted to the Chair.
Is there discussion on the motion?
Mr. Kanjorski.
Mr. KANJORSKI. Mr. Chairman, I am in full support of the Chair's motion.
Chairman BAKER. Is there any further discussion on the motion?
Mr. LAFALCE. As I understand the motion, it is to be determined by the Chairman and the Ranking Minority Member?
Chairman BAKER. That is correct.
Any further comment?
Mr. BENTSEN. Mr. Chairman.
Chairman BAKER. Mr. Bentsen.

Mr. BENTSEN. So you are saying at this point, it is not necessarily the intent of the Chair or the Ranking Member to issue a subpoena? You just want the authority to do so and will issue it based on how the hearings flow?

Chairman BAKER. The gentleman is correct. This is not an announcement that a subpoena will be issued; only setting in place the proper authority should the Chairman and the Ranking Member concur that his presence is required.

Mr. BENTSEN. I, for one, support the motion and I would predict that as the hearings go on, we will find that it will be necessary to hear from him.

Chairman BAKER. In that event, we will be prepared.

Is there further discussion?

Without objection, the previous question is ordered. Is there any objection to the motion as reported by the clerk?

Without objection, the motion is adopted unanimously. The Chair, for the record, notes the presence of a quorum, and that is important for the issuing of the subpoena.

There being no further business, I wish to move to organizational business, I wish to move to opening statements.

As I indicated earlier, each side will manage 30 minutes in regular order; and I've got to start the clock on myself.

On December 12, this subcommittee conducted the first congressional hearing concerning the failure of Enron. From that time until now, there have been a series of vital determinations, which have enabled the staff to construct a disturbing picture of events. The misrepresentations, obfuscation and acts of secrecy should certainly warrant full investigation by appropriate enforcement officials to bring those to justice who have violated their fiduciary responsibilities.

Whether the Powers Report is appropriately balanced or not, given the limited information on which the Report is based, it does establish a basis on which to conclude that the corporate financial reporting was intentionally complex and misleading. On further examination, it may be determined that the rules aimed at requiring disclosure were so misused that they were warped into a black bag from which no information was able to escape.

It should be made clear as to the role I envisage for this subcommittee in light of these disturbing revelations. We are not prosecutors. In fact, inflammatory accusation will only inhibit our ability to get to the facts—facts which are essential for us to reconstruct the regulatory environment so that these events will not reoccur. We should carefully assess the record, find how and if the system failed, and enact the appropriate corrective remedies.

It is clear, in Baton Rouge, Louisiana, this afternoon there are employees wondering if their corporation is really telling the true story, pensioners wondering if they are safe, investors worrying about the analyst's report. This singular event has created a crisis of confidence that must be reconciled.

How is it that the auditors, the analysts, the board members, the investors, the regulators and even the financial press could not find anything to alert the public that Enron was not all it appeared to be? Even if it was the Enron plan to dupe the entire financial marketplace and abscond with millions of dollars for a chosen few, how

is it possible for that to occur in our technological society with watchdogs on every corner?

The historical facts may answer that question. It wasn't possible. I direct your attention to a *New York Times* article published January 27 of this year in which it is described how a German-based energy company balked at a merger with Enron principally over concerns with Enron's accounting practices. These events occurred in 1999, long before anyone had the nerve to suggest that Enron had problems.

I find a quote from the article very instructive: "consultants from PriceWaterhouseCoopers told Veba that Enron, through complex accounting and deal-making, had swept tens of millions of dollars in debt off its books, making the company's balance sheet look stronger than it really was, according to the people involved in analyzing the failed deal. The consultants drew on public sources like trade publications, securities filings and interviews."

The story goes on: "'We were wondering why this wasn't common knowledge, or why it wasn't discovered by those people whose business it was to discover these things,' said one of the people who worked on analyzing the deal. He agreed to discuss the episode on the condition that his firm remain anonymous."

I remind you, this occurred in 1999.

In accordance with full transparency and disclosure standards, I must also acknowledge that the article goes on to point out that the SEC and FASB should have taken more responsibility to intervene to protect the public interest. That is where I feel the subcommittee's attention should be appropriately focused.

If the rules are not clear, if there's any doubt in anyone's mind, I feel we must make it very clear. If in your professional judgment, Mr. Auditor, Mr. Analyst, Mr. Board Member, or any other person in a fiduciary role, if you see it and it doesn't look right, it is your obligation to report it to the appropriate authority. The practice of walking by the accident scene and leaving the victims to their own demise will no longer be an act tolerated by the Congress.

It is the principal obligation of this subcommittee to find out how the system failed and then to act to ensure the system not only works, but to ensure there is redundancy. We must guarantee protection of the shareholders, the employees, and every pensioner whose lifelong savings may be tied to the truthfulness of the required disclosures.

It is clear that some were able to find the truth to protect their own interests. The big question is, why was it impossible for others to see the truth?

To that end, I feel it is an absolute necessity to establish audit independence. The reported numbers should add up properly and tell the true corporate story. I believe there are two very different ways to accomplish this goal.

One is to require dramatic new standards of responsibility for everyone, from the corporate board to the audit committee to the SEC, to ensure the individual auditor is not intimidated by management.

The other approach, one which would change the culture on Wall Street and across America, is to separate auditing from the corporation entirely by requiring external audits to be paid for by

someone other than the corporation. Perhaps, as some have suggested, it is time to have the stock exchanges engage the auditors and report their findings simultaneously to the exchange and the corporation. After all, should we really be surprised when you pay the piper, the piper plays your tune?

I intend to explore these ideas more fully with Chairman Pitt today in the effort to propose the best remedy, if possible, for this problem. But we won't take long to evaluate proposals as this subcommittee will act in days, not months or years.

The simple point is this: In viewing the corporate landscape today, I do not like what I see. Although most corporations are very well run and responsible, it is difficult to accept when a corporation closes its doors due to competitive pressure. But that is an unfortunate consequence of a free market system, losers finally lose.

But it appears there is a new threat in our complicated market that did not seem possible in the slower, contemplative world of typewriters and white out. It is clear now that it is possible for an aberrant corporate manager to take corporate assets, manipulate the books, enrich himself, and leave others to pay the price by making the transaction complicated, convoluted and computerized.

As a result, faithful employees lose it all. Life savings evaporate, investors are duped, lives are ruined—not in innovative competition, but from dark, sinister manipulation.

We will bring the sunlight in. Whether we just add some really big windows or whether we take the roof completely off, sunlight will shine in the corporate board room. Those who choose to ignore their responsibilities and enrich themselves while bringing harm to others shall have no safe harbor.

Those who labor long, build value, and create opportunity should be rewarded. We should all have confidence that the American dream is within our reach.

[The prepared statement of Hon. Richard H. Baker can be found on page XX in the appendix.]

Chairman BAKER Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, we have learned much since our last hearing in December about the factors contributing to the collapse of Enron. We have, for example, begun to understand how many of the checks and balances, which are supposed to contain excesses in our capital markets, either failed or short-circuited. We have also started to ascertain exactly how Enron's executives, directors, attorneys and auditors contributed to the corporation's demise. We have further discovered more about how the decisions and actions of regulators, stock analysts, credit raters and investment bankers helped to cause Enron's disintegration.

Additionally, many of my colleagues helped to create the environment that resulted not only in the insolvency of Enron, but also in the bankruptcy of numerous other high-flying companies in recent years. In the 1990s, many of my colleagues successfully pushed for the passage of deregulatory efforts and blocked the development of new regulatory safeguards. As we proceed, we therefore need to reflect on the Congress' own culpability for the current events.

More than a decade ago our committee helped to clean up the savings and loan crisis. Deregulatory efforts contributed significantly to that debacle. Once again, it appears that we may have

gone too far in deregulating. Enron's failure and the collapse of other companies may be the revenge of the rush of some to deregulate the securities markets.

In light of recent events, the Private Securities Litigation Reform Act of 1995, which became law despite a Presidential veto, deserves careful review. This statute, part of the so-called Contract with America, was supposed to prevent "frivolous" lawsuits. This law, however, has apparently helped businesses to manipulate their financial results. Evidence now indicates that earnings restatements by companies have more than tripled since the early 1990s. This law may also prevent investors from recovering billions of dollars they lost in Enron.

And last year, before examining the resources needed by the Securities and Exchange Commission, many of my colleagues rushed to cut the fees collected on securities transactions. The Commission was and is the regulator with primary responsibility for overseeing Enron, yet it appears that the Commission has failed to review Enron's financial disclosures since 1997. I want to know why that occurred. Moreover, it seems that the Bush Administration has decided to recommend an insufficient increase in the Commission's budget for fiscal 2003. To protect investors from other Enrons, we must significantly increase these resources in the months ahead.

The financial devastation caused by Enron warrants our thorough investigation. We need to examine quickly and comprehensively the deficiencies in our public policies that contributed to this corporate bankruptcy. We must also determine appropriate ways to reform our Nation's securities laws and regulations.

There are, however, many of my colleagues who want to rush to pass legislation before we uncover the entire set of facts in this case. To each of them, I urge restraint. If we take our time and learn the complete story, we have an opportunity to do something meaningful and responsible on a bipartisan basis. We should ultimately develop strong, effective and appropriate policy to prevent similar debacles in the future, and gathering all the pertinent facts will facilitate attaining this goal.

When we do consider a bill, I have already identified many issues that we should address. In addition to reviewing the consequences of the Private Securities Litigation Reform Act, we must fix the problem of auditor independence. My feeling is that no accounting firm should serve as both auditor and consultant to the same company. Although I applaud the efforts to the industry in recent days to mitigate these conflicts, we may need to pursue further reforms.

We must also improve supervision over the accounting profession. The current oversight system resembles a Rube Goldberg contraption. As a result, we must develop a new regulatory regime that involves genuine public oversight and real accountability. Moreover, we have learned of the excesses of Enron only because it failed. We should take this opportunity to better understand the problem of earnings management and how it affects other companies.

Many other issues fall firmly within our jurisdiction and demand our examination in the months ahead. We must return to the issue of analyst independence. We must also study the corporate governance systems of public companies. We must further scrutinize the

financial disclosure requirements of American businesses. We must additionally analyze the flaws of our accounting standards and the deficiencies of credit rating agencies. Finally, we must review the responsibilities of the Securities and Exchange Commission.

In closing, Mr. Chairman, we must move with diligence to dissect what went wrong first, and then take action to restore faith in our Nation's capital markets.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page XX in the appendix.]

Chairman BAKER. The gentleman yields back the balance of his time.

Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman; and let me first thank our good friend, Chairman John Boehner, for the use of the committee room. As many of you know, our committee room is being renovated and will not be completed until sometime late this month. So we appreciate the hospitality.

Our committee began its work on the Enron collapse with our first hearing over a month-and-a-half ago, in mid-December of 2001. Today and tomorrow, we continue our review of Enron and its impact on investors, employees and the financial markets.

We on this subcommittee are working to achieve three basic goals; First, making sure that Congress knows how the biggest corporate collapse in American history happened; second, to restore investor confidence in accounting regulators and in rules governing our markets; and third, making sure that the free market system and the regulatory system that underpins it, emerge stronger and better as a result of our work.

This subcommittee oversees the financial and capital markets. We oversee the regulation of those markets, so we have a fundamental responsibility. We take our work very seriously, and we are committed to doing what is right. We are also working hard, but we are not working alone. We are working closely with the major investigators, the Justice Department, the SEC, and Enron's and Andersen's own internal teams. We greatly appreciate their active assistance and cooperation and their insights, and we will make sure that our work complements theirs and does nothing to impede it.

I am also gratified that the President in his State of the Union address told us to make our work here a top priority. The President believes, and I agree, that "corporate America must be made more accountable to employees and shareholders, and be held to the highest standards of conduct." That is exactly where we as a committee are headed.

There has been a lot of talk from a lot of people about what might have happened at Enron, but Congress and the American people deserve to know the facts directly and from those who are most directly involved. That is what is going to happen today and tomorrow.

We have with us three of the people most directly involved, the chief securities regulator, SEC Chairman Harvey Pitt; Enron's chief internal investigator, Mr. William Powers; and the company's outside auditor, Mr. Berardino, CEO of Arthur Andersen, who will

be making his second appearance before the subcommittee. We thank them all for being so willing to be here.

Everyone should know, they all wanted to come here and testify, though these are very difficult circumstances for them. Until last night, we were expecting Mr. Ken Lay, former CEO of Enron.

Chairman BAKER. That is the ghost of Enron, Mr. Chairman.

Mr. OXLEY. I take back that thanking of Chairman Boehner. We don't have strange whistling in our committee room.

At the last minute, we were notified, as you all know, that Mr. Lay would not appear; and I know all the Members join me in saying we are extremely disappointed that he broke his commitment to our subcommittee; and indeed, the unanimous resolution that the subcommittee passed giving Mr. LaFalce and me the ability to issue a subpoena will be acted on forthwith.

Congress' job is different from those of the judges, juries and prosecutors who will deal with the many individual instances of alleged wrongdoing. Our job is not to convict, prosecute or persecute. Our job is to understand what happened, address the problems and make our free market system better and more impregnable than ever before. I think I speak for all my colleagues in saying, we are committed to that goal and we will be working hard together to achieve it in the weeks and months ahead.

I yield back the balance of my time.

[The prepared statement of Hon. Michael G. Oxley can be found on page XX in the appendix.]

Chairman BAKER. I thank the Chair.

Mr. LaFalce.

Mr. LAFALCE. I thank the Chairman.

First of all, I want to explain that the Chairman of the full committee and I, as Ranking Member, are ex officio Members of all the subcommittees. In previous Congresses, it was as non-voting Members, and in this Congress it is as voting Members, but we had agreed to abstain from voting in subcommittee matters unless the other Members were given notice in advance; and it was only because Mr. Oxley voted that I voted during the course of the subcommittee markup with respect to the issue before us.

In January of 2001, our committee was given jurisdiction over the securities industry, and from that time I began warning that earnings manipulation and deceptive accounting, along with analysts' hype, threatened the integrity of our capital markets. And from early 2001 on, I began calling for a significant increase in the SEC's budget to strengthen its personnel, oversight, and enforcement—not a 2 or 3 percent increase, but a 200 or 300 percent increase before this subcommittee, before the Rules Committee and on the floor of the House of Representatives.

I think that Enron's colossal failure and its devastating impact on investors and the working men and women at Enron have more than justified those concerns.

Today, we are going to hear from Mr. Powers on what went wrong at Enron and how a culture of corporate arrogance and greed resulted in losses of over $60 billion to investors and employees. The Special Investigative Committee's Report is a devastating indictment of Enron's senior management, its board of directors, its auditors, its lawyers, securities analysts who were supposed to be

representing the public, and so forth, all of whom failed to fulfill their responsibilities to Enron shareholders. The safeguards that should have protected investors failed at every level.

But they have also failed at every level for countless other publicly held corporations, a number of whom have had to have their earnings restated in record numbers; and I suspect that there are many, many more to come. But Enron, in particular, has been a wake-up call, because Enron is what it took to challenge investors' faith in the integrity of our capital markets. My hope is that Enron has what it takes to have us do something about it.

We must address the systemic problems that Enron's failure has made all too apparent. We must restore the faith of investors in our capital markets, and we must restore the faith of workers in their employers; but to do so, we must engage in a bipartisan, if possible—collective in any event—rethinking and reformulation of how we oversee our capital markets and our financial disclosure system. We must also give the SEC the resources it needs to do its job.

I was extremely disappointed to learn that the Administration has not seen fit to provide the SEC with any increase in its resources to address these challenges or even to fund pay parity for SEC employees. The budget that I became aware of today apparently calls for a 4 percent nominal increase in the SEC budget. That is grossly inadequate to even fund pay parity for the present employees, much less strengthen the resources that are needed to do the job.

I have been engaged in what I think have been productive, so far bipartisan, discussions, with both Mr. Oxley and Mr. Baker, along with Mr. Kanjorski, to attempt to craft legislation to deal with the serious policy issues that cases such as Enron give rise to. We are not there yet. We still have serious areas of disagreement, but I hope we will be able to come to some consensus.

But, at a minimum, I believe we must address the following areas: Seriously consider the recommendations that were made by Arthur Levitt, that I strongly supported when he made, to separate the audit and consulting functions to ensure that auditor judgment is not tainted by the fees received for non-audit services.

Data now available under the SEC's disclosure rule on non-audit fees makes clear that for the auditors of many large public companies, audit fees are often a minor percentage of the fees they receive. Even in the absence of Enron, I think that data alone justifies a reexamination.

Some have also suggested that we should consider going beyond that, that in order to improve auditor independence, we should consider term limits for auditors. The suggestions have been made by serious individuals and should at least be considered seriously.

Second, exclusive self-regulation has brought us to where we are today, and I don't think can work in and of itself. We need significantly enhanced public oversight and regulation of both the auditing and securities industries, including a strong new auditing regulator with a full range of powers. I would like to see representatives of working men and women on that regulator. I would like to see representatives of institutional investors on that regulator.

With respect to the securities industry, we have to hold them to a much higher standard. The fact that in the year 2000, when the market was falling precipitously, only one in 100 recommendations were "sell" recommendations gives cause for great concern. The public relies on the securities analysts for counsel and advice, and they have been relying on their advice at their own peril.

Third, we must find a way to provide a massive increase in SEC resources. The President's proposed budget just doesn't do it and given the mechanisms where the SEC has to work in concert with the OMB, we are not going to find out from them what resources are really necessary.

And it is not just the resources of the SEC. It is the FBI resources to work with the SEC; it is the Justice Department resources to work with the SEC.

We offered amendments in committee and when we're considering the totality of the governmental response, we consider not just the SEC, but the FBI and Justice Department amongst others, and our amendments were defeated. That is regrettable. There are a number of other items that I think are extremely important, but with your consent, Mr. Chairman, I would simply ask that the entirety of my statement be included in the record at this time.

[The prepared statement of Hon. John J. LaFalce can be found on page XX in the appendix.]

Chairman BAKER. Without objection, Mr. LaFalce.

I had a prior discussion with Ranking Member Kanjorski and if I could suggest the following procedure for the remaining time to be allocated. In order to facilitate as many Members being heard as is possible with the remaining 10 minutes per side, we have agreed to recognize each Member for a 2-minute statement, and on the Majority side the five Members who would be recognized to help prepare for that would be Mr. Shays, Mr. Cox, Mr. Paul, Mr. Bachus and Mr. Royce in that order today. On the Minority side it will be Mr. Ackerman, Mr. Bentsen, Mr. Sandlin, Mr. Sherman and Mr. Inslee in that order on the Minority side. Without objection, so ordered.

Mr. Shays, you're recognized for 2 minutes.

Mr. SHAYS. Thank you, Mr. Chairman, for having this hearing.

Enron was a disaster to its employees and stockholders and it has raised tremendous concern among my constituents. How could the seventh largest company in the United States of America nearly evaporate before our eyes? They want to know will standards, regulations and laws be strengthened and will people be held accountable, not just company fines paid.

Enron is a story of risky investments and greed, regulators not regulating, analysts not digging deep enough, auditors not auditing, directors not directing, lenders not checking creditworthiness. It is also a story of cover-up and fraud.

Enron is also a story about big campaign dollars, buying access and influence. Enron has given to both Democrat and Republican parties, raising serious questions about who is setting the agenda in Washington. We need to end the abuse of corporate treasury and union dues contributions and campaigns, and I think Enron is a clear example of that.

Congress has to also consider, among other issues, separating consulting and accounting work, dividing investment banking from analysts and making disclosure of stock holdings and investment banking ties more prominent in research reports, potentially term limiting auditor contracts for individual companies, requiring outside entities be incorporated into financial disclosure statements so as not to understate liabilities and overstate earnings, and encourage diversity by employees with 401Ks.

There's lots of work to be done. I am eager to participate in all the hearings you may call, Mr. Chairman.

Chairman BAKER. Thank you very much, Mr. Shays.

Mr. Ackerman, you are recognized for 2 minutes.

Mr. ACKERMAN. Thank you, Mr. Chairman, and thank you, Mr. Kanjorski.

I am amazed, confused, bewildered, astonished, and a lot of other adjectives, by the sequence of events that has brought us here today, and the American people are equally outraged and concerned. We have convened this hearing on the Enron debacle to learn what happened and what we might do to make sure that this kind of thing never happens again. It would have been much easier if former Enron CEO Ken Lay had decided to join us.

We are faced with the single largest bankruptcy our Nation has ever seen. We have people who have invested in and/or worked all their lives for Enron only to have their life savings and dreams stolen from them. These employees were sold snake oil, told that the stock their employer was peddling to them was sound even as the Enron bosses were dumping Enron shares left and right. Workers and investors were told stay in "steerage", and all the time that was happening the crew was bailing out.

One of the key failures that has come to light is that the major accounting firms, including Arthur Andersen, have engaged in cozy business relationships with their clients. The accountants would consult with, advise and set up business arrangements for their clients and then turn around and audit the very same companies, thereby providing the imprimatur of sound business practices on the schemes they themselves may have helped to devise. That's absurd. During the night, why do we allow the fox to guard the chicken coop and why are we surprised when the sun comes up that all we're left with are feathers?

The GAO has recognized the problems inherent to the company providing both auditing and non-auditing services to the same client. They have announced this business practice will no longer be allowed when doing business with the Federal Government. Today, I am introducing, and I invite all Members who wish to join me in introducing, legislation to require that the SEC revise its auditor independence rules so they are at least as tough as the GAO practices. If the Federal Government will no longer tolerate this potential for abuse in business practices, why should it be allowed to continue in the private sector?

I am almost afraid to ask what I think is the real question: Is this the tip of the iceberg? How many other corporate giants may have smoking mirror businesses peppered over by prestigious CPA firms?

I am pleased that the subcommittee will have the opportunity today to hear from these witnesses to learn what went wrong and how we work to make sure this type of systemwide failure never happens again. Will these hearings be sufficient? Maybe, maybe not, for too many influential people aren't going to be talking.

Chairman BAKER. The gentleman's time has expired.

Mr. ACKERMAN. We may need to have a special prosecutor who will be diligent in uncovering the truth. The people broke the law, they should go to jail.

I thank the Chairman for calling the hearing.

Chairman BAKER. Mr. Cox, recognized for 2 minutes.

Mr. COX. Thank you, Mr. Chairman. I want to welcome the Chairman of the Securities and Exchange Commission, and we are very much looking forward to your testimony and that of the board special committee to follow you.

I am also very pleased as we meet here today that as we try and pick up the pieces, as the victims of the Enron debacle try through both civil and ultimately criminal proceedings to gain vindication, that we can rely upon the very pro-shareholder legislation that this Congress enacted some years ago in the form of the Securities Litigation Reform Act, because many of the Members of this subcommittee, given our change in jurisdiction in the Congress——

Chairman BAKER. Pull your mike up.

Mr. COX.——were not present at the birthing and the drafting of that legislation. I just want to bring to the Members' attention some of what it is going to do for the shareholders of Enron who are now seeking vindication. In the old days it used to be that the first lawyers of the courthouse got to represent you in a class action. We ended that abuse. We ended that process and now the court is going to pick the best class representative.

The Securities Litigation Reform Act gives the court the power to review unconscionable attorneys fees so that the recoveries for abused shareholders will be greater. It imposed new responsibilities on auditors to detect and report illegal acts. It eliminated the professional plaintiffs that used to victimize shareholders in fraudulent and extortionate lawsuits. It strengthened the conflict of interest rules relating to attorneys, ensuring that shareholders are going to get fair representation.

Mr. Chairman, as you know, the Securities Litigation Reform Act broadened the SEC's aiding and abetting enforcement authority, strengthening the ability of the Commission to prosecute those who aid and abet violations of our securities laws.

I also wanted to point out, in conclusion, that far from making it more difficult to bring these kinds of lawsuits, it seems to have advantaged meritorious cases. In the 5 years preceding the enactment of the Securities Litigation Reform Act the average number of securities laws fraud suits filed in our Federal courts was 189. That's increased now 250 percent, so that for 2001 the actual number of cases filed was 486, and the average settlements have gone way up, from an average of—pre-enactment to $18 million post-enactment so that shareholders are getting more as a result of these important reforms.

I think it is very important that we also take a look at the rating agencies, Mr. Chairman, and I am pleased that you have done that

in your testimony. You have brought that to our attention. We are going to be looking at the role of the accounting profession and corporate governance and the independence of the auditing committee. Many of these questions your testimony is going to be especially valuable on.

I thank you for being here this afternoon and thank you, Mr. Chairman.

Chairman BAKER. The gentleman's time has expired.

Mr. Bentsen, you are recognized for 2 minutes.

Mr. BENTSEN. Thank you, Mr. Chairman, for having this second hearing on the collapse of Enron. Mr. Chairman, if this had been just a normal bankruptcy for economic reasons or bad business decisions, we probably wouldn't be having these hearings, but this isn't just a normal bankruptcy.

I want to read a quote from an e-mail that was sent by a person who ought to be here this week and is not here, but I think it is pretty telling. This was done at the end of August, and it says, "One of my highest priorities is to restore investor confidence in Enron. This should result in a significantly higher stock price."

This was an e-mail that was sent to one of the many thousands of employees, one of my fellow Houstonians, last fall at the same time that senior executives of Enron were dumping their stock, either through selling it in the open market or selling it back to the company, which in some instances they appeared to use as their own private bank.

The fact is, Mr. Chairman, that a number of my fellow Houstonians were hoping today and tomorrow that the Congress on their behalf would be able to ask questions that they don't have a right to ask, that the Congress would be able to ask questions that they don't have at the table in the bankruptcy court. And before us today in the audience we have a number of former Enron employees who traveled up here because they're looking for some answers. They are trying to find what happened to the company that they put their heart and soul in, what happened to their savings accounts, where are their cash balance accounts, why were some employees given retention bonuses after the company filed bankruptcy. Unfortunately, Mr. Chairman, they are not going to get those answers today, because Kenneth Lay, who agreed to testify after you and the Ranking Member had been exceedingly generous, I think, in trying to structure the hearing, chose to back out in the eleventh hour under the lame excuse that somehow they didn't appreciate comments made by colleagues of ours on the talk shows yesterday. And I think that is truly unfortunate, because what we need to find out is whether or not this was a case of the end of the "rational exuberance," whether or not this is the new form of the savings and loan model that we went through in the 1980s, who was minding the store, what did they know and when did they know it.

And I appreciate the fact that you and the Chairman of the full committee have taken the authority to issue subpoenas, because we will have many questions to ask and we will need to have these individuals come here, and I appreciate you calling this hearing today.

Chairman BAKER. Mr. Paul, you are recognized for 2 minutes.

Mr. PAUL. Thank you, Mr. Chairman.

I see that there have been two driving forces pushing this Enron story. One has been the politics of it. I find that unfortunate. I wish that politics would be less involved than the policy issues. But the other driving force is the attack on capitalism, which I think is misplaced, and it is driven by those who would like to have a lot more regulations and use this as an example of the failure of capitalism. I see exactly the opposite.

This is an example of the failure of corporatism. We have large corporations who buy influence, and they come up here to get subsidies in the form of corporate welfare. Enron received $1.6 billion worth of corporate welfare from the Eximbank and the Overseas Private Investment Corporation. That is where I see the problem.

Also, we have a responsibility for our monetary system, and yet we do very little to monitor the excessive easy credit system that allows banks to make billions of dollars worth of credit that are uncollateralized. This can only happen in a funny money, fiat paper money system, and we ought to look at that more carefully.

We have been talking about the accounting, and I think the accounting is a very serious problem. The idea of creating debt and calling it an asset, that is outrageous. That's almost like what Social Security does, what we do here. It looks like they learned some of the lessons from us.

So I find this rather tragic to attack capitalism on this issue. We should not think this is a reason for more regulation in a free market when the market fails and the market takes care of these companies. But what did we do with Long-Term Capital Management? We bailed them out and sent the wrong message. No wonder we have encouraged companies like Enron, and there are a lot more around.

Fraud—you say we have to do this investigation for fraud. Sure, we would like to know about it, but that's never been the prime responsibility of the Federal Government. That is a State issue. In many ways we are connected, but I would like to see us address the subject for which we are directly responsible—the Federal Government's subsidy of corporations like Enron who are created with a monetary system that is illogical that we have seen with the financial bubble.

[The prepared statement of Hon. Ron Paul is found on page XX in the appendix.]

Chairman BAKER. Thank you, Mr. Paul.

Mr. Sandlin is recognized for 2 minutes.

Mr. SANDLIN. Thank you, Mr. Chairman.

On December 12, the Capital Markets Subcommittee held the first of what I hope are several hearings on the financial implications of the Enron bankruptcy and its auditor, Arthur Andersen. In a remarkable 6-week period, a series of troubling and at times stunning revelations, we have been exposed, highlighting possible corporate malfeasance, testing our faith in self-regulation. Crafting the necessary legislative and regulatory remedies can only occur by identifying the deliberate misdeeds and illegal activities that precipitated this historic meltdown.

Most pertinent to this subcommittee's investigation of Enron's collapse are the numerous questions surrounding the vast arrays

of entities and partnerships created by senior Enron officials. With the blessing of Enron's executive committee of the Board of Directors, deceptive and illegal partnerships were created to conceal hundreds of millions of dollars of debts from Enron's balance sheet. I am deeply troubled that the most volatile and complicated partnerships were created by Enron's former Chief Financial Officer, Andrew Fastow, and blessed through the paternal ignorance or sly acquiescence of Enron's former CEO, Ken Lay.

America's securities laws are designed to prevent the creation of stocking horses whose only intent is to deceive investors for the benefit of the company's stock price. I am deeply disappointed that Mr. Lay has canceled his appearance before this subcommittee—please note I change that—Mr. Lay has canceled his appearance before this subcommittee and is taking the fifth amendment by absentia. Americans want to know about the role that senior officers played in engineering and executing the hundreds of special purpose entities that enriched select employees while deceiving shareholders, Federal and State regulators, and Enron employees.

All of America now knows Enron, to paraphrase a former company vice-president, "imploded in a wave of accounting scandals," as Enron's Arthur Andersen signed off on the veracity of Enron's financial statements, financial statements that Enron admitted overstated its earnings by almost $600 million over 5 years. Further, I believe that the actions taken by Andersen's employees to destroy documents after the company knew of the SEC inquiry into Enron's bankruptcy raises the prospect of criminal penalties and civil liability.

Chairman BAKER. Can you begin to wrap up?

Mr. SANDLIN. I applaud Harvey Pitt for putting forward a very modest proposal. I believe it is only a first step.

Mr. Chairman, we appreciate you calling this hearing today.

Chairman BAKER. Thank you, Mr. Sandlin.

Mr. Bachus is recognized for 2 minutes.

Mr. BACHUS. Mr. Chairman, I would ask unanimous consent to use my 2 minutes at the opening of the Powers testimony because my statement focuses on the 11,000 Enron employees who lost their retirement.

Chairman BAKER. Any objection to Mr. Bachus being recognized for 2 minutes prior to the next witness on this panel? Any objection? Without objection, so ordered.

Mr. Inslee. I'm sorry. Mr. Sherman, you're next.

Mr. SHERMAN. I join with Mr. Shays in pointing out the need for campaign finance reform. I echo Mr. LaFalce's comments that we need a revved up SEC. We need a SEC staff that will review every financial statement and demand the clarification of every fuzzy footnote. I join with Mr. Ackerman in his fear that there may be more Enrons out there. We need better accounting rules.

As I said in December, it is as if we found a SUV had plowed into schoolchildren driving 101 miles an hour in a school zone. Arthur Andersen should have pulled them over, but then we find out that the posted speed limit in that school zone is 100 miles an hour.

Today's *Washington Post* indicates the Chewco partnership could have been kept off the books. Even today, if only $4.4 million of

capital had been rounded up, over $1 billion of financial statement impact would still be hidden and Enron might still be alive, suckering in more investors.

We need better accounting rules for addressing special purpose entities, addressing derivatives, addressing transactions in the company's own stock and especially addressing derivatives in the company's own stock, including puts and calls and options in the company's own stock. We should explore whether audit firms should be allowed to provide substantial tax and management consulting services. But I would point out that if we shrink these firms to half their present size, which would happen if we did that, then a fee of half the size might still have the same conflict of interest impact.

Chairman BAKER. Begin to wrap up, sir.

Mr. SHERMAN. I would point out that if Arthur Andersen was just its own auditing department, it would have received a fee of only $25 million from Enron, but that would represent 1 percent of its total revenue.

Finally, we need to explore whether there should be tenure and term limits for auditors so they serve 5 years and then leave. We need new accounting standards and we need to explore new limits on the relationship between auditors and clients.

Chairman BAKER. The gentleman's time has expired.

Mr. Royce, you are recognized for 2 minutes.

Mr. ROYCE. Enron's efforts to disguise its bad investment losses and to increase its earnings by about $1 billion higher than they should have been through financial sleight of hand were intentionally deceptive, and it was a blatant attempt to undermine the fundamental purpose of financial accounting, which is transparency. Corporate executives of publicly held companies have a moral responsibility and a legal responsibility to make their balance sheets representative of the financial reality that exists and to make them understandable to the investing public, and that is one of the things that the SEC needs to address here today. Enron's use of questionable special partnerships clearly runs contra to the principles of consolidation and transparency, upon which our fair and successful free market system is predicated.

And at the same time, Enron employees involved in the partnerships were enriched by self dealings to the extent of millions of dollars that they should never have received. That should be investigated.

Also Enron's collapse raises the issue of the culpability of the accounting and auditing industry in ensuring that corporations live up to these moral obligations. Emerging behind the scenes accounts of document shredding at Arthur Andersen raise serious concerns about the degree to which Andersen was willing to subjugate its fiduciary responsibility to shareholders in pursuit of lucrative internal auditing and consulting contracts, posing a potential conflict of interest within the industry, and that we must address. And Enron's accounting treatment was determined with structural advice from Arthur Andersen. Arthur Andersen, amazingly enough, billed Enron $5.7 million for the advice in terms of how to set up these partnerships and did that on top of its regular audit fee.

And finally, the fact that those individuals charged with overseeing the auditing community were unable to prevent Enron's collapse casts serious doubt over the efficacy of the peer review process by which accounting firms currently review each other's work. The Public Oversight Board and the peer review process seems untenable in its current form, and that creates the necessity for a new system to ensure that public accountancy is correct, impartial and free of the moral hazard associated with the conflict of interest currently plaguing the auditing process.

[The prepared statement of Hon. Ed Royce can be found on page XX in the appendix.]

Chairman BAKER. Mr. Inslee, you are recognized for 2 minutes.

Mr. INSLEE. Thank you, Mr. Chair. I think Joe Lewis had the best comment about Mr. Lay's nonappearance when he said "They can run, but they can't hide." And I think if Mr. Lay thinks that he is going to avoid us getting to the bottom of this, he is sadly mistaken. But for us to do that I hope that we have a very broad approach in our subcommittee rather than just a narrow one. And what I mean by that is that it wasn't just investors who are in the tentacles of Enron. It was consumers of electricity, particularly on the West Coast. And for months and months and months last year, Enron and other companies strangled the consumers of the West Coast and the Administration did nothing for months and months and months, and the evidence would suggest at the request of Enron, and Mr. Lay specifically.

Now we need to know if this is true or not. Mr. Lay apparently isn't going to tell us. The Vice President apparently isn't going to share that information with us, but I hope that this subcommittee will get that information for the American people to find out why its Government sat on its hands for almost half a year while the West Coast bled millions of dollars in outrageous electrical prices, 50 percent increases a month and more.

So Mr. Chair, I hope to be working with you on a subpoena, and perhaps we can discuss this tomorrow with Enron as a whole, to obtain this information for the American people that the Vice President has seen fit not to share with the American people. And I hope to have discussions with you and perhaps we can resolve this tomorrow. Thank you.

Chairman BAKER. I thank the gentleman. I think we are at the point now where we can engage our first panel. Chairman Pitt, by a vote of fourteen to thirteen, I wish to welcome you to the subcommittee this afternoon. You may be aware that the subcommittee has decided to take testimony under oath. Do you have objection to testifying under oath?

Mr. PITT. None at all, sir.

Chairman BAKER. Under the rules of the House and the rules of the subcommittee you are entitled to be advised by counsel. Do you have any desire to be advised by counsel during your testimony today?

Mr. PITT. No, I do not.

Chairman BAKER. In that case, if you would please rise and raise your right hand, I will swear you in.

[Witness sworn.]

Consider yourself under oath. And I wish to sincerely welcome your presence here. I think your leadership and insight will be of value to the subcommittee and to the country.

I point out for the record you assumed your new duty on what date, sir?

Mr. PITT. I was sworn in on August 3, but I actually started at the beginning of September.

Chairman BAKER. And how does that comport with the disclosure of Enron's public demise?

Mr. PITT. Well, I think that I had been in the service about 2 months when the Enron debacle exploded.

Chairman BAKER. I just thought for the record it would be important for everyone to know your lack of relationship to the events that have unfortunately now unfolded. If you would please proceed, sir. Your testimony will be made part of the record.

Mr. PITT. Thank you, Mr. Chairman. My remarks may extend a bit and I apologize for that, but with the subcommittee's permission and Chair's permission.

Chairman BAKER. We hope you will take all the time needed to give all the explanations that would be informative.

STATEMENT OF HARVEY L. PITT, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman Baker, Congressman Kanjorski, Members of the subcommittee, I am pleased to appear on behalf of the SEC under oath to testify about possible legislative solutions to abuses and weaknesses that Enron's failure exposed in our disclosure and financial reporting system. I commend you, Mr. Chairman, and Congressman Kanjorski, as well as Chairman Oxley and Congressman LaFalce, for your leadership. These hearings are timely and appropriate.

The Enron debacle is tragic, and too many Americans have felt its consequences. Innocent investors were betrayed by abuses of our system of disclosure and accounting. Most tragic are investors, who entrusted some portion of their life savings to a company that purported to be profitable, placing confidence in the company, its auditors, research analysts, rating agencies and our federally—mandated disclosure system. Equally betrayed are those who held Enron stock in retirement accounts and made life—altering decisions based upon the stock's perceived value, only to find themselves locked into a rapidly sinking investment that ate up years of hard work. The fate of these Americans fuels our markets. They have no lobby, no trade associations. Their interests are and must be paramount, and I am appalled at what happened to them as a result of Enron's collapse. The Commission as an institution and I, both as its Chairman and personally, are committed to doing everything in our power to prevent abuses of our system from happening again.

Our primary responsibilities, as you know, are to protect public investors and to promote the fairness, effectiveness and efficiency of our capital markets. In the face of Enron's meltdown and tragic consequences, our staff is currently conducting an enforcement investigation to find out if there had been violations of the Federal securities laws and by whom. When Enron began to implode, my

fellow commissioners and I immediately—and unanimously—ordered a no-holds-barred investigation, which is still underway. Until the investigation is completed, we cannot fairly assign blame. The public can be confident, however, that our Enforcement Division will conduct a thorough investigation and the SEC will deal with any wrongdoing and wrongdoers swiftly and completely.

Congress wisely permeated the Federal securities laws with a philosophy that investors must be fully informed and confident that our markets are free from fraudulent, deceptive and manipulative conduct. We are tasked with defining and enforcing these laws. Congress has already given us enormous power to do so.

Even prior to Enron, we had been working to improve and modernize our corporate disclosure and financial reporting system to make disclosures in financial reports more meaningful and intelligible to average investors. Investors are entitled to the best regulatory system possible. To reassure investors and restore their confidence, we must address flaws in our current disclosure and accounting systems that have languished for far too long.

I am committed, as is the Commission, to reexamining every assumption, every rule and regulation in light of Enron. There are fundamental and longstanding flaws in our system, and now they are on the table. No one yet knows the final answers, but at the end of the process we will have a better system of corporate disclosure and financial reporting.

In his State of the Union address, the President appropriately demanded "stricter accounting standards and tougher disclosure requirements." He wants corporate America to "be made more accountable to employees and shareholders and held to the highest standards of conduct." We at the SEC share and embrace these principles, and we are firmly committed to achieving them. We are at work on numerous initiatives to improve and modernize our current disclosure and regulatory system.

These initiatives include, but are no means limited to, the following:

A system of "current" disclosure. Investors need current information, not just periodic disclosures, along with clear requirements for public companies to make affirmative disclosures of, and to provide timely updates to, unquestionably material information on a real-time basis.

Public company disclosure of significant current "trend" and "evaluative" data. Providing current trend and evaluative data would enable investors to assess a company's evolving financial posture. It would also preclude " wooden" approaches to disclosure and encourage evaluative disclosures that begin where line item and GAAP disclosures end. This information, upon which corporate executives and bankers already base critical decisions, can be presented without confusing or misleading investors, without prejudicing legitimate corporate interests or exposing companies to unfair assertions of liability.

Financial statements that are clear and informative. Investors and employees concerned with preserving and increasing their savings and retirement funds deserve comprehensive financial reports they can easily and quickly interpret and understand.

Conscientious identification and assessment by public companies and their auditors of critical accounting principles. Public companies and their advisers should be required to identify the most critical accounting principles upon which a company's financial status depends and which involve the most complex, subjective or ambiguous assessments. Investors should be told concisely and clearly how these principles are applied as well as information about the range of possible effects in differing applications of these principles.

Accounting standard—setting that responds expeditiously, concisely and clearly to current and immediate needs and reflects business realities. Improved standard—setting is a high priority of ours. The FASB, the private standards setting board for accounting principles, is the appropriate place for resolving debate on technical issues, but it must act. For too many years the FASB has been allowed to fail at setting standards for accounting for special purpose entities. In the wake of Enron, it must act and act quickly to give guidance.

An effective and transparent system of private regulation of the accounting profession, subject to our rigorous oversight. We recently initiated discussion of how best to restructure the regulatory system governing the accounting profession. We suggested creating a new Public Accountability Board to assume responsibility for auditor and accountant discipline and quality control. At least a predominant majority of the members of the new disciplinary body we envision must be unaffiliated with the accounting profession. Our proposed oversight body would be funded not by the accounting profession, but from the entire private sector, giving no group the ability to dictate, control or influence their decisions and efforts.

A system that ensures that those entrusted with the important public responsibility of performing audits of public companies are single-minded in their devotion to the public interest and are not subject to conflicts that might confuse or divert them from their efforts. Those who perform audits must be truly independent and, in particular, must not be subject to the conflict of increasing their own compensation at the risk of ensuring the public's protection. Their fidelity to the cause of full, fair and understandable financial reporting must be ironclad and unequivocal.

More meaningful investor protection by audit committees. Audit committees must be proactive, not merely reactive, to ensure the quality and integrity of corporate financial reports. Especially critical is the need to improve interaction between audit committee members and senior management and outside auditors. Audit committees must understand what and why critical accounting principles were chosen, how they were applied, and have a basis for believing that the end result fairly presents their company's actual status.

Analyst recommendations predicated on financial data they have deciphered and interpreted. This subcommittee, through your leadership, Chairman Baker, and Congressman Kanjorski's and the full committee, led by Chairman Oxley and Congressman LaFalce, brought sadly needed attention to the shortcomings and the conduct of Wall Street analysts. We see these shortcomings again in the Enron situation. Changes here are long overdue. Working with

the Congress and the securities industry, we are on the threshold of new self-regulatory rules that will create more transparency for analyst recommendations.

These are just some of the initiatives that we are considering and resolutions we are proposing for consideration. We are committed to making disclosures more meaningful and intelligible to average investors, and toward that end we are soliciting broad input. We will hold our first ever "Investor Summit" this May, to solicit investor input on the policy issues that confront us as we begin reforming our disclosure and financial reporting process. We also plan to hold a series of roundtables to discuss significant issues regarding our ideas for reform and the suggestions of others. We must consider the issues, put forward the most responsible proposals we can, and engage in dialogue with all parties willing to participate. This is the process we have begun, and we are committed to following through promptly on this process by taking all steps necessary to reassure the public and preserve confidence in our disclosure and financial reporting process.

We have the requisite authority to enforce the Federal securities laws vigorously. We also believe that we already have statutory authority to adopt rules that would implement the important improvements that I just mentioned, as well as others necessary to address the problems in our system brought to light so vividly by Enron's collapse. By the same token, if major and sweeping changes are to be made, even by rulemaking, Congress should, and must, be an active participant in the process.

Congress is the body of Government most directly accountable to the people. We intend to work closely with you to ensure that the regulatory framework we ultimately propose meets your view of what is appropriate and in the interests of the public. In our view, any such changes should include provisions broadly reaffirming and enabling the SEC to improve the current disclosure and accounting system.

One area of possible legislation already identified is the need to require corporate insiders to make public their trading activities more quickly than current law requires. Under the current law, which dates back to 1934, the principal provision covering reporting by insiders calls for filing by the tenth day of the month after the month when the trading occurred. That may have been good enough in 1934, but it is not nearly good enough for our markets today.

Our system must be modernized and improved. We are up to the task, but only if we are able to tap our best minds to produce our most creative solutions and only if we are able to discuss these issues openly, honestly and as constructively as possible. The SEC is committed to that end, and we seek participation by everyone with an interest in our capital markets. Together, we can, we must and we will make a difference. That is our vision and our unalterable mission.

On behalf of the Commission, I appreciate the opportunity to submit our views on legislative solutions, and I am happy to try to respond to any questions the subcommittee Members may have.

[The prepared statement of Hon. Harvey L. Pitt can be found on page XX in the appendix.]

Chairman BAKER. Thank you, Chairman Pitt. We do appreciate very much your appearance here and your insights. I first want to thank you for your work on behalf of the committee over the past months in an announcement which will be made on Thursday relative to recommendations for analyst conduct.

Chairman Oxley, Ranking Members LaFalce and Kanjorski and I have worked together for some time to take a positive immediate step which I think will be very responsive to the circumstances that have been revealed by the Enron matter, but that is not something that happened overnight. It has been a great deal of effort with a number of parties and it will be a meaningful first step.

In looking at the recommendations in your testimony, I certainly agree with all of them and perhaps have additional ideas to consider to perhaps go a bit further. Corporate governance for boards of directors are constructed at the State level, and, audit standards obviously don't recognize State lines. Theoretically boards of directors are to hire the audit team through an audit committee, to remain independent of management interest and to report to the board on behalf of the shareholder.

It is my view that that practice in business theory is not necessarily the practice in business reality, and there are two ways, I think, to address that problem. One, as you propose, would be to put larger windows on the house so we can see into the boardroom and have more disclosure by virtue of that transparency. And I have other ideas to add to your very good list.

The other would be, as I said in the opening statement, to take the roof off the House and change the way the auditor is reimbursed. Today, the corporation pays the auditor. Some have suggested that another alternative would be to have the exchanges engage the audit and have the report made available to the corporation and to the exchanges, again to the benefit of shareholders since the transactions are engaged through an exchange. I don't know if that makes a great deal of market sense or not, but if you are paying someone to perform a task, there is a great deal of pressure, I think, for you to perform that task to their satisfaction.

Some have suggested simply barring consulting from the audit function might be the advisable remedy. I am not sure. It doesn't seem the pressure is any less to have a $12 million audit and a $12 million consulting contract than it is to have a $24 million audit. You still want to make management happy. What is your view?

Mr. PITT. Well, I believe that the question of independence is a critical question. The place where independence is the most significant is on the front lines with those who are actually doing the auditing. Those individuals could be influenced by an extra $100,000 or $200,000. What we need is a dual approach: First, one that ensures that those who are on the front line do not have any conflict in their loyalty and obligation to the shareholders of the corporation they're auditing.

And the second is to impose on the firms the ability to supervise and the incentives to make certain that no effort has been spared to produce the highest quality audit. There are many ways in which that can be done. One of the things that I think is critical is that we and this proposed Public Accountability Board should be

given authority to remove auditors where the conduct of the auditors is found to be illegal or is found to be unethical or is found to be incompetent or where supervisory problems have created major issues.

The question of who pays for the audit I think, is a fair one to put on the table. I can't tell you that the right answer is necessarily to try to find another entity to select the auditors, but it is worth looking into, and I do believe in any event that no audit should be deemed to be a prerogative or a right. Firms should be susceptible to losing audits if they do not adhere to the public trust.

Chairman BAKER. It is my opinion after consulting with many boards of directors that it is not uncommon today for management to have significant influence on the audit team report. So I am very interested in finding ways to preserve audit integrity and to eliminate any intimidation by management to direct the outcome. To that end I prepared a letter that outlines the specifics of both approaches, and certainly not to exclude any others you might deem appropriate, but for the committee's purpose. I will forward that to you immediately and ask that the agency respond within the next month, as the matter is of extreme urgency, as to the highest and best standards, in addition to what you have recommended today, as to those elements which I have outlined in that correspondence. Is that 30-day window all you have to do a reasonable request of your time at this moment?

Mr. PITT. Under the circumstances, it is very reasonable. We will respond in 30 days. If it is possible to respond sooner, we will certainly do that.

Chairman BAKER. In looking at the public record, in 1999, an enterprise, a private enterprise, able to surveil the SEC disclosures, newspaper accounts and a handful of interviews, I presume with energy analysts, came to the conclusion that there were off balance sheet indebtedness in the Enron portfolio that was apparently not that visible to others. Having reached that conclusion, that entity withdrew from a proposed merger. Where is it in the structure of the SEC, recognizing that this is before your time, when does the SEC have an obligation, or FASB, to proactively act and intercede with what is obviously an accounting myth that created real dollar losses 3 years later for innocent third parties? Shouldn't FASB, or the SEC in that day, have taken some action to preclude what was obviously a house of cards?

Mr. PITT. Let me respond to that in several ways. First, I think it is impossible to say that we can expect any agency of Government, even one I think as expert as the SEC and even one that might have significant additional resources, to review every single corporate filing and to find problems where they exist before they do damage to the public. It would be nice if that could happen, but I don't think that's possible. What I do think is possible is to have a system that avoids some of the gamesmanship that we have seen, or at least that's been reported. If people cannot read a financial statement and understand it immediately, if they cannot understand dense footnotes in what is being disclosed, then our system is a failure in that regard.

Chairman BAKER. I will make my point this way because I have exhausted my time. Even if FASB identified the problems, they really don't have authority to take any enforcement action.

Mr. PITT. FASB is not an enforcement agency.

Chairman BAKER. And even when they are standard—setting it, seems to take them a decade or longer to get something set. We do need a much more responsive mechanism to identify and respond to market impropriety where it obviously is publicly identifiable.

Mr. PITT. I agree completely. We need three levels. One is illegality. The SEC always has had that as its responsibility, and I believe we are doing a vigorous job in ferreting out illegality. We want an effective disciplinary process, however, that will extend to unethical practices; that is, practices that may not be illegal, but are unethical as well as practices that reflect incompetence. All of those three pose significant risk to investors, and we believe we can set up a private sector body that will give us not only protection against illegal conduct, but also unethical and incompetent conduct as well.

Chairman BAKER. Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman. You didn't have any ill effects from taking the oath, did you, Mr. Pitt?

Mr. PITT. I feel perfectly fine.

Mr. KANJORSKI. Mr. Pitt, you have had a chance, of course, to start your targeted investigation of what happened at Enron. But I assume, based on some of the information and allegations and high media hype on Enron, you have seen a potential for systemic problems of accounting analyst effects, and so forth, on other corporations.

Can you tell us now whether or not there are any other Enrons out there potentially?

Mr. PITT. My concern is not directed to Enron. It existed before Enron, and Enron only exacerbated the circumstances with the outrageous conduct that occurred. I think our system is capable of being gamed. I think it has been capable of being gamed for a long time. We intend to fix it to eliminate any of the gamesmanship. It is my hope that if we do so and do so promptly we will avoid further Enrons, but of course, there can never be a guarantee of that.

Mr. KANJORSKI. In your opinion, are there other Enrons out there?

Mr. PITT. I believe that we are in the process now of investigating a number of financial frauds. The number seems to be a large number, and some of it may be an outgrowth of Enron, but there are over 17,000 public companies. And my sense is that Enron presents a combination of factors. It is my hope that there are not other Enrons out there, but I am not willing to take the chance and rely on hope. We are investigating a number of situations, and we want to change the rules so that we are satisfied that there are no other Enrons out there. But at the present time no one can give you the assurance that you seek.

Mr. KANJORSKI. During the period of "irrational exuberance," I have been struck that average individuals have been buying shares of stock from their employees' pension funds that are sometimes 100 times their profit ratio. With almost abandonment, sometimes

the pension funds, with extraordinary Wall Street management, also engaged in these activities. I just want to make sure that we do not have more employees, more investors over the next several months or years doing the same thing, until we close whatever loophole has to be closed or we arm your agency with whatever powers you need. I am convinced that the average investor presently does not have the insight or the capacity to make some of these judgments, which obviously, the most sophisticated Wall Street analysts cannot penetrate. More precisely, one of the things I wanted to look at: Were you aware of the special enterprises?

Mr. PITT. Special purpose entities.

Mr. KANJORSKI. It would seem to me that if SPEs were listed on the documents of a corporation and you could see the size and the transaction on a cursory read, one might say I do not want to go there, I do not know enough, or I want to spend the time to find out what they are. If SPEs are not listed, they do not appear in accounting reports. It certainly goes to the question of what is accounting all about if not transparency.

One of the things that I have discussed with other Members of the subcommittee—about which I am most disturbed—is that all of this occurred in a private market. This is not a public market. This is not publicly controlled corporations. These are private corporations, completely removed from Government responsibility. And certainly the practice of accounting is the same thing. It is a profession, and if the profession does go awry and it does injure the general public because it influences the markets and how securities are sold and who suffers losses, the Government has some role in this, but our role should be limited to need. I am just a little worried about the baby going out with the bath water here. We obviously have several thousands—17,000, did you say—public corporations. We do not want to authorize a governmental agency to put its imprimatur on their audits. I do not think you could handle enough accountants to do that, and certainly you would not want to. But, we do have to have somebody look these disclosures over.

I just spoke with a major accounting firm in Pennsylvania over the weekend, in the top 50 nationwide. Its entire business is the cost of the audit in the Enron case. That figure represents its entire revenues for a year. We have the five big accounting firms doing these huge audits and consulting. We also have many smaller firms. So we are really talking about a two- or three-tier situation here.

I met with the Chairman of Andersen, and their revenues per year are in excess of $10 or $12 billion, I think. So the $25 million audit fee or $27 million consulting fee for Enron is really minuscule to him and to his firm. To the rest of us, it is quite substantial.

Our problem is maybe there is a time when certain size public corporations through public trades should fall under a category of special examination or certification by someone, hopefully a private entity. Also, we should look at some of these larger accounting companies and encourage them to go back to the days when the accounting profession was a profession and not a business, and apply the same standards of professionalism.

I do not think our problem goes to all accountants. My experience is you can rely on audits by most accounting firms in this country

and that the individuals are not easily persuaded by consulting fees or the price of the audit. They carry on the standard in the profession in a very high order, probably the best in the world. We are wreaking havoc and injury on them to many other well-functioning corporations because of this case.

Do you think that the Congress, running full speed ahead in putting legislation forward to solve some of these problems, superficially may not be too early? Should we instead participate in your summit in May and listen to some of the problems before legislating? Can you also accommodate Members of this subcommittee and Members of the Congress to listen or participate in some way in that event?

Mr. PITT. Yes. I think the answer to your question is unquestionably yes. My view is we need to take action. We need to do it quickly. It is up to Congress to decide whether you want to do it through legislation or whether you want to do it by working with us and making sure that you are comfortable with whatever regulatory approach we finally select. Either way, you have our complete and undivided cooperation and attention. I am committed to solving this problem. It has roots that have gone on for far too long; and, either by legislation or by regulation, I am determined to solve the problem.

Chairman BAKER. The gentleman's time has expired. Thank you, Mr. Kanjorski. And I want to echo your point with regard to corporate conduct. By and large, the vast majority of individuals and corporations attempt to conduct their business in a professional and responsible manner, and we have an aberrant actor which does not represent a systemic problem.

Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

Chairman Pitt, the Chairman of one of the Big Five accounting firms recently suggested that the strength in audit committee independence should be hired and fired by the audit committee of the board of directors, and one auditor suggests that it should be a crime to lie to an outside auditor. Do you have views on those particular positions?

Mr. PITT. Let me say a few things. I think the audit committee should have the power to select and to discharge auditors based on their work with the audit firm and their understanding of their capabilities and competence and performance. I also think, as I indicated before in response to Congressman Kanjorski's question, that the SEC and the Public Accountability Board should have the ability to take away audits where people engage in inappropriate conduct.

With respect to lying to an auditor, there are already provisions in the Securities Exchange Act which make it a crime as well as a civil misdemeanor to prevent an auditor from performing his function in accordance with the law, which should include some of this behavior. It is not a provision that has been widely utilized in the past, but there already is authority in the statute that would enable the SEC to take action against those who obstruct the filing of public reports that would be honest and accurate.

As to whether or not we need additional legislation, I guess I come back to my original suggestion. If this is something that you

would like us to consider, we will work with you closely. It is not an idea we are prepared to reject out of hand. It is a logical suggestion. We want to see where it fits in and make certain that we know what the ramifications of it are, but we are willing to work with you on all sorts of proposals.

Mr. OXLEY. The issue of auditor independence and scope of service within the audit profession has been in the news and the minds of corporations. You have spoken on this topic many times. Your views on this subject change in light of the action of the Big Five firms and several major companies last week, and what are your current views on this subject?

Mr. PITT. I view what the Big Five firms have done to be a very positive step. It is a recognition of public concern, and I commend them for taking that action. It does not have any impact, however, on all the additional changes in our system that we need. If this is an approach that the firms take to assure public confidence, I think we should support it. And in light of Enron, every position that anybody has taken should be subject to careful review. That's the way we can prevent another Enron from occurring.

So I am not adverse to what the firms have done. I support it completely. I just think it's important for everyone to understand there is much, much more that needs to be done and that this recent action alone will not solve the problem.

Mr. OXLEY. Mr. Chairman, in the Enron Report released this weekend, Enron's outside attorneys were criticized for not bringing a stronger, more objective, and more critical voice to the disclosure process. What oversight role and enforcement power does the Commission have with respect to the work of outside attorneys, and should the SEC have additional authority in that area?

Mr. PITT. The SEC has authority over attorneys who appear in practice before the agency if they engage in conduct which is inimical to the integrity of the system we have. We can take action to prevent them from appearing and practicing before the agency in a representative capacity. In addition, we have the ability to proceed against lawyers whose conduct rises to the level of having either violated the Federal securities laws or aided and abetted or caused a violation. There have been a lot of tensions between the SEC and the private bar, and times when the SEC had been accused of putting its judgment in the place of the private firms. I think the Commission has authority, but the question becomes what the nature of the conduct is that would give rise to the Commission exercising it. Where lawyers are giving good faith advice, the position that the Commission has taken under my predecessors is that the Commission will not take action against those lawyers. That's been the longstanding policy now for about 20-some odd years.

Mr. OXLEY. Thank you.

Mr. Chairman, thank you.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much.

Chairman BAKER. I don't think your mike is on.

Mr. LAFALCE. Thank you. Thank you, Mr. Chairman.

Mr. Pitt, one of the first cases that I ever handled after I was admitted to the bar in 1964 involved a professional malpractice where I went after an insurance broker for failing to advise a retailer of the desirability, or indeed, necessity of product liability insurance. There's a difference between proceeding in good faith and proceeding in good faith negligence, and so do you have the capacity to go after attorneys or accountants who may have proceeded in good faith or were still violative of the basic principles that lawyers and accountants should hold themselves to, for example were violative of professional malpractice?

Mr. PITT. There is some ambiguity about the Commission's authority to proceed against professionals in cases where the conduct is simply negligent. In my view, the ambiguity——

Mr. LAFALCE. Is that something we could clarify for you legislatively?

Mr. PITT. Those ambiguities could be clarified legislatively. They may also be capable of being clarified by rulemaking. I believe that some of the ambiguities arose from the wording.

Mr. LAFALCE. I am now specifically asking you to consider very clear rules that could be articulated and enforced by the SEC.

Mr. PITT. I would be, speaking for the Commission, more than willing to consider whether there is a need for that type of either legislation or regulation.

Mr. LAFALCE. All right. My next question is to what extent did the securities legislation that passed the Congress about 5 years or so ago preclude civil actions for the aiding and abetting of inappropriate practices by accountants, lawyers, and so forth, and leave it exclusively in the hands of the SEC?

Mr. PITT. The legislation, which is the Private Securities Litigation Reform Act, did not affect the ability of private parties to bring an action for aiding and abetting. It left in place a decision by the Supreme Court that challenged the existence of a private aiding and abetting cause of action. There was some ambiguity as to whether the SEC might be foreclosed from bringing aiding and abetting actions and the legislation overturned that ambiguity and made it clear that we could sue.

Mr. LAFALCE. By making it clear you could sue and in not dealing with the Supreme Court decision, didn't they, in fact, ratify the Supreme Court decision, and therefore preclude in the eyes of most people civil suits, and shouldn't we at the very least come in with a legislative remedy if we believe that civil litigation is an appropriate recourse to clarify that fact?

Mr. PITT. Well, I believe that case, which is the Central Bank of Denver case, interpreted the laws as they were passed in 1934. I think it would be hard to——

Mr. LAFALCE. With respect to at least one issue you said is grossly outmoded, and that was the issue.

Mr. PITT. I have said that the statute is outmoded in its regime of financial and reporting and disclosure. With respect to aiding and abetting, one of the things that I think we would need to do is to look at whether any of the conduct that ultimately becomes actionable in the Enron situation is conduct that might be foreclosed from being pursued. I have no problem going back and reconsidering whether there should be a private cause of action for

aiding and abetting. I'm just not aware at the moment as to whether there has been a material adverse impact on investor rights. If there has been, that's obviously something we would react to.

Mr. LAFALCE. I think when you rely so much on SROs, you need strong possibilities of civil litigation and if we are going to continue relying on SROs, it would seem imperative to me, but we can pursue that. Let me pursue another issue, and that is the heavy reliance that investors make not on auditors, not on boards of directors, not even on corporate management, but on securities analysts. These securities firms have been around for a long time. They are prestigious worldwide and they have some young 25-year-old kids who have never seen a depression or a recession or a stock go wrong and they hype these stocks unbelievably.

Analyst hype has been significantly responsible for so much of the rise and so much of the precipitous fall. I don't get angry at the fact that Ken Lay is not going to come here. I'm disappointed at that. I get angry at the securities firms, though, who permit their analysts to sucker in individuals across America and across the world, to make investments when they knew or should have known better, at the very least should have known better, and if they didn't know better, then their rights to be analysts should be taken away from them.

Now, I'm not sure that the SROs are doing a good enough job. I know they want to make improvements. So far, I think the securities SROs are doing a better job than the accounting SROs and trying to get to the point where they should be, but I don't think they are close to getting there yet. And to what extent does the SEC have the authority, to what extent has it exercised it in stripping individuals of the right to hold themselves out as securities analysts for securities firms?

Mr. PITT. We have brought actions in the past against analysts for conduct that violated statutory provisions.

Mr. LAFALCE. Are you talking about conflicts of interests or are you talking about professional competency?

Mr. PITT. Illegality. What we have sought to do is have ethical standards imposed on top of that so that we are not limited to legal violations.

Mr. LAFALCE. That is important, but in the total scheme of things, Mr. Pitt, I don't think that most of the injury that has been experienced by investors has come about because of criminal or unethical behavior, although to be sure, that has been real. I think much more of it has come about because of incompetency, and I'm wondering what ability the SEC has to deal with that issue, the incompetency of securities analysts.

Chairman BAKER. Your time has expired. We will certainly let the gentleman respond and we can move on.

Mr. PITT. As I believe you're aware, working with the Chairman of the subcommittee and the Ranking Member and working with the Chairman of the full committee, and with you as the Ranking Member, we have facilitated an effort by the self-regulatory bodies in the securities industry to carefully revisit the conduct that was involved. The fact that there were people recommending Enron stock when it was pennies away from total zero is appalling. I don't understand how people could do that. But I don't believe that the

problem needs to go unsolved. I believe we have come up with a methodology under the guidance and leadership of this subcommittee to come up with some very rigorous requirements that go well beyond legal requirements and that will be enforced both by the self-regulators, but also by us. If you look at what happened in the CS First Boston case with respect to IPOs, the Commission, for the first time, enforced—in an injunctive action that wound up with a fine and penalty of a $100 million—self-regulatory organization rules.

So if we have proper rules, the SEC will make sure that the self-regulatory bodies enforce it. If they don't, we will enforce it, and we still have the right to inspect for all of those violations as well, which I can assure you, we intend to do.

Chairman BAKER. And Chairman Pitt, on top of that, the subcommittee fully intends to be a full level of supervision over the implementation and compliance aspect of those proposals. So I think we are entering into a new era. Thank you, Mr. Chairman.

Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Pitt, thank you for being here. I appreciate it and I know you've got quite a task ahead of you. I would like you to comment on Secretary O'Neill's suggestion that penalties should be strengthened for CEOs——

Chairman BAKER. Mr. Shays, if you would pull that mike closer.

Mr. SHAYS. I'm sorry. Thank you. Mr. Pitt, I'd like you to comment on what Secretary O'Neill suggested in the *Wall Street Journal* today that CEOs who release misleading financial statements, including barring them from using insurance to cover costs of some stockholder lawsuits.

Mr. PITT. I believe very strongly that there needs to be personal exposure on the part of those who manage and oversee public companies. The ability of managers to have their fines paid by their companies or not to suffer personal consequences, in my view, leaves open the necessary deterrent effect. We have been meeting with Secretary O'Neill as part of the President's working group, and we have discussed these proposals, and I believe that there are ways in which we can strengthen the penalties against individuals.

Mr. SHAYS. I have a number of questions, so the bottom line is you want to strengthen them. Several commentators have suggested that the companies be required to change audit firms every few years, and others have suggested at least within a firm, that they rotate the auditors. I mean Enron—excuse me, Arthur Andersen can say that their business with Enron was only 1 percent of their total billings, but it was 100 percent to those Arthur Andersen employees who had the account.

Mr. PITT. You raise two very good points. The first is that I think we need to deal with conflicts on the front line, those people who are doing the audits in an office, and make sure that they don't have any diversion of their loyalty. With respect to rotation of auditors, that's an idea that has been around. It's something that I think we all have to look at. Way back when, some 20 or so years ago, there was a study and it concluded that a great number of the financial frauds occurred in the first 2 years of an auditor's engagement. One of the things I think we would all want to be sure of

is that we aren't creating more problems rather than less, but mandatory rotation is definitely a serious idea worthy of consideration.

Mr. SHAYS. Is it true that in the year 2000, the corporation and finance division of the SEC decided not to perform the regularly scheduled review of Enron's filing with the Commission? I understand the last time they did it, it was 1997, and that they do it every 3 years. One, is this true, and second, why? And if they had done it, is it likely the SEC, taking this review, would have been able to spot the problems at Enron?

Mr. PITT. I can tell you only the information that's been supplied to me, because, obviously, I wasn't there at the time. My understanding is that in 1997, there was a full review. The next scheduled one would have been 2000, but that it was deferred. The expectation was that there were new standards that were coming up and that there would be a greater basis for evaluating the financial statements. I think there was also some suggestion that, because the company was apparently performing so well, there were decisions made that that could be deferred.

One of the first things that I have done in response to the Enron debacle is to direct our staff to review all of the Fortune 500 companies to do an immediate inspection of their financials to see whether there's anything that jumps off the page. The question as to whether, if there had been a review done, it would have uncovered Enron, is unfortunately impossible for anyone to answer. I don't think that it's necessarily the case that had our staff, back in the year 2000, done this, we would be in any different position than we are now. The fact of the matter is, I believe, that there were sound reasons why they didn't do the review at that time, but, of course, all of us wish that they had.

Mr. SHAYS. Are we going to be well served by going from the big—what used to be the Big Eight, now the Big Five, to the Big Four? I mean, I would think that would be a big concern, not to use the word again, that we just are seeing that number collapse.

Mr. PITT. I share your concern on that, and it's part of the reason why I say solving the conflict issues will not solve the problem. If you had only one audit firm, just one, it would be the most independent audit firm possible, but it would have the least incentives, since there would be no competition, to improve quality control or competence. So as a result, these are two separate issues. I believe that there has been a need for greater capital in the accounting firms, and one of the issues that we have to perceive is how we can avoid dictating to the firms how much income they can generate instead of applying appropriate protections to make sure that there is no allegiance to anyone but public investors. That's the critical element.

Mr. SHAYS. I will.

Chairman BAKER. Your time has expired.

Mr. SHAYS. Thank you. Thank you, Mr. Pitt.

Chairman BAKER. Mr. Ackerman.

Mr. ACKERMAN. If this indeed was a scheme if that's the right word, was this difficult to set up?

Mr. PITT. I can't answer that. If it was a scheme, my concern is that because it occurred under any set of circumstances, by defini-

tion it was too easy to set up. It should not have been possible for this to happen.

Mr. ACKERMAN. It should not have been, but evidently it was easy enough to fly well below the radar.

Mr. PITT. Apparently this was set up and there are a variety of factors that contributed to it. The one thing that I think your question appropriately focuses us on is to fix the flaws in the system that have been allowed to exist that would have permitted this kind of thing to occur. That is what is critical.

Mr. ACKERMAN. I think there's a lot of public concern about transparency, and one of the things that gives the public confidence is when you have a certified public auditing company with some great prestige, especially that they are acting as well in the public's interest, to be the guarantor that everything was, shall we say, kosher, and they certified that somebody's cooking the books was kosher, if that's the right term of art to use.

If a CPA firm is doing that, should the public not be skeptical and come to a conclusion, why are they only doing this with one of their clients, maybe they are doing it with others?

Mr. PITT. I believe that the public, in light of the disclosures and revelations that have come out, has a perfect right to be skeptical. I want to try to remove that skepticism by giving them renewed confidence that our system is the very best, but there is no doubt that if people have done some of the things that have been alleged to have occurred, investors will lose confidence in our markets. And that would be a detriment to all Americans and something that we at the SEC have a sworn oath to avoid.

Mr. ACKERMAN. I don't know if you addressed this earlier, because I stepped out for a few minutes, but you had previously said that you are not sure as to whether or not anybody is to blame in this episode; is that right?

Mr. PITT. No. What I said was that there is an investigation that is underway in which I am not a participant. Until that investigation is complete, I don't believe that we can reach conclusions about who is to blame and what laws, if any, were violated. Once our investigation is completed, however, I think we will have the facts on which we can make those assessments and judgments.

Mr. ACKERMAN. Could you help the public, in just simple terms, understand the function of your agency?

Mr. PITT. Yes. Our agency is designed to assist investors who buy "intricate merchandise," as this subcommittee's predecessors called it way back in 1933, that is, it is not a car, an automobile where you can kick the tires and see what you're getting. It's something that's much less tangible than that, and so our role is to make sure that the system gives investors all of the information that they need to make a fair judgment as to whether to buy or sell a stock and to understand the information that they are given. We have many other roles, but in the Enron context that's the principal one.

Mr. ACKERMAN. Is it also your function to regulate the auditing companies as well as the corporation itself that's being audited by the auditing company?

Mr. PITT. I believe that the statutes that we administer give us authority over accounting firms. I would say that the Commission's

approach in past years has not been to regulate as much as it has been to rely on private sector entities.

Mr. ACKERMAN. You say it's not as simple as kicking the tires. I guess that's a good analogy as any for people to understand. I think you can kick the tires. Isn't there responsibility to check to make sure that assets are what they are said to be and debts that are written off, if they really exist should not be written off? I mean the salad oil case, I mean, you know, somebody should have looked into the tank to make sure it was salad oil and not water.

Chairman BAKER. And you're out of order, Mr. Ackerman—time, excuse me.

Mr. ACKERMAN. My water has drained.

Chairman BAKER. Would the gentleman yield back.

Mr. ACKERMAN. Can he just answer that?

Chairman BAKER. Sure.

Mr. PITT. I would just say, of course, that's a responsibility, and it's one that we think has to be overseen and enforced by the SEC, but there's no question that the audits of public companies are designed to give investors confidence that the financial statements have been prepared by management in an acceptable and proper way.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Cox, you're recognized.

Mr. COX. Thank you, Mr. Chairman.

Chairman Pitt, you mentioned in your formal remarks, your opening presentation, that one of the areas that the SEC is investigating is the role of the rating agencies. The report that we are going to cover with Chairman Powers in just a short while makes fascinating reading. I haven't read anything so scandalously convoluted since the equity funding scandal, but as the report puts it rather simply at the beginning of the 1990s, even before these SPEs were created, Enron had a substantial load of debt and they were looking to acquire assets and build businesses around them without putting new debt on their balance sheet.

And the reason—according to this special report of the board—they didn't want to put new debt on their balance sheet is Enron wanted to present itself more attractively to the rating agencies, particularly in light of the ratios that were favored by the rating agencies. That suggests what is obvious, in any case, that the rating agencies weren't of much help here at getting beneath what was apparent on the surface. Some time ago, when the treasurer of my county where I live in Orange County, California, committed some notorious criminal acts and bankrupted the whole county, and it became the largest municipal bankruptcy in American history, I got very interested in the role of the ratings agencies because they didn't blow the whistle on that in a timely fashion either, and I inferred that perhaps it was something about the inadequacy of municipal disclosure and the fact that the Federal Government doesn't regulate that nearly the way it does corporate disclosure, but now we've got the biggest municipal bankruptcy in American history and the biggest corporate bankruptcy in American industry, and the ratings agencies in both cases were essentially useless. What is the SEC doing by way of looking into the role of the rating agencies in the Enron matter?

Mr. PITT. One of the things we are doing is taking a much closer look at how the rating agencies perform, what their due diligence is. They have an enormous amount of impact on the stock market and on corporate bond offerings and the like, and yet they are essentially totally unregulated. We believe that we need to understand how they are performing and come back with a recommendation as to whether we need rules or statutes to deal with some of the abuses that some people believe may have occurred in this area.

Mr. COX. Let me ask you also whether or not you think that given that presently there is not much regulation, in addition to potential new regulation, we might give potential new powers to rating agencies to discover information?

Mr. PITT. I think that, again, there's another avenue that if the rating agencies are under an obligation to do the kind of diligence you're talking about, they could provide another safeguard to public investors, and that's something that's worth exploring.

Mr. COX. I thank you very much, Mr. Chairman, for your comments on that subject and I yield back, Mr. Chairman.

Chairman BAKER. I thank the gentleman.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman and Chairman Pitt.

Chairman Pitt, in your testimony you talked about legislation that would update the filing period for insiders when they're selling stock to the public, and I think that's the bill that Mrs. Carnahan has introduced in the Senate. I'm looking at more introducing the bill in the House, but there is another factor, and I'm curious your position on that, and that has to do with sales of stock back to the company, whether to pay off loans or what, and how loans are disclosed on the books, and this doesn't just involve Enron. We have seen it with respect to Tyco and other companies, and it appears, in some respects, these companies are being used almost as a private bank. Is that something that you would be supportive of, of having a more efficient disclosure mechanism?

Mr. PITT. I think the answer is that we do need to take a closer look at that and there may be a need for greater disclosure and greater requirements. I think that, in terms of the disclosure issues, we probably have sufficient regulatory authority, but I can understand why Congress might deem it appropriate to legislate here.

Mr. BENTSEN. Maybe you all can go ahead and change the rules, and we won't have to do that. Let me ask you this: There was a story in the *New York Times* a week or so ago about the partnerships and the Chinese wall conflict between investment banks that were structuring the partnerships, and in effect, doing private placements and the information that they were giving to potential investors in the private placement, and that that information was not being provided with general stockholders, the public stockholders, and whether or not current law would preclude a banker on one end who's underwriting a private placement from providing any information to the brokerage side as it would relate to the stock, and whether or not you believe that maybe trips the wire of Regulation FD, and whether or not that's selective disclosure.

And furthermore, I would ask, particularly as we look at some of the Chewco and Jedi deals that they were backstopped, as I understand it, with the ability to issue additional Enron shares as a credit enhancement, which would appear to me to be somewhat material, because that would dilute the value of existing shares that were out there. Would that make sense to you that maybe that's something where there was a violation of Regulation FD?

Mr. PITT. Well, I don't know whether it will constitute a violation of Regulation FD or not, but, if the information was material and it was not disclosed to the public, that's a violation of existing law. And that's what our enforcement division is looking into right now. I think if that case can be made they will make it.

Mr. BENTSEN. And then with respect to the Jedi deal based upon the Powers Report, and all it appears in one instance that there really wasn't true ownership, equity ownership, on the part of the purchaser. I mean, these deals all look to me, in some respects, sort of like the old S&Ls where you took bad loans, flipped them, booked a lot of goodwill that didn't exist to buoy your balance sheet, and then you backstopped it with stock and sort of bet, and the stock went south and so did the company.

But, is there a similarity in your mind where you set up a partnership to move this bad asset off your books, book goodwill that may or may not exist, you create a corporation to purchase it, you guarantee the 3 percent so there really isn't a 3 percent equity contribution on the part of the purchaser? I mean, isn't this—and you guarantee in effect to buy it back. This sounds a lot like parking.

Now, it's not parking per se, because it's not stock and the like, but it sounds very similar to that. Do the existing securities laws take that into account?

Mr. PITT. I believe they do. We have many cases in which companies use devices like window dressing, and right before the end of a quarter, move assets off their books to try to create an impression. The Commission has brought many such cases. So, if there is the equivalent of parking, as you say, and I think that's an excellent analogy, that means there is no economic reality to the transaction. If that's the case, then it's a fraud.

Mr. BENTSEN. Are you able to determine whether or not that may be going on in other companies, public companies, besides Enron at this time?

Mr. PITT. At the present time, we have started to take a very close look at what other companies are doing with respect to off-the-book treatment of liabilities. This is an area where 20 years ago the FASB was asked to give guidance, and with one or two modest exceptions, they have not given any guidance to either the profession or the public. Therefore, it's something that we have demanded and they have agreed they will do prior to the end of this year.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Paul.

Mr. Bachus.

Mr. BACHUS. Thank you, Mr. Chairman.

Chairman Pitt, I was going to ask you what your plans were and what your proposals were and to outline where we go from here,

but you have done an excellent job of doing that in your opening statement, so I am going to refrain from doing that. I do want to say that I'm very glad that it's become evident, I think to all of us, that the dogs of ruin that were unleashed on Enron were done in 1997 and 1998, and you took over in August as Chairman of the SEC, and as I think every Member here said, there's no suggestion that you did anything improper, and I'm glad that that's been made pretty clear. With that, I'm going to yield to the gentlelady from West Virginia, for the balance of my time.

Chairman BAKER. Thank you for that.

Mrs. CAPITO. Thank you, Mr. Chairman. I suppose the most disturbing thing for me has been the fact that executives were allowed to sell their stocks and that company employees were unable to sell their stocks and ended up losing a lifetime of savings. You mentioned in your remark corporate insiders disclosure reform that you would like to have, but my understanding is that insider trading has always been and is illegal. How could this situation be prevented in the future, and what is your SEC oversight on insider trading? And I would like to hear your insights.

Mr. PITT. I think we are talking about two different types of activity. One is insider trading, which is illegal, and the other are trades by insiders, which are not necessarily illegal under current law. But, the point you make is, nonetheless, I think, quite valid that the situation arose where executives were free to sell their stock, as I understand it, while rank and file employees were precluded from doing so. And I consider the notion that that could happen to be outrageous.

It doesn't necessarily mean that the actual trades by the executives were insider trading, but it does mean that something is terribly wrong with our system if those in power can sell, but those who have worked with their blood and sweat to make the company a better place have no such opportunity. My understanding is that these things are governed by laws regarding pension plans, and the SEC is given no authority with respect to the conduct of pension plans. We are given authority if a pension plan engages in trading that has an illegal impact, but basically it's the Secretary of Labor and the Secretary of the Treasury who, I think, possess the direct authority to deal with pension plan violations.

Mrs. CAPITO. Thank you. I have no further questions. I yield back.

Chairman BAKER. The gentleman yields back the balance of his time?

Mr. BACHUS. I yield back the balance of my time.

Chairman BAKER. Mr. Sandlin.

Mr. SANDLIN. Thank you, Mr. Chairman. I would like to ask a few questions that were begun by Mr. LaFalce and Mr. Bentsen, not particularly dealing with just the accountants or the attorneys for Enron, but having to do with the investment banking. Someone has to underwrite these——

Mr. PITT. Sorry?

Mr. SANDLIN. Someone has to underwrite these transactions, someone is extending credit. It's being looked at by stock analysts and investment bankers and credit rating agencies, and of course the analysts are making money through the recommendations, and

it's tied to bringing in deals to the investment banks. Do you think that the Stock Exchange should require that firms and analysts clearly note all current holdings in an investment relationship with the companies that they themselves rate?

Mr. PITT. Well, I think that the rules should prohibit any potential conflicts without certainly full disclosure of them. There are a number of ways that can be done, but I agree with you that the basic concept is that anyone who has a conflict should have to have to disclose it in plain English so that investors understand that the recommendations they are getting are not unbiased.

Mr. SANDLIN. And is that going to be a part of your investigation and part of the things you look at in making your recommendations in your list of initiatives to try to make corrections?

Mr. PITT. There is no doubt that that's being looked at. I think the SROs and the securities industry recognize the issue and they have moved to take steps to curtail it.

Mr. SANDLIN. Mr. Pitt, in talking about Andersen, I believe the public would be very surprised to learn that Andersen recently passed its triennial peer review. I noted in the press that on January the 2nd, Andersen touted a newly completed peer review that did not identify the systemic failures of Andersen, and it seems that the peer review erroneously gives the public confidence in these audits performed by Andersen, and due to the fact that we have had these fundamental failures of the system, why did the SEC staff stop work on a lengthy report identifying the shortcomings and how the industry regulates itself as was reported recently in the *Wall Street Journal*?

Mr. PITT. I'm delighted you asked that question.

Mr. SANDLIN. I only get about 5 minutes.

Mr. PITT. The first I learned about any such report was when a *Wall Street Journal* reporter called the SEC the day before the article appeared. Somebody thought it was clever to try to tie me into that report, and, as the article in the 27th paragraph indicated, the fact is that I had no idea there was such a report. Moreover, when we've looked at this, we have found that the so-called report was not really a report at all. The former chief accountant of the SEC apparently wanted a report done that would have established all of the things that the Commission did in this area, a kind of a score card. When former Chairman Levitt left, his staff thought that the project was in such a woeful state that it should not be continued. After Chairman Levitt left, apparently the former chief accountant insisted that the report still be worked on from time to time, but kept taking portions of it home and never allowed the report to be finished. It is my understanding, although I have no first-hand knowledge of this, that sometime before I took over, people made a decision that this was a useless exercise. So, that is the explanation of what happened there.

Mr. SANDLIN. Let me ask you this and I'm not trying to assign blame here. I'm not saying that. Obviously, the report was stopped no matter who began it or what the process was. Do you think that that would be a valuable thing to do now or do you think that would not be helpful?

Mr. PITT. What I think is valuable is to devise a system of thorough review and not peer review, and one of the things we have

committed to do is exactly that. It has been our position that the current system of peer review is not working. You have firm-on-firm review. It doesn't provide the kind of discipline that we need, and so we have proposed an approach that basically would provide an independent board that would oversee the reviews instead of having firms review each other, and we would do it on a continuing basis, plus we would give them disciplinary powers and the like. That is one of the reasons why we concluded that the existing public oversight board, while an excellent idea and comprised of very capable individuals, was effectively a failure.

Chairman BAKER. Mr. Sandlin, your time has expired.

Mr. SANDLIN. Thank you, Mr. Chairman. Thank you, Mr. Pitt.

Chairman BAKER. Mr. Castle.

Mr. CASTLE. Thank you very much, Mr. Chairman.

Mr. Pitt, I have before me a chart which I don't expect you to read from there, sir, but I will read it, a little bit of it too, and I think some other Members may have it. It was presented to us, but it's entitled at the top, "Investor Information Ensnared in Web of Corporate Reporting Conflicts," and then it shows Enron Corporation and then it has Arthur Andersen, Auditing, Consulting. It has special purpose entities, it has investment banks, Merrill Lynch, and so forth, lenders, creditors, Citigroup, JP Morgan, research analysts, credit agencies, which were mentioned by Mr. Cox, and I added law firm to it because somehow it seemed to be omitted from it, and it seems to me all of these entities have something very much in common.

All of these entities have a tremendous vested interest in keeping the price of Enron stock as high as they possibly can by whatever means they can, whether it be proper or improper. That's not to suggest that people who work in this business, for the most part, would do anything improper at all, but it does mean the temptation is there when you start to deal with stock options or whatever. I think if you look at these people—I've been thinking about this a little bit. It probably involves about a thousand people total who are really involved in wanting to keep that stock price as high as they possibly could.

As a matter of fact, if you want to break it down for the House of Representatives, it probably involves about 6 congressional districts, be they in Houston, in New York, in Connecticut, in northern New Jersey, or wherever it may be. Over here on the other side, we have the investors, the employees, and the shareholders, with the exception of the chieftains obviously, who get stock options, whatever it may be.

Employees and investors and shareholders also have that same interest in keeping that stock as high as they possibly can, but they can't do a doggone thing about it, unlike these people who can do all kinds of things about it if they want to, and that is a very serious problem. This side over here actually represents directly probably hundreds of thousands of people. I don't know that, but stockholders, people directly involved, employees or whatever it may be, and indirectly when you look at pension plans and that kind of thing, it involves millions of people in the United States of America and they are all losers by what happened here today from

a financial point of view by what happened with Enron in the course of this last year.

Chairman BAKER. Mr. Castle, I'll just help you with your visual aid. That chart up against the wall over there is the large of what you have before the Members to help those following you. I didn't put attribution on it. I circulated that little pile.

Mr. CASTLE. Thank you. I didn't know that, Mr. Chairman. That chart's pretty hard to read too, sir, but I won't get into that. I only have 5 minutes.

You have a huge impact on the economy of the United States of America about all this, and that's why I think all of us are as frustrated and as upset as we are, and we're not frustrated and upset at you. You're trying your very best to resolve these problems. But I want you to understand the intensity of what we are dealing with.

I saw your proposals which you have outlined here which I think are good, although I think they need to be fleshed out a heck of a lot, and I'd sort of like to get a time line on some of them as well, but these are the kinds of things that we should be doing, and I think you have the right attitude about going about doing these things, but I think most of us feel and a few Members have asked this, are there other Enrons out there? I mean, Andersen was involved with, I think, Sunbeam and a few other corporations that had rather questionable accounting and other practices along the way. Are there others out there? Are we going to look at a whole year of these reports coming out? That question has been sort of been asked, but I'd like to ask you directly, if you have any indications of anything else going on out there that we need to be worried about since, and then I have a couple of other questions along those lines.

Mr. PITT. Let me say two things. One is, I share your sense of outrage. I assure you that this conduct is egregious, it is outrageous, and it is incredibly troublesome for our entire capital market system, which is still the best in the world, but this has undermined a great deal of investor confidence in it. I believe that there are many possible bases for this problem to have arisen, and we have to start working on those that are most apparent and evident and that give us the greatest chance of preventing another one of these from occurring.

What I cannot tell you is whether there are other Enrons out there. I can tell you that there are other companies now that are doing restatements. In the first 2 months that our chief accountant, Bob Herdman, was on the job, not a single public company and not a single accounting firm walked in the door to ask a single question about appropriate accounting treatment. They were so afraid of dealing with the SEC. We put out the word that if they came in in good faith and they took care of investors, we would work with them to get the accounting right, and now his telephone is ringing off the hook. The best way to prevent another Enron is to have people ask the questions they need to ask and have the SEC give guidance to prevent those problems from arising. That's what we are all about, and that's what we're trying to do.

Mr. CASTLE. Just remember there is a huge amount of self-interest in all this, and keep that in mind as you make decisions on

this. Let me ask this question which I don't think has been asked that was written out here and that is—and I think you started to answer it just then, but have you seen indications from whatever filings you're receiving now that these various entities, the auditors, the company management, the attorneys, analysts, credit rating agencies—all the ones we have named, banks, and so forth, are being more diligent and conservative in their filing, not just the questions they are asking you, but are you seeing that thread through this? Because we have to stamp this problem out.

Mr. PITT. Yes. I think there are indications throughout the system that people are reacting and reacting positively, but what I will tell you is I won't rely on that. I think we have to fix what's wrong with the system; but, yes, I think those people are starting to take important measures to prevent these kinds of problems from arising again. It still will require action by the SEC or by the SEC and the Congress in order to make sure they can't do it anymore.

Mr. CASTLE. Thank you, Mr. Pitt. You and the SEC may be the only ones with your finger in the dike right now. So do your job as well as you can. Thank you, sir.

Mr. PITT. Thank you.

Mr. CASTLE. I yield back.

Chairman BAKER. Thank you, Mr. Castle.

Mr. Sherman.

Mr. SHERMAN. Thank you. I would also say that I agree with the proposals that you've made. I look forward to putting some flesh on those bones. Usually people who administer Government agencies would like to see their budget increased. So perhaps you'll enjoy this question. The President has proposed simply increasing your budget basically by inflation. What is the largest increase that you could imagine that you would need to do everything possible to give us the maximum possible confidence in our financial and capital markets?

Mr. PITT. I'm going to answer what I think the substance of your question is, but I have to start by telling you I don't think there's a number big enough to give us what you're asking. I just don't think it is possible for a Government agency to provide a guarantee of the entire system.

Mr. SHERMAN. Excuse me. I didn't ask for a guarantee. I just said what would it take to do the best job that could be done?

Mr. PITT. We proposed—bear in mind that my approach when I got to the job was to start with the assumption that we would ascertain whether we needed more people and, as a result, we were prepared to have a limited increase in budget as the President's budget provides. But, we also asked for $76 million for pay parity. That pay parity has not been funded. That is a disappointment to me, and it is my hope that we can get that corrected working with OMB and the Congress. With respect to whether we need more people or not, there are a lot of variables. I had wanted to take 2 to 4 months to kind of get a sense of where people are. Unfortunately I have spent my first several months dealing with 9/11, and now Enron, and that has somewhat delayed me. But, I intend to make a very careful study of our manpower needs, and you can be

sure that, if we need more people to do the job, we will not be shy about asking for them.

Mr. SHERMAN. Let me follow up on that. Part of the problem with the Enron financial statements is some truly incomprehensible footnotes, footnotes that just demand clarification, footnotes that beg for additional questions. Now, back in a prior life, I have dealt with the SEC in public offering registrations, initial public offering. You submit a document when you first register a company, they first go public, and you get questions and they insist that you actually—that every paragraph be clear. What would it take for you to provide that kind of read, review, demand clarity, ask questions, review of every quarterly filing and every annual filing by every publicly traded corporation, not just the day they come in the door, but every quarter that they stay up there on the board?

Mr. PITT. I'm willing to answer that question, but I have to state that I couldn't possibly begin to guess at it sitting here. It's a fair question. I'm willing to try and look into the issue. It may be hard to quantify.

Mr. SHERMAN. Rather than answer it now, but perhaps you could get back to us for the record. But I would point out that if only the SEC had read those footnotes and asked questions, we might be in a better position now. I went through a very scary experience at the cost of your agency, 2 hours of the time of your chief accountant and deputy chief accountant, as they explained to me Raptors and Chewco, and what shocked me was how close Enron came to being completely legal. They explained how Enron had failed to meet the standards for these special purpose entities not to have to be consolidated. The whole issue is about consolidation. And for roughly $30 or $40 million of outside capital, they could have adhered to all these rules and kept all their billions of dollars of restatements off their financial statements and their tens of billions of dollars of capital worth, and we might not have seen, heard of Enron, except through their commercials and their funny "E" and their impression of the people of the West Coast when it came to their energy prices. What concerns me is what are you proposing to do to make sure that even if you adhere to those rules—because Enron would still be a basket case, it would still be a sham, $30 million isn't going to cure Enron, it's just going to bring them into compliance with the extremely flawed accounting rules that we have.

Chairman BAKER. The gentleman's time has expired.

Mr. SHERMAN. I would like the witness to be able to respond.

Chairman BAKER. Certainly.

Mr. PITT. You have put your finger on one of the principal problems, and I echo your concerns. What we want is a system in which people don't try to take a very narrow approach and say, "well, if we can squeeze it in between these two boxes, then we can do almost anything." We want the reality of the situation to govern. Even if a company meets the technical requirements of GAAP, if a picture presented of the company is not accurate, then we believe that that is a violation of law. We have to work our disclosure system to make certain that people can't do that.

Chairman BAKER. The gentleman's time has expired. I'd also direct the committee to the 1990 FASB decision with regard to this matter as well.

Mr. PITT. That is correct.

Chairman BAKER. Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman Pitt, we had the Chief Accountant of the Securities and Exchange Committee, Mr. Herdman of the Securities and Exchange Commission, here in December, and at that time, I asked him a question which I would like to repeat to you, and I understand that he had a role in creating the 3 percent rule that actually helps keep these special purpose entities off the books, these partnership agreements, when he was on the emerging issues task force. I would caution that that really needs to be revisited in terms of that FASB rule.

But, let me just repeat the question I just asked him. If fraud is discovered in this investigation with respect to Enron in terms of insider trading, what is the likelihood that the profits made through fraud through that insider trading would then be compelled to be paid back to Enron so the assets and stock held by the employees of Enron and shareholders of Enron who did not have access to this insider information could then at least be partially benefited?

He said: "That's beyond my personal expertise." I don't know about specific remedies the SEC has available. I think this is called disgorgement, and I would ask you for the policy there with respect to the investigation.

Mr. PITT. There are two ways in which moneys could be returned to investors. The first through the SEC comes from something known as disgorgement, which means that if there are ill-gotten gains, those who have made those ill-gotten gains will have to pay those back and those moneys will go to the class of people who are injured by the improper conduct.

The SEC also has the power to levy fines, but that money goes into the U.S. Treasury. It does not go into the pockets of investors.

A second way in which investors can recover is through private litigation, and there have been a number of private lawsuits filed where investors can demonstrate that they have been defrauded. They are entitled to recover damages under the Federal securities laws, and the courts have been quite active in permitting plaintiffs to recover damages where they have made out their case.

So those are the two essential ways. I suppose there is a third way. Sometimes the Justice Department will require some form of restitution as part of its settlement of a criminal action, so in a sense that and disgorgement are really the same, but that's a third source.

Mr. ROYCE. With respect to the self dealing with the partnership agreements where tens of millions were made by Enron employees, I would assume that arguably that would come under that provision as well.

How about with respect to the accounting firm Arthur Andersen that may or may not—we haven't heard the Andersen side of this, but we know the initial report that came out this weekend with respect to Enron's analysis argues that those partnership agreements

were set up with the structural advice of the accounting firm. The accounting firm supposedly was paid $5.7 million to set up those partnership agreements. What's the likelihood that there could be action there with respect to——

Mr. PITT. I think there have been a number of suits already filed against Andersen in the private litigation. And, again, the SEC also can bring action against Andersen.

Mr. ROYCE. Can you do it in a way it doesn't make the beneficiary the Treasury, but makes the beneficiary the victims?

Mr. PITT. Through disgorgement? The answer is yes.

Disgorgement and prejudgment interest, the answer, it could be done. We have done that in cases where we have found entities to have violated the law.

Mr. ROYCE. The Enron collapse has generated an unprecedented level of media and public attention, but Enron is not the only significant bankruptcy to hit shareholders in recent months. K-Mart and Global Crossing recently filed for bankruptcy protection as well. Global Crossing was the largest bankruptcy filing in the telecom industry and the fifth largest corporate bankruptcy in the U.S. The SEC has recently announced it is investigating Global Crossing's accounting. Are there regulatory and policy issues that are common to these collapses? Are there concerns unique to Global Crossing or K-Mart that the Congress and the public should be hearing about?

Chairman BAKER. Mr. Royce, your time has expired.

Mr. PITT. I think the answer to your question is yes. I think that there may be aspects of this that are unique to the companies. That will have to await an investigation, which I am not involved in. But, as soon as we get the results of that, we will know that. But there are items that are common, and that's why I have talked today, and in the past, in trying to repair a system that has been allowed to languish in need of repair for far too long.

Chairman BAKER. For the record, before recognizing Mr. Inslee, I just have three documents relative to FASB actions relative to the 3 percent investment rule in 1990, 1991 and 1996; and I would like to introduce them into the record for Members' review.

[The information can be found on page XX in the appendix.]

Chairman BAKER. Mr. Inslee, you are recognized.

Mr. INSLEE. Mr. Pitt, I am down here on your left.

Mr. Pitt, I want to be helpful. I am from the Seattle area, and I represent thousands of people who were victimized by Enron who never bought a single Enron share of stock, but they got hurt because Enron was successful in capturing the energy policy of the United States and making sure that the Federal Government took no action for months and months and months to restrain these very, very injurious electrical price hikes which were benefiting Enron and hurting consumers all up and down the West Coast in the billions of dollars. Now we're told that involved in that decision were secret meetings between Mr. Lay and the Vice President where that issue was discussed.

I can't vouch for the total accuracy, but I have been told on April 17, 2001, Mr. Lay met in a secret meeting with Mr. Cheney and urged the Administration to take no action to restrain these huge price increases. I am told that the next day, on April 18, 2001, the

Vice President announced to the *Los Angeles Times* that the Administration was against taking any action to help the consumers in the West Coast in this regard; and, for months thereafter, the Administration failed to take any action to restrain prices. Finally it did, after essentially, I think, being shamed into what was going on on the West Coast.

Now the question I have, the Vice President has refused to talk about those secret meetings or give any information about them. I would like to know whether the SEC is investigating that situation where Enron was successful in exposing the West Coast to these predatory pricing factors?

Mr. PITT. One of the things that I have learned in my 6 months in office is that we get very little credit for anything, but we do get blamed for just about everything. I cannot respond to that question because it does not fall within the SEC's jurisdiction. If there is something that relates to securities anywhere in that context, you can be sure that our Enforcement Division will leave no stone unturned. But in terms of general energy policy, that, frankly, is beyond our competence, and I couldn't begin to give you any answer on that.

Mr. INSLEE. Who is investigating how that occurred for the Federal Government?

Mr. PITT. I think there are a variety of investigations that are going on, including in the Congress. There appear to be more investigations than one could throw a stick at. So I assume that somewhere that is being dealt with. It is enough for us to try to deal with the problems that we do have jurisdiction over, and I can assure you that we are making a very concerted effort to deal with those problems in a way that will make both sides of the aisle pleased with our actions.

Mr. INSLEE. Mr. Pitt, we would like to help you in that regard. Many of us would like to make sure you have the resources, the cops on the beat to get this job done. And this is a big, big job. This is a systemic failure that we need your organization to be very aggressive on.

I would ask you a question. There is a disagreement in Congress about resource allocation. Some of us feel that it's a high priority to give you more cops on the beat to work on these issues. Some of us feel that, no, it's more important to repeal the AMT adjusted tax and give Enron over $250 million in a retroactive tax break. What do you think is more important to this country right now, a $250 million tax break to Enron and other corporations or beefing up your security apparatus and giving you more resources to get this job done? If you had to make that call, what do you think is more important?

Mr. PITT. One of the blessed aspects of this job is that the SEC is an independent regulatory agency. As much as I would like to assist you on that question, I don't have any basis to believe that the SEC would take a position on that.

What I will say is that there is, obviously, a need for the securities laws to be enforced in a way that gives investors the assurance that events that gave rise to Enron are not likely to recur. or me, that is not only my first priority right now, it's my only priority.

Chairman BAKER. Your time has expired, Mr. Inslee.

Mr. INSLEE. Thank you, Mr. Chairman.

Thank you, Mr. Pitt.

Chairman BAKER. Mrs. Biggert.

Mrs. BIGGERT. Thank you for your patience. We appreciate the time you have spent with us.

I understand that the SEC has issued guidance about 2 weeks ago on the special purpose entities and the market-to-market accounting, and I think the third one was related-parties transactions; is that correct?

Mr. PITT. There was a petition filed, and we put out a release giving interpretative advice with respect to some of those issues. Yes, that's correct.

Mrs. BIGGERT. What I was wondering was whether you received any feedback either from the accounting firms or from corporations, companies on this?

Mr. PITT. I will ask. Our Chief Accountant happens to be here. I know that the request for guidance came from the accounting firms. So my assumption is that either there was no feedback or it was positive. I don't know if we have heard from corporations.

What I am told is that the feedback so far from corporations has been positive. But it's so new that it's still a little early to reach a definitive conclusion.

Mrs. BIGGERT. So is there any deadline or any time period for any feedback, or is this just open-ended?

Mr. PITT. No, it's not open-ended. The interpretative release we put out is effective, and there is no further kick-in period. People will have to start complying with it.

But we have put deadlines on every aspect, including what we have asked FASB to do in terms of coming out with guidance. We have given them a deadline. We are putting deadlines on ourselves.

I must confess that, when I started this, many of the issues were identical. Enron was a poster child for this. I thought we would probably need about 2 years to implement the kind of changes that we're talking about. I no longer believe we have that much time, and we are rethinking our entire timetable.

Mrs. BIGGERT. Has there been any feedback as far as the cost of compliance? Is there anybody saying that the cost of compliance would be too high?

Mr. PITT. I have not heard that yet, but you raise to me what is a very, very important point. We have a very difficult balance. We do want investors to be fully protected and confident. But if the benefits are outweighed dramatically by the costs, we need to know that, and we need to avoid trying to make the imposition of those things a normal course.

One of the things I am trying to do is hire a Chief Economist who will assist us in making those determinations.

Mrs. BIGGERT. So there really hasn't been any negative feedback?

Mr. PITT. We have not gotten any negative feedback. But I am sure if there's a concern, we will hear it.

Mrs. BIGGERT. Thank you very much. Thank you for being here.

Thank you, Mr. Chairman.

Chairman BAKER. Inquiry has been made as to how the subcommittee will proceed with the next panel. It is my intent to finish this round of questions with Chairman Pitt and then move im-

mediately to Mr. Powers. We have limited opportunity to receive his testimony, so the subcommittee will stay engaged into the early evening if necessary to conclude that work. Nutritional considerations are at the Members' own choosing.

Mrs. Jones.

Mrs. JONES. Thank you, Mr. Chairman.

Mr. Chairman, good afternoon. You know we only have 5 minutes. I am going to keep my questions short if you keep your answers short for me.

Let me ask you, before you became the Chairman of the SEC, what did you do?

Mr. PITT. I was a lawyer, and before that I worked at the SEC.

Mrs. JONES. What was your practice as a lawyer?

Mr. PITT. General corporate and securities practice.

Mrs. JONES. Did you ever represent any of the five accounting firms that are being discussed in the news?

Mr. PITT. I represented all five of them and the American Institute of Certified Public Accountants.

Mrs. JONES. I used to be a judge, and often litigators would file before the court affidavits of prejudice or ask judges to recuse themselves because of some prior relationship—either they were a lawyer with the firm or some other reason. Do you have any reason to believe as a result of your prior practice that there could be—and you know, in the ethics law they don't say it has to be an impropriety, but an appearance of impropriety. Would you answer that for me?

Mr. PITT. Sure. I believe that any questions that anyone wants to ask of me are legitimate, and I have an obligation to try and respond to them. I want the Members of this subcommittee and of Congress to have confidence in me. There is not the least bit of concern that I can detect, either legally or from an appearance point of view, with my trying to resolve the very difficult issues of restructuring our system of financial and narrative disclosures. We have made a decision that I will not participate, and am not participating, in any investigation that is specifically focused on an accounting firm. So that is why I have not participated after authorizing the staff to investigate Enron. That's why I have not participated in the investigation.

Mrs. JONES. That deals with the issue that you believe has the appearance of impropriety by you not involving yourself in the investigation.

Mr. PITT. This has been reviewed by the SEC's General Counsel, who predated me at the Commission. There is not any inhibition on my trying to solve generic problems. When I left private practice, I left my clients behind.

Mrs. JONES. I don't mean to offend you, Mr. Pitt. I am really asking these questions on behalf of the public who needs to know just as we are talking about disclosure.

But, I guess the final question I have in this range is then that if as we move along it would appear that there were a situation that you did not sit—sitting as you do today, recall that you gave some advice or counsel to one of these folks, you would then be willing to disclose or step away or whatever was required in that instance? Because it happens to everyone who practices for a con-

siderable period of time that they may not recall that they gave advice or counsel, sir.

Mr. PITT. It's always possible. And if I became aware of something that I thought created an obligation to step aside, I would.

Mrs. JONES. Thank you very much. I appreciate your response.

Let me ask you, what is Regulation FD dealing with traders trade by insiders as it relates to what we have been discussing with Enron?

Mr. PITT. Regulation FD was a rule that was proposed and adopted by the Commission to require that if a corporation discloses material information to anyone it must disclose it to everyone.

We have proposed a different approach to that issue, although we would not repeal Regulation FD. Our approach is to say the companies should be affirmatively required to disclose material information to everyone.

Regulation FD is an anti-disclosure rule. You can satisfy it by not disclosing anything to anyone. What I want to see is a system in which companies are affirmatively required to tell all material facts to investors.

Mrs. JONES. And that Regulation FD—and I am no securities lawyer by any stretch of the imagination—would allow insiders like the Enron folks to dispose of their stock as long as they had in place a plan for disposal of the stock and there was no information that they had that would not have already been in the public purview.

Mr. PITT. No. There is Rule 10b5-1, which the Commission adopted again in a previous Administration. It basically says is if you have a pre-existing intent to sell and you can demonstrate it as the rule requires so that you can show that you are not influenced by any additional information you get, then you will be able to continue along that plan as long as it meets all of the requirements of the rule and doesn't reflect any other fraudulent behavior.

Mrs. JONES. So that would be a way in which the Enron folks could claim—and you don't know the facts—but if they could show that they disposed of this property with a plan in place and no further information, they may not have any liability or culpability for selling their own stock; is that correct?

Mr. PITT. That's a possibility.

Chairman BAKER. The gentlelady's time has expired.

Do you want to follow up?

Mr. PITT. I disagree with you that you are not a securities lawyer. You're doing a very good job.

Mrs. JONES. With that, I will say thank you very much.

Chairman BAKER. Mr. Chairman, try using a lot more of that.

Mr. Ose.

Mr. OSE. I first want to make sure that you receive the plaudits that are due you as you have in the past—for your efforts following September 11 in reestablishing and getting the capital markets opened. You did a remarkable job. And while Enron is a huge, huge issue, it is minuscule in comparison.

Mr. PITT. I appreciate that, and I would make one observation, that all of the techniques we used to solve the 9/11 problem are exactly the same techniques we are using to solve the Enron problem.

Mr. OSE. I want to go on to my questions. I notice in your testimony in the third paragraph that you are effectively saying that this investigation into Enron is under way; is that correct?

Mr. PITT. That is correct.

Mr. OSE. The second question I have is when I'm called and the responsibilities that fall on me as a subcommittee Chairman on Government Reform to inquire about the status of an investigation on the alleged favorable placement of IPO stock to certain elected officials, the response I get is the SEC cannot comment one way or the other as to whether or not an investigation is under way. So here you are in front of the whole world saying that an investigation is under way, and yet when I have called asking about the alleged placement of IPO stock with certain elected officials the response I get is SEC cannot offer any comment. Can you reconcile those two?

Mr. PITT. I can, but I hope it hasn't been a call you have made to me.

Mr. OSE. You and I have talked about something else.

Mr. PITT. Let me explain it to you. The Commission's policy is neither to admit nor deny the existence of an investigation as a general proposition because the mere fact of investigation does not mean that anybody has done anything wrong. However, in a situation of national importance like Enron where the company itself discloses that it is under investigation, they made the disclosure first, it seems to me pointless for us to deny or not confirm the fact that they are telling the truth, that we are investigating them. And so that is the distinction that we have followed. We have done that in a number of other areas.

Mr. OSE. Let me draw the parallels for you. The Enron investigation talks about alleged inappropriate behavior on the part of corporate officials. This situation I called asking about introduces the concept that perhaps there's inappropriate behavior by elected officials receiving preferential treatment in the place of IPO stock. I don't know of anything that is more important to the body politic in this country than whether or not their elected officials are being improperly rewarded, and I can't find out from SEC whether or not there's an investigation going on. Is there an investigation going on in this issue?

Mr. PITT. Since I am under oath, I can tell you with great confidence I don't know the answer to that question. I don't know whether there is such an investigation. If there is one or isn't one, I don't know. If there isn't one, I don't know why we haven't at least explored whether there are ways we can discuss this. But once we make an exception to our general rule, we undermine the integrity of our investigative process.

Mr. OSE. My time is waiting here. My only point is that the parallels between the two sets of circumstances are uncannily similar: One is corporate officials; one is Government officials.

Now I want to go to the third question I have, and that has to do with Enron. We have heard a lot of talk how people lost a ton of money because the stock collapsed. But on both sides of the transaction there is a seller and a buyer. If the stock is falling, the seller who might short sell or might buy puts or sell calls makes as much money as they would if the stock were appreciating. Is the

SEC investigating what happened to the stock in these various—investigating whether or not people benefited from short selling the stock out of these SPEs?

Mr. PITT. I cannot tell you exactly what our enforcement staff is investigating because I am not involved in it. What I can say is that if there's any reason for them to believe that violative conduct took place in that connection, I am positive they are investigating it.

Mr. OSE. I will commit this avenue of thought to you because I happen to think just intuitively—my instincts tell me something happened of this nature—can't prove it to you yet, but my instincts say something went on here.

Chairman BAKER. The gentleman's time has expired.

Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Pitt, we've heard testimony today about Raptor, Braveheart, Chewco, LJM. You have you heard that testimony, sir?

Mr. PITT. I've read about them.

Mr. MOORE. Do you know those to be limited partnerships?

Mr. PITT. I have read that they are limited partnerships, but I have no direct knowledge about any of them.

Mr. MOORE. Are you aware that Enron had created a number of limited partnerships or have you heard that?

Mr. PITT. I'm sorry. Enron——

Mr. MOORE. That Enron created a number of limited partnerships?

Mr. PITT. I have certainly read that, yes.

Mr. MOORE. You don't have any personal knowledge of this?

Mr. PITT. I am not involved in the investigation.

Mr. MOORE. Do you have any idea or understanding as Chairman of the SEC why Enron would create limited partnerships?

Mr. PITT. There are reasons why limited partnerships might be created. What I cannot tell you is why the specific types of limited partnerships that appear to have been created here were created. It's just something that I can't address for you.

Mr. MOORE. All right. Is it your understanding that some of the principal officers or officers in Enron were involved in these limited partnerships?

Mr. PITT. That's what I have read, yes.

Mr. MOORE. Do you know William C. Powers, Junior?

Mr. PITT. I don't know him personally, but I know him by reputation and by reference to the report he issued yesterday.

Mr. MOORE. Have you read that report, sir?

Mr. PITT. I have not read the whole report, but I have read the executive summary. I am still wading through the whole report.

Mr. MOORE. In fact, is it your understanding that he served as Chairman of the Special Investigating Committee of the Board of Directors of Enron Corporation?

Mr. PITT. That is my understanding, yes.

Mr. MOORE. In the executive summary that you read, Mr. Pitt, did you see that Mr. Powers found that CFO Andrew Fastow and other Enron employees involved in these partnerships enriched themselves in the aggregate amount of tens of millions of dollars?

Mr. PITT. I have seen the number $30 million attached to it. That's what I have read.

Mr. MOORE. Do you have any reason to disagree with that?

Mr. PITT. I don't have a reason to agree or disagree. I would assume that they would have checked before they wrote their report, but I have seen a lot of things in writing that don't appear to be accurate.

Mr. MOORE. I have, too. Did you see his conclusion that 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.

Mr. PITT. That's what I understand to have been their conclusion.

Mr. MOORE. And did you also see his final conclusion, or one of his final conclusions, that there was a systematic and pervasive attempt by Enron's management to misrepresent the company's financial condition?

Mr. PITT. I believe that was one of the conclusions that is in the report.

Mr. MOORE. Would those conclusions, if they are true, be a concern to you as Chairman of the SEC?

Mr. PITT. They are an enormous concern to me as Chairman of the SEC and as a citizen, and I am outraged if they turn out to be accurate—outraged.

Mr. MOORE. I assume that's part of what you want to do, if in fact any of those conclusions are correct, to try to make sure these things don't happen in the future with regard to other corporations; is that correct, sir?

Mr. PITT. Absolutely. And in some respects, even if they're not illegal, we still have work to do to make sure that investors are fairly and fully informed. We are not responding solely to illegality.

Mr. MOORE. You have detailed a plan or a proposal to try to assure that. What can we do? Can you give us a short summary in the couple of minutes I have left as to what we can do to make sure that investors are not deceived in the future?

Mr. PITT. I don't have a monopoly on ideas, but what we have proposed is a substantial revamping and revision of our disclosure and financial reporting system, a substantial revamping of the way audit committees perform their functions, a substantial and significant improvement in the private discipline and oversight of the accounting profession and the promulgation of accounting standards that make common sense instead of just give people a target to shoot at so they can say they complied with GAAP.

Mr. MOORE. What kind of accounting standards would we have that would make common sense and give people an understanding of what information is intended to be conveyed?

Chairman BAKER. That would be your last question.

Mr. PITT. My concern is that the FASB has promulgated standards that are too detailed. I think what we need are standards that basically address what the concept is, what are the core principles we want to achieve and then have those articulated so that nobody can try to finesse their way around what the concepts are by rely-

ing on the literal language of some detailed provision in paragraph 12(6), which is what happens now.

Chairman BAKER. Thank the gentleman for yielding.

Mr. Leach.

Mr. LEACH. Well, thank you, Mr. Chairman.

There are a lot of public issues that have been raised properly, ranging from 401Ks to campaign reform issues, and I would just like to raise a couple that tie directly to this subcommittee's jurisdiction.

The first is it seems to me that the Enron collapse in the bankruptcy proceedings and following it underscore the need for the Congress to move on to what's called netting reform, whereby when companies go into bankruptcy, there's an automatic netting of financial derivatives contracts, and the Enron example could be very chaotic if this had been a financial company instead of an energy company that had gone bankrupt.

Second, it seems to me just as there's an issue of SEC resources there's also one of jurisdictional bifurcation; and my sense is that the Enron issue really underscores the need for Congress to review again whether the SEC and CFTC ought to be combined. Also, I think we are going to have to review whether certain derivatives, energy contracts should be outside the realm of regulation.

Third, I am in some ways as concerned with the legal as well as the illegal or possibly illegal acts of Enron. For example, this whole notion that tax shelters in the Cayman Islands can be used to hide tax losses may be legal, but its fairly unconscionable; and likewise the full notion that you have tax shelters in the Caymans—and Enron apparently had 900-some—to shield the company from alleged tax liabilities is equally unconscionable. And I raise this from the perspective of a couple of questions.

One is, as head of the SEC, do you have a position on the netting issue and whether Congress should move on something this subcommittee has twice passed?

Second, given the particularly—this whole problem of derivatives, what is your view on combining of the SEC and CFTC?

Finally, do you think the SEC and, for that matter, the IRS ought to give priority attention to all business schemes which organize offshore to avoid U.S. tax and U.S. regulatory laws? Do you have any recommendations to Congress and what steps you think might be taken in this particular area?

Mr. PITT. Well, let me try and respond briefly to those.

I have joined Chairman Greenspan in supporting the netting provision change in the bankruptcy laws, and that was a position obviously that was intended to reflect realities that we believed at the time. It is my view, as I have said, that the more we learn about Enron, the more people have to rethink prior positions. It doesn't mean that you'll change those positions, but it means that at least everything has to be fair game and on the table.

As for the combination of the SEC and the CFTC, I think that's a very complicated issue. It is not clear to me that we will enhance the effectiveness of either agency by combining the two.

So, in one sense, I don't start by trying to increase our territorial reach. I think our territorial reach is quite broad, and I think we've in the past neglected some areas. It's something I would certainly

be willing to work with this subcommittee on and with you on to consider, but I don't start out by advocating the position of the agencies. We have worked very closely with the CFTC, and I have worked very closely with Jim Newsome, and the President's Working Group on Financial Markets has provided a good forum for us to work collaboratively.

With respect to foreign corporations using foreign tax havens and the like and bank secrecy statutes and the like, I think this has been a problem. Some of it is addressed in the PATRIOT Act, because using foreign jurisdictions is also a way that people can hide terrorist illegal activities and it's something that I think we have to take a very close and hard look at to see whether we are allowing illegality to go undetected.

Chairman BAKER. The gentleman's time has expired. Thank you, Mr. Leach.

By regular order Mr. Watt would be next, and then you would follow. The gentleman defers.

Ms. Jackson-Lee.

Ms. JACKSON-LEE. Mr. Chairman, I cannot thank you enough for your kindness and indulgence of this subcommittee and the Ranking Member, Mr. Kanjorski, and the full committee, Mr. Oxley and Mr. LaFalce.

Mr. Chairman, you must recognize that many of us who have interacted with some of the bleeding that has occurred, looking at the human face, the ex-Enron employees, many of whom who have traveled here to Washington as well, the pensioners and retirees, many of whom live around Houston, Texas; and of course, the State of Texas, really look at what has occurred as a failing of our system for them. They had great faith, not only in their corporation, but in the structures of laws.

One of the things that they have reminded me of, they look for several elements—objectivity, independence and integrity. That seems to have been a wash in the circumstances of Enron with respect to oversight.

The other thing that we noted was, although it was a cause for great joy, the seemingly meteoric spiraling of stock prices in Enron starting in 1984 was about $5 or $6—it wasn't Enron then—but moved quickly between 1999 and 2000 to a $90 peak.

Two questions I would like for you to explore for me in light of the pain that so many of these employees are facing. We will hear from them—people who can't get insulin, can't get dialysis, just a huge outpouring of occurrences. Where was our oversight as relates to the independence and objectivity of the auditing firm? Where did the glut of money start rising in the simple stereotype with the accountant with the glasses on and pouring over numbers and coming up with whatever the truth was? How do we get into this business where accounting firms felt obligated to be engaged in consulting on the basis of just needing money? And how quickly can you act to separate out those functions on the regulatory factor?

Then, secondarily, whether or not any red flags at the SEC, knowing that it preceded your timing—I think the peak of the stock price was August 23, 2000, when it went to $90, but there were promises it would go up to $120—aren't those red flags that

there ought to have been some intervention, some oversight, more in-depth review of the company at that time?

Mr. PITT. Those are critical questions. And the first one—it is not possible for me to address the specific situation of Enron and how the auditors performed there, but what I can tell you is that the sense of outrage and concern that you very articulately expressed is something that I completely agree with. If there has been a failure by accounting firms in any of these cases, speaking generically, they must first be brought to task to answer for what they have done; and, second, we have to repair the system so that it doesn't happen again.

I am focused at this point in time on trying to repair the system so there aren't any more people in your district or in any other district in this country who suffer what these people have suffered. They were innocent victims, and I grieve for what happened to them. So we have an obligation to do something about those, and we will, and if we conclude that the auditors were derelict in their responsibility, you can be certain that we will take every step within our power to address that.

With respect to the notion of independence and consulting, let me say that there are two levels. I believe independence is an absolutely critical requirement. It is the bedrock of financial statements in this country. In my view, the first place one has to look is on the front lines. The audit partners who are doing the audits are absolutely required to be above any question and not to be subject to any confusion about where their duties lie.

I think, in terms of the way compensation has existed, there are considerable questions whether that was appropriately handled in the first instance.

For the firms, to me the issue is making certain that the firms fulfill their responsibility to ensure that the people on the front lines do an honest count and an honest audit, just as you're referring to. I am very much concerned that all of the incentives in the system be geared toward getting exactly that result.

How quickly can we respond? Well, in the first instance, it appears that the major accounting firms have suggested that they will voluntarily cleave off some of their consulting efforts that have raised questions in some people's minds. I believe that we have to look at this independence question also, and if there are problems there, we have to act quickly. I believe that we can take action generally within about a 90-to-120-day timeframe once we have concluded that there is something that we should do.

We are going to try our best to make certain that we don't expend any extra time trying to solve these problems, but we do have to give people the opportunity to be heard and to share their views with us and make certain that we are not headed down some wrong path that might create a problem worse than the one we are trying to solve.

Ms. JACKSON-LEE. I appreciate the time that we have in questioning.

Let me just quickly say, you offered or extended your agency's willingness to collaborate with Congress. I think the voluntary aspect is something that is commendable, but we need laws to change what has happened. I ask you to comment on the red flag—not spe-

cifically of the company—but red flag when you see the inflation of stock going up. Is there a time and place to intervene, to be able to look to ask the hard questions, what is happening?

Mr. PITT. In hindsight, it may well be that the rising price could have triggered some questions. What everyone hopes for when they invest in a company, obviously, is that the price will go up. Even though I don't invest in the stock market because of my job, everyday I keep hoping that the Dow Jones will jump dramatically and keep on going upward because that is better for the economy and the country.

I think there's no direct correlation, however. Just because a company's stock price rises doesn't necessarily mean that there was something fraudulent.

On the other hand, I think dramatic movements can sometimes contain the seeds of clues that would raise red flags, and one of the things we do is have a market stock "watch." We have a very sophisticated computer system that kicks out strange movements in stock, but also correlates them to major news stories and looks back to see if people traded before the news came out. I think we can increase the sophistication of what we have, but your essential point is one that I completely agree with. We have to be alert to any signs that something may be amiss in the system.

Chairman BAKER. The gentlelady's time has expired.

Mr. Chairman, I heard this admonition: "If it grows like a weed, it probably is one." Not bad advice.

Mr. LaTourette.

Mr. LATOURETTE. Mr. Chairman, thank you for your patience both during our discussion on whether or not the witnesses needed to be sworn in and also during the questioning.

When we get about this time of the panel, most of the innovative and thoughtful questions have been asked. I have been troubled and I want to talk about something that is parochial in the last couple of minutes of my time. But, Mr. LaFalce in his opening statement, and I think Mr. Sherman and even the benign Mr. Inslee, talked to you a little bit about your budget, and Mr. LaFalce made the observation that perhaps the President's request wasn't enough. Mr. Sherman threw you a beach ball and asked you to hit it out of the park. As a director of an agency, who wouldn't want more money? And Mr. Inslee asked you to balance alternative minimum tax repeal versus more cops on the beat, which is familiar rhetoric here on Capitol Hill.

Does the President's proposal—and I understood your answer on pay parity, and you're going to have that out with Mr. Daniels at OMB, but does the President's proposal, in terms of what your budget is going to be, cause you any concerns at all that you will not be able to execute the things that you've laid out for us in your testimony today?

Mr. PITT. It doesn't, or at least let me say it didn't. We were amenable to a very modest budget increase to be consistent with national budget policy. What we had thought was there would be pay parity.

In light of both 9/11 and Enron, obviously I have not had the time to see whether there are deficiencies in our manpower, but don't start by assuming the answer to every problem is more people

and more money. I think we should use the people we have efficiently and smartly, and then if we need more, we should come back and make the case.

Mr. LATOURETTE. Watching you for the last 3 hours, you don't strike me as the kind of person, likewise, who would be squeamish about asking for more stuff if you felt you needed it to do your job.

Mr. PITT. Nobody has accused me of being a shrinking violet.

Mr. LATOURETTE. There is a similar problem in other parts of the country that has to do with fraud and neglect, and I just want to ask whether it has come to your attention. Ms. Jones and I are from Cleveland. There's a fellow who worked for Lehman Brothers—in charge of that office, and I understand that this is something that has been repeated in New York and also in Illinois—who for 15 years directed false statements to a post office box and walked away with about $300 million of investors' money, and I ask you is this the first time you have heard of it?

Mr. PITT. I don't know if I have heard of this specific situation. I would like to tell you that I never heard of anything like that, but even in the 6 months I have been on the job, unfortunately, I have seen a lot of comparable things.

Mr. LATOURETTE. Like in the Enron situation where people have been on the line or over the line, I don't think we are going to have a problem there in that this fellow left a note behind for the FBI. He wrote a letter to his mom saying he would like to turn himself in. So, hopefully, he will turn himself in with the money.

Mr. PITT. I wouldn't take bets on the latter.

Mr. LATOURETTE. I am not, either, but it is of great concern to the people who trusted him for 15 years.

The only thing I'd ask of you is, if we get you the information, can I have your observation that you would give us a hand in trying to help the folks in Chicago and Cleveland out?

Mr. PITT. We would be very anxious to receive the information, and we'll do whatever we can to avoid anybody getting away with that kind of chicanery.

Mr. LATOURETTE. Just so I understood your answer on the 3 percent rule about—I took it to mean that you're going to impose some common sense, rather than just meeting this threshold of 3 percent and then who is in charge and so forth and so on. If I understood Mr. Powers' Report over the weekend correctly, these particular SPEs were designed not to transfer risk or do some laudable objectives, they were designed for the specific purpose of creating a favorable financial statement. What I took you to mean is that you are not going to look at the 3 percent rule. You are going to say there are good 3 percent things and there's bad 3 percent things and we are going to sort of reward or recognize those that have merit and not those that can be used for trickery. Is that a fair summary?

Mr. PITT. That is fair.

About 40 years ago, there was a criminal case in which it was articulated by the Second Circuit that compliance with generally accepted accounting principles will not save somebody from a fraud action and a criminal conviction if what they have done doesn't make sense and defrauds investors.

Mr. LATOURETTE. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Shadegg.

Mr. SHADEGG. Thank you, Mr. Chairman; and thank you for holding this hearing. It's been useful, and I look forward to it and the continuation tomorrow.

Thank you, Mr. Pitt, for your patience and for your thoughtful answers.

There are many different aspects of this issue we could go into. I want to look, and I think the Chairman has set the tone for this, on what we can do looking forward to try to make this system work. It seems to me there's nothing more important that this Congress can do. If Americans or people around the world don't have faith in our markets, if they don't believe that a company's value is accurately represented and that its stock represents fairly its value, we could have collapse of the entire capital system in the world.

I've read through your recommendations, and I think most are well taken. I want to explore and follow up on Mr. LaTourette's questions about the 3 percent rule, and I kind of want to get down to the basics.

Throughout the literature and the articles I have been reading these things are called special purpose entities. But for people back home, we in Washington often talk in code language that is not understandable. The term I like better is off-balance sheet entities.

It is a little funny. I want to figure out how my wife and I, who want to borrow some money to build a new home, can create an off-balance sheet entity in which we dump all of our debt for our cars and our current obligations and qualify for a larger loan for our current home.

I don't mean to be flip about that, but I think the average person out in America reading sees SPE and they read it is an off-sheet balance entity and then they discover it was created to hide debt to make a financial statement look a little bit better and they're going, well, wait a minute. Why in the world should they be able to do that?

I would like you to explain to me why we shouldn't have a completely consolidated balance sheet. What is the legitimate reason for letting a company, if there is any, have an off-balance sheet entity to hide debt in?

Then your specific testimony says, refer this issue to FASB, and says, well, for too many years the FASB has failed to set standards for accounting for special purpose entities. Should this Congress allow that duty to remain with FASB or should Congress step in and not allow these things to occur? Because if you can't trust what you're looking at in the report, if there's an off-balance entity in which debt is hidden, I don't think anybody can have confidence in the system.

Mr. PITT. Let me start with your last question, because it is one of major concern to me. I think that the concept of FASB makes enormous sense. I think having the private sector set standards makes sense. I think what does not make sense is to let FASB languish.

The SEC did not exercise appropriate oversight over FASB for many, many years. That, I can assure you, is going to change. If

it doesn't change, we won't recognize FASB. We would change the system.

Mr. SHADEGG. I appreciate that recognition that there is a problem here, that we have not overseen FASB.

Mr. PITT. That's a place where the SEC has a clear duty, and I intend to make sure that the Commission fulfills it.

With respect to off-balance sheet items, first of all, if you and your wife figure out how to do this, without my being flip, I hope you will tell me, because my wife is very anxious for me to figure out how to do the same thing, particularly since I have come to work in the Government. There are many types of ventures in which companies can have relationships with other entities and the questions of consolidation go to whether or not the other entity is independently managed, whether there's any recourse against the public company for satisfying some of the obligations of the off-balance sheet entity.

There are legitimate reasons why people might set up legitimate partnerships to perform a number of special purposes. What is not legitimate is basically to try to use them to siphon off liabilities and put them someplace else. If that is what happened—and certainly Mr. Powers' Report suggests that is what happened—if that is what happened, in my view, that's illegal, and that has to be addressed.

Mr. SHADEGG. You would agree that the 3 percent rule—just as a standard, if it's 3 percent independently owned, that is sufficient to keep it off the balance sheet, appears now, at least in hindsight, to be a bad rule?

Mr. PITT. You're asking a fair question. I'm not the best person to respond to that because, frankly, the nuances of SPEs and the accounting rules that apply to them are probably beyond my comprehension.

Mr. SHADEGG. I want to ask one related question. It appears from what I can read that in at least one instance the 3 percent rule wasn't honored. But that's not a rule in a sense that violating it is something you can go after and enforce. That's a judgmental standard which in fact there was not a 3 percent operation, and if in fact there was money kicked back so the independent entity had less than 3 percent, that may play into whether or not fraud occurred, but it is not a regulatory violation. Am I correct about that?

Mr. PITT. I don't necessarily agree with that. I'd have to know a lot more.

But I would say that a failure to comply with GAAP for the purpose as alleged here of hiding or secreting liabilities is eminently redressable under our existing authority. That, where I come from, which is Brooklyn, is fraud.

Chairman BAKER. Mr. Shadegg, would you yield for a question?

In my reading of the events in particular with one SPE, not only was the 3 percent trigger complied with, but Enron advanced the capital to the investor to put up the 3 percent, then advanced the money to the SPE to acquire the debt asset that was purchased by the SPE to get it off the books. So that the entire operation was Enron controlled, Enron funded, and they took the profit from the sale of that debt asset to the SPE and booked it as recurring revenue to the corporation.

There is no explanation, in my judgment, that can justify that conduct.

Mr. PITT. I could not agree more. If that is what occurred, then it makes a mockery of the requirements and, as I say, that would be fraud.

Chairman BAKER. Thank you.

Mr. SHADEGG. That is, in fact, what I had read.

Chairman BAKER. Mr. Chairman, I certainly appreciate, and I speak for the entire committee, your tolerance in this lengthy hearing this evening and your contributions to the overall progress of our committee's work. I do appreciate your willingness to respond to my letter in the most timely manner possible.

Legislative effort is eminent, and I hope that your input can be constructive for the subcommittee in offering the best product possible and again appreciate your generous work and effort in regard to the endless conduct rules which we will be announcing on Thursday of this week. We appreciate your courteous appearance.

Mr. PITT. Thank you very much. I have said from the outset of my tenure that I believe that Government is a service business, and we want to be of service to this subcommittee and to every individual Member, that if there are things that we can help with, please let us know and we will try to work with you in the public interest.

Chairman BAKER. Thank you for your courtesy.

We would like to now call our next panel, Mr. William C. Powers, Junior, Director of Enron Corporation, who was directed by the board to conduct his own review of the activities within Enron and who is principally responsible for the release of the report which has been the subject of news stories yesterday.

By prior agreement, before I recognize the witness, the panelist for the subcommittee work, Mr. Bachus had reserved his 2-minute statement from the earlier opening prior to this panel. Mr. Bachus, you are recognized for your 2 minutes.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Powers, welcome to the subcommittee.

Tragically, 11,000 Enron employees lost their retirement savings under a savings plan that was administered by a committee and trustee, all of which were handpicked by the company. The plan has written rules and guidelines that created duties on the part of the company, the directors and agents of the company to the employees. I have read the plan, takes about 30 minutes to read it. My question is, was this a forgotten document?

It is apparent to me that, had the plan been followed, those 11,000 employees wouldn't have lost their retirement savings. There are all sorts of illegalities, misconduct and nondisclosures associated with this catastrophe. Aside from all that, there was total disregard of the retirement savings plan, which is similar to the retirement savings plans most Americans participate in. A hundred million Americans or more participate in these 401K plans. My line of questioning will deal with this plan.

It is clear, and I am sure that you will agree, this plan was violated. The plan gave discretion to the committee and to the trustee appointed by the company. The plan mandated, among other

things, diversification in investment. It required the company to share all pertinent information with the committee.

Whatever else we have here, we have an old-fashioned, plain vanilla violation of their fiduciary duties under the Enron retirement savings plan by the company's senior executives. How the heck did that happen?

The plan requires that the committee and trustee under the direction of the company and with information supplied by the company shall do certain things, including specifically; "diversify the plan with investments to avoid large losses."

How is this plan so utterly disregarded or ignored? Was this a case of everyone being asleep at the switch or was there a willful intention to withhold information? The actions of the company and its agent when reviewed against the backdrop of its fiduciary duties arising under the plan reveal a wealth of violations for Enron. Fiduciary failures are under ERISA which is administered by the Pensions and Welfare Benefits Administration of the U.S. Department of Labor. I will be contacting Labor Secretary Elaine Chao to urge her to launch an investigation of the named fiduciary about the failures of the committee and the trustee and senior executives of the company to comply with Enron's written savings plan.

This investigation by Congress and any other agencies must be thorough and complete. If violations or improprieties have occurred, let the chips fall where they may. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bachus.

Mr. Powers, by action of the subcommittee earlier today, it is required that all witnesses before the subcommittee take an oath. Do you have any objection to testifying under oath?

Mr. POWERS. None whatsoever.

Chairman BAKER. I also have to ask, do you desire to be advised by counsel during your testimony today?

Mr. POWERS. No, I do not, Mr. Chairman.

Chairman BAKER. In that case, sir, if you would please raise your right hand, I will swear you in.

[Witness sworn.]

Chairman BAKER. Thank you, sir. You may proceed at your leisure. Your statement will be included in the record as presented. You may summarize or proceed at your convenience.

STATEMENT OF WILLIAM POWERS, JR., CHAIRMAN, ENRON BOARD OF DIRECTORS SPECIAL INVESTIGATIVE COMMITTEE

Mr. POWERS. Thank you very much, Mr. Chairman.

Mr. Chairman, distinguished Members of the subcommittee, my name is William Powers and I'm the Dean of the University of Texas School of Law. For the past 3 months I've served as Chairman of the Special Investigative Committee of the Board of Directors of Enron, and I very much appreciate this opportunity to come before you today and testify.

As you know, during October of last year, questions were being raised about Enron's transactions with partnerships that were controlled by its Chief Financial Officer, Andrew Fastow. In the middle of October, Enron announced that it was taking an after-tax charge of more than $500 million against its earnings, because of

transactions with one of those partnerships. Enron also announced a reduction in shareholder equity of more than a billion dollars. At the end of October, the Enron board established a special committee to investigate these matters, and then asked me if I would join the Board for the purpose of chairing that committee and conducting that investigation. With the help of counsel and professional accounting advisors, we've spent the last 3 months, in fact, doing that investigation.

Our committee's report was filed on Saturday. It covers a great deal of ground and it will, I hope, be helpful in providing a starting point for the necessary further investigations by congressional committees, by the Securities and Exchange Commission, and by the Department of Justice. A copy of the executive summary of our report is attached to my statement here.

Many questions are currently part of the public discussion, such as questions relating to the employees' retirement savings that Congressman Bachus raises, very important questions, and, of course, one of the most tragic consequences of this sad story. The questions such as those related to the retirement savings or other questions related to sales of Enron securities by insiders were beyond the scope of the charge that we were given. These are matters of absolute vital importance. They need to be investigated. They were not part of our charge.

In the 3 months that we had for our investigation, we did not investigate those vital questions. Instead, we were charged with investigating transactions between Enron and partnerships controlled by the Chief Financial Officer or people who worked in his department, and that's what our report discusses.

Frankly, Mr. Chairman and Members, what we found was absolutely appalling. First, we found that Fastow and other employees involved in these partnerships enriched themselves in the aggregate by tens of millions of dollars that they should have never received. Fastow got at least $30 million, Michael Kopper at least $10 million, two others $1 million each, and still two more, amounts that we believe were in the hundreds of thousands of dollars.

Second, we found that some of these transactions were improperly structured. If they'd been structured correctly, Enron could have kept assets and liabilities, especially debt, off of its balance sheet. And that raises significant policy issues in itself. But Enron did not follow those accounting rules.

But, finally, we found something more troubling than those individual instances of misconduct or failure to follow accounting rules. We found a systematic and pervasive attempt by Enron's management to misrepresent the company's financial condition. Enron management used these partnerships to enter into transactions that it could not, or would not, enter into with unrelated commercial entities. Many of the most significant transactions were not designed to achieve bona fide economic objectives.

As our report demonstrates, these transactions were extremely complex, and I won't try to describe all of them in any detail here, but I do think it would be useful to give just one example. It involves efforts by Enron to hedge against losses on investments that Enron had made.

Enron was not just a pipeline and energy trading company. It also had large investments in other businesses, some of which had appreciated substantially in value. These were volatile investments, and Enron was concerned because it had recognized the gains when those investments went up and it didn't want to recognize the losses when those investments went down.

So Enron purported to enter into certain hedging transactions in order to avoid recognizing the losses from these investments. But the problem was these hedges weren't real. The idea of a hedge is normally to contract with a credit-worthy outside party that's prepared, for a price, to take on the economic risk of the investment. If the value of the investment goes down, that outside company bears the loss. But that's not what happened here. Here, Enron was essentially hedging with itself.

The outside parties to which Enron hedged were these so-called "Raptors." The purported outside investor in them was a Fastow partnership. In reality, these were entities in which only Enron had a real economic interest and whose main assets were Enron's own stock. The notes of Enron's corporate secretary, from a meeting of the finance committee of the board regarding these Raptors, captured the reality of what was going on. Those notes said, quote; "Does not transfer economic risk, but transfers P+L volatility."

If the value of Enron's investments fell at the same time that the value of Enron stock fell, the Raptors would be unable to meet their obligations and the hedges would fail.

This is precisely what happened in late 2000 and early 2001 when two of these Raptor vehicles lacked the ability to pay Enron on the hedges. Even if these hedges had not failed in the sense I just described, the Raptors would still have paid Enron on the hedges with stock that Enron had provided in the first place. In essence, Enron would simply have paid itself back.

By March of 2001, it appeared that Enron would be required to take a charge against earnings of more than $500 million to reflect the inability of these Raptors to pay. Rather than take that loss, Enron compounded the problem by making even more of its own stock available to the Raptors, $800 million worth. It gave the false impression that the Raptors had enough money to pay Enron what the Raptors owed. This transaction was apparently hidden from the board and certainly it was hidden from the public.

Let me say that while there are questions about who understood what information was available to whom concerning many of these very complex transactions, there is no question that virtually everyone, everyone from the board of directors on down, everyone understood that the company was seeking to offset its investment losses with its own stock. That's not the way it's supposed to work. Real earnings are supposed to be compared to real losses.

So, as a result of these transactions, Enron improperly inflated its reported earnings for a 15-month period. That is, from the third quarter of 2000 through the third quarter of 2001 Enron inflated its earnings by more than $1 billion. This means that more than 70 percent of Enron's reported income from this period was not real. It was attributable to these Raptor vehicles.

Now, how could this have happened? The tragic consequences of the related third-party transactions and the accounting errors were

a result of failures at many levels and by many people. It was a flawed idea. There was self-enrichment by employees, inadequately designed controls, poor implementation, inattentive oversight, simple and not-so-simple accounting mistakes, and an overreaching in a culture that appears to have encouraged pushing the limits.

Whenever this many things go wrong, it is not just the action of one or two people. There was misconduct by Fastow and other senior Enron management. There were failures in the performance of Enron's outside advisors, and there was a fundamental default in the leadership of the management. And leadership and management begin at the top with the Chairman and CEO, Ken Lay. In this company, leadership and management depended as well on the Chief Operating Officer, Jeff Skilling. And the board of directors failed in its duty to provide leadership and oversight.

In the end, Mr. Chairman and Members, this is a tragedy that could have and should have been avoided. I hope that our report and the work of this committee will help reduce the danger that it will happen to some other company and its employees and its investors in the future.

Thank you, Mr. Chairman.

[The prepared statement of William Powers Jr. can be found on page XX in the appendix.]

Chairman BAKER. Thank you very much. I'm not sure that's the appropriate response. I think your report has been one of the most disturbing things I have ever had the misfortune to read. I have never seen such an example of corporate collusion that your report paints, and I have got to show extraordinary restraint to stay focused on the real point at which I believe our work should be aimed. Your report raises many issues which I think will keep this subcommittee busy for some time to come, as I suspect the SEC will be also.

Audit function. Is it your view that members of the board who engaged the audit team stood on the sideline while management managed the audit team?

Mr. POWERS. Much of the audit team was dealt with and initiated by people in the finance group, and we do think there's a lack of oversight by the audit committee. We chastised the audit committee.

Chairman BAKER. Let me be more specific. Is it your view that if an audit function were conducted and it was prepared inappropriately, in the perspective of a managerial member, would that audit be altered before presentation to the board? When an audit work is done and it would be presented to the board as a final report, in your view, is there evidence that before an audit report was finally concluded and handed to the board, that management intervened and restructured those reports so the board would get a different perspective of the audit work?

Mr. POWERS. I'm not aware of a specific instance of that, although there may be. I mean, there is a great deal of information in our——

Chairman BAKER. I'll come at it a different way. If the auditor came into that business environment and looked at the relationships between the Enron investments and the SPEs, the funding of the interested party who must hold the 3 percent, looked at the

purchase requirements between the SPE and Enron wherein the capital to make that acquisition was advanced by Enron, how is it that an auditor conducting his professional responsibility would not red-flag those transactions as either inappropriate or wrong? What happened with that audit inquiry when looking at those specific facts?

Mr. POWERS. These are questions we would like to ask. We did have some access to Anderson's papers, but limited, and we did not in the end have an opportunity to ask Andersen those very questions.

Chairman BAKER. In 1999, a public corporation was engaged in negotiations with Enron for a merger purpose. That corporation surveilled the publicly available documents, news reports, and did interviews and concluded that the off-balance-sheet debt structure was so enormous they would not proceed with the merger.

Mr. POWERS. That's correct.

Chairman BAKER. Given that information, what was the board's response to that public determination not to proceed with the merger way more than 18 months ago, almost 3 years ago? Is there no record of board discussion about these revelations in the public light as to Enron's true financial condition?

Mr. POWERS. We weren't able to ascertain that there was any reaction by the board that then took that, as you pointed out, red flag and investigated further in these transactions.

Chairman BAKER. In your work in the preparation of this report, did you interview all the board members, or any of the board members?

Mr. POWERS. We interviewed all of the members of the audit committee and we interviewed many other board members. I don't think we interviewed all of the board members.

Chairman BAKER. The members of the audit committee, did they indicate to you they felt that the Andersen work was proceeding in an independent course, or was it their view that the audit report had been manipulated by internal management?

Mr. POWERS. It was their view that Andersen was doing the audit report and it was their position that they were relying on the audit report.

Chairman BAKER. So their position is that Andersen was incompetent and did not prepare the financials in an appropriate manner?

Mr. POWERS. To the extent there are mistakes and errors here, which there are, that's the position of the people on the board that we—the people on the audit committee——

Chairman BAKER. But there's no evidence to indicate that, anytime prior to the public bankruptcy, that the board took any corrective action to dismiss Andersen or otherwise engage other accountants?

Mr. POWERS. That's correct.

Chairman BAKER. I'm out of time, but I'm not out of gas. I have to relinquish my time.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you.

You are probably the first witness that can give us substance about what happened at Enron. Thank you very much for coming

forward and listening to this debate. I agree with Mr. Baker, it is most shocking. But I guess the first thing I am going to ask conceerns hedges. These transactions involve derivatives. Is that correct?

Mr. POWERS. Yes. Not all of the transactions. Some of them involve sale of assets to get them off the books, but many of these involve hedges.

Mr. KANJORSKI. Right. But the normal use of a derivative is that somebody is coming forward with a private insurer with independent assets to insure your risk that you are placing in their hands.

Mr. POWERS. Absolutely.

Mr. KANJORSKI. And a hedge is a good economic tool to prevent exactly what happened here if it is a legitimate derivative. The problem here is they did not have honest and substantial counterparties.

Mr. POWERS. Absolutely. There's nothing—not only nothing inappropriate; a legitimate economic hedge is a very useful economic device. The problem here was these structures were structured to look as though they were hedges, and in fact it was Enron hedging with itself.

Mr. KANJORSKI. Instead of being in hedges in the sense of guaranteeing against the fluctuation of the market, Enron created transactions to take bad assets off the books, depreciated assets or lost assets, and make them appear as though they were not part of their company, or they were the counterparties' responsibility. Therefore, they would show the sale of the transactions as a profit, which would inflate their earnings and they would not have an asset that had a negative value on their books.

Mr. POWERS. Well, there are two different transactions. I did describe a hedge. Some of the transactions were sales of property to get them off the books, get the debt off the books. Many of those were bought back. The hedges themselves, the structure was so that the supposed counterparty that is paid on the hedge will owe Enron an obligation on the hedge that Enron could show as income to offset the loss in the investment. So those are two different issues, both of which were affecting the books.

Mr. KANJORSKI. Going to a simple example, because I'm sure the American public is still trying to figure out what this is. Let's say I had a transaction and I wanted to borrow money from a bank, and I had a home worth X and I had a mortgage of X or X-plus on that home. What I could do, under circumstances you use here, is construct a hedge vehicle or derivative and pass over the ownership of the properties of that hedge vehicle. They would pay me an inflated price, and they also would assume the mortgage so that my ultimate profit and loss statement, or balance sheet, would not show the existence of the mortgage, would not show the deflated value of the home, and would make me look rather substantial, when, in fact, I was not.

Mr. POWERS. I understand. That's correct. Some of these transactions moved debt off of Enron's books so Enron looked like it had less debt than it had.

Mr. KANJORSKI. My question is this: We have had these problems with hedging and derivatives before, and I have to confess they get

so complicated that it is hard to understand whether, in fact, there is grave risk or not. But, do you think we have sufficient legislation and authorization to the SEC or other Federal agencies to look into what these derivatives or hedges are? When do they constitute a realistic honest hedge? When are they falsely constructed such as this? Do we have anybody watching over the derivative hen house?

Mr. POWERS. Congressman, you identify a major problem and that is not—these types of instruments were a large cause of what happened with Enron. Now, I must confess I am not a securities lawyer and was not a derivatives expert before I came into this. I helped find out what happened. I was surprised to see the ability to move assets in a way that affected the financial sheets rather than real economic consequences, and it is a problem that I think this subcommittee and committees and other regulatory agencies need to look into.

I'm not sure I'm in a position, not having known a great deal about these entities before I got into this investigation, to give that kind of advice, but it is—you're identifying a very serious problem that needs to be looked into.

Mr. KANJORSKI. I have an honest problem, and we will have the accountants in here, I think tomorrow. I do not even know how you move approximately $800 million off your balance sheet without showing where the transaction happened, why, under what circumstances, what is the deflated value of the remaining stock, and so forth. It strikes me that this is a con, and you do not have to be terribly sophisticated to see that you are not getting anything from your counter-party, because your counter-party has nothing. You have created a false phantom counter-party, and it is all hinged on the stock going up. If everything goes up, if your stock value goes up and the asset transferred to the counter-party goes up, then nobody knows, nobody cares, and we all profit. But, at some point when there is a reversal, it is an implosion. Is that basically what occurred here at Enron?

Mr. POWERS. I think that's what did occur here.

Mr. KANJORSKI. This transaction is a billion dollars, but we keep hearing that Enron had a capital value of $70 or $80 billion, and most of the employees had investments in the firm. Moreover, Enron's investors were looking at the net worth, or the cap value, of $70 or $80 billion, believing that they would have an ability to retrieve their investment. What happened to that $70 or $80 billion? We did not lose it all on this transaction. This restatement precipitated the company's collapse, and showed the false accounting. Is there any fraud? What happened in that nature? What happened to the other $70 or $80 billion?

Chairman BAKER. That will have to be the gentleman's last question. His time has expired.

Mr. POWERS. The billion dollars to which I referred was not merely a billion dollars in capital value, in equity; it was a billion dollars in earnings. And when the markets lost faith in the earnings reports, that is, Enron wasn't earning what people thought it was earning. Now, I don't think that they knew the details of how that happened, but people started losing faith in the earnings reports, and I think they started losing faith in the credit capacity and a number of other things with Enron's ability to do business

as a counterparty. The market lost faith in Enron and then that precipitated the drop in the capital value of the stock.

Mr. KANJORSKI. I ask permission to ask one more question. Is it possible that this situation is systemic and occurring in other corporations in the United States today and that we are not aware of it?

Mr. POWERS. It's possible that that's occurring. I should say I hope most people in most corporations are doing their jobs in the right way. But it's certainly—these transactions are very complex and they're very hard to sort out and it certainly is possible.

Chairman BAKER. Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. Let me, before I begin, yield to my good friend from Delaware, Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman.

I'm only going to ask one question, Mr. Powers. I note that you're the Dean of a very significant law school in America, in Texas, and I'm sure you teach at that school criminal law, unless it's changed a lot since I went to law school. And you've made some very strong statements—and it is chilling to read your testimony here and to see this report—but, you've made some very strong statements, including "improperly enriching themselves," and so forth. I'd just like to ask you, in your opinion as somebody who is knowledgeable, do you believe that any of these individuals that you have looked into, particularly Enron employees in this case, have committed violations of the law, criminal laws, either in the State of Texas or the Federal Government?

Mr. POWERS. Let me say that we did not focus on that and come to judgments as a matter of the committee. I'm not an expert in securities law violations, and I'm not sure it's appropriate for me. It's rather the SEC and the Justice Department who make those determinations. This is very serious conduct, and I'm sure those entities and agencies and the Justice Department are going to make those determinations, and certainly this warrants close attention.

Mr. CASTLE. But it's not beyond the realm of possibility.

Mr. POWERS. Certainly.

Mr. CASTLE. Thank you. I yield back. Thank you, Mr. Chairman.

Mr. OXLEY. Pleased to yield to my good friend from Delaware. Let me first of all, Dean Powers, say that this report was both comprehensive and a seminal view of what transpired, and you and Mr. McLucas and the other participants in this deserve a great deal of credit for not only writing this report, but making it quite understandable for myself and the other Members, and really gives us an idea for the first time how we can get our hands around this issue. And you're to be commended for that.

Mr. POWERS. Thank you.

Mr. OXLEY. According to your report, all of the checks built into our system appear to have failed in some way or another—attorneys, accountants, regulators, management, the board, bankers, analysts, and the rating agencies. Were these independent failures or were they interrelated, and was one failure the trigger or critical event leading to the others?

Mr. POWERS. It's an important point that you're raising that this was a systematic failure. It wasn't just one person engaged in misconduct. You would expect the checks and balances to check that

individual failure. Within Enron, to which I can make a more direct statement, because that's what we looked at more—we didn't look at the credit agencies; for example, why didn't they see this? Within Enron, the checks and balances simply broke down and the people who were in the finance department, Fastow and others, and frankly in the accounting department, weren't checking each other. The deals were with Fastow, and nobody else around who knew what was going on provided a check and that oversight broke down at the board level, at the senior management level, and in the finance department.

Mr. OXLEY. Would board oversight of a company, specifically by the audit committee, improve if the board took over the responsibility for retaining and firing the auditors from management?

Mr. POWERS. That's that's not a question that I've given a great deal of thought to. There certainly is a problem. When I came into this, it was surprising to me to see how much, for example, that the auditors had helped design the vehicles and audited the vehicles, and how much management used the audit groups, and then the audit groups would come back and audit the management. It's a very serious problem.

I don't know that I have—what you're suggesting sounds like a very plausible solution. Whether it ends up being the right solution, I don't know.

Mr. OXLEY. But it's worthy of pursuit?

Mr. POWERS. I think it's absolutely worthy of pursuit.

Mr. OXLEY. So your statement really was that the auditors were in on baking the cake here, that they were part and parcel of helping certain people in management essentially craft these partnership arrangements?

Mr. POWERS. The auditors were paid a great deal of money to help design these vehicles, that's correct.

Mr. OXLEY. And that in and of itself is an aberration? Is that outside of Enron? I mean, I'm trying to understand whether, in fact, the auditor himself concluded that in his job description.

Mr. POWERS. I haven't looked at other companies. My understanding is it's not unique, that aspect is not unique to Enron, that auditors both do what would be called real-time auditing, they're involved in the structuring of the transactions themselves, at least looking at them, and then they do the audit.

Mr. OXLEY. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you very much, Mr. Chairman. I would concur with your view that they were in the room helping bake the cake. I think the problem is they were eating it, too, is the problem.

Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman. Dean Powers, over here.

Mr. POWERS. Thank you.

Mr. LAFALCE. Could you tell me, when you're not being Dean, what your area of legal expertise is?

Mr. POWERS. Torts, products liability, and legal philosophy.

Mr. LAFALCE. OK, good. Could you tell me what you had as part of your job description, as a newly appointed member of the board of Enron, that you think you could have done better had you had greater power such as subpoena powers, and so forth? And second,

what do you think entities other than your investigative committee should be doing; that is, what didn't you do that either the SEC or the FBI or the Justice Department or the Congress should be doing?

Mr. POWERS. Well, I think Congress should be looking at the policy ramifications, as this subcommittee is doing, and determine whether changes in the system——

Mr. LAFALCE. With respect to Enron in particular. The policy is much larger than Enron.

Mr. POWERS. As Congressman Bachus indicated, there are issues at Enron that we have not looked into like the 401K plans, and I think it would be appropriate for Congress to look into those.

Mr. LAFALCE. Let me get into some specific issues. It's my experience that very often corporate management decides who's going to be on the board, and they don't select board members on the basis of who's going to be toughest on us, who's going to give us greatest oversight. They select board members very frequently on the basis of who will go along with us more readily than somebody else, and who would it be nice to have as a board member so they will let management do their thing.

First question I ask you is, how do we deal with that? And, second, so long as management is hiring an auditor or a lawyer or what have you, chances are that professional group is going to want to give management what management wants to hear, if it's at all humanly possible. So they will stay on as basically employees, and they are employees whether they'd like to call themselves that or not. And so how do we deal with that in a policy way, because I personally have believed for a long time that the Enron problem was systemic earlier this year. The first half of the year we had over 260 restatements of earnings that were mandated by the SEC, an absolute record number, and a number of us said at that time that this is the tip of the iceberg. And self-regulatory organizations, whether for accountants or for securities analysts, have not worked; and I question whether they can work, and I'm wondering what your thoughts are on that.

Mr. POWERS. I agree that it is incredibly important that boards have sufficient detachment from management that they can oversee management, and that professionals have sufficiently independent professional——

Mr. LAFALCE. How do you get from here to there, because most often it's management that recommends somebody to the board?

Mr. POWERS. I'm not that familiar with how boards are selected in other companies. Companies that want good advice in oversight ought to have board members who——

Mr. LAFALCE. Those are not the companies we need to be concerned about.

Mr. POWERS. I agree.

Mr. LAFALCE. It's the companies we need to be concerned about, and I don't think we can count on the officers of those companies or on the board of directors of those companies. There are too many conflicts of interests that I don't think could ever be eradicated. We have to rely, though, on the outside auditors and we have to rely on attorneys doing a better job, and most especially we have to rely on securities analysts, and not only with respect to Enron, but with

respect to hundreds and hundreds of companies. They have fallen down on the job. They have been guilty in my judgment of professional malpractice, and the self-regulatory organizations for these so-called independent outside experts simply have not worked and cannot work. And I'm wondering if you have any policy prescriptions you might be inclined to recommend at this juncture.

Mr. POWERS. Well, I recommend that there are problems that the committee and other agencies ought to look into. As I say, this is not my ordinary field of expertise and I don't think I'm in a position to give particularly precise recommendations on them other than, as you suggest, to recognize it as an issue that needs to be addressed.

Mr. LAFALCE. I thank you.

Mr. POWERS. Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Bachus.

Mr. BACHUS. Thank you, Dean. Dean Powers, 11,000 Enron employees invested in the 401K plan and this is this plan right here, 68 pages, and they lost their life savings. Now, that plan is basically an agreement between the company and the employees. I have read that plan. It takes about 30 or 40 minutes to read it. Did you and the committee read the plan?

Mr. POWERS. No, we didn't.

Mr. BACHUS. Let me go over some of the pertinent parts of it. First of all, the committee—and the administrator of the plan is designated as, quote; "the committee," and the investment manager is designated as the trustee.

Now, in sections 13 and 14, they are both selected with sole discretion of the company and could be removed for any reason at any time by the company. So they have total power in putting this committee together and designating the trustees. Now, that's an awfully important document, isn't it, between the employees and the company?

Mr. POWERS. It's a very important document.

Mr. BACHUS. And the senior executives of the company can't disregard this agreement, can they, legally?

Mr. POWERS. I don't believe they can.

Mr. BACHUS. That's right. Now, it's been stated in published reports that the company's contributions to the 401K plans were required to be invested in Enron stock, and I just assumed that to be the case until this weekend when I read this plan. And, in fact, that's not really correct. I don't know whether you're aware of that. Let me say, here is Article 15 and that's the fiduciary provisions. Now, you are a professor who teaches torts; so fiduciary duty is a very serious duty that's owed, is it not?

Mr. POWERS. Absolutely.

Mr. BACHUS. And the duties owed—in fact, that article says that the article shall control over any contrary, inconsistent, or ambiguous provisions contained in the plan. So these fiduciary provisions take precedence, and it says in there and it specifically states that the committee and the trustee shall act solely in the interest of the participants—in other words, the employees—in discharging their duties. Not in the best interest of the company, but of the 401K participants, and I will quote the second provision, and this is

something I've seen no focus in any of the media on, by, quote: "diversifying the investments of the plan so as to minimize the risk of large losses." Now, they didn't diversify, as we all know, and we all know the result.

Now, it also says in Article 8, "the company shall supply full and timely information to the committee." Now, Dean Powers, do you think that the information Mr. Lay received from Ms. Watkins on August the 15th would have been pertinent and should have been given to the committee as important information about the financial condition of the company?

Mr. POWERS. Congressman Bachus, I have not gone through these plans, and not because it's not important. As I said earlier, this is one of the greatest tragedies of these whole events, are the employees losing their investments and savings and retirement hopes. I really feel that I'm not in a position to comment.

Mr. BACHUS. I will go on because I don't want to put you on the spot.

Mr. POWERS. Thank you.

Mr. BACHUS. But I think when we start looking at these, it's——

Mr. POWERS. These are very serious issues you raise.

Mr. BACHUS. It absolutely is. It also says one matter of great concern has been the lockdown that occurred on October the 26th that prohibited employees from diversifying the 401K plan. Now, the lockdown was characterized as necessary due to administrative changes; but under this same provision, the committee is required as a named fiduciary to discharge its duty with care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man had.

Now, we know what the senior executives were doing. They were selling their stock. I think they sold $350 million worth of stock during this period of time. But they were supposed to be giving these trustees and this committee the same information that they were acting on to sell their stock, but, in fact, just the opposite happened and they allowed a lockdown of this plan. I believe that that was a violation of the committee's fiduciary duty to the employees and one which basically resulted in them losing their retirement plan.

And this document, and I think there is one other—well, I guess that's—I think my time is up, but let me simply say to you that I know that wasn't part of your inquiry. I think when you read that, you will see that the company had all sorts of obligations that they failed to do.

Mr. POWERS. And you're raising very important issues here, Congressman.

Mr. BACHUS. Thank you.

Chairman BAKER. Thank you, Mr. Bachus.

Mr. Ackerman.

Mr. ACKERMAN. Thank you very much, Dean Powers. In the 3 short months that you've been in this business, you have basically shaken up the financial world, maybe the legal world, those who watch ethics as well, and covered things that are shocking and amazing, as so many people have said. You yourself have said that you were appalled. And yet when we look at some of these things, it seems if you could uncover them with your small group of inves-

tigators in 3 months, that a major accounting firm, with all of the resources that they have, should have been able to uncover and discover this. I mean, it doesn't take long if you stand on the street corner in New York to figure out that somebody has a shell game going or Three Card Monte or a Ponzi scheme, or anything else that you want to call it. And evidently from the looks of this, this has been what is occurring here: absolute world-class thievery. Now, how is it that an accounting firm couldn't figure that out?

Mr. POWERS. I'm not sure I'm in a position to answer that. As I said earlier, we would have liked to have discussed more fully those issues with the outside accountants. I will say these are extremely complex transactions and I had enormously able help to do this.

Mr. ACKERMAN. I'm sure. But one would think that a major accounting firm would have extremely capable help as well.

Mr. POWERS. Yes.

Mr. ACKERMAN. You're not a securities guy, as you said, or a derivatives guy, as you've told us, and you figured all this out.

Here's a question, I think. If Arthur Andersen was hired to be the outside auditors, and it also appears that they're the inside auditors, that they would have some kind of mandate to advise the company, the board, as to the kind of checks and balances and controls that would have to be in place. Now, isn't there a failure on the part of the auditors as well as the company here?

Mr. POWERS. Our report makes that point, that we do think there's a failure on the advice and oversight of the outside auditors.

Mr. ACKERMAN. Well——

Mr. POWERS. Absolutely.

Mr. ACKERMAN. One would, you know, come to the conclusion that if that was the case or reasonably assured that that was the case, that some kind of collusion and fraud and conspiracy and all those kinds of words was taking place. And your mandate as you've described it, and as we know, was very narrowly focused on one area, and some of the other areas, as you pointed out, are exceptionally troubling. And one might infer from your report, if not conclude from your report, that there are other areas that bear looking into that was not within your mandate. Do you think that there's enough here to warrant a special prosecutor?

Mr. POWERS. Again, we tried to find out what happened, and I think our report is a start to help others who will have to make the determinations as to whether there ought to be prosecutions, whether there ought to be a special prosecutor and things of that sort. I don't think it's appropriate for me to make the policy as to whether those prosecutions ought to go ahead. We tried to find out. I think we have found out to a large extent what happened. And it wasn't our job to make the determination as to whether to prosecute people.

Mr. ACKERMAN. I guess it's in part our job to make recommendations and to speak out on behalf of those kinds of things, and the report that you have done I think should give reasonably prudent people, hopefully Members of Congress, too, enough to chew on and consider as we make our deliberations. And I thank you and your small group of people for the service you've performed.

Mr. POWERS. Thank you.

Mr. ACKERMAN. I yield back the balance of my time.

Chairman BAKER. Thank you, Mr. Ackerman.

Mr. Shays.

Mr. SHAYS. Wow, your report blows my mind.

Chairman BAKER. You need to pull your mike a little closer.

Mr. SHAYS. I am absolutely dumbfounded by—I feel like I am in Sin City. I feel like every part was not just asleep, but they were kind of colluding with each other and compromised. I mean you talk about the attorneys, you talk about the accountants, you talk about the regulators, you talk about the management, you talk about the board, you talk about the bankers, you talk about the analysts, you talk about the rating agencies, and nobody looks good. But it's even worse than that, because when I start to go through your report, I just see extraordinary conflicts of interest, and I'd love you to just respond to one of them.

Should the fact that in 2001, Vincent & Elkins received $36 million in fees from Enron, from a variety of legal work, have disqualified them to respond to the accusations of Sharon Watkins, who in August had met with Lay and said, you know, we've got a problem with this company?

Mr. POWERS. Congressman, as I indicate in the report, I did not participate in the final judgments on Vincent & Elkins because they are a——

Mr. SHAYS. Forget it. Should any firm that basically made $36 million in one year be the one to have been hired by the board to look into the accusations of an employee who said, "A lot of crooked things are going on here"? Isn't there an inherent conflict of interest?

Mr. POWERS. With all due respect, Congressman, it's hard for me to answer that, other than in the context of Vincent & Elkins, and I didn't focus or look into that part because I felt it was inappropriate given the relationship that Vincent——

Mr. SHAYS. I'm just asking you a general comment. If you're going to be looking at the transactions of a company, does it make sense for you to ask the very group that was involved in the transactions and was hired by the company to decide whether these transactions made sense, to then hire that company? Is there logic to do that?

Mr. POWERS. I can comment on whether it makes sense for Enron to do that. I think it was questionable for Enron to do that. Vincent & Elkins certainly disclosed to Enron what its involvement was, and I don't have an opinion on what they did, but Enron might have looked to somebody else.

Mr. SHAYS. But this was a law firm—I'm just taking this as an example. I could take others. This is a law firm that basically has been involved in some of the SPEs, it earned $36 million. I think because we talk billions, we don't think $36 million is a lot in one year, and yet they are the company that's asked to evaluate. Shouldn't a company simply say, we shouldn't be the ones to look at this because we were involved in some of these transactions? I mean, they are being asked to comment on the very transactions they were involved in.

Mr. POWERS. I think VE was cognizant of its obligations, and again I haven't looked into that because it was a part that I didn't

focus on. But they disclosed all that to Enron, and I'm not in a position——

Mr. SHAYS.They didn't disclose it to Enron. Enron is the one that paid them.

Mr. POWERS. Sure. I'm just saying I'm not in a position——

Mr. SHAYS. You're really saying you don't want to. You are in a position, as a lawyer who's at a law school who deals with ethics, to talk about the merit of a company that does business and has earned $36 million to pass judgment on things that it basically allowed to happen while it was earning their fees. So I mean, it seems——

Mr. POWERS. I agree.

Mr. SHAYS. You don't want to is really the answer; not that you can't.

Mr. POWERS. Well, I will agree with you that I don't want to, but I can say that Enron might have gone somewhere else. I'm not in a position——

Mr. SHAYS. What about the company? You lawyers sometimes, it seems to me, are very willing to protect each other. But the bottom line is here are some lawyers who are basically hired by a company to comment on transactions they were involved in, to say whether they were appropriate or not, so I will let it stand on its merit. Did you interview Arthur Andersen?

Mr. POWERS. The committee looked at some Arthur Andersen papers. We didn't have access to all of Arthur Andersen's work papers. We talked with Arthur Andersen in order to try to have interviews with them, and there was back and forth. They said they would participate with us. And finally when Enron fired them, they would not participate with us. So we did not end up getting discussions, and we were not able to put in questions to Arthur Andersen as to what their position was.

Mr. SHAYS. Did you interview Vincent & Elkins about their questionable activities?

Mr. POWERS. I didn't because I wasn't part of that part of the investigation. I think the committee talked to people at Vincent & Elkins.

Mr. SHAYS. Extensively?

Mr. POWERS. I will have to check on that.

I'm told we interviewed four or five lawyers at Vincent & Elkins.

Mr. SHAYS. I'm sorry?

Mr. POWERS. I'm told we interviewed four or five lawyers at Vincent & Elkins.

Mr. SHAYS. Viva was a company that is from Germany; described in the articulate statement of the Chairman, they were able to come in, hire an auditing firm and understand that this company, Enron, was not worth merging with, in fact, their debt was so high. They were able to know back a few years ago the incredibly poor condition of Enron. What does that tell you?

Mr. POWERS. Well, I think they saw risk in Enron because they were unable to figure out its debt structure, and they had red flags that caused them to not want to merge with Enron. That tells me that——

Mr. SHAYS. That it wasn't too difficult to figure out?

Mr. POWERS. That there was risk there; that's correct.

Chairman BAKER. If the gentleman would yield on that point, they actually concluded in the written documents that 75 percent of Enron's equity was encumbered. So that they did actually figure out the level of debt and it was not an indeterminate amount.

Mr. SHAYS. Let me just make a statement, then, because my time is up. I think it says a world about the extraordinary failure of all these different groups that I listed that were in your report, that failed to step up to the plate, that a company from outside this country would hire someone inside PriceWaterhouse and basically exposed this company years ago. And even then nobody caught on, which is mind-boggling.

Chairman BAKER. The gentleman's time has expired. I thank the gentleman.

Mr. POWERS. Thank you.

Chairman BAKER. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman and Mr. Powers. Mr. Powers, in your statement you say, we found a systematic and pervasive attempt by Enron's management to misrepresent the company's financial condition. Who is Enron's management, or who do you mean by that? Is that the board of directors, is that the CEO, or is that selected individuals?

Mr. POWERS. OK. The best we could ascertain the genesis of the scheme itself, certainly Fastow, there are people in the finance department who know about these transactions. We think people in the accounting department know about these transactions. It has been very difficult to ascertain precisely what people higher up in the management—we are told Skilling knew and was involved in a great deal.

Mr. BENTSEN. Is your investigation finding that this was a situation where basically some people in management were making these non-economic hedges and off-balance-sheet financings and skimming off the top, or is this a situation where the company itself—I mean, from reading your report it sounds like going back to the early 1990s, they started using off-balance-sheet financing a great deal. Not the only company in the world to do that certainly, for a variety of reasons. But, over time, was this a company where the bad bets kept piling up and they were trying to dig out, or was this a case where you had a handful of individuals at the top who were actually looting the company?

Mr. POWERS. Well, I think there were a handful of individuals, Fastow and others, who were designing these both to manage Enron's financial statements and to enrich themselves.

Mr. BENTSEN. After Skilling resigned last summer, in August or whenever it was, was the board—I guess in your statement you're sort of laying out that the board either was asleep at the switch or really didn't know what was going on; is that sort of correct?

Mr. POWERS. I think on particular facts, the evidence shows that they were misled.

Mr. BENTSEN. That they didn't understand that there's no economic value or these deals were underwater, that they had—I mean, effectively it looks to me like the Raptor deal—and a friend of mine—an analyst, who I know is an analyst or not, highly regarded this committee, but I was talking to—said these were basi-

cally naked puts, that they had pledged either stock or the agreement to issue stock.

Now, who has the authority to issue stock for a public corporation? I mean, $800 million worth of stock is a pretty good chunk of stock, even for a company with $60 billion of market value. I mean, does the CFO have that authority, or is it the board of directors that has to make the determination that stock will be issued or that a put will be issued?

Mr. POWERS. This is actually stock that they had obtained or preexisting contracts they had with other companies, but the board did approve of using that stock. The board didn't approve the particular hedging transactions.

Mr. BENTSEN. Let's follow the line of thought and let's assume that the board was misled—maybe. And so Skilling resigns in August or whenever it is this summer. Did the board find out at that point in time that the company was in serious trouble or did the board find out at that time that they had a bunch of deals out there that were underwater, whether they had been skimming or whatever?

Mr. POWERS. I think the board was not informed at that time that these vehicles were underwater.

Mr. BENTSEN. When did they find out? Was it not until October? Was it not until November? I guess my question is because during that period of time the employees and the public and the investing public were being told things were never better, the stock was under value. Now obviously, some of that is a game face that you put on and spin, but it kept going on. Options were issued or granted to employees. I mean, was this going on? The board still didn't have any idea what their balance sheet looked like, what their liabilities looked like?

Mr. POWERS. Well, I think the board was not aware that these vehicles were underwater until Lay came back in as the CEO, and then they did restructure them.

Mr. BENTSEN. Lay came back as the CEO after Skilling resigned in August. I have something here where they issued a grant of options on August 27 and Lay says "one of my highest priorities is restoring investor confidence in Enron." This should result in a significantly higher stock price. And as late as September 26, Lay told the employees that the stock was under value, that the company's prospects were never better. At that point in time, did the chairman and CEO, did the board of directors, did the auditing committee of the board understand what the true financial condition of the company was?

Mr. POWERS. Well, a lot goes under the true financial condition of the company for reasons that were beyond the vehicles we were looking at. We were not able definitively to ascertain how much Lay knew about these individual vehicles and he denies that he did. Skilling, in the interview, denied that he had much involvement with them, and therefore doesn't say that he told Lay. We were not able to ascertain with that precision exactly what Lay or Skilling——

Mr. BENTSEN. Well, my time is up, but Mr. Chairman, it is like three blind mice running around and their fingerprints are all over the place. The board agrees to the parts and everything else. Either

nobody was looking at the sum of the parts or everybody was looking the other way.

Mr. POWERS. Well, we would agree that people were not minding the store. I just can't say with certainty what Lay or Skilling knew at that point about the particulars of those transactions.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BAKER. The gentleman's time has expired.

Mr. Royce.

Mr. ROYCE. We have talked a lot about systemic failure. In 1999, an SEC blue ribbon panel commission recommended that audit committees be made up solely of independent directors, each of whom would be financially literate with at least one having either financial expertise or accounting expertise. However, under the rules implemented by the New York Stock Exchange, directors on the company payroll are permitted, former employees and their families are allowed after 3 years, and audit committee members with a significant business relationship are also acceptable if the board determines that their ties won't interfere with their judgment.

My question to you, based upon your observations, if the SEC's recommendations had been adopted verbatim first, fully half of Enron six-member committee would probably have been barred from service. In your opinion did the close relationship between Enron's audit committee and the company impair or compromise its judgment or its objectivity in any way?

Mr. POWERS. We didn't have reason to believe that the audit committee didn't have objective judgment in the sense that they were complicit in these transactions. But they did understand and approve the overall use of Enron's own stock as a hedge which should have, in our view, raised red flags.

Mr. ROYCE. Did any of those members on the board raise any questions about these off-book dealings? You interviewed them, I take it, and the committee interviewed them. Are there particular individuals who, during these meetings, raised objections or raised questions or did they simply nod and acquiesce?

Mr. POWERS. They did not raise the right questions.

Mr. ROYCE. OK. Do you happen to know how these board members were chosen?

Mr. POWERS. I don't.

Mr. ROYCE. In your opinion, would an additional assertion on the effectiveness of internal accounting controls in the management disclosure and analysis section of the annual report have brought Enron's troubles to the attention of either senior management or the board of directors in a more timely fashion?

Mr. POWERS. I don't know whether it would or not. I'm sorry.

Mr. ROYCE. Let's go to the question of waivers. Was the board fully informed when it granted waivers to Mr. Fastow in 1999 to engage in these hedging ventures that were very risky with these partnership agreements, or SPEs, as we are calling them, using Enron's own stock and allowing Enron essentially to do business with itself? Do you think the board was fully informed when it granted those waivers or do you think there was information that was withheld from the board that had they known it, they would have been able to exercise a decision here more in keeping?

Mr. POWERS. I think there was clearly information about the nature of those partnerships including Fastow's compensation that was withheld from the board.

Mr. ROYCE. And the board members that you interviewed indicated they simply weren't given full disclosure? Did they ask for more information, do you know?

Mr. POWERS. They were told that it was inappropriate to know about Fastow's compensation because these were supposed to be arms length independent entities and knowing about his compensation would defeat that. They asked about it, were not told and were satisfied with that answer.

Mr. ROYCE. Were the auditors, Arthur Andersen, involved in those discussions at the time that that assertion was made to the board members? Do you know offhand?

Mr. POWERS. We don't know whether Andersen was present. We have seen some of Andersen's work papers and from what we have seen, it doesn't look like they asked about Fastow's compensation. But again, there may be papers or Andersen may have a different view on that. We have not been able to find that Andersen looked into that.

Mr. ROYCE. My last question is whether you had an opportunity to interview Cliff Baxter at all about the circumstances?

Mr. POWERS. That was a tragic—one of the tragedies that came out of this. The committee interviewed him. I did not personally interview Mr. Baxter.

Mr. ROYCE. I thank you very much for your testimony here today, and Mr. Chairman, thank you.

Chairman BAKER. Mr. Sandlin.

Mr. SANDLIN. Thank you, Mr. Chairman.

Thank you, Dean, for being here. My oldest daughter just began at the University of Texas as a freshman. Hillary should be horrified that I mentioned that here in Congress. It's good to have you here. Appreciate the hard work that you have done in a short period of time under difficult circumstances, and it appears as we go through this and listening to the questions that as usual, if you follow the money, you know what the incentives are and what's happening. I noticed in your report, I was interested in Mr. Fastow that you have been talking about. He received off the partnerships $30 million profit; is that correct?

Mr. POWERS. That's correct.

Mr. SANDLIN. Mr. Kopper, $10 million; two others got $1 million each; two more got hundreds of thousands of dollars and it was also interesting, Mr. Fastow—he obviously knew that it was something to be hidden. I saw in your report, it says, item 404 of regulation S-K required the disclosure, where practicable, of the amount of his interest in the transactions, and yet management discussed with him the possibility or way to hide that; is that correct?

Mr. POWERS. That's correct. Mr. Fastow did not want to reveal that.

Mr. SANDLIN. And on top of that he knew that it should be revealed and they were trying to find a way not to; is that correct?

Mr. POWERS. That's correct.

Mr. SANDLIN. I was interested in tracking these so-called retention bonuses. I saw Mr. John Lavorato got $5 million for 90 days, and this was after Enron filed for bankruptcy; is that correct?

Mr. POWERS. I think it was in conjunction with Enron filing for bankruptcy trying to keep key employees that Enron thought was necessary to move ahead.

Mr. SANDLIN. You would have been pretty key if you got $5 million for 90 days work, wouldn't you, especially when you are giving the employees the rank and file $4,500; is that correct?

Mr. POWERS. That's correct.

Mr. SANDLIN. Has demand been made upon those folks to return that money through the bankruptcy court?

Mr. POWERS. I don't know that.

Mr. SANDLIN. I am sure it is being looked at closely. I noticed also that Enron and its advisors, of course, set up these off-the-book partnerships that we have been talking about, and yet 2 days ago, they indicated they had absolutely no information as to who might be the investors. Did you see that?

Mr. POWERS. I have heard that. I didn't actually see it in the papers.

Mr. SANDLIN. That doesn't seem to be very plausible, does it?

Mr. POWERS. We have been unable to get those work papers because the partnerships have not provided them. I think Enron did not look into who the investors were.

Mr. SANDLIN. You would understand, then, how they can be in such a bad financial situation if they entered into these arrangements with partnerships, and they don't know who their partners are and they don't know what the arrangements are and they don't have the documents. It's pretty clear they are not doing a very good job, isn't it?

Mr. POWERS. They didn't know the limited partners in those and how those limited partners were dividing the profits.

Mr. SANDLIN. They knew who they were doing business with as far as dealing with their own executives and people making $30 million, $10 million and $2 million?

Mr. POWERS. They knew they were doing business with Fastow.

Mr. SANDLIN. I would like to talk a little bit about this. Since we are talking about the lawyers, it seems to me the ultimate obligation and decision is made by the business itself; isn't that correct? Accountants are advisers and attorneys are advisers. In your report, on page 183, on related party disclosures, you say, "nevertheless, it appears that no one outside of Enron Global Finance, the entity principally responsible for the related party transactions, exercised significant supervision or control over the disclosure process concerning these transactions." Isn't that correct?

Mr. POWERS. That's correct.

Mr. SANDLIN. In fact, Enron had several attorneys advising them; is that correct?

Mr. POWERS. That's my understanding, yes.

Mr. SANDLIN. And although in your report, you said that Andersen did not fulfill its professional responsibilities, you did not make that same finding about, say, for example, Vincent&Elkins; is that correct?

Mr. POWERS. Again, I stayed away from that aspect of the report and I don't remember the exact language that was used. It may be different language than was used with Andersen.

Mr. SANDLIN. You may have seen that V&E told Enron that some of the partnership deals might have been legal from a technical standpoint, but would be portrayed badly—that was a quote by the media—or in the event of the lawsuit. Have you seen those quotes?

Mr. POWERS. I have seen that in our report.

Mr. SANDLIN. Certainly it was portrayed badly, correct?

Mr. POWERS. It was portrayed badly.

Mr. SANDLIN. I think they were correct in that assessment. I think I'm out of time and it's about to blink, so I'll get back to the few remaining seconds I have and say thank you again for coming.

Chairman BAKER. Thank you, Mr. Sandlin.

Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Did you say that that you determined that LMJ and Enron officials, especially Fastow and Kopper, took deliberate actions to intentionally frustrate the efforts of the audit staff and attorneys?

Mr. POWERS. Well, they certainly did not want their compensation known. And they were effective in not making it known.

Mrs. BIGGERT. Then what about the issue——

Mr. POWERS. And I add that Fastow especially withheld a great deal about these transactions from the board.

Mrs. BIGGERT. One of the questions that was asked earlier was about the fact that the SEC decided not to perform regularly scheduled review of Enron's filings with the Commission. Did that come up in your report or did you look into that?

Mr. POWERS. I don't believe we did look into that, no.

Mrs. BIGGERT. Do you think with all these things that went on, the lawyers, the accountants, everything seemed to have failed, if the SEC had looked at that, do you think they might have found out about the special entities, or would have brought that to their attention?

Mr. POWERS. Again, these are very complex transactions, and one has to be able to really dig into the papers to find out about them. More people looking at these might have revealed them, but I can't say for sure whether the SEC could have found this.

Mrs. BIGGERT. You didn't check into it?

It all seemed to be so many things that happened; what would have triggered a stop on this so we could have found out. There's been so much in the press and every time we pick up a newspaper, and particularly the financial papers, but also the financial sections of every paper, there seems to be a lot of talking about Enron. Has the financial press helped or hurt or had any impact on your investigation?

Mr. POWERS. I don't think they have had any impact on our investigation. We may have learned a few things from press reports, but most of it was—well, it had a very small impact on our investigation.

Mrs. BIGGERT. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Biggert.

Mr. Sherman.

Mr. SHERMAN. Thank you. I am outraged by the retention bonuses, outraged by the self-dealing, but I want to focus on those aspects that are not unique to Enron, but may be systemic problems in the future. American culture says, as long as you adhere to the rules, you can go out and maximize profit. And it's certainly easier to change the rules and make sure that they cause people to adhere to good, socially acceptable standards, than it is going to be to change the culture.

Mr. Ackerman asked a question a lot of us are asking, and I think, Dean Powers, that your statement may serve as the answer, and I would like to get your response. How did they miss this? How did the board not know? The analogy I've used before is that the accounting rules allow the car to go at 100 miles an hour. It's legal. It's wrong, but it's legal. And the only reason that car isn't on the road today moving quickly toward accounting fantasy land is that they went at 101 miles an hour, and that what people didn't focus on was the last mile an hour. They knew the car was going fast. They might have known in a moral sense that it was wrong, that it exposed a lot of people to a lot of risk, but they thought they were adhering to the speed limit.

I see, Dean, you're nodding, and I want to point out particular items in your statement that have kind of led me to this conclusion. You quote the corporate secretary, "Does not transfer economic risk, but transfers P+L volatility." It's as if the corporate secretary thinks wow, we've discovered a road that you're allowed to go 100 miles an hour on. Do I have this right so far?

Mr. POWERS. I think the corporate secretary is probably—she's taking the minutes. Recording something that happened in the finance committee meeting.

Mr. SHERMAN. And your comment later, is that from the board of directors on down, they understood that the company was seeking to offset its investment losses with its own stock to have transactions that affected the profit and loss statement or insulated the profit and loss statement, but transactions that didn't have any economic reality.

Mr. POWERS. I think they understood that they were setting up instruments that were hedging with their own stock. I am not sure everybody appreciated, because of the complexity of the transactions that therefore they had no economic consequence. We think they had no economic consequence. This was a red flag. But we can't conclude that everyone on the board appreciated that.

Mr. SHERMAN. So they tended to appreciate that they were hedging with their own stock, but they didn't know particular details or enough about accounting rules to know that this thing, which you and I would call wrong, was actually banned by the accounting rules.

Chairman BAKER. That's your last question, your time has expired.

Mr. POWERS. That's correct.

Mr. SHERMAN. Your statement at the beginning says if these transactions had been structured correctly, Enron could have kept assets and liabilities, especially debt, off its balance sheet. Enron did not follow the accounting rules. You're implying that if they had just slowed down to 99 miles an hour, they'd still be within all

the rules and more specifically, I gather if they had just had $20- or $30- or $40-million of real capital at stake from independent investors, these shams would still be legally recognized?

Mr. POWERS. I think you're raising a very crucial issue here, but it's important to distinguish between different transactions. For example, the Chewco transaction was not a hedging transaction. It was buying assets that Enron wanted to keep off the books for the reason of keeping debt off the books and other reasons. That transaction failed because Chewco did not satisfy the 3 percent outside equity at risk requirement, and that was because of Barclays Bank, and so forth, and we outline that in the report.

Chairman BAKER. The gentleman's time has expired.

Mr. SHERMAN. I thank the gentleman for his indulgence.

Chairman BAKER. Mr. Shadegg.

Mr. SHADEGG. Dean Powers, do you want to finish your answer to that last question?

Mr. POWERS. If the committee would like me to. That violation, if corrected, would have permitted that transaction. The hedging transactions, I think, were more fundamentally flawed, because they were using Enron's own stock to hedge the transactions. I don't think that could have been corrected simply by adjusting the transaction to meet the accounting rules.

Mr. SHADEGG. Dean, as a recovering lawyer, let me ask you some legal questions and see if I can get some background. First of all, what is your background in law? Do you have background in securities law?

Mr. POWERS. No. I teach torts and products liability and legal philosophy. I have taught contracts and some other topics.

Mr. SHADEGG. Torts and contracts ought to help here a little bit. Did you look into how many off-balance-sheet entities there were? I, for example, have read 3,000. I have heard there were 3,500. And I compare that with other major corporations in America where I have heard there are as few as 6.

Mr. POWERS. We did not look at that issue. We looked at the three entities that were engaged in with related parties, that is, with Enron employees.

Mr. SHADEGG. So you did not investigate whether there are literally hundreds of abuses by off-balance-sheet entities, maybe even thousands of them?

Mr. POWERS. That's correct. We did not investigate that.

Mr. SHADEGG. Are you as mystified as I am by the exploitation of off-balance-sheet entities to conceal debt, or is that——

Mr. POWERS. I was certainly appalled by what we looked at in these entities.

Mr. SHADEGG. Let's go to the issue of the knowledge of these board members. We just went through some questioning that went at the notion that accounting rules allow them to operate at 100 miles an hour. Everybody knows that 100 miles an hour isn't safe, but it was only when they went 101 miles an hour that we got into this trouble. I'm a little troubled. First of all, did you interview all of the members of the board of directors?

Mr. POWERS. No. I think we interviewed nine members.

Mr. SHADEGG. It was just with respect to these 3 peculiar entities that seem to have been abused?

Mr. POWERS. Yes.

Mr. SHADEGG. Did you find that none of the board members were aware of, for example, the compensation packages or the conflicts of interest?

Mr. POWERS. Well, they certainly understood that Fastow was in LJM, and that he was the chief financial officer of the company, and as our report indicates, we think that was a basic flaw in setting up these transactions in the first place.

Mr. SHADEGG. Didn't Fastow have to ask for an ethics exemption to be able to do that, and did you question them about how or why they granted that ethics exemption?

Mr. POWERS. He had to get a finding by the office of the Chair, granting this not really exemption, but granting these transactions was in the best interest of Enron. That did not need to come to the board, but it did actually come to the board and made that finding.

Mr. SHADEGG. It did come to the board and they were aware of it?

Mr. POWERS. They were aware of it, that's correct.

Mr. SHADEGG. Do you see a need for significant revisions in the ethics rules governing officers and their disclosures to full board members, including things like the extent of their interest in an off-balance-sheet entity?

Mr. POWERS. I think it's questionable whether an officer ought to have an interest in one of these transactions at all. Certainly if a company were to come to the conclusion after this episode, it was worthwhile, you'd certainly want to get detailed information about the compensation that officer was going to get.

Mr. SHADEGG. Let me go to that point. You have written what I think is an invaluable report, which will be a great resource to the Congress as we go forward. Are there specific things that you have concluded in preparing that report or other members of the committee that worked with you that you would recommend to this Congress to make sure that this kind of incident doesn't happen again, that you can't be ignorant of speed limit rules that allow you to go up to the line like this or allow board members to be as in the dark as it appears they were?

Mr. POWERS. We worked very hard to describe what happened and we—and I don't have the background, and we did not come to conclusions on what ought to be done, though certainly, that's what this subcommittee and other Government bodies will be looking at.

Mr. SHADEGG. I appreciate your contribution to the process and I yield back the balance of my time.

Chairman BAKER. Thank you.

Mr. Inslee.

Mr. INSLEE. Thank you, Dean. We appreciate your efforts. I am interested—I am from the Seattle area, and I am interested in the pricing of electricity issues. And obviously it has become apparent that to keep this house of cards propped up, Enron wanted to keep the electricity on the West Coast as high as possible. We would like to find out what Enron did in that regard, particularly in regard to any of the Executive authorities, the White House included. And I'm wondering if you would send to us any documents pertaining to Enron or their representatives, requests of the Administration including the Vice President's task force, and the reason I asked

you because, as you know, the Vice President has been unwilling to share those with us. Would you be willing to provide those documents to the subcommittee?

Mr. POWERS. I don't think our committee has any documents of that sort. As far as providing them, we have cooperated and provided many documents with SEC, would cooperate with the committees. Documents in the company are not mine to send. The company would have to make a decision. I certainly would support every document or bit of information within the company being provided to the Congress.

Mr. INSLEE. You're a director of the corporation now. You are certainly the closest thing we have here as a representative of the corporation. Would you recommend to the corporation that they honor my request to you to provide all the documents which I am now making to you pertaining to the communication by Enron with the Vice President's energy task force.

Mr. POWERS. Absolutely. I would support that.

Mr. INSLEE. I will communicate with you further to try to facilitate that. And the public is very, very interested in this. They are very concerned, disappointed that this information has not been forthcoming to date. So we will communicate further. Let me ask you, too, about an issue regarding the futures contracts. I am told that back in 1992, the Commodities Futures Trading Commission, then headed by Wendy Graham, honored a request by Enron to exempt the futures contracts that Enron dealt in from regulation by the Commodities Futures Trading Commission. I am told that Ms. Graham, 5 weeks after leaving her position as chair of that board, went on the Enron board, and that following that and since that time, Enron's futures contracts were free of any Government regulation at least by that agency, and that those contracts were the ones that were involved in this ramp-up of costs of electrical prices on the West Coast.

Did you ask Ms. Graham about her role in that regard to any extent?

Mr. POWERS. We didn't investigate that at all.

Mr. INSLEE. Is the failure to cover these futures contracts by Enron and others, do you think that could have played a part in the problem that Enron experienced and/or the problem that consumers experienced in the West Coast? Do you have any feeling about that?

Mr. POWERS. I really don't know anything about that.

Mr. INSLEE. Given the nature of this loss, do you think it would make sense for Congress to at least reexamine that issue to whether the public should have some regulatory control over these now unregulated futures contracts that at least played a part in these agreements?

Mr. POWERS. Well, certainly Congress should look into those issues and make judgments about what the best policy and what the law is. I myself don't have enough knowledge about those to know whether there's an issue to look into.

Mr. INSLEE. I want to come back to what Mr. Sherman talked about on the issue of the 3 percent rule. And I will quote from your report. You said, "there's no question that virtually everyone from the board of directors on down understood that the company was

seeking to offset its investment losses with its own stock." That is not the way it is supposed to work. Real earnings are supposed to be compared to really losses, something I really agree with. Even if we fixed the 3 percent rule, even if we raised it to 6 percent or 10 percent or 15 percent, that still wouldn't solve the problem that you are alluding to; is that right?

Mr. POWERS. That's absolutely correct. Those are different issues and different problems.

Mr. INSLEE. How would we, in your judgment—what would be the best way to solve that problem other than just tinkering with this percentage equity rule.

Mr. POWERS. It's my understanding that there is a current accounting rule and practice that a company cannot recognize gains in its stock as income, and indirectly, that's what was happening here. So I think there's an accounting rule that prohibits this. The problem was the transactions got so complicated that people really didn't appreciate, or some people may not have appreciated that that's what was going on.

Mr. INSLEE. Just a last question. Obviously, you and many of us are concerned about the accounting aspect of this and the relationship between the auditing firm and management. Do you have any thoughts about—given about what you know about the relationship of management with the auditors, if you were going to pick a solution to that problem right now on a nationwide basis, comparing a requirement that auditors rotate, for instance, so that there be mandatory termination of auditors' duties at some point or a limitation of functions, be it management versus auditing function or a decision that some other third party decides who the auditor is, if you were to pick amongst those types of solutions, what you know about Enron, what would have been most effective?

Chairman BAKER. The gentleman's time has expired. That's your last question. Please respond.

Mr. POWERS. I am not an accountant and I don't know which of those would be a better solution. I honestly don't know.

Mr. INSLEE. Thank you. And we will talk about these records. Thank you.

Chairman BAKER. Mr. LaTourette.

Mr. LATOURETTE. Thank you, Mr. Chairman. Dean, I just have one question and I will yield the rest of my time to the Chairman. And I want to focus on the conclusion of your report, and I think you've reiterated in your testimony today, that basically, what we find is a culture that has many flaws by many people at many levels. You talked about the management, the board, the outside evaluators auditors and lawyers. And if you read and watch the news, there are also some hints and insinuations that this was helped along by governmental agencies in attention or favors done by people in Government. Did you and the folks that you investigated with find anything to substantiate any of those, or is that something you didn't look into?

Mr. POWERS. We didn't look into it, but we certainly didn't find anything one way or the other on that.

Mr. LATOURETTE. There is nothing in anything that you uncovered from the limited amount of materials that you had available to you that indicated that Enron's failure was anything but this

culture that was created in Enron, and sort of these incestuous relationships that existed, perhaps, with their auditors and lawyers and folks like that?

Mr. POWERS. That's correct.

Mr. LATOURETTE. Thank you very much.

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

Chairman BAKER. It appears to me that Mr. LaTourette was on an analysis course that makes a great deal of sense. Tremendous earnings pressures to beat the analysts' written recommendations or expectation earnings, and then there's the whisper numbers and smart management wants to beat the whisper number by 1 penny or 2, not by 3, because then it looks like you knew something that you didn't disclose. So that you manage from month to month to get the earnings target so your stock price continues to rise.

That creates tremendous managerial pressure to use whatever means to keep the revenue stream up so that credit markets don't cut off the credit window in this case, which was rather significant to Enron's continued success. So you had a very smart CFO manipulating revenue streams, hiding debt in order to keep the appearances whole so that they could perhaps see a turnaround in market price, and thereby truly profit.

It's not unlike the S&Ls in the 1980s who were buying broker deposits and giving away toasters. They were hoping that the interest rate market would turn around and everything would be fine. So I think I understand the corporate culture that drove this, but there is something more insidious that bothers me, and that is, all the options granted to the insiders and corporate officials, that if the stock price ran up and you could exercise your option, then if you had to have a restatement position later in driving the price back down again, the official profited from the rising price and exercised a no-cost option because of his employment contract, but then did not have to give anything back when a restatement of earnings occurred because of that official's misconduct or misjudgment.

Did you examine any of the relationships between options, restatement of earnings and the effect on management?

Mr. POWERS. We did not look into the options and the sales of stock by insiders in this situation. And it wasn't in our charge and we had a lot on our plate.

Chairman BAKER. With regard to what you did find, your statement with regard to Andersen not fulfilling its professional responsibilities, give me your top three complaints.

Mr. POWERS. Well, it's our understanding, using your own stock as a way of, even through a complicated system, to end up reflecting earnings on your balance sheet, is not proper. That's one.

Chairman BAKER. So your target really is that first Andersen should have identified the economic relationship between the parent and the SPE as problematic because of the financial relationships, and in your opinion, they did not.

Mr. POWERS. There were supposedly controls in place that tried to mitigate the danger of that conflict that they did not manage as well.

Chairman BAKER. Andersen's view they reported to the audit committee, and the audit committee determined it was not mate-

rial to the long-term profitability of the corporation. Help me understand here what is wrong with the Andersen position.

I'll restate. Andersen reported to the audit committee, and purportedly according to their view of the facts, they had concerns about the structure of the SPEs and their financial relationship too, and they made a determination that these matters were not made of material significance to the profitability of the corporation.

Mr. POWERS. We don't believe Andersen complained to the audit committee on that, and we weren't able to talk to Andersen.

Chairman BAKER. Give me a quick two and I'll come back later. What is your second one on your list?

Mr. POWERS. That would be the second. The first one was using your own stock to collateralize your earnings. That is a more fundamental one. The 3 percent rules and having audit procedures in place to make sure those things are met, is also a problem.

Chairman BAKER. I will try to come back to you later. I have exhausted Mr. LaTourette's time.

Mrs. Jones.

Mrs. JONES. Professor Powers, or Chair Powers, who were the other—you've identified yourself as the Dean of a law school. Who is Raymond—and I can't read this name, Troubh. Who is he? What type of job does he have?

Mr. POWERS. He's was a lawyer for sometime in New York, and then an investment banker, and now he's on the board of directors of several companies.

Mrs. JONES. And what about Herbert Winokur?

Mr. POWERS. He's the Chairman and CEO of Capricorn Investments. He's a member of the board of directors and has been of Enron.

Mrs. JONES. I noticed that in your responses to a number of the questions you stopped short—what's the name of the law firm that's involved.

Mr. POWERS. Vinson & Elkins.

Mrs. JONES. That you stopped short in saying why you did not do something with regard to the lawyers or investigate any further the lawyers. Can you finish that sentence, we did not because——

Mr. POWERS. The committee did. Vinson & Elkins has been counsel for the law school on major litigation. They are a major supporter. And I thought the report would speak better if I was not involved in the judgments about Vinson & Elkins and let the other members of the committee make those determinations.

Mrs. JONES. So where are the findings with regard to Vinson & Elkins?

Mr. POWERS. There are some in the executive summary conclusions and some in the disclosure section, I believe, and there may be others throughout—I'm not sure I am pinpointing every one.

Mrs. JONES. I didn't find them so I will have to go through and look through again. And so, did Mr. Winokur have a relationship with Vinson & Elkins as well?

Mr. POWERS. No, other than the fact that Vinson & Elkins was Enron's lawyers.

Mrs. JONES. Tell me, the one transaction or one transaction was with California Public Employee Retirement System; is that correct?

Mr. POWERS. Yes. That's correct.

Mrs. JONES. And do you know what caused the California Employee Retirement System to jump ship and say "let me us out of this transaction before we're in the process of losing dollars for our retirees as well." Was there anything in your findings that told you something?

Mr. POWERS. CalPERS wanted out of an original investment called Jedi I, so they could get into a new investment. Then they got into a new investment.

Mrs. JONES. Did they then lose money in the new investment?

Mr. POWERS. We don't know the outcome of that.

Mrs. JONES. But it was an investment with the Enron Corporation?

Mr. POWERS. And it was—Enron—originally Jedi was a combined investment fund that was half Enron and half CalPERS.

Mrs. JONES. What I'm asking you is they wanted to get out of that investment and to be able to get into a larger investment. Was the larger investment with Enron?

Mr. POWERS. It was with Chewco, which was this off-balance-sheet entity of Enron.

Mrs. JONES. Did you, in fact, review any securities law violations with regard to the work that you did, sir?

Mr. POWERS. We didn't.

Mrs. JONES. Are you able, based upon the review you've done and the statements you've made about the accountants, able to say whether you would support the restoration of aiding and abetting liability for accountants?

Mr. POWERS. We really have not looked into it, and as I said, accounting and regulation of accounting is not an area that I've looked into. I have tried to find out what happened here, but I really do not have a well-informed opinion.

Mrs. JONES. You found out that Andersen allegedly assisted Enron in covering up the limited partnerships that were the real losses for the Enron Corporation; is that right?

Mr. POWERS. They were involved in the structuring of these transactions, correct.

Mrs. JONES. Based on that and based on your statement that this is terrible conduct, clearly, wouldn't you think it would be appropriate that accountants be held responsible for aiding and abetting someone for causing them to lose?

Mr. POWERS. I think accountants should be held liable for their misconduct. I don't know enough about the act or how that act works. But I agree there ought to be appropriate liability under appropriate rules for accountant misconduct.

Mrs. JONES. Tell us how many people were involved in the committee other than your three names on your report.

Chairman BAKER. And that will be the last question.

Mr. POWERS. We had 3 members of the committee and then we had lawyers and accountants. I'd say 25 different people helping us.

Mrs. JONES. Mr. Chairman, can I just ask were they firms or were they individual professors?

Mr. POWERS. They're firms. The lawyers were Wilmer, Cutler and Pickering, and our accountants were Deloitte & Touche.

Chairman BAKER. Mr. Crowley—excuse me, Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Dean Powers, I am going to give you just about 2 or 3 dates here and some information that I believe is correct, and the record will correct me if I am wrong, but I understand and maybe you found this out during your investigation, August 23 of the year 2000, stock for Enron peaked at $90 a share, does that sound about right to you?

Mr. POWERS. I don't know independently, but that sounds reasonable.

Mr. MOORE. You know in August of 2001, I believe the date was August 14, 2001 that Jeff Skilling resigned and Ken Lay became the CEO of Enron; is that correct?

Mr. POWERS. Yes.

Mr. MOORE. Maybe the record will reflect my information is that the stock at that time was $43 a share. That was a year after the peak at $90 a share. A year later, it's $43 a share. August 21, just 7 days later, after Mr. Lay became CEO, does your information reflect or your investigation reflect that he sent an e-mail, memorandum to employees of Enron that said that he "had never felt better about the prospects of the company. Our growth has never been more certain."

Mr. POWERS. I've seen reference to that.

Mr. MOORE. Is that timeframe approximately, correct, August of 2001?

Mr. POWERS. I don't have any reason to think that's not the right date.

Mr. MOORE. Based upon your investigation, do you believe that was an accurate statement that the prospects for the company had never been better in August, 2001?

Mr. POWERS. In retrospect the prospects of the company were not—the company went down from there.

Mr. MOORE. Is that the best answer you can give me?

Mr. POWERS. As I said earlier——

Mr. MOORE. I am not asking you what was in Mr. Lay's mind. I'm asking that, based upon your investigation, do you believe in August, 2001, that the prospects for the company had never been better based upon—in retrospect right now.

Mr. POWERS. No. I think they had been better. I don't think that was accurate.

Mr. MOORE. What is the purpose of an audit? I understand you're not an accountant. What is the purpose of an audit as you understand it, sir?

Mr. POWERS. To assure the public the best that the audit process can; that the financial statements of the company are accurate.

Mr. MOORE. And should that audit be "independent"?

Mr. POWERS. I think that audit ought to be independent.

Mr. MOORE. Did you understand that the auditors gave advice to Enron as to how Enron could exclude losses of several partnerships from its balance sheet?

Mr. POWERS. Yes. I believe that's correct.

Mr. MOORE. Is it your understanding that last year, Enron paid its auditors $25 million for auditing services?

Mr. POWERS. I don't have the exact figures in my head, but very substantial amounts.

Mr. MOORE. Is it your understanding, based upon your investigation, that last year Enron paid its auditors $27 million for consulting services?

Mr. POWERS. Yes. I believe that's correct.

Mr. MOORE. In addition to the $25 million for auditing services?

Mr. POWERS. Yes.

Mr. MOORE. Does that cause you any concern?

Mr. POWERS. I think one of the things that surprised me was that the accountants were providing both consulting and auditing services at that magnitude.

Mr. MOORE. Why does that surprise you, sir? I want people that are listening or watching this to understand why that should cause concern.

Mr. POWERS. Because we want the audit to be independent of the people that created the transactions.

Mr. MOORE. What would make you to believe or cause you to believe that wouldn't be independent?

Mr. POWERS. If they helped structure the transactions, they already are going to have a view on the transactions.

Chairman BAKER. Mr. Gonzalez, Mr. Kanjorski asked unanimous consent to intervene for one minute.

Mr. KANJORSKI. I cannot resist, Dean Powers. As the Dean of the University of Texas Law School, we have another matter up here that may have an ancillary effect on this process.

We have pending before us bankruptcy reform legislation, and the present bankruptcy law in Texas and four other States allows for unlimited homestead exemptions. A lot of these folks that came up here and lost their retirements may not understand that anybody in Texas who puts someone else's money in their home and is sued for it, for recovery, can go bankrupt and keep all the assets in their home, sometimes to the tune of $10, $20 and $30 million. It is a peculiar constitutional exemption in the State of Florida, in the State of Texas, and elsewhere. In this case, I am aware of a number of individuals who are parties to the Enron collapse who would have the option of escaping liability if sued.

Could you express an opinion to me, other Members of this subcommittee and to the Congress, whether or not it is about time we remove that homestead exemption from the Federal Bankruptcy Act so that Texans can suffer the same consequences as every other American in bankruptcy?

Mr. POWERS. I understand that Texas has the homestead provision, and I can certainly see the rationale for uniformity throughout the country that it ought to be the same. I am not a bankruptcy expert by any means, but I certainly understand the concern.

Mr. KANJORSKI. Will you help us with the legal community of Texas to change the law properly?

Chairman BAKER. I think he's yielding back his time.

Mr. Gonzalez.

Mr. GONZALEZ. Dean, let me just help you with this homestead thing. Being from Texas, you know we hold that sacred and we are in a battle with these guys over it, and the few abuses, if there are

abuses, but I think in terms of the whole picture and what it means to so many families in Texas and have been able to salvage their homes in the direst times. But you teach torts, you teach products liability and give us a couple more sessions, you won't have those courses anymore. And if you give us enough time, we will take care of legal philosophy.

I really want to touch on, and this is an interesting aspect, I know you have recused yourself from the Vinson & Elkins involvement, and I am going to touch on that, and if you feel uncomfortable about that, then I will understand. But whether you are a officer, director or accountant or lawyer to Enron, to whom do you owe a duty? It's the shareholder, isn't it?

Mr. POWERS. Shareholders and unfortunately now the creditors.

Mr. GONZALEZ. At the time it was the shareholders' interest that should have been paramount. And that's who they owed it to, and you touched on this, sometimes you have conflicts and objectivity goes out the window because you have a vested interest in what you are doing personally and maybe you're not the best person at that point in time. So an officer is doing something they are not supposed to be doing to protect their own vested interest in whatever the entity, SPEs and whatever they are and their stock options, then you hope the board of directors is going to catch it.

If the board of directors is too busy or if there's a chummy relationship, as Congressman LaFalce portrayed earlier, then the accountants and the lawyers really do loom large, and they should be the most objective of all the parties that owe this duty to the shareholders, wouldn't you agree?

Mr. POWERS. Well, I think the outside professionals need to be objective in their advice to the company.

Mr. GONZALEZ. But more than anyone else, they are probably in the best position to be objective. And they don't have an investment in what's going on with that company to the extent that the directors who are deriving benefits from the stocks, most of them get paid through stock, and of course the officers themselves.

Tomorrow we'll hear from the accountant and you have expressed something we are having difficulties with, they are consultants and they're also the accountants. So I would like to zero in on the lawyers. The lawyers at Vinson & Elkins had as much to do as anybody else in creating these SPEs, partnerships, Raptors, whatever they were, is that a fair statement?

Mr. POWERS. I don't know that.

Mr. GONZALEZ. Well, you were aware to the extent that they had knowledge of a legal—because these things are legal entities that a lawyer had to have his hand in it somewhere.

Mr. POWERS. My understanding, and I have read through the report, is that the law firm had some involvement in these transactions.

Mr. GONZALEZ. Now Enron had in-house counsel. Did they have general counsel?

Mr. POWERS. Yes.

Mr. GONZALEZ. Who was a former partner at Vinson & Elkins; is that correct?

Mr. POWERS. Yes.

Mr. GONZALEZ. To some extent, you have a relationship that was pre-existing and continues to some extent.

Mr. POWERS. To some extent.

Mr. GONZALEZ. You also had former Vinson & Elkins partners who had an interest in some of these partnerships. Are you aware, and I'm not sure if it was SPE, Raptor or partnership, and I'm thinking of one individual who was a former V&E partner, and then was also the former head of Enron of Mexico.

Mr. POWERS. I am not aware of that.

Mr. GONZALEZ. Let's just assume what I just stated is factual, and I need to be very careful, because these are all reports and there's triple hearsay, but in fact, you have these pre-existing relationships with the law firm, general counsel, for instance, and they are hiring people from Vinson & Elkins to come and work at Enron. I think that is true. You have some of these individuals who leave the law firm and then become partners in some of these other entities that are somehow aligned with Enron. Do you see a problem with providing objective responsible mature calculated legal advice given these relationships?

Mr. POWERS. I don't know those relationships to exist.

Mr. GONZALEZ. Just assume that they do.

Mr. POWERS. I think people can have—law firms have people leave the firm and go to be in-house counsel.

Mr. GONZALEZ. There's life after Vinson & Elkins, I'm sure.

Mr. POWERS. And still be in a position to give outside professional advice. And it's certainly quite common that people from law firms go to companies as in-house counsel, and people as in-house counsel go back to the law firms.

Mr. GONZALEZ. Is there the potential—and you don't want to limit someone's ability to move onward and upward, but nevertheless, is there any problems in any of these relationships? Do you see if, in fact—and I'm not real sure that any of these Raptors, SPEs, partnerships involved former partners at Vinson & Elkins. But someone said that these were acceptable, legally speaking, and didn't violate any of the duties to the shareholders who are now left holding the bag along with the creditors?

Mr. POWERS. Again, I didn't focus on that, so I really don't know the answer to your question.

Mr. GONZALEZ. Thank you very much.

Chairman BAKER. Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

Dean, I'll be brief, the hour is late and I find your report very enlightening. Just one question. I think I understand conceptually how hedges and derivatives work, and I understand from your report they are being backed up by worthless guarantees in the company. In your view—and I have heard an analogy that this is kind of like to keep it very simplistic, it's like a ticket scalper.

Let's say a ticket scalper has a ticket and he wants to make something more than $50 and he is left holding the bag and the game starts and nobody wants the tickets, and they are now worth $20 or $30 or maybe nothing. In your view, had the market price stayed up where they didn't get in trouble with these worthless guarantees, would the house of cards fallen anyway, or as long as the money stayed there, would this thing have gone on?

Mr. POWERS. In our view, back in with the company's own stock would have still been inappropriate, but if the price of Enron stock had not gone down, I think there's a real likelihood that these would not have come to the attention of the public. I think that's what precipitated the problem. The price of Enron stock going down and that even on its terms meant that the Raptors couldn't honor their obligation and had to be restructured and charges to equity and earnings.

Mr. LUCAS. So we have a systemic problem, Mr. Chairman, that had the price stayed up, this maybe would have never come to light. So we have, I think, a big problem industry-wide. Thank you.

Chairman BAKER. Mr. Ross.

Mr. ROSS. Thank you, Mr. Chairman, the hour is late and I'll be brief. You know this has had an impact all across America. I represent an area in Arkansas about the southern half of the State, a small business within my congressional district, total retirement plan is roughly $4.5 million. It's a small business. With the collapse of Enron, over a quarter-of-a-million dollars in a very small retirement plan, some $4.5 million.

If they had had access to half the information that's in this report, they would have known that's a stock they didn't need to be in. Unfortunately, they didn't and those employees now are looking at smaller retirements, much smaller retirements. We can't go back and fix what happened at Enron. We can find out who's responsible and punish them and bring about some justice.

Have you given any thought to the many, many employees of Enron who now are left with no retirement or very little retirement or the retirees who counted on that check to assist and subsidize their Social Security payment and the people, like in my congressional district, that have been hit by this through their retirement plan and 401Ks, and so forth and so on? Have you given any thought to that and have any recommendations from your perspective, having lived through this; how we can ensure that something like this doesn't happen in the future to where those people see something similar to this before it's too late?

Mr. POWERS. Well, I've given a great deal of thought to it in the sense this is a great human tragedy. As far as recommendations, it seems like a simple idea that the financial reporting of a company ought to accurately portray the condition of the company so that people can make judgments about their investments. I don't have a specific recommendation of how to ensure that happens, but that's crucially important, it seems to me.

There are substantial issues that are being raised about 401K plans, and I think those are crucially important to look at. Again, I don't want to sit here and say I have particular insights into how to structure 401K plans. We tried to show what happened, show what happened such that the value of the stock in those 401K plans was destroyed, and I hope we have done that. But I don't have particular recommendations as to how 401K plans should be structured. It's an astonishingly important problem to solve and especially for the people who are victims of—in their retirement plans of the collapse of the Enron stock.

Mr. ROSS. One final question of you, and that is I got up at 3:30 this morning in Arkansas to head up here thinking I was going to

hear the former Chair of Enron testify and somewhere between Arkansas and Washington I learned that he was not going to appear before us without a subpoena. Why did you choose to appear and why would you appear and he not?

Mr. POWERS. Well, I was not, I'd like to say, involved when any of these transactions that took place. I was called in to do an investigation. The purpose of that investigation was to bring to light what happened. When I started I never for a moment thought this would be the result of it, but the task of our committee was to find out what happened and tell the story and I think that's what we've done, and if I can be helpful to the committee in helping to explain that story, that's what I'm here to do.

Mr. ROSS. It's frustrating that, you know, we pick up the paper and we have committee meetings and we learn where papers are shredded and where people refuse to come without a subpoena and appear before us which, you know, in Arkansas when people do things like that we think they have something to hide, and I'm real troubled by the failure of the former Chair of Enron to appear before us today.

I want to thank you for coming and hopefully you've helped us have a greater understanding of what did happen so we can prevent this from happening in the future. Thank you.

Mr. POWERS. Thank you.

Chairman BAKER. Your time has expired, Mr. Ross.

Ms. Jackson-Lee.

Ms. JACKSON-LEE. Again I thank the committee for its kindness. Dean Powers, welcome and thank you very much.

Mr. POWERS. Thank you.

Ms. JACKSON-LEE. This report is quite filled with enormous challenges for what we may have to face prospectively, and I'd like to follow the line of questioning that my colleagues began with respect to the board's assessment. Might I also say that my colleagues I think have very ably suggested that we realize that people are innocent until proven guilty, but there is a lot here, almost insurmountable information, as to what occurred throughout your report.

What drove the board to develop this committee around 2001? What was the driving force that caused them to do so?

Mr. POWERS. OK. Of course I wasn't on the board when it was formed, but it was my understanding that questions were being raised in the press about some of these entities and the board wanted to investigate them, have outside people come in and investigate them to, I think, from their hope restore confidence that they were proper transactions. That's not what turned out to be the case.

Ms. JACKSON-LEE. Something was bothering them, if you will. I mean, something was awry and they decided to organize this committee, and when did you get involved with the committee?

Mr. POWERS. I was appointed as Chair of the committee and placed on the board on, I believe, the 31st of October.

Ms. JACKSON-LEE. So just a few days after? The committee came about on the 28th and then you came on on the 31st. How large is the board?

Mr. POWERS. I believe the board is, I think, 14 people.

Ms. JACKSON-LEE. And so the audit committee is how many?

Mr. POWERS. Six, I understand.

Ms. JACKSON-LEE. So a good portion of the board is the audit committee, almost half if its 14. I noticed that the committee noted that it had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Do you think that undermined the committee's ability to get more information or find out definitively how these employees were involved?

Mr. POWERS. I think that somebody with subpoena and cross-examination ability will be able to build on this and get more information.

Ms. JACKSON-LEE. So you think that certainly that should occur, that subpoena power should be used and employees should be able to or a former executive should come in under subpoena and be asked more questions? You think that would be helpful?

Mr. POWERS. I think the appropriate committees and Government agencies should continue and build on this investigation by using their subpoena and cross-examination power, absolutely.

Ms. JACKSON-LEE. Was the board aware of the fact, and I think you note here in your page 4, that the combination of two of these SPEs resulted in a billion dollars write-off to a certain extent, that the assets were represented to be a billion dollars more than they were around the third quarter 2001?

Mr. POWERS. Well, there were reports on the financial statements that use the term revenues of—very large sums were being attributed to transactions that can be traced to these Raptor transactions.

Ms. JACKSON-LEE. And there was a loss, in essence there was a loss of a billion dollars around the third quarter of 2001?

Mr. POWERS. There were several restatements and losses, but the ones attributable to the Raptors, I don't think we know exactly what board members knew as to how much was being attributed to the Raptors at that period of time.

Ms. JACKSON-LEE. With the board organizing this committee, you coming on 3 days later, was there any reason why the board didn't see fit at that time to terminate Arthur Andersen, and then as well as you were investigating and seeing these occurrences, was there not some concern at the board level and were they aware of the $100 million that was being utilized to give to executives to retain them in contrast to the employees getting nothing and, of course, the pensioners as the stock was going down losing everything? Did you all not discuss that we are in an investigation, maybe we should consider granting this large sum of money to executives in contrast to our employees who were then laid off on December 3, 2001?

Mr. POWERS. Right. That was discussed. We were very early on in our investigation and didn't have the information that we now have that we've been able to develop at the time the board made those——

Ms. JACKSON-LEE. Do you think it was ill advised by the managers at the time?

Chairman BAKER. And that will be have to be your last question.

Ms. JACKSON-LEE. Thank you, Mr. Chairman.

Do you think you were ill-advised?

Mr. POWERS. Absolutely.

Ms. JACKSON-LEE. Thank you.

Chairman BAKER. Thank you, Ms. Jackson-Lee.

Mr. Shays.

Mr. SHAYS. I have what amounts to about 2 minutes worth of questions.

Chairman BAKER. I have about 2 minutes left.

Mr. SHAYS. Do you want to go first?

Chairman BAKER. No. Please, Mr. Shays, proceed.

Mr. SHAYS. My wife thought I should apologize to you; so I will apologize to you.

Mr. POWERS. There's no need for that.

Mr. SHAYS. I just will say to you that I find your report so amazing, so scathing, and I was just trying to understand just one little part of it, and on your report on the executive summary, in conclusions on page 25, you have a paragraph again dealing with Vinson & Elkins and you say "Vinson & Elkins, as Enron's longstanding outside counsel, provided advice and prepared documentation in connection with many of the transactions discussed in the report." Is "the report" making reference to your report?

Mr. POWERS. Yes, I believe it is there.

Mr. SHAYS. And then you go on to say it also assisted Enron with the preparation, and so on, and then at the end of the paragraph say "it would be inappropriate to fault Vinson & Elkins for accounting matters which are not within its expertise; however, Vinson & Elkins should have brought a stronger, more objective and more critical voice to the disclosure process."

What I'm interested to know is did you read their report that it was in response to Sherron Watkins' criticism? They were asked to come in and write a report and they basically, on October 15, said the accounting practices do not warrant further investigation, they basically discounted Ms. Watkins and you really substantiated Ms. Watkins. So I'm interested in how you characterized their report.

Mr. POWERS. Again I have——

Mr. SHAYS. I'm nicer this time.

Mr. POWERS. I understand.

Mr. SHAYS. Let's put it this way. Did their report agree with your findings or did it have 180 degrees diametrically opposite view?

Mr. POWERS. It did not agree with our findings, but I would like to answer, but realizing I will say at the outset I have got Vinson & Elkins as a major supporter. I think Vinson & Elkins saw as its role asking Arthur Andersen about this and some of the people within Vinson & Elkins.

Mr. SHAYS. You can basically answer the question this way and I will be satisfied with the answer if I get an answer, and that is they did a report. Did your report fly totally in disagreement with their finding? Their finding was the accounting practice did not warrant further investigation, and I think your finding is diametrically opposed to that, isn't it?

Mr. POWERS. Yes. But their finding was based on the fact that Arthur Andersen in their report told them the accounting on these was OK. Now, again, I fully agree that's a defensive statement for Vinson & Elkins, and that's the reason I stayed out of that part.

Mr. SHAYS. I really came back to be nicer to you.

Mr. POWERS. You've been very nice, Congressman.

Mr. SHAYS. Thank you for giving me that opportunity.

Chairman BAKER. I think you need a couple more minutes to work that out.

Mr. Powers, if I may, I appreciate your long suffering willingness to be here. I just have a few more questions with regard to the audit function, and I want to make sure I understand before Mr. Berardino's testimony tomorrow. He has had a rather direct response to the criticism leveled by your report, and I'm trying to get at the essential elements of your findings that we should address with Mr. Berardino, because it is my belief that had we engaged in an independent audit function, everything from the 401K concerns to the function of the SPEs to the mismanagement of revenue streams to the effects of shareholder equity would, to a great extent, if not altogether eliminate it, significantly mitigate it, and my interest in going forward is to try to understand the systemic failure that occurred with regard to the audit function in this case.

Earlier you indicated that you do not believe that Andersen did appear before the audit committee and allege their concerns with regard to the structure of the SPEs.

Mr. POWERS. That's correct. That's our understanding.

Chairman BAKER. Was there anything you found in the course of your work that was a statement of concern by Andersen with regard to any of the financial activities?

Mr. POWERS. Well, I think we did come across a statement of concern in a meeting Andersen had among its own people.

Chairman BAKER. And the point of that concern in that meeting was what?

Mr. POWERS. Well, my understanding was it was generally a concern about the accounting structure of some of some of these, and I can't be precise here, but other vehicles at Enron.

Chairman BAKER. Is it possible for you to have resources to provide us with that portion of your inquiry in reference to the meeting of the Andersen officials relating to their concerns about whatever the subject was for us for tomorrow morning?

Mr. POWERS. Our understanding of that internal meeting is only what Congress has already released; so we don't have any—we didn't gather any independent information on that.

Chairman BAKER. OK. That information came from an interview with someone or did it come from a document? I'm not understanding how that conclusion was reached.

Mr. POWERS. Our understanding is it's an e-mail that the House Energy Commerce Committee released and it's been reported.

Chairman BAKER. So it wasn't really a finding of your internal work; it was a matter released in a public forum by another congressional committee?

Mr. POWERS. Yes.

Chairman BAKER. What I'm trying to get us on track here is anything which your group in the course of your work in the preparation of the report we are in receipt, is there anything else that you can tell me—document, interview, e-mail—anything that will help me better understand the concerns about the performance of Andersen in the conduct of their audit work for Enron.

Chairman BAKER.—beyond the general statement that they did not meet their professional responsibility? I want as much detail as you can provide on the failure to meet that professional obligation.

Mr. POWERS. OK. Can I take just a—.

Chairman BAKER. Absolutely. We don't have anything against consultants.

Mr. POWERS. We would be happy to have our counsel talk to your staff after the meeting and give whatever information they have from their investigation.

Chairman BAKER. That would be terrific and very helpful. Our goal here, I believe, is to establish a system in which truly independent audits can be engaged not only to tell shareholders, but employees and everyone else who has a stake in that corporation's future as best we know it the true financial condition at the time of the audit, and it's my opinion based upon your statements, your study, and the work of others that in this case the independence of the audit is called clearly into question and, more importantly, the whole environment in which the audit was conducted appears not to have been in accordance with traditional standard.

Now, I'm certainly going to explore that in some considerable detail with Mr. Berardino tomorrow, but anything that might be provided to the committee before the 10:00 a.m. hour would be extraordinarily helpful to us in trying to understand our responsibilities.

Mr. POWERS. We'll certainly do our best to help if we can find something that would be of assistance.

Chairman BAKER. You're very kind. Let me for the record include any official record documents forwarded by Mr. Bachus relative to his concerns on the 401K plans. The record will remain open for all Members to include any extraneous material or questions or statements they wish to pose. Obviously, Mr. Powers, as we proceed there may be need to forward additional inquiries to you to get your particular perspectives on resolution of this matter. Our subcommittee will now recess until 10:00 a.m. in the morning at which time we will receive testimony from Mr. Berardino, the CEO of Andersen consulting. We stand in recess. Thank you, sir.

Mr. POWERS. Thank you.

[Whereupon, at 8:29 p.m., the hearing was adjourned.]

THE ENRON COLLAPSE: IMPLICATIONS TO INVESTORS AND THE CAPITAL MARKETS

TUESDAY, FEBRUARY 5, 2002

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 10:15 a.m., in room 2167, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Ney, Shays, Cox, Castle, Royce, Oxley, LaTourette, Shadegg, Weldon, Biggert, Toomey, Ferguson, Rogers, Kanjorski, Ackerman, Bentsen, Sandlin, Jones of Ohio, Capuano, Sherman, Inslee, Moore, Gonzalez, Ford, Lucas of Kentucky, Crowley, Israel, and Ross.

Also present: Representatives Capito, Tiberi, Jackson-Lee, and Sanders.

Chairman BAKER. I would like to call this hearing of the Capital Markets Subcommittee to order. This is a continuation of the hearing initiated yesterday as the committee makes its inquiry into the conduct of the audit community in relation to the failure of Enron Corporation.

Pursuant to agreement reached yesterday at the outset of that hearing, we were to extend a 30-minute period for opening statements to each side today and to recognize those Members who did not have the opportunity to make opening statements on yesterday to facilitate every Member possible getting an opportunity to make the opening statement.

In summary of activities to date, the hearing of yesterday created some issues of import to our proceedings this morning. For those who have not participated in the hearing yesterday, we did receive insight from Chairman Harvey Pitt of the Securities and Exchange Commission, as well as comment from Mr. Powers, responsible as a board of directors member of Enron for determining the causal effects of the Enron bankruptcy and the subsequent financial catastrophe.

Mr. Powers' Report, although not based on the full scope of information necessary to reach final conclusions, has raised some very troubling issues that we hope to address in the proceeding this morning.

With that in mind, I would now recognize first Mr. Castle as the appropriate Member who was not able to make a statement on yes-

terday. Mr. Castle, under the rule you will be recognized for 2 minutes.

Mr. CASTLE. Thank you, Mr. Chairman. As more and more troubling facts are revealed about Enron's collapse, there is one point in particular that many Americans find most disturbing, and that is the ability of a group of inside players at the top of a corporate structure to work the entire system to their advantage while millions of small investors, including the ordinary Enron employees and their life savings, were, in effect, trapped in this moving vehicle as it headed off the cliff long after the drivers themselves had escaped.

Investors, be they multi-millionaires or individuals and small investors trying to make the most of their life savings, need to rely on some sort of an objective review of those who have control of their money. They need an independent opinion and review of the practices and the legality of those who are managing their money. We normally expect the independent accountants and auditors to provide this function.

It is very troubling when it becomes apparent that the supposed independent auditors at Enron apparently completely failed at their assigned task of independently verifying the truthfulness of Enron's financial practices. The auditors are in the games of the players, but they have the authority to call time out and say, these financial practices do not make sense and we are not going to endorse them until they are clarified. At the very least, Arthur Andersen did not perform this role adequately in the case of Enron.

The worst case scenario is even grimmer. Independent press reports, and now the Powers Report, indicate that there was a complete breakdown in appropriate corporate behavior that extends to Enron's management, to its board, and to its auditor, Arthur Andersen. We are trying to determine if Andersen and its experienced accountants were duped by Enron who were actively involved in constructing their evasive financial practices. Thus far, Enron's explanations have been incomplete and unconvincing.

If a group of auditors have let investors down and have helped create uncertainty in the entire financial market about corporate accounting standards, we are obligated to try to work out new procedures, new rules, and a new framework that will help prevent this from happening again.

We are here to help develop the solution to this tremendously serious problem in our financial system. We hope there are not other Enrons out there, but it is quite possible there are. Arthur Andersen has a long way to go to address questions about its role in Enron's collapse and to provide meaningful proposals to real change in corporate accounting. I hope that process can start today.

I yield back the balance of my time.

[The prepared statement of Hon. Michael N. Castle can be found on page XX in the appendix.]

Chairman BAKER. Thank you Mr. Castle.

Mr. Lucas is recognized for 2 minutes.

Mr. LUCAS. Thank you, Mr. Chairman.

Yesterday, SEC Chairman Pitt outlined the steps the Commission plans on taking to improve and modernize the current disclosure and regulatory systems and I applaud him for those efforts.

Also Dean Powers' testimony was very enlightening and very troubling. We need only to look at the performance of the stock market in recent days to see the effects of the lack of confidence in the current situation.

As we search for solutions to the problems that the Enron collapse has exposed, we should not rush to judgment, hoping only to assign blame. The SEC and Congress must move constructively to restore the integrity of our financial markets, the soundness of our financial systems, and the public's confidence in our markets. I look forward to today's hearings in order that we may better understand the breadth and depth of this problem.

I yield back the balance of my time.

Chairman BAKER. Thank you, Mr. Lucas.

Chairman Oxley, did you wish to be heard, sir?

Mr. OXLEY. Thank you, Mr. Chairman.

We welcome Mr. Berardino back to the subcommittee. As the Chair knows, Mr. Berardino was our witness back in December, and it was the first hearing on the Enron situation and we welcome him back.

There are some issues that were uncovered in the meantime that Mr. Berardino will be addressing and some questions from the panel, but I do want to say that we have appreciated Mr. Berardino's cooperation in this matter; that, while other witnesses have been unwilling to comply with our request to appear, Mr. Berardino has been very forthright in appearing every time the committee has requested him, and for that we appreciate it. And this gives us an opportunity to explore some of the underlying issues *vis-a-vis* Enron and the auditor that I think will be in order to our benefit.

And with that, I yield back.

Chairman BAKER. Thank you, Mr. Chairman.

Mr. Crowley.

Mr. CROWLEY. Thank you, Mr. Chairman.

After the stock market crash of 1929, the Federal Government gave the accounting industry the valuable franchise of auditing public companies. In this role, the so-called independent auditors were supposed to be the independent watchdog to make sure that financial book-cooking like we are seeing today at Enron did not occur. These outside auditors are supposed to represent the true oversight role for investors and the American public on the internal controls of a company. They ought to be the investing public's first line of defense.

We can all acknowledge that there will always be some bad actors in the corporate world, overtaken by power and greed. And while they are the exception and not the rule, from Ivan Bosky to what appears now after reading and listening to the Powers Report, Andrew Fastow, they are out there. But it is the independent auditors that are supposed to catch these criminals before they can wreak the kind of havoc that we are seeing today.

In a capitalist society this is generally not a role for the Government to play, but I am growing more and more concerned about the actual independence of these auditors. In fact, I am angered by auditors who feign ignorance or claim they too had concerns about

the partnerships of Enron, but they continually signed off on the Enron books, books which they questioned privately.

America's market system is based on both transparency and consumer confidence, and we cannot have one without the other. Therefore, it is imperative to have truly independent outside auditors reviewing the books of publicly traded companies. When these outside auditors fail to perform their duties, they should be punished and punished hard as an example.

I look forward to hearing Mr. Berardino explain his company and his industry and hope that, working together with this committee, the SEC and business can work to provide a truly independent auditor for publicly traded companies and ensure that another Enron does not occur again.

And I'm tired of hearing about, borrowing from a phrase from football, "all the end runs around Enron." That has to end, from the highest levels of Government to the highest levels of corporate government as well. No more end runs around Enron. People have to step up to the plate and take responsibility where it is due. So I do look forward to your testimony today.

Chairman BAKER. Thank you, Mr. Crowley.

Mr. Ney.

Mr. NEY. Thank you, Mr. Chairman.

For 70 years we have operated on the principle investors making decisions about securities has been based on an honest assessment of the company's financial health. This model has given us the finest and best-regulated markets in the world. Unfortunately, this model is now broken. Investors do not believe that they are receiving honest information about a company's fiscal position. Investors certainly weren't given the truth in the Enron case.

This has to be fixed. We have got to restore investor confidence, especially during this time in our country's history and all the trauma we have gone through as a Nation and how important it is for our people and for jobs. The image of ourselves being a rubber stamp for companies that are cooking the books has to be done away with. You can't allow a system that breeds such deep cynicism about corporate reporting to remain if we're to have capital markets that invest with people's trust.

This subcommittee, of course, is here to explore the best way to put integrity into the accounting profession. And that doesn't mean there is not integrity within the profession. Obviously something has gone wrong. Ideas have been floated to have the Government become an auditor for the auditors or to take over all corporate auditing. Others have floated the idea of a robust industry self-regulator, which we do have examples of that in our country that I think have worked.

In looking at all these proposals, I think we have to ask the simple question: Will it solve the problem? And if we go upon that course, I think we'll have a better, stronger industry.

We need to ask our witnesses, of course, to tell us what, in fact, they think we need to do to make disclosure meaningful. I really don't want to see Congress consider legislation just to look like we are doing something, and I know this is not the intent of the subcommittee or committee. I don't want us to make a commotion just so we can say that action is being taken. I do want to be able to

go home to the constituents and say that we, in fact, fixed the problem, not that we did something. I want to make sure that the situation, hopefully, never happens again so we can restore the confidence of investors in our markets. I look forward to exploring what's the best way to restore the integrity of our accounting profession and our capital markets in the best way possible.

Again, I want to thank Chairman Baker and Ranking Member Kanjorski and Chairman Oxley for holding this hearing.

Chairman BAKER. Thank you Mr. Ney.

Mr. Moore, you are recognized for 2 minutes.

Mr. MOORE. Thank you, Mr. Chairman.

I, too, would like to welcome Mr. Berardino here today, and I appreciate the fact that he's here, because other witnesses, namely Mr. Lay, have refused to appear. I am going to give my opening statement from yesterday so it is not necessarily directed at the witness here today.

The healthy function of our capital markets depends upon reliable auditing and accounting information as well as accurate financial statements. Investors have to be able to trust financial statements of the companies in which they decide to place their money. Additionally, investors need to be able to trust the financial analysts who recommended investors buy the stocks of companies like Enron.

In the case of Enron, as the stock plummeted from its 52-week high, about $90 a share, down to less than $1 a share, financial analysts continued to urge a "buy" or "strong buy" for Enron stock.

There are now two separate actions underway relating to the way Enron prevented its employees from making changes to their pensions. The Department of Labor has launched an investigation and a class action suit has been filed on behalf of Enron employees. What I am particularly interested in is the new policy that Enron instituted on October 26, 2001, effectively freezing any employee 401K transactions. Enron ostensibly instituted the freeze due to a change in pension plan administrators. Unfortunately for Enron's employees, the freeze was in place while Enron's stock plummeted, forcing employees to sit by as their retirement savings collapsed.

Enron's unfortunate timing of an employee lockdown, while executives maintained flexibility to cash out, is outrageous and potentially illegal and an attempt by Enron to manipulate the rapidly declining value of its stocks by preventing a mass sell-off of the company's stock.

I am interested to hear today if the witness has any comments to make about $25 million in audit fees paid to his firm, as well, as $27 million paid for consulting fees, and whether there is any conflict there, apparent or otherwise, and I think there needs to be some discussion about that.

In these difficult times, American workers are having a tough time saving their money for retirement and Congress needs to do whatever it can do to encourage long-term savings. It is now the responsibility of SEC, the accounting industry, and Congress to prevent a corporate collapse and to protect the American people and investors in this country. Thank you.

Chairman BAKER. Thank you.

I have identified three additional Members on the Majority side, Mr. Rogers, Mrs. Biggert and Mr. Ross. I am just making that announcement, because it is my intention to proceed with the witness.

Mr. Rogers you are recognized for 2 minutes.

Mr. ROGERS. I have no statement.

Chairman BAKER. Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman, I appreciate the way that you have handled the hearing yesterday and I applaud you for the way that you are conducting these hearings.

I look forward to hearing Mr. Berardino's testimony. As he said in his written statement, there is some explaining to do, and I appreciate his candor. I think his testimony will move us forward in our quest to solve the problems and to restore confidence in the financial system and basically to ensure that another Enron does not happen. So I look forward to hearing from the witness.

Thank you and I yield back.

Chairman BAKER. Thank you, Mrs. Biggert.

Mr. Ross.

Mr. ROSS. Thank you, Mr. Chairman.

I appreciate the subcommittee convening this hearing today to discuss the important issues that have surfaced as a result of the collapse of Enron. Like my colleagues, I am disappointed that Mr. Kenneth Lay, the former CEO of Enron, chose not to testify before the subcommittee, and I would encourage him to come to the Congress and respond to the numerous issues surrounding the company's demise and his role as its chief executive in the oversight of its business operations.

However, I am pleased that you have decided to join us today, sir, and have come to hopefully begin an honest and open dialogue to discuss your area of expertise and how we can keep something like this from ever happening again. The fallout of Enron has had far-reaching effects.

There are thousands of people unemployed, and many have suffered enormous financial loss. While most people are aware of the Enron employees' inability to sell their stocks in the company and the subsequent losses in the 401K plans, many are not aware of the numerous companies who also invested in Enron stock. For example, one small company in my congressional district back in south Arkansas lost roughly $276,000, a quarter-of-a-million dollars, last year on Enron stock in their retirement plan for its employees. We are talking about a plan that the total plan is $4.5 million. One-quarter million now gone. This was $50,000 they lost from all other stocks combined during the recent decline in the stock market. This plan serves 35 to 40 people. Many of them I know. Many are first-time investors. They are moms, they are dads, they're trying to raise families and build better lives for themselves, their children, their grandchildren. And this has had severe implications on their future.

For a district where the average household income for a family of four is $19,000, the need for tools to increase financial security is essential. If this company had been aware of the information surrounding the bleak financial condition of Enron, believe me,

they would have had an opportunity to make the necessary changes to protect their employees' interest.

That is why the financial disclosure requirements for public companies must—and I stress must—be enhanced to ensure the accuracy of the information provided.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Ross.

Mr. Ferguson for 2 minutes.

Mr. FERGUSON. I appreciate you holding these important hearings. I was extremely disappointed to hear that Mr. Lay was not going to testify before this subcommittee today. And as the committee has indicated, we sought Mr. Lay's testimony in good faith we and were assured it was going to be given.

I believe that this subcommittee and, more importantly, the American people, deserve to know what happened in the Enron collapse from the people who are most directly involved. Regardless of Mr. Lay's appearance before this subcommittee, we will get to the bottom of this situation. We are going to continue to ask difficult questions and we expect to get some answers.

The collapse of Enron represents a combination of irresponsible actions on the part of decisionmakers with knowledge of the company's financial well-being, and a meltdown of the financial safeguards used to identify problems at a stage when corrective action might still be taken. I am most disturbed that the collapse has had a substantial impact on thousands of Americans across the country who put their retirement and other investments into mutual funds and pension funds and other vehicles that invested in the company.

We have a moral obligation to ensure that safeguards are established to prevent a disaster of this magnitude in the future. While it is near impossible to create a system that prevents all failure, corporate America must be made more accountable to the employees and shareholders, which will require stricter accounting standards and tougher disclosure requirements.

I thank Chairman Pitt for coming before us yesterday and offering his views on the current financial reporting and disclosure regime, as well as Mr. Powers for discussing his findings of his report, reviewing the facts and circumstances related to the collapse of Enron. Mr. Powers made several statements of particular significance to today's hearing, including the fact that he found failures in the performance of Enron's outside advisers and that the tragedy could have and should have been avoided.

I also thank Mr. Berardino for returning before the subcommittee to clarify his previous testimony in light of information that he did not have at the time. I look forward to hearing your testimony on current auditor procedures, but I am also particularly interested to hear your thoughts on the impact that consulting fees have on influencing audits as well as to shed some light on the very serious matter of document destruction.

With that, I yield back, Mr. Chairman.

Chairman BAKER. Thank you sir.

The last Member I have for recognition is Mr. Shadegg for 2 minutes.

Mr. SHADEGG. Thank you, Mr. Chairman, I will be brief. I want to thank you for holding this, the third in a series of hearings on

this important issue. I, too, want to thank the witnesses who testified yesterday. I thought their testimony was very interesting, and Mr. Powers' Report was enlightening and helpful.

These hearings are extremely important to the future of this country. We must ensure the integrity of our financial markets. If we do not do so, then the economy we currently enjoy and the lifestyle we have will disappear. It is absolutely essential we discover the causes for what happened.

In going through these hearings Mr. Chairman, it occurs to me that one definition of insanity is to do the same thing over and over again and expect a different result. One thing we cannot do in these hearings is decide that we need just one more oversight body or just one more law or one more regulation. We have to find exactly what was the cause here and get to the bottom of it and try to find a solution which will result in the prevention of this kind of a collapse ever occurring again, and ensure that Americans and people throughout the world can have faith in our markets without relying on a regulatory system which will just let us or could just let us down again.

I notice that in a discussion on one of the morning shows this morning, the comments focused on the fact that the market was down yesterday and that that is as a result of some people looking at the Enron collapse and worrying about whether or not a similar type of accounting nightmare could exist in a company which is still in the market today. And they commented that it is the market itself that can correct these kinds of problems. That is true, but we have an obligation to ensure that the institutions that are supposed to be doing their jobs, that the SEC, FASB and the others are doing their jobs. I commented yesterday in my questioning about how I have a difficult time understanding off-balance-sheet entities as a mechanism for disguising debt.

It seems to me—and I quip that my wife and I would like to buy a new home and would like to figure out a way to create in our own personal balance sheet an off-balance-sheet entity where we could put some of our debt and to be able to qualify for a more expensive home.

It seems to me we have to get to the root cause of this problem. It seems to me that there was clearly fraud that went on. It seems to me that it is impossible to believe these board of director members didn't know and others didn't know what was going on. So we have to try to get to the bottom of these issues. We have to ensure that we have done everything we can.

We know at the end of the day the market will do what it can to correct, but we also know that it is ultimately the individual integrity of the people involved, the members of the board of directors, the officers, and the accountants that we must rely on for the integrity of the entire system.

And with that, I yield back.

Chairman BAKER. Thank you, Mr. Shadegg.

Ms. Jones.

Mrs. JONES. Thank you, Mr. Chairman.

Yesterday and today, we have the distinct opportunity as Members of this Capital Markets Subcommittee to bring to the attention of the public some of the details of what has occurred with regard

to Enron. As we go through this process, it is my hope that we can open some of the doors that have been closed to us so we have a better understanding of a process that's involved when a company like Enron can go 15 years, from nowhere to the seventh largest in our country.

In Ohio alone, the State's two pension funds for Government employees lost $114 million on Enron stock. Interestingly enough, fund managers were increasing the weight of Enron stock, even when the stock was plummeting, on the belief of Enron's long-term potential. Even pension officials felt that Enron financials were good enough to invest in.

Ohio's loss is not alone. Other State pension and/or retirement plans were impacted as well. The Florida State Board of Administration lost $335 million. The California Pension Fund lost $49; Alabama, $47; Texas, $24; Missouri, $23 million; and New York City's fund for firefighters, police officers, teachers, and other workers lost $109 million. These losses, coupled by bank exposure estimated around $4.6 billion, will ultimately impact consumers by increased fees and possibly less money to lend.

Never in my years has one such issue or scandal, depending on how you look at Enron, had so many tangled webs, from extensive political influence that had the White House helping setting energy policy, conflicting interactions with Arthur Andersen, and on and on and on.

I have more statement. I will put it into the record, Mr. Chairman. I am just hopeful that as the people appear before our committee this morning, we can get to some facts. As a former prosecutor and judge, we can always wade around an issue, but fact is the most important thing we can get for the public so they can have a full understanding of what happened in this instance, so they can begin to educate themselves and never put themselves in a position that these Enron employees have been in, and so that we can put ourselves in a position to pass legislation that would never allow employees such as these Enron employees to not be able to access their funds while the money managers were going on down the road with the rest of the dollars.

I appreciate the opportunity to be heard, Mr. Chairman and yield any time I have left.

Chairman BAKER. Thank you.

Mr. Ford, you are recognized for 2 minutes.

Mr. FORD. Thank you. I won't take all that time, Mr. Chairman.

It is good to see that one of our invited guests made it today. Pleasure to see you. I look forward to hearing your testimony. But one of the things I hope that we are able to get to and one of the things I want to address in my questions as the hearing proceeds, Mr. Chairman—I am from Memphis, it's hard for me to pronounce these big East Coast last names—but Mr. Berardino, is that the correct way? Penn taught me well.

But I am curious about the destruction of some of the documents. And one of the things I hope to sort of speak to, and I know some of the steps the company has taken, and we applaud the effort to bring on Chairman Volcker, but at the same time, I hope that we can get some commitment from you, perhaps today or in the very near future, from the company regarding mandatory document re-

tention. And perhaps your company can take the lead in providing a template for the industry to follow.

I see my good friend, Goody Marshall, in the audience as well. Always a pleasure to see you. With that, look forward to your comments and I thank you for being here this morning.

Chairman BAKER. Thank you, Mr. Ford.

That concludes all Member opening statements.

Mr. Israel, did you wish to be recognized?

Mr. ISRAEL. I do, Mr. Chairman. Thank you.

I think it is sadly ironic that Mr. Lay has gone through a revolving door at the White House and suddenly he's grown shy about coming to Washington, but I do appreciate Mr. Berardino visiting with us today.

I think the real scandal here lies not simply in the potential illegalities of this case, but in the fact that so much of what was done was legal, offshore special purpose entities, fuzzy accounting, lazy and conflicting analysis, lax oversight, conflicts of interest.

Our financial system depends on a series of checks and balances to ensure market confidence, and every single step in this system, save the short sellers, failed catastrophically. This is nothing short of the worst indictment of our entire system in years.

Our job is to work together on a bipartisan basis. Marginal solutions are not going to cut it. We need to go back to the drawing board and start over. What do we want our regulatory system to achieve, what are the best structures to get us there, and how do we balance investor protection with clear regulation?

I look forward to working with the Chairman and all of my colleagues to restore confidence to our accounting system and to our financial entities. I thank the Chairman and yield back.

Chairman BAKER. Thank you, Mr. Israel.

I do believe now that concludes all Members' opening statements. Any Member who wishes to introduce any written statement for the record certainly will have that opportunity.

Mr. Berardino, it's my pleasure to welcome you back. I want to say for the public record that this is not your first voluntary appearance. It is your second. You were among the first to appear before this committee in mid-December and present your views of where the Enron matter stood as it relates to Andersen. And we appreciate the fact that you have made every effort to provide the committee with your perspectives in regard to this matter.

I have been directed by the committee in this proceeding with regard to all witnesses before the committee in relation to our work in the resolution of the Enron matter to swear witnesses in. Do you have any objection to testifying under oath?

Mr. BERARDINO. No, I do not.

Chairman BAKER. In that light, do you desire to be advised by counsel during your testimony today?

Mr. BERARDINO. Yes, sir.

Chairman BAKER. In that case, would you please instruct your counsel to come to the table and assist you? And I need to ask him or her a question as well.

Mr. BERARDINO. I am not sure that's necessary, Mr. Chairman. And I have my counsel with me and if I need to refer to him, I will.

Chairman BAKER. This creates a slight technical thing. We need to consult. I am advised that if your counsel wishes to give testimony, we would be obligated to swear him in as well in conformity with the committee rule. If it is advisory only and he will not be making statements for his own perspectives, it's my understanding that we would be in conformity with the subcommittee direction to only require you to take that oath.

If that is acceptable to the Members of the subcommittee, I shall proceed then to administer the oath. Would you please rise and raise your right hand?

[Witness sworn.]

Chairman BAKER. You are now under oath. Thank you very much, sir. Your statement, of course, has been made part of the official record. You may summarize it or deliver it as you choose.

TESTIMONY OF JOSEPH BERARDINO, CHIEF EXECUTIVE OFFICER, ARTHUR ANDERSEN LLP

Mr. BERARDINO. Chairman Oxley, Congressman LaFalce, Chairman Baker, Congressman Kanjorski and Members of the committee. Andersen and this committee share common goals to get to the truth about what happened at Enron and to help develop policies that will improve our capital markets, enhance audit quality and better protect the investing public. That is why I am back before you today for the second time in less than 2 months.

At the outset, let me make a few important observations. It is abundantly clear that something very tragic and disturbing happened at Enron. All that is involved, in my opinion, has to do with three things. First, we must face up to our responsibilities. That is what my being here is all about.

Second, we need to get to the bottom of what happened. We know more than we did a couple of months ago and we have learned some unpleasant things which we have been straightforward in bringing to the public's attention. Our investigation is continuing and we will take actions when appropriate.

Third, and this is the main reason I am here today, we need to think honestly about changes that need to be made. When I last appeared before this committee, I pledged to do just that, and I am also here to report to you that Andersen has already taken the first steps toward fundamental changes in our audit practice here in the United States.

First, former Federal Reserve Board Chairman Paul Volcker has agreed to chair an Independent Oversight Board to work with us in the U.S. Mr. Volcker and the board will have free access to all information relevant to a full review of the policies and procedures of our firm to assure the quality and credibility of our firm's auditing process. The board will have full authority to mandate changes and such practices. As this committee well knows, Mr. Volcker is a man of unquestionable integrity. He is one of the most independent thinkers in America's finance. Paul Volcker calls it as he sees it and the investing public will be well served by his involvement.

Second, we have taken some immediate steps to address concerns about potential conflicts of interest. Andersen will no longer accept assignments from publicly traded U.S. audit clients for the design

and implementation of financial information systems. And we will no longer accept engagements to provide internal audit outsourcing to publicly traded U.S. audit clients.

Third, Andersen will work with each publicly traded U.S. audit client's management and audit committee to establish a formal process for determining the company's acceptable scope and level of fees for those non-audit services that we continue to provide.

Fourth, Andersen will create a new independent Office of Ethics and Compliance to investigate on a confidential basis any concerns of Arthur Andersen partners, employees, or individuals from outside the firm relating to issues of audit or auditor quality, integrity, independence and compliance.

And fifth, Andersen will establish a new Office of Audit Quality comprised of senior partners with the sole mission of deriving audit quality.

These are just the first steps, and I want to stress that, first steps in a process that will fundamentally change our U.S. audit practice. We look forward to working with Mr. Volcker and the Independent Oversight Board as we implement these and other changes. However, the forms we are willing to implement cannot be the end of the matter within our firm and beyond. With the accounting profession in crisis, we all need to do something more fundamental.

Let me offer some observations about some of the areas that could benefit from change. Many participants in the financial reporting system, including auditors, rating agencies, analysts, investment bankers, and other financial institutions have a great deal of crucial information about public companies, information that can tell us a lot about their likely future performance. We now have a system which auditors, among others, have what must be considered a very inefficient and ineffective conversation with company boards, management and shareholders. We need to take a fresh look at how auditors communicate the work they perform and the conclusions they reach.

Today the auditor can issue a standard unqualified opinion or they can disclaim an opinion if so desired. Financial statements prepared by management that satisfy generally accepted accounting principles get a pass. Financial statements prepared by management that comply with GAAP but push the edge of the accounting envelope, and that may pose significant risk to the company and its shareholders, will get the same unqualified opinion as those representing more prudent accounting decisions and disclosures.

Now, I think we need to keep this in context. Many, many, many companies get it right, but there are some pushing the envelope, and the investing public does not know which one is which. So this system is bad for everyone and for investors most of all, and they don't get all the information they need or would like to make informed decisions. There is a significant danger that they may be led astray by this pass-fail grade in our product called the auditor's report.

Therefore, I would suggest we consider replacing the current standard auditor's report with a report that grades the quality of the company's accounting practices and business risks. This change will give investors important guidance on how to assess the com-

pany's financial statements, the information contained in those statements and related financial risks, but it also gives the company an incentive to have higher disclosure practices and more prudent accounting.

But there's much more we need to do. We also need to move to a more dynamic and richer financial reporting model. We need to provide several streams of relevant information, many of which are discussed in some detail in my written testimony. And we need to simplify accounting principles. We need reports, in plain English.

We need to further strengthen the role of the audit committees by encouraging them to engage manager and auditor to ensure that risk is managed and that crucial information is communicated to shareholders in an intelligible way. We also need to give serious thought to making it a felony to lie or withhold information to mislead investors and auditors.

Let me also say a word about the Enron Special Investigation Committee Report that was released on February 2. As you well know, that document is more than 200 pages long, took more than 3 months to produce, and was released just this Saturday night. We have experts in my firm that are now analyzing and investigating these findings. The report acknowledges the time and resource restrictions that limited the scope of the review. It notes a lack of access to people and documents that the committee admits may have information relevant to their conclusions.

The committee did not speak to people at Andersen. When the committee was formed we offered to assist it, but the company's lawyers indicated that they were not ready to discuss anything with us. We did provide the committee with our work papers when requested. The committee asked to speak with some of our people, and we were in the process of working out interviews when Enron fired us. We never heard from the committee again.

I would note that the report cites numerous instances of possible additional secret arrangements among the company or related party special purpose entities. The report says there were indications of hidden inside agreements of non-documented transactions between Enron and these SPEs. We need to investigate the accuracy of these alleged matters. If people withheld information from us, they were withholding it from investors, and that can't be tolerated.

Before concluding, I would like to thank Chairman Oxley for the opportunity to clarify my December testimony, which I did in a letter submitted to the committee on January 21 and in my written statement today. I appreciate the open and forthright manner in which Chairman Oxley handled this matter.

Mr. Chairman, we have an opportunity to make some good from what happened here. This is a tragedy on many levels. I am here because I want to be part of the solution. At Andersen, we are determined to convert our current challenge into an opportunity, as difficult as that may be; an opportunity to reaffirm the principles that drive our 28,000 people here in the United States and 85,000 people around the world in our desire to serve our clients and the public that relies on our work with candor and integrity. The steps I have outlined today start the process. We will work with you in the days and weeks ahead to continue it.

Thank you.

[The prepared statement of Joseph F. Berardino can be found on page XX in the appendix.]

Chairman BAKER. Thank you Mr. Berardino.

I want to ask the committee's indulgence. I have a series of questions I would like to pose to Mr. Berardino that may take me a little over the normal 5-minute customary rule, but if the committee will provide me with this opportunity, I think it extremely important given the fact the committee has under consideration legislation to address the concerns that you have identified and to adopt some of the recommendations perhaps that you have outlined this morning.

Let me start with the first and most obvious question. Without regard to any specific accountant or any particular event, in general, what would be Andersen's code of ethical conduct requirement for any auditor that finds an activity that diminishes shareholder value that is GAAP compliant?

Mr. BERARDINO. Mr. Chairman, we have an obligation to speak to the shareholders through the audit committee. There are professional standards that say when we see accounting that is on the edge, major subjective decisions that go in or commonly go into preparing the financial statements, we communicate the risk, the decision is made by management, and our concurrence or disagreement as appropriate, to the audit committee.

Chairman BAKER. In the scope of Andersen's relationship with Enron, which was over some multiple years, again not with regard to specific meeting, specific transaction, or a specific report, to your knowledge in the last 24 months, has management of Enron met with the audit team prior to its final report being posed to the board or to the audit committee and resultingly changed the findings of the audit or modified the form in which the audit was to be prepared?

Mr. BERARDINO. Mr. Chairman, I frankly can't answer that question with authority, because obviously I wasn't there doing the work, and if not——

Chairman BAKER. Let me ask you differently. Without regard to Enron, as a matter of common practice, does the Andersen team, when conducting a corporate audit, meet first and primarily with the audit committee prior to the release, publication, finalization of the report; and is it customary to meet with management prior to having that report approved by the audit committee?

Mr. BERARDINO. Absolutely. Yes, sir.

Chairman BAKER. So you do meet with management.

Mr. BERARDINO. Yes. And the audit committee.

Chairman BAKER. Is it customary to meet with management first?

Mr. BERARDINO. Obviously we are meeting with management all the time as we conduct our work.

Chairman BAKER. And that is my point. Is it common practice for management to object to a particular method by which a transaction is evaluated or to make recommendations as to the manner in which it is reported? For example, as opposed to having it in the statement, having it in the footnotes; is that a common practice?

Mr. BERARDINO. As I am sure you can appreciate, the audit is an interim process. We are looking for the facts. We are looking to understand management's judgment. Management will give us their view. We will challenge their views and we will come to a conclusion.

Chairman BAKER. So it would be your opinion, from professional conduct of Andersen's general accounting process, that even were you to meet with management, were you to make changes in the reporting of the financial statement, whether it be to put a matter into the footnotes or to reconstruct the manner in which a transaction were to be reported, that you believe that the audit team can reach a professional conclusion in that environment and not have your financial report be distorted in any manner that would not reflect the accurate financial condition to the shareholder?

Mr. BERARDINO. Mr. Chairman this is a very fundamental and important question. The financial statements are management's and the company's. The only thing we put in that report is our auditor's report.

Chairman BAKER. Let me interrupt. It is my view, business class 101, that the board establishes an audit committee. The audit committee retains the auditor. They do so so an audit can be made for the shareholder interest to state publicly the value of that shareholder's interest in that publicly traded corporation. Management is to run the company. They are not to run the audit. Do you dispute that point?

Mr. BERARDINO. Not at all.

Chairman BAKER. Then it would be your conclusion, then, given the fact that the audit team in Andersen's work, Enron or not, conducts its activities independent of interference by management to give the true and accurate picture to the shareholder?

Mr. BERARDINO. That is true, Mr. Chairman. But the point I would like to emphasize is that at the end of the day, these are the company's financial statements. And this is where we get into the issue of companies that report just barely in accordance with the rules and those that are more forthcoming. We cannot make a company report any more than what the rules require.

Chairman BAKER. I understand.

Mr. BERARDINO. That's a challenge we need to look at.

Chairman BAKER. And from that, conclude as to the true financial condition. And I was trying to help you in saying that in all cases, you feel your audit team has taken the managerial information and provided an accurate picture to the shareholder based upon your findings at the time the financial statement was prepared.

Mr. BERARDINO. Yes, Mr. Chairman.

Chairman BAKER. In that light—and this is an example of what is a very complicated subject. I will move through it rather quickly, because I believe you to be familiar with it. Enron and CalPers were partners in Jedi. CalPers wanted to extricate itself from Jedi. Its stake was worth approximately $383 million. Fastow and Kopper formed Chewco to buy out the CalPers interest to facilitate their release from that prior arrangement. Enron, I am told, arranged for Jedi to loan $132 million to Chewco, a related party. Fastow and Kopper then arranged for Barclays to loan Chewco

$240 million and Enron guaranteed it on the back side. In order to meet the 3 percent minimum investor criteria, the investor had to provide $11.5 million of equity. Barclays then helped provide the credit to facilitate that investor equity position, which later—we are skipping a bunch—is now disputed by Barclays as to whether it was ever an equity position and may have, in fact, been a loan in its entirety.

Without regard to the specifics or the facts that I have just made, was there any indication determined by the audit team in the course of their normal audit function that would have led any reasonable accountant to look at the transactions on the corporate books and conclude it was not what management represented to you?

Mr. BERARDINO. Well, Mr. Chairman, this is part of the fact pattern we need to undertake. I don't know with authority what we knew and when we knew it. What we have testified to is that information had been withheld from us in that transaction, and when it was forthcoming we and the company restated those financial statements.

Chairman BAKER. It also is important to note that the sale of assets to an SPE, which Enron extended the credit for the purchase to be consummated, was then booked as earned income on the corporate revenue side.

My point of these facts, only one limited instance and not to take undue subcommittee time, there are many. I am now told that the number of SPEs could well exceed 400, of which 30 or so are questionable in their construct and operation. I am very troubled by the fact that all of these activities require a check, the movement of stock, board approval, physical evidence of a relationship with a party which is not in the shareholder interest, either by failure to make appropriate disclosure or by engaging in activity and having the disclosure so convoluted a reasonable man could not make a determination as to the professional relationship that was being established.

What can you tell me today, without regard to a specific event or activity, with regard to your perspective and Andersen's role in getting it right, not with regard to one particular quarterly report or one particular financial statement, can you now acknowledge in retrospect that the true financial condition of Enron was not accurately reported in the financial statements prepared by Andersen at the time of their preparation?

Mr. BERARDINO. Mr. Chairman, in hindsight we could look at what happened and I really regret to tell you I can't answer your question with authority, because there are several unanswered questions: What did people know, when did they know it? And as I testified last time, everyone's talked about the off-balance-sheet liabilities, but Enron had to move assets off the books with those liabilities. And one of the big questions I have—and I don't have an answer to—is when did those assets go bad and when did people know they went bad?

Chairman BAKER. Even more simple. From the events as now determined, in 1999, February, you were the auditor at the time of the proposed merger. Published reports which I have read in great detail indicate that VEBA's due diligence, using another audit firm,

determined that 75 percent of equity was impaired by off-balance-sheet debts, led to their determination not to proceed with the merger.

If you were the auditor at the time that merger failed, described in press reports as a merger of equals and giants, an enormously important financial transaction to every shareholder, every partner, every consultant, every auditor and it failed, how is it possible for Andersen not to have known in 1999 as a result of such a public meltdown on a proposed merger, based on the fact that the accounting practices of Enron were being questioned, led to the failure of that merger? What's the explanation? How could you not know?

Mr. BERARDINO. Mr. Chairman, I wish I could be more helpful. I did not do the audit on this company. There were many people involved who had intimate knowledge at the time. I am not one of them.

Chairman BAKER. I don't want to go to the specifics and I don't want to ask who the auditor was or ask what the auditor found. My point is I am reading newspaper articles, now 3 years old, saying that the failure of the merger was questionable accounting practices and off-balance-sheet debt to excess. If I were a member of the board, if I were a shareholder, and certainly if I were the auditor, I would want to have a reasonable explanation on the public record why VEBA's auditors were wrong, or I take the matter up with someone.

I have greatly exhausted my time on the subcommittee, and I want to come back if you have time and talk about the solution side. But these are very deeply troubling matters.

Mr. Kanjorski.

Mr. KANJORSKI. Give me an opportunity, Mr. Chairman, to raise another issue. Mr. LaFalce, unfortunately, has a personal family situation that he has to tend to, and would have liked to have been here. But, I will certainly take his time.

Yesterday, Dean Powers testified before the committee. His report concluded, in many instances, that the hedges or the derivatives that were established with these special purpose entities had nothing to do with setting off the economic risks, the normal expected purpose of a special purpose entity. In fact, they were a vehicle to take debt off the balance sheet and falsely inflate earnings and profits. You have had a chance now to examine some of these transactions and these sheets. Is his analysis correct or incorrect?

Mr. BERARDINO. Congressman, I will answer you specifically, but I just want to remind the subcommittee that this report was issued just Saturday. It's 200 pages long. We were not consulted, had not seen a draft, and there are a lot of questions and conclusions that were conjecture, "appears," "seems like," and so forth.

But, I want to respond specifically to the issue of SPEs and lack of economic vitality, and I'll suggest what I did last time, which is that the rules for SPEs were not economically driven. Our firm disagreed with those rules because they were not economically driven. They were accounting conventions to move assets and liabilities off the books.

The reason we disagreed is you have a 3 percent new money coming into these SPEs and the sponsor has 97 percent of the risk

and awards. We never thought that made any sense. We lost that debate in our profession, and the rules, in fact, are accounting rules that don't reflect economics.

Mr. KANJORSKI. You blame it on FASB or someone else. Somebody has got to stand up here, Mr. Berardino, and say "we allowed this to happen. We participated in misrepresentations to investors, shareholders, pensioners, and 401K investors." Somebody has got to stand up. To say, "well, we just have not examined the report, we just do not quite know yet," is not acceptable.

It is a simple question. You have examined these transactions. Were there any economic risks involved that are the normal intention of hedges, or were these transactions vehicles to deflate debt and falsely inflate earnings and profits? That is a pretty simple question.

Mr. BERARDINO. With respect, Congressman, the rules are accounting rules, not economic rules. Number two is we are finding out things that we didn't know. Why did we not know them?

Mr. KANJORSKI. I do not know why you did not know of these things. Obviously, you are not the man to testify. As a matter of fact, I would make the recommendation to the Chairman we start subpoenaing some of the responsible people that did these things. But, I do know your company helped set up these transactions. You are not some innocent. Coming in here as an auditor and having all these transactions that are out there, you are not just looking at them. You went through the intellectual analysis of how to structure these things.

When we heard Dean Powers talk about moving $800 million of Enron stock over to one of these transactions in which Enron was hedging itself, it seemed clear to me his interpretation was correct. What strikes me is why it was not clear to a trained auditor or accountant. Those hedges were not worth anything. There was no recovery. There was no setting-off risk. It was strictly a chance to take debt off the balance sheet and inflate earnings and profit. It accomplished nothing. If the Enron stock went down in any respect, it was a sure loss for everybody except the insiders who got their fees up front and got their profits. Is that not a reality?

Mr. BERARDINO. Congressman, I don't know, because I don't have all the facts.

Mr. KANJORSKI. Well, did your company see these things and go to the board with them or to the shareholders meetings? Did your company do something?

Mr. BERARDINO. Congressman, there were many meetings with management.

Mr. KANJORSKI. Management, look, we cannot put a lot of faith in what we heard about these managers getting $30 million incomes for setting up these transactions.

I understand that you are not in a position to prevent greed. But one of our colleagues here, Mr. Shadegg, proposed the idea that the purpose of this subcommittee and what the Congress' responsibility is, is to see that this situation never happens again. We must take positions or pass legislation.

I am just a small-town lawyer, and I am not sophisticated with hedges and derivatives, but having listened to Dean Powers yesterday I know these instruments are good in the system if they are

properly used. It seems to me that everything that Dean Powers testified to yesterday highlighted in capital letters: GREED, absolutely unfettered greed. It is clear to me that the public and the shareholders have a right to assume that professionals, whether they be in the accounting profession or the legal profession or other outside professionals, have a responsibility to use their best judgment. Are their senses as strong as ours?

What I am worried about is Mr. Shadegg's intention that we cure this problem. I do not know that we can ever develop a drug to cure greed, but we can shine light on greed. But, that is not good enough, because, after the fact, people have already lost. I mean, we are deluding these 401K investors into believing that they are going to get everything back. We are deluding the pensioners, the shareholders, the people that offered credit to this company that they are ever going to get anything back.

But what are we going to do? We are not going to cure greed. We are not going to have a drug for it. I have given up on that. It is starting to get to the point of ugliness now, but we can do something with the accounting profession. Something is going to be done with the accounting profession.

Mr. Berardino, I know you are just a CEO of that huge company, but you have got to help us. You have got to identify who the people were who put these sham transactions together to hide a debt and to expand the appearance of earnings when they were not there. You have got to work with us on this problem. Identify these people, so we can have them up here and put the light on them. We have got to go through their mental processes of why this was done and did they understand, for those lousy $10 or $30 million in rip-offs by inside people in this company, people have paid with their life earnings and shareholders have lost billions of dollars?

That is an economic tragedy that we can survive from. I think yesterday's market and the news media is really testing the fabric of the strength of the economic system of this country, because of activities, that your accounting firm either failed by negligence or were culpably a part of the inside transactions, that went on to send this company into bankruptcy and to shake the trust of the American people, and maybe the world, in our financial institutions. Something has to be done. I urge you, Mr. Berardino, to cooperate with the Chairman and this committee in giving us the proper people who we can put the light on to find out what was done, when it was done, why it was done and how we can hope to prevent it from being done again in the future.

Mr. BERARDINO. Congressman, I'm up to that challenge. I'm here for the second time, as you well know. We will work with this committee in any way humanly possible to achieve that end.

Chairman BAKER. Thank you, Mr. Berardino. The gentleman's time has expired.

Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman and Mr. Berardino.

First of all, before I ask questions, the comment you made regarding the 3 percent rule and the consolidating of financial statements, it's interesting back in 1996 Andersen was the only company among the accounting firms that actually opposed that rule, and your comments were absolutely correct.

Mr. Chairman, I would like to make a copy of that available for the record.

Chairman BAKER. Without objection.

[The information can be found on page XX in the appendix.]

Mr. OXLEY. Thank you.

Mr. Berardino, the Powers Report notes that the disclosures regarding Enron's transaction with LJM and other partnerships were: "Obtuse, did not communicate the essence of the transactions, failed to convey the substance of what was going on, sought to disguise their import of these transactions and sought to avoid disclosing Fastow's"—who was the CFO—"financial interest." The Powers Report states that this misleading disclosure reflects an absence of forceful and effective oversight by, among others, auditors at Andersen.

How do you respond to this very disturbing criticism, and what steps is Andersen taking to remedy the situation?

Specifically, I asked Dean Powers, based on that statement, that indeed it appeared that Andersen was complicit in arranging these special purpose entities and indeed, as I indicated and characterized it, was involved with baking the cake. If that is indeed accurate, what steps immediately can Andersen take to avoid that in the future?

Mr. BERARDINO. First of all, thank you for that clarification; and I find myself in the awkward position of defending something we disagreed with. But to specifically respond on the disclosures for Enron, let me just suggest that there are no requirements to disclose SPEs unless it is probable that these debts will come back on the books. So there's a judgment call that the manager makes and the auditors make as to the likelihood, probability, or remoteness of these transactions coming back on the books.

That's why I keep saying, at the important time the assets that went with these liabilities were increasing in value—and then we all know what happened. They decreased, and they decreased very rapidly. When that happened, when it was probable, whether there were side agreements we weren't aware of, these are all questions we still have, and it will be relevant to understand what happened.

Mr. OXLEY. Is the assumption, then, always that the assets will continue to increase and hold value? Is that the assumption that the accountants use in this process?

Mr. BERARDINO. The assumption is that the assets will hold their value and will support the liabilities that are off the books with it.

Mr. OXLEY. And that is a hard-and-fast rule, that assets never depreciate in value?

Mr. BERARDINO. No. In order to, in the first instance, set up the transaction, you need to move enough assets off the books to satisfy the liabilities, and you need to monitor on an ongoing basis—the company needs to monitor whether or not these assets can still satisfy the liabilities at such a point that they can't then——

Mr. OXLEY. What is the auditor's role in that?

Mr. BERARDINO. To monitor the management's judgment as to whether those assets have maintained their value.

I would also like to correct the record in one respect, because people keep saying things like we set these things up. Our firm where—the accountants and the accounting advisors' management,

in conjunction with their investment bankers, lawyers and others, would present us a transaction and would ask the obvious question, does this pass the rules? And we would give our judgment as to whether it would pass the rules, and at the end of the day those judgments were rendered.

Mr. OXLEY. Mr. Berardino, that was not the testimony by Dean Powers. Dean Powers made it very clear that Andersen's accountants were very much involved in crafting these special purpose entities, that they were not just checking the box, but were, in fact, trying to find ways to make it work.

Mr. BERARDINO. Mr. Chairman, there's room for both of us to be accurate in portraying what happened. This isn't an indurate process. The company is, with their bankers and lawyers, designing transactions that are accounting transactions, and they ask our advice. So we'll say, yes, this works or, no, this doesn't work, that kind of conversation.

Mr. OXLEY. Isn't it a fact that Andersen received $5.7 million for that advice?

Mr. BERARDINO. That is true. I would just amplify and say that was over a 5-year period for scores of transactions, and again that was what you would expect the accounting firm to be doing, is looking at these transactions and giving advice as to whether or not they pass the rules or not.

Mr. OXLEY. Is there some evidence from your perspective or from what the Dean told us yesterday that there was active participation in the crafting of these off-the-books entities, that Andersen did play a role in setting these up? That is true, is it not?

Mr. BERARDINO. We were aware of the transactions.

Mr. OXLEY. You were more than aware.

Mr. BERARDINO. We gave judgments.

Mr. OXLEY. Dean Powers was pretty clear in saying that it was pretty clear that Andersen's people were involved in the get-go in creating these off-the-books entities. Is Andersen denying that they were involved in the take-off of these?

Mr. BERARDINO. Mr. Chairman, I think we may be talking past each other in terms of what involved and what setting up all means. This committee did not talk to us, did not get our perspective on what our involvement was. I wasn't there. I can't tell you how active and what the nature of our people's judgments were. Suffice it to say, we were very much involved as the company setting up these transactions and giving advice on whether they would pass the rules. I'm not sure I'm being inconsistent with the——

Chairman BAKER. Would you yield, Mr. Chairman?

Mr. OXLEY. I'll be glad to yield.

Chairman BAKER. I just wanted to suggest that it's apparent, as Mr. Kanjorski suggested, that there may be others more appropriate to respond to some of these questions; and we need to visit about the time and venue in which we might have some of those individuals available.

Mr. OXLEY. Precisely. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Chairman Oxley.

Mr. Ackerman.

Mr. ACKERMAN. Thank you.

Mr. Berardino, let me tell you first, before I ask you a question, what's in my heart. You've come back now for the second time to amend some things that you said before that weren't necessarily as accurate as you would have liked them to be, and we have been listening to you for a while, and we've basically gotten nothing, and I'm finding it very difficult to believe that a person who has risen to a position of such prominence and importance in the financial community can present himself as knowing absolutely nothing about what's going on in his own business.

Maybe it's better to be dumb than culpable, but we want some answers. And I, for one, am extremely troubled by what I'm hearing. Your not knowing what was going on, if that's the case, is basically saying that you have squandered the integrity of your company. You've enabled the enrichment of the greedy at the price of destroying the dreams of so many decent, innocent people, and that is totally unacceptable.

It seems to me that we had some testimony yesterday from some folks who spent a mere 3 months looking at what's happened and came back absolutely astounded, astounded as are we and as are the American people.

You were asked the question before about the company that sought a merger with your company and in 2 weeks said this is unbelievable, we can't go through with this deal. Didn't that raise a suspicion in your mind that something that your prestigious firm was auditing and delving into and looking into was off base somewhere if in 2 weeks they could say that this is a house of cards, to say something is wrong with my auditors, I'm the captain of this ship? And to appear before us and say that, well, I was GAAP compliant, and I'm not the auditor, and I didn't—it's not acceptable. You're the captain of the ship.

I mean, if they came to you and said we want to rob a bank and here's who's going to drive the car and this is what we are going to pay for the gun and this is the day and time we're going to do it and who are fully disclosing all of this, you don't think you have the responsibility to blow the whistle?

Now I don't even know what my question is. I mean, this is so mind boggling. I mean, how do you let this happen, Captain? I mean, your ship is going to go down, and you're going to be lashed to the mast unless you start talking to us about what happened. Maybe you can explain it.

Mr. BERARDINO. Congressman, we are still getting facts. You want me to give you conclusions without all the facts. The special committee——

Mr. ACKERMAN. How long have you been the auditors of this company and how long have you been their consultants?

Mr. BERARDINO. This committee had conclusions that——

Mr. ACKERMAN. Could you just answer that question first? How long have you been the auditors for Enron?

Mr. BERARDINO. Our firm has been the auditor since I think the mid-1980s.

Mr. ACKERMAN. Since the mid-1980s, and now you're just getting the facts. That's very interesting. My kid cousin wouldn't use you to do his tax returns if that's what you're telling me.

Mr. BERARDINO. Congressman, when I was here last I reported that, in one instance, we had facts and reached an improper professional conclusion and the company restated its earnings. I said, in the second instance, information was withheld from us; and once we had the information, we required and the company restated its financial statements. In this report there are allegations that maybe there was some other information withheld from us. I don't know if that's true or not. I haven't been consulted. We haven't been able to approach the committee.

Mr. ACKERMAN. I'm just having difficulty here. I'm not making an analogy, but I can't help but think if Hitler was brought to the Nuremberg trials and he said "I didn't know what was going on, I was just a president of a small country——"

Chairman BAKER. Your time has expired, Mr. Ackerman.

Mr. ACKERMAN. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Ney. And let me, before I recognize Mr. Ney, acknowledge that I'm having distributed the article printed in the *New York Times* which I made reference to with the proposed merger. I'm the one who's doing that.

Mr. NEY. Thank you, Mr. Chairman.

Mr. Berardino, based on what is now known, did Enron officials, especially Andrew Fastow and Michael Kopper, keep material information about the special purpose entities from Andersen auditors?

Mr. BERARDINO. I don't know. Apparently in the one transaction that was restated, 80 percent of the restatement information that was relevant was withheld. Who knew it? Who withheld it? We don't have that information.

Mr. NEY. Are you looking into it to find out internally?

Mr. BERARDINO. Frankly, we can't look into it. We are no longer the auditors for Enron. We don't have access to their people. We don't have subpoena power. We're sitting here like everybody else reading this report that was issued Saturday.

Mr. NEY. I understand you're not the auditors, but you still should be able internally to question people that were around Enron, your people, and involved with Enron to find out if, in fact, to the best of their knowledge was information directly kept from them, and maybe they have that information.

Mr. BERARDINO. Unfortunately, they don't know what they didn't know. OK? There are new facts coming out every day, and we don't have an opportunity to respond to them. I wish we did. I'd like to have facts. I'd like to give you more definitive answers. I just can't.

Mr. NEY. There's a new report out that Enron management might have taken large sums, $15 million in 2000 alone, from employee benefits accounts for spending at other departments. That's, of course, outrageous. I think we all know that, and I feel it's a crime. In fact, Ken Lay should have just had a mask and a gun. It would have been much easier than what he did to these people.

Now, the Enron accountant who found it out reported it to a senior Enron management official, including Ken Lay himself, and Lay supposedly told her to mind her own business. Does Andersen have any knowledge of that conversation?

Mr. BERARDINO. The first I've heard of it.

Mr. NEY. Another question I wanted to ask: There has been a lot of news about the $25 million paid by Enron for Andersen's non-auditing services. But the Andersen/Enron relationship, it's been stated, was deeper. A recent news article said that Andersen employees were given permanent office space at Enron headquarters. They were dressed like Enron colleagues—which I wondered what that was—and then they went on to explain they wore Enron golf shirts, shared in Enron office birthday parties and ski trips to Colorado. Enron employees thought, they've stated, that your people were other Enron employees.

That brings up just, obviously, several issues and questions. Didn't that violate the ethical standards of the CPAs that you're supposed to be independent in spirit as well as, in fact, and are these relationships norm throughout the accounting business?

Mr. BERARDINO. I don't have any particular insight on that. I will tell you absolutely we are to be independent. It is not unusual, in fact, it is common that we have offices at our clients' headquarters, because we're constantly asking them questions and with a company of Enron's size we were continually doing our audits. So that would not be unusual.

These other, you know, social points you raise I just have no particular knowledge, so I can't respond.

Mr. NEY. Would you please be intent for the future to go back to your company and say, did this happen? Talk to the people who were over there that were your employees to make sure that type of thing, if it happened, doesn't happen again?

Mr. BERARDINO. Absolutely.

Mr. NEY. You do have——

Mr. BERARDINO. Well, we mentioned in my testimony this Office of Ethics, and we are going to make much more considered policies and directives to our people so that they understand what proper behavior might be.

Mr. NEY. Last question I have, Mr. Chairman, the Powers Report states that the annual reviews of the LJM transactions by the Audit and Compliance Committee involved brief presentations by Enron management. Andersen was present at the audit committee and did not involve any meaningful examination of the nature or terms of the transactions. So the question would be, why didn't Andersen, which was present, seek further information about these transactions which ultimately did contribute to the collapse of the entire company?

Mr. BERARDINO. I think the record will show in time that there were conversations with this audit committee over a long period of time where these transactions were on the agenda.

Mr. NEY. Thank you.

Mr. Chairman, I hope that we can get down to the bottom of these eventually with other witnesses or whatever, because I think they're important as to the questions that have been raised here to be answered to this issue.

Chairman BAKER. I can assure the gentleman that, with the committee's assistance, we will have much more informative hearings on the matter to determine as best we can the causes for these problems.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

One thing I wanted to clarify, and I'm sorry Mr. Oxley has left, but he raised an important point. Mr. Berardino, when you testified last December before us, I asked this question, because at the back of your statement you made the comment, and I don't have the transcript in front of me, that at the time you didn't think that disclosing that stock values would affect the repayment of debt was a material item. I think you said something to the effect, and I am paraphrasing here, that the perception was the stock was always going on, and it's similar to what Mr. Oxley was asking, that asset values were always going up. So they weren't necessarily material items. I think now they have become very material in retrospect.

Let me go back to some other questions, though, that you raised. Knowing what you know today, would Andersen take on Enron as a client? It's a yes or no answer, I mean, I guess.

Mr. BERARDINO. Well——

Mr. BENTSEN. In the way that they appeared to have run their business.

Mr. BERARDINO. We look very seriously at the integrity of management, the value of their representations, because we do test checks at a company. We don't look at every transaction. And I think the report yesterday was pretty direct in some of its criticisms about lack of supervision and in some cases integrity, and that would prevent us from taking on a client where those were real concerns.

Mr. BENTSEN. Let me ask you this. Going back a year or so, is there a percentage at Andersen with which clients, long-time clients, are reviewed on a periodic basis, semiannually, annually? Is there a procedure at the partner level, at the management committee level with which you review clients? I mean, presumably you review how much revenues you are raising from clients and whether or not it's worth keeping or not based upon that and your costs associated with that, but did that go on with the case of Enron?

Mr. BERARDINO. Yes, it did. In fact, there is a February memo that has been well reported in the public where that conversation was taking place within our U.S. management team, and the risks of the company were being evaluated as well as the procedures we would undertake to review.

Mr. BENTSEN. Was there ever a time at the partner level that questions were raised about how Enron was conducting its business? I mean, was there ever a discussion of whether or not Andersen might want to fire Enron as a client because of concerns about how the business was being run?

Mr. BERARDINO. I wasn't part of those discussions. I don't know specifically what was discussed other than the general process we do go through every year about each of our clients as to whether we want to continue and whether or not we have the understanding——

Mr. BENTSEN. Board meeting minutes or management committee meetings that you've seen.

Mr. BERARDINO. Not to my knowledge.

Mr. BENTSEN. Was there ever an occasion at the partner level where perhaps a call came—I mean, presumably somebody looks at

the sum of the parts of all of the profit centers within the firm. Somebody has to, I guess, decide how to divvy up the profits at the end of the year. But was there ever a discussion that was made that perhaps there was something, a rather aggressive approach?

Because you said the books—you're right about the fact that the books are the company's books and the accounting firm is just really adding its interpretation of the books. But it's also for a fee and legitimately, in virtually every case, for a fee is putting its imprint on there. It's giving its qualified opinion which the marketplace takes as an interpretation that things are on the up and up.

But was there ever a case where you received a call or someone at the partner level or management level of the firm received a call from the division that was responsible for Enron that said, there's a problem with how they want to lay out the books, with either SPEs or SPVs or whatever, dilution of stock, you name it, some of the stuff that's in the Powers Report? Was there ever a call made and the discussion was, look, the client always comes first? Was there ever a situation in the case of Enron like that?

Mr. BERARDINO. I'll make two comments. One is that was not brought to my attention, that kind of conversation, until the third quarter of 2001 when we had many conversations with the company on that report. But I'm Chief Executive officer of our firm worldwide. We have a management structure in the U.S. that would have those conversations to the extent they existed, but I wasn't part of those.

Mr. BENTSEN. For the record, could your firm provide us with an answer to that question, whether or not there were discussions? Because the perception is out there that while the auditing firm looks at the books—and, sure, you've given the information, although, as Mr. Ney was saying, you had offices there so you can pepper them with questions on a regular basis. But when you're sitting down to close a deal—I mean, the Chewco deal wasn't fully baked, but they had to get the deal done, and so they did it improperly. And Andersen was apparently involved to some extent, and they assumed that they would fix it between November and December or whenever they closed their books, and they would find the other 1 1/2 percent equity ownership to make the deal work, make it legal under the terms of FASB.

The question I have is, somewhere in the management structure was there a discussion that said, look, this isn't quite how it ought to be but, look, they are a good client, you know, they're an upstanding company, whatever, let's work with them to get this done. Because that's a breakdown in the system, and it undermines sort of the old adage of FDR going back to the Securities and Exchange Act, that the whole idea was to have a level playing field. Part of the level playing field is the imprimatur of the auditing firm that the books at least have been looked at even with a qualified opinion; and if the question is that the client is starting to push around the auditor, then we have an unlevel playing field.

Mr. BERARDINO. I think that's a fair question. Unfortunately, you have the wrong person in front of you to give you more specific answers.

Mr. BENTSEN. You are the Chief Executive Officer and presumably you have access to the minutes of the meetings of the partner

committees and whoever has responsibility over the U.S. functions, North American functions and could provide those for the committee.

Mr. BERARDINO. We'd be happy to be helpful if we can be.

Mr. BENTSEN. We would appreciate seeing that.

Thank you, Mr. Chairman.

Mr. BERARDINO. Thank you.

Chairman BAKER. The gentleman's time has expired.

Mr. Shays.

Mr. SHAYS. Mr. Chairman, I would like to just pass for two or three rounds and then reclaim any time.

Chairman BAKER. Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman.

Mr. Berardino, I have had sort of mixed feelings about this this entire morning. It's been interesting. I believe your testimony, which I have tried to read in full, well beyond what you've said here today, is very comprehensive in terms of what should be done. But I consider it sort of a mea culpa testimony, if you will, as opposed to something I'd like to have heard a year ago or whenever it may be.

I couldn't find my notes on this, but I recall reading that Andersen had done auditing work for, I think, Sunbeam—is that correct—in the past?

Mr. BERARDINO. Yes.

Mr. CASTLE. And Rite Aid, was that not correct? Waste Management, all of them had some sort of fundamental non-disclosure issues, particularly Sunbeam. That created tremendous stockholder havoc out there.

I mean, my whole bottom line on this is that there's a whole series of insiders, of which auditors are one to a degree, but there are insiders who are doing these kinds of things, most of whom hopefully in this country are operating in a perfectly acceptable level. They are the ones who are running the companies, and they are the lawyers and the others who are giving advice, all the investment counselors. There are securities analysts who are giving advice on these various things that have some knowledge about what is going on.

Then there is sort of a filter system, and to me the filter system is the auditors, and it's the auditors that have to filter to those of us, and in this case there are millions of people who suffered huge losses out there. And when I say millions, I'm not talking about people who directly own Enron stock, but all the pensions plans—not just Enron's either—but all the pension plans in this country, and all the major stock holdings of a lot of operations and they all lost on it, because that filter, in my judgment, among other things, did not work. The water was plenty dirty by what happened to all the others, but I question, has the filter worked or not?

I wish the ideas you had in here had been in place in order to have prevented this. I know that you want to be a part of the solution, and I appreciate that, and I have also listened to you, say, three or four times, in various ways, that you did not do the audit, meaning you personally did not do the audit in this particular case, but isn't there a corporate responsibility to know? I mean, is Andersen just too big? Do we have a problem with the big five ac-

counting firms or whatever? Do we need to do this in a way so that everyone knows what's going on at this point?

It just seems to me unacceptable—and I consider you to be a person of integrity, but it's unacceptable that these kinds of things are happening in a huge, multi-million dollar, fee-based structure for a major corporation in the United States of America, and yet you can sit there and legitimately be able to say I simply did not know. And not that you would have known at the time, because you didn't do the work, but that it would not have somehow have gotten to you.

Just in a broad sense, what are we doing with auditing in this country?

Mr. BERARDINO. Well, I think that's a fair question, and what I came here to do today is to help you with your thoughtful deliberations in terms of what we're going to do going forward. And I've put some very serious proposals on the table that we are just going to do as a firm. We are not going to wait for people to tell us what to do, but also that I think could be part of the fix.

The fact is, as auditors, we know a lot more than we can tell the public. We tell the public through the audit committee, and the question is whether we ought to be telling more directly to the shareholders in some way. That mechanism does not presently exist. I think there are ways we can get better. We are looking at this crisis. It is a crisis. It is a tragedy we have. We understand that. Real people were involved. But I also understand——

Mr. CASTLE. I appreciate what you've said, and I agree that your testimony is basically positive and good for us, but still I'd like to know a little more about the question of the size of auditing firms. In other words, it has just gotten too out of hand in terms of the magnitude with a limited number—I think I read someplace that basically all the audits for all the corporations of the country are done not just by the Big Five, but by like about 20 or 25 firms throughout the country. I have to assume they're all big. Even the smaller more regional ones are pretty large.

Mr. BERARDINO. Right.

Mr. CASTLE. And we're at the point where we are not getting good independent reporting with good oversight of what's happening there and you're removed from some of these answers.

Chairman BAKER. That will be the gentleman's last question. His time has expired, but please respond.

Mr. BERARDINO. Congressman, that's a question I have given some thought to. Really, you've got a balance here, and I'm not going to say I've got the ultra wisdom here, but one of the benefits of bigger firms is you can develop deeper expertise, invest more in training, and have people on the cutting edge to understand the technology risks, the tax risks, all the risks a company has. And, you know, as a public policy statement I don't know where that white line is.

No, I don't think we're too big, but when you've got 28,000 people just in the U.S. that make judgments every day—you know, I can't change human nature. People will make bad judgments. We need to limit it. I'm not apologizing for it.

We are considering every possible avenue to make sure those judgments are better and the backbone and the skepticism is there

to ask the hard questions, and every one of my proposals is designed to make sure we're better.

Mr. CASTLE. Well, my time is up, as the Chairman has so warned me, but I would just comment that the whole structure issue of the way the very firms are set up at least concerns me. I also don't know if it's right or wrong, but it at least concerns me. I hope we add it to the list of things we look at.

Mr. BERARDINO. I think it is a fair question.

Chairman BAKER. The gentleman yields back his time.

Mr. Sandlin is recognized.

Mr. SANDLIN. Thank you, Mr. Chairman; and, Mr. Berardino, we do appreciate your coming here today.

We are disappointed that Mr. Lay has taken the Fifth Amendment by absentia, and we do appreciate your willingness to testify.

You remember recently when Arthur Levitt and SEC a couple of years ago recommended that accounting firms should separate their auditing business from their consulting business? Do you remember that?

Mr. BERARDINO. Well, if I could just correct you just the slightest bit.

Mr. SANDLIN. Well, that's my question. Do you remember that happening?

Mr. BERARDINO. Yeah, well, no, I don't, because I——

Mr. SANDLIN. And at that time Arthur Andersen opposed any required division of auditing and consulting; is that correct?

Mr. BERARDINO. That's not correct.

Mr. SANDLIN. And you took the position at the time that the industry could police itself?

Mr. BERARDINO. If I could just correct you on one small matter, Congressman, the question Mr. Levitt put on the table was whether auditors could do consulting work for their clients, not whether or not they could also be in the consulting business and offer those services to non-audit clients. So that's the only small exception. I did disagree.

Mr. SANDLIN. And your position at the time was that Andersen should audit what Andersen did?

Mr. BERARDINO. No, I——

Mr. SANDLIN. Andersen was doing consulting; is that correct?

Mr. BERARDINO. My testimony——

Mr. SANDLIN. Andersen was doing consulting; was that correct?

Mr. BERARDINO. Yes.

Mr. SANDLIN. Andersen was doing auditing; is that correct?

Mr. BERARDINO. Yes.

Mr. SANDLIN. In fact, on this self-policing on January 2nd, about 30 days ago, Andersen was touting this peer review that did not identify the systemic failures in Andersen; is that correct?

Mr. BERARDINO. Yes.

Mr. SANDLIN. And that report was reported after the Enron problem, after Chewco, after Jedi, after Fastow took off with $30 million, after Kopper made off with $10 million, after Lavorato took a $5 million retention bonus, after Louise Kitchen took $2 million, after the employees were locked down in their pensions. In fact, it was a month after Enron filed for bankruptcy and your peer review said there were no systemic failures; isn't that correct?

Mr. BERARDINO. Yes, that's correct.

Mr. SANDLIN. And the report that came from the independent group said, quote; "Andersen did not fulfill its professional responsibilities in its auditing work."; Is that correct?

Mr. BERARDINO. I don't——

Mr. SANDLIN. You don't remember that being in the report from the Enron investigative board?

Mr. BERARDINO. I don't remember the exact wording, but it was something to that effect.

Mr. SANDLIN. I believe it said "did not fulfill its professional responsibilities in its auditing work."

And talking about failures, when it appeared that Enron was in trouble, the response of Arthur Andersen was to immediately destroy evidence and to shred documents; is that correct?

Mr. BERARDINO. No, it's not.

Mr. SANDLIN. Did Enron—excuse me——

Mr. BERARDINO. Congressman, if I could expand on my answer?

Mr. SANDLIN. Let me ask you this, and you can ask your counsel if you need to ask questions. Did Arthur Andersen engage in destroying and shredding documents?

Mr. BERARDINO. Congressman——

Mr. SANDLIN. Did Arthur Andersen shred documents?

Mr. BERARDINO. Arthur Andersen is an institution. There were individuals——

Mr. SANDLIN. I think Mr. Andersen is deceased. I'm asking if your company and your employees shredded documents after knowing about an SEC investigation. Did they do that or did they not?

Mr. BERARDINO. We, top management in this firm found out that people had destroyed documents.

Mr. SANDLIN. Thank you.

Mr. BERARDINO. We self-reported to the Justice Department, self-reported to the SEC——

Mr. SANDLIN. So the answer is that they did.

Let me ask you this. Arthur Andersen received $25 million in auditing fees, $27 million in consulting fees. Taking into account the reports and all the problems that we've had and the money that you got paid, would you now support a complete division and requirement of a division of auditing and consulting services in the accounting business?

Mr. BERARDINO. Congressman, we put on the table today some very significant suggestions that we think Congress should consider that we think——

Mr. SANDLIN. Let me ask—and that's a good point. That's a good point. I listened to your five proposals you made, and every one of them was to make it better for accounting and for Arthur Andersen. I didn't hear one thing about the Enron employees. I didn't hear one thing about health care. I didn't hear one thing about the pensions. I didn't hear one thing about Arthur Andersen contributing money to help the people that you helped destroy, the lives that you destroyed. All I heard was what can we do to make it better for Arthur Andersen so we can go on about our business and make more money in the accounting business.

Now that was the five goals in the five areas that you listed. I wrote them down. Now are you willing to do something and add

a sixth to help the Enron employees, to help the people whose lives that you helped destroy? Can you do that?

Mr. BERARDINO. Congressman, I'm interested in doing things that pass two tests. Test number one——

Mr. SANDLIN. Can you help the Enron employees?

Mr. BERARDINO. Test number one is that this has to be public's interest to build confidence in our profession in the public mind.

Mr. SANDLIN. OK.

Mr. BERARDINO. And number two is has to improve the quality of auditing.

The steps I put forward are first steps.

Mr. SANDLIN. Thank you. Let me say this——

Mr. BERARDINO. The first steps that I think will help both those tests, and there will be more as we have a further conversation.

Mr. SANDLIN. That's a very charming story and——

Chairman BAKER. Can you——

Mr. SANDLIN. Yes, sir. That helps the accounting industry, but I'm interested in Arthur Andersen doing something and taking assets, taking some of those fees and putting them in the funds to help the people whose lives you destroyed, not just the accounting industry.

Thank you for coming.

Chairman BAKER. The gentleman's time has expired.

Mr. Royce.

Mr. ROYCE. Yes, sir.

The Powers Report states that your firm declined to speak with the investigatory board chaired by Dean Powers about the Jedi-Chewco transaction which was structured, in their words, in apparent disregard of the accounting requirements for non-consolidation. Now, today you told us that you did not refuse to cooperate with the board, and my question would be: would you be willing, then, to communicate with the Powers investigatory board regarding those questions?

Because we have two assertions that we have heard, one yesterday and the other today, by you. I guess the comment you made is, well, we're off the case, we're no longer employed by Enron. But that doesn't answer the question as to why you shouldn't respond to their inquiries, and my first question is, are you——

Mr. BERARDINO. Because they didn't make an inquiry. We offered to help. We were very available. We begged them to talk to us. We never saw a draft of the report. The board fired us in the middle of the investigation, and you're asking me to respond to things I saw on Saturday night for the first time.

Mr. ROYCE. I see.

Mr. BERARDINO. To answer your question specifically, we have been the most forthcoming firm, the most forthcoming profession. We're back here for the second time voluntarily, because we want to get it right. We will be happy to talk to anybody who's interested in getting to the bottom of this so I can answer these questions more specifically.

Mr. ROYCE. So if Dean Powers approaches you next week and asks to talk to the auditors who were on—site so we might be able to glean some information, you would be willing to allow them to do that?

Mr. BERARDINO. Absolutely.

Mr. ROYCE. The second question goes to the issue Chairman Oxley raised and just to repeat that assertion, as the *New York Times* put it, Enron's accounting treatments for the partnerships LJM and Chewco were determined with extensive participation and structuring advice from your company which billed Enron $5.7 million above and beyond its regular audit fees for this service. Chairman Oxley raised some questions. If we put those questions in writing so that you could then go back to the auditors who conducted this audit, could we then get some answers about that structuring agreement, about your participation, your firm's participation arguably in setting up those partnership agreements?

Mr. BERARDINO. We are here to be helpful any way we can be helpful.

Mr. ROYCE. All right. Well, I appreciate that.

The next question that I would have would go to the question of the document shredding that's been raised here today. What exactly was shredded? Could you enlighten us about what we know about those files? What did they pertain to? Was it the partnership agreements?

Mr. BERARDINO. Well, unfortunately, it's hard to recreate shredded documents. You can recreate deleted e-mails. And, from the moment we knew about this at the top of this organization, we have been trying to recreate whatever is possible to recreate, and we're able to recreate a lot of it. We are still studying what happened, why it happened, and as soon as that investigation is complete, we will make those results publicly available.

Mr. ROYCE. Could you give us some insight, since you've got some of the puzzle pieces together, as to the subject matter of what was shredded?

Mr. BERARDINO. No, I cannot. I just don't know.

Mr. ROYCE. All right. And it's been reported that Arthur Andersen cut a deal to handle some of the internal auditing work for Enron along with vetting its public reports for the trading firm's audit committee. The fact that your company audited Enron's internal and public financial data seems to pose a serious conflict of interest with Andersen developing Enron's internal accounting controls on one hand and then publicly attesting to the veracity of the data produced on the other. As CEO, did this strike you as a serious conflict of interest up until——

Mr. BERARDINO. No, it hasn't. And I would say back to the debate we had 2 years ago with the SEC, this issue was specifically debated and it is permissible for auditors to do internal audit work. Now, as you've read in my testimony and my spoken testimony as well, we understand that though we may win on debating points technically, there is a concern in the public interest, and that's why I have those two tests, is the public interest being served, does it undermine our credibility in the public? In this case, it obviously does, and that's why we voluntarily stepped forward and will no longer provide those services.

Mr. ROYCE. Do you think the entire accounting industry should pick up this same remedy in terms of conflict of interest and establish it as a reform industrywide?

Chairman BAKER. That's the gentleman's last question. His time has expired, but please respond.

Mr. BERARDINO. Frankly, given what happened here, the whole system needs to be looked at, and we are putting forward our ideas on our part in the system, and I think this is part of the conversation.

You've got the benefit of my wisdom. To the extent you agree with it or disagree with it, I think we can have a healthy conversation and debate and end up in a place where the public has more confidence in the profession and where we can do even better audits.

Mr. ROYCE. I thank you, Mr. Chairman; and I will be getting back with the questions that Chairman Oxley asked and that I asked so that we could have those in writing so that there could be some time for the witness to respond to us, because we'd like the specifics. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Royce. I'm sure the subcommittee will work on a follow-up series of questions on the subject you have brought to the attention as well as Chairman Oxley and a number of other issues which I think would be very helpful for the committee's proceedings.

Mrs. Jones.

Mrs. JONES. Thank you, Mr. Chairman.

Mr. Berardino, I, too, would like to have the benefit of your wisdom. Could you tell me how long have you been the CEO of Andersen, sir?

Mr. BERARDINO. Just over a year.

Mrs. JONES. What were you doing previously, sir?

Mr. BERARDINO. I was in charge of our auditing practice.

Mrs. JONES. And what's the purpose of an audit, sir?

Mr. BERARDINO. The purpose of the audit is to give investors an opinion on the fairness of the financial statements in accordance with the rules that are established.

Mrs. JONES. So, based on your audit, it was your opinion that Enron was an organization that investors should invest in; is that correct?

Mr. BERARDINO. We don't make judgments on who should be investing or not. It was a public company.

Mrs. JONES. Excuse me. Let me rephrase my question, then. Maybe I should say that, based on your audit, people in reliance on the name Arthur Andersen invested in Enron.

Mr. BERARDINO. Among other things that they rely on. They rely on their investment advisors, and so forth.

Mrs. JONES. Except that the reason we are seated here and you no longer represent Enron and the public is outraged, that there was something about this audit that did not represent the true financial status of the Enron Corporation. Is that a fair statement, sir?

Mr. BERARDINO. We're here because a big company collapsed very quickly.

Mrs. JONES. Let me restate my question. The reason we are here is because you audited Enron Corporation and the representations you made were not, in fact, a true financial picture of the corporation such that a lot of people lost money, and we're in a public

hearing trying to decide whether the auditing principles that have governed our Nation for the past few years are truly in the best interest of the public. Is that a fair statement, sir?

Mr. BERARDINO. And I'm here to give you some thoughts on how we might go forward with a much better——

Mrs. JONES. Well, then why don't you give me some thoughts? How is it that the public would not have been able—strike that. How is it that the public could not see what was wrong with Enron based on your auditing practice?

Mr. BERARDINO. I don't know how to answer that question. The public——

Mrs. JONES. You're an auditor, though, sir, aren't you?

Mr. BERARDINO. Yes.

Mrs. JONES. So based on the audit that your firm did, shouldn't the public have been able to see the problems with Enron?

Mr. BERARDINO. The public—really, what I can tell you is that in the 9 months before any of these accounting issues became public, this stock went down 70 percent.

Mrs. JONES. Let me ask you this.

Mr. BERARDINO. A number of——

Mrs. JONES. Hold up a minute. As the auditor, shouldn't you have been able to see the problem with Enron such that you could have told the public the problem that was going on?

Mr. BERARDINO. I think that's a fair question, Congresswoman, as to what our role should be. We audit in accordance with certain rules. If the rules are passed, we have no ability to say anything beyond what's in the management's financial statements.

I think a fairer question is——

Mrs. JONES. I'm not asking you to ask the questions. I'm asking the questions, sir. Hold on a second.

Let me say this, then. You, as Arthur Andersen and this group of auditors who give consultation to the SEC, and so forth, have the ability to lobby as to what are the appropriate rules and regulations, do you not, sir?

Mr. BERARDINO. Yes, we do.

Mrs. JONES. In fact, you lobbied very recently just in 1995 to have some change in the Private Security Litigation Reform Act that, as a result of that Act, there have been a high number of restatements by many corporations restating what their financial picture is, because before they were able to camouflage it; is that correct, sir?

Mr. BERARDINO. There have been a lot of restatements. There have been—we did participate in that bill being prepared. We also lobbied against these SPE rules and were unsuccessful.

Mrs. JONES. Let's stay with what I'm talking about. You can talk about SPE rules in your testimony, OK?

So there have been a ton—not a ton—a high number of restatements, and the restatements that were made by these public officials speak to what—excuse me—by these corporate officials speak to what?

Mr. BERARDINO. Restatements happen for one of two reasons. One is, there's an honest misapplication of generally accepted accounting principles or there is just a difference of opinion between the SEC staff and the auditor as to what the result should be.

Mrs. JONES. An honest misapplication of auditing principles or a disagreement between the SEC and the representatives of Arthur Andersen can cause Enron employees and people across the country to be in a financial disaster right now; is that correct, sir?

Mr. BERARDINO. I don't know.

Mrs. JONES. Let me ask you this, sir. What is the purpose of a consultant? I might be out of time, but answer that question for me.

Mr. BERARDINO. A consultant is to offer advice to a company on areas within whatever area of expertise they might practice.

Mrs. JONES. So on the one hand you audit and you give them—you go through the books based upon representations and you represent to the public the financial status of a company on the other side and you sit and consult and give them advice on how they should answer those questions.

Mr. BERARDINO. Well, auditors——

Mrs. JONES. Yes or no?

Mr. BERARDINO. Auditors have tremendous insight into a company and how they can be approved.

Mrs. JONES. But my question was a yes or no answer. Is that true what I stated about consulting and auditing?

Mr. BERARDINO. Yes.

Mrs. JONES. Thank you. I yield my time.

Chairman BAKER. The gentlelady's time has expired.

Judy Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman.

Mr. Berardino, as you know, Chairman Pitt testified before our subcommittee yesterday, and one of the questions that I asked him was regarding the SEC guidance that was released on January 22, and it involved the special purpose entities and the market-to-market accounting and the related-party transactions. Have you seen that release of the guidance?

Mr. BERARDINO. No, but I'm generally aware of it. In fact, we had a conversation with the SEC encouraging just that release because of the confusion that was out there in those issues.

Mrs. BIGGERT. On a couple of the issues, for example, the market-to-market accounting, and they were talking about the 3 percent rule, and I recall in someplace that your firm has not been in accordance with the SEC on the use of the 3 percent rule?

Mr. BERARDINO. Well, when that rule was put in place, we disagreed with it, and we're on record as disagreeing with it, but other people felt differently.

Mrs. BIGGERT. Do you think that—I just wondered if there was a change in that rule under these guidance terms.

Mr. BERARDINO. Not to my knowledge. I think there is suggested additional disclosures which were very unclear in the original pronouncement.

Mrs. BIGGERT. Does your firm intend to respond to those?

Mr. BERARDINO. Yes. Absolutely. I should say our clients are, and we are insisting that they do.

Mrs. BIGGERT. I noticed that he said that there have been no negatives to it so far. But, of course, it's only been 2 weeks, so that's not a very long time.

One of the proposals that has been suggested is rotating auditing firms every 5 years or so or at least a change in the partners in charge every 3 to 5 years. How long was David Duncan the partner in charge at Enron?

Mr. BERARDINO. I don't know, but I will tell you that there is a 7-year policy in our firm and in the profession, where you cannot be the signing partner on an audit for more than 7 years in a row.

Mrs. BIGGERT. The number of corporations that have retracted and corrected prior earnings has doubled in the past 3 years, and I think we have talked a little bit about this with Sunbeam and Waste Management, and these were not detected by the accounting firms, including yours. Do you think that the profession should, you know, maybe consider what are the ethic standards to avoid more of these embarrassments?

Mr. BERARDINO. This is a very fundamental question, and one of the problems we have is these rules are overly complex and subject to very different interpretations firm to firm and individual to individual. And although these restatements are very high, that does not mean companies are doing something illegal or immoral. It means that the rules are complicated, and we've had disagreements within the profession on how to apply them, and that does not do much for the confidence of the investing public when they see these restatements.

So I think there's a real serious question, I allude to it in my testimony, as to the complexity of the accounting, the legalistic nature of it, a flight to the lowest common denominator in financial reporting by some companies that really needs to be addressed as part of this conversation we're having.

Mrs. BIGGERT. Let me just go back to the 3 percent rule again. Because it seems that 97 percent of, you know, a special entity could be, let's say, Enron and only 3 percent an outside company, and that—or investor—and that would be enough—is that to cause a whistle-blowing on it or to say that there's something wrong with this.

Mr. BERARDINO. Well, to try to to defend the other point of view, not the one we had, the idea was that if you've got certain assets you wanted to move off your books, if those assets were sufficient to pay off the debt, an arbitrary bright line of 3 percent was brought in to say you need to have some outside investor involved.

We looked at it and said, you know, if you look at the form of it, you get to the answer of moving it off the books. But when you look at risks and rewards, 97 percent stays with the sponsoring company. It just didn't make any sense to us. And this is one of the fundamental questions about accounting as to what are you trying to accomplish. And in this case, unfortunately, the rules were drafted the way they were drafted.

Mrs. BIGGERT. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Biggert.

Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Berardino, I guess I'm one of the few people who have no trouble pronouncing your name.

But I'd just like to start off—I was just reading in the paper today some items on the issue, obviously, and some of the comments relative to Mr. Pitt's testimony yesterday and some of the concerns about his past association with the accounting field, and there was one comment I'd like your opinion on. After some of the recommendations you've made and some of the comments you made today, do you still think it's a good idea for the two open slots in the SEC to be awarded to people who are currently working for two of the major—the Big Five accounting firms, or do you think maybe we should reach a little bit for a little more independence?

Mr. BERARDINO. Congressman, you're an expert in public policy and oversight, and I'm not. I will tell you this. If you look at the accounting profession today, we are the most regulated profession you'll ever see. We have State Boards of Licensing. We have a Public Oversight Board. We're now putting two more Public Oversight Boards——

Mr. CAPUANO. Mr. Berardino, excuse me. That is not even close to true. I don't mean to be disrespectful, but I'm an attorney. I've dealt with accounting firms. My wife is a CPA. I know very well how you were overseen, by whom and by what; and most of the oversight for the auditing field is done by other auditors, as is proven on an annual basis or a semiannual basis by a peer review audit.

You are not the most heavily regulated profession in the field. You're not even close. That is one of the reasons, in my opinion, why we are here today.

Earlier, in response to one of the Chairman's questions, you said you cannot make clients report more than is required. I agree with you. However, you can add comments to your audits, which of course in this particular case every written report I have seen indicates, or any of those comments were confusing or misleading.

You can also qualify your reports. You can also add a disclaimer to your reports and if any of that fails for any reason, any partner within the firm can also add a dissenting opinion to the work papers for those audits.

Have any of those occurrences happened relative to Enron and Arthur Andersen? Have you had any disclaimers? Have you had any dings? Have you had any dissenting opinions in your work papers which you would know, because they are your work papers?

Mr. BERARDINO. The SEC will only accept an unqualified opinion. There is no such thing anymore as a qualified opinion. You can disclaim an opinion if you think the company is ready to go out of business.

Mr. CAPUANO. The problem with a qualified opinion is, you can do it, you just won't do it.

Let me tell you something else. When I was the mayor of my city, Arthur Andersen was the auditor of my community. They did a good job. As the client, like most taxpayers, part of my job is to push the envelope as best I can. I understand that. I respect that.

Do you know how people like me are kept in check? By the auditors saying if you do that we have to put a comment, we've got to put a ding, we've got to put a disclaimer. And that's what stops clients from going over the line. And if you tell me that you didn't do it—which I know you didn't do it, you know you didn't do it—

that doesn't require any legislation, that doesn't require any hearings, that doesn't require the SEC.

That requires Arthur Andersen or any other auditor to look in the mirror and say, is this right or is this wrong? If it's wrong and over the line I need, I am required—not can—I am required to put a disclaimer in there. I am required to walk away from this client.

Arthur Andersen didn't do that. And honestly I am not that angry. I am angry, of course, about the whole situation. What I am is disappointed. As a professional, I am disappointed that another professional organization that holds the belief and the trust of the American public in your hands blew it so badly.

Let me ask——

Mr. BERARDINO. Congressman, can I respond to that?

Mr. CAPUANO. Sure.

Mr. BERARDINO. One of the suggestions I put in the testimony I gave you is that we ought to have a formal ability to do that in our auditors' report, that we ought to have a formal ability to risk-adjust our opinion for those companies that barely get over the line of acceptability and contrast that with those that are at the gold standard.

Yet we say no. We say no a lot.

Mr. CAPUANO. Mr. Berardino, you do have that ability by walking away from a client. You say, excuse me, I love being paid, but this company is going to get Arthur Andersen in trouble. This company is going to get me in trouble. This company is going to render my partners liable for millions of dollars of problems in the future, possibly against me.

You do have that ability. You choose not to use it. I respect it. You do have that ability.

I was also reading about Global Crossing today. You have a great distinction of being the auditor on the largest bankruptcy in history and now the fourth largest bankruptcy in history. And I actually think that this committee should start looking into things other than just Enron.

I think we need to start asking questions; many of the same questions relative to this instance may or may not apply to other companies. Global Crossing has a lot of questions coming up. I am sure you are preparing for it internally because it is going to come. That's a problem. You got the first and the fourth.

Nobody saw it coming? Nobody did a disclaimer? Nobody did a dissent? That is problematic to me.

Chairman BAKER. You need to wrap up.

Mr. BERARDINO. Congressman, with respect, Global Crossing stock has been coming down for months and months and months, because its business was not succeeding. The prices for its product came down precipitously. And I think what we need to do—and you know this well, I'm sure—is we need distinguish between a business failure—and there will be business failures in this country—and an auditing failure.

And I suggest to you there will be more and more business failures, and if we immediately rush to judgment that said, where were the auditors——

Mr. CAPUANO. You are telling me that some of the news reports, which is all I know about Global Crossing, that they are all overre-

acting? There's no problems at Global Crossing? Please don't tell me that. I am not looking to catch you up. And I don't know anything about Global Crossing except what I read in the general media. But please don't say that today because you're under oath.

I am not looking to trip you up. Please don't say that, because I really don't want to be back here 6 months from now with you in front of us telling us, well, it really wasn't a business failure, there were accounting issues as well.

Chairman BAKER. That's the gentleman's time, but please respond to his comment.

Mr. BERARDINO. Congressman, all I'm trying to do is make sure we debate what we need to debate so we can improve the system. And I do think there is a misunderstanding in the American public between a business failure and an audit failure.

All I am suggesting is we are going to have the debate, and I am here because I want to be part of that debate. Let's debate the right issues, and I think your comments are very understandable and very fair in terms of what the right issues should be.

Chairman BAKER. The gentleman's time has expired.

Mr. Rogers.

Oh, Mr. Shays.

Mr. SHAYS. Thank you, Mr. Berardino, for being here. I think it's very clear that the Powers Report basically had an indictment practically of every profession. It went after attorneys, accountants, regulators, management, the board, bankers, analysts and the rating agencies, and it basically said, all of them, these independently failed to act properly. And you're obviously a major player in this process.

I give you high marks for coming before the committee in both December and now. But I am concerned, frankly, as I have been listening that you are deflecting questions by saying not enough time and you weren't there.

Mr. Oxley asked you a softball question. Even though you may not like to give it, he said, with hindsight, isn't it clear that Arthur Andersen failed to do its job properly? And I am going to ask you the same question, because maybe you have had more time to think about it.

Mr. BERARDINO. Congressman, you put me in a difficult position asking that question. It's a fair question, but I do think there are a lot of facts we don't know like, were we misled, was there information withheld from us, and I just don't know the answer to that question. I have admitted early on that we made a bad judgment and that caused part of the restatement.

We have also admitted that information was withheld in another transaction, and that was restated.

Mr. SHAYS. I would have to say to you that the easy answer and a simple one would be simply to say, we failed to do our job properly. I mean, that is the bottom line. It's what Powers has said. It's just basic reading of the documents to see what ultimately happened.

This company went under because it made very risky investments, but it was able to conceal these investments. When I look at what's available to you—I mean, the memo that was sent to Mr.

Duncan by Michael Jones is a devastating memo. Did you read that memo?

Mr. BERARDINO. Is that the one in February?

Mr. SHAYS. Yes.

Mr. BERARDINO. That was a memo, Congressman, where our team was discussing the risks at Enron.

Mr. SHAYS. Did you read the memo?

Mr. BERARDINO. Yes.

Mr. SHAYS. Let me read the paragraph.

"Ultimately the conclusion was reached to retain Enron as a client citing that it appeared that we had the appropriate people and process in place to serve Enron and management in our engagement risks. We discussed whether there would be a perceived independence issue solely considering our level of fees. We discussed that the concerns should not be on the magnitude of fees, but on the nature of fees. We arbitrarily discussed that it would not be unforeseeable that fees could reach $100 million per year."

That is an extraordinary—when I look at it, because then after February, then you get Raptor and you get exactly what happened, the failure to disclose and basically hide $800 million of liability and losses. So I would think as CEO, as president, as chairman, you would look and say, we know we failed to do our job; and now, as CEO, I am going to take care of this, as chairman, I am going to take care of this and correct it.

Mr. BERARDINO. Congressman, I put together six bold ideas as a first step. I am not sitting here telling you we did everything right. I am telling you we can do better. And I put some suggestions on the table to provide a good-faith deposit with this committee and the American public.

Mr. SHAYS. These ideas are very helpful, they truly are, both in terms of what you can do for your company and what you can do for the accounting industry and the profession at large.

Let me take your statement and say—this is on page 5: "As every accountant also knows, some companies do the bare minimum to meet generally accepted accounting principle requirements, while others are much more prudent in their accounting decisions and disclosures."

And then you go down and say: "What can an auditor do when financial statements prepared by management barely pass the current test, when they comply with the GAAP, but push the edge of the accounting envelope, when they disclose required information, but not other information that would be meaningful for investors?"

What else can the auditor do when a client squeaks by? Our only other option is to resign the engagement. Isn't there something in between? You know, we have a qualified question.

Mr. BERARDINO. That is exactly what I am recommending in my proposals here.

Mr. SHAYS. But you can qualify it. You have the ability now.

Mr. BERARDINO. Under our professional guidelines, we can issue a standard form report.

Mr. SHAYS. But part of that can be qualified. You can highlight a question that is of concern; isn't that true?

Mr. BERARDINO. I don't think so. And what I'm suggesting is——

Mr. SHAYS. I need to understand this part. You're telling me you either give them an A-plus or nothing or resign? Can't you express concerns about transactions? Can't you put footnotes in that say——

Mr. BERARDINO. We can recommend that and we have those conversations with audit committees who stand in the shoes of the shareholders because they are elected by the shareholders, and that's part of my comment about this quote-unquote conversation.

We report this to the audit committee, we make recommendations, but at the end of the day, we only can give the standard form report. And what I am suggesting is, you've got companies that are gold standard, others something like less than that.

Wouldn't it be helpful for us to have, if you will, a risk-adjusted opinion?

Mr. SHAYS. It would be helpful, but I would dispute and take strong issue that you don't have the ability to highlight a concern in a report with a footnote, with a qualified report. I, for the life of me, can't believe that you don't have the ability to do that.

Chairman BAKER. I think that is what certainly can be addressed with legislation the committee is formulating. If there is any doubt, I think we can make clear that that is a minimum requirement of audit responsibility.

Thank you, Mr. Shays.

Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

As the only CPA Member of the committee, I am perhaps the most disappointed. I would agree with the witness that, right now, your only tool is a nuclear bomb, that is to say that you can insist that reclassifications be made and the financial statements change. You can insist upon a footnote. If they say no, you can nuke them or you can acquiesce.

By nuking them, that is failing to give them an unqualified opinion. If you give them a qualified opinion, the SEC throws out the statement and the stock is selling for 25 cents the next day. If you give a disclaimer, the stock is selling for 15 cents the next day. And I do look forward to working with my colleagues to give you some conventional weapons.

I would like to put into the record with unanimous consent the *New York Times* article, January 27, 2002, that deals with this failed 1999 merger, because it's been characterized that VEBA, the German company, wouldn't go through with the merger because the accounting problems of Enron were so obvious.

I would point out that, at least according to the article, it was a clash of management styles plus a belief that they were being told it was going to be a merger of equals, but it would be like the Daimler/Chrysler merger, in which the merger of equals led to the Germans taking over and probably would have led to Enron taking over; and only as the third reason for the merger not going forward were concerns about aggressive accounting principles. And as I understand it, some of the people involved on the VEBA side were free to short the stock of Enron and none of them did.

[The article referred to can be found on page XX in the appendix.]

Chairman BAKER. Would the gentleman yield on that point? Since the discovery of that article, I have pursued some of the principles in the German-based corporation. We have talked to intermediaries and, for the record, although the article did not characterize it in that fashion, I am told by officials of the affected merger that that was one of the principal contributing factors for their concerns—for the record.

Mr. SHERMAN. I'm sure that it was an important consideration.

But I want to go on to Mr. Sandlin's comment, what are you doing for those who are hurt, particularly the employees, and ask you whether you would be willing to contribute to the relief fund, the amount equal to all of the fees you have collected from Enron in the last 10 years so long as a mechanism was designed so that if you had any liability through the legal process that you would get credit for your advance contribution?

Mr. BERARDINO. Congressman, I am not sure what the legal implications of what you suggest are. But I will tell you we feel deeply for the people who have been impacted.

Mr. SHERMAN. They expect the sympathy. They'd like the cash.

Mr. BERARDINO. I understand, and we'll take it on board if you don't mind.

Mr. SHERMAN. I hope that you'll get back to me in writing, because many predict that you are going to have billions of dollars of liability, whether you do or not. So long as you get credit for it when the books are closed, you ought to be providing that money now because a lot of people have lost their jobs already.

I've got a couple of questions where I am going to ask you to respond in writing because my time is going to expire.

I'm from the tax world where the IRS auditor and the private advisor are two very separate—and nobody goes to the IRS and says, can you structure my business deal for me, auditor, at the IRS. Now you are going to stop engaging, for your audit clients, in certain business consulting activities.

Can I count on you, or have you decided not to be engaged in structuring transactions and providing advice for, then, how your auditors will approve those transactions that are going to be reported?

Mr. BERARDINO. Congressman, I put a few—I said a "good-faith deposit" on the table in terms of these ideas. We need to have a broader conversation.

Mr. SHERMAN. Because that is where I see the greatest harm. A number of my colleagues have talked about the idea. If you get paid for advising on how to set up a SPE and then you come in and audit to see whether it's been done right, that may be of greater concern, being involved in internal auditing, which I wish perhaps you would continue to consider, or we as a committee ought to consider, whether that should be an area that you're involved in. Because there, at least, you're learning something about the company.

I would like to turn to the Enron transactions, because here you had phony transactions with phony entities, and all the discussion has been about the phony entities. Let me ask you if all the transactions that have been engaged with Jedi and Chewco and whatever, if all those transactions had been engaged in with legitimate,

well-capitalized, genuinely independent entities, would Enron statements have to be restated in major part?

Mr. BERARDINO. I don't know. I am not an expert.

Mr. SHERMAN. I hope you address that for the record within a month or two. Finally, if the Chair would indulge me, your written statement from your last testimony, where you said that you passed on $51 million of adjustments on the theory that they were immaterial when they were over 8 percent of normalized income and over 50 percent, or about 50 percent, of actual reported income, can I have your assurance that Arthur Andersen will require the restatement of all of its clients if there's a matter involving 5 percent of normalized income?

Mr. BERARDINO. We have worked closely, 2 years ago, with the SEC on the SAB 99 that came after the events in question, that have substantially clarified that issue. And we are giving our people very clear guidance on having no past adjustments.

Mr. SHERMAN. But you did not, when that announcement came out, require the immediate change in Enron's 1997, I believe, financial statements?

Mr. BERARDINO. No, we did not.

Chairman BAKER. The gentleman's time has expired.

Mr. Shadegg.

Mr. SHADEGG. Thank you, Mr. Chairman.

Mr. Berardino, I appreciate you being here, and I appreciate the tough position you're in. I think on the one hand, as Mr. Shays said, you get high marks for coming forward. I think your testimony is well done. I think the suggestions you have come forward with are appropriate and they are an attempt to try to improve the future.

Clearly, we have to do some things to improve in the future. The tough time you are getting here though has to do with the past. The analogy that occurs to me, it's like you own a bakery shop and it is a big bakery shop, and you discover that some baker down in the shop, unbeknownst to you, did some things that were inappropriate and now you are being called to answer the customer standing in front of you, yelling at you about the bad baked goods they got and the consequences that came from those, which could be pretty severe.

In this instance, the consequences are very severe, and I don't know how anyone in your position at the top of that bakery with thousands of bakers working for him can answer every question or solve every problem. I think you can, as you have done, come forward with some proposals for the future, but that doesn't resolve the past.

Now, I acknowledge that you can't admit certain things here. I'm a recovering lawyer. There are plenty of practitioners that are going to be taking a look at your testimony, and I don't expect you to make statements that are going to hurt your company in the long run.

I am troubled by a couple of different things. It seems to me that on the one hand, if we try to improve the system in the way you've outlined, without creating bright lines, hard rules—you cannot do this, you can do that—that we are going to put people back in this impossible position.

You talked about the nuclear weapon. You guys are put in a position where you have a very profitable account. You lose that account. If you give a certain answer, you keep that account; if you give the other answer, we are putting people in an impossible position.

It seems to me, we have to come up with hard and fast rules that say, for example, you cannot have an off-balance-sheet entity under these circumstances; and I think a lot of the trouble goes to FASB. A great deal of the fix has to go to whether FASB can be fixed or whether this Congress has to step beyond FASB and set some hard and fast rules.

Going, however, to some of the questions that go backward to what happened, I am looking at the memo actually of a meeting that happened exactly a year ago today, and that's the meeting that is documented in this memo where it says we need to do certain follow-up. And it appears to me that while you have done a good job of saying, here's what we should do in the future, I don't know what you have done about Andersen internally with regard to these people.

For example, on the to-dos, "Inquire as to whether Andy Fastow or LJM would be viewed as an affiliate from an SEC perspective, which would require looking through the transactions and treating them as within the consolidated group," was that, in fact, done?

This is clear back to last February and nothing came out until October.

Mr. BERARDINO. I don't know. I would be happy to get back to you.

Mr. SHADEGG. Are you looking at your personnel to see if that was done?

Mr. BERARDINO. We are looking at everything—not just our personnel—our processes, the way we run our firm. That is why we brought Chairman Volcker in, because frankly I wanted to get some outside perspective, not just have us be thinking in our usual paradigm. So I gave you some initial ideas. We will be coming forward with more ideas.

Mr. SHADEGG. This memo goes on to say that a special committee of the board of directors should be created to look at these ethics issues. Have you determined whether that special committee was established?

Mr. BERARDINO. I don't know. Eventually, as you well know, Vinson & Elkins did work more toward late summer.

Mr. SHADEGG. It seems to me that as forthcoming as you are being in looking forward and the suggestions you are making to go forward, Arthur Andersen has to look at these individuals and has to decide whether they acted properly and whether they didn't and do something about that.

That takes me to another troubling instant. This memo is written to David Duncan, and he's now been fired; and I have to tell you, for the all the world, he looks to me like a fall guy. He has now been fired over the issue of shredding of documents. And yet there are memos that appear in the popular press that I have read that suggest an attorney in your Chicago office by the name of Nancy Temple, in fact, pretty much instructed him to shred, albeit in a cagey way by saying that we have this policy on shredding,

and then pretty much telling him not to or to stop the shredding. And it seems to me it is not doing Arthur Andersen any good or anyone in this investigation any good for you to try to create a fall guy.

Did you do a thorough investigation of both Mr. Duncan and Ms. Temple before he was fired? And are you looking yourself now in terms of rehabilitating Arthur Andersen and whether or not it was appropriate to fire Duncan or whether or not he is, in fact, being made just a fall guy?

Mr. BERARDINO. Congressman, I personally do not look for fall guys. I understand the optics of what we have done. Within days of finding out about this destruction, we self-reported, publicly reported; and on the preliminary—underline "preliminary"—investigation, realizing there was some egregious conduct, we also brought in Senator Danforth to say that we are open for inspection and we are completing that investigation.

So from the beginning of January, about a month ago, we first found out about this. And we are not looking for fall guys; we are looking for the truth, and we will deal with the truth when we have all the facts. And many people will second-guess what we will do, and they're welcome to, because we are not an organization that looks for fall guys. We are looking for the truth.

Mr. SHADEGG. Let me ask you two quick follow-up questions.

Do you agree with me that we need some hard and fast rules here, and do you agree with me that FASB has to be a part of this overall review in terms of having generalized rules that people can bend putting them in an impossible position?

Mr. BERARDINO. Congressman, I agree with just about everything you said. I think everything is up for grabs and we need to look at all these issues, including the ones you mentioned.

And I want to specifically thank you for recognizing the hard position I'm in with all the investigations in terms of looking backward and admitting or denying or anything else. The facts will come out. This firm will be forthcoming. We have given every possible signal to our availability for these inquiries, through our actions when things went wrong that we prefer didn't go wrong, to let people know what the real values of this organization are.

And now we are putting forward some ideas for all those who want to come forward as part of the solution to be involved in.

I fully respect your points of view and I wish I could be even more forthcoming.

Mr. SHADEGG. I appreciate your testimony and particularly the suggestions you have made.

I yield back the balance of my time.

Chairman BAKER. The gentleman's time has expired.

Mr. Inslee.

Mr. INSLEE. Thank you, Mr. Chairman.

You know, the thing that's most stunning to me in this is that as far as I can tell, no one stood up at your firm until the very last second of the game and said, "Houston, we have a problem." And because no one did that personally—I am not talking about institutionally—but, no one took it personally upon their shoulders to take that stand.

You're having a very well-deserved flogging today. But I want to tell you that it's not just your firm that was affected by Enron—I think you should be aware of this—it's the whole Federal Government.

You know, first Enron captured the Administration's energy policy of this country and exposed the western United States to enormous increases in their electrical bills. Second, then they captured the House that passed a tax cut bill that would have given Enron over $250 million worth of retroactive tax relief. Back in the 1990s, they captured the Commodities Futures Trading Commission, which obtained total deregulation of their futures contract that formed the whole basis of this disaster.

They have captured the Federal Government, not just your accounting firm. Now we are trying to do something about that by passing campaign finance reforms.

Mr. Shays has been one of the great leaders on that subject in Congress. And we are going to have that up for a vote shortly, and I would like to know if you think that it would be helpful to regain investor confidence, the public's confidence not only in you, but in the Federal Government's ability to regulate these industries to pass a campaign finance reform bill. Does your company back that?

Mr. BERARDINO. Congressman, I am not a politician. I'm a citizen. I'm a professional. That is not really my area of expertise, and I just really can't offer you a professional opinion on that.

Mr. INSLEE. We would appreciate you developing a position on that, because you ought to recognize, if anybody does, what happens when the Federal Government drops the ball regulating private industry. And you need to develop a position on that, and Corporate America needs to develop a position on that so we can get honest campaign finance reform through here.

I want to ask you about this FASB situation. This 3 percent rule—and I'm sorry to say I was not aware of it until these hearings started—is one of the most ridiculous things I ever heard of in terms of trying to capture real economic activity. You have taken the same position, in essence.

Looking at the track record of FASB and the lack of a track record, do you think at this moment we are going to have to assume some decisionmaking by elected officials who are answerable to the public to really get some meaningful reform to get these rules to really be more reflective of honest economic activity?

Mr. BERARDINO. Congressman, I think that's a fair question. I don't have a strong point of view except to this extent.

The American public—and I recognize I am speaking with the people today—have got to decide what they want from the accounting profession, from management, from the whole structure that we have. And one of the fundamental problems we've got is, nobody knows what these financial statements are supposed to do. And as a result, we have evolved to this bright-line rule-making.

There's one opinion on derivatives that's 500 pages long. You need to be a rocket scientist to understand it and interpret it.

So are there fundamental problems and questions? Absolutely. I would suggest that it starts with an honest conversation as to what we're trying to accomplish, and honest people can be in different places there. And that, I think, is a fair dialogue; and I think FASB

and the SEC, accountants' offices and others need to be part of that conversation.

Mr. INSLEE. Let me ask you, in your opinion, how much have these failures—I will call them failures—been repeated, and are they being repeated right now. Let me tell you why I'm real concerned.

You passed, I'm told, with flying colors what was styled as a peer review fairly recently. I have to tell you, that is very concerning to me to think that given what happened in this instance, you were given in a peer review a passing grade.

How prevalent are the auditing activities that you were engaged in, where you essentially allowed a corporation to hedge with its own stock over and over and over again? How prevalent is that in auditing in our economy?

Mr. BERARDINO. Congressman, great question. Two points:

Number one is, the vast majority of companies wake up every day trying to get it right. Some cases, the rules are really hard; some cases, the subjective decisions are very difficult.

Number two is, our 28,000 people in the United States wake up every day trying to get it right. I have been going all over this country speaking with my clients, and they say, who's the real Andersen, the one we read about in the paper or the one we see every day that's tough as nails, that's calling it hard, that's making us make the changes that are required or the one we read about in the newspaper? So I would suggest to you that this is big, this is tragic, this is something alarming here. But many companies, and our firm, get it right a lot.

Chairman BAKER. This is your last, Mr. Inslee.

Mr. INSLEE. I want to read you something from Mr. Powers' Report. He says, "Let me say that while there are questions about who understood what concerning many of these very complex transactions, there's no question that virtually everyone from the board of directors on down understood that the company was seeking to offset its investment losses with its own stock. That is not the way it's supposed to work. Real earnings are supposed to be compared to real losses."

My question is, how many other corporations besides Enron would that statement apply to today as far as you know? Is this——

Mr. BERARDINO. Very, very few. Many companies enter into SPEs. That's very common. But I would suggest to you that many, many companies, a vast majority, 99 percent, are trying to get it right.

Chairman BAKER. The gentleman's time has expired.

Mr. Ferguson.

Mr. FERGUSON. Thank you, Mr. Chairman.

Just an introductory comment on some of my colleagues' comments before. We have to be very, very careful not to turn this into a partisan battle. This is not a partisan situation. You know—we are in a fact-finding mode right now; and you know, one thing that we do know is that Enron made billions of dollars when the Clinton Administration was in power, and when the Bush Administration came to power, they went bankrupt. That is not a suggestion of anything other than there are certain things we need to know and

there are certain things we need to find out. But one thing that we are realizing very quickly is that—as we try to score political points in this situation, we realize that the facts simply don't support that.

Now, in our continuing fact-finding mode, I have some questions and I had some questions during my introductory comments. I am interested in the use of SPEs; and specifically, Mr. Berardino—and I realize that you are in a difficult position here. I do appreciate the fact that you're here. I realize there have been a number of questions that you have been unable to answer, and frankly, I think there are some you should be able to answer and I hope you will get back to us with some of those answers.

And what I said in my introductory comments, that we are going to ask tough questions and we are going to expect some answers, we are going to ask that you get us those answers in as quick a manner as possible. We will expect that from other witnesses who did not show the courtesy of responding and appearing here today, and I appreciate your willingness to be here today.

How many of Andersen's other clients currently use SPEs to keep material amounts of debt off the books? Do you have any estimation of that?

Mr. BERARDINO. No.

Mr. FERGUSON. Can you find out?

Mr. BERARDINO. We can try. Yes. Sure.

Mr. FERGUSON. Is that of interest to you? There is a catastrophic result in not finding out that type of information. In this particular situation, I would think that that might be something that you would be interested in finding out from some of your other clients.

Mr. BERARDINO. As one of your colleagues mentioned, the SEC recently put out some clearer rules and guidance on SPEs.

We have clearly given our people guidance to say that SPEs exist, the kinds of disclosures, the kinds of audit procedures, the kinds of discussions with boards. I don't know that we've accumulated which clients are in that category, but I will give this committee every confidence that we're all over this issue with all of our clients.

Mr. FERGUSON. Let's talk about credit rating agencies. Do you believe these agencies have fulfilled their responsibilities to the public?

I'm not asking you as an expert. I'm asking your opinion. You're a CEO of a major company in the financial field.

Mr. BERARDINO. Credit agencies—I refer to them in my statement; they have unfettered access to all the information relevant to the financial health of an organization. They made judgments, we made judgments; you can draw your own conclusions.

Mr. FERGUSON. Do we need to be considering additional regulatory reforms in this regard?

Mr. BERARDINO. I think everybody in the system should be evaluated, and I would put them on my list, absolutely.

Mr. FERGUSON. They are on my list. I can't speak for the Chairman or anyone else in this committee, but we have regulatory oversight and legislative responsibility. And this is a tragic situation, as others have noted. And in addition to the frustration that I feel for those who have lost out, in my estimation, to others who have

made millions of dollars, including Mr. Lay, that is an unbelievable development, in my estimation.

The last question I have is that of the report that Ken Lay was given a fully-funded pension of a half-a-million dollars. Are you familiar with this? Was it audited? And can it be rescinded?

How can a bankrupt company give a half-a-million-dollar pension to an embattled, if not problematic, CEO?

Mr. BERARDINO. It's a good question, and I don't have an answer. I was not aware of it until you mentioned it.

Mr. FERGUSON. Thank you, Mr. Chairman. I have no further questions.

Chairman BAKER. Thank you, Mr. Ferguson.

Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

And thank you, Mr. Berardino, for being here. Are you aware generally of the timeframe in August of the year 2000 that Enron stock peaked at about $90 a share?

Mr. BERARDINO. Yes.

Mr. MOORE. Are you aware that in August, 1 year later in 2001, that Jeff Skilling resigned as CEO and Ken Lay became the new CEO?

Mr. BERARDINO. Yes.

Mr. MOORE. At that time the stock price was about $43 a share; does that sound about right?

Mr. BERARDINO. Sounds about right.

Mr. MOORE. That was August 14 of 2001. And 1 week later, are you aware that Ken Lay sent an e-mail to employees, touting the stock of Enron; and basically said that he, quote: "never felt better about the prospects of the company; our growth has never been more certain."

Are you aware of that memorandum?

Mr. BERARDINO. Yes.

Mr. MOORE. Do you believe that to be a truthful statement, accurate statement at that time in August of 2001?

Mr. BERARDINO. Congressman, I have no inside information of what might have been in Mr. Lay's head.

Mr. MOORE. I'm not asking you about what was in Mr. Lay's head. I'm asking you, as the auditors for Enron in August of 2001, and specifically about August 21, do you believe that to be a correct statement that the prospects for Enron were never better?

Mr. BERARDINO. We audit and don't predict the future. I have no point of view.

Mr. MOORE. I am not asking you to predict the future. As of August of 2001, I'm asking; at that time in August of 2001, specifically the 21st, sometime in August of 2001, was Enron in good shape?

Mr. BERARDINO. I don't know.

Mr. MOORE. You were the auditor and you don't know if Enron was in good shape in August of 2001?

Mr. BERARDINO. Our firm was the auditor, and you need to talk to people who were closer to the account to get a better answer. I just can't answer that responsibly right now.

Mr. MOORE. Would you try to get me an answer for that from your firm?

Mr. BERARDINO. We will be happy to make whatever information we have available.

Mr. MOORE. Would you make that information available to me by talking to the people who conducted the audits, and tell me if they believed in August of 2001 that Enron was in good shape, "never been in better shape"?

Mr. BERARDINO. Congressman, with respect, we do not pass judgments on whether companies are in great shape, terrible shape, and so forth.

Mr. MOORE. You give a pass and fail, right?

Mr. BERARDINO. We give an opinion on financial statements, based on their applying the rules.

Mr. MOORE. How many SPEs were associated with Enron?

Mr. BERARDINO. I don't know.

Mr. MOORE. You don't have any information as a result of being the auditors how many SPEs there were?

Mr. BERARDINO. We can try to get you that information.

Mr. MOORE. I would appreciate that, as well. Is there an obligation to disclose all SPEs associated with a company such as Enron?

Mr. BERARDINO. No.

Mr. MOORE. And that's the 3 percent rule; is that correct.

Mr. BERARDINO. No.

Mr. MOORE. Correct me then.

Mr. BERARDINO. Many companies have special-purpose entities where they move assets and liabilities off the books. The judgment that has to be made is, how probable is it that those liabilities will come back on the books, because the assets that had been moved off the books—you know, will it be a self-sustaining entity or not.

The rules are designed for those assets to pay off the liabilities. If at any point——

Mr. MOORE. Why would those be moved off the books?

Mr. BERARDINO. Because the company wants to show a better financial position, perhaps attract a lower cost of capital.

Mr. MOORE. They want to show a better financial position to the people who might purchase their stock, correct?

Mr. BERARDINO. Yes.

Mr. MOORE. And would the people who might purchase their stock be in a position to know about these SPEs when a company such as Enron moved these SPEs off their books to show themselves in a better financial position?

Mr. BERARDINO. The rules at the time—if the assets can sufficiently satisfy the liabilities, there was no requirement——

Mr. MOORE. I understand what the rules are. I am asking you—let's strike that and move on here.

Would you support a provision for full disclosure of all SPEs without regard to 3 percent?

Mr. BERARDINO. I support a relook of all the SPE rules, because they are mistaken in the first place.

Mr. MOORE. How are they mistaken?

Mr. BERARDINO. We ought to use the judgment—the authoritative literature should look at the risk and rewards of the SPEs which—in this case, we're using the 3 percent—would be 97 percent, and therefore many of them should not be moved off the books.

Mr. MOORE. Is there any reason that you know of that there shouldn't be full disclosure?

Mr. BERARDINO. Well, I think it really depends on the risks inherent in the SPEs. Many of these are fairly benign where the assets will liquidate the liabilities. And you get to the point where you give so much information to an investor, it's data, it's just information that is hard to sort.

There needs to be a judgment at the end of the day, and that's why I resist some of these bright-line rules, and others seem to agree with that, because you need judgment as to what would be relevant to an investor.

Mr. MOORE. You told Congressman Inslee there needed to be a debate, and the American people need to decide what information they need. Do you remember that comment?

Mr. BERARDINO. Sure do.

Mr. MOORE. Would you agree that the American people are entitled to full information, accurate information, so they can make an informed decision before they decide to purchase stock in a particular publicly traded corporation?

Chairman BAKER. And that is the gentleman's last question.

Mr. BERARDINO. Yes.

Chairman BAKER. Mr. Cox.

Mr. COX. Thank you, Mr. Chairman.

Mr. Berardino, have you read this, apparently, e-mail that my colleague Mr. Shays referred to earlier, from David Duncan in February of 2001—to David Duncan from Michael Jones in Houston saying about the 14-person meeting, some by telephone and some in person, and the purpose of that meeting was to determine whether to keep Enron as a client? Are you familiar with that memo?

Mr. BERARDINO. Yes.

Mr. COX. Am I characterizing it fairly, that the purpose of that meeting, which is recounted in this e-mail, printed in this memo, was to determine whether to keep Enron as a client?

Mr. BERARDINO. I'd just make a slight modification.

We have meetings like this regarding every one of our clients, to assess the risks of the client in terms of their financial viability, the accounting they're using, the people we have assigned and, yes, the decision as to whether we would retain them or not.

So I'd suggest, this is part of a process and not a unique meeting relative to Enron.

Mr. COX. Presumably, in most of those meetings you don't have discussions with so many people about the fact that your client's month-to-month earnings are, quote: "intelligent gambling," which is stated——

Mr. BERARDINO. That's a fair characterization.

Mr. COX. This is a pretty serious meeting, and it was a year ago.

Mr. BERARDINO. Absolutely.

Mr. COX. Did you write a letter to the audit committee of the board on the basis of that meeting?

Mr. BERARDINO. Not to my knowledge.

Mr. COX. Are you aware that Federal law requires you to do so if there's any concern about violation, for example, a 10(b)(5) violation of the requirement to present fairly the financial results?

Mr. BERARDINO. We are very aware of those rules, but that was not the context of the meeting nor the conclusion of the meeting.

Mr. COX. I'm referring to in Federal law, Section 10(a) of the 1934 Act, as amended by the Securities Litigation Reform Act of 1995, Section 10(a) which was added, imposes—and I am sure you are familiar with this, because you used to head up auditing—imposes a requirement on the auditors that if in the course of the audit engagement, they come across any information that might be illegal—and "illegal" is defined as even violating a rule—then they are required formally to bring it to the attention of the audit committee. And if the audit committee doesn't do what they like, then they are required to formally bring it to the board.

The board gets one business day to notify the Commission, and the Commission is supposed to copy you on that letter to make sure that you know the Commission got it.

Did any of those things, at any time in your representation of Enron, take place?

Mr. BERARDINO. Congressman, I read that memo, and I didn't see anything in that memo and——

Mr. COX. You resigned the engagement. When did you resign the engagement?

Mr. BERARDINO. We were dismissed by the client at the end of December.

Mr. COX. When did that occur?

Mr. BERARDINO. I don't remember. December, sometime.

Mr. COX. December. At any time during your representation of Enron did Arthur Andersen ever follow the procedures outlined in Section 10(a) of the 1934 act?

Mr. BERARDINO. The only situation that I'm aware of was the Watkins memo in late August.

Mr. COX. In response to the Watkins memo, did you trigger the process described in Section 10(a)?

Mr. BERARDINO. The company took it immediately to its legal counsel, outside legal counsel, for investigation.

Mr. COX. Vinson & Elkins interviewed two Andersen partners that were quite sure that Andersen was on notice of everything that was going on with that Watkins letter and the Watkins meeting with Lay.

In response to that, did you then start the procedure that's described in Section 10(a)?

Mr. BERARDINO. I don't know, Congressman. We will have to get back to you with that.

Mr. COX. Section 10(a) of the 1934 Act also requires that you take into account the potential materiality, although it doesn't require materiality. The Act explicitly states even if it's not material, then you've got to start this procedure; but one of the things you are supposed to do in your investigation is to determine the litigation effect, the potential damages and so on.

Did Arthur Andersen ever do that? Did you ever figure out how much money people might be liable for in a lawsuit as a result of—let me make a request; and I have discussed this with the Chairman, and with his permission, let me make a request that Andersen provide to this committee your work papers and any docu-

mentation of the tests that you performed and the analysis and estimates that you performed under Section 10(a) of the 1934 Act.

Mr. BERARDINO. Well, you know, I don't see any reason we couldn't provide that, but we will confer and we will be as helpful as we can be.

Mr. COX. Let me say in conclusion that your statement, what can an auditor do, what is an auditor to do, strikes me as amazingly cramped. It's a cramped view of the tools at your disposal.

You don't lose your First Amendment rights to write a letter to your client. There's nothing preventing you at any time from writing a letter to your client saying "Today, we have issued you a clean opinion. We have done so because technically you are in compliance with GAAP. We want you to know however, Mr. Client, that we think you are skating on thin ice. We disagree with the judgments you have made, and we think there is a serious risk that you are misrepresenting to investors and to the public and to everybody who depends upon these financial statements the results of operations. Therefore we strongly recommend that you make different accounting choices. Consider this to be an integral part of our opinion that we have issued today. Sincerely, Mr. Berardino."

There is no reason in the world you can't do it. The 10(a) procedure that we added in the 1934 Act to the law that we passed in 1995 has a formal way to do that, and it also provides whistleblower protection so that nothing you say in such a letter could be used to hold you or any accountant that works for you liable in any civil proceeding.

You are completely free to say whatever you like so far as the rules hemming you in: What's an auditor to do? My gosh, we would have to resign the engagement or nuke them there or else keep our mouth shut.

There are a lot of ways in between that you could address it.

Chairman BAKER. That is a did-you-know, and that is your last question.

Mr. BERARDINO. Congressman, we would be happy to show you whatever documentation we have on the conversations that we had with the audit committee. And I will tell you, there were meaningful conversations. So I understand your point; I think it's a fair point. I just want to let you know that there were specific conversations with the audit committee.

Mr. COX. I would yield to Mr. Shays.

Mr. SHAYS. I think that would be helpful if you could submit that to the committee.

Chairman BAKER. I can assure the Members on both sides that all issues raised in the course of questions today will be summarized in a document by staff and forwarded to Andersen for their appropriate response on all matters raised for which there was no direct resolution today.

So this matter certainly will be one of the topics on which we will——

Mr. BERARDINO. We'd be happy to be as helpful as we know how to be.

Chairman BAKER. Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman. This is a postmortem on Enron. And what we're trying to do is identify an individual's

misdeeds, shortcomings, as opposed to those that may be systemic; and it is not the easiest thing to do. And not to overreact, overregulate or overlegislate, but we've reached a point where something's going to get done. And it's going to get done real quick. And when something gets done real quick in the legislative body it's not always the best result. So I am hoping that we will cautiously proceed.

I used to be a district court judge, and the plaintiff's expert accountant would get up there and evaluate an estate or company at $10 million. Then the defendant's expert accountant would say it was a minus-$250,000. And I thank God for the independent accountant that I would appoint to come in and testify.

Now all three qualified—their credentials, their licensing—and they all came down and they would say they all applied the generally accepted accounting principles. So what I would ask the court's expert, then how can we have such a range? And he would say, garbage in, garbage out. And that was the quality of the data that was looked at by the experts.

My question to you really has to do with the quality of the data that your people look at that's provided by the client and to the extent that you control the quality of that information. In your written testimony you say, what can an auditor do when financial statements prepared by management barely pass a current test?

When they comply with GAAP that push the edge of the accounting envelope, when they disclose required information, but not other information that would be meaningful for investors, the auditor can go to the company's board through its audit committee. You said you conducted meaningful conversations—your people had meaningful conversations. You did take that step; is that correct?

Mr. BERARDINO. Yes.

Mr. GONZALEZ. And you still felt that at that point the only thing you could do was give them a passing grade; whether they pass or not, you just move them on?

Mr. BERARDINO. I am talking about that in the abstract, not in the context of Enron.

Mr. GONZALEZ. Well, in the context of Enron, because this is an Enron postmortem.

Mr. BERARDINO. I can't answer that question specifically on Enron, because you are absolutely right about garbage in, garbage out.

But the only thing I would add is, why is it OK to mislead an auditor or hold information away from an auditor; and we don't know to what extent that happened in this case.

Mr. GONZALEZ. Now the German outfit some time ago had enough information, less than what was available to you as the auditor of Enron, and came to a conclusion that those books did not really tell the true story.

Mr. BERARDINO. I don't know what they had, what they didn't have, nor the basis of their conclusion.

Mr. GONZALEZ. The *New York Times* story, January 22, notes that as early as November, 2000, Andersen had concluded that Enron's internet servicing unit, which the company considered crucial to its growth, had such poor controls that there was a high risk

that its financial results would be misrepresented. So you knew there were some problems going on.

Mr. BERARDINO. I haven't denied that, and I just responded that we had meaningful conversations with the audit committee about some of these problems.

Mr. GONZALEZ. What do you do to guarantee the quality of the information that you are receiving?

I agree with you that they have no right to mislead you, but you're in a position to know when they're pulling your leg.

Mr. BERARDINO. And we have got human beings making judgment calls, and I don't know how good or bad those calls were, because I don't have all the facts.

Mr. GONZALEZ. Let me conclude with this. This is from your written testimony.

"In recent days"—it is not; it was a report—"Andersen has announced that it will no longer accept new assignments related to internal audit outsourcing and the design and implementation of financial information systems for its publicly traded audit clients."

Does that translate to consulting services, and if it does, did it allow you to basically design a reporting model that determined the quality of the information that was being presented out there for public consumption by Enron?

Mr. BERARDINO. We did not design any accounting models for Enron. What we put on the table here is in response to public observations that we will take some of these consulting services off the table as it relates to our audit clients, because it passes those two tests I mentioned earlier.

Mr. GONZALEZ. Design and implementation of financial information systems. What does that mean then?

Mr. BERARDINO. We will no longer do that for audit clients. And 2 years ago when we had debate with the SEC, we agreed that that would be OK to do that.

Mr. GONZALEZ. How did this manifest itself in your relationship with Enron?

Mr. BERARDINO. We did not, to my knowledge, design systems for Enron.

Chairman BAKER. The gentleman's time has expired.

Mr. Ford.

Mr. FORD. To follow up where I think my friend was going with regard to Andersen's suggestion that you would no longer design or implement these financial information systems for your future audit clients, aren't these types of consulting engagements, Mr. Berardino, a fraction of the consulting work that Andersen performs for its audit clients?

To what extent rather does this represent——

Mr. BERARDINO. That information is public knowledge.

Mr. FORD. That may be true, but just to what extent. I am not that bright.

Mr. BERARDINO. It's meaningful. It's not 100 percent.

Mr. FORD. How much of the $52 million in fees you received from Enron last year are attributable to this type of consulting work that you now propose to discontinue?

Mr. BERARDINO. Very little.

Mr. FORD. Say the system was in place beforehand. To what extent—and I know, again——

Mr. BERARDINO. The number would not have changed significantly, because the nature of the work we were doing for Enron was accounting and auditing related.

Mr. FORD. I would imagine that this controversy in the wake of this controversy is what motivated this proposal on the part of Arthur Andersen.

Mr. BERARDINO. Actually, Congressman, with permission, this is not the test case. Enron is not the test case in terms of the nature of the work we were doing, being auditing our own work. There are many other companies where we do quite a bit more either in absolute dollars or percentage-wise.

The reason we have taken this step is because I think in the current context it is important that my firm, my profession, builds more confidence in the public in terms of potential conflicts of interest and the quality of our auditing. And I thought from a public positioning standpoint, this would be an appropriate step.

Mr. FORD. The only reason the public is even interested in what you guys do is because of what happened. This case is such a high profile. And forgive me for presupposing, but maybe this was motivated by the failure of this company.

So can I take it, perhaps the motivation for this, also, that one can glean from this proposal is that this is perhaps an admission on the part of Arthur Andersen that maybe you were wrong to oppose Mr. Levitt's recommendations?

Mr. BERARDINO. Well, you know, frankly, I challenged Mr. Levitt on those proposals.

Life goes on, and I do think it's important that we respond to public perceptions, and that's what we're doing.

Mr. FORD. Is this——

Mr. BERARDINO. Let me be honest with you. I don't think the fact that we will not do this work will make us better auditors tomorrow. I think some of the other proposals they put on the table will move us in that direction more clearly.

Mr. FORD. Of the $5.7 million you received for your services, how much of that was for the design and implementation of these financial information systems?

Mr. BERARDINO. None.

Mr. FORD. You have suggested withholding of material information from an auditor should be made a felony. Are you willing to go on record saying that the destruction of audit-related documents should also be classified as a felony?

Mr. BERARDINO. Congressman, as you know, we put the limelight on that issue. I am embarrassed at what happened in my firm. And I have been forthcoming in reporting it and forthcoming in inspecting it, bringing in Senator Danforth, a man by who all reports enjoys many peoples' respect, to help us come up with the best possible policy and, hopefully, a model.

Mr. FORD. But you've taken the bold step of suggesting that if your clients withhold this information, that that should be classified as a felony. Shouldn't destruction of documents, audit-related documents, also in the same vein, be classified as a felony?

Mr. BERARDINO. I think it already is, Congressman. If you purposely destroy documents that you think are relevant to an investigation, but, you know, it's inappropriate, it should be unlawful. I agree.

Mr. FORD. We have heard, as I stated in my opening, we've heard of other instances of document destruction by auditors in the wake of a problem audit. Grant Thornton being an example, another big accounting firm, destroyed documents during litigation of a failed audit, and it seems that we may be in need of industry-wide retention policies that include severe penalties for offending accounting firms.

Your commitment today—I understand that you've been asked some pointed questions from my colleagues, and I associate myself with what Mr. Cox has requested of the Chairman, and I hope that he accommodates him, but would you be willing today to support mandatory retention, availability of all audit work papers and other audit-related documents so that the investing public can look behind those audits and make their own judgments about the financial health of companies in which they wish to invest?

Mr. BERARDINO. I don't know where the white line is, Congressman. I am prepared to have that discussion. We've taken a public lead there, and so in good faith, we'd be more than happy to take whatever advice to get to the right answer, but I can't be any more specific than that right now.

Mr. FORD. Maybe I should—and there's two quick questions. You said you'd be willing to cooperate. Are you willing cooperate with—to the extent you can with the lawyers for the defrauded investors and the lawyers for those investors who believe they were defrauded and cooperate with the lawyers for the employees at Enron?

Mr. BERARDINO. I have a feeling they'll want me to cooperate, but absolutely.

Mr. FORD. Last question. I'm a little—I'm reading through, and everyone has sort of referenced Mr. Powers' document here, and I think this has been an education for everybody about how and what auditors do, and companies like the kind of work and the advice that you provide, but I'm slight—my understanding of these four words, and I just—I graduated from law school. I know I look like I just graduated from law school, but I did graduate a few years ago.

But in page 5 of Mr. Powers' Report, it says in virtually all of these transactions, referring to Chewco and LJM, Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen which management reported to the board. What does extensive participation and structuring advice mean in the eyes of folks in your community, because maybe I don't understand what auditors do, but my just sort of initial elementary understanding would suggest that extensive participation means you did a lot.

I know we come out with these words dislocation, meaning you lost your job or—but extensive participation from where I come from means you did a lot, and structuring advice means you helped them put the thing together. Maybe you didn't do that, but could you respond to maybe what those terms, in your eyes, mean, sir?

Chairman BAKER. That's the gentleman's last question.

Mr. BERARDINO. We're trying to communicate on this one. Investment bankers come up with these ideas, or the finance department or somebody other than us. It's not like we are running around town shopping these ideas. Our client comes to us and says here's the transaction we want to do, we think this is the accounting answer. Do you agree? And we say no a lot. OK. The company comes back and says OK, will this pass? No. OK. They come back. OK, now it passes the test. Now, to some people that's called structuring the transaction. To an auditor that's called standing up and defending what the right accounting should be. And so, I'm not smart enough to know what word to use for that kind of interactive conversation, but that's what was going on.

Mr. FORD. But you did eventually say yes after those questions that they reported back——

Mr. BERARDINO. Absolutely. Yeah.

Mr. FORD. Thank you.

Chairman BAKER. Mr. Lucas.

Mr. LUCAS. Mr. Berardino, do you think it's possible that your people who were on site at Enron were lured into the mystique and success and the glamour of Enron, and in my vernacular, they were just going along kind of fat, dumb and happy sort of in the land of milk and honey and human nature, being what it is that your people really lost their objectivity, even though they were well intentioned that they got involved in the glitz and glamour of the Enron environment?

Mr. BERARDINO. Congressman, that's a good question and I'm a student of human nature and recognize why you ask that question. I certainly hope not. All I know is I've been in this business for 30 years. I know our people really well and they wake up every day trying to do the right job, trying to make the right judgments. Whether or not people went over that line or not, you know, I can't tell you.

Mr. LUCAS. It was interesting to me that they said you had offices there and your employees wore the Enron shirts, and I just wondered if they got wrapped up in the web of that culture, and even though they were well intentioned, they lost their objectivity. One of the things, I think, Mr. Chairman, that we ought to do is if we could talk to some of the folks that were on site, and maybe if you have a chief of the audit or something and if we could talk to some of those people, because I understand you can't answer those questions, but obviously, some of the people on the site could. I think that would be very insightful. That's all I have.

Chairman BAKER. Thank you, Mr. Lucas.

And Chairman Oxley and Mr. Kanjorski and I have discussed this, and we certainly will try to accommodate the committee's interest on those requests.

Mr. CROWLEY. Thank you, Mr. Chairman. As low man on the totem pole here, it takes a while to get down to someone like myself and many of the questions that I intend to ask were asked especially by my good friend, Mr. Ford from Tennessee, but there are a number of things that still are not very clear to me. And Mr. Berardino, your firm acted as an inside accountant, an outside auditor, as well as a consultant; is that correct, for Enron?

Mr. BERARDINO. What was the first phrase you used? Inside——

Mr. CROWLEY. In other words, you looked on the outside, you did things on the inside in terms of accounting, you did things as an auditor looking outside as well?

Mr. BERARDINO. We were auditors. People keep saying we did internal auditing. At one point we did, but most recently we gave an opinion on the internal control.

Mr. CROWLEY. When was that done? What would the date on that have been?

Mr. BERARDINO. It was reported in their year 2000 annual report.

Mr. CROWLEY. So between 1997 and 2000, you did do internal?

Mr. BERARDINO. We may have done some, but it was less and less. What happened was that the early years, as they were building the company, we did internal auditing, and then that declined over time.

Mr. CROWLEY. So in your second recommendation that you made, and we appreciate the recommendations you made, and I'll quote. It says to address concerns about potential conflicts of interest, Andersen will no longer accept assignments from publicly traded U.S. audit clients for the design, implementation, on and on. Do you or do you not admit now, after your testimony and hearing from Members of Congress, that a conflict of interest does exist, that it's not just a potential conflict of interest, that there are serious conflicts of interest here?

Mr. BERARDINO. I guess I don't agree. I think there is a perception that there could be, and all I'm saying is that perception is important and we are responding to it.

Mr. CROWLEY. Your firm helped to establish, the degree to which is arguable, Chewco, LJM1, and LJM2.

Mr. BERARDINO. We did not help to establish. We reviewed the accounting that others developed.

Mr. CROWLEY. Did you consult on those?

Mr. BERARDINO. We gave advice.

Mr. CROWLEY. You gave advice. In the vernacular I come from, giving advice means to help someone, but that's another story. We'll come back to that later on. In giving that advice, your company profited from that; correct?

Mr. BERARDINO. We were doing an audit. We answered questions. We said no a lot, and we said yes at the end of the day to those transactions. If that's advice or consultation—if you think that's what it is, that's fine. In my vernacular, it's something different. It's called part of the audit. You're always looking at transactions and assessing what the right accounting should be; so——

Mr. CROWLEY. But you profited from giving that advice?

Mr. BERARDINO. Yeah. We received fees for——

Mr. CROWLEY. In essence, consent?

Mr. BERARDINO. Yeah.

Mr. CROWLEY. You consented to it? Through your firm you consented to it?

Mr. BERARDINO. Absolutely.

Mr. CROWLEY. You okayed it? You okayed entities that the sole purpose, the special purpose, the only purpose was to defraud and to dupe. Your firm okayed that; is that correct?

Mr. BERARDINO. I disagree with your characterization, because I don't know what was in people's mind when they designed the transactions. We saw the transactions. We applied the accounting to the extent we thought it was appropriate.

Mr. CROWLEY. And as a result of the creation of those entities, tens of thousands of people have lost their jobs, tens of thousands of people have lost just about everything they had ever invested in their lives.

Mr. BERARDINO. Congressman, I have stated often my sympathy, sincere sympathy to people who have lost their money. I will also suggest that this company made bad business decisions by their own admission. They made investments that didn't pay off. That's what went wrong. How they designed it is part of the conversation, absolutely.

Mr. CROWLEY. It's not entirely all your fault—it's not personally your fault, although there may be some responsibility here. What we're trying to get to is the bottom of what caused this, the collapse of one of the largest corporations in the history of this country, and have really left the little guy and gal holding the bag, absolutely nothing in it when everyone else gets to walk away with big bucks. And the people that I represent and the State that I represent, New York, is looking at enormous losses where pension funds, as mentioned before, were looking at enormous losses and the little guys walked away with nothing because of the accounting mistakes that your firm made.

Mr. BERARDINO. Congressman, I can't let that stand. This company failed. Whether the accounting was appropriate, whether we had all the information, these are fair questions that we will all get to the bottom of, but at the end of the day, we do not cause companies to fail.

Mr. CROWLEY. Mr. Chairman, I would just ask that—I believe there is more information that is needed and I would ask that you issue the requisite subpoenas to individuals that would not come forward voluntarily, as you have, and for those documents, whatever is left at Andersen, to be brought forward as well that would be pertinent information to this committee and to the findings that what we are trying to——

Mr. BERARDINO. I will remind this committee that there are millions of documents that we still have that are relevant and we have been nothing less than forthcoming.

Chairman BAKER. I take Mr. Berardino at his word. He has indicated his willingness to provide the committee with appropriate information under his control and access to individuals, and the committee will do so.

Mr. CROWLEY. Mr. Chairman, I only make the point that if individuals are not forthcoming, that those individuals be subpoenaed to come before this committee. That's what I'm saying.

Chairman BAKER. As you're aware, we've already taken an action with regard to a particular individual and the authority of the subpoena has to be specific. As we find individuals whose content and information would be helpful to the committee, we certainly will act in appropriate fashion. Thank you, Mr. Crowley.

Mr. Sanders, you're recognized.

Mr. SANDERS. Thank you, Mr. Chairman. I'm not a Member of this subcommittee, and I appreciate your allowing me to participate. Mr. Chairman, if there is—and I don't know if there is, but if there is a silver lining in the whole Enron/Arthur Andersen disaster, it is that the American people I think are beginning to catch on about the need for a wide variety of reforms in the way Government does business. For a start, if my understanding is correct, Arthur Andersen has contributed some $5 million to the political process, Enron contributed more, and to a large degree, sad to say, the Congress of the United States is significantly controlled by big money interests like Arthur Andersen, who contribute huge sums of money to end up getting their way and I hope that out of this will come strong campaign finance reform.

Second of all, in terms of the pension situation, I think, and I fear that many millions of Americans thought all they had to do was invest in the stock market and their assets would go up 15 to 20 percent a year and everybody would become rich. Well, it ain't that easy. And I know that some people want to privatize Social Security, and I think maybe the debacle that is taking place might make some people think twice about allowing Americans to invest substantial parts of their money in the stock market rather than in the guarantees that the current Social Security system provides.

In terms of accounting reforms, let me just mention something about Arthur Andersen. You know, sometimes we think that gee, isn't it too bad that Arthur Andersen may not have done a good job with Enron, but let's look at their track record in recent years, and Mr. Berardino, you tell me if I'm missing anything here. Just last June, Arthur Andersen was fined $7 million by the SEC for fraudulently cooking the books of Waste Management. Were you fined $7 million, sir?

Mr. BERARDINO. Yes.

Mr. SANDERS. A month earlier, Arthur Andersen agreed to pay $110 million to settle an accounting fraud lawsuit over the firm's audits of Sunbeam. Am I correct in that statement, sir?

Mr. BERARDINO. Yes.

Mr. SANDERS. In addition, your firm was in charge of auditing the largest issuer of junk bonds in Asia, a company called Asia Pulp & Paper, which is now undergoing one of the largest bankruptcies in Asian history and is $12 billion in debt. Andersen is being sued for cooking the company's books by some $220 million. Is that a correct statement, sir?

Mr. BERARDINO. They have been a client, yes, sir.

Mr. SANDERS. And are you being sued?

Mr. BERARDINO. I think so.

Mr. SANDERS. OK. In Australia, Andersen has allegedly cookayed the books of HIH Insurance to the tune of some $470 million. This company is now undergoing the largest bankruptcy in Australian history. In Britain, because of Andersen's involvement in the collapse of the luxury car manufacturer, John DeLorean, England banned Andersen for years from bidding on Government contracts. This ban was lifted in 1977.

Bottom line is that it's not just Enron, and it is a scary situation. I was a mayor of a city for 8 years. We had to look at the judgment of auditing firms to tell us what kind of investments were appro-

priate for the city. Millions of Americans look to auditing firms for independent objective judgment. Mr. Chairman, I would suggest that Americans now are going to look twice before they accept the judgment of Arthur Andersen and perhaps some of the other auditing giants in this country, and I think it's not just—everybody else here has touched on the conflict of interest situation. I absolutely agree, but I think it goes beyond that and I think Americans now have real doubts about the ability of some of these large auditing firms to tell them the truth about the financial condition of the companies that they are working for and, in fact, what we may need to do is move beyond private auditing firms and to some Government agency giving us some type of objective analysis about what a company is doing before people are going to invest in that company.

Mr. Berardino, I want to congratulate you because I understand that your company was successful in keeping Enron from paying taxes for 4 out of 5 years, and they received, in fact, $382 million in tax refunds through the creation of offshore tax shelters. I wonder if you would be prepared to spread your wisdom to the middle class of this country, the poor suckers who actually have to work hard and pay taxes while you and your friends were able to get Enron to avoid paying taxes.

Now, I wonder—you got some consulting fees at a time when thousands of Enron workers have lost their retirement savings. I was wondering if you feel any obligation on the part of your company perhaps to take some of those consulting fees and put it into the fund for Enron employees so that some of them can get a few bucks back rather than losing everything they had. Is that something that Arthur Andersen might consider?

Chairman BAKER. And that's the gentleman's last question. Please respond.

Mr. BERARDINO. I responded to that earlier, but I would like to just put on the record two things: We have 2,500 public companies in this country. We get a lot of it right, almost all of it, and from time to time, we've had failures and we're not pleased about that. Second we did not design this company's tax position——

Mr. SANDERS. You did not work on them with their tax——

Mr. BERARDINO. No. Another firm worked with them on their tax. We audited the tax expense, which is very different from structuring.

Mr. SANDERS. But you apparently thought it was Okay for them to set up these offshore companies and not pay taxes for 4 out of 5 years.

Mr. BERARDINO. All I'm suggesting is for the record, we did not design those. We audit and report on what the results of those entities are all about. Big difference.

Chairman BAKER. The gentleman's time has expired.

Mr. SANDERS. Thank you, Mr. Chairman.

Chairman BAKER. Also with us today is Ms. Jackson-Lee, not a Member of the committee, but she has been patient in waiting her time and I recognize her for 5 minutes.

Ms. JACKSON-LEE. Thank you very much, Mr. Chairman. And as I said yesterday, I thank you for committee's indulgence and that

of the Ranking Member, Mr. Kanjorski, and of course Mr. Oxley and Mr. LeFalce.

Let me thank Mr. Berardino for his presence here. He is here without, as I understand it, being subpoenaed. I am not a Member of this committee. Enron happens to be in my congressional district, and thereby there is a great deal of concern in our local community, and in particular among the ex-Enron employees and retirees. Just this morning, one of the employees testified before the Governmental Affairs Committee on the Senate side and noted language, Mr. Chairman, that I would like to include in the record.

If I have it correctly, it was a theme that was used by Enron employees, and I think many of us have been struck by the enormous loyalty that these people have had or still have to the company and its mission. They use the term "RICE", respect, integrity, communication and excellence. As I was sitting next to one of the employees, they were able to recite it for me with great appreciation for what it means. I believe that this is what we have lost in light of the facts that have been unfolding, and let me just say to provide you the facts. You did not recall the dates. Let me say that for the record, Enron filed for bankruptcy on December 2, a Sunday, as I recall it, 2001, and 4,000, many of whom are my constituents, were fired on December 3, 2001. You were not terminated and Arthur Andersen, until more than a month later, January 17, 2002.

So the employees lost all the way around. I am wondering, Mr. Berardino, with respect to the question of independence. Objectivity, integrity and independence are words that I use. What was the responsibility of Arthur Andersen? Did you engage in giving advice to the board on the structures, these off-line, off-budget companies, and how much of that advice did you give?

Mr. BERARDINO. Well, this $5 million people refer to over 5 years, we responded to the structures, the investment bankers and the finance department brought to us. We did not structure those deals. We gave, as an auditor needs to, an opinion on what the right accounting was.

Ms. JACKSON-LEE. Do you believe that you were providing advice around 1999?

Mr. BERARDINO. I'm sure we were.

Ms. JACKSON-LEE. The Powers Report, which I'm sure you have read, has made it very clear that the minutes of the finance committee reflect that Arthur Andersen was giving them advice on the structures. In particular, they indicate that Arthur Andersen provided substantial services with respect to structuring and accounting for many of the transactions, that it reviewed Enron's financial statement disclosures with respect to the related party transaction including representations that the terms of the transactions were reasonable, and no less favorable than the terms of similar arrangements. You had a witness that testified some months ago that indicated that you did not have any involvement; yet board minutes reflect that you did have involvement in giving advice on these structures and transactions. Can you not recollect more clearly how intense that advice was?

Mr. BERARDINO. I can't right now.

Ms. JACKSON-LEE. Wouldn't you think the board would be entitled to rely upon Andersen's involvement and as well would reason-

ably expect auditors to raise questions to their client, the audit and compliance committee, if confronted with transactions whose economic substance was in doubt? Do you think that's part of the responsibility in your role as an auditor?

Mr. BERARDINO. I'm not exactly sure what your question is.

Ms. JACKSON-LEE. My question is, is it not the responsibility of an auditor if you are, in fact, engaged in providing advice on these structures and transactions that if you see a red flag or if you believe that these transactions are, if at best, minimally weak and nonsupportable, to raise a flag to the audit and finance committee of the board?

Mr. BERARDINO. And as I—the answer's yes and——

Ms. JACKSON-LEE. Did you do that? Did Arthur Andersen do that?

Mr. BERARDINO. We will supply you with information we have on what those conversations were with the audit committee.

Ms. JACKSON-LEE. I am probably more used to seeing accountants, though I respect the need for companies to get advice with those very thick eyeglasses and being the straight and narrow individuals, and I'm sure you have a great deal of respected and responsible employees, but sitting at their desks, if you will, and looking at the numbers and telling the facts, it comes to my mind that Global Crossing, a company that you advised, you got $2 million, $2.3 million in auditor fees and $12 million for non-audit work.

I don't know where all this money came from in the accounting business now, but how can we look to an objective assessment on the auditing feature if you have so much money in non-audited responsibilities? Isn't that an enormous conflict? Did that not raise a flag in the work you were doing for Enron that you would yield to the more important responsibility, I believe, of auditing and telling them what's going on with the books in order to protect pensioners, retirees and employees as opposed to, I guess, falling for this large sum of money in the non-audit work?

Chairman BAKER. And that would have to be the gentlelady's last question, but please respond.

Ms. JACKSON-LEE. Thank you, Mr. Chairman.

Mr. BERARDINO. We take our responsibilities as auditors very seriously. I'm trained as an auditor and I'm proud of it. It's a hard job and our people are trained to do the right thing, to raise the red flags when they see them, and we do that day in and day out, but we are human beings and we may not get it right every time. I'm not apologizing for that, but I'm telling you that we take this role extremely seriously.

Ms. JACKSON-LEE. Mr. Chairman, I thank you very much.

I don't want you to apologize to me, Mr. Berardino, but I do think you owe an apology to the employees and the pensioners and retirees. I thank the Chairman very much.

Chairman BAKER. Thank you.

Mr. Berardino, I have the intent to go a little further. I know this has gone on for quite some time, but I think it appropriate now to focus rather than on the identifiable problems, but more importantly, as to some specific elements in addition to your own rec-

ommendations of approaches the committee might consider in light of the circumstances that we have discussed here at length.

With regard to ethical conduct, as I understand the rules at the moment and the discussion you had with Mr. Cox relative to provision 10A of the 1995 Act, that if there is a discovery by an audit team member of an action which violates the law, then there is an obligation to report and a process which is followed.

Is it advisable to have a similar requirement when the audit team member discovers an action is to be taken by the corporation that would result in a likely deterioration of shareholder value? Now, that is a business judgment, and I understand the difficulty of second-guessing the management, but where there is a strongly held opinion sufficient for the audit member to take this to a higher level, shouldn't we require that audit member to take that action where, in the case of one of the questionable SPE's, he feels uncomfortable that the financing mechanisms in place are really to obstruct the public view of the risk the corporation really is undertaking by its creation?

Mr. BERARDINO. Well, Congressman, Mr. Chairman, I think this gets to the heart of the matter in terms of our responsibilities as auditors. At present, we are responsible to go to an audit committee. They are elected by the shareholders. Is that enough? I think we need to have a conversation about what is appropriate corporate governance and can it be improved. These are very difficult judgments and we could be accused of prematurely raising some flags that may be inappropriate, and so we need to think that through and I——

Chairman BAKER. If you go to the audit committee today and you are basically outvoted and the audit committee chooses to proceed, at least the audit team then should report to someone in management of the firm and a firm determination made as to whether you should report your disagreement to an outside entity, whether it be an office within the SEC, a specially created new committee. I don't suggest we go to FASB, frankly. I would like a more timely resolution of these matters, but in concept, is that something based on the facts and management's ability today?

And I will relate to your earlier comment, I was giving you business school philosophy where the board establishes the audit committee who engages the audit and the audit is for the benefit of shareholder protection, and your view, and I suspect the view of many, is that the audit is the property of the corporation as well as the shareholders; therefore there is a dual master. Should we not separate that dual responsibility and make, first and foremost, the obligation to report to the audit committee and have the audit committee report to shareholders?

Mr. BERARDINO. I think there is a lot to talk about there. You know, I think that's a fair point. I would also suggest one of points that I put on the table, which is this grading system that we might develop so that not all audit opinions look the same and that the judgments that companies make from, let's say, on-the-line aggressive to very conservative, that there's a way of communicating that to the public.

Chairman BAKER. I think it goes to the heart of whether we maintain the current corporate audit relationship or whether some-

thing extraordinarily culturally different is engaged. If you're going to be paid ultimately by management and feel a responsibility to management where management has a plan that's not consistent with appropriate corporate governance or at odds with shareholder interest, the auditors should not only have a sense of responsibility, but an obligation to make that known to someone.

Now, before it becomes public information, it could go to a Government office where a judgment could be made. For example, if it were the case where a manager sat across the table from one of your audit team managers and said we don't like the way you've constructed these footnotes or this financial report and unless you change it, we're going to go find someone else, what has been suggested so far is a remedy for a bad auditor.

Let's assume the reverse. Let's assume we have a good auditor and a bad manager. Where is your relief? To whom can you go other than to be fired? We should have a place where you can seek counsel confidentially, beyond public view, and get assistance and a determination that your recommendations are appropriate and have consequences for management. Is that an acceptable structure to consider?

Mr. BERARDINO. Mr. Chairman, I think everything should be considered and I applaud the direction you're going in. It's a little out of the box, but we need some out-of the box solutions.

Chairman BAKER. I think we have got some out of the box problems is a real observation, and where you have management and an audit team that, for whatever reason, views the world similarly, then we either have outside folks looking at the auditing or have liability on the board and the audit committee of the board to have some corporate governance liabilities for their failure to act.

It appears to me in this case that neither the audit committee nor the board of directors took action appropriate based on the information they should have had access to. I also like Mr. Ford's suggestion with regard to mandatory document retention. In my modest recordkeeping that the IRS requires of me, I have to keep my boxes for 7 years. It seems only fair that there should be some statutory requirement for similar retention regardless of the matter if it's pertinent or material to the financial condition of the corporation.

Mr. BERARDINO. I agree.

Chairman BAKER. Another element that I have observed is that where no—cost options are granted to insiders or executives and by whatever manner the value of the stock is enhanced either by the effect of the SPE or some announcement which may not be, on all corners, accurate, stock value goes up. Six months later there is a mandatory restatement. Stock value goes down. But in between, the executive has exercised his option. He doesn't have to give his money back. The shareholder takes the full extent of the loss. What would be wrong with a requirement that if there's a restatement of earnings and an official exercises a no—cost option in any period preceding that restatement of 12 months that he gives the money back?

Mr. BERARDINO. I think what you're getting at here, Mr. Chairman, is a rethink of corporate governance and incentives. I think we need to look at what the incentives are——

Chairman BAKER. Well, here's the incentive.

Mr. BERARDINO.——versus what they might be.

Chairman BAKER. If I run this company well, I have an option. The value's going to go up. I'm going to make a bunch of money. Here's the dilemma. If I run this company poorly and obfuscate the facts and inflate the value, I'm going to make money. Let's make a penalty. If you don't run it properly and you're inflating earnings and stock prices arbitrarily out of manipulative reporting, you're going to have to give the money back, and if we find that it's fraudulent, you're going to have to give back more than just the money.

Mr. BERARDINO. And if you mislead your auditor intentionally——

Chairman BAKER. I'm for that one.

Mr. BERARDINO. ——withhold information, and there ought to be a qualitative assessment as to how rigorous the accounting is.

Chairman BAKER. I've got that one down. That was my next one. Withholding material information from the audit team is a felony. I think if we keep the records, we know that there's going to be a consequence for withholding. We know there's going to be a consequence for artificially pumping up the stock price. If we say to the board of directors, you're responsible for managing the audit team member, if you're intimidated or told by management to do something you think is not only in contravention with GAAP, but is materially adverse to the shareholders' interest, you have an obligation to report that fact to somebody, and we'll create that somebody in some office somewhere so you can go speak to them and get advice, and if it is not corrected, then they can take action against the corporate board. You get your fee, and we get the financial statement in the appropriate fashion that it should be for the best public interest. Now we're starting to get a legislative package that makes some sense.

Mr. BERARDINO. Well, Mr. Chairman, and I'd just remind you, one of the suggestions I've made for my firm is that if anyone is uncomfortable with the decisions being made on the audit that there will be a separate office that they could go to on a no-name basis to make sure we get to the bottom of it quickly.

Chairman BAKER. I think if we do this in a statutory mode in a corporate governance manner, that the consequence of this would be to have exactly that occur within that corporation, within the audit community, and to have the board of directors of a corporation understand their liability should they not get it right. I see what has happened here is that a lot of people made decisions for which there was no downside risk other than the bankruptcy of the corporation. If it is, in fact, true that Mr. Lay's pension buildup insulates him from the loss of his $475,000 for the remainder of his life and all these shareholders and employees lost everything, I have a view that resources were being improperly managed for the benefit of a handful of people and information flows were curtailed, and it may be worse than that.

So there's one other step. One way to have audit independence is to put all these blockages, warnings, prohibitions and disclosure requirements. Another way, which is not my suggestion, but one I have read and found very intriguing, is to have the external audit engaged by the exchanges and have the auditor report simulta-

neously to the corporation and to the exchange to be paid by fees collected on stock transactions. You are not then engaged by the corporation. You are clearly engaged by a third party for the benefit of the shareholders who have their investment in that corporation. This is a relatively old idea, but I have read recently people discussing the advisability of that. Do you have a comment about that approach?

Mr. BERARDINO. I'd need to think about that a little bit. One of the concerns you need to consider is each firm has, over the years, developed areas of expertise and whether or not you'll be able to make those assignment so that the best expertise is available to a client would be one question I'd ask, but I think this kind of thinking is appropriate and I'd like to give it a little more thought. That would be my first reaction, though.

Chairman BAKER. I will include that on the long list of inquiries, to get the best professional advice possible on a cultural change in the way the corporate/audit relationship is structured or the best way if we maintain the current methodology to ensure that there is transparency and disclosure recordkeeping and most importantly, liability for not conducting your professional obligations appropriately. I've gone on for a bit, but if your folks are hanging in here, Mr. Kanjorski, did you have another series?

Mr. KANJORSKI. Other than those on the list that you have already expressed, there are other things that I am certainly interested in. In the policy area, Mr. Berardino, I am particularly worried about how far the Government should get into being the final determiner of how the private market operates. Should we be attempting to find some way to put a Good Housekeeping Seal of Approval on either audits or company activities?

I am actually more interested in the whole theory of these off-balance sheet transactions and how prevalent they are. Obviously if they are for the purposes of spreading risk, I can see the advantage to operations like these, but are they now being misused and abused in your estimation?

Mr. BERARDINO. Well, Congressman, I haven't done a study of that; so with that caveat, there are billions of dollars of off-balance sheet transactions. Most of them are very benign. Where there is very little risk to the asset, the asset will pay off the liability and many of us could quickly agree that it's an appropriate transaction. The question is really evaluating the risk of that asset being able to pay off the liability and I'm just not smart enough, I don't have enough context to tell you to what extent that is a risk out there. I think it's a relatively minimal risk, but that's not based on any scientific analysis.

Mr. KANJORSKI. How far do you think the Government should get into the accounting profession and into corporate governance of public corporations?

Mr. BERARDINO. Well, I've always come from the camp that our profession should be self-regulated, and recognize the need to have some outside influence beyond accountants to discipline and oversee the profession. No question this body represents the people and the people have gotten engaged in this issue in a way that they've never engaged before, and I would hope we could come out with a better answer.

I've given you some of my ideas. I worry about the Government being too intrusive, because I do think the shareholders elect their representatives to sit on a board and understand what's going on and to protect them, and upon occasion that will not work; and the question is whether or not we need more Government involvement to reduce that. But I'd say in this context, this is a fair conversation and I'm not going to sit here telling you that I've got a firm point of view. I'm agnostic. I want a better solution, because I, as I started to say earlier, we have lots of different bodies regulating us, and I'd like to have one do it right rather than this piecemeal patchwork approach that we have now. It's just not helpful. So I'm agnostic. I could get to a different answer. I think today's conversation hopefully gives us a little more information so that we can collectively come up with something that makes sense.

Mr. KANJORSKI. Well, do you look at Enron as an aberration or is it systemic? I am sure we are not going to see anybody else here today who is fully aware of corporate governance issues as to what has happened. We are always closing the door after the horse has run away. Is there a way that we can close the door before the horse leaves the barn, or is that just a false hope?

Mr. BERARDINO. I think there is some serious corporate governance issues in this country. As I said earlier, the vast majority of companies and boards get it right. The thing that is so shocking about this is its rapid ascent and incredible quick collapse on a scale, a magnitude we will hopefully never see again. So I would put this in the aberration category, but I do think whenever you have a natural disaster, it's an opportunity to rethink everything and come up with a better solution. I think we can come out of this with a better solution and that's why my glass is half full as painful as all of this has been.

Mr. KANJORSKI. You are the head of one of the huge top five accounting firms. I am also beginning to look at this problem a little differently, like whether or not we should tier the profession. I think for us to put into place very stringent rules and regulations and statutes, that apply across the board, may be onerous. It seems to me that not everyone in the accounting profession has lost their balance here, not to suggest that your firm or others in the Big Five have.

Mr. BERARDINO. Thank you.

Mr. KANJORSKI. Clearly, you are in an entirely different category of accounting than most accounting operations in this country, especially when we are talking about separating auditing from consulting. I do not have any doubt as to where my vote would be in regard to separating auditing from consulting with the major corporate structures in the country and the major accounting firms. I just think it is too conflicting. But, I will also be very practical. There are smaller companies and smaller accounting operations where the cost of having separate auditors and separate consultants would be prohibitive. In some ways, we would be injuring the middle-sized businesses and the middle-size accounting firms. They would be paying a terrible price for an aberration. How do we get balance there?

Mr. BERARDINO. Well, Congressman, I think that's a very thoughtful point, because you do have smaller firms working with

our entrepreneurial small businesses that are very different space. But before you go too quickly, let's look at these big firms. Let's look at my firm. We are $9 billion around the world in revenue. That's awfully big.

Mr. KANJORSKI. $9 billion.

Mr. BERARDINO. $9 billion. We've got a billion or so of equity in our firm. You're asking five firms with several billions of dollars of individual partners equity; right? We can't go to the stock market to raise capital. Individual partners who grew up with nothing and built these firms to underwrite trillions of dollars of shareholders equity.

And what happens when there's the a next big surprise? Who's going to underwrite that? So although we are big in absolute terms and although we are bigger than some of these middle size firms, when you look at our capacity relative to the wealth of this country and the stock market, we're a small fraction, and that's a significant concern.

We've gone from eight firms to five already, because firms have not been able to compete and stay in business because they weren't big enough. And the question is, do you want to go to four, three, two or one, or have the Government take over? I think that's a good question. I'm not suggesting that I have the answer.

Mr. KANJORSKI. Are there those in the accounting profession that think maybe the Big Five are too big? Ought we encourage many smaller size firms? I was talking to an accounting firm over the weekend in preparation for this hearing. I believe they are the 25th largest accounting firm in the country. Their entire revenues for the year are not equal to what your income was from this one audit report. So, the disparity from the huge to the average, or the medium, is gigantic.

I was thinking in terms of legal firms. I am after all, a lawyer by profession. I would hate to think we would have four or five huge law firms in the country or in the world that handle all the big transactions. It is pretty hard for me to understand. One, why that situation does not become a business as opposed to a profession. Two, only four or five guys have to sit around the golf club to divvy up clients and you have got a conspiracy. It just seems to me that the rest have are not participating. Whatever happened to the substantial medium-sized accounting firms in the world that do good auditing and good accounting? Why are they not out there doing it?

Mr. BERARDINO. Because they can't compete and they can't stand the legal liability when one of their clients goes out of business.

Mr. KANJORSKI. Well, if that is true, they cannot compete. As one of the firm's partners told me: When the company that they were involved with, for about 15 or 20 years, was going on for its first IPO, Wall Street said it could not use that small accounting firm. You have to use one of the Big Five. Is that the pressure that is coming from the investment banking community?

Mr. BERARDINO. Yeah, absolutely. Absolutely. But I'm suggesting if you go from four to eight or ten, you're going to dilute competence, you're going to dilute the amount of equity in these firms.

Mr. KANJORSKI. Do you think bigness and competence are——

Mr. BERARDINO. I'm sorry?

Mr. KANJORSKI. Bigness and confidence are synonymous?

Mr. BERARDINO. They don't have to be, but I would suggest in a proper profession they are.

Chairman BAKER. Mr. Kanjorski, if I may——

Mr. BERARDINO. But these are very fair questions, Congressman. I wanted to just not so much challenge you, but to give you some context in terms of where this might go. These are not easy questions, and the answers will be even more difficult, but I think they're fair questions, and I want to just make sure you were just aware of where I was coming from.

Chairman BAKER. Mr. Shays.

Mr. SHAYS. Thank you. Mr. Chairman, I had wanted to get on this committee because I figured that it was probably one of the most important committees that I could serve on, and particularly it impacts my district and Mr. Berardino, for instance, is a constituent of mine. And so in some ways, it's a little awkward to be in this position. I want to say that I think you've done a very fine job coming before this committee in many respects.

The one area that I'm wrestling with is when you spoke last time, I felt you had given the committee the impression that the non-auditing side of the equation was a lesser source of revenue from Enron, and then I'm realizing that it was pretty 50/50, and I am somewhat haunted by that memo that makes reference to $100 million, and, you know, because it's in a memo that says do we continue to do business, and let me just be very upfront here. I mean, I was contacted by a number of accountants who were saying, you know, we need to be able to do consulting work and auditing work.

And so I wrote a letter to Arthur Levitt saying, you know, postpone this decision, give more time, and he called me back because he happens to be a constituent. He said, Chris, postponement means death. So then I went on the floor of the House the next day and said I didn't want anyone to make an assumption that this letter asking for a postponement meant we should kill this regulation. But I wrestle with this and I'm wrestling with this now, because I'm seeing $100 million in a document that was basically to decide whether or not to continue serving, and then I see this document that then later results in—I mean, the real failure was the Raptor and the failure to disclose $800 million of liability or overstating income by that amount.

Tell me what this $100 million was all about.

Mr. BERARDINO. Congressman, you know, it's very hard to answer that question. On the one hand we have very complex global clients that have hundreds and hundreds of CPAs on their staff that are doing very complex things, and I think you would agree you would want us to do a very thorough job and to get a fair income from that. Enron was in one of the elitist category, seventh largest in the country. We don't have any $100 million clients, and Enron never became a $100 million client. We have many in the $25- or $50 million range, but we are a $9 billion organization.

All these clients are less than 1 percent of our fees. What was in that memo, if you want to take an innocent point of view, and you may be critical of this, is a recognition by our people that the objects of these fees being so big would be problematic as you've

just suggested. That's what was written in that memo. And what the counter to that was, well, let's look at what we're doing, and I'd suggest to you when you get underneath the facts on that $50-something million, something like three-quarters of that you would only hire your accountant to do.

Mr. SHAYS. I guess the question that it leads me to is basically, the $52 million in the year 2001, $25 million was auditing, and $27 million trumped the auditing. It was non-auditing fees, consulting, and so on; is that correct?

Mr. BERARDINO. I've just had somebody give me the facts. Would you mind if I read this quickly?

Mr. SHAYS. No.

Mr. BERARDINO. The basic——

Mr. SHAYS. As long as these are your words, because you're the one under oath. No, I'm serious. In other words, as long as you believe what you're reading here.

Mr. BERARDINO. I would never say anything I didn't believe was accurate, plus I'd get back at these guys if I was wrong. But anyway, $25 million was the basic audit. $3 million was due diligence work where we went in and helped the company investigate companies they might buy. $3 million was taxes, $3 million was reviewing internal controls. $4 million was actually Andersen Consulting. That's no longer part of our organization; so that $52 really is $48, and the $14 million is lots of small special projects and consulting jobs.

Mr. SHAYS. But basically the $25 million is the auditing and the $27 million is non-auditing?

Mr. BERARDINO. I'm not trying to be a pain in the neck, honestly.

Mr. SHAYS. No, I understand.

Mr. BERARDINO. What I'd suggest is a lot of the other work you would only go to your auditor for anyway.

Mr. SHAYS. Let me ask you, though, how do you then jump up theoretically to $100 million? What was being said—but it's in a memo that basically——

Mr. BERARDINO. Yeah, I understand.

Mr. SHAYS. Is it non-auditing?

Mr. BERARDINO. Clearly any other work to get beyond this number would have been non-auditing services that never occurred.

Mr. SHAYS. What that says to me in a big way, I mean, I had to look myself in the mirror as well and all the other accountants who came to me and say this was a figure that was being dangled in front of your organization that, in my judgment, distorted judgment, and what this says to me is your organization had a moment of truth then to say good-bye and that was the moment of truth, and I bet that's the moment all of you regret, and sadly, the person this memo was sent to is the person accused of shredding documents.

So yeah, I'm a little suspicious, and I have to look at myself in the mirror as well. This really is an indictment at the non-auditing side of the equation.

Mr. BERARDINO. Congressman, I think that's a fair question, and I've addressed that in the points I put on the table both in how decisions are made to retain clients by bringing in some outside advice into our organization so that we can really think these

through. I will promise you one thing. This firm will learn a lot of lessons from this and we will come through it stronger, because we are willing to challenge everything we've done historically, and I put on the table some initial ideas.

I've heard some other ideas here I hadn't thought of before. Mr. Volcker will give me other ideas that I haven't thought of before as well as his board, and I just want to leave this committee with that impression. We are deadly serious. We will take a lead, and as I have talked to many of our clients around the country, they have all said we went through a crisis and we got through it because we were willing to change.

My profession has put some issues on the table that you heard from Chairman Pitt yesterday. Whether that's the right answer or not isn't important. What's important is we're willing to change and we're willing to work with this committee, and I want to thank this committee for its thoughtful way—I said this last time. You're trying to understand. I apologize I can't answer all those questions about what happened, but I'm not going to do that irresponsibly. But that does not mean that we're in denial. That does not mean that we're not willing to work hand in hand with whoever's interested, this committee, SEC, other members of the financial appointing process to get to a better answer and that's what we all ought to be about, and I want to applaud you for that leadership.

Chairman BAKER. Thanks, Mr. Berardino.

Mr. Sanders wants to be recognized one more round.

Mr. SANDERS. Thank you very much, Mr. Chairman. I think that you and Mr. Kanjorski and others are wrestling with the nub of the issue and as understand it, this is what it is, and, Mr. Berardino, maybe you can help me out here. There are millions and millions of investors in this country who need a referee, need an objective source to say that which company should I invest in? There are trillions of dollars of workers' money in pension funds.

In my small State of Vermont, we lost $4 million in the Enron debacle. And it seems to me, Mr. Chairman, that the essence of the issue is to whom is the auditor loyal? Where is your first loyalty? If firemen in New York City put their retirement savings in a pension fund, is it your primary responsibility to tell their investment counselors the truth about the company, or is it your primary responsibility to work with the company to earn as much profit as possible for the company, some of which you share?

And this touches on—I don't want to get back to the conflict of interest issue, because everybody has raised it and I agree with that, but it even goes beyond that and I think maybe the Chairman raised that issue. If you look at a set of books by a company and you said, hey, this is a bunch of crap, it is not the truth, it is very likely that the company will say well, thank you very much for your opinion, you're fired, we will find somebody else who tells us our books are very, very good.

And I think that's another conflict situation which auditors are in, and I think ultimately the investors of their country, the workers of this country who put money into pension funds have got to know that there is somebody out there who is telling them the truth. Investment is always risky, but at least you've got to have all of the facts and——

Chairman BAKER. Mr. Sanders, if I can interrupt on that point just because, you know, as friends here know, I think there's another element to this that goes to the heart of that institutional investor's goal, and to some extent, small investors. We all sat around and watched the market go crazy. People were getting 20 percent rates of return. Management sits there and is told by the board and by shareholders if you don't beat the expectations for earnings next quarter by a penny or two—if you beat it by 3 cents, that's questionable. Beat it by a penny or two, you're smart. And you not only have to beat the written analyst estimates of your return, but the whisper numbers, that people really say, oh, that's not the accurate number.

The end of the process is that management then is forced to take on risk to keep the earnings where they should be to enhance shareholder value, and we find ourselves replicating the 1980s and S&Ls in Louisiana who were buying broker deposits and giving away toasters to have returns look good for shareholders.

So this is a cultural problem. And I don't lay fault on any one participant, but I want to respond to you by saying I think we should make the audit team, the audit committee, and the board of directors responsible first and primarily to the shareholders. Once that's done, everything else should flow appropriately, and I thank the gentleman for yielding.

Mr. SANDERS. I mean that's kind of the direction that I was going.

Chairman BAKER. I hoped.

Mr. SANDERS. And I was going to ask Mr. Berardino this question. If there needs to be somebody, some institution that the shareholders and the pension funds can look at who don't have a conflict of interest who are telling them the truth, who are not going to get fired when they tell the truth, who are not making money and profits with the company if it is doing some of the things that the Chairman indicated, who's going to be that institution, and what is the proper role in that process for the Government? That's number one, who presumably does not get rich or poor, based on the activities of the company? And second of all, as I understand it, Mr. Berardino, Arthur Andersen has the dubious distinction of having received the largest fine from the SEC, which was $7 million with regard to Waste Management. You are a company that has $9 billion in revenue in a given year.

So the two issues that I want to know is, number one, $7 million is the largest fine, and yet compared to the $9 billion in revenue, it ain't nothing. If you screw up or another auditing firm screws up, is a paltry fine like that enough of a disincentive so that you don't do it again, and second of all, in terms of the broad issue of conflict of interest so you can look your company in the eye and say, sorry, we are not going along with that, and what is the proper role of the Government in that situation?

Mr. BERARDINO. Congressman, I am going to answer that in two ways. I don't know what the proper role of the Government is. I am prepared to engage you in debate, as we are now, because I think a lot of smart people can get to a lot of different answers and collectively we get to a better place. But I will tell you one thing. All those big numbers were floating around. I grew up with noth-

ing. Most of my partners grew up with nothing and we only care about our reputation, which—we only care about our reputation and we have been working as hard as we have been these last 2 months as we have been criticized left and right, as things have been leaked and put in the news that are half truths. We have been a stand-up firm that's gone out time and time again, come to this committee, come with ideas, made our people and documents available, self report the destruction of documents. This has all been very painful. I'm not asking you for your sympathy, but I'm telling you the real firm you are looking at is a stand-up firm that wants to get it right and any fine that impugns our reputation hurts us.

Mr. SANDERS. I take a little bit of offense when you suggest that the only thing you care about is your reputation. I grew up without any money. You grew up without any money. You have a lot of money now. I am sure they are paying you quite handsomely. In all due respect, you're in the business to make money as well. In terms of the reputation of Arthur Andersen, I don't think I'm telling anything out of school here, it does not have a good reputation. I listened to you time after time after time when your company was either fined or you settled. You don't have a good reputation.

But you see, you are not answering my question. My question was I see an inherent problem that if, in fact, and maybe it's so and maybe it's not so, based on your track record I think Arthur Andersen has had a lot of problems in recent years. But assuming you wanted to do the right thing and you also wanted to make money, which is fair enough, and you came to a company and you said, company, you are not telling me the truth and the company says you're fired, I don't want to hear that, what is the recourse of that conflict right there? How can you be honest and make money at the same time?

Mr. BERARDINO. Well, I have given you my ideas and my testimony. I think if we have had an ability in our report to distinguish gradations of quality reporting that would provide incentive for every registrant to have the highest degree of standards in its accounting and not achieve the bare minimum not to get the clean opinion, let's look at the incentives, and I think that is where Chairman Baker is going. Let's look at those incentives and challenge whether or not we've got the right ones. And I'm not going to sit here and tell you I've got all the answers, but I am making suggestions that I think can make a difference.

Chairman BAKER. I wish to just get perhaps a little bit of balance in the hearing record from your perspective of the annual revenues you received for accounting services. Can you give me an approximation of the number of clients that represents?

Mr. BERARDINO. We have 2,500 public companies here in the U.S. Worldwide, with all the services we render, we have 100,000 clients.

Chairman BAKER. So that with 100,000 clients, the reported concerned cases are less than 10 or perhaps less than 5.

Mr. BERARDINO. And some of the cases that have been cited have happened over a long period of time.

Chairman BAKER. We could multiply that by some number of years. My point is that the failure rate for corporate activity as it

relates to accounting standards and professional product is less than one—tenth of 1 percent now. There is an egregious case with Enron because of its unfortunate demise on many fronts. I wish to make it clear I think the accounting profession is that, a profession, and that most diligent people labor and long to provide an honest service for their clients who are trying to run a business honestly.

What we now find ourselves with, however, is clear identification of conflicts and conflicts which are not of your own making. We are operating in 2001 with a SEC Code written in 1933 and 1934. There is an inordinate need for this committee to move beyond the current crisis of reforming accounting principles and move to the broader question, what is the proper governance in today's technological world. When you had typewriters and White-Out and people were a great deal more contemplative, when I was in the real estate business many, many years ago and you had to do a purchase agreement and it was with carbon paper and you had to have an amendment to that purchase agreement and you had to run it back and forth, there was time for people to think about making the deal. Today, billions of dollars move by computer transaction in microseconds. It's a different environment. However, in this environment, or in the old one, there is always the necessity for ethical conduct and professional judgment, and what this committee needs to do, in my opinion, is to provide the accountant who's on the site making the evaluations of the financial practices of a corporation, is to report the facts as he sees them.

There's a question in my mind as to whether or not the environment today enables that to happen in every case, and I want to ensure the members of the accounting profession, who are I am sure listening to your testimony quite anxiously today, that we will work to achieve professional standards that serve the public interest well.

We do now have a crisis of confidence. There are people in my hometown in Baton Rouge this morning who are working at a corporation wondering if its books are being accurately reflected and is their job at risk. There are people who are relying on their pension to pay their monthly living expenses wondering if there is going to be a restatement of earnings and their stock price is going to deteriorate. There are people who hold large investments hoping to buy their first home or their child's education. This goes to the core of our capital market's structure, and the confidence that people have in the ability that they're receiving the facts to make educated judgments about their economic future cannot be allowed to be put at risk, and that is what the committee will do. That is the answer we will seek, and we hope with your good counsel and cooperation that we can achieve a remedy within days, if not months, that is responsive to this crisis and forever puts it in a manner that it cannot reoccur.

To that end the committee is committed, and I want to thank you for your second voluntary appearance. The hearing is adjourned.

[Whereupon, at 2:15 p.m., the hearing was adjourned.]

A P P E N D I X

February 4, 2002

The News from U.S. Rep. Richard H. Baker
Sixth District, Louisiana
FOR IMMEDIATE RELEASE: February 4, 2002
CONTACT: Michael DiResto, 225-929-7711

Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Subcommittee on Capital Markets,
Insurance and Government-Sponsored Enterprises
February 4, 2002
Hearing of the Capital Markets Subcommittee
"The Enron Collapse: Impact on Investors and Financial Markets"

On December 12th, this committee conducted the first congressional hearing concerning the failure of Enron. From that time until now, there have been a series of vital determinations, which have enabled the staff to construct a disturbing picture of events. The misrepresentations, obfuscation and acts of secrecy should certainly warrant full investigation by enforcement officials to bring those to justice who have violated their fiduciary responsibilities.

Whether the Powers report is appropriately balanced or not, given the limited information on which the report is based, it does establish a basis on which to conclude that the corporate financial reporting was intentionally complex and misleading. On further examination, it may be determined that the rules aimed at requiring disclosure were so misused that they were warped into a black bag from which no information was able to escape.

But it should be made clear as to the role I envisage for this committee in light of these disturbing revelations. We are not prosecutors. In fact, inflammatory accusation will only inhibit our ability to get to the facts -- facts which are essential for us to reconstruct the regulatory environment so that these events will never be repeated again. We should carefully assess the record, find how and if the system failed, and enact the appropriate corrective remedies.

It is clear that in Baton Rouge this afternoon there are employees wondering if their corporation is really telling the true story, pensioners wondering if they are safe, and investors worrying about the analyst's report. This singular event has created a crisis of confidence that must be reconciled.

How is it that the auditors, the analysts, board members, investors, regulators, and even the financial press could not find anything to alert the public that Enron was not all what it appeared to be. Even if it was the Enron plan to dupe the entire financial marketplace and abscond with millions of dollars for a chosen few, how is it possible for that to occur in our technological society with watchdogs on every corner?

The historical facts answer that question. It wasn't possible.

I direct your attention to a New York Times article published on January 27, 2002, in which it is detailed how a German based energy company balked at a merger with Enron principally over concerns with Enron's accounting practices. These events occurred in 1999, long before anyone had the nerve to suggest that Enron had enron-itis.

I find this quote very interesting and instructive:

"Consultants from PricewaterhouseCoopers told Veba that Enron, through complex accounting and deal making, had swept tens of millions of dollars in debt off its books, making the company's balance sheet look stronger than it really was, according to people involved in analyzing the failed deal....

"The consultants drew on public sources like trade publications and securities filings, these people said."

The story goes on, "We were wondering why this wasn't common knowledge, or why it wasn't discovered by those people whose business it was to discover these things, said one of the people who worked on analyzing the deal. He agreed to discuss the episode on the condition that his firm not be identified." I remind you that this occurred in 1999.

In accordance with full transparency and disclosure standards, I must acknowledge that the article does go on to point out that the S.E.C and F.A.S.B should have taken more responsibility to intervene to protect the public interest. That is where this committee should appropriately focus. If the rules are not clear, if there is any doubt in anyone's mind, we must make it very clear: If in your professional judgment, Mr. Auditor, Mr. Analyst, Mr. Board Member or any other person in a fiduciary role, if you see it and it doesn't look right, it is your obligation to report to the appropriate authority. The practice of walking by the accident and leaving the victims to their own demise will no longer be an act tolerated by this Congress.

It is the principle obligation of this committee to find out how the system failed, and then act to insure the system not only works, but to insure there is redundancy in the system. We must guarantee protection of the shareholders, the employees, and every pensioner whose lifelong savings may be tied to the truthfulness of the required disclosures.

It is clear that some were able to find the truth to protect their own interests. The big question is why was it impossible for others to see the truth?

To that end, I feel it is of absolute necessity to establish audit independence. The reported numbers should add up properly and tell the true corporate story. There are two very different ways to accomplish this goal.

One is to require dramatic new standards of responsibility for everyone from the corporate board, to the audit committee, to the S.E.C to insure the individual auditor is not intimidated by management.

The other approach, one which would change the culture on Wall Street and across America, is to separate the auditor from the corporation entirely, by requiring external audits to be paid for by someone other than the corporation. Perhaps, as some have suggested, it's time to have the stock exchanges engage the auditors and report their findings simultaneously to the exchange and the corporation.

After all, should we really be surprised that when you pay the piper, that the piper plays your tune?

I will explore these ideas with Chairman Pitt today in the effort to propose the best remedy possible for this problem. But we won't take long to evaluate proposals, as this committee will act in days, not months or years.

The simple point is this.... In viewing the corporate landscape today, I do not like what I see. Although most corporations are well run and responsible, it is difficult to accept when a corporation closes its doors due to competitive pressure. But that is an unfortunate consequence of a free market system; losers finally lose.

But it appears there is a new threat in our complicated market place that did not seem possible in the slower, contemplative world of typewriters and whiteout. It is clear it is now possible for the aberrant corporate manager to take corporate assets, manipulate the books, enrich himself, and leave others to pay the price, by making the transaction complicated, convoluted, and computerized.

As a result, faithful employees lose it all. Life savings evaporate. Investors are duped. Lives are ruined, not from innovative competition, but from dark, sinister manipulation.

We will bring the sunlight in. Whether we just add some really big windows, or take the roof completely off, sunlight will make it inside the corporate boardroom.

Those who chose to ignore their responsibilities and enrich themselves while bringing harm to others shall have no safe harbor.

Those who labor long, build value, and create opportunity should be rewarded. We should all have confidence that the American dream is within our reach.

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Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
"The Enron Matter"

February 4, 2002

Our Committee began its work on the Enron collapse with our first hearing over a month and a half ago, in mid-December 2001. Today and tomorrow, we continue our review of Enron and its impact on investors, employees, and the financial markets.

We on this Committee are working to achieve three goals:

- *First,* making sure the Congress knows how the biggest corporate collapse in American history happened;
- *Second,* restoring the confidence of investors in accounting, regulators and the rules governing our markets; and
- *Third,* making sure that the free market system, and the regulatory system that underpins it, emerge stronger and better as a result of our work.

This Committee oversees the financial and capital markets. We oversee the regulation of those markets. So we have a fundamental responsibility here. We take our work very seriously, and we're committed to doing it right.

We are working hard, but we're not working alone. We are working closely with the major investigators -- the Justice Department, the SEC, and Enron's and Andersen's own internal teams. We greatly appreciate their active assistance and cooperation, and their insights. We will make sure that our work complements theirs, and does nothing to impede it.

I also am gratified that the President, in his State of the Union address, told us to make our work here a top priority. The President believes – and I agree -- that "corporate America must be made more accountable to employees and shareholders and held to the highest standards of conduct." That's exactly where we, as a Committee, are headed.

There's been a lot of talk from a lot of people about what might have happened at Enron. But Congress and the American people deserve to know the facts directly -- and from those who are most directly involved.

That's what is going to happen today and tomorrow.

We have with us three of the people most directly involved:

- The chief securities regulator, SEC Chairman Harvey Pitt;
- Enron's chief internal investigator, Mr. William Powers;
- The company's outside auditors, Mr. Joe Berardino of Arthur Andersen.

We thank them all for being so willing to be here. Everyone should know that they all wanted to come here and testify, although these are very difficult circumstances for them.

Congress's job is different from those of the judges, juries, and prosecutors who will deal with the many individual instances of wrongdoing. Our job is not to convict, prosecute, or persecute. Our job is to understand what happened, address the problems, and make our free market system better and more impregnable than before. I think I speak for all my colleagues in saying that we're committed to that goal, and will be working hard – together -- to achieve it in the weeks and months ahead.

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Statement of Congressman Steve Israel
The Enron Hearings
Committee on Financial Services
United States House of Representatives
February 4-5 2002

Mr. Chairman, members of the Committee, there is a plenty of scandal to go around here.

Congressional Committees, regulators and law enforcement officials will do their investigations and may determine that there were many laws broken. This is scandalous, that the 7th largest company in the United States and one of our big 5 accounting firms would have engaged in such a coordinated plan of covert activities. And as is often the case, it is working families whose lives and security are decimated, while the rich, powerful and well-connected thrive.

I believe, however, Mr. Chairman, that the real scandal lies not just in the illegalities of the case, but in the fact that so much of what these people did *was* legal.

Let's look at the record and see what was legal.

Example 1: Offshore Special Purpose Entities (SPEs). Enron used these somewhat common tools to move assets and debt off their books. The company loaned money to the SPE, and arranged for equity investors to provide the funds needed to meet the "3% Rule," which kept the transaction off the books and without disclosure. This was done despite the fact that Enron effectively had control of the SPE through the loans.

The Enron executives appear to have set up the SPEs to derive special benefits in addition to their Enron salary and stock.

Different accounting rules have been recently developed for certain types of SPE transactions used in securitizations of financial assets (such as credit card or other types of receivables). Under that guidance, very generally, SPEs that are permitted *only* to perform very limited functions, including holding title to assets, collecting cash on those assets, issuing debt, and repaying the debt, are *not* consolidated.

In other words, the use of these SPEs was arguably legal in most cases, though clearly Enron, its auditors and lawyers abused this.

Example 2: Fuzzy Accounting. Aggressive accounting tactics are all the rage in our current "next quarter's numbers world." It is outrageous, but the accountants will tell you that legally, their job is much narrower than it appears. They are only signing off on this transaction or that, and the partner at the top of the audit is only certifying the accuracy of the statements, given all of the disclosures in the footnotes. Unfortunately, our *public* accountants, whose responsibilities are defined by federal statute, have been acting more like lawyers, nitpicking about their liability rather than taking responsibility for their industry.

Questionable certainly, but because of the materiality and 3% rules, each individual questionable accounting tactic, taken in isolation, *appears* to have been legal.

Example 3: Lazy and Incompetent Analysis. The analysts were caught by surprise. They shouldn't have been. Short sellers were taking advantage of the company's situation. The short sellers picked up the books and looked at the footnotes. They tried to understand them but couldn't. That set off alarms. The analysts, who are paid millions, should have done the same thing.

Companies, investment banks, TV shows and credit agencies certainly didn't get their money's worth from this group of people. Having said that, lazy and incompetent analysis is not illegal.

Example 4: Lax Oversight. Congress continually looked the other way on accounting issues. The appearance is certainly strong that through [political connections, the accounting industry and others delayed and killed Chairman Levitt's auditor independence plan. The appearance was certainly that the industry got what it paid for.

Until we get campaign finance reform, this is all still legal.

Example 5: Conflicts of Interest. A company that is in charge of auditing a public company's books for the investing public should not use that service as a loss leader. Four of the big five firms have decided not to consider these incestuous relationships. But there is no legal reason compelling them to do so.

Still legal.

Mr. Chairman, the Enron affair goes to a significant failure of the lax oversight of the SEC, of FASB, of the AICPA, and of the analyst sector.

Our financial system depends on a series of checks and balances to ensure market confidence. Every single step in this system –save the short sellers– failed catastrophically. This is nothing short of the worst indictment of our entire system in years.

Our job now is not for the weak of heart. Marginal solutions are simply not going to cut it. We should go back to the drawing board and start over. What do we want our regulatory system to achieve? What are the best structures to get us there? How do we balance investor protection with clear regulation? How do we ensure transparency and confidence? All hard questions.

But rushing together some off-the-shelf legislation and parading it before the cameras will not do. Instead, we should take a serious look at serious changes to this system.

How many more Enrons are there? Nobody can say with any real degree of confidence. And if nobody knows, then perhaps it's time to take a good hard look at our entire financial regulation structure and start over.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

SECOND HEARING ON THE ENRON COLLAPSE

MONDAY, FEBRUARY 4, 2002

Mr. Chairman, we have learned much since our last hearing in December about the factors contributing to the collapse of Enron. We have, for example, begun to understand how many of the checks and balances which are supposed to contain excesses in our capital markets either failed or short-circuited. We have also started to ascertain exactly how Enron's executives, directors, attorneys, and auditors contributed to the corporation's demise. We have further discovered more about how the decisions and actions of regulators, stock analysts, credit raters, and investment bankers helped to cause Enron's disintegration.

Many of my colleagues additionally helped to create the environment that resulted not only in the insolvency of Enron but also the bankruptcy of numerous other high-flying companies in recent years. In the 1990s, some of my colleagues successfully pushed for passage of deregulatory efforts and blocked the development of new regulatory safeguards. As we proceed, we therefore need to reflect on Congress's own culpability for the current events.

More than a decade ago, our Committee helped to clean up the savings and loan crisis. Deregulatory efforts contributed significantly to that debacle. Once again, it appears that we may have gone too far in deregulating. Enron's failure and the collapse of other companies may be the revenge of the rush of some to deregulate securities markets.

In light of recent events, the Private Securities Litigation Reform Act of 1995, which became law despite a presidential veto, deserves careful review. This statute, part of the so-called Contract with America, was supposed to prevent "frivolous" lawsuits. This law, however, has apparently helped businesses to manipulate their financial results. Evidence now indicates that earnings restatements by companies have more than tripled since the early 1990s. This law may also prevent investors from recovering the billions of dollars they lost in Enron.

And last year, before examining the resources needed by the Securities and Exchange Commission, many of my colleagues rushed to cut the fees collected on securities transactions. The Commission was and is the regulator with primary responsibility for overseeing Enron. Yet, it appears that the Commission failed to review Enron's financial disclosures since 1997. I want to know why that occurred. Moreover, it seems that the Bush Administration has decided to recommend an insufficient increase in the Commission's budget for fiscal 2003. To protect investors from other Enrons, we must significantly increase these resources in the months ahead.

The financial devastation caused by Enron warrants our thorough investigation. We need to examine quickly and comprehensively the deficiencies in our public policies that contributed to this corporate bankruptcy. We must also determine appropriate ways to reform our nation's securities laws and regulations.

There are, however, many of my colleagues who want to rush to pass legislation before we uncover the entire set of facts in this case. To each of them, I urge restraint. If we take our

time and learn the complete story, we have an opportunity to do something meaningful and responsible on a bipartisan basis. We should ultimately develop strong, effective, and appropriate policy to prevent similar debacles in the future, and gathering all of the pertinent facts will facilitate attaining this goal.

When we do consider a bill, I have already identified many issues that we should address. In addition to reviewing the consequences of the Private Securities Litigation Reform Act, we must fix the problem of auditor independence. My feeling is that no accounting firm should serve as both an auditor and a consultant to the same company. Although I applaud the efforts of the industry in recent days to mitigate these conflicts, we may need to pursue further reforms.

We must also improve supervision over the accounting profession. The current oversight system resembles a Rube Goldberg contraption. As a result, we must develop a new regulatory regime that involves genuine public oversight and real accountability. Moreover, we have learned of the excesses of Enron only because it failed. We should take this opportunity to better understand the problem of earnings management and how it affects other companies.

Many other issues fall firmly within our jurisdiction and demand our examination in the months ahead. We must return to the issue of analyst independence. We must also study the corporate governance systems of public companies. We must further scrutinize the financial disclosure requirements of American businesses. We must additionally analyze the flaws of our accounting standards and the deficiencies of credit rating agencies. Finally, we must review the responsibilities of the Securities and Exchange Commission.

In closing, Mr. Chairman, we must move with diligence to dissect what went wrong first and then take action to restore faith in our nation's capital markets. Accordingly, I look forward to hearing from each of our witnesses and yield back the balance of my time.

Statement by Hon. John J. LaFalce before the Capital Markets Subcommittee on the Enron Bankruptcy

February 4, 2002

Since this Committee assumed jurisdiction over capital markets issues, I have warned that earnings manipulation and deceptive accounting threatened the very integrity of our capital markets, and in early 2001 began calling for a significant increase in the SEC's budget to strengthen its personnel, oversight, and enforcement. Enron's colossal failure and its devastating impact on investors and on the working men and women at Enron have more than justified those concerns.

Today we will hear what went wrong at Enron and how a culture of corporate arrogance and greed resulted in losses of over $60 billion to investors and employees. The Special Investigative Committee's Report is a devastating indictment of Enron's senior management, its board of directors, its auditors, and its lawyers, all of whom failed to fulfill their responsibilities to Enron's shareholders. The safeguards that should have protected investors failed at every level.

The failure of Enron has challenged investors' faith in the integrity of the capital markets. We must address the systemic problems that Enron's failure has made all too apparent if we are to prevent future Enrons, restore the faith of investors in our capital markets, and restore the faith of workers in their employers. To do so, we must engage in a collective rethinking and reformulation of how we oversee our capital markets and our financial disclosure system. We must also give the SEC the resources it needs to do its job. I was extremely disappointed to learn that the Administration has not seen fit to provide the SEC with any increase in resources to address these challenges, or even to fund pay parity for SEC employees.

I believe that the Committee should proceed deliberatively and on the basis of a thorough and thoughtful record to identify real solutions to these problems. I have been engaged in productive bi-partisan discussions with both Mr. Oxley and Mr. Baker to attempt to craft legislation to deal with the serious policy issues Enron and cases like it raise. I am hopeful that we will be able to agree on a set of tough and serious proposals to address these issues. At a minimum, I believe we must address the following areas:

We must seriously consider the separation of audit and consulting functions to ensure that auditor judgement is not tainted by the fees received for non-audit services. An auditor's first duty should be to the

public, and the public is being ill-served by the current performance of this profession. Data now available under the SEC's disclosure rule on non-audit fees makes clear that, for the auditors of many large public companies, audit fees are a minute percentage of the fees they receive. Even in the absence of Enron, that data alone justifies a re-examination. I fully support the recommendations of previous SEC Chairman Levitt in this area. We also should consider other proposals to improve auditor independence, such as term limits for auditors.

- Exclusive self-regulation has brought us to where we are today and cannot work in and of itself. We need significantly enhanced public oversight and regulation of the auditing and securities industry, including a strong new auditing regulator with a full range of powers.

- We must find a way to provide a massive increase in SEC resources to provide more regular and systematic oversight by the SEC of the disclosure of public companies.

- Financial reporting for public companies must be substantially strengthened to confront misleading and fraudulent accounting practices that have resulted in billions of dollars of losses to investors.

- The functioning of audit committees and the boards of directors of public companies must be reformed to ensure that independent directors are truly independent and that auditors are working for shareholders, not management.

- We must require real-time disclosure of insider stock sales, so that investors know when insiders are getting out.

While the reforms needed are not without cost, they are far less costly than the losses to investors and our economy of continued financial scandals and failures. Earlier this year, I said that the record number of earnings restatements mandated by the SEC were the "tip of the iceberg." Even as we deliberate, more companies may be forced to restate their financial results because of misleading or fraudulent accounting. We must use this opportunity to restore the accuracy and integrity of financial reporting to ensure that "the next Enron" gets cleaned up before it's too late.

Opening Statement of Congressman Robert Ney before the
Subcommittee on Capital Markets, Insurance, and
Government Sponsored Enterprises

Thank you Mr. Chairman. I appreciate the hard work you and Ranking Member Kanjorski are doing in ensuring that this committee exercises its duty looking into the collapse of Enron. With this Committee's jurisdiction over the accounting profession we have an important public duty to exercise our oversight role in the Enron matter. I also believe that as part of our investigation we must bring Ken Lay before our committee to complete our investigation. We have subpoena power and we should use it.

For 70 years we have operated on the principal of investors making decisions about securities based on an honest assessment of a company's financial health. This model has given us the finest and best-regulated markets in the world.

Unfortunately this model is now broken. Investors do not believe that they are receiving honest information about a company's fiscal position. Investors certainly weren't given the truth in the Enron case. We must fix this. We must restore investor confidence. The image of auditors being a rubber stamp for companies that are "cooking the books" must be done away with. We cannot allow a system that breeds such deep cynicism about corporate reporting to remain if we are to have capital markets that investors trust.

This committee is here to explore the best way to put integrity into the accounting profession. Ideas have been floated to have the government become an auditor for the auditors, or to take over all corporate auditing. Others have floated the idea of a robust industry self-regulator. In looking at all of these proposals we must ask the simple question: will it solve the problem? We need to ask our witnesses to tell us what we need must do to make disclosure meaningful.

I don't want to see Congress consider legislation just to look like it is doing something. I don't want us making a commotion just so we can say that action is being taken. I want to be able to go to my constituents and say not that we did "something," instead I want to say that we fixed the problem. I want to make sure that and Enron situation never happens again so that we can restore the confidence of investors in our markets. I look forward to exploring what is the best way to restore the integrity of our accounting professions and our capital markets.

Again, I want to thank Chairman Baker and Ranking Member Kanjorski for holding this important hearing. I look forward to working on this important issue.

Ron Paul

Statement of Ron Paul

Mr. Chairman, the collapse of Enron has so far been the cause of numerous hearings as well as calls for increased federal control over the financial markets and the accounting profession. For example, legislation has been introduced to force all publicly traded companies to submit to federal audits.

I fear that many of my well-meaning colleagues are reacting more to media reports portraying Enron as a reckless company whose problems stemmed from a lack of federal oversight. It is a mistake for Congress to view the Enron collapse as a justification for more government regulation. Publicly held corporations already comply with massive amounts of SEC regulations, including the filing of quarterly reports that disclose minute details of assets and liabilities. If these disclosure rules failed to protect Enron investors, will more red tape really solve anything? The real problem with SEC rules is that they give investors a false sense of security, a sense that the government is protecting them from dangerous investments.

In truth, investing carries risk, and it is not the role of the federal government to bail out every investor who loses money. In a true free market, investors are responsible for their own decisions, good or bad. This responsibility leads them to vigorously analyze companies before they invest, using independent financial annalists. In our heavily regulated economy, however, investors and analysts equate SEC compliance with reputability. The more we look to the government to protect us from investment mistakes, the less competition there is for truly independent evaluations of investment risk.

The SEC, like all government agencies, is not immune from political influence or conflicts of interest. In fact, the new SEC chief used to represent the very accounting companies now under SEC scrutiny. If anything, the Enron failure should teach us to place less trust in the SEC. Yet many in Congress and the media characterize Enron's bankruptcy as an example of unbridled capitalism gone wrong.

Few in Congress seem to understand how the Federal Reserve system artificially inflates stock prices and causes financial bubbles. Yet what other explanation can there be when a company goes from a market value of more than $75 billion to virtually nothing in just a few months? The obvious truth is that Enron was never really worth anything near $75 billion, but the media focuses only on the possibility of deceptive practices by

management, ignoring the primary cause of stock overvaluation: Fed expansion of money and credit.

The Fed consistently increased the money supply (by printing dollars) throughout the 1990s, while simultaneously lowering interest rates. When dollars are plentiful, and interest rates are artificially low, the cost of borrowing becomes cheap. This is why so many Americans are more deeply in debt than ever before. This easy credit environment made it possible for Enron to secure hundreds of millions in uncollateralized loans, loans that now cannot be repaid. The cost of borrowing money, like the cost of everything else, should be established by the free market- not by government edict. Unfortunately, however, the trend toward overvaluation will continue until the Fed stops creating money out of thin air and stops keeping interest rates artificially low. Until then, every investor should understand how Fed manipulations affect the true value of any company and the level for the markets.

Therefore, if Congress wishes to avoid future bankruptcies like Enron, the best thing it can do is repeal existing regulations which give investors a false sense of security and reform the country's monetary policy to end the federal reserve - generated boom-and-bust cycle. Congress should also repeal those programs which provide taxpayer subsidies to large, politically-powerful corporations such as Enron.

Enron provides a perfect example of the dangers of corporate subsidies. The company was (and is) one of the biggest beneficiaries of Export-Import Bank subsidies. The Ex-Im bank, a program that Congress continues to fund with tax dollars taken from hard-working Americans, essentially makes risky loans to foreign governments and businesses for projects involving American companies. The Bank, which purports to help developing nations, really acts as a naked subsidy for certain politically-favored American corporations- especially corporations like Enron that lobbied hard and gave huge amounts of cash to both political parties. Its reward was more that $600 million in cash via six different Ex-Im financed projects.

One such project, a power plant in India, played a big part in Enron's demise. The company had trouble selling the power to local officials, adding to its huge $618 million loss for the third quarter of 2001. Former president Clinton worked hard to secure the India deal for Enron in the mid-90s; not surprisingly, his 1996 campaign received $100,000 from the company. Yet the media makes no mention of this favoritism. Clinton may claim he was "protecting" tax dollars, but those tax dollars should never have been sent to India in the first place.

Enron similarly benefitted from another federal boondoggle, the Overseas Private Investment Corporation. OPIC operates much like the Ex-Im Bank, providing taxpayer-funded loan guarantees for overseas projects, often in countries with shaky governments and economies. An OPIC spokesman claims the organization paid more than one billion dollars for 12 projects involving Enron, dollars that now may never be repaid. Once again, corporate welfare benefits certain interests at the expense of taxpayers.

The point is that Enron was intimately involved with the federal government. While most of my colleagues are busy devising ways to "save" investors with more government, we should be viewing the Enron mess as an argument for less government. It is precisely because government is so big and so thoroughly involved in every aspect of business that Enron felt the need to seek influence through campaign money. It is precisely because corporate welfare is so extensive that Enron cozied up to DC-based politicians of both parties. It's a game every big corporation plays in our heavily regulated economy, because they must when the government, rather than the marketplace, distributes the spoils.

This does not mean Enron is to be excused. There seems to be little question that executives at Enron deceived employees and investors, and any fraudulent conduct should of course be fully prosecuted. However, Mr. Chairman, I hope we will not allow criminal fraud in one company, which constitutionally is a matter for state law, to justify the imposition of burdensome new accounting and stock regulations. Instead, we should focus on repealing those monetary and fiscal policies that distort the market and allow the politically powerful to enrich themselves at the expense of the American taxpayer.

Opening Statement for the Record
Congressman Ed Royce
Enron Hearings – 4 February 2002

Thank you, Mr. Chairman, for the opportunity to address this most important issue. The astonishingly rapid demise of Enron Corporation – and with it, the loss of $32 billion worth of market capitalization and the jobs of thousands of loyal employees – is cause for great alarm on many levels.

First and foremost, we must recognize the human face of this tragedy -- those employees and shareholders tricked into investing their hard-earned money in an apparently stable company by unscrupulous executives who transacted business in one way and reported it publicly in another. These innocent victims of corporate deceit were assured by Enron executives and Wall Street analysts as late as October of 2001 that Enron was a "safe bet" and "an undervalued stock," and the result of all this duplicity has been the loss of billions of dollars worth of personal wealth and retirement security.

Second, I am concerned by the lack of basic business ethics among Enron Corporation executives. As it has been pointed out in the press, "whether or not Enron's actions violated any laws, they certainly violated the public trust essential for free markets to work." Enron's efforts to disguise its bad investment losses and to increase its earnings by about $1 billion more than they should have been through financial sleight-of-hand were intentionally deceptive, and a blatant attempt to undermine the fundamental purpose of financial accounting – transparency.

Corporate executives of publicly-held companies have a moral and legal responsibility to make their balance sheets both representative of financial reality and understandable to the investing public. Enron's use of questionable special partnerships clearly runs contra to the principles of consolidation and transparency upon which our fair and successful free-market system is predicated. Even more troubling is the fact that at the same time that Enron executives were engaging in this financial subterfuge, those directly involved in the questionable off-balance sheet partnerships were enriched by tens of millions of dollars in self-dealings that they should never have received.

Enron's collapse also raises the issue of the culpability of the accounting and auditing industry in ensuring that corporations live up to these moral and legal obligations. Emerging behind-the-scenes accounts of document-shredding at Arthur Andersen raise serious concerns about the degree to which Andersen was willing to subjugate its fiduciary responsibilities to shareholders in pursuit of lucrative internal auditing and consulting contracts, posing a potential conflict of interests within the industry which must be seriously addressed. Another particularly disturbing fact arising from this situation is that Enron's accounting treatment was determined with structural advice from Arthur Andersen, which billed Enron $5.7 million above its regular audit fees for advice on three of these partnership transactions alone.

Finally, the fact that those charged with overseeing the auditing community were unable to prevent Enron's collapse casts serious doubt over the efficacy of the peer-review process by which accounting firms currently review each others' work. The Public Oversight Board and

self-regulating peer review process in the auditing profession seems untenable in its current form, necessitating the creation of a new system to ensure that public accountancy is correct, impartial and free of the moral hazard associated with the conflict of interest currently plaguing the auditing process.

In short, Enron's bankruptcy is both a story of personal tragedy for thousands of employees and shareholders and a cautionary tale of how the current system of business oversight failed terribly at every level. In the case of Enron's unprecedented $50 billion bankruptcy, every party charged with protecting the shareholder shirked its responsibility, creating a financial fallout that has wiped out billions of dollars worth of shareholder value and shaken public confidence in American corporate ethics to its very core.

Enron's executives neglected their responsibility to provide timely, transparent and accurate financial statements. Arthur Andersen failed to catch the executives' obfuscation and financial misdirection. The auditing community's peer review process and the Public Oversight Board failed to catch Andersen's errors. And the entire financial community – from the analysts to the institutional investors – failed to recognize that Enron was a proverbial house-of-cards, waiting to tumble as soon as the market exposed the lies underpinning Enron's enormous profits. Each of these entities were meant to guard the interests of shareholders, but in light of this unprecedented systemic failure, I feel it is our duty here to ask ourselves the ancient Roman question: *Sed quis custodiet ipsos custodes*? – Who will guard the guardians themselves? – to prevent a catastrophe of this magnitude from ever occurring again.

TESTIMONY OF

HARVEY L. PITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING
LEGISLATIVE SOLUTIONS TO PROBLEMS RAISED BY EVENTS RELATING TO ENRON CORPORATION

BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 4, 2002

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
HARVEY L. PITT, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

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UNITED STATES HOUSE OF REPRESENTATIVES

February 4, 2002

Chairman Baker, Congressman Kanjorski, Members of the Subcommittee:

I am pleased to appear before you on behalf of the Securities and Exchange Commission to testify about possible legislative solutions to problems raised by events relating to Enron Corporation. I would like to commend Chairman Baker and the Committee for convening these hearings. They are a timely and appropriate way for all of us to reflect on one of America's worst business failures.

The Enron debacle is tragic, and many Americans have felt its consequences. Innocent investors were betrayed by abuses of our system of disclosure and accounting. Most tragic are investors who entrusted some portion of their life savings to a company that purported to be profitable, placing their confidence in the company, its auditors, research analysts, rating agencies and our federally mandated disclosure system. Equally betrayed are those who held Enron stock in their retirement accounts and made life-altering decisions based upon the stock's perceived value, only to find themselves locked in to a rapidly sinking investment that ate up years of hard work. It is these Americans, whose faith fuels our markets, who have no lobby and no trade associations, whose interests are, and must be, paramount. I am appalled at what happened to them as a result of Enron's collapse. The Commission as an institution, and I both as its Chairman and personally, are committed to doing everything in our power to prevent other abuses of our system like Enron from happening again.

The SEC's primary responsibilities are to protect public investors and to promote the fairness, effectiveness and efficiency of our capital markets. In the face of Enron's meltdown and tragic consequences, our agency currently is conducting an enforcement investigation to identify violations of the federal securities laws that may have occurred, and those who perpetrated them. When Enron began to implode, my fellow Commissioners and I immediately – and unanimously – ordered a no-holds barred investigation, which is still underway. Until the investigation is complete, we cannot fairly assign blame for past events. The public can have full confidence, however, that

our Division of Enforcement will conduct a thorough investigation and that the SEC will redress any and all wrongdoing and wrongdoers swiftly and completely.

Congress wisely permeated the federal securities laws with a philosophy that investors must be fully informed and confident that our markets are free from fraudulent, deceptive and manipulative conduct. We are tasked with defining and enforcing these laws; Congress already has given us enormous power to do so. Anyone who violated the laws we enforce will be held fully accountable. Moreover, we are assisting the criminal authorities and the Department of Labor in every way possible in enforcing the laws they administer. We are doing our utmost to get to the bottom of this disaster and ensure that all who are responsible for this outrage get all they deserve.

Even prior to Enron, we had been working to improve and modernize our corporate disclosure and financial reporting system, to make disclosures and financial reports more meaningful and intelligible to average investors. Investors are entitled to the best regulatory system possible. To reassure investors and restore their confidence, we must address flaws in our current disclosure and accounting systems that have languished too long.

Who should address these flaws? At the dawn of a new century, let us reflect a moment on the wisdom of America's leaders a century ago. Teddy Roosevelt confronted the power of business, at that time in the form of vast "trusts," and asked the fundamental question – was government capable of policing business where the public interest requires? Many today are again asking the same question – is government capable of policing business where the public interest requires? The clear answer is, and must always be, yes. The federal government, and in particular the SEC, can and will police business. My fellow Commissioners and I guarantee that. Enron changes how citizens look at the safety of the markets, the truth of corporate disclosures, the dependability of financial statements, the validity of analyst recommendations, and the reliability of rating agency evaluations. I am committed, and the Commission is committed, to reexamining every assumption, every rule and regulation, in light of Enron. There are fundamental, longstanding flaws in our system – and now they are on the table. I do not know, and do not have for you today, the final answers. But, at the end of the process we will have a better system of corporate disclosure.

We already have been working with Congress, the Justice Department, the Labor Department, and the President's Working Group on Financial Markets. The SEC does not have a monopoly on wisdom nor do we have definitive answers to the problem. What we do have is an undeniable obligation to think about the issues, search for answers, lead constructive debate, and to move quickly on behalf of investors to try to prevent future Enrons.

In his State of the Union Address, the President appropriately demanded "stricter accounting standards and tougher disclosure requirements." He wants corporate America to "be made more accountable to employees and shareholders and held to the highest standard of conduct." The SEC shares and embraces these principles, and we are firmly

committed to making them a reality. We are working on many initiatives for improving and modernizing the current disclosure and regulatory systems. These initiatives include, but are not limited to, the following:

- *A system of "current" disclosure.* Investors need current information, not just periodic disclosures, along with clear requirements for public companies to make affirmative disclosures of, and to provide updates to, unquestionably material information in real time.

- *Public company disclosure of significant current "trend" and "evaluative" data.* Providing current trend and evaluative data, as well as historical information, would enable investors to assess a company's financial posture as it evolves and changes. It would also preclude "wooden" approaches to disclosure, and encourage evaluative disclosures that begin where line item and GAAP disclosures end. This information, upon which corporate executives and bankers already base critical decisions, can be presented without confusing or misleading investors, prejudicing legitimate corporate interests or exposing companies to unfair assertions of liability.

- *An updated and improved system of periodic disclosure.* In addition to the new disclosure regime we believe investors deserve, we intend to keep, but improve, the existing periodic disclosure system. Quarterly and annual reports can be produced more quickly, and can be more comprehensible than they presently are, appropriately reflecting risks and returns. We intend to make them so.

- *Financial statements that are clear and informative.* Investors, and employees concerned with preserving and increasing their savings and retirement funds, deserve comprehensive financial reports they can easily and quickly interpret and understand.

- *Conscientious identification and assessment by public companies and their auditors of critical accounting principles.* Public companies and their advisers should be required to identify the three, four or five most critical accounting principles upon which a company's financial status depends, and which involve the most complex, subjective, or ambiguous decisions and/or assessments. Investors should be told, concisely and clearly, how these principles are applied, as well as information about the range of possible effects in differing applications of these principles.

- *Accounting standard setting that responds expeditiously, concisely, and clearly, to current and immediate needs and reflects business realities.* Improved standard setting is a high priority. The FASB, the private standard setting board for accounting principles, is the appropriate place for resolving debate on technical issues. But it must act. For too many years the FASB has failed to set standards for accounting for special purpose entities. In the wake of Enron, it must act and act quickly to give guidance.

- *An effective and transparent system of private regulation of the accounting profession, subject to our rigorous oversight.* We recently initiated discussion of how best to restructure the regulatory system governing the accounting profession. We suggested creating a new Public Accountability Board to assume responsibility for auditor and accountant discipline and quality control. At least a predominant majority of the members of the new disciplinary body we envision must be unaffiliated with the accounting profession. Our proposed oversight body would be funded not by the accounting profession but from the entire private sector, giving no group the ability to dictate, control or influence their decisions and efforts.

- *A system that ensures that those entrusted with the important public responsibility of performing audits of public companies, are single-minded in their devotion to the public interest, and are not subject to conflicts that might confuse or divert them from their efforts.* Those who perform audits must be truly independent and in particular must not be subject to the conflict of increasing their own compensation at the risk of ensuring the public's protection. Their fidelity to the cause of full, fair and understandable financial reporting must be ironclad and unequivocal.

- *More meaningful investor protection by audit committees.* Audit Committees must be proactive, not merely reactive, to ensure the quality and integrity of corporate financial reports. Especially critical is the need to improve interaction between audit committee members and senior management and outside auditors. Audit Committees must understand what and why critical accounting principles were chosen, how they were applied, and have a basis for believing the end result fairly presents their company's actual status.

- *Analyst recommendations predicated on financial data they have deciphered and interpreted.* This Subcommittee, through Chairman Baker and Congressman Kanjorski, and the full Committee, led by Chairman Oxley and Congressman LaFalce, have led the way in bringing attention to shortcomings in the conduct of Wall Street analysts. We see these shortcomings again in the Enron situation. Changes here are long overdue. Working with the Congress and the securities industry, we are on the threshold of new rules that will create more transparency for analyst recommendations.

These are just some of the initiatives we are considering and solutions we are proposing for consideration. We are committed to making disclosures more meaningful, and intelligible, to average investors. We are soliciting broad input. The Commission will hold its first ever "Investor Summit" this May, to solicit investor input on the policy issues that confront us as we begin reforming our disclosure and financial reporting process. We are also planning to hold a series of Roundtables to discuss significant issues regarding our ideas for reform and the suggestions of others. It is incumbent on the SEC to consider the issues, put forward the most responsible proposal it can, and

engage in dialogue with all parties willing to participate. That is the process we have begun, and I can assure you we are committed to following through promptly on this process by taking all steps necessary to reassure the public and preserve confidence in our disclosure and financial reporting process.

We have the requisite authority to enforce the federal securities laws vigorously. We also believe we already have statutory authority to adopt rules that would implement the important improvements that I just mentioned, as well as others necessary to address the problems in our system brought to light so vividly by the collapse of Enron. By the same token, if major and sweeping changes are to be made, even by rulemaking, Congress should, and must, be an active participant in the process. Congress is the body of government most directly accountable to the people. We intend to work closely with you to ensure that the regulatory framework we ultimately propose meets your view of what is appropriate and in the interests of the public.

It is Congress, however, that must make the final judgment whether legislation is necessary or appropriate. As I have said before, we will work, and indeed are already working, with Members on both sides of the aisle, in both the House and the Senate, regarding legislation Congress may consider. We will continue in these efforts and are committed to implementing any legislative changes Congress ultimately believes are necessary. In our view, any such changes should include provisions broadly reaffirming and enabling the SEC to improve the current disclosure and accounting system.

One area of possible legislation already identified is the need to require corporate insiders to make public their trading activities more quickly than current law requires. Under current law, which dates back to 1934, the principal provision covering reporting by insiders calls for filing by the tenth day of the month after the month when the trading occurred. That may have been good enough in 1934, but it is not nearly good enough today.

Our system must be improved and modernized. We are up to the task, but only if we are able to tap our best minds to produce our most creative solutions, and only if we are able to discuss these issues openly, honestly, and as constructively as possible. The SEC is committed to that end, and we seek participation by everyone with an interest in our capital markets. Together, we can, we must and we will make a difference. That is our vision and our unalterable mission.

On behalf of the Commission, I appreciate the opportunity to submit our views on legislative solutions. I am happy to try to respond to any questions the Subcommittee may have.

TESTIMONY OF WILLIAM C. POWERS, JR.
Chairman of the Special Investigative Committee
Of the Board of Directors of Enron Corporation

Before the Committee on Financial Services
United States House of Representatives

February 4, 2002

Mr. Chairman and distinguished Members of the Committee. My name is William Powers. I am the Dean of the University of Texas Law School. For the past three months, I have served as Chairman of the Special Investigative Committee of the Board of Directors of Enron Corporation. I appreciate the opportunity to come and testify before you today.

As you know, during October of last year, questions were being raised about Enron's transactions with partnerships that were controlled by its Chief Financial Officer, Andrew Fastow. In the middle of October, Enron announced that it was taking an after-tax charge of more than $500 million against its earnings, because of transactions with one of those partnerships. Enron also announced a reduction in shareholder equity of more than a billion dollars. At the end of October, the Enron Board established a Special Committee to investigate these matters, and then asked me if I would join the Board for the purpose of chairing that Committee, and conducting that investigation. With the help of counsel and professional accounting advisors, we have spent the last three months conducting that investigation.

Our Committee's Report was filed on Saturday. It covers a lot of ground and will, I hope, be a helpful starting point for the necessary further investigations by Congressional Committees, by the Securities and Exchange Commission, and by the

Department of Justice. A copy of the Executive Summary of our Report is attached to my Statement here.

Many questions currently part of public discussion—such as questions relating to the employees' retirement savings and sales of Enron securities by insiders—are beyond the scope of the charge we were given. These are matters of vital importance, but they are not matters we addressed in our Report.

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 amounts 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 of its balance sheet. But Enron did *not* follow the accounting rules.

Finally, we found something more troubling than those individual instances of misconduct and failure to follow accounting rules. We found a systematic and pervasive attempt by Enron's Management to misrepresent the Company's financial condition. Enron Management used these partnerships to enter into transactions that it could not, or

would not, do with unrelated commercial entities. Many of the most significant transactions apparently were not designed to achieve bona fide economic objectives.

As our Report demonstrates, these transactions were extremely complex. I won't try to describe them in detail here. But I do think it would be useful to give just one example. It involves efforts by Enron to "hedge" against losses on investments it had made.

Enron was not just a pipeline and energy trading company. It also had large investments in other businesses, some of which had appreciated substantially in value. These were volatile investments, and Enron was concerned because it had recognized the gains when these investments appreciated, and it didn't want to recognize the losses if the investments declined in value.

Therefore, Enron purported to enter into certain "hedging" transactions in order to avoid recognizing losses from its investments. The problem was that the hedges weren't real. The idea of a hedge is normally to contract with a credit-worthy outside party that is prepared—for a price—to take on the economic risk of an investment. If the value of the investment goes down, that outside party will bear the loss. That is not what happened here; here, Enron was essentially hedging with itself.

The outside parties with which Enron "hedged" were the so-called "Raptors." The purported outside investor in them was a Fastow partnership. In reality, these were entities in which only Enron had a real economic stake, and whose main assets were Enron's own stock. The notes of Enron's corporate secretary, from a meeting of the

Finance Committee regarding the Raptors, capture the reality: "Does not transfer economic risk but transfers P+L volatility."

If the value of Enron's investments fell at the same time that the value of Enron stock fell, the Raptors would be unable to meet their obligations, and the "hedges" would fail. This is precisely what happened in late 2000 and early 2001 when two of these Raptor vehicles lacked the ability to pay Enron on the "hedges." Even if the hedges had not failed in the sense I just described, the Raptors would have paid Enron with the stock that Enron had provided in the first place; Enron would simply have paid itself back.

By March 2001, it appeared that Enron would be required to take a charge against earnings of more than $500 million to reflect the inability of the Raptors to pay. Rather than take that loss, Enron compounded the problem by making even more of its own stock available to the Raptors—$800 million worth. It gave the false impression that the Raptors had enough money to pay Enron what they owed. This transaction was apparently hidden from the Board, and was certainly hidden from the public.

Let me say that while there are questions about who understood what concerning many of these very complex transactions, there's no question that virtually everyone, from the Board of Directors on down, understood that the company was seeking to offset its investment losses with its own stock. That is not the way it is supposed to work. Real earnings are supposed to be compared to real losses.

As a result of these transactions, Enron improperly inflated its reported earnings for a 15-month period—from the third quarter of 2000 through the third quarter of

2001—by more than $1 billion. This means that more than 70 percent of Enron's reported earnings for this period were not real.

How could this have happened? The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, self-enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits.

Whenever this many things go wrong, it is not just the act of one or two people. There was misconduct by Fastow and other senior employees of Enron. There were failures in the performance of Enron's outside advisors. And there was a fundamental default of leadership and management. Leadership and management begin at the top, with the CEO, Ken Lay. In this company, leadership and management depended as well on the Chief Operating Officer, Jeff Skilling. The Board of Directors failed in its duty to provide leadership and oversight.

In the end, this is a tragedy that could and should have been avoided. I hope that our Report, and the work of this Committee, will help reduce the danger that it will happen to some other company.

EXECUTIVE SUMMARY AND CONCLUSIONS

The Special Investigative Committee of the Board of Directors of Enron Corp. submits this Report of Investigation to the Board of Directors. In accordance with our mandate, the Report addresses transactions between Enron and investment partnerships created and managed by Andrew S. Fastow, Enron's former Executive Vice President and Chief Financial Officer, and by other Enron employees who worked with Fastow.

The Committee has done its best, given the available time and resources, to conduct a careful and impartial investigation. We have prepared a Report that explains the substance of the most significant transactions and highlights their most important accounting, corporate governance, management oversight, and public disclosure issues. An exhaustive investigation of these related-party transactions would require time and resources beyond those available to the Committee. We were not asked, and we have no attempted, to investigate the causes of Enron's bankruptcy or the numerous business judgments and external factors that contributed it. Many questions currently part of public discussion—such as questions relating to Enron's international business and commercial electricity ventures, broadband communications activities, transactions in Enron securities by insiders, or management of employee 401(k) plans—are beyond the scope of the authority we were given by the Board.

There were some practical limitations on the information available to the Committee in preparing this Report. We had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Certain former Enron employees who (we were told) played substantial roles in one or more of the

transactions under investigation—including Fastow, Michael J. Kopper, and Ben F. Glisan, Jr.—declined to be interviewed either entirely or with respect to most issues. We have had only limited access to certain workpapers of Arthur Andersen LLP ("Andersen"), Enron's outside auditors, and no access to materials in the possession of the Fastow partnerships or their limited partners. Information from these sources could affect our conclusions.

This Executive Summary and Conclusions highlights important parts of the Report and summarizes our conclusions. It is based on the complete set of facts, explanations and limitations described in the Report, and should be read with the Report itself. Standing alone, it does not, and cannot, provide a full understanding of the facts and analysis underlying our conclusions.

Background

On October 16, 2001, Enron announced that it was taking a $544 million after-tax charge against earnings related to transactions with LJM2 Co-Investment, L.P. ("LJM2"), a partnership created and managed by Fastow. It also announced a reduction of shareholders' equity of $1.2 billion related to transactions with that same entity.

Less than one month later, Enron announced that it was restating its financial statements for the period from 1997 through 2001 because of accounting errors relating to transactions with a different Fastow partnership, LJM Cayman, L.P. ("LJM1"), and an additional related-party entity, Chewco Investments, L.P. ("Chewco"). Chewco was managed by an Enron Global Finance employee, Kopper, who reported to Fastow.

The LJM1- and Chewco-related restatement, like the earlier charge against earnings and reduction of shareholders' equity, was very large. It reduced Enron's reported net income by $28 million in 1997 (of $105 million total), by $133 million in 1998 (of $703 million total), by $248 million in 1999 (of $893 million total), and by $99 million in 2000 (of $979 million total). The restatement reduced reported shareholders' equity by $258 million in 1997, by $391 million in 1998, by $710 million in 1999, and by $754 million in 2000. It increased reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000. Enron also revealed, for the first time, that it had learned that Fastow received more than $30 million from LJM1 and LJM2. These announcements destroyed market confidence and investor trust in Enron. Less than one month later, Enron filed for bankruptcy.

Summary of Findings

This Committee was established on October 28, 2001, to conduct an investigation of the related-party transactions. We have examined the specific transactions that led to the third-quarter 2001 earnings charge and the restatement. We also have attempted to examine all of the approximately two dozen other transactions between Enron and these related-party entities: what these transactions were, why they took place, what went wrong, and who was responsible.

Our investigation identified significant problems beyond those Enron has already disclosed. Enron employees involved in the partnerships were enriched, in the aggregate, by tens of millions of dollars they should never have received—Fastow by at least $30 million, Kopper by at least $10 million, two others by $1 million each, and still two more

by amounts we believe were at least in the hundreds of thousands of dollars. We have seen no evidence that any of these employees, except Fastow, obtained the permission required by Enron's Code of Conduct of Business Affairs to own interests in the partnerships. Moreover, the extent of Fastow's ownership and financial windfall was inconsistent with his representations to Enron's Board of Directors.

This personal enrichment of Enron employees, however, was merely one aspect of a deeper and more serious problem. These partnerships—Chewco, LJM1, and LJM2—were used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risk. Some transactions were designed so that, had they followed applicable accounting rules, Enron could have kept assets and liabilities (especially debt) off of its balance sheet; but the transactions did not follow those rules.

Other transactions were implemented—improperly, we are informed by our accounting advisors—to offset losses. They allowed Enron to conceal from the market very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that third party was simply an entity in which only Enron had a substantial economic stake. We believe these transactions resulted in Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost $1 billion higher than should have been reported.

Enron's original accounting treatment of the Chewco and LJM1 transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance. In virtually all of the transactions, Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen, which Management reported to the Board. Enron's records show that Andersen billed Enron $5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.

Many of the transactions involve an accounting structure known as a "special purpose entity" or "special purpose vehicle" (referred to as an "SPE" in this Summary and in the Report). A company that does business with an SPE may treat that SPE as if it were an independent, outside entity for accounting purposes if two conditions are met: (1) an owner independent of the company must make a substantive equity investment of at least 3% of the SPE's assets, and that 3% must remain at risk throughout the transaction; and (2) the independent owner must exercise control of the SPE. In those circumstances, the company may record gains and losses on transactions with the SPE, and the assets and liabilities of the SPE are not included in the company's balance sheet, even though the company and the SPE are closely related. It was the technical failure of some of the structures with which Enron did business to satisfy these requirements that led to Enron's restatement.

Summary of Transactions and Matters Reviewed

The following are brief summaries of the principal transactions and matters in which we have identified substantial problems:

The Chewco Transaction

The first of the related-party transactions we examined involved Chewco Investments L.P., a limited partnership managed by Kopper. Because of this transaction, Enron filed inaccurate financial statements from 1997 through 2001, and provided an unauthorized and unjustifiable financial windfall to Kopper.

From 1993 through 1996, Enron and the California Public Employees' Retirement System ("CalPERS") were partners in a $500 million joint venture investment partnership called Joint Energy Development Investment Limited Partnership ("JEDI"). Because Enron and CalPERS had joint control of the partnership, Enron did not consolidate JEDI into its consolidated financial statements. The financial statement impact of non-consolidation was significant: Enron would record its contractual share of gains and losses from JEDI on its income statement and would disclose the gain or loss separately in its financial statement footnotes, but would *not* show JEDI's debt on its balance sheet.

In November 1997, Enron wanted to redeem CalPERS' interest in JEDI so that CalPERS would invest in another, larger partnership. Enron needed to find a new partner, or else it would have to consolidate JEDI into its financial statements, which it did not want to do. Enron assisted Kopper (whom Fastow identified for the role) in

forming Chewco to purchase CalPERS' interest. Kopper was the manager and owner of Chewco's general partner. Under the SPE rules summarized above, Enron could only avoid consolidating JEDI onto Enron's financial statements if Chewco had some independent ownership with a minimum of 3% of *equity* capital at risk. Enron and Kopper, however, were unable to locate any such outside investor, and instead financed Chewco's purchase of the JEDI interest almost entirely with debt, not equity. This was done hurriedly and in apparent disregard of the accounting requirements for non-consolidation. Notwithstanding the shortfall in required equity capital, Enron did not consolidate Chewco (or JEDI) into its consolidated financial statements.

Kopper and others (including Andersen) declined to speak with us about why this transaction was structured in a way that did not comply with the non-consolidation rules. Enron, and any Enron employee acting in Enron's interest, had every incentive to ensure that Chewco complied with these rules. We do not know whether this mistake resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper or others putting their own interests ahead of their obligations to Enron.

The consequences, however, were enormous. When Enron and Andersen reviewed the transaction closely in 2001, they concluded that Chewco did not satisfy the SPE accounting rules and—because JEDI's non-consolidation depended on Chewco's status—neither did JEDI. In November 2001, Enron announced that it would consolidate Chewco and JEDI retroactive to 1997. As detailed in the Background section above, this retroactive consolidation resulted in a massive reduction in Enron's reported net income and a massive increase in its reported debt.

Beyond the financial statement consequences, the Chewco transaction raises substantial corporate governance and management oversight issues. Under Enron's Code of Conduct of Business Affairs, Kopper was prohibited from having a financial or managerial role in Chewco unless the Chairman and CEO determined that his participation "does not adversely affect the best interests of the Company." Notwithstanding this requirement, we have seen no evidence that his participation was ever disclosed to, or approved by, either Kenneth Lay (who was Chairman and CEO) or the Board of Directors.

While the consequences of the transaction were devastating to Enron, Kopper reaped a financial windfall from his role in Chewco. This was largely a result of arrangements that he appears to have negotiated with Fastow. From December 1997 through December 2000, Kopper received $2 million in "management" and other fees relating to Chewco. Our review failed to identify how these payments were determined, or what, if anything, Kopper did to justify the payments. More importantly, in March 2001 Enron repurchased Chewco's interest in JEDI on terms Kopper apparently negotiated with Fastow (during a time period in which Kopper had undisclosed interests with Fastow in both LJM1 and LJM2). Kopper had invested $125,000 in Chewco in 1997. The repurchase resulted in Kopper's (and a friend to whom he had transferred part of his interest) receiving more than $10 million from Enron.

The LJM Transactions

In 1999, with Board approval, Enron entered into business relationships with two partnerships in which Fastow was the manager and an investor. The transactions between

Enron and the LJM partnerships resulted in Enron increasing its reported financial results by more than a billion dollars, and enriching Fastow and his co-investors by tens of millions of dollars at Enron's expense.

The two members of the Special Investigative Committee who have reviewed the Board's decision to permit Fastow to participate in LJM notwithstanding the conflict of interest have concluded that this arrangement was fundamentally flawed.[1/] A relationship with the most senior financial officer of a public company—particularly one requiring as many controls and as much oversight by others as this one did—should not have been undertaken in the first place.

The Board approved Fastow's participation in the LJM partnerships with full knowledge and discussion of the obvious conflict of interest that would result. The Board apparently believed that the conflict, and the substantial risks associated with it, could be mitigated through certain controls (involving oversight by both the Board and Senior Management) to ensure that transactions were done on terms fair to Enron. In taking this step, the Board thought that the LJM partnerships would offer business benefits to Enron that would outweigh the potential costs. The principal reason advanced by Management in favor of the relationship, in the case of LJM1, was that it would permit Enron to accomplish a particular transaction it could not otherwise accomplish. In

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1/ One member of the Special Investigative Committee, Herbert S. Winokur, Jr., was a member of the Board of Directors and the Finance Committee during the relevant period. The portions of the Report describing and evaluating actions of the Board and its Committees are solely the views of the other two members of the Committee, Dean William C. Powers, Jr. of the University of Texas School of Law and Raymond S. Troubh.

the case of LJM2, Management advocated that it would provide Enron with an additional potential buyer of assets that Enron wanted to sell, and that Fastow's familiarity with the Company and the assets to be sold would permit Enron to move more quickly and incur fewer transaction costs.

Over time, the Board required, and Management told the Board it was implementing, an ever-increasing set of procedures and controls over the related-party transactions. These included, most importantly, review and approval of all LJM transactions by Richard Causey, the Chief Accounting Officer; and Richard Buy, the Chief Risk Officer; and, later during the period, Jeffrey Skilling, the President and COO (and later CEO). The Board also directed its Audit and Compliance Committee to conduct annual reviews of all LJM transactions.

These controls as designed were not rigorous enough, and their implementation and oversight was inadequate at both the Management and Board levels. No one in Management accepted primary responsibility for oversight; the controls were not executed properly; and there were structural defects in those controls that became apparent over time. For instance, while neither the Chief Accounting Officer, Causey, nor the Chief Risk Officer, Buy, ignored his responsibilities, they interpreted their roles very narrowly and did not give the transactions the degree of review the Board believed was occurring. Skilling appears to have been almost entirely uninvolved in the process, notwithstanding representations made to the Board that he had undertaken a significant role. No one in Management stepped forward to address the issues as they arose, or to bring the apparent problems to the Board's attention.

As we discuss further below, the Board, having determined to allow the related-party transactions to proceed, did not give sufficient scrutiny to the information that was provided to it thereafter. While there was important information that appears to have been withheld from the Board, the annual reviews of LJM transactions by the Audit and Compliance Committee (and later also the Finance Committee) appear to have involved only brief presentations by Management (with Andersen present at the Audit Committee) and did not involve any meaningful examination of the nature or terms of the transactions. Moreover, even though Board Committee-mandated procedures required a review by the Compensation Committee of Fastow's compensation from the partnerships, neither the Board nor Senior Management asked Fastow for the amount of his LJM-related compensation until October 2001, after media reports focused on Fastow's role in LJM.

From June 1999 through June 2001, Enron entered into more than 20 distinct transactions with the LJM partnerships. These were of two general types: asset sales and purported "hedging" transactions. Each of these types of transactions was flawed, although the latter ultimately caused much more harm to Enron.

Asset Sales. Enron sold assets to LJM that it wanted to remove from its books. These transactions often occurred close to the end of financial reporting periods. While there is nothing improper about such transactions if they actually transfer the risks and rewards of ownership to the other party, there are substantial questions whether any such transfer occurred in some of the sales to LJM.

Near the end of the third and fourth quarters of 1999, Enron sold interests in seven assets to LJM1 and LJM2. These transactions appeared consistent with the stated purpose of allowing Fastow to participate in the partnerships—the transactions were done quickly, and permitted Enron to remove the assets from its balance sheet and record a gain in some cases. However, events that occurred after the sales call into question the legitimacy of the sales. In particular: (1) Enron bought back five of the seven assets after the close of the financial reporting period, in some cases within a matter of months; (2) the LJM partnerships made a profit on *every* transaction, even when the asset it had purchased appears to have declined in market value; and (3) according to a presentation Fastow made to the Board's Finance Committee, those transactions generated, directly or indirectly, "earnings" to Enron of $229 million in the second half of 1999 (apparently including one hedging transaction). (The details of the transactions are discussed in Section VI of the Report.) Although we have not been able to confirm Fastow's calculation, Enron's reported earnings for that period were $570 million (pre-tax) and $549 million (after-tax).

We have identified some evidence that, in three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against loss. If this was in fact the case, it was likely inappropriate to treat the transactions as sales. There also are plausible, more innocent explanations for some of the repurchases, but a sufficient basis remains for further examination. With respect to those transactions in which risk apparently did not pass from Enron, the LJM partnerships functioned as a vehicle to accommodate Enron in the management of its reported financial results.

Hedging Transactions. The first "hedging" transaction between Enron and LJM occurred in June 1999, and was approved by the Board in conjunction with its approval of Fastow's participation in LJM1. The normal idea of a hedge is to contract with a creditworthy outside party that is prepared—for a price—to take on the economic risk of an investment. If the value of the investment goes down, that outside party will bear the loss. That is not what happened here. Instead, Enron transferred its own stock to an SPE in exchange for a note. The Fastow partnership, LJM1, was to provide the outside equity necessary for the SPE to qualify for non-consolidation. Through the use of options, the SPE purported to take on the risk that the price of the stock of Rhythms NetConnections Inc. ("Rhythms"), an internet service provider, would decline. The idea was to "hedge" Enron's profitable merchant investment in Rhythms stock, allowing Enron to offset losses on Rhythms if the price of Rhythms stock declined. If the SPE were required to pay Enron on the Rhythms options, the transferred Enron stock would be the principal source of payment.

The other "hedging" transactions occurred in 2000 and 2001 and involved SPEs known as the "Raptor" vehicles. Expanding on the idea of the Rhythms transaction, these were extraordinarily complex structures. They were funded principally with Enron's own stock (or contracts for the delivery of Enron stock) that was intended to "hedge" against declines in the value of a large group of Enron's merchant investments. LJM2 provided the outside equity designed to avoid consolidation of the Raptor SPEs.

The asset sales and hedging transactions raised a variety of issues, including the following:

Accounting and Financial Reporting Issues. Although Andersen approved the transactions, in fact the "hedging" transactions did not involve substantive transfers of economic risk. The transactions may have looked superficially like economic hedges, but they actually functioned only as "accounting" hedges. They appear to have been designed to circumvent accounting rules by recording hedging gains to offset losses in the value of merchant investments on Enron's quarterly and annual income statements. The economic reality of these transactions was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron.

Enron used this strategy to avoid recognizing losses for a time. In 1999, Enron recognized after-tax income of $95 million from the Rhythms transaction, which offset losses on the Rhythms investment. In the last two quarters of 2000, Enron recognized revenues of $500 million on derivative transactions with the Raptor entities, which offset losses in Enron's merchant investments, and recognized pre-tax earnings of $532 million (including net interest income). Enron's reported pre-tax earnings for the last two quarters of 2000 totaled $650 million. "Earnings" from the Raptors accounted for more than 80% of that total.

The idea of hedging Enron's investments with the value of Enron's capital stock had a serious drawback as an economic matter. If the value of the investments fell at the same time as the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This is precisely what happened in late 2000 and early 2001. Two of the Raptor SPEs lacked sufficient credit capacity to pay Enron on the "hedges." As a result, in late March 2001, it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect the

shortfall in credit capacity. Rather than take that loss, Enron "restructured" the Raptor vehicles by, among other things, transferring more than $800 million of contracts to receive its own stock to them just before quarter-end. This transaction apparently was not disclosed to or authorized by the Board, involved a transfer of very substantial value for insufficient consideration, and appears inconsistent with governing accounting rules. It continued the concealment of the substantial losses in Enron's merchant investments.

However, even these efforts could not avoid the inevitable results of hedges that were supported only by Enron stock in a declining market. As the value of Enron's merchant investments continued to fall in 2001, the credit problems in the Raptor entities became insoluble. Ultimately, the SPEs were terminated in September 2001. This resulted in the unexpected announcement on October 16, 2001, of a $544 million after-tax charge against earnings. In addition, Enron was required to reduce shareholders' equity by $1.2 billion. While the equity reduction was primarily the result of accounting errors made in 2000 and early 2001, the charge against earnings was the result of Enron's "hedging" its investments—not with a creditworthy counter-party, but with itself.

Consolidation Issues. In addition to the accounting abuses involving use of Enron stock to avoid recognizing losses on merchant investments, the Rhythms transaction involved the same SPE equity problem that undermined Chewco and JEDI. As we stated above, in 2001, Enron and Andersen concluded that Chewco lacked sufficient outside equity at risk to qualify for non-consolidation. At the same time, Enron and Andersen also concluded that the LJM1 SPE in the Rhythms transaction failed the same threshold accounting requirement. In recent Congressional testimony, Andersen's CEO explained that the firm had simply been wrong in 1999 when it concluded (and

presumably advised Enron) that the LJM1 SPE satisfied the non-consolidation requirements. As a result, in November 2001, Enron announced that it would restate prior period financials to consolidate the LJM1 SPE retroactively to 1999. This retroactive consolidation decreased Enron's reported net income by $95 million (of $893 million total) in 1999 and by $8 million (of $979 million total) in 2000.

Self-Dealing Issues. While these related-party transactions facilitated a variety of accounting and financial reporting abuses by Enron, they were extraordinarily lucrative for Fastow and others. In exchange for their passive and largely risk-free roles in these transactions, the LJM partnerships and their investors were richly rewarded. Fastow and other Enron employees received tens of millions of dollars they should not have received. These benefits came at Enron's expense.

When Enron and LJM1 (through Fastow) negotiated a termination of the Rhythms "hedge" in 2000, the terms of the transaction were extraordinarily generous to LJM1 and its investors. These investors walked away with tens of millions of dollars in value that, in an arm's-length context, Enron would never have given away. Moreover, based on the information available to us, it appears that Fastow had offered interests in the Rhythms termination to Kopper and four other Enron employees. These investments, in a partnership called "Southampton Place," provided spectacular returns. In exchange for a $25,000 investment, Fastow received (through a family foundation) ***$4.5 million*** in approximately two months. Two other employees, who each invested $5,800, each received ***$1 million*** in the same time period. We have seen no evidence that Fastow or any of these employees obtained clearance for those investments, as required by Enron's Code of Conduct. Kopper and the other Enron employees who received these vast

returns were all involved in transactions between Enron and the LJM partnerships in 2000—some representing Enron.

Public Disclosure

Enron's publicly-filed reports disclosed the existence of the LJM partnerships. Indeed, there was substantial factual information about Enron's transactions with these partnerships in Enron's quarterly and annual reports and in its proxy statements. Various disclosures were approved by one or more of Enron's outside auditors and its inside and outside counsel. However, these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not communicate the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and, in some respects, to disguise their substance and import. The disclosures also asserted that the related-party transactions were reasonable compared to transactions with third parties, apparently without any factual basis. The process by which the relevant disclosures were crafted was influenced substantially by Enron Global Finance (Fastow's group). There was an absence of forceful and effective oversight by Senior Enron Management and in-house counsel, and objective and critical professional advice by outside counsel at Vinson & Elkins, or auditors at Andersen.

The Participants

The actions and inactions of many participants led to the related-party abuses, and the financial reporting and disclosure failures, that we identify in our Report. These participants include not only the employees who enriched themselves at Enron's expense, but also Enron's Management, Board of Directors and outside advisors. The factual basis and analysis for these conclusions are set out in the Report. In summary, based on the evidence available to us, the Committee notes the following:

Andrew Fastow. Fastow was Enron's Chief Financial Officer and was involved on both sides of the related-party transactions. What he presented as an arrangement intended to benefit Enron became, over time, a means of both enriching himself personally and facilitating manipulation of Enron's financial statements. Both of these objectives were inconsistent with Fastow's fiduciary duties to Enron and anything the Board authorized. The evidence suggests that he (1) placed his own personal interests and those of the LJM partnerships ahead of Enron's interests; (2) used his position in Enron to influence (or attempt to influence) Enron employees who were engaging in transactions on Enron's behalf with the LJM partnerships; and (3) failed to disclose to Enron's Board of Directors important information it was entitled to receive. In particular, we have seen no evidence that he disclosed Kopper's role in Chewco or LJM2, or the level of profitability of the LJM partnerships (and his personal and family interests in those profits), which far exceeded what he had led the Board to expect. He apparently also violated and caused violations of Enron's Code of Conduct by purchasing, and offering to Enron employees, extraordinarily lucrative interests in the Southampton Place

partnership. He did so at a time when at least one of those employees was actively working on Enron's behalf in transactions with LJM2.

Enron's Management. Individually, and collectively, Enron's Management failed to carry out its substantive responsibility for ensuring that the transactions were fair to Enron—which in many cases they were not—and its responsibility for implementing a system of oversight and controls over the transactions with the LJM partnerships. There were several direct consequences of this failure: transactions were executed on terms that were not fair to Enron and that enriched Fastow and others; Enron engaged in transactions that had little economic substance and misstated Enron's financial results; and the disclosures Enron made to its shareholders and the public did not fully or accurately communicate relevant information. We discuss here the involvement of Kenneth Lay, Jeffrey Skilling, Richard Causey, and Richard Buy.

For much of the period in question, Lay was the Chief Executive Officer of Enron and, in effect, the captain of the ship. As CEO, he had the ultimate responsibility for taking reasonable steps to ensure that the officers reporting to him performed their oversight duties properly. He does not appear to have directed their attention, or his own, to the oversight of the LJM partnerships. Ultimately, a large measure of the responsibility rests with the CEO.

Lay approved the arrangements under which Enron permitted Fastow to engage in related-party transactions with Enron and authorized the Rhythms transaction and three of the Raptor vehicles. He bears significant responsibility for those flawed decisions, as well as for Enron's failure to implement sufficiently rigorous procedural controls to

prevent the abuses that flowed from this inherent conflict of interest. In connection with the LJM transactions, the evidence we have examined suggests that Lay functioned almost entirely as a Director, and less as a member of Management. It appears that both he and Skilling agreed, and the Board understood, that Skilling was the senior member of Management responsible for the LJM relationship.

Skilling was Enron's President and Chief Operating Officer, and later its Chief Executive Officer, until his resignation in August 2001. The Board assumed, and properly so, that during the entire period of time covered by the events discussed in this Report, Skilling was sufficiently knowledgeable of and involved in the overall operations of Enron that he would see to it that matters of significance would be brought to the Board's attention. With respect to the LJM partnerships, Skilling personally supported the Board's decision to permit Fastow to proceed with LJM, notwithstanding Fastow's conflict of interest. Skilling had direct responsibility for ensuring that those reporting to him performed their oversight duties properly. He likewise had substantial responsibility to make sure that the internal controls that the Board put in place—particularly those involving related-party transactions with the Company's CFO—functioned properly. He has described the detail of his expressly-assigned oversight role as minimal. That answer, however, misses the point. As the magnitude and significance of the related-party transactions to Enron increased over time, it is difficult to understand why Skilling did not ensure that those controls were rigorously adhered to and enforced. Based upon his own description of events, Skilling does not appear to have given much attention to these duties. Skilling certainly knew or should have known of the magnitude and the risks associated with these transactions. Skilling, who prides himself on the controls he

put in place in many areas at Enron, bears substantial responsibility for the failure of the system of internal controls to mitigate the risk inherent in the relationship between Enron and the LJM partnerships.

Skilling met in March 2000 with Jeffrey McMahon, Enron's Treasurer (who reported to Fastow). McMahon told us that he approached Skilling with serious concerns about Enron's dealings with the LJM partnerships. McMahon and Skilling disagree on some important elements of what was said. However, if McMahon's account (which is reflected in what he describes as contemporaneous talking points for the discussion) is correct, it appears that Skilling did not take action (nor did McMahon approach Lay or the Board) after being put on notice that Fastow was pressuring Enron employees who were negotiating with LJM—clear evidence that the controls were not effective. There also is conflicting evidence regarding Skilling's knowledge of the March 2001 Raptor restructuring transaction. Although Skilling denies it, if the account of other Enron employees is accurate, Skilling both approved a transaction that was designed to conceal substantial losses in Enron's merchant investments and withheld from the Board important information about that transaction.

Causey was and is Enron's Chief Accounting Officer. He presided over and participated in a series of accounting judgments that, based on the accounting advice we have received, went well beyond the aggressive. The fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact.

Causey was also charged by the Board of Directors with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between Enron and the LJM partnerships, and he was to review those transactions with the Audit and Compliance Committee annually. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions and did not give those transactions the level of scrutiny the Board had reason to believe he would. He did not provide the Audit and Compliance Committee with the full and complete information about the transactions, in particular the Raptor III and Raptor restructuring transactions, that it needed to fulfill its duties.

Buy was and is Enron's Senior Risk Officer. The Board of Directors also charged him with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between them. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions. Perhaps more importantly, he apparently saw his role as more narrow than the Board had reason to believe, and did not act affirmatively to carry out (or ensure that others carried out) a careful review of the economic terms of all transactions between Enron and LJM.

The Board of Directors. With respect to the issues that are the subject of this investigation, the Board of Directors failed, in our judgment, in its oversight duties. This had serious consequences for Enron, its employees, and its shareholders.

The Board of Directors approved the arrangements that allowed the Company's CFO to serve as general partner in partnerships that participated in significant financial

transactions with Enron. As noted earlier, the two members of the Special Investigative Committee who have participated in this review of the Board's actions believe this decision was fundamentally flawed. The Board substantially underestimated the severity of the conflict and overestimated the degree to which management controls and procedures could contain the problem.

After having authorized a conflict of interest creating as much risk as this one, the Board had an obligation to give careful attention to the transactions that followed. It failed to do this. It cannot be faulted for the various instances in which it was apparently denied important information concerning certain of the transactions in question. However, it can and should be faulted for failing to demand more information, and for failing to probe and understand the information that did come to it. The Board authorized the Rhythms transaction and three of the Raptor transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks. Nor does it appear that they reacted to warning signs in those transactions as they were presented, including the statement to the Finance Committee in May 2000 that the proposed Raptor transaction raised a risk of "accounting scrutiny." We do note, however, that the Committee was told that Andersen was "comfortable" with the transaction. As complex as the transactions were, the existence of Fastow's conflict of interest demanded that the Board gain a better understanding of the LJM transactions that came before it, and ensure (whether through one of its Committees or through use of outside consultants) that they were fair to Enron.

The Audit and Compliance Committee, and later the Finance Committee, took on a specific role in the control structure by carrying out periodic reviews of the LJM

transactions. This was an opportunity to probe the transactions thoroughly, and to seek outside advice as to any issues outside the Board members' expertise. Instead, these reviews appear to have been too brief, too limited in scope, and too superficial to serve their intended function. The Compensation Committee was given the role of reviewing Fastow's compensation from the LJM entities, and did not carry out this review. This remained the case even after the Committees were on notice that the LJM transactions were contributing very large percentages of Enron's earnings. In sum, the Board did not effectively meet its obligation with respect to the LJM transactions.

The Board, and in particular the Audit and Compliance Committee, has the duty of ultimate oversight over the Company's financial reporting. While the primary responsibility for the financial reporting abuses discussed in the Report lies with Management, the participating members of this Committee believe those abuses could and should have been prevented or detected at an earlier time had the Board been more aggressive and vigilant.

Outside Professional Advisors. The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions. Andersen has admitted that it erred in concluding that the Rhythms transaction was structured properly under the SPE non-consolidation rules. Enron was required to restate its financial results for 1999 and 2000 as a result. Andersen participated in the structuring and accounting treatment of the Raptor transactions, and charged over $1 million for its services, yet it apparently failed to provide the objective

accounting judgment that should have prevented these transactions from going forward. According to Enron's internal accountants (though this apparently has been disputed by Andersen), Andersen also reviewed and approved the recording of additional equity in March 2001 in connection with this restructuring. In September 2001, Andersen required Enron to reverse this accounting treatment, leading to the $1.2 billion reduction of equity. Andersen apparently failed to note or take action with respect to the deficiencies in Enron's public disclosure documents.

According to recent public disclosures, Andersen also failed to bring to the attention of Enron's Audit and Compliance Committee serious reservations Andersen partners voiced internally about the related-party transactions. An internal Andersen e-mail from February 2001 released in connection with recent Congressional hearings suggests that Andersen had concerns about Enron's disclosures of the related-party transactions. A week after that e-mail, however, Andersen's engagement partner told the Audit and Compliance Committee that, with respect to related-party transactions, "[r]equired disclosure [had been] reviewed for adequacy," and that Andersen would issue an unqualified audit opinion. From 1997 to 2001, Enron paid Andersen $5.7 million in connection with work performed specifically on the LJM and Chewco transactions. The Board appears to have reasonably relied upon the professional judgment of Andersen concerning Enron's financial statements and the adequacy of controls for the related-party transactions. Our review indicates that Andersen failed to meet its responsibilities in both respects.

Vinson & Elkins, as Enron's longstanding outside counsel, provided advice and prepared documentation in connection with many of the transactions discussed in the

Report. It also assisted Enron with the preparation of its disclosures of related-party transactions in the proxy statements and the footnotes to the financial statements in Enron's periodic SEC filings.[2/] Management and the Board relied heavily on the perceived approval by Vinson & Elkins of the structure and disclosure of the transactions. Enron's Audit and Compliance Committee, as well as in-house counsel, looked to it for assurance that Enron's public disclosures were legally sufficient. It would be inappropriate to fault Vinson & Elkins for accounting matters, which are not within its expertise. However, Vinson & Elkins should have brought a stronger, more objective and more critical voice to the disclosure process.

Enron Employees Who Invested in the LJM Partnerships. Michael Kopper, who worked for Fastow in the Finance area, enriched himself substantially at Enron's expense by virtue of his roles in Chewco, Southampton Place, and possibly LJM2. In a transaction he negotiated with Fastow, Kopper, and his co-investor in Chewco received more than $10 million from Enron for a $125,000 investment. This was inconsistent with his fiduciary duties to Enron and, as best we can determine, with anything the Board—which apparently was unaware of his Chewco activities—authorized. We do not know what financial returns he received from his undisclosed investments in LJM2 or Southampton Place. Kopper violated Enron's Code of Conduct not only by purchasing his personal interests in Chewco, LJM2, and Southampton, but also by secretly offering an interest in Southampton to another Enron employee.

2/ Because of the relationship between Vinson & Elkins and the University of Texas School of Law, the portions of the Report describing and evaluating actions of Vinson & Elkins are solely the views of Troubh and Winokur.

Ben Glisan, an accountant and later McMahon's successor as Enron's Treasurer, was a principal hands-on Enron participant in two transactions that ultimately required restatements of earnings and equity: Chewco and the Raptor structures. Because Glisan declined to be interviewed by us on Chewco, we cannot speak with certainty about Glisan's knowledge of the facts that should have led to the conclusion that Chewco failed to comply with the non-consolidation requirement. There is, however, substantial evidence that he was aware of such facts. In the case of Raptor, Glisan shares responsibility for accounting judgments that, as we understand based on the accounting advice we have received, went well beyond the aggressive. As with Causey, the fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact. Moreover, Glisan violated Enron's Code of Conduct by accepting an interest in Southampton Place without prior disclosure to or consent from Enron's Chairman and Chief Executive Officer—and doing so at a time when he was working on Enron's behalf on transactions with LJM2, including Raptor.

Kristina Mordaunt (an in-house lawyer at Enron), Kathy Lynn (an employee in the Finance area), and Anne Yaeger Patel (also an employee in Finance) appear to have violated Enron's Code of Conduct by accepting interests in Southampton Place without obtaining the consent of Enron's Chairman and Chief Executive Officer.

* * *

The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, self-

enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits. Our review indicates that many of those consequences could and should have been avoided.

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EITF ABSTRACTS

Issue No. 90-15

Title:	Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions
Dates Discussed:	July 12, 1990; September 7, 1990; November 8, 1990; January 10, 1991; July 11, 1991
References:	FASB Statement No. 13, *Accounting for Leases* FASB Statement No. 23, *Inception of the Lease* FASB Statement No. 29, *Determining Contingent Rentals* FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases* FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* FASB Interpretation No. 19, *Lessee Guarantee of the Residual Value of Leased Property* SEC Staff Accounting Bulletin No. 57, *Views concerning Accounting for Contingent Warrants in Connection with Sales Agreements with Certain Major Customers*

ISSUE

A company (lessee) enters into a lease that has been designed to qualify as an operating lease under Statement 13, as amended; however, certain characteristics of the lease have raised questions as to whether operating lease classification is appropriate:

1. Lessee residual value guarantees and participations in both risks and rewards associated with ownership of the leased property

2. Purchase options

3. Special-purpose entity (SPE) lessor that lacks economic substance

4. Property constructed to the lessee's specifications

5. Lease payments adjusted for final construction costs.

The issue is whether either operating lease treatment or another method of accounting is appropriate for leases with all or some of the characteristics described above.

EITF DISCUSSION

The Task Force reached a consensus that a lessee is required to consolidate a special-purpose entity lessor when all of the following conditions exist:

1. Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee

2. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through such means as

   a. The lease agreement

   b. A residual value guarantee through, for example, the assumption of first dollar of loss provisions

   c. A guarantee of the SPE's debt

   d. An option granting the lessee a right to (1) purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise or (2) receive any of the lessor's sales proceeds in excess of a stipulated amount

3. The owner(s) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease.

If the above conditions exist, the assets, liabilities, results of operations, and cash flows of the SPE should be consolidated in the lessee's financial statements. This conclusion should be

applied to SPEs that are established for both the construction and subsequent lease of an asset for which the lease would meet the aforementioned conditions. In those cases, the consolidation by the lessee should begin at the inception of the lease, as defined in Statement 13 and amended in Statement 23, rather than the beginning of the lease term.

A lease containing the general characteristics described in the issue above that does not meet conditions for consolidation noted above, may qualify for operating lease treatment. However, it was noted that it is necessary to evaluate the facts and circumstances of each lease in relation to the requirements of Statement 13, as amended, to determine the appropriate lease classification. In particular, the Task Force noted that determining the existence of an economic penalty that results in reasonable assurance of the lessee's renewal of the lease beyond the initial lease term must be assessed based on the facts and circumstances of each lease.

At the July 11, 1991 meeting, the Task Force Chairman announced that he had received a letter from the acting Chief Accountant of the SEC outlining the SEC staff position on a number of recent implementation questions relating to this issue. Those questions and the SEC staff responses are as follows:

Question No. 1

Did the EITF consensus resolve the SEC staff's concerns with respect to the leasing transactions discussed in various SEC staff announcements in EITF minutes?

Response

The SEC staff believes the consensus, along with appropriate disclosures, provides timely guidance with respect to certain leasing transactions involving SPEs that were of the most concern to the SEC staff. These included sale-leaseback transactions involving personal property, real property when the property is built to the lessee's specifications, and property meeting the specifications of the lessee that is purchased by the lessor.

All leasing transactions should be carefully analyzed, particularly those including any potential penalties or involving special-purpose property, in accordance with Statement 13, as amended. Registrants' disclosures should include a general description of the leasing arrangements as required by paragraph 16(d) of Statement 13. The SEC staff believes such disclosures should include the significant terms of leasing arrangements, including renewal or purchase options, escalation clauses, obligations with respect to refinancing of the lessor's debt, significant penalties (as defined in Statement 98), and the provisions of any significant guarantees, such as residual value guarantees.

In addition, Financial Reporting Codification Section 501, *Management's Discussion and Analysis* , requires disclosure of any known demands, commitments, events, or uncertainties that will

result in or that are reasonably likely to have a material impact (or for which management cannot make such determination) on the registrant's liquidity, capital resources, or income from continuing operations or would cause reported financial information not to be indicative of future operating results or of future financial condition. In addition, Article 5 of Regulation S-X requires disclosure of all material commitments and contingent liabilities.

Question No. 2

Is the guidance in Issue 90-15 applicable to SPEs utilized in transactions other than those specified in the consensus?

Response

The Working Group (which was specifically formed to work with the SEC staff to study this issue and propose a consensus to the Task Force) only considered the SPE issue as it relates to leasing transactions. These transactions may vary significantly from other types of SPE transactions in structure and in terms of risks and rewards. Accordingly, the consensus did not include nonleasing transactions in its scope.

The views expressed by the SEC staff at the February and May 1989 EITF meetings are still applicable to SPE transactions other than those addressed by Issue 90-15. The SEC staff notes that the conditions identified in Issue 90-15 are consistent with the views on SPEs previously expressed by the SEC staff. The Issue 90-15 conditions focus on the risks and rewards and substantive nature of the SPE, which are critical to consolidation. Accordingly, the conditions set forth in Issue 90-15 may be useful in evaluating other transactions involving SPEs.

The SEC staff would expect to resolve these other nonleasing transactions on a case-by-case approach. Consistent with SAB Topic 5K (SAB 57), the SEC staff recommends that registrants discuss such unusual transactions with the SEC staff on a pre-filing basis.

Question No. 3

What is meant in the consensus by the term *expected substantive residual risks*? Does it mean the 90 percent threshold specified in paragraph 7(d) of Statement 13?

What amount qualifies as a substantive residual equity capital investment (condition (3) of the consensus)?

Response

In these transactions, the significant elements of management and control over the leased asset generally are specified by contract when the lease is negotiated and the SPE is established.

Certain of these elements of management and control raise concerns on the part of the SEC staff with respect to who possesses the risks and rewards of ownership of the leased asset. These include elements such as a nonsubstantive lessor without equity at risk, a lessee who has the ability to realize all appreciation and bears substantial risk of depreciation, and a lessee who act as the construction agent and selling agent and who is at more than nominal risk. In determining if a registrant has substantive residual risks and rewards of the leased asset (condition (2) of the consensus), the SEC staff would review a transaction to determine if the lessee has these or similar elements of management and control. If the lessee would reasonably be expected to bear the substantive residual risks and receive rewards due to such elements, the SEC staff would consider condition (2) to be met. This would be a judgmental decision based on the specific facts and circumstances of each transaction, and does not involve the 90 percent determination as set forth in Statement 13.

The initial substantive residual equity investment should be comparable to that expected for a substantive business involved in similar leasing transactions with similar risks and rewards. The SEC staff understands from discussions with Working Group members that those members believe that 3 percent is the minimum acceptable investment. The SEC staff believes a greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and the market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3 percent is needed.

As the consensus states, the investment should be at risk with respect to the leased asset for the entire term of the lease. The investment would not be considered to be at risk, for example, if the investor were provided a letter of credit or other form of guarantee on the initial investment or return thereon. An investor note payable issued to the SPE would not qualify as an initial substantive residual equity investment at risk.

Question No. 4

If the initial substantive residual equity capital is reduced below the minimum amount required because of losses recorded by the SPE in accordance with generally accepted accounting principles (GAAP), is the investor required to make an additional capital investment?

Response

The SEC staff understands that the Working Group discussed this question and concluded that the answer is no.

Question No. 5

May the investor withdraw its initial minimum required equity investment prior to the expiration of the lease term?

Response

There may be circumstances in which an investor makes an investment in excess of the minimum required equity investment. In those circumstances, the investor may withdraw its initial investment in excess of the minimum required equity. However, the EITF included in condition (3) of the consensus, a requirement that the initial minimum equity investment be at risk during the entire term of the lease. Accordingly, that minimum amount could not be withdrawn either directly or indirectly. The SEC staff understands that the Working Group believed that transactions would include documentation that would enable the lessee to determine the lessor had maintained its capital at risk.

Question No. 6

If an SPE contained a building whose value increased such that the equity of the SPE increased on an appraised fair value basis, could the investor withdraw its initial capital to the extent of the increase in the fair value of the property?

Response

No. Condition (3) requires the initial investment to be at risk during the entire term of the lease. As noted in Question 4 above, the minimum investment is not required to be increased for GAAP losses and it is not permitted to be withdrawn for appraisal increases.

Question No. 7

Does the consensus apply to previous transactions within its scope?

Response

EITF consensuses are applied on a prospective basis unless a consensus specifically addresses transition. Accordingly, the SEC staff believes the guidance in the consensus should be applied on a prospective basis to the transactions within its scope.

The SEC staff has made various announcements regarding leasing transactions that have been included in the EITF meeting minutes. These announcements focused on the same issues as the conditions in Issue 90-15, but were more general in nature. Registrants should have followed the guidance in the announcements and the SEC staff's prior position as set forth therein, when

filing financial statements that include material leasing transactions involving an SPE and that were completed prior to January 10, 1991 (the date of the consensus).

Question No. 8

If a previously formed SPE has an existing lease in it and has not been consolidated (for example, due to immateriality or because it would not have required consolidation pursuant to the SEC staff announcements or Issue 90-15), and if a new lease is put in the SPE so that the SPE meets the conditions in Issue 90-15 for consolidation, can only the new lease be consolidated on a pro rata basis? Since the SPE was formed prior to the consensus, is the SPE and any future transactions it participates in grandfathered?

Response

The SEC staff does not permit pro rata consolidation except in limited circumstances (those specifically provided for in the authoritative literature), which do not include a leasing SPE. Neither the SPE nor its future transactions would be considered to be grandfathered, and accordingly, the entire SPE should be consolidated on a prospective basis.

Question No. 9

May an existing nonsubstantive SPE become a substantive entity by having an investor put in sufficient capital to meet condition (3) of the consensus and accordingly be unconsolidated?

Response

Yes. However, if an investor puts in additional capital, it may result in changes in the lease terms, including perhaps the lease payments. The SEC staff believes a lease entered into with a consolidated SPE, which is then unconsolidated when a substantive equity investment is made, is analogous to a sale-leaseback transaction and results in a new lease that should be assessed pursuant to the conditions of Issue 90-15 at the time the changes are made. The lessee would also need to evaluate the lease in accordance with Statement 13, as amended, and Statement 98 for transactions within its scope.

The SEC staff would apply the same guidance when an existing nonsubstantive SPE enters into significant substantive leases with other unrelated lessees and accordingly no longer meets condition (1) of the consensus.

STATUS

A related issue was discussed in Issue No. 96-20, "Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities ." That Issue was nullified by Statement 140, which

replaced Statement 125, in September 2000. Under Statement 140, a qualifying SPE shall not be consolidated in the financial statements of a transferor or its affiliates. Other aspects of this consensus were not affected by the issuance of Statement 140. [Note: See STATUS section of Issue 96-20 for details.]

Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities ," provides responses to several additional questions that relate specifically to conditions (1) and (3) of Issue 90-15. The questions relate to the following issues: multiple properties within a single SPE-lessor, multi-tiered SPE structures, payments made by lessee prior to beginning of lease term, payments to equity owners of an SPE during the lease term, fees paid to owners of record of an SPE, source of initial minimum equity investment, equity capital at risk, payment to owners of record of an SPE prior to the lease term, costs incurred by lessee prior to entering into a lease agreement, and interest-only payments.

Another related issue was discussed in Issue No. 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities ." The categories of issues are: (1) environmental risk, (2) non-performance-related default covenants, and (3) depreciation. Categories (1) and (2) apply to leasing transactions irrespective of whether the lessor is an SPE. Category (3) applies when the lessor is an SPE. (See Issue 97-1 for details of the consensus reached.)

No further EITF discussion is planned.

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Topic No. D-14

Topic: Transactions Involving Special-Purpose Entities

Dates Discussed: February 23, 1989; May 18, 1989; May 31, 1990

The SEC Observer announced that the SEC staff is becoming increasingly concerned about certain receivables, leasing, and other transactions involving special-purpose entities (SPEs). Certain characteristics of those transactions raise questions about whether SPEs should be consolidated (notwithstanding the lack of majority ownership) and whether transfers of assets to the SPE should be recognized as sales. Generally, the SEC staff believes that for nonconsolidation and sales recognition by the sponsor or transferor to be appropriate, the majority owner (or owners) of the SPE must be an independent third party who has made a substantive capital investment in the SPE, has control of the SPE, and has substantive risks and rewards of ownership of the assets of the SPE (including residuals). Conversely, the SEC staff believes that nonconsolidation and sales recognition are not appropriate by the sponsor or transferor when the majority owner of the SPE makes only a nominal capital investment, the activities of the SPE are virtually all on the sponsor's or transferor's behalf, and the substantive risks and rewards of the assets or the debt of the SPE rest directly or indirectly with the sponsor or transferor.

Also, the SEC staff has objected to a proposal in which the accounting for a transaction would change only because an SPE was placed between the two parties to the transaction. The SEC staff believes that insertion of a nominally capitalized SPE does not change the accounting for the transaction.

The SEC staff is considering the issuance of a Staff Accounting Bulletin setting forth guidelines on the accounting for transactions involving SPEs and until such time would consider transactions on a case-by-case basis. The SEC Observer emphasized that the SEC staff views the issue of SPEs to be primarily a consolidation issue.

The SEC Observer reminded the Task Force of previous SEC Observer comments regarding the SEC staff's position on the proper accounting for certain lease transactions, including build-to-

order lease transactions and those involving SPEs. The SEC staff has reviewed many variations of such transactions and generally objected to sales or operating lease treatment. The transactions involve a lessor that may be a SPE who holds title to the asset, but performs little, if any, substantive functions, while it is clear that the lessee assumes substantially all the risks and rewards of ownership. The SEC staff is not attempting to change generally accepted accounting principles in this area but believes that the application of such principles should result in an accounting treatment that is not misleading and pointed out that literature in addition to FASB Statement No. 13, *Accounting for Leases* , including that related to consolidation, should be considered. While the SEC staff encourages the Task Force to clarify this area, the SEC staff will continue its review of such transactions on a case-by-case approach based on its previously stated position. The Task Force agreed to add the issue to the agenda. [See Subsequent Developments section below.]

Subsequent Developments

In July 1990, Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions ," was added to the agenda. This Issue deals with the subject of leasing transactions involving SPEs. In January 1991, a consensus was reached on this Issue. The Task Force indicated that if certain conditions exist, as described in Issue 90-15, then the assets, liabilities, results of operations, and cash flows of the SPE should be consolidated in the lessee's financial statements.

FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* was issued in June 1996. Statement 125 was replaced by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* in September 2000.

Statement 140 provides guidance for determining whether transfers of financial assets (including financing lease receivables) qualify as sales or secured borrowings based upon the notion of control set forth in paragraph 9. Lease accounting issues (other than transfers of financial assets that arise from sales-type and direct financing leases) are outside the scope of Statement 140.

Statement 140 also provides that a qualifying SPE shall not be consolidated by the transferor or its affiliates. As a result, this announcement is partially resolved by Statement 140. Consolidation of qualifying SPEs by other parties, and consolidation of entities that are not considered qualifying SPEs, are outside the scope of Statement 140. Those parties should apply existing consolidation policy guidance including AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements* , FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* , Topic D-14, and Issue 90-15 .

Related issues were discussed in Issues No. 96-20, "Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities ," and No. 97-6, "Application of Issue No. 96-20 to Qualifying Special-Purpose Entities Receiving Transferred Financial Assets Prior to the Effective Date of FASB Statement No. 125 ." Statement 140 nullified both Issues 96-20 and 97-6.

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EITF ABSTRACTS

Issue No. 96-21

Title:	Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities
Date Discussed:	September 18-19, 1996
References	FASB Statement No. 13, *Accounting for Leases* FASB Statement No. 23, *Inception of the Lease* FASB Statement No. 28, *Accounting for Sales with Leasebacks* FASB Statement No. 66, *Accounting for Sales of Real Estate* FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases* FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*

ISSUE

Issue No. 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions ," requires a lessee to consolidate a special-purpose entity (SPE) lessor when certain conditions exist.

If the conditions of Issue 90-15 are met, the assets, liabilities, results of operations, and cash flows of the SPE should be consolidated in the lessee's financial statements. This conclusion should be applied to SPEs that are established for both the construction and subsequent lease of an asset for which the lease would meet the required conditions. In those cases, the consolidation by the lessee should begin at the inception of the lease, as defined in Statement 13, and amended by Statement 23, rather than at the beginning of the lease term.

Since the issuance of Issue 90-15, there have been several issues relating specifically to the following two conditions of Issue 90-15:

> Condition 1: Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee.
>
> Condition 3: The owner(s) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire term of the lease.

Additionally, several issues have been raised in leasing transactions involving SPEs that also arise in other leasing transactions. These issues relate primarily to the application of paragraph 7(d) of Statement 13 and the sale-leaseback provisions of Statement 98.

The categories of issues are:

1. Multiple properties within a single SPE-lessor
2. Multi-tiered SPE structures
3. Payments made by lessee prior to beginning of lease term
4. Payments to equity owners of an SPE during the lease term
5. Fees paid to owners of record of an SPE
6. Source of initial minimum equity investment
7. Equity capital at risk
8. Payment to owners of record of an SPE prior to the lease term
9. Costs incurred by lessee prior to entering into a lease agreement
10. Interest-only payments.

Categories 3, 9, and 10 above apply to leasing transactions irrespective of whether the lessor is an SPE.

EITF DISCUSSION

The Task Force reached a consensus on the following implementation questions and responses:

Multiple Properties within a Single SPE-Lessor

Question No. 1

Assume that an SPE is formed to acquire two separate properties that are to be leased to two unrelated lessees. The two asset acquisitions are financed with the proceeds from two nonrecourse borrowings that do not contain cross-collateral provisions; that is, in the event of default, each borrowing is collateralized only by a pledge of the respective assets leased to a single lessee and an assignment of the respective lease payments under the related lease. The

SPE has no assets other than the leased properties and the related leases. In this situation, how should the individual lessees apply condition 1 of Issue 90-15, which provides that substantially all of the activities of the SPE involve assets that are to be leased to a single lessee?

Response

The use of nonrecourse debt with no cross-collateral provisions effectively segregates the cash flows and assets associated with the two leases and, therefore, in substance, creates two SPEs. For purposes of applying Issue 90-15, each lessee would be considered to have satisfied condition 1 of Issue 90-15. For either lessee to be in a position of not satisfying condition 1 of Issue 90-15, the assets of the SPE (subject to the two leases) would need to be commingled such that, in the event of default, both lenders to the SPE would have equal rights (that is, *pari passu*) to the cash flows and assets related to both leases of the SPE. In this regard, the amounts of the cash flows from each lease and the fair values of the individual assets subject to the leases must represent more than a minor amount (that is, more than 10 percent) of the aggregate cash flows from all leases and the aggregate fair value of all assets of the SPE, respectively.

Multi-tiered SPE Structures

Question No. 2

A sponsor forms an SPE ("SPE 1"). SPE 1 acquires property with the proceeds from nonrecourse debt and leases the property to Lessee 1. SPE 1 has no other activities and the terms of the lease satisfy condition 2 of Issue 90-15, which discusses the residual risks and rewards associated with the leased assets and related debt. The sponsor owns 100 percent of SPE 1's voting common stock. The sponsor contributes the common stock of SPE 1 to capitalize another SPE ("SPE 2") that is formed to own and lease assets to Lessee 2. The other assets of SPE 2 are financed entirely with nonrecourse debt and are subject to a lease, the terms of which also satisfy condition 2 of Issue 90-15. Thus, SPE 2, which is wholly owned by the sponsor, becomes the parent of SPE 1. At what entity level should Lessee 2 apply the conditions of Issue 90-15?

Response

Consistent with the response to Question 1 that addresses multiple properties within a single SPE, the conditions set forth in Issue 90-15 are to be applied at the lowest level at which the parties to a transaction create an isolated entity, whether by contract or otherwise. Therefore, in this situation, the test for compliance with condition 1 of Issue 90-15 should be applied to the parent-only financial statements of SPE 2.

Question No. 3

In the transaction described in Question 2, the assets of SPE 2 will include the common stock of SPE 1 and the assets leased to Lessee 2. How should Lessee 2 apply conditions 1 and 3 of Issue 90-15 to the parent-only financial statements of SPE 2?

Response

Ownership of the stock of another SPE that is engaged in leasing property would not constitute an activity contemplated by condition 1 of Issue 90-15. Accordingly, in this situation, the lessee should consider condition 1 of Issue 90-15 to be satisfied in evaluating the activities of SPE 2. In addition, the sponsor's contribution of the stock of SPE 1 to capitalize SPE 2 would not be considered an initial substantive residual equity capital investment, as contemplated by condition 3 of Issue 90-15, because a sponsor's investment cannot be used to capitalize more than one SPE for purposes of applying condition 3 of Issue 90-15.

Payments Made by Lessee Prior to Beginning of Lease Term

Question No. 4

In some build-to-suit lease transactions, the lessee may be obligated to make payments to the lessor prior to the completion of construction of the asset and the beginning of the lease term (sometimes referred to as "construction period lease payments"). How should construction period lease payments be considered in applying the 90 percent of fair value recovery criterion of paragraph 7(d) of Statement 13? If the lease is an operating lease, how should the lessee account for those payments?

Response

Payments made prior to the beginning of the lease term should be considered as part of minimum lease payments and included in the 90 percent of fair value recovery test, as specified in paragraph 7(d) of Statement 13, at their future value at the beginning of the lease term (that is, to give effect to the time value of money, the future value at the beginning of the lease term of the lease payments would be calculated just as payments during the lease term are discounted back to the beginning of the lease term for purposes of applying the 90 percent criterion of paragraph 7(d) of Statement 13). The lessee should use the same interest rate to accrete payments to be made prior to the beginning of the lease term that it uses to discount lease payments to be made during the lease term. If the lease is classified as an operating lease, the lessee should consider the payments made prior to the beginning of the lease term to be prepaid rent. A lessee should recognize its total rental costs associated with an operating lease over the term of the lease as required by Statement 13 and Technical Bulletin 88-1 (that is, generally on a straight-line basis over the term of the lease).

Payments to Equity Owners of an SPE during the Lease Term

Question No. 5

Issue 90-15 specifies that a lessee would not consolidate an SPE-lessor if the owners of record of the SPE make an initial substantive residual equity capital investment that is at risk during the entire term of the lease. What accounting basis should be used to determine whether payments to the owners of record of the SPE during the lease term are a return on equity capital versus a return of equity capital?

Response

The characterization of any payments made by the SPE-lessor to its owners of record should be based on the SPE's GAAP basis financial statements. That is, distributions of the SPE-lessor's GAAP basis earnings should be considered a return on equity capital, but any distribution in excess of previously undistributed GAAP earnings should be considered a return of equity capital, which would reduce the amount of the equity capital investment that is at risk. If the amount of the equity capital investment is reduced below the minimum amount required as a result of a distribution in excess of previously undistributed GAAP earnings, the owner of record would have to make an additional investment in order to continue to avoid condition 3 of Issue 90-15. As discussed in Question 4 to Issue 90-15, an owner of record would not be required to make an additional equity capital investment if residual equity capital is reduced below the minimum amount required because of losses recorded by the SPE in accordance with generally accepted accounting principles.

Fees Paid to Owners of Record of an SPE

Question No. 6

The terms of some lease agreements require that the lessee pay fees for structuring the lease transaction, sometimes referred to as structuring or administrative fees. What is the accounting effect from both the lessee's perspective and the SPE's perspective when such fees are paid by the lessee to the owners of record of the SPE?

Response

Fees that are paid by the lessee to the owners of the SPE for structuring the lease transaction would be included as part of minimum lease payments (but not in the fair value of the leased property) for purposes of applying the 90 percent recovery criterion described in paragraph 7(d) of Statement 13. With respect to the SPE and the application of Issue 90-15, the fees would be considered a return of the owners' initial equity capital investment. To the extent that the fees reduce the equity capital investment below the minimum amount required, the owners of

record would not be considered to have a substantive residual equity capital investment that is at risk during the entire term of the lease.

Source of Initial Minimum Equity Investment

Question No. 7

Would an equity investment that is financed with nonrecourse debt qualify as an initial substantive residual equity capital investment as that term is used in condition 3 of Issue 90-15? Would an equity investment that is financed with recourse debt qualify?

Response

If the source of the funds used to make the initial minimum equity investment is financed with nonrecourse debt that is collateralized by a pledge of the investment, the investment would not meet the at-risk requirement discussed in condition 3 of Issue 90-15. Similarly, the at-risk requirement would not be met if the owners purchased residual insurance or obtained a residual guarantee in an amount that would ensure recovery of their equity investment. If the initial minimum equity investment is financed with recourse debt from a party not related to the lessee, the owners (borrowers) must have other assets at risk to support the borrowing in order to avoid condition 3 of Issue 90-15. Thus, if the loans were full recourse loans and if the fair value of the residual equity investment serves as collateral for the debt, the lessor-owner would be considered at risk to the extent that the owners of record are liable for any decline in the fair value of the residual interest and have, and are expected to continue to have during the term of the lease, other significant assets, in addition to and of a value that exceeds their equity investment, that are at risk.

Equity Capital at Risk

Question No. 8

If the equity capital investment interest has rights that are similar to the debt interests, for example, if both debt and equity repayment provisions are the same, would the equity capital investment be considered substantive or at risk during the entire term of the lease?

Response

To satisfy the at-risk requirement specified in condition 3 of Issue 90-15, an initial substantive residual equity capital investment must represent an equity interest in legal form, must be subordinate to all debt interests, and must represent the residual equity interest during the entire term of the lease.

Payment to Owners of Record of an SPE Prior to the Lease Term

Question No. 9

In some build-to-suit lease transactions involving SPEs, the lease or related construction agreement provides that the SPE will construct, or cause to be constructed, the property that is to be leased. The terms of the construction or lease agreements provide that payments are to be made by the SPE to the owners of record during the construction period, which, in some cases, may be several years. Such payments generally are made to provide the owners of record with a cash yield on their equity capital investments. What is the effect of those payments, given the requirements of Issue 90-15 to maintain an initial minimum equity capital investment?

Response

Payments made by the SPE to the owners of record of the SPE during the construction period would be deemed to be a return of their initial equity capital investment as opposed to a return on their equity capital investment. To the extent that those payments reduce the equity capital investment below the minimum amount required under Issue 90-15, the owners of record of the SPE will not be considered to have made an initial substantive residual equity capital investment that is at risk during the entire term of the lease.

Costs Incurred by Lessee Prior to Entering into a Lease Agreement

Question No. 10

In some build-to-suit lease transactions, the lessee may incur certain development costs prior to entering into a lease agreement with the developer-lessor. Those costs may include both "soft costs" (for example, architectural fees, survey costs, and zoning fees) and "hard costs" (for example, site preparation, construction costs, and equipment expenditures). What are the nature and amount of such costs, if any, that the future lessee may incur prior to entering into the lease agreement before the lessee would be considered the owner of the construction in-progress and subject to a sale-leaseback transaction?

Response

A lessee who commences construction activities would recognize the asset (construction in-progress) on its balance sheet, and any subsequent lease arrangement would be within the scope of Statement 98. Construction activities have commenced if the lessee has (1) begun construction (broken ground), (2) incurred hard costs (no matter how insignificant the hard costs incurred may be in relation to the fair value of the property to be constructed), or (3) incurred soft costs that represent more than a minor amount of the fair value of the leased property (that is, more than 10 percent of the expected fair value of the leased property). In a

build-to-suit lease, if a lessee transfers an option to acquire real property that it owns to an SPE, the fair value of the option is included in incurred soft costs. Off-balance-sheet purchase commitments, if at market, would not be considered incurred costs for purposes of the above tests.

Question No. 11

Assume that a lessee commences construction activities (as defined in Question 10) prior to the involvement of an SPE and that the subsequent transfer to the SPE is deemed to be within the scope of Statement 98. How should the lessee apply the provisions of Statement 98 to the transaction?

Response

Because the lessee is considered the owner of the project, the entire transaction would be evaluated as a sale-leaseback under Statement 98. If the transaction qualifies as a sale under Statements 28, 66, and 98, the sale would be recognized and profit or loss would be recognized in accordance with the requirements of those Statements. If the transaction fails to qualify for sale-leaseback accounting under those Statements, the amounts previously expended by the lessee would continue to be reported as construction in-progress in the lessee's financial statements, and the proceeds received from the SPE would be reported as a liability. Additional amounts expended by the SPE to fund construction would be reported by the lessee as construction in-progress and as a liability to the SPE. Once the property is placed in service, the property would be depreciated and the lease payments would be accounted for as debt service payments on the liability.

Interest-Only Payments

Question No. 12

A lease of real estate with an SPE frequently requires rental payments equal to the sum of the interest on the SPE's debt plus a return on the SPE's equity. Thus, during the term of the lease, there will be no amortization of the principal of the SPE's debt and there will be no return of the SPE's equity. The lessee has guaranteed that at the end of the lease term the value of the property will be equal to a specified amount. The maximum deficiency that the lessee is required to pay is limited such that the lease would be classified as an operating lease under paragraph 7(d) of Statement 13 (that is, present value of the minimum lease payments including the maximum deficiency is less than 90 percent of the fair value of the leased property). Assuming the lease otherwise qualifies as an operating lease, what is the lessee's accounting for this "interest-only" lease?

Response

A lessee would recognize rent expense over the lease term as required by paragraph 15 of Statement 13 - generally using the straight-line method. Although the maximum deficiency under the residual value guarantee is included in minimum lease payments for purposes of lease classification under paragraph 7(d) of Statement 13, those payments would not be considered in the application of paragraph 15 of Statement 13 unless and until it becomes probable that the value of the property at the end of the lease term will be less than the residual value guaranteed by the lessee. Beginning on the date the deficiency becomes probable, the expected deficiency (up to the maximum for which the lessee is responsible) would be accrued by the lessee using the straight-line method over the remaining term of the lease. Accrual of a deficiency by a lessee would be required regardless of whether the lessee expects to exercise a purchase or renewal option at the end of the lease term.

STATUS

A related issue was discussed in Issue No. 97-1, "Implementation Issues in Accounting for Lease Transactions, including Those involving Special-Purpose Entities ." The categories of issues are: (1) environmental risk, (2) non-performance-related default covenants, and (3) depreciation. Categories (1) and (2) apply to leasing transactions irrespective of whether the lessor is an SPE. Category (3) applies when the lessor is an SPE. (See Issue 97-1 for details of the consensuses reached.)

A related issue was discussed in Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction ." This Issue addresses how an entity (lessee) that is involved with the construction of an asset should determine whether it should be considered an owner of that asset during the construction period. These transactions often involve an owner-lessor SPE. (See Issue 97-10 for details of the consensuses reached.)

No further EITF discussion is planned.

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REPORT OF INVESTIGATION

BY THE

SPECIAL INVESTIGATIVE COMMITTEE

OF THE

BOARD OF DIRECTORS OF ENRON CORP.

William C. Powers, Jr., Chair
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February 1, 2002

William Powers, Jr.
Member of the Enron Board of Directors and Chairman of the Special Investigation Committee

3600 Murillo Circle
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February 1, 2002

To the Members of the Board of Directors
Enron Corporation

Enclosed is a copy of the Report of the Special Investigation Committee.

Sincerely,

William Powers, Jr.

Enclosure

TABLE OF CONTENTS

EXECUTIVE SUMMARY AND CONCLUSIONS 1

INTRODUCTION 29

I. BACKGROUND: ENRON AND SPECIAL PURPOSE ENTITIES 36

II. CHEWCO 41

A. Formation of Chewco 43

B. Limited Board Approval 46

C. SPE Non-Consolidation "Control" Requirement 47

D. SPE Non-Consolidation "Equity" Requirement 49

E. Fees Paid to Chewco/Kopper 54

F. Enron Revenue Recognition Issues 56

1. Enron Guaranty Fee 56

2. "Required Payments" to Enron 57

3. Recognition of Revenue from Enron Stock 58

G. Enron's Repurchase of Chewco's Limited Partnership Interest 60

1. Negotiations 60

2. Buyout Transaction 62

3. Returns to Kopper/Dodson 64

4. Tax Indemnity Payment 64

H. Decision to Restate 66

III. LJM HISTORY AND GOVERNANCE 68

A. Formation and Authorization of LJM Cayman, L.P. and LJM2 Co-Investment, L.P. 68

B. LJM Governance Issues 75

IV. RHYTHMS NETCONNECTIONS 77

A. Origin of the Transaction 77

B. Structure of the Transaction 79

C. Structure and Pricing Issues 82

1. Nature of the Rhythms "Hedge" 82

2. SPE Equity Requirement 83

3. Pricing and Credit Capacity 84

D. Adjustment of the "Hedge" and Repayment of the Note 85

E. Unwinding the Transaction 87

1. Negotiations 87

2. Terms 89

3. Financial Results 89

F. Financial Participation of Enron Employees in the Unwind 92

V. THE RAPTORS 97

A. Raptor I 99

1. Formation and Structure 99

2. Enron's Approval of Raptor I 105

3. Early Activity in Raptor I 107

4. Credit Capacity Concerns in the Fall of 2000 110

B. Raptors II and IV 111

C. Raptor III 114

1. The New Power Company 115

2. The Creation of Raptor III 115

3. Decline in Raptor III's Credit Capacity 118

D. Raptor Restructuring 119

1. Fourth Quarter 2000 Temporary Fix 119

2. First Quarter 2001 Restructuring 121

a. The Search for a Solution 121

b. The Restructuring Transaction 122

E. Unwind of the Raptors 125

F. Conclusions on the Raptors 128

VI. OTHER TRANSACTIONS WITH LJM 134

A. Illustrative Transactions with LJM 135

1. Cuiaba 135

2. ENA CLO 138

3. Nowa Sarzyna (Poland Power Plant) 140

4. MEGS 141

5. Yosemite 142

6. Backbone 143

B. Other Transactions with LJM 145

VII. OVERSIGHT BY THE BOARD OF DIRECTORS AND MANAGEMENT 148

A. Oversight by the Board of Directors 148

1. The Chewco Transaction 149

2. Creation of LJM1 and LJM2 150

3. Creation of the Raptor Vehicles 156

4. Board Oversight of the Ongoing Relationship with LJM 158

B. Oversight by Management 165

C. The Watkins Letter 172

VIII. RELATED-PARTY DISCLOSURE ISSUES 178

A. Standards for Disclosure of Related-Party Transactions 178

B. Enron's Disclosure Process 181

C. Proxy Statement Disclosures 184

1. Enron's Disclosures 184

2. Adequacy of Disclosures 187

D. Financial Statement Footnote Disclosures 192

1. Enron's Disclosures 192

2. Adequacy of Disclosures 197

E. Conclusions on Disclosure 200

EXECUTIVE SUMMARY AND CONCLUSIONS

The Special Investigative Committee of the Board of Directors of Enron Corp. submits this Report of Investigation to the Board of Directors. In accordance with our mandate, the Report addresses transactions between Enron and investment partnerships created and managed by Andrew S. Fastow, Enron's former Executive Vice President and Chief Financial Officer, and by other Enron employees who worked with Fastow.

The Committee has done its best, given the available time and resources, to conduct a careful and impartial investigation. We have prepared a Report that explains the substance of the most significant transactions and highlights their most important accounting, corporate governance, management oversight, and public disclosure issues. An exhaustive investigation of these related-party transactions would require time and resources beyond those available to the Committee. We were not asked, and we have not attempted, to investigate the causes of Enron's bankruptcy or the numerous business judgments and external factors that contributed it. Many questions currently part of public discussion—such as questions relating to Enron's international business and commercial electricity ventures, broadband communications activities, transactions in Enron securities by insiders, or management of employee 401(k) plans—are beyond the scope of the authority we were given by the Board.

There were some practical limitations on the information available to the Committee in preparing this Report. We had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Certain former Enron employees who (we were told) played substantial roles in one or more of the

transactions under investigation—including Fastow, Michael J. Kopper, and Ben F. Glisan, Jr.—declined to be interviewed either entirely or with respect to most issues. We have had only limited access to certain workpapers of Arthur Andersen LLP ("Andersen"), Enron's outside auditors, and no access to materials in the possession of the Fastow partnerships or their limited partners. Information from these sources could affect our conclusions.

This Executive Summary and Conclusions highlights important parts of the Report and summarizes our conclusions. It is based on the complete set of facts, explanations and limitations described in the Report, and should be read with the Report itself. Standing alone, it does not, and cannot, provide a full understanding of the facts and analysis underlying our conclusions.

Background

On October 16, 2001, Enron announced that it was taking a $544 million after-tax charge against earnings related to transactions with LJM2 Co-Investment, L.P. ("LJM2"), a partnership created and managed by Fastow. It also announced a reduction of shareholders' equity of $1.2 billion related to transactions with that same entity.

Less than one month later, Enron announced that it was restating its financial statements for the period from 1997 through 2001 because of accounting errors relating to transactions with a different Fastow partnership, LJM Cayman, L.P. ("LJM1"), and an additional related-party entity, Chewco Investments, L.P. ("Chewco"). Chewco was managed by an Enron Global Finance employee, Kopper, who reported to Fastow.

The LJM1- and Chewco-related restatement, like the earlier charge against earnings and reduction of shareholders' equity, was very large. It reduced Enron's reported net income by $28 million in 1997 (of $105 million total), by $133 million in 1998 (of $703 million total), by $248 million in 1999 (of $893 million total), and by $99 million in 2000 (of $979 million total). The restatement reduced reported shareholders' equity by $258 million in 1997, by $391 million in 1998, by $710 million in 1999, and by $754 million in 2000. It increased reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000. Enron also revealed, for the first time, that it had learned that Fastow received more than $30 million from LJM1 and LJM2. These announcements destroyed market confidence and investor trust in Enron. Less than one month later, Enron filed for bankruptcy.

Summary of Findings

This Committee was established on October 28, 2001, to conduct an investigation of the related-party transactions. We have examined the specific transactions that led to the third-quarter 2001 earnings charge and the restatement. We also have attempted to examine all of the approximately two dozen other transactions between Enron and these related-party entities: what these transactions were, why they took place, what went wrong, and who was responsible.

Our investigation identified significant problems beyond those Enron has already disclosed. Enron employees involved in the partnerships were enriched, in the aggregate, by tens of millions of dollars they should never have received—Fastow by at least $30 million, Kopper by at least $10 million, two others by $1 million each, and still two more

by amounts we believe were at least in the hundreds of thousands of dollars. We have seen no evidence that any of these employees, except Fastow, obtained the permission required by Enron's Code of Conduct of Business Affairs to own interests in the partnerships. Moreover, the extent of Fastow's ownership and financial windfall was inconsistent with his representations to Enron's Board of Directors.

This personal enrichment of Enron employees, however, was merely one aspect of a deeper and more serious problem. These partnerships—Chewco, LJM1, and LJM2—were used by Enron Management to enter into transactions that it could not, or would not, do with unrelated commercial entities. Many of the most significant transactions apparently were designed to accomplish favorable financial statement results, not to achieve *bona fide* economic objectives or to transfer risk. Some transactions were designed so that, had they followed applicable accounting rules, Enron could have kept assets and liabilities (especially debt) off of its balance sheet; but the transactions did not follow those rules.

Other transactions were implemented—improperly, we are informed by our accounting advisors—to offset losses. They allowed Enron to conceal from the market very large losses resulting from Enron's merchant investments by creating an appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that third party was simply an entity in which only Enron had a substantial economic stake. We believe these transactions resulted in Enron reporting earnings from the third quarter of 2000 through the third quarter of 2001 that were almost $1 billion higher than should have been reported.

Enron's original accounting treatment of the Chewco and LJM1 transactions that led to Enron's November 2001 restatement was clearly wrong, apparently the result of mistakes either in structuring the transactions or in basic accounting. In other cases, the accounting treatment was likely wrong, notwithstanding creative efforts to circumvent accounting principles through the complex structuring of transactions that lacked fundamental economic substance. In virtually all of the transactions, Enron's accounting treatment was determined with extensive participation and structuring advice from Andersen, which Management reported to the Board. Enron's records show that Andersen billed Enron $5.7 million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.

Many of the transactions involve an accounting structure known as a "special purpose entity" or "special purpose vehicle" (referred to as an "SPE" in this Summary and in the Report). A company that does business with an SPE may treat that SPE as if it were an independent, outside entity for accounting purposes if two conditions are met: (1) an owner independent of the company must make a substantive equity investment of at least 3% of the SPE's assets, and that 3% must remain at risk throughout the transaction; and (2) the independent owner must exercise control of the SPE. In those circumstances, the company may record gains and losses on transactions with the SPE, and the assets and liabilities of the SPE are not included in the company's balance sheet, even though the company and the SPE are closely related. It was the technical failure of some of the structures with which Enron did business to satisfy these requirements that led to Enron's restatement.

Summary of Transactions and Matters Reviewed

The following are brief summaries of the principal transactions and matters in which we have identified substantial problems:

The Chewco Transaction

The first of the related-party transactions we examined involved Chewco Investments L.P., a limited partnership managed by Kopper. Because of this transaction, Enron filed inaccurate financial statements from 1997 through 2001, and provided an unauthorized and unjustifiable financial windfall to Kopper.

From 1993 through 1996, Enron and the California Public Employees' Retirement System ("CalPERS") were partners in a $500 million joint venture investment partnership called Joint Energy Development Investment Limited Partnership ("JEDI"). Because Enron and CalPERS had joint control of the partnership, Enron did not consolidate JEDI into its consolidated financial statements. The financial statement impact of non-consolidation was significant: Enron would record its contractual share of gains and losses from JEDI on its income statement and would disclose the gain or loss separately in its financial statement footnotes, but would *not* show JEDI's debt on its balance sheet.

In November 1997, Enron wanted to redeem CalPERS' interest in JEDI so that CalPERS would invest in another, larger partnership. Enron needed to find a new partner, or else it would have to consolidate JEDI into its financial statements, which it did not want to do. Enron assisted Kopper (whom Fastow identified for the role) in

forming Chewco to purchase CalPERS' interest. Kopper was the manager and owner of Chewco's general partner. Under the SPE rules summarized above, Enron could only avoid consolidating JEDI onto Enron's financial statements if Chewco had some independent ownership with a minimum of 3% of *equity* capital at risk. Enron and Kopper, however, were unable to locate any such outside investor, and instead financed Chewco's purchase of the JEDI interest almost entirely with debt, not equity. This was done hurriedly and in apparent disregard of the accounting requirements for non-consolidation. Notwithstanding the shortfall in required equity capital, Enron did not consolidate Chewco (or JEDI) into its consolidated financial statements.

Kopper and others (including Andersen) declined to speak with us about why this transaction was structured in a way that did not comply with the non-consolidation rules. Enron, and any Enron employee acting in Enron's interest, had every incentive to ensure that Chewco complied with these rules. We do not know whether this mistake resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper or others putting their own interests ahead of their obligations to Enron.

The consequences, however, were enormous. When Enron and Andersen reviewed the transaction closely in 2001, they concluded that Chewco did not satisfy the SPE accounting rules and—because JEDI's non-consolidation depended on Chewco's status—neither did JEDI. In November 2001, Enron announced that it would consolidate Chewco and JEDI retroactive to 1997. As detailed in the Background section above, this retroactive consolidation resulted in a massive reduction in Enron's reported net income and a massive increase in its reported debt.

Beyond the financial statement consequences, the Chewco transaction raises substantial corporate governance and management oversight issues. Under Enron's Code of Conduct of Business Affairs, Kopper was prohibited from having a financial or managerial role in Chewco unless the Chairman and CEO determined that his participation "does not adversely affect the best interests of the Company." Notwithstanding this requirement, we have seen no evidence that his participation was ever disclosed to, or approved by, either Kenneth Lay (who was Chairman and CEO) or the Board of Directors.

While the consequences of the transaction were devastating to Enron, Kopper reaped a financial windfall from his role in Chewco. This was largely a result of arrangements that he appears to have negotiated with Fastow. From December 1997 through December 2000, Kopper received $2 million in "management" and other fees relating to Chewco. Our review failed to identify how these payments were determined, or what, if anything, Kopper did to justify the payments. More importantly, in March 2001 Enron repurchased Chewco's interest in JEDI on terms Kopper apparently negotiated with Fastow (during a time period in which Kopper had undisclosed interests with Fastow in both LJM1 and LJM2). Kopper had invested $125,000 in Chewco in 1997. The repurchase resulted in Kopper's (and a friend to whom he had transferred part of his interest) receiving more than $10 million from Enron.

The LJM Transactions

In 1999, with Board approval, Enron entered into business relationships with two partnerships in which Fastow was the manager and an investor. The transactions between

Enron and the LJM partnerships resulted in Enron increasing its reported financial results by more than a billion dollars, and enriching Fastow and his co-investors by tens of millions of dollars at Enron's expense.

The two members of the Special Investigative Committee who have reviewed the Board's decision to permit Fastow to participate in LJM notwithstanding the conflict of interest have concluded that this arrangement was fundamentally flawed.[1/] A relationship with the most senior financial officer of a public company—particularly one requiring as many controls and as much oversight by others as this one did—should not have been undertaken in the first place.

The Board approved Fastow's participation in the LJM partnerships with full knowledge and discussion of the obvious conflict of interest that would result. The Board apparently believed that the conflict, and the substantial risks associated with it, could be mitigated through certain controls (involving oversight by both the Board and Senior Management) to ensure that transactions were done on terms fair to Enron. In taking this step, the Board thought that the LJM partnerships would offer business benefits to Enron that would outweigh the potential costs. The principal reason advanced by Management in favor of the relationship, in the case of LJM1, was that it would permit Enron to accomplish a particular transaction it could not otherwise accomplish. In

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1/ One member of the Special Investigative Committee, Herbert S. Winokur, Jr., was a member of the Board of Directors and the Finance Committee during the relevant period. The portions of the Report describing and evaluating actions of the Board and its Committees are solely the views of the other two members of the Committee, Dean William C. Powers, Jr. of the University of Texas School of Law and Raymond S. Troubh.

the case of LJM2, Management advocated that it would provide Enron with an additional potential buyer of assets that Enron wanted to sell, and that Fastow's familiarity with the Company and the assets to be sold would permit Enron to move more quickly and incur fewer transaction costs.

Over time, the Board required, and Management told the Board it was implementing, an ever-increasing set of procedures and controls over the related-party transactions. These included, most importantly, review and approval of all LJM transactions by Richard Causey, the Chief Accounting Officer; and Richard Buy, the Chief Risk Officer; and, later during the period, Jeffrey Skilling, the President and COO (and later CEO). The Board also directed its Audit and Compliance Committee to conduct annual reviews of all LJM transactions.

These controls as designed were not rigorous enough, and their implementation and oversight was inadequate at both the Management and Board levels. No one in Management accepted primary responsibility for oversight; the controls were not executed properly; and there were structural defects in those controls that became apparent over time. For instance, while neither the Chief Accounting Officer, Causey, nor the Chief Risk Officer, Buy, ignored his responsibilities, they interpreted their roles very narrowly and did not give the transactions the degree of review the Board believed was occurring. Skilling appears to have been almost entirely uninvolved in the process, notwithstanding representations made to the Board that he had undertaken a significant role. No one in Management stepped forward to address the issues as they arose, or to bring the apparent problems to the Board's attention.

As we discuss further below, the Board, having determined to allow the related-party transactions to proceed, did not give sufficient scrutiny to the information that was provided to it thereafter. While there was important information that appears to have been withheld from the Board, the annual reviews of LJM transactions by the Audit and Compliance Committee (and later also the Finance Committee) appear to have involved only brief presentations by Management (with Andersen present at the Audit Committee) and did not involve any meaningful examination of the nature or terms of the transactions. Moreover, even though Board Committee-mandated procedures required a review by the Compensation Committee of Fastow's compensation from the partnerships, neither the Board nor Senior Management asked Fastow for the amount of his LJM-related compensation until October 2001, after media reports focused on Fastow's role in LJM.

From June 1999 through June 2001, Enron entered into more than 20 distinct transactions with the LJM partnerships. These were of two general types: asset sales and purported "hedging" transactions. Each of these types of transactions was flawed, although the latter ultimately caused much more harm to Enron.

Asset Sales. Enron sold assets to LJM that it wanted to remove from its books. These transactions often occurred close to the end of financial reporting periods. While there is nothing improper about such transactions if they actually transfer the risks and rewards of ownership to the other party, there are substantial questions whether any such transfer occurred in some of the sales to LJM.

Near the end of the third and fourth quarters of 1999, Enron sold interests in seven assets to LJM1 and LJM2. These transactions appeared consistent with the stated purpose of allowing Fastow to participate in the partnerships—the transactions were done quickly, and permitted Enron to remove the assets from its balance sheet and record a gain in some cases. However, events that occurred after the sales call into question the legitimacy of the sales. In particular: (1) Enron bought back five of the seven assets after the close of the financial reporting period, in some cases within a matter of months; (2) the LJM partnerships made a profit on *every* transaction, even when the asset it had purchased appears to have declined in market value; and (3) according to a presentation Fastow made to the Board's Finance Committee, those transactions generated, directly or indirectly, "earnings" to Enron of $229 million in the second half of 1999 (apparently including one hedging transaction). (The details of the transactions are discussed in Section VI of the Report.) Although we have not been able to confirm Fastow's calculation, Enron's reported earnings for that period were $570 million (pre-tax) and $549 million (after-tax).

We have identified some evidence that, in three of these transactions where Enron ultimately bought back LJM's interest, Enron had agreed in advance to protect the LJM partnerships against loss. If this was in fact the case, it was likely inappropriate to treat the transactions as sales. There also are plausible, more innocent explanations for some of the repurchases, but a sufficient basis remains for further examination. With respect to those transactions in which risk apparently did not pass from Enron, the LJM partnerships functioned as a vehicle to accommodate Enron in the management of its reported financial results.

Hedging Transactions. The first "hedging" transaction between Enron and LJM occurred in June 1999, and was approved by the Board in conjunction with its approval of Fastow's participation in LJM1. The normal idea of a hedge is to contract with a creditworthy outside party that is prepared—for a price—to take on the economic risk of an investment. If the value of the investment goes down, that outside party will bear the loss. That is not what happened here. Instead, Enron transferred its own stock to an SPE in exchange for a note. The Fastow partnership, LJM1, was to provide the outside equity necessary for the SPE to qualify for non-consolidation. Through the use of options, the SPE purported to take on the risk that the price of the stock of Rhythms NetConnections Inc. ("Rhythms"), an internet service provider, would decline. The idea was to "hedge" Enron's profitable merchant investment in Rhythms stock, allowing Enron to offset losses on Rhythms if the price of Rhythms stock declined. If the SPE were required to pay Enron on the Rhythms options, the transferred Enron stock would be the principal source of payment.

The other "hedging" transactions occurred in 2000 and 2001 and involved SPEs known as the "Raptor" vehicles. Expanding on the idea of the Rhythms transaction, these were extraordinarily complex structures. They were funded principally with Enron's own stock (or contracts for the delivery of Enron stock) that was intended to "hedge" against declines in the value of a large group of Enron's merchant investments. LJM2 provided the outside equity designed to avoid consolidation of the Raptor SPEs.

The asset sales and hedging transactions raised a variety of issues, including the following:

Accounting and Financial Reporting Issues. Although Andersen approved the transactions, in fact the "hedging" transactions did not involve substantive transfers of economic risk. The transactions may have looked superficially like economic hedges, but they actually functioned only as "accounting" hedges. They appear to have been designed to circumvent accounting rules by recording hedging gains to offset losses in the value of merchant investments on Enron's quarterly and annual income statements. The economic reality of these transactions was that Enron never escaped the risk of loss, because it had provided the bulk of the capital with which the SPEs would pay Enron.

Enron used this strategy to avoid recognizing losses for a time. In 1999, Enron recognized after-tax income of $95 million from the Rhythms transaction, which offset losses on the Rhythms investment. In the last two quarters of 2000, Enron recognized revenues of $500 million on derivative transactions with the Raptor entities, which offset losses in Enron's merchant investments, and recognized pre-tax earnings of $532 million (including net interest income). Enron's reported pre-tax earnings for the last two quarters of 2000 totaled $650 million. "Earnings" from the Raptors accounted for more than 80% of that total.

The idea of hedging Enron's investments with the value of Enron's capital stock had a serious drawback as an economic matter. If the value of the investments fell at the same time as the value of Enron stock fell, the SPEs would be unable to meet their obligations and the "hedges" would fail. This is precisely what happened in late 2000 and early 2001. Two of the Raptor SPEs lacked sufficient credit capacity to pay Enron on the "hedges." As a result, in late March 2001, it appeared that Enron would be required to take a pre-tax charge against earnings of more than $500 million to reflect the

shortfall in credit capacity. Rather than take that loss, Enron "restructured" the Raptor vehicles by, among other things, transferring more than $800 million of contracts to receive its own stock to them just before quarter-end. This transaction apparently was not disclosed to or authorized by the Board, involved a transfer of very substantial value for insufficient consideration, and appears inconsistent with governing accounting rules. It continued the concealment of the substantial losses in Enron's merchant investments.

However, even these efforts could not avoid the inevitable results of hedges that were supported only by Enron stock in a declining market. As the value of Enron's merchant investments continued to fall in 2001, the credit problems in the Raptor entities became insoluble. Ultimately, the SPEs were terminated in September 2001. This resulted in the unexpected announcement on October 16, 2001, of a $544 million after-tax charge against earnings. In addition, Enron was required to reduce shareholders' equity by $1.2 billion. While the equity reduction was primarily the result of accounting errors made in 2000 and early 2001, the charge against earnings was the result of Enron's "hedging" its investments—not with a creditworthy counter-party, but with itself.

Consolidation Issues. In addition to the accounting abuses involving use of Enron stock to avoid recognizing losses on merchant investments, the Rhythms transaction involved the same SPE equity problem that undermined Chewco and JEDI. As we stated above, in 2001, Enron and Andersen concluded that Chewco lacked sufficient outside equity at risk to qualify for non-consolidation. At the same time, Enron and Andersen also concluded that the LJM1 SPE in the Rhythms transaction failed the same threshold accounting requirement. In recent Congressional testimony, Andersen's CEO explained that the firm had simply been wrong in 1999 when it concluded (and

presumably advised Enron) that the LJM1 SPE satisfied the non-consolidation requirements. As a result, in November 2001, Enron announced that it would restate prior period financials to consolidate the LJM1 SPE retroactively to 1999. This retroactive consolidation decreased Enron's reported net income by $95 million (of $893 million total) in 1999 and by $8 million (of $979 million total) in 2000.

Self-Dealing Issues. While these related-party transactions facilitated a variety of accounting and financial reporting abuses by Enron, they were extraordinarily lucrative for Fastow and others. In exchange for their passive and largely risk-free roles in these transactions, the LJM partnerships and their investors were richly rewarded. Fastow and other Enron employees received tens of millions of dollars they should not have received. These benefits came at Enron's expense.

When Enron and LJM1 (through Fastow) negotiated a termination of the Rhythms "hedge" in 2000, the terms of the transaction were extraordinarily generous to LJM1 and its investors. These investors walked away with tens of millions of dollars in value that, in an arm's-length context, Enron would never have given away. Moreover, based on the information available to us, it appears that Fastow had offered interests in the Rhythms termination to Kopper and four other Enron employees. These investments, in a partnership called "Southampton Place," provided spectacular returns. In exchange for a $25,000 investment, Fastow received (through a family foundation) *$4.5 million* in approximately two months. Two other employees, who each invested $5,800, each received *$1 million* in the same time period. We have seen no evidence that Fastow or any of these employees obtained clearance for those investments, as required by Enron's Code of Conduct. Kopper and the other Enron employees who received these vast

returns were all involved in transactions between Enron and the LJM partnerships in 2000—some representing Enron.

Public Disclosure

Enron's publicly-filed reports disclosed the existence of the LJM partnerships. Indeed, there was substantial factual information about Enron's transactions with these partnerships in Enron's quarterly and annual reports and in its proxy statements. Various disclosures were approved by one or more of Enron's outside auditors and its inside and outside counsel. However, these disclosures were obtuse, did not communicate the essence of the transactions completely or clearly, and failed to convey the substance of what was going on between Enron and the partnerships. The disclosures also did not communicate the nature or extent of Fastow's financial interest in the LJM partnerships. This was the result of an effort to avoid disclosing Fastow's financial interest and to downplay the significance of the related-party transactions and, in some respects, to disguise their substance and import. The disclosures also asserted that the related-party transactions were reasonable compared to transactions with third parties, apparently without any factual basis. The process by which the relevant disclosures were crafted was influenced substantially by Enron Global Finance (Fastow's group). There was an absence of forceful and effective oversight by Senior Enron Management and in-house counsel, and objective and critical professional advice by outside counsel at Vinson & Elkins, or auditors at Andersen.

The Participants

The actions and inactions of many participants led to the related-party abuses, and the financial reporting and disclosure failures, that we identify in our Report. These participants include not only the employees who enriched themselves at Enron's expense, but also Enron's Management, Board of Directors and outside advisors. The factual basis and analysis for these conclusions are set out in the Report. In summary, based on the evidence available to us, the Committee notes the following:

Andrew Fastow. Fastow was Enron's Chief Financial Officer and was involved on both sides of the related-party transactions. What he presented as an arrangement intended to benefit Enron became, over time, a means of both enriching himself personally and facilitating manipulation of Enron's financial statements. Both of these objectives were inconsistent with Fastow's fiduciary duties to Enron and anything the Board authorized. The evidence suggests that he (1) placed his own personal interests and those of the LJM partnerships ahead of Enron's interests; (2) used his position in Enron to influence (or attempt to influence) Enron employees who were engaging in transactions on Enron's behalf with the LJM partnerships; and (3) failed to disclose to Enron's Board of Directors important information it was entitled to receive. In particular, we have seen no evidence that he disclosed Kopper's role in Chewco or LJM2, or the level of profitability of the LJM partnerships (and his personal and family interests in those profits), which far exceeded what he had led the Board to expect. He apparently also violated and caused violations of Enron's Code of Conduct by purchasing, and offering to Enron employees, extraordinarily lucrative interests in the Southampton Place

partnership. He did so at a time when at least one of those employees was actively working on Enron's behalf in transactions with LJM2.

Enron's Management. Individually, and collectively, Enron's Management failed to carry out its substantive responsibility for ensuring that the transactions were fair to Enron—which in many cases they were not—and its responsibility for implementing a system of oversight and controls over the transactions with the LJM partnerships. There were several direct consequences of this failure: transactions were executed on terms that were not fair to Enron and that enriched Fastow and others; Enron engaged in transactions that had little economic substance and misstated Enron's financial results; and the disclosures Enron made to its shareholders and the public did not fully or accurately communicate relevant information. We discuss here the involvement of Kenneth Lay, Jeffrey Skilling, Richard Causey, and Richard Buy.

For much of the period in question, Lay was the Chief Executive Officer of Enron and, in effect, the captain of the ship. As CEO, he had the ultimate responsibility for taking reasonable steps to ensure that the officers reporting to him performed their oversight duties properly. He does not appear to have directed their attention, or his own, to the oversight of the LJM partnerships. Ultimately, a large measure of the responsibility rests with the CEO.

Lay approved the arrangements under which Enron permitted Fastow to engage in related-party transactions with Enron and authorized the Rhythms transaction and three of the Raptor vehicles. He bears significant responsibility for those flawed decisions, as well as for Enron's failure to implement sufficiently rigorous procedural controls to

prevent the abuses that flowed from this inherent conflict of interest. In connection with the LJM transactions, the evidence we have examined suggests that Lay functioned almost entirely as a Director, and less as a member of Management. It appears that both he and Skilling agreed, and the Board understood, that Skilling was the senior member of Management responsible for the LJM relationship.

Skilling was Enron's President and Chief Operating Officer, and later its Chief Executive Officer, until his resignation in August 2001. The Board assumed, and properly so, that during the entire period of time covered by the events discussed in this Report, Skilling was sufficiently knowledgeable of and involved in the overall operations of Enron that he would see to it that matters of significance would be brought to the Board's attention. With respect to the LJM partnerships, Skilling personally supported the Board's decision to permit Fastow to proceed with LJM, notwithstanding Fastow's conflict of interest. Skilling had direct responsibility for ensuring that those reporting to him performed their oversight duties properly. He likewise had substantial responsibility to make sure that the internal controls that the Board put in place—particularly those involving related-party transactions with the Company's CFO—functioned properly. He has described the detail of his expressly-assigned oversight role as minimal. That answer, however, misses the point. As the magnitude and significance of the related-party transactions to Enron increased over time, it is difficult to understand why Skilling did not ensure that those controls were rigorously adhered to and enforced. Based upon his own description of events, Skilling does not appear to have given much attention to these duties. Skilling certainly knew or should have known of the magnitude and the risks associated with these transactions. Skilling, who prides himself on the controls he

put in place in many areas at Enron, bears substantial responsibility for the failure of the system of internal controls to mitigate the risk inherent in the relationship between Enron and the LJM partnerships.

Skilling met in March 2000 with Jeffrey McMahon, Enron's Treasurer (who reported to Fastow). McMahon told us that he approached Skilling with serious concerns about Enron's dealings with the LJM partnerships. McMahon and Skilling disagree on some important elements of what was said. However, if McMahon's account (which is reflected in what he describes as contemporaneous talking points for the discussion) is correct, it appears that Skilling did not take action (nor did McMahon approach Lay or the Board) after being put on notice that Fastow was pressuring Enron employees who were negotiating with LJM—clear evidence that the controls were not effective. There also is conflicting evidence regarding Skilling's knowledge of the March 2001 Raptor restructuring transaction. Although Skilling denies it, if the account of other Enron employees is accurate, Skilling both approved a transaction that was designed to conceal substantial losses in Enron's merchant investments and withheld from the Board important information about that transaction.

Causey was and is Enron's Chief Accounting Officer. He presided over and participated in a series of accounting judgments that, based on the accounting advice we have received, went well beyond the aggressive. The fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact.

Causey was also charged by the Board of Directors with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between Enron and the LJM partnerships, and he was to review those transactions with the Audit and Compliance Committee annually. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions and did not give those transactions the level of scrutiny the Board had reason to believe he would. He did not provide the Audit and Compliance Committee with the full and complete information about the transactions, in particular the Raptor III and Raptor restructuring transactions, that it needed to fulfill its duties.

Buy was and is Enron's Senior Risk Officer. The Board of Directors also charged him with a substantial role in the oversight of Enron's relationship with the LJM partnerships. He was to review and approve all transactions between them. The evidence we have examined suggests that he did not implement a procedure for identifying all LJM1 or LJM2 transactions. Perhaps more importantly, he apparently saw his role as more narrow than the Board had reason to believe, and did not act affirmatively to carry out (or ensure that others carried out) a careful review of the economic terms of all transactions between Enron and LJM.

The Board of Directors. With respect to the issues that are the subject of this investigation, the Board of Directors failed, in our judgment, in its oversight duties. This had serious consequences for Enron, its employees, and its shareholders.

The Board of Directors approved the arrangements that allowed the Company's CFO to serve as general partner in partnerships that participated in significant financial

transactions with Enron. As noted earlier, the two members of the Special Investigative Committee who have participated in this review of the Board's actions believe this decision was fundamentally flawed. The Board substantially underestimated the severity of the conflict and overestimated the degree to which management controls and procedures could contain the problem.

After having authorized a conflict of interest creating as much risk as this one, the Board had an obligation to give careful attention to the transactions that followed. It failed to do this. It cannot be faulted for the various instances in which it was apparently denied important information concerning certain of the transactions in question. However, it can and should be faulted for failing to demand more information, and for failing to probe and understand the information that did come to it. The Board authorized the Rhythms transaction and three of the Raptor transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks. Nor does it appear that they reacted to warning signs in those transactions as they were presented, including the statement to the Finance Committee in May 2000 that the proposed Raptor transaction raised a risk of "accounting scrutiny." We do note, however, that the Committee was told that Andersen was "comfortable" with the transaction. As complex as the transactions were, the existence of Fastow's conflict of interest demanded that the Board gain a better understanding of the LJM transactions that came before it, and ensure (whether through one of its Committees or through use of outside consultants) that they were fair to Enron.

The Audit and Compliance Committee, and later the Finance Committee, took on a specific role in the control structure by carrying out periodic reviews of the LJM

transactions. This was an opportunity to probe the transactions thoroughly, and to seek outside advice as to any issues outside the Board members' expertise. Instead, these reviews appear to have been too brief, too limited in scope, and too superficial to serve their intended function. The Compensation Committee was given the role of reviewing Fastow's compensation from the LJM entities, and did not carry out this review. This remained the case even after the Committees were on notice that the LJM transactions were contributing very large percentages of Enron's earnings. In sum, the Board did not effectively meet its obligation with respect to the LJM transactions.

The Board, and in particular the Audit and Compliance Committee, has the duty of ultimate oversight over the Company's financial reporting. While the primary responsibility for the financial reporting abuses discussed in the Report lies with Management, the participating members of this Committee believe those abuses could and should have been prevented or detected at an earlier time had the Board been more aggressive and vigilant.

Outside Professional Advisors. The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal controls over the related-party transactions. Andersen has admitted that it erred in concluding that the Rhythms transaction was structured properly under the SPE non-consolidation rules. Enron was required to restate its financial results for 1999 and 2000 as a result. Andersen participated in the structuring and accounting treatment of the Raptor transactions, and charged over $1 million for its services, yet it apparently failed to provide the objective

accounting judgment that should have prevented these transactions from going forward. According to Enron's internal accountants (though this apparently has been disputed by Andersen), Andersen also reviewed and approved the recording of additional equity in March 2001 in connection with this restructuring. In September 2001, Andersen required Enron to reverse this accounting treatment, leading to the $1.2 billion reduction of equity. Andersen apparently failed to note or take action with respect to the deficiencies in Enron's public disclosure documents.

According to recent public disclosures, Andersen also failed to bring to the attention of Enron's Audit and Compliance Committee serious reservations Andersen partners voiced internally about the related-party transactions. An internal Andersen e-mail from February 2001 released in connection with recent Congressional hearings suggests that Andersen had concerns about Enron's disclosures of the related-party transactions. A week after that e-mail, however, Andersen's engagement partner told the Audit and Compliance Committee that, with respect to related-party transactions, "[r]equired disclosure [had been] reviewed for adequacy," and that Andersen would issue an unqualified audit opinion. From 1997 to 2001, Enron paid Andersen $5.7 million in connection with work performed specifically on the LJM and Chewco transactions. The Board appears to have reasonably relied upon the professional judgment of Andersen concerning Enron's financial statements and the adequacy of controls for the related-party transactions. Our review indicates that Andersen failed to meet its responsibilities in both respects.

Vinson & Elkins, as Enron's longstanding outside counsel, provided advice and prepared documentation in connection with many of the transactions discussed in the

Report. It also assisted Enron with the preparation of its disclosures of related-party transactions in the proxy statements and the footnotes to the financial statements in Enron's periodic SEC filings.[2/] Management and the Board relied heavily on the perceived approval by Vinson & Elkins of the structure and disclosure of the transactions. Enron's Audit and Compliance Committee, as well as in-house counsel, looked to it for assurance that Enron's public disclosures were legally sufficient. It would be inappropriate to fault Vinson & Elkins for accounting matters, which are not within its expertise. However, Vinson & Elkins should have brought a stronger, more objective and more critical voice to the disclosure process.

Enron Employees Who Invested in the LJM Partnerships. Michael Kopper, who worked for Fastow in the Finance area, enriched himself substantially at Enron's expense by virtue of his roles in Chewco, Southampton Place, and possibly LJM2. In a transaction he negotiated with Fastow, Kopper, and his co-investor in Chewco received more than $10 million from Enron for a $125,000 investment. This was inconsistent with his fiduciary duties to Enron and, as best we can determine, with anything the Board—which apparently was unaware of his Chewco activities—authorized. We do not know what financial returns he received from his undisclosed investments in LJM2 or Southampton Place. Kopper violated Enron's Code of Conduct not only by purchasing his personal interests in Chewco, LJM2, and Southampton, but also by secretly offering an interest in Southampton to another Enron employee.

2/ Because of the relationship between Vinson & Elkins and the University of Texas School of Law, the portions of the Report describing and evaluating actions of Vinson & Elkins are solely the views of Troubh and Winokur.

Ben Glisan, an accountant and later McMahon's successor as Enron's Treasurer, was a principal hands-on Enron participant in two transactions that ultimately required restatements of earnings and equity: Chewco and the Raptor structures. Because Glisan declined to be interviewed by us on Chewco, we cannot speak with certainty about Glisan's knowledge of the facts that should have led to the conclusion that Chewco failed to comply with the non-consolidation requirement. There is, however, substantial evidence that he was aware of such facts. In the case of Raptor, Glisan shares responsibility for accounting judgments that, as we understand based on the accounting advice we have received, went well beyond the aggressive. As with Causey, the fact that these judgments were, in most if not all cases, made with the concurrence of Andersen is a significant, though not entirely exonerating, fact. Moreover, Glisan violated Enron's Code of Conduct by accepting an interest in Southampton Place without prior disclosure to or consent from Enron's Chairman and Chief Executive Officer—and doing so at a time when he was working on Enron's behalf on transactions with LJM2, including Raptor.

Kristina Mordaunt (an in-house lawyer at Enron), Kathy Lynn (an employee in the Finance area), and Anne Yaeger Patel (also an employee in Finance) appear to have violated Enron's Code of Conduct by accepting interests in Southampton Place without obtaining the consent of Enron's Chairman and Chief Executive Officer.

* * *

The tragic consequences of the related-party transactions and accounting errors were the result of failures at many levels and by many people: a flawed idea, self-

enrichment by employees, inadequately-designed controls, poor implementation, inattentive oversight, simple (and not-so-simple) accounting mistakes, and overreaching in a culture that appears to have encouraged pushing the limits. Our review indicates that many of those consequences could and should have been avoided.

The Special Investigative Committee of the Board of Directors of Enron Corp. submits this Report of Investigation to the Board of Directors.

INTRODUCTION

As directed by the Board, this Report addresses transactions between Enron and investment partnerships created and managed by Andrew S. Fastow, Enron's former Executive Vice President and Chief Financial Officer ("CFO"), and other Enron employees who worked for Fastow.

Many of the transactions we reviewed are extraordinarily complex. The Committee has done its best, given the available time and resources, to conduct a careful and impartial investigation. We have prepared a Report that explains the substance of the transactions and highlights their most important accounting, corporate governance, management oversight, and public disclosure issues. An exhaustive investigation of these related-party transactions would require time and resources beyond those available to the Committee. In light of the Board's expressed desire for a prompt explanation of these transactions, and pressing requests from governmental authorities to both the Committee and the Company, we provide this Report without further delay. We believe that the information and analysis it provides is a substantial first step in reviewing and understanding these transactions, and serves as an important starting point for further governmental or other investigations.

The Committee's mandate was specific and focused, so we need to explain what we did *not* do. We were not asked, and we have not attempted, to investigate the causes

of Enron's bankruptcy or the numerous business judgments and external factors that contributed it. Many questions currently part of public discussion—such as questions relating to Enron's international business and commercial electricity ventures, broadband communications, transactions in Enron securities by insiders, or management of employee 401(k) plans—are beyond the scope of the authority we were given by the Board.

Formation of the Committee. On October 16, 2001, Enron announced its earnings for the third quarter of 2001. The announcement included an unexpected after-tax charge against earnings of $544 million "related to losses associated with certain investments, principally Enron's interest in The New Power Company, broadband and technology investments, and early termination during the third quarter of certain structured finance arrangements with a previously disclosed entity." In a conference call with securities analysts that day, Enron Chairman Kenneth Lay said that Enron's shareholders' equity was being reduced by $1.2 billion in connection with "the early termination" of "certain structured finance arrangements with a previously disclosed-entity." Both the $544 million charge and the reduction of shareholders' equity related to transactions between Enron and LJM2 Co-Investment, L.P. ("LJM2"), a partnership created and managed by Fastow. The immediate response from the investment community and the media was intense and negative.

On October 22, Enron announced that the Securities and Exchange Commission ("SEC") had requested that Enron voluntarily provide information about the related-party transactions with LJM2 that had been addressed in Enron's earnings announcement. Two

days later, on October 24, Enron announced that Fastow would be on a leave of absence and would be replaced as CFO.

The Board of Directors established a Special Committee on October 28, consisting of three directors who were not employees of Enron. The Board authorized the Committee to conduct an investigation of the related-party transactions that were the subject of the SEC inquiry. In the weeks that followed, two new members were added to the Board: Dean William C. Powers, Jr. of the University of Texas School of Law and Raymond S. Troubh. Powers and Troubh, neither of whom had been a member of the Board at the time of the transactions under investigation, were appointed to the Committee (later renamed the Special Investigative Committee) and Powers was named Chairman. Two of the previously-appointed Directors stepped down so that the new Directors would constitute a majority. As constituted after these changes, the Committee's members are Powers, Troubh, and Herbert S. Winokur, Jr.[3/]

[3/] Powers became Dean of the University of Texas Law School on September 1, 2000. He has been on the faculty since 1977. James Derrick, Enron's General Counsel, served on the Law School Foundation Board of Directors and the Executive Committee of the Law Alumni Association. He resigned from both positions when Powers was appointed to the Enron Board. He had previously been President of the Law Alumni Association. In 1998, Enron pledged a $250,000 gift to the Law School; the final payment was made in January 2001. Enron has also provided $2,250 in matching money for gifts made to the Law School by Enron employees. Vinson & Elkins has been a major financial supporter of the Law School. The portions of the Report describing and evaluating actions of Vinson & Elkins are solely the views of Troubh and Winokur.

Winokur has been a member of the Board of Directors of Enron since 1985. He was Chairman of the Finance Committee during the time period relevant to this Report and participated in the decisions of the Board and the Finance Committee that are addressed in the Report. The portions of the Report describing and evaluating actions of the Board and its Committees are solely the views of Powers and Troubh.

The Committee engaged Wilmer, Cutler & Pickering as its legal counsel. Wilmer, Cutler engaged Deloitte & Touche LLP to provide accounting assistance.[4] The Committee has relied on Wilmer, Cutler for legal advice and Deloitte & Touche for advice on accounting issues.

On November 8, 2001, Enron filed a Current Report on Form 8-K providing additional information about the previously announced charges, and about its business transactions with LJM2 and another limited partnership in which Fastow had been the general partner (LJM Cayman, L.P., known as "LJM1"). Enron also announced its intention to restate its prior period financial statements for the years ending December 31, 1997 through 2000, and the quarters ending March 31 and June 30, 2001. On November 19, 2001, Enron filed its quarterly report on Form 10-Q, which provided additional information about the restatement. On December 2, 2001, Enron and certain of its subsidiaries filed voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code.

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[4] Wilmer, Cutler has performed certain legal services distinct from this Report and unrelated to any issues addressed in this Report for Enron or its subsidiaries in the last five years. These consist of the representation of an Enron subsidiary before the United States Supreme Court in *Enron Power Marketing, Inc. v. Federal Energy Regulatory Commission*, ___ U.S. ___, 121 S. Ct. 2587 (2001), and the representation of Enron in connection with consideration by the European Commission of a merger of two outside entities. Deloitte & Touche has previously performed certain accounting and tax services for Enron, and certain limited tax-related services for Chewco Investments, not relating to the issues discussed in this Report. It also conducted a peer review of Arthur Andersen LLP in late 2001, including an expanded scope review of Andersen's Houston office, although this peer review did not cover Andersen's work for Enron.

The Committee's Investigation. Our investigation was a private internal inquiry. We requested and received voluntary production of documents from many people inside and outside of Enron. Many people also cooperated by providing information through interviews and otherwise. The Committee's counsel reviewed more than 430,000 pages of documents and interviewed more than 65 people, several more than once. Counsel interviewed nine current Enron Directors, more than 50 current and former Enron employees, and some of Enron's outside professional advisors.

There were some practical limitations on the information available to the Committee in preparing this Report. Although the Board directed that Enron employees cooperate with us, we had no power to compel third parties to submit to interviews, produce documents, or otherwise provide information. Certain former Enron employees who (we were told) played substantial roles in one or more of the transactions under investigation—including Fastow, Michael J. Kopper, and Ben F. Glisan, Jr.—declined to be interviewed either entirely or with respect to most issues. Fastow provided a limited number of documents and submitted to a brief interview, during which he declined to respond to most questions.[5]

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[5] In addition, largely because of time constraints and resource limitations resulting from the Company's bankruptcy, there are certain Enron-related materials the Committee has not been able to review (or review fully). At present, it is impossible to determine whether those materials contain important information. For example, the Committee has had little or no access to e-mails that are still being retrieved from archive tapes. Our counsel has informed us that, based on experience in other investigations, review of e-mails of this type may provide information that could be relevant to our analysis and conclusions.

Moreover, we have not had access to information and materials in the possession of many of the relevant third parties. Arthur Andersen LLP ("Andersen") permitted the Committee to review some, but not all, of its workpapers relating to Enron. It did not provide copies of those workpapers or allow the Committee to interview knowledgeable Andersen personnel. Representatives of LJM1 and LJM2 (collectively, "the LJM partnerships") declined to provide documents to the Committee and, in light of a confidentiality agreement between those entities and their limited partners, the Committee has not had access to materials in the possession of the limited partners.

There also may be differences between information obtained through voluntary interviews and document requests and information obtained through testimony under oath and by compulsory legal process. In particular, there can be differences between the quality of evidence obtained in informal interviews (such as the ones we conducted) and information obtained in questioning and cross-examination under oath. Moreover, given the circumstances surrounding Enron's demise and the many pending governmental investigations, some of the people we interviewed may have been motivated to describe events in a manner colored by self-interest or hindsight. We made every effort to maintain objectivity. When appropriate, our counsel used cross-examination techniques to test the credibility of witnesses. Within these inherent limitations, we believe that our

investigation was both careful and impartial, and that the evidence developed is a reasonable foundation on which to base at least preliminary judgments.[6]

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[6] Many of the transactions discussed in this Report are extraordinarily complex. In order to enhance the reader's understanding, we have taken several steps:

First, the Report uses certain conventions. The term "Enron" refers either to Enron Corp. or any of its subsidiaries or affiliates, unless the context requires greater precision. Dollar amounts or share amounts are approximate unless the precise figure is important. Each person is identified by his or her full name (and title, where relevant) the first time he or she is mentioned, and thereafter by last name only. No disrespect is intended. There were literally hundreds of people who were involved, in one way or another, in the transactions we reviewed. To avoid confusion, we refer to all but a few of the most substantial participants by title, position, or function rather than by name. The Report also omits certain details of transactions where we considered it appropriate in order to make the substance of the transaction more understandable to the non-expert reader.

Second, where we believed it would be helpful, we have included in the text of the report diagrams of the transactions being discussed. The diagrams omit certain details in order to make the structure and transaction more understandable.

Third, we have included in the Appendix both a glossary of certain terms and a timeline showing relevant events. Those are not intended to be exhaustive or all-inclusive, but rather as summaries of relevant information.

Fourth, the historical financial data presented in this Report do not reflect the effects, if any, of the announced restatement of prior period financial statements, unless otherwise indicated.

I. BACKGROUND: ENRON AND SPECIAL PURPOSE ENTITIES

During the late 1990s, Enron grew rapidly and moved into areas it believed fit its basic business plan: buy or develop an asset, such as a pipeline or power plant, and then expand it by building a wholesale or retail business around the asset. During the period from 1996 to 1998, we are told, approximately 60% of Enron's earnings were generated from businesses in which Enron was not engaged ten years earlier, and some 30% to 40% were generated from businesses in which Enron was not engaged five years earlier.

Much of this growth involved large initial capital investments that were not expected to generate significant earnings or cash flow in the short term. While Enron believed these investments would be beneficial over a period of time, they placed immediate pressure on Enron's balance sheet. Enron already had a substantial debt load. Funding the new investments by issuing additional debt was unattractive because cash flow in the early years would be insufficient to service that debt and would place pressure on Enron's credit ratings. Maintaining Enron's credit ratings at investment grade was vital to the conduct of its energy trading business. Alternatively, funding the investments by issuing additional equity was also unattractive because the earnings in the early years would be insufficient to avoid "dilution"—that is, reducing earnings per share.

One perceived solution to this finance problem was to find outside investors willing to enter into arrangements that would enable Enron to retain those risks it believed it could manage effectively, and the related rewards. These joint investments typically were structured as separate entities to which Enron and other investors contributed assets or other consideration. These entities could borrow directly from

outside lenders, although in many cases a guaranty or other form of credit support was required from Enron.

Enron's treatment of the entities for financial statement purposes was subject to accounting rules that determine whether the entity should be consolidated in its entirety (including all of its assets and liabilities) into Enron's balance sheet, or should instead be treated as an investment by Enron. Enron management preferred the latter treatment—known as "off-balance-sheet"—because it would enable Enron to present itself more attractively as measured by the ratios favored by Wall Street analysts and rating agencies. Enron engaged in numerous transactions structured in ways that resulted in off-balance-sheet treatment. Some were joint ventures. Others were structured as a vehicle known as a "special purpose entity" or "special purpose vehicle" (referred to as an "SPE" in this Report). Some involved both.

From the early 1990s through 2001, we understand that Enron used SPEs in many aspects of its business. We have been told that these included: synthetic lease transactions, which involved the sale to an SPE of an asset and lease back of that asset (such as Enron's headquarters building in Houston); sales to SPEs of "financial assets" (a debt or equity interest owned by Enron); sales to merchant "hedging" SPEs of Enron stock and contracts to receive Enron stock; and transfers of other assets to entities that have limited outside equity.

There is no generally accepted definition of SPEs to distinguish them from other legal entities, although the staff of the Financial Accounting Standards Board ("FASB") has used the concept of entities whose activities and powers are significantly limited by

their charter or other contractual arrangement. An SPE may take any legal form, including a corporation, partnership, or trust. At the margin, it may be difficult to determine whether an entity is or is not an SPE; key considerations in the accounting literature include how long the entity is intended to be in existence, and the restrictions placed on its activities.

The accounting literature provides only limited guidance concerning when an SPE should be consolidated with its sponsor for financial statement purposes. Much of the literature developed in the context of synthetic lease transactions, in which an SPE acquires property or equipment and leases it to a single lessee. The accounting objective of these lease transactions was to finance the acquisition of an asset while keeping the corresponding debt off of the acquiring company's balance sheet. SPEs later came to be used in other non-leasing transactions, largely to obtain similar accounting results. Over time, in part because of SEC staff concerns that there was no standard practice in dealing with the consolidation of SPEs, the FASB Emerging Issues Task Force released several statements attempting to clarify the relevant principles. By the late 1990s, several generally recognized consolidation principles had been established.

To begin, "[t]here is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies . . . ." FASB, Accounting Research Bulletin No. 51, Consolidated Financial Statements (1959). Ordinarily, the majority holder of a class of equity funded by independent third parties should consolidate (assuming the equity meets certain criteria dealing with size, ability to exercise control,

and exposure to risk and rewards). If there is no independent equity, or if the independent equity fails to meet the criteria, then the presumption is that the transferor of assets to the SPE or its sponsor should consolidate the SPE.

This presumption in favor of consolidation can be overcome only if two conditions are met:

First, an independent owner or owners of the SPE must make a substantive capital investment in the SPE, and that investment must have substantive risks and rewards of ownership during the entire term of the transaction. Where there is only a nominal outside capital investment, or where the initial investment is withdrawn early, then the SPE should be consolidated. The SEC staff has taken the position that 3% of total capital is the *minimum* acceptable investment for the substantive residual capital, but that the appropriate level for any particular SPE depends on various facts and circumstances. Distributions reducing the equity below the minimum require the independent owner to make an additional investment. Investments are not at risk if supported by a letter of credit or other form of guaranty on the initial investment or a guaranteed return.

Second, the independent owner must exercise control over the SPE to avoid consolidation. This is a subjective standard. Control is not determined solely by reference to majority ownership or day-to-day operation of the venture, but instead depends on the relative rights of investors. Accountants often look to accounting literature on partnership control rights for guidance in making this evaluation.

Of the many SPEs utilized by Enron over the past several years, some were involved in the transactions between Enron and related parties that are the subject of this

Report. We have only looked at these SPEs. The unconsolidated SPEs involved in Enron's related-party transactions present issues on both aspects of the non-consolidation test: whether any outside investor had more than 3% residual capital at risk in the entities, and whether any investor other than Enron exercised sufficient control over the entities to justify non-consolidation. We discuss these issues below in connection with specific entities and transactions.

II. CHEWCO

Chewco Investments L.P. is a limited partnership formed in 1997. Transactions between Enron and Chewco are a prologue for Enron's later dealings with the LJM partnerships. Chewco is, to our knowledge, the first time Enron's Finance group (under Fastow) used an SPE run by an Enron employee to keep a significant investment partnership outside of Enron's consolidated financial statements.

Enron's dealings with Chewco raise many of the same accounting and corporate governance issues posed by the LJM transactions we discuss below. Like the LJM partnerships, Chewco's ownership structure was a mystery to most Enron employees, including many who dealt with Chewco on behalf of Enron. Like LJM, the transactions between Enron and Chewco resulted in a financial windfall to an Enron employee. Some of this financial benefit resulted from transactions that make little apparent economic or business sense from Enron's perspective. But there is also an important distinction: The participation of an Enron employee as a principal of Chewco appears to have been accomplished without any presentation to, or approval by, Enron's Board of Directors.

Chewco played a central role in Enron's November 2001 decision to restate its prior period financial statements. In order to achieve the off-balance sheet treatment that Enron desired for an investment partnership, Chewco (which was a limited partner in the partnership) was required to satisfy the accounting requirements for a non-consolidated SPE, including having a minimum of 3% equity at risk provided by outside investors. But Enron Management and Chewco's general partner could not locate third parties willing to invest in the entity. Instead, they created a financing structure for Chewco

that—on its face—fell at least $6.6 million (or more than 50%) short of the required third-party equity. Despite this shortfall, Enron accounted for Chewco as if it were an unconsolidated SPE from 1997 through March 2001.

We do not know why this happened. Enron had every incentive to ensure that Chewco met the requirements for non-consolidation. It is reasonable to assume that Enron employees, if motivated solely to protect Enron's interests, would have taken the necessary steps to ensure that Chewco had adequate outside equity. Unfortunately, several of the principal participants in the transaction declined to be interviewed or otherwise to provide information to us. For this reason, we have been unable to determine whether Chewco's failure to qualify for non-consolidation resulted from bad judgment or negligence, or whether it was caused by Enron employees putting their own economic or personal interests ahead of their obligations to Enron.

When the Chewco transaction was reviewed closely in late October and early November 2001, both Enron and Andersen concluded that Chewco was an SPE without sufficient outside equity, and that it should have been consolidated into Enron's financial statements. As a result, Enron announced in November that it would restate its prior period financial statements from 1997 through 2001. The retroactive consolidation of Chewco—and the investment partnership in which Chewco was a limited partner—had a huge impact. It decreased Enron's reported net income by $28 million (out of $105 million total) in 1997, by $133 million (out of $703 million total) in 1998, by $153 million (out of $893 million total) in 1999, and by $91 million (out of $979 million total) in 2000. It also increased Enron's reported debt by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000.

A. **Formation of Chewco**

In 1993, Enron and the California Public Employees' Retirement System ("CalPERS") entered into a joint venture investment partnership called Joint Energy Development Investment Limited Partnership ("JEDI"). Enron was the general partner and contributed $250 million in Enron stock. CalPERS was the limited partner and contributed $250 million in cash. Because Enron and CalPERS had joint control, Enron did not consolidate JEDI into its consolidated financial statements.

In 1997, Enron considered forming a $1 billion partnership with CalPERS called "JEDI II." Enron believed that CalPERS would not invest simultaneously in both JEDI and JEDI II, so Enron suggested it buy out CalPERS' interest in JEDI. Enron and CalPERS attempted to value CalPERS' interest (CalPERS retained an investment bank) and discussed an appropriate buyout price.

In order to maintain JEDI as an unconsolidated entity, Enron needed to identify a new limited partner. Fastow initially proposed that he act as the manager of, and an investor in, a new entity called "Chewco Investments"—named after the Star Wars character "Chewbacca." Although other Enron employees would be permitted to participate in Chewco, Fastow proposed to solicit the bulk of Chewco's equity capital from third-party investors. He suggested that Chewco investors would want a manager who, like him, knew the underlying assets in JEDI and could help manage them effectively. Fastow told Enron employees that Jeffrey Skilling, then Enron's President

and Chief Operating Officer ("COO") had approved his participation in Chewco as long as it would not have to be disclosed in Enron's proxy statement.[7]

Both Enron's in-house counsel and its longstanding outside counsel, Vinson & Elkins, subsequently advised Fastow that his participation in Chewco would require (1) disclosure in Enron's proxy statement, and (2) approval from the Chairman and CEO under Enron's Code of Conduct of Business Affairs ("Code of Conduct").[8] As a result, Kopper, an Enron employee who reported to Fastow, was substituted as the proposed manager of Chewco. Unlike Fastow, Kopper was not a senior officer of Enron, so his role in Chewco would not require proxy statement disclosure (but would require approval under Enron's Code of Conduct).

Enron ultimately reached agreement with CalPERS to redeem its JEDI limited partnership interest for $383 million. In order to close that transaction promptly, Chewco was formed as a Delaware limited liability company on very short notice in early November 1997. As initially formed, Kopper (through intermediary entities) was the sole member of both the managing member and regular member of Chewco. Enron's counsel, Vinson & Elkins, prepared the legal documentation for these entities in a period of

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[7] Skilling told us that he recalled Fastow's proposing that the Chewco outside investors be members of Fastow's wife's family, and that Skilling told Fastow he did not think that was a good idea.

[8] Enron's Code of Conduct provided that no full-time officer or employee should "[o]wn an interest in or participate, directly or indirectly, in the profits of any other entity which does business with or is a competitor of the Company, unless such ownership or participation has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp. and such officer has determined that such interest or participation does not adversely affect the best interests of the Company."

approximately 48 hours. Enron also put together a bridge financing arrangement, under which Chewco and its members would borrow $383 million from two banks on an unsecured basis to buy CalPERS' interest from JEDI. The loans were to be guaranteed by Enron.

Enron employees involved in the transaction understood that the Chewco structure did not comply with SPE consolidation rules. Kopper, an Enron employee, controlled Chewco, and there was no third-party equity in Chewco. There was only debt. The intention was, by year end, to replace the bridge financing with another structure that would qualify Chewco as an SPE with sufficient outside equity. Ben F. Glisan, Jr., the Enron "transaction support" employee with principal responsibility for accounting matters in the Chewco transaction, believed that such a transaction would preserve JEDI's unconsolidated status if closed by year end.

While Chewco was being formed, Enron and Chewco were negotiating the economic terms (primarily the profit distribution "waterfall") of their JEDI partnership. Kopper was the business negotiator for Chewco. During the negotiations, Fastow contacted Enron's business negotiator (who reported to him) and suggested that he was pushing too hard for Enron and that the deal needed to be closed. Enron's negotiator explained to Fastow the status of the discussions with Kopper, that he believed it was his job to obtain the best economic terms for Enron, and that accepting Kopper's current position would (based on Enron's economic modeling) result in greater benefits to Chewco than would be required if the negotiations continued. We were told that Fastow indicated he was comfortable closing the transaction on the terms then proposed by Kopper. Enron's negotiator told us he was uncomfortable with this discussion and

Fastow's intervention, and believes that Enron could have improved its position if he had been permitted to continue the negotiations.

B. Limited Board Approval

The Chewco transaction was presented to the Board's Executive Committee on November 5, 1997, at a meeting held by telephone conference call. The minutes of the meeting reflect that Skilling presented the background of JEDI, and that Fastow explained that Chewco would purchase CalPERS' interest in JEDI. Fastow described Chewco as an SPE not affiliated with either Enron or CalPERS. According to the minutes, he "reviewed the economics of the project, the financing arrangements, and the corporate structure of the acquiring company." He also presented a diagram of the proposed permanent financing arrangement, which involved (1) a $250 million subordinated loan to Chewco from a bank (Enron would guarantee the loan); (2) a $132 million advance to Chewco from JEDI under a revolving credit agreement; and (3) $11 million in "equity" contributed by Chewco. Neither the diagram nor the minutes contains any indication of the source of this equity contribution. The Committee voted to approve Enron's guaranty of the bridge loan and the subsequent subordinated loan. The minutes of the meeting of the full Board on December 9 show that these approvals were briefly reported by the Committee to the Board at that meeting.

Enron's Code of Conduct required Kopper to obtain approval for his participation in Chewco from the Chairman and CEO. Lay, who held both positions at this time, said he does not know Kopper and is confident that he was neither informed of Kopper's

participation nor asked to approve it under the Code.[2/] Skilling, who was President and COO, said that Fastow made him aware that Kopper would manage Chewco. Skilling told us that, based on Fastow's recommendation, he approved Kopper's role in Chewco. Skilling's approval, however, did not satisfy the requirements of the Code of Conduct. Skilling also said he believes he discussed Kopper's role in Chewco with the Board at some point.

We have located no written record of the approval Skilling described or any disclosure to the Board concerning Kopper's role. Although the minutes show that Kopper was on the Executive Committee's November 5 conference call when the Chewco loan guaranty was discussed and approved, the minutes do not reflect any mention of Kopper's personal participation in the Chewco transaction. Other than Skilling, none of the Directors we interviewed (including Lay and John Duncan, Chairman of the Executive Committee) recalls being informed of, or approving, Kopper's role in Chewco.

C. SPE Non-Consolidation "Control" Requirement

If Enron controlled Chewco, the accounting rules for SPEs required that Chewco be consolidated into Enron's consolidated financial statements. This principle raised two relevant issues: (1) did Kopper control Chewco, and (2) did Kopper, by virtue of his position at Enron, provide Enron with control over Chewco? With respect to the first question, as formed in November, Kopper controlled Chewco. Kopper was the sole

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2/ The minutes of the November 5 Executive Committee meeting reflect that Lay joined the meeting "during" Fastow's presentation concerning Chewco.

member of Chewco's managing member, and had complete authority over Chewco's actions.

In December 1997, Enron and Kopper made two changes to the Chewco structure that were apparently designed to address the control element. First, Chewco was converted to a limited partnership, with Kopper as the manager of Chewco's general partner. The new Chewco partnership agreement provided some modest limits on the general partner's ability to manage the partnership's affairs. Second, an entity called "Big River Funding LLC" became the limited partner of Chewco. The sole member of Big River was an entity called "Little River Funding LLC." Those entities had been part of the bridge financing structure and, at the time, Kopper had controlled them both. But by an assignment dated December 18, Kopper transferred his ownership interest in Big River and Little River to William D. Dodson.[10] This transfer left Kopper with no formal interest in Chewco's limited partner.

The assessment of control under applicable accounting literature was, and continues to be, subjective. In general, there is a rebuttable presumption that a general partner exercises control over a partnership. The presumption can be overcome if the substance of the partnership arrangement provides that the general partner is not in control of major operating and financial policies. The changes to the Chewco structure and limitations on the general partner's ability to manage the partnership's affairs may

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[10] It is presently common knowledge among Enron Finance employees that Kopper and Dodson are domestic partners. We do not have information concerning their relationship in December 1997 or what, if anything, Enron Finance employees knew about it at that time.

have been sufficient to overcome that presumption, but the issue is not free from doubt. In addition, even if Kopper did control Chewco, it is not clear whether Enron would be deemed to control Chewco. Although Kopper may have been able to influence Enron's actions concerning Chewco, he was not a senior officer of Enron and may not have had sufficient authority within the company for his actions to be considered those of Enron for these purposes.

D. SPE Non-Consolidation "Equity" Requirement

In order to qualify for non-consolidation, Chewco also had to have a minimum of 3% outside equity at risk. As formed in early November, however, Chewco had no equity. There had been efforts to obtain outside equity—including preparing a private placement memorandum and making contact with potential investors—but those efforts were unsuccessful.

In November and December of 1997, Enron and Kopper created a new capital structure for Chewco, which had three elements:

- $240 million unsecured subordinated loan to Chewco from Barclays Bank PLC, which Enron would guarantee;
- $132 million advance from JEDI to Chewco under a revolving credit agreement; and
- $11.5 million in equity (representing approximately 3% of total capital) from Chewco's general and limited partners.

Kopper invested approximately $115,000 in Chewco's general partner, and approximately $10,000 in its limited partner before transferring his limited partnership interest to Dodson. But no third-party investors were identified to provide outside equity.

Instead, to obtain the remaining $11.4 million, Enron and Kopper reached agreement with Barclays Bank to obtain what were described as "equity loans" to Big River (Chewco's limited partner) and Little River (Big River's sole member).

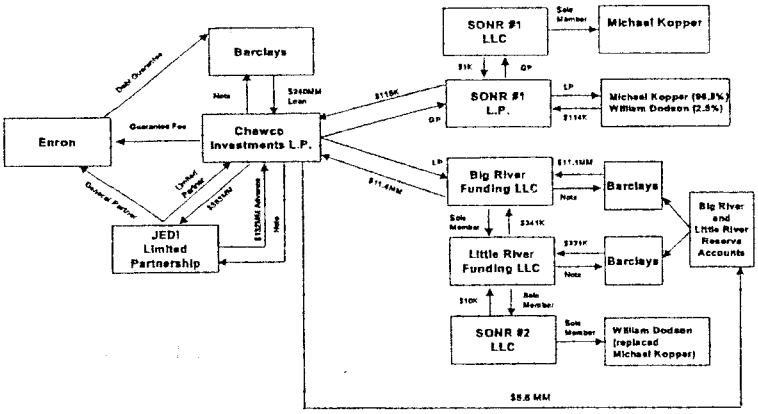
The Barclays loans to Big River and Little River were reflected in documents that resembled promissory notes and loan agreements, but were labeled "certificates" and "funding agreements." Instead of requiring Big River and Little River to pay interest to Barclays, the documents required them to pay "yield" at a specified percentage rate. The documentation was intended to allow Barclays to characterize the advances as loans (for business and regulatory reasons), while allowing Enron and Chewco simultaneously to characterize them as equity contributions (for accounting reasons). During this time period, that was not an unusual practice for SPE financing.

In order to secure its right to repayment, Barclays required Big River and Little River to establish cash "reserve accounts." The parties initially made an effort to maintain the "equity" appearance of the transaction—by providing that the reserve accounts would be funded only with the last 3% of any cash distributions from JEDI to Chewco, and that Barclays could not utilize those funds if it would bring Chewco's "equity" below 3%. But Barclays ultimately required that the reserve accounts be funded with $6.6 million in cash *at closing*, and that the reserve accounts be fully pledged to secure repayment of the $11.4 million.

In order to fund the reserve accounts, JEDI made a special $16.6 million distribution to Chewco. In late November, JEDI had sold one of its assets—an interest in

Coda Energy, Inc., and its subsidiary Taurus Energy Corp.[11/] Chewco's share of the proceeds of that sale was $16.6 million. In a letter agreement dated December 30, 1997, Enron and Chewco agreed that Chewco could utilize part of the $16.6 million to "fund . . . reserve accounts in an aggregate amount equal to $6,580,000: (a) the Little River Base Reserve Account . . . in an amount equal to $197,400 and (b) the Big River Base Reserve Account . . . in an amount equal to $6,382,600." The letter agreement was prepared by Vinson & Elkins and was signed by an officer of Enron and by Kopper. Pursuant to the agreement, at closing on December 30, JEDI wired $6.6 million to Barclays to fund the reserve accounts.

A diagram of the Chewco transaction is set forth below:



11/ Enron employees told us that JEDI's decision to sell Coda was not related to Chewco's purchase of CalPERS' interest in JEDI.

The existence of this cash collateral for the Barclays funding was fatal to Chewco's compliance with the 3% equity requirement. Even assuming that the Barclays funding could properly have been considered "equity" for purposes of the 3% requirement, the equity was *not* at risk for the portion that was secured by $6.6 million in cash collateral. At a minimum, Chewco fell short of the required equity at risk by that amount and did not qualify as an adequately capitalized SPE.[12/] As a result, Chewco should have been consolidated into Enron's consolidated financial statements from the outset and, because JEDI's non-consolidation depended upon Chewco's non-consolidation status, JEDI also should have been consolidated beginning in November 1997.

Many of the people involved in this transaction for Enron profess no recollection of the Barclays funding, the reserve accounts, or the $6.6 million in cash collateral. This group includes the Enron officer who signed the December 30 letter agreement and the authorization for the $6.6 million wire transfer to Barclays at closing. By contrast, others told us that those matters were known and openly discussed. Their recollection is supported by a substantial amount of contemporaneous evidence.

There is little doubt that Kopper (who signed all of the agreements with Barclays and the December 30 letter) was aware of the relevant facts. The evidence also indicates that Glisan, who had principal responsibility for Enron's accounting for the transaction,

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12/ Even if the Barclays loans did qualify as outside equity at risk, there is a question whether Chewco met the 3% requirement because a small portion of the required 3%—Kopper's $125,000—came from a person affiliated with Enron. If Kopper's contribution is not counted, even with the Barclays funding Chewco had slightly less than 3% outside equity.

attended meetings at which the details of the reserve accounts and the cash collateral were discussed. If Glisan knew about the cash collateral in the reserve accounts at closing, it is implausible that he (or any other knowledgeable accountant) would have concluded that Chewco met the 3% standard.[13]

Although Andersen reviewed the transaction at the time it occurred, we do not know what information the firm received or what advice it provided. Enron's records show that Andersen billed Enron $80,000 in connection with its 1997 review of the Chewco transaction. The CEO of Andersen testified in a Congressional hearing on December 12, 2001 that the firm had performed unspecified "audit procedures" on the transaction in 1997, was aware at the time that $11.4 million had come from "a large international financial institution" (presumably Barclays), and concluded that it met the test for 3% residual equity. He also testified, however, that Andersen was unaware that cash collateral had been placed in the reserve accounts at closing.

The Andersen workpapers we were permitted to review indicate that Andersen was aware of the $16.6 million distribution to Chewco in 1997, and that it had traced the cash disbursements to JEDI's records. We do not know what Andersen did to trace those disbursements, or whether its review did or should have identified facts relating to

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[13] Documents from 1997 indicate that Glisan was actively monitoring the accounting literature and guidance on the substantive outside equity requirements for non-consolidated SPEs. We located a handwritten note apparently made by Glisan that identifies one of the "unique characteristics" of the Chewco transaction as "minimization of 3rd party capital." We do not know what Glisan meant by this reference because he declined to be interviewed by us (other than a brief interview on another subject).

funding the reserve accounts. We have been otherwise unable to confirm or disprove Andersen's public statements about the transaction.

Largely because Kopper, Glisan, and Andersen declined to speak with us on this subject, we have been unable to determine why the parties utilized a financing structure for Chewco that plainly did not satisfy the SPE non-consolidation requirements. Enron had every incentive to ensure that Chewco was properly capitalized. It is reasonable to assume that Enron employees, if motivated to protect only Enron's interests, would have taken the necessary steps to ensure that Chewco had sufficient outside equity. We do not know whether Chewco's failure to qualify resulted from bad judgment or carelessness on the part of Enron employees or Andersen, or whether it was caused by Kopper or other Enron employees putting their own interests ahead of their obligations to Enron.

E. Fees Paid to Chewco/Kopper

From December 1997 through December 2000, Kopper (through the Chewco general partner) was paid approximately $2 million in "fees" relating to Chewco. It is unclear what legitimate purposes justified these fees, how the amounts of the payments were determined, or what, if anything, was done by Kopper or Chewco to earn the payments. These fee payments raise substantial management oversight issues.

During this period, the Chewco partnership agreement provided that Chewco would pay an annual "management fee" of $500,000 to its general partner, an entity called SONR #1 L.P. Kopper was the sole manager of the general partner of SONR #1, and owned more than 95% of the limited partnership interest in SONR #1. (Dodson owned the remainder of the interest.) None of the persons we interviewed could identify

how this fee was determined or what "management" work was expected of the Chewco general partner. Through December 2000, SONR #1 received a total of $1.6 million in Chewco management fees. With minor exceptions, these fees were not paid out of income distributed to Chewco from JEDI. Instead, they were drawn down by Chewco from the revolving credit agreement with JEDI.[14]

Chewco apparently required little management. The principal activities were back-office matters such as requesting draws under the JEDI revolving credit agreement, paying interest on the Barclays subordinated loan to Chewco (until December 1998 when it was repaid) and on the Barclays "equity" loans to Big River and Little River, and preparing unaudited financial statements for internal use. For most of the relevant period, these tasks were performed by an Enron employee on Enron time. In addition, during certain periods, these tasks appear to have been performed by Fastow's wife, who had previously worked in Enron's Finance group. We do not know if she received compensation for performing these services.

In December 1998, Chewco received a payment of $400,000 from Enron. This payment is variously described as a "restructuring" fee, an "amendment" fee, and a "nuisance" fee. None of the people we interviewed could identify a basis for this payment. Although both the JEDI partnership agreement and revolving credit agreement were amended in November and December 1998, those amendments appear generally to

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[14] As discussed below, upon Enron's repurchasing Chewco's interest in JEDI in March 2001, Enron permitted Chewco to extend repayment on $15 million of the then-outstanding balance on the revolving credit agreement. That $15 million obligation is unsecured and non-recourse.

be *beneficial* to Chewco and, therefore, should not have required compensation to induce Chewco's consent.[15] Glisan signed the approval form for the wire transfer of the $400,000 fee to Chewco.

F. Enron Revenue Recognition Issues

Beginning in December 1997, Enron took steps to recognize revenues arising from the JEDI partnership (in which Chewco was Enron's limited partner) that we believe are unusual and, in some cases, likely would not have been undertaken if Chewco had been an unrelated third party. These include fees paid to Enron by JEDI and Chewco that appear to have had as their principal purpose accelerating Enron's ability to recognize revenue. These fees do not implicate the serious management oversight issues that are raised by the fee payments to Kopper, but they present significant questions about the accounting treatment that permitted Enron to recognize certain of these revenues. Moreover, although the revenues at issue on some of these payments are relatively small compared to Enron's overall financial statements, they raise larger questions about Enron's approach to revenue recognition issues in JEDI.

1. Enron Guaranty Fee

As described above, Enron provided a guaranty of the $240 million unsecured subordinated loan by Barclays to Chewco in December 1997. Pursuant to a letter agreement, Chewco agreed to pay Enron a guaranty fee of $10 million (cash at closing)

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[15] Although such compensation may not be unusual in the arm's-length, commercial context, it is hard to understand the justification for payment of a substantial fee to Chewco in these circumstances.

plus 315 basis points annually on the average outstanding balance of the loan. This fee was not calculated based on any analysis of the risks involved in providing the guaranty, or on typical commercial terms. Instead, the fee took into account the overall economics of the transaction to Enron and the accelerated revenue recognition that would result from characterizing the payment as a fee.

During the 12 months that the subordinated loan was outstanding, Chewco paid Enron $17.4 million under this fee agreement. JEDI was the source of these payments to Enron. The first $7 million was taken from the $16.6 million distribution to Chewco at closing, and the remainder was drawn down by Chewco from its revolving credit agreement with JEDI. For accounting purposes, Enron characterized these payments as "structuring fees" and recognized income from the $10 million up-front fee in December 1997 (and for the annual fees when paid during 1998). These were not in fact "structuring fees," however, and accounting rules generally require guaranty fee income to be recognized over the guaranty period. Enron's accounting treatment for the $10 million payment was not consistent with those rules.

2. "Required Payments" to Enron

The December 1997 JEDI partnership agreement required JEDI to pay Enron (the general partner) an annual management fee.[16] Under applicable accounting principles, Enron could recognize income from this fee only when services were rendered. In March 1998, however, Enron and Chewco amended the partnership agreement to convert

[16] The annual fee was the greater of (a) 2.5% of $383 million less any distributions received by Chewco, or (b) $2 million.

80% of the annual management fee to a "required payment" to Enron. Although this had no effect on the amount payable to Enron, it had a substantial effect on Enron's recognition of revenue. As of March 31, 1998, Enron recorded a $28 million asset, which represented the discounted net present value of the "required payment" through June 2003, and immediately recognized $25.7 million in income ($28 million net of a reserve). Glisan was principally responsible for Enron's accounting for this transaction. We were told that he suggested the change to the partnership agreement so that Enron could recognize additional earnings during the first quarter of 1998.

Enron's accounting raises questions concerning whether the "required payment" should have been recognized over the period from 1998 to 2003. If the payment was contingent on Enron's providing ongoing management to JEDI, Enron may have been required to recognize the income over the covered period. Accounting standards for revenue recognition generally require that the services be provided before recording revenue. It seems doubtful that the management services related to the "required payment" (covering 1998 to 2003) had all been provided at the time Enron recognized the $25.7 million in income. If those services had not been provided by March 1998, Enron's accounting appears to have been incorrect.

3. Recognition of Revenue from Enron Stock

From the inception of JEDI in 1993 through the first quarter of 2000, Enron picked up its contractual share of income or losses from JEDI using the equity method of accounting. JEDI was a merchant investment fund that carried its assets at fair value. Changes in fair value of the assets were recorded in JEDI's income statement. JEDI held

12 million shares of Enron stock, which were carried at fair value. During this period, Enron recorded an undetermined amount of income resulting from appreciation in the value of its own stock. Under generally accepted accounting principles, however, a company is generally precluded from recognizing an increase in the value of its own stock as income.

Enron had a formula for computing how much income it could record from appreciation of its own stock held by JEDI. Enron and Andersen apparently developed the formula in 1996, and modified it over time. While Enron could not quantify for us how much income it recorded from the appreciation of Enron stock held by JEDI, Andersen's workpapers for the first quarter of 2000 indicate that Enron recorded $126 million in Enron stock appreciation during that quarter. Anderson's workpapers for the third quarter of 2000 reflect a decision (described as having been made in the first quarter) that income from Enron stock held by JEDI could no longer be recorded on Enron's income statement. The workpapers do not say whether this decision was made by Andersen, Enron, or jointly.

In the first quarter of 2001, Enron stock held by JEDI declined in value by approximately $94 million. Enron did not record its share of this loss—approximately $90 million. Enron's internal accountants decided not to record this loss based on discussions with Andersen. According to the Enron accountants, they were told by Andersen that Enron was not recording increases in value of Enron stock held by JEDI and therefore should not record decreases. We do not understand the basis on which Enron recorded increases in value of Enron stock held by JEDI in 2000 and prior years,

and are unable to reconcile that recognition of income with the advice apparently provided by Andersen in 2001 concerning not recording decreases in Enron stock value.

G. Enron's Repurchase of Chewco's Limited Partnership Interest

In March 2001, Enron repurchased Chewco's limited partnership interest in JEDI and consolidated JEDI into its consolidated financial statements. Fastow was personally involved in the negotiations and decision-making on this repurchase. As described below, the repurchase resulted in an enormous financial windfall to Kopper and Dodson (who collectively had invested only $125,000). Much of the payout to these individuals is difficult to justify or understand from Enron's perspective, and at least $2.6 million of the payout appears inappropriate on its face. Moreover, Kopper received most of these benefits—by coincidence or design—shortly before he purchased Fastow's interests in the LJM partnerships (described below in Section III). Because Fastow and Kopper declined to be interviewed by us concerning the Chewco repurchase, we do not have the benefit of their responses to the serious issues addressed in this section.

1. Negotiations

During the first quarter of 2000, senior personnel in Enron's Finance area came to the conclusion that JEDI was essentially in a liquidation mode, and had become an expensive off-balance sheet financing vehicle. They approached Fastow, who agreed with their conclusion. The next step was to determine an appropriate buyout price for Chewco's interest in JEDI.

The discussions concerning the buyout terms involved, among others, Fastow, Kopper, and Jeffrey McMahon (then Senior Vice President, Finance and Treasurer of Enron).[17] Because JEDI's assets had increased in value since 1997, on paper Chewco's limited partnership interest had become valuable. On the other hand, Kopper and Dodson had invested only $125,000 in Chewco.

McMahon told us that, in light of the circumstances, he proposed to Fastow that the buyout be structured to provide a $1 million return to the Chewco investors.[18] According to a document McMahon identified as the written buyout analysis he provided to Fastow, this would give the investors a 152% internal rate of return on their investment and a return on capital multiple of 7.99. McMahon said that Fastow received the proposal, said he would discuss it with Kopper, and later reported back to McMahon that he had negotiated a payment of $10 million. McMahon also said that Fastow told him that Skilling had approved the $10 million payment. McMahon's recollection of events is consistent with a handwritten memorandum addressed to "Andy" (in what we are told is Kopper's handwriting) that analyzes McMahon's written proposal and refers to Enron's purchasing Chewco's interest for $10.5 million. McMahon said he told Fastow

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17 During a brief interview, Fastow told us that he had *not* participated in these negotiations because, in light of Kopper's having become his partner in the general partner of LJM2, he believed it would have been inappropriate. Fastow's statement is contrary to information we obtained from interviews of several people familiar with the negotiations, all of whom said he was personally involved. Moreover, Fastow's statement is inconsistent with the handwritten memorandum, addressed to "Andy," that is discussed in the text below. We showed a copy of the memorandum to Fastow during the brief interview, but he declined to respond to any questions about it.

18 McMahon also said he believed at the time that Dodson was the outside equity investor in Chewco, and that Kopper was representing Dodson in the buyout discussions.

that $10 million would be inappropriate and, if that was the agreement, it would be better for Enron to continue with the current JEDI structure and not buy out Chewco's interest.

By mid-2000, Enron had decided to purchase Chewco's interest on terms that would provide a $10.5 million return to the Chewco investors. Chewco had already received $7.5 million in cash (net) from JEDI, so Chewco would receive an additional cash payment at closing of $3 million.[19] By this point, McMahon had left the Treasurer's position and the Finance group. We were unable to locate any direct evidence about who made the ultimate decision on the buyout amount. Skilling told us that he had no involvement in the buyout transaction, including being advised of or approving the payment amount.

2. Buyout Transaction

The buyout was completed in March 2001, when Enron and Chewco entered into a Purchase Agreement (dated March 26, 2001) for repurchasing Chewco's interest. (It is not clear why the transaction did not close until the first quarter of 2001.) The contract price for the purchase was $35 million, which was determined by taking:

- The $3 million cash payment that had been agreed to in 2000; plus

[19] The $7.5 million consisted of several elements: (1) distributions from JEDI that funded the Big River and Little River reserve accounts and interest on those amounts; (2) distributions from JEDI and advances under the revolving credit agreement that funded Chewco's working capital reserve and interest on those amounts; (3) the $400,000 fee paid in December 1998; and (4) other net cash distributions from JEDI, some of which had been used to repay the subordinated loan and equity loans from Barclays and part of the outstanding balance on the revolving credit agreement.

- $5.7 million to cover the remaining "required payments" due to Enron under the JEDI partnership agreement (as discussed above in Section II(F)(2));[20] plus
- $26.3 million to cover all but $15 million of Chewco's outstanding $41.3 million obligation under the revolving credit agreement with JEDI.

At closing, pursuant to a letter agreement with Chewco, Enron kept the $5.7 million and wired $29.3 million to Chewco; Chewco then paid down $26.3 million on the revolving credit agreement and retained the remaining $3 million.

Chewco was not required to pay off the entire $41.3 million balance on the revolving credit agreement. Instead, it paid only $26.3 million, and the remaining $15 million was converted to a term loan due in January 2003. The $15 million was left outstanding because, in December 1999, Chewco had paid $15 million *to LJM1* to purchase certificates in Osprey Trust.[21] Although not disclosed in either the Purchase Agreement or the term loan agreement, Enron and Chewco agreed (1) to make the terms of the loan agreement (maturity date, interest rates) match those of the Osprey Trust certificates, and (2) that Chewco would be required to use the principal paid from the Osprey Trust certificates to repay the $15 million term loan, and would retain any yield paid on the certificates (which it could use to pay interest on the term loan). Enron did

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[20] The $5.7 million payment is referred to in the Purchase Agreement as being for unspecified "breakage costs." There is some evidence that this generic description was used because it was less likely to draw attention from Andersen during their review of the transaction. Because Andersen did not permit us to review workpapers from 2001 or interview their personnel on this matter, we do not know what review Andersen conducted. Enron's records show that it paid $25,000 in fees to Andersen in connection with the Chewco buyout.

[21] Osprey Trust is a limited partner, along with Enron, in Whitewing Associates.

not, however, require that the Osprey Trust certificates serve as collateral for the $15 million loan. The loan is unsecured and non-recourse to Kopper and Dodson.[22]

3. Returns to Kopper/Dodson

As a result of the buyout, Kopper and Dodson received an enormous return on their $125,000 investment in Chewco. In total, they received approximately $7.5 million (net) cash during the term of the investment, plus an additional $3 million cash payment at closing. Even assuming Chewco incurred some modest expenses that were not reimbursed at the time by Enron or drawn down on the revolving credit line, this represents an internal rate of return of more than 360%.

This rate of return does not take into account the $1.6 million in management fees received by Kopper. It also does not reflect the fact that the buyout was tax-free to Chewco, as described below.

4. Tax Indemnity Payment

One of the most serious issues that we identified in connection with the Chewco buyout is a $2.6 million payment made by Enron to Chewco in mid-September 2001. Chewco first requested the payment after the buyout was consummated—under a Tax Indemnity Agreement between Enron and Chewco that was part of the original 1997 transaction. There is credible evidence that Fastow authorized the payment to Chewco

[22] In effect, if Chewco does not repay the unsecured loan when it comes due in 2003, it will amount to a forgiveness by Enron of $15 million in advances under the revolving credit agreement (which funded, among other things, the payment of management fees to Kopper). We understand that Chewco made the first semi-annual interest payment under the term loan in a timely manner in August 2001.

even though Enron's in-house counsel advised him unequivocally that there was no basis in the Agreement for the payment, and that Enron had no legal obligation to make it.

When Chewco purchased the JEDI limited partnership interest in 1997, Enron and Chewco executed a Tax Indemnity Agreement. Agreements of this sort are not unusual in transactions where anticipated cash flows to the limited partner may be insufficient to satisfy the partner's current tax obligations. On its face, the Agreement compensates Chewco for the difference between Chewco's current tax obligations and its cash receipts during the partnership. Chewco subsequently requested payments, and Enron made payments, for that purpose prior to 2001.

After the closing of Enron's buyout of Chewco in March 2001, Kopper requested an additional payment under the Tax Indemnity Agreement. Kopper claimed that Chewco was due a payment to cover any tax liabilities resulting from the negotiated buyout of Chewco's partnership interest. Enron's in-house legal counsel (who had been involved in the 1997 negotiations) consulted with Vinson & Elkins (who also had been involved in the negotiations) concerning Chewco's claim. Both concluded that the Agreement was not intended to cover, and did not cover, a purchase of Chewco's partnership interest. In-house counsel communicated this conclusion to Kopper.

The amount of the indemnity payment in dispute was $2.6 million. After further inconclusive discussions, Kopper told Enron's in-house counsel that he would consult with Fastow. Fastow then called the counsel, who says he told Fastow unequivocally that the Agreement did not require Enron to make any payment to Chewco. In a subsequent conversation, Fastow told Enron's counsel that he had spoken with Skilling and that

Skilling (who Fastow said was familiar with the Agreement and the buyout transaction) had decided that the payment should be made. As a result, in September 2001, Enron paid Chewco an additional $2.6 million to cover its tax liabilities in connection with the buyout. Skilling told us he does not recall any communications with Fastow concerning the payment. Fastow declined to respond to questions on this subject.

H. Decision to Restate

In late October 2001, the Enron Board (responding to media reports) requested a briefing by Management on Chewco. Glisan was responsible for presenting the briefing at a Board meeting on short notice. Following the briefing, Enron accounting and legal personnel (as well as Vinson & Elkins) undertook to review documents relating to Chewco. This review identified the documents relating to the funding of the Big River and Little River reserve accounts in December 1997 through the $16.6 million distribution from JEDI.

Enron brought those documents to the attention of Andersen, and consulted with Andersen concerning the accounting implications of the funded reserve accounts. *After* being shown the documents by Enron and discussing the accounting issues with Enron personnel, Andersen provided the notice of "possible illegal acts" that Andersen's CEO highlighted in his Congressional testimony on December 12, 2001.

Enron's accounting personnel and Andersen both concluded that, in light of the funded reserve accounts, Chewco lacked sufficient outside equity at risk and should have

been consolidated in November 1997.[23] In addition, because JEDI's non-consolidation depended on Chewco's status, Enron and Andersen concluded that JEDI also should have been consolidated in November 1997. In a Current Report on Form 8-K filed on November 8, 2001, Enron announced that it would restate its prior period financials to reflect the consolidation of those entities as of November 1997.

[23] When presented in late October 2001 with evidence of the $6.6 million cash collateral in the reserve accounts, Glisan apparently agreed that the collateral precluded any reasonable argument that Chewco satisfied the 3% requirement, but claimed that he had been unaware of it at the time of the transaction.

III. LJM HISTORY AND GOVERNANCE

A. Formation and Authorization of LJM Cayman, L.P. and LJM2 Co-Investment, L.P.

Enron entered into more than 20 distinct transactions with the two LJM partnerships. Each transaction theoretically involved a transfer of risk. The LJM partnerships rarely lost money on a transaction with Enron that has been closed, so far as we are aware, even when they purchased assets that apparently declined in value after the sale. These transactions had a significant effect on Enron's financial statements. Taken together, they resulted in substantial recognition of income, and the avoidance of substantial recognition of loss. This section discusses the formation and authorization of these partnerships. It also addresses their governance insofar as it is relevant to Enron's ability to avoid consolidating them for financial statement purposes. The Board decisions described in this section are addressed in greater detail in Section VII, below.

LJM1. On June 18, 1999, Fastow discussed with Lay and Skilling a proposal to establish a partnership, subsequently named LJM Cayman, L.P. ("LJM1"). This partnership would enter into a specific transaction with Enron. Fastow would serve as the general partner and would seek investments by outside investors. Fastow presented his participation as something he did not desire personally, but was necessary to attract investors to permit Enron to hedge its substantial investment in Rhythms NetConnections, Inc. ("Rhythms"), and possibly to purchase other assets in Enron's merchant portfolio. Lay and Skilling agreed to present the proposal to the Board.

At a Board meeting on June 28, 1999, Lay called on Skilling, who in turn called on Fastow, to present the proposal. Fastow described the structure of LJM1 and the hedging transaction (which is described in Section IV below). Fastow disclosed that he would serve as the general partner of LJM1 and represented that he would invest $1 million. He described the distribution formula for earnings of LJM1, and said he would receive certain management fees from the partnership.[24/] He told the Board that this proposal would require action pursuant to Enron's Code of Conduct (an action within Lay's authority) based on a determination that Fastow's participation as the managing partner of LJM1 "will not adversely affect the interests" of Enron.

After a discussion, the Board adopted a resolution approving the proposed transaction with LJM1. The resolution ratified a determination by the Office of the Chairman that Fastow's participation in LJM1 would not adversely affect the interests of Enron.

LJM1 was formed in June 1999. Fastow became the sole and managing member of LJM Partners, LLC, which was the general partner of LJM Partners, L.P. This, in turn, was the general partner of LJM1. Fastow raised $15 million from two limited partners, ERNB Ltd. (which we understand was affiliated with CSFB), and Campsie Ltd. (which

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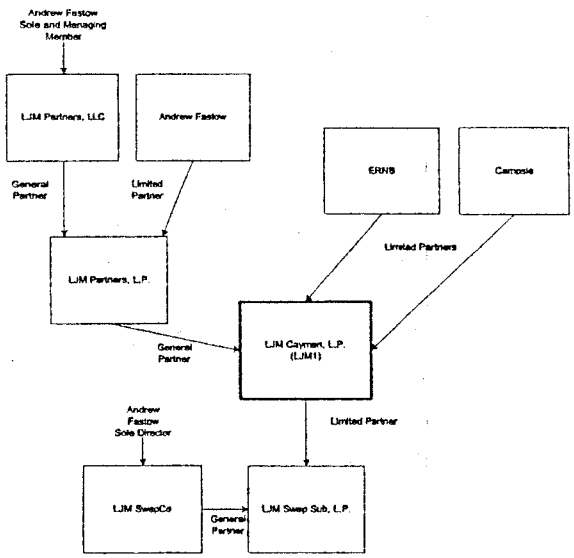
[24/] The hedging transaction Fastow proposed included the transfer of restricted Enron stock to LJM1. The Board was told that all proceeds from appreciation in the value of Enron stock would go to the limited partners in LJM1, and not to Fastow; that 100% of the proceeds from all other assets would go to Fastow until he had received a rate of return of 25% on his invested capital; and that of any remaining income, half would go to Fastow and half would be divided among the partners (including Fastow) in proportion to their capital commitments.

we understand was affiliated with NatWest). The following is a diagram of the LJM1 structure:



LJM1 entered into three transactions with Enron: (1) the effort to hedge Enron's position in Rhythms NetConnections stock, (2) the purchase of a portion of Enron's interest in a Brazilian power project (Cuiaba), and (3) a purchase of certificates of an SPE called "Osprey Trust." The first two of these transactions raise issues of significant concern to this investigation, and are described further below in Sections IV and VI.

LJM2. In October 1999, Fastow proposed to the Finance Committee of the Board the creation of a second partnership, LJM2 Co-Investment, L.P. ("LJM2"). Again, he

would serve as general partner through intermediaries. LJM2 was intended to be a much larger private equity fund than LJM1. Fastow said he would raise $200 million or more of institutional private equity to create an investment partnership that could readily purchase assets Enron wanted to syndicate.

This proposal was taken up at a Finance Committee meeting on October 11, 1999. The meeting was attended by other Directors and officers, including Lay and Skilling. According to the minutes, Fastow reported on various benefits Enron received from transactions with LJM1. He described the need for Enron to syndicate its capital investments in order to grow. He said that investments could be syndicated more quickly and at less cost through a private equity fund that he would establish. This fund would provide Enron's business units an additional potential buyer of any assets they wanted to sell.

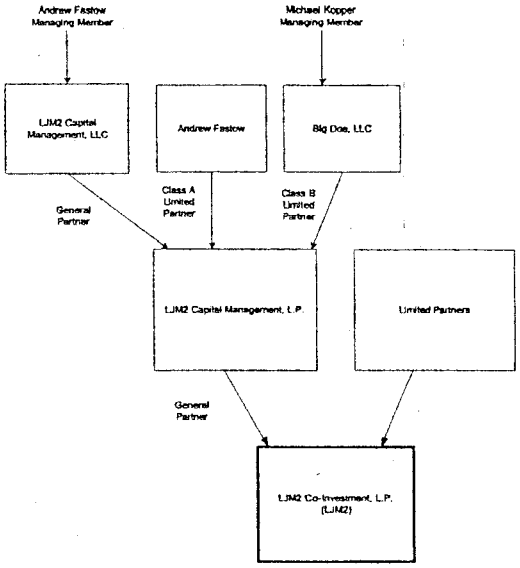
The minutes and our interviews reflect that the Finance Committee discussed this proposal, including the conflict of interest presented by Fastow's dual roles as CFO of Enron and general partner of LJM2. Fastow proposed as a control that all transactions between Enron and LJM2 be subject to the approval of both Causey, Enron's Chief Accounting Officer, and Buy, Enron's Chief Risk Officer. In addition, the Audit and Compliance Committee would annually review all transactions completed in the prior year. Based on this discussion, the Committee voted to recommend to the Board that the Board find that Fastow's participation in LJM2 would not adversely affect the best interests of Enron.

Later that day the Chairman of the Finance Committee, Herbert S. Winokur, Jr., presented the Committee's recommendation to the full Board. According to the minutes, he described the controls that had been discussed in the Finance Committee and noted that Enron and LJM2 would not be obligated to engage in transactions with each other. The Board unanimously adopted a resolution "adopt[ing] and ratify[ing]" the determination of the Office of the Chairman necessary to permit Fastow to form LJM2 under Enron's Code of Conduct.

LJM2 was formed in October 1999. Its general partner was LJM2 Capital Management, L.P. With the assistance of a placement agent, LJM2 solicited prospective investors as limited partners using a confidential Private Placement Memorandum ("PPM") detailing, among other things, the "unusually attractive investment opportunity" resulting from the partnership's connection to Enron. The PPM emphasized Fastow's position as Enron's CFO, and that LJM2's day-to-day activities would be managed by Fastow, Kopper, and Glisan. (We did not see any evidence that the Board was informed of the participation of Kopper or Glisan; Glisan later claimed his inclusion in the PPM was a mistake.) It explained that "[t]he Partnership expects that Enron will be the Partnership's primary source of investment opportunities" and that it "expects to benefit from having the opportunity to invest in Enron-generated investment opportunities that would not be available otherwise to outside investors." The PPM specifically noted that Fastow's "access to Enron's information pertaining to potential investments will contribute to superior returns." The drafts of the PPM were reviewed by Enron in-house lawyers and Vinson & Elkins. Both groups focused on ensuring that the solicitation did not appear to come from Enron or any of its subsidiaries.

We understand that LJM2 ultimately had approximately 50 limited partners, including American Home Assurance Co., Arkansas Teachers Retirement System, the MacArthur Foundation, and entities affiliated with Merrill Lynch, J.P Morgan, Citicorp, First Union, Deutsche Bank, G.E. Capital, and Dresdner Kleinwort Benson. We are not certain of this because LJM2 declined to provide any information to us. We further understand that the investors, including the general partner, made aggregate capital commitments of $394 million. The general partner, LJM2 Capital Management, L.P., itself had a general partner and two limited partners. The general partner was LJM2 Capital Management, LLC, of which Fastow was the managing member. The limited partners were Fastow and, at some point after the creation of LJM2, an entity named Big Doe LLC. Kopper was the managing member of Big Doe.[25] (In July 2001, Kopper resigned from Enron and purchased Fastow's interest in LJM2.) The following is a diagram of the LJM2 structure:

[25] In his capacity as an Enron employee, Kopper reported to Fastow throughout the existence of LJM2 until his resignation in July 2001. We have seen no evidence that Kopper obtained the required consent to his participation in LJM2 under Enron's Code of Conduct. Kopper certified his compliance with the Code in writing, most recently in September 2000.



In April 2000, Enron and LJM Management L.P. entered into a "Services Agreement" under which Enron agreed to have its staff perform certain tasks (for a fee), including opening and closing accounts, executing wire transfers, and "Investment Execution & Administration." The Services Agreement described these activities as "purely ministerial," and contemplated that LJM would pay market rates. That same month, Causey and Fastow signed an agreement regarding the use of Enron employees by LJM1 and LJM2. The employees would continue to be "regular, full-time" Enron employees for benefits purposes, but the LJM partnerships would pay the bonuses, and in some cases the base salary. LJM would also pay the costs. The memorandum describing

this agreement says that "[i]t is understood that some activities conducted by LJM2 employees will also be for the benefit of Enron," and that in such cases Causey and Fastow would "reasonably agree upon allocation of costs to Enron and LJM2." This understanding was memorialized in a second Services Agreement dated July 17, 2000. We were unable to determine what LJM2 actually paid for any services under these agreements.

The LJM partnerships entered into more than 20 distinct transactions with Enron. A substantial number of these transactions raise issues of significant concern, and are described further in Sections IV, V, and VI of this Report.

B. LJM Governance Issues

The structures of LJM1 and LJM2—in which Fastow controlled the general partner of each partnership—raise questions about non-consolidation by Enron of the LJM partnerships and certain entities (described in more detail below) in which one of the LJM partnerships was an investor. In each case, Enron could avoid consolidation under relevant accounting rules only if the entity was controlled by an *independent* third party with substantive equity and risks and rewards of ownership. The first question, then, is whether Fastow controlled LJM1 and LJM2. If so, Enron arguably would control LJM1 and LJM2, and Enron would be required to consolidate them on its financial statements.

As described above, the criteria for determining control with respect to general partners are subjective. Nevertheless, the accounting rules indicate that a sole general partner should *not* be viewed as controlling a limited partnership if the partnership

agreement provides for the removal of the general partner by a reasonable vote of the limited partners, without cause, and without a significant penalty. Similarly, other limits on the authority of the general partner, such as requiring approval for the acquisition or sale of principal assets, could be viewed as giving the limited partners sufficient control for non-consolidation.

Both LJM1 and LJM2 present substantial questions about whether Fastow was in effective control. Fastow was the effective general partner of both partnerships, and had management authority over them. On the other hand, both partnership agreements limited the general partner's investment authority, and required approval of certain investment decisions by the limited partners. Moreover, the LJM2 partnership agreement provided for removal of the general partner, without cause, by a recommendation of an Advisory Committee and a vote of the limited partners (initially limited partners with 75% in interest, later reduced to two-thirds). Given the role of the limited partners (which were somewhat different for LJM1 and LJM2, and in the case of LJM2 changed over time), arguments could be made both for and against consolidation based on Fastow's control of the partnerships. Andersen's workpapers include a discussion of the limited partner oversight in LJM2 and changes in June 2000 to strengthen the rights of limited partners to remove the general partner and members of the Advisory Committee.

We have reviewed these issues in detail, and have concluded that there are no clear answers under relevant accounting standards. Fastow declined to speak with us about these issues. As we have noted, the limited partners of both LJM1 and LJM2, citing confidentiality provisions in the partnership agreements, declined to cooperate with our investigation by providing documents or interviews.

IV. RHYTHMS NETCONNECTIONS

The Rhythms transaction was Enron's first business dealing with the LJM partnerships. The transaction is significant for several reasons. It was the first time that Enron transferred its own stock to an SPE and used the SPE to "hedge" an Enron merchant investment. In this respect, Rhythms was the precursor to the Raptor vehicles discussed below in Section V. Rhythms also provided the first—and perhaps most dramatic—example of how the purportedly "arm's-length" negotiations between Enron and the LJM partnerships resulted in economic terms that were skewed toward LJM and enriched Fastow and other investors. In the case of Rhythms, those investors included several Enron employees who were secretly offered financial interests by Fastow and who accepted them in apparent violation of Enron's Code of Conduct.

A. Origin of the Transaction

In March 1998, Enron invested $10 million in the stock of Rhythms NetConnections, Inc. ("Rhythms"), a privately-held internet service provider for businesses using digital subscriber line technology, by purchasing 5.4 million shares of stock at $1.85 per share. On April 7, 1999, Rhythms went public at $21 per share. By the close of the trading day, the stock price reached $69.

By May 1999, Enron's investment in Rhythms was worth approximately $300 million, but Enron was prohibited (by a lock-up agreement) from selling its shares before the end of 1999. Because Enron accounted for the investment as part of its merchant portfolio, it marked the Rhythms position to market, meaning that increases and decreases in the value of Rhythms stock were reflected on Enron's income statement.

Skilling was concerned about the volatility of Rhythms stock and wanted to hedge the position to capture the value already achieved and protect against future volatility in income. Given the size of Enron's position, the relative illiquidity of Rhythms stock, and the lack of comparable securities in the market, it would have been virtually impossible (or prohibitively expensive) to hedge Rhythms commercially.

Enron also was looking for a way to take advantage of an increase in value of Enron stock reflected in forward contracts (to purchase a specified number of Enron shares at a fixed price) that Enron had with an investment bank.[26] Under generally accepted accounting principles, a company is generally precluded from recognizing an increase in value of its own stock (including forward contracts) as income. Enron sought to use what it viewed as this "trapped" or "embedded" value.

Fastow and Glisan developed a plan to hedge the Rhythms investment by taking advantage of the value in the Enron shares covered by the forward contracts. They proposed to create a limited partnership SPE, capitalized primarily with the appreciated Enron stock from the forward contracts. This SPE would then engage in a "hedging" transaction with Enron involving the Rhythms stock, allowing Enron to offset losses on Rhythms if the price of Rhythms declined. Fastow would form the partnership and serve as the general partner.

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[26] Enron originally entered into these contracts to hedge economically the dilution resulting from its employee stock option programs. The contracts had become significantly more valuable due to an increase in the price of Enron stock.

On June 18, 1999, Fastow presented the proposal to Lay and Skilling, and received approval to bring it to the Board. Ten days later, on June 28, Fastow presented the proposal to the Board at a special meeting (described above in Section III.A.). The minutes indicate that Fastow identified the "appreciated" value in the Enron shares subject to the forward contracts, and explained that the value would be transferred to LJM1 in exchange for a note receivable. This would permit LJM1 to enter into a swap with Enron to hedge Enron's position in Rhythms. Fastow's presentation materials described the anticipated value to Enron and the extent of Fastow's economic interest in LJM1, and stated (on two different slides) that Fastow would not receive "any current or future (appreciated) value of ENE stock."[27] The minutes indicate that Fastow also told the Board that an outside accounting firm would render a fairness opinion stating that the value Enron would receive in the transaction exceeded the value of the forward contracts Enron was transferring to LJM1. The Board voted to approve the transaction at the same time it approved Fastow's role in LJM1.

B. Structure of the Transaction

The Rhythms transaction closed on June 30, 1999. The parties to the transaction were Enron, LJM1, and LJM Swap Sub L.P. ("Swap Sub"). Swap Sub was a limited partnership created for purposes of the transaction and was intended to be a non-consolidated SPE. An entity controlled by Fastow, LJM SwapCo., was the general

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[27] Fastow's presentation said that he would be the general partner of LJM1. To implement the restriction against his benefiting from Enron stock, the LJM1 partnership agreement provided that all distributions of the proceeds from Enron stock would be to the limited partners of LJM1.

partner of Swap Sub. LJM1 was the limited partner of Swap Sub and was meant to provide the required 3% outside equity at risk. We do not know why Swap Sub was used, although a reasonable inference is that it was used to shield LJM1 from legal liability on any derivative transactions with Enron.

As finally structured, the transaction had three principal elements:

First, Enron restructured the forward contracts, releasing 3.4 million shares of Enron stock that it then transferred to LJM1. At the closing price on June 30, these shares had a value of approximately $276 million. Enron, however, placed a contractual restriction on most of the shares that precluded their sale or transfer for four years. The restriction also precluded LJM1 and Swap Sub from hedging the Enron stock for one year. The restriction did not, however, preclude LJM1 from pledging the shares as security for a loan. The value of the shares was discounted by approximately $108 million (or 39%) to account for the restriction. In exchange for these Enron shares, LJM1 gave Enron a note (due on March 31, 2000) for $64 million.

Second, LJM1 capitalized Swap Sub by transferring 1.6 million of the Enron shares to Swap Sub, along with $3.75 million in cash.[28/]

Third, Enron received from Swap Sub a put option on 5.4 million shares of Rhythms stock. Under the option, Enron could require Swap Sub to purchase the

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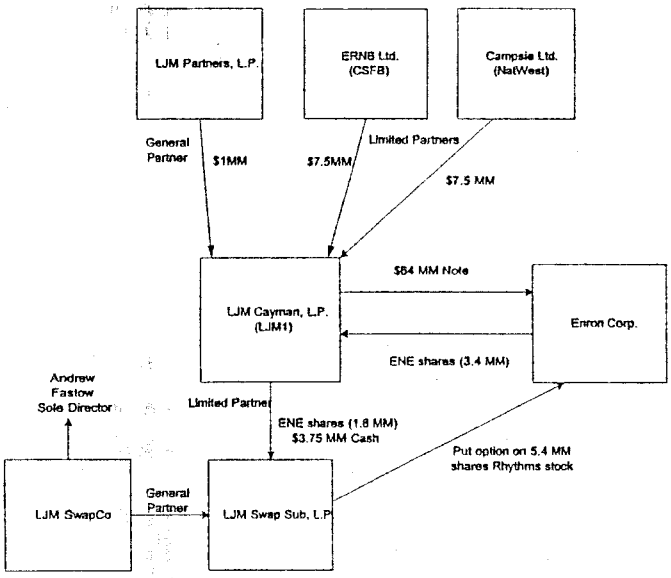
28/ LJM1 obtained the cash by selling an unrestricted portion of the 3.4 million Enron shares transferred by Enron to LJM1.

Rhythms shares at $56 per share in June 2004. The put option was valued at approximately $104 million.

A diagram of the Rhythms transaction is set forth below:



Enron obtained a fairness opinion from PricewaterhouseCoopers ("PwC") on the exchange of the 3.4 million restricted Enron shares for the Rhythms put and the $64 million note. PwC opined that the range of value for the Enron shares was $170-$223 million, that the range of value for the Rhythms put and note was $164-$204 million, and

that the consideration received by Enron therefore was fair from a financial point of view.[29]

C. Structure and Pricing Issues

1. Nature of the Rhythms "Hedge"

The "hedge" that Enron obtained on its Rhythms position affected the gains and losses Enron reported on its income statement but was not, and could not have been, a true economic hedge. Attempting to use the "trapped" value in the forward contracts, Enron transferred to LJM1, and LJM1 transferred to Swap Sub, 1.6 million shares of the restricted Enron stock. Swap Sub's ability to make good on the Rhythms put rested largely on the value of the Enron stock. If Enron stock performed well, Swap Sub could perform on the put even if Rhythms stock declined—although the losses would be absorbed by the value in the Enron stock. But if Enron stock and Rhythms stock both declined, Swap Sub would be unable to perform on the put and Enron's hedge on Rhythms would have failed. In either case, this structure is in sharp contrast to a typical

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[29] The transaction as initially closed on June 30 was somewhat different. In late July or early August, the parties adjusted the terms by reducing the term of the Rhythms put option and increasing the note payable to Enron. None of the people we interviewed were able to explain why these changes were made, although some assumed that PwC may have required the changes in order to issue its fairness opinion. When the Board approved the transaction, it included in its resolution the statement: "Kenneth Lay and Jeffrey Skilling are hereby appointed as a Committee of the Board . . . to determine if the consideration received by the Company is sufficient in the event of a change in the terms of such transaction from those presented to the Board." We found no evidence that any of the changes implemented in July or August were presented to Lay or Skilling for approval.

economic hedge, which is obtained by paying a market price to a creditworthy counterparty who will take on the economic risk of a loss.

There are substantial accounting questions raised by using an SPE as a counterparty to hedge price risk when the primary source of payment by the SPE is an entity's own stock—although Andersen apparently approved it in this case. Those accounting issues are of central concern to the Raptor transactions. A detailed discussion of those issues is set out in Section V below relating to the Raptors.

2. **SPE Equity Requirement**

In order to satisfy the SPE requirement for non-consolidation, Swap Sub needed to have a minimum of 3% outside equity at risk. At its formation on June 30, 1999, Swap Sub had negative equity because its liability (the Rhythms put, valued at $104 million) greatly exceeded its assets ($3.75 million in cash plus $80 million in restricted Enron stock). On this basis alone, there is a substantial question whether Swap Sub had sufficient equity to satisfy the requirement for non-consolidation.

Our review of whether Swap Sub met the 3% requirement was limited by the absence of information. We were unable to interview either Glisan (who was primarily responsible for Enron's accounting of the transaction) or Andersen. We do not know what analysis they relied on to conclude that Swap Sub was properly capitalized.

Andersen indicated recently that it made an error in 1999 in analyzing whether Swap Sub qualified for non-consolidation. In his December 12, 2001, Congressional testimony, Andersen's CEO said:

> In evaluating the 3 percent residual equity level required to qualify for non-consolidation, there were some complex issues concerning the valuation of various assets and liabilities. When we reviewed this transaction again in October 2001, we determined that our team's initial judgment that the 3 percent test was met was in error. We promptly told Enron to correct it.

Andersen did not explain further the nature of the error. Our review of the workpapers that Andersen made available indicates that at least some of the analyses were performed using the unrestricted value, rather than the discounted value, of the Enron stock in Swap Sub. This may be the error to which Andersen refers.

On November 8, 2001, Enron announced that Swap Sub was not properly capitalized with outside equity and should have been consolidated. As a result, Enron said it would restate prior period financial statements to reflect the consolidation retroactive to 1999, which would have the effect of decreasing Enron's net income by $95 million in 1999 and $8 million in 2000.

3. Pricing and Credit Capacity

We encountered sharply divergent recollections about how Enron priced the Rhythms put option and analyzed the credit capacity of Swap Sub. Vincent Kaminski, head of Enron's Research Group—which handled sophisticated option pricing and modeling issues—told us that he was very uncomfortable with the transaction and brought his concerns to Richard Buy (head of Enron's Risk Assessment and Control ("RAC") Group), his supervisor. Kaminski says that, based on the quantitative analysis performed by his group, he strongly recommended to Buy that Enron not proceed with the transaction. Kaminski recalls that he gave Buy three reasons: (1) the transaction involved an obvious conflict of interest because of Fastow's personal involvement in

LJM1; (2) the payout was skewed against Enron because LJM1 would receive its benefit much earlier in the transaction; and (3) the structure was unstable from a credit capacity standpoint because the SPE was capitalized largely with Enron stock. Buy told us that he does not recall any discussions with Kaminski (or Kaminski's group being involved in the transaction). Buy says that at some point his group evaluated the credit capacity, found that it was too low, and recommended changes in the structure that improved it.

D. Adjustment of the "Hedge" and Repayment of the Note

After the transaction closed on June 30, Enron accounting personnel realized that the put option from Swap Sub on Rhythms stock was not reducing Rhythms-related volatility in Enron's income statement to the degree desired.[30] In an effort to improve the hedge, Enron entered into four more derivative transactions on Rhythms stock (put and call options) with Swap Sub at no cost to either party. The options were put in place on July 13, less than two weeks after the closing. They were designed to get the economics of the hedge closer to a swap. Analysts in Kaminski's group modeled the hedge to help Glisan determine how the options should be structured and priced.

On December 17, 1999, three months before it was due, LJM1 paid the $64 million note plus accrued interest. The source of this payment is unclear. LJM1 had only $16 million in initial equity. In September 1999 (as described below in SectionVI.A.1.), LJM1 purchased an interest in the Cuiaba project from Enron for $11.3 million. There is

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[30] Because the put provided one-sided protection, Enron was exposed to income statement volatility when Rhythms' price increased and subsequently decreased. In addition, Enron was subject to income statement volatility from the time value component of the put option.

some evidence that LJM1 may have obtained additional capital to make the December payment.[31] There also is evidence that LJM1 may have sold some of the restricted Enron stock to finance the $64 million repayment.[32] Unless the restriction was released, such sales would have been in violation of LJM1's agreement with Enron. The restriction agreement did permit LJM1 to use the shares as collateral for a loan, and it is possible that LJM1 repaid the $64 million note by borrowing against the shares.

Regardless of how LJM1 obtained the funds to repay the $64 million note, LJM1 retained significant value in the 3.6 million Enron shares (post-split) it was holding.[33] Even assuming LJM1 liquidated shares to pay the note (which at the closing price on December 17 would have required selling 1.6 million shares), LJM1 would have retained 2 million (post-split) Enron shares having an unrestricted value of $82 million on December 17.

31/ In a document titled "Ben Glisan, Jr. FY 99 - Accomplishments," Glisan identified: "LJM1 Liquidity—Transaction resulted in additional partnership capital being invested into LJM so that an [sic] $64 MM loan from ENE could be repaid." Because Glisan declined to be interviewed on this subject, we do not know the meaning of this reference.

32/ In addition, on December 17, the reported trading volume in Enron stock was 5.1 million shares, approximately twice the normal volume. To our knowledge, the only evidence of the restriction on LJM1's Enron stock is the letter agreement between the parties.

33/ LJM1 had received 3.4 million (pre-split) shares and had transferred 1.6 million to Swap Sub. There was a 2-for-1 split in August 1999. That left 1.8 million (pre-split), or 3.6 million (post-split), shares in LJM1.

E. Unwinding the Transaction

In the first quarter of 2000, Enron decided to liquidate its Rhythms position. This decision was based on several factors: (1) the expiration of the lock-up on Rhythms stock; (2) the intervening decline in the value of Rhythms stock; and (3) the continuing volatility of the Rhythms position and the hedge. Skilling made this decision. Even after the additional options had been put in place in July 1999, Enron's earnings continued to fluctuate as the position and options were marked to market.

During this period, Enron's accounting staff focused on the credit capacity of Swap Sub. Kaminski told us that, in February or March of 2000, the accounting group asked him to analyze the credit capacity of the Rhythms structure. Kaminski and his analysts reviewed the structure and determined there was a 68% probability that the structure would default and would not be able to meet its obligations to Enron on the Rhythms put. Kaminski says that, when he relayed this conclusion to the accounting group, they said they had suspected that would be the result. Causey told us that he did not recall this quantification of the likelihood of credit failure, but he did remember discussions about credit risk. He also told us he recalled considering the possibility that Enron might need to establish a credit reserve, but was not sure whether a reserve had been created. Our review did not identify any evidence that such a reserve was established.

1. Negotiations

Once Enron decided to liquidate the Rhythms position, it had to terminate the derivatives with Swap Sub. Causey had principal responsibility for implementing the

termination. In late February or early March 2000, Causey approached Fastow about unwinding the transaction.

On March 8, 2000, as the negotiations were underway, Enron gave Swap Sub a put on 3.1 million shares (post-split) of Enron stock at $71.31 per share. Swap Sub did not pay any option premium or provide any other consideration in exchange for the put. On March 8, the closing price of Enron stock was $67.19 per share; the put was therefore "in the money" to Swap Sub by $4.12 per share (or approximately $12.8 million intrinsic value) on the day it was executed.[34/] Causey told us he believes the put was given to Swap Sub to stabilize the structure and freeze the economics so that the negotiations could be completed.

Causey said that, at the outset, Fastow emphasized that he had no interest in the Enron stock owned by LJM1 and Swap Sub. Causey took this to mean that Fastow had no residual interest in the unwind of the transaction. Causey says Fastow told him that he was negotiating with his limited partners on the appropriate terms to unwind the transaction. Fastow subsequently came back to Causey with a proposal that Swap Sub receive $30 million from Enron in connection with the unwind. Causey and others saw their responsibility as determining whether that price would be fair to Enron. After analysis, they concluded that it was fair and Enron agreed to the proposal.

[34/] We were told that the put was agreed to by Enron when the current market price was $71.31, but the price went down before the put documentation was executed.

2. Terms

Enron and Swap Sub entered into a letter agreement dated March 22, 2000, setting out the terms of the unwind. At the same time, Enron agreed to loan $10 million to Swap Sub. We were told that Fastow informed Causey that he was going to buy out one of his LJM1 limited partners for that amount, and Swap Sub agreed that it would repay the loan with the proceeds of the unwind. The unwind terms were: (1) termination of the options on Rhythms; (2) Swap Sub's returning to Enron the 3.1 million (post-split) Enron shares that it had received from LJM1 but keeping the $3.75 million cash that it had received from LJM1; and (3) Enron's paying $16.7 million to Swap Sub.[35] The letter agreement was executed by Causey for Enron and by Fastow for Swap Sub and for "Southampton, L.P.," which was described in the letter as the owner of Swap Sub. The final agreement (which made no material change in the terms) was effective as of April 28, 2000.

3. Financial Results

The unwind transaction resulted in a huge windfall to Swap Sub and LJM1. Enron did not seek or obtain a fairness opinion on the unwind. We have not identified any evidence that the Board or any Board Committee was informed of the transaction. Lay told us he was unaware of the transaction. Skilling told us he was aware that Enron had sold its Rhythms position, but was not aware of the terms on which the hedge was

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[35] The $16.7 million payment was calculated as follows: $30 million per the agreement between Fastow and Causey, plus $500,000 for accrued dividends on the Enron stock, less $3.75 million cash in Swap Sub, less $10.1 million principal and interest on the loan.

unwound. We have not located any Enron Deal Approval Sheet ("DASH"), an internal document summarizing the transaction and showing required approvals, concerning the unwind.[36]

Swap Sub. Because of the decline in price of Rhythms stock, the Rhythms options were substantially in the money to Enron when the structure was unwound. Enron calculated the options as having a value of $207 million. In exchange for terminating these options (and receiving approximately $27 million cash), Swap Sub returned Enron shares having an unrestricted market value of $234 million. Enron's accounting personnel determined that this exchange was fair, using the unrestricted value of the shares.

The Enron shares, however, were *not* unrestricted. They carried a four-year contractual restriction. Because of the restriction, at closing on June 30, 1999, those shares were given a valuation discount of 38%.[37] Although some of the discount would have amortized from June 1999 through March 2000, a substantial amount should have remained. For example, assuming straight-line amortization of the restricted discount over four years, at the closing price on March 22, 2000, there would have been approximately $72 million of the discount left at the time of the unwind. If an appropriate valuation discount had been applied to the shares at that time, the value

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[36] Enron policy required the RAC Group to prepare a DASH for every business transaction that involved an expenditure of capital by Enron. The DASH had to be approved by the relevant business unit, the Legal Department, RAC, and Senior Management before funds could be distributed.

[37] The PwC fairness opinion given in connection with the initial transaction concluded that a restriction discount of 20% to 40% was reasonable.

Enron gave up (the $207 million in Rhythms options plus $27 million in cash) exceeded the value Enron received ($161 million in restricted Enron shares) by more than $70 million. It is difficult to understand why Enron's accounting personnel did not use the discounted value of the restricted shares to assess the fairness of the exchange.[38]

When Enron unwound the Raptor vehicles (discussed below in Section V.E.), as part of the accounting for the transaction, Andersen *required* Enron to use the discounted value of Enron shares it received. Andersen reviewed the Rhythms unwind in 2000, but apparently raised no questions about Enron bringing the stock back at its unrestricted value.

LJM1. After LJM1 transferred Enron shares to Swap Sub in June 1999, LJM1 retained 3.6 million (post-split) Enron shares that it had received as part of the initial transaction. Those shares were not addressed in the April 2000 unwind; LJM1 was simply permitted to retain them. We have not been able to determine what happened to those shares between June 1999 and April 2000 (although, as noted above, it is possible that LJM1 sold some or all of the shares in December 1999 to generate funds to pay the $64 million note). At the closing of the initial transaction in June 1999, those shares had a discounted value of $89 million. If LJM1 still held the shares on April 28, 2000, they had an undiscounted value (at closing price) of $251 million, and a smaller discounted value. Even assuming LJM1 used some of the shares to repay the $64 million note in

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[38] Causey told us he did not recall whether Enron had used the unrestricted value of the shares in connection with the unwind. He and others in the Accounting Group told us they were focused primarily on the value of what Enron was receiving, not the value of what Swap Sub was getting or giving up, and from Enron's perspective the restriction (if the shares were in Enron's hands) was not important.

December 1999, being permitted to retain the balance after the unwind provided LJM1 with an enormous economic benefit if those shares were sold or hedged.

F. Financial Participation of Enron Employees in the Unwind

Unbeknownst to virtually everyone at Enron, several Enron employees had obtained, in March 2000, financial interests in the unwind transaction. These include Fastow, Kopper, Glisan, Kristina Mordaunt, Kathy Lynn, and Anne Yaeger Patel. Fastow's participation was inconsistent with his representation to the Board that he would not receive any "current or future (appreciated) value" of Enron stock in the Rhythms transaction. We have not seen evidence that any of the employees, including Fastow, obtained approval from the Chairman and CEO under the Code of Conduct to participate financially in the profits of an entity doing business with Enron. Each of the employees certified in writing their compliance with the Code. While every Code violation is a matter to be taken seriously, these violations are particularly troubling. At or around the time they were benefiting from LJM1, these employees were all involved in one or more transactions between Enron and LJM2. Glisan and Mordaunt were involved on Enron's side.

Contemporaneously with the March 22, 2000 letter agreement between Enron and Swap Sub (setting out the terms of the unwind), the Enron employees signed an agreement for a limited partnership called "Southampton Place, L.P." As described in the March 20, 2000 partnership agreement, Southampton's purpose was to acquire a portion of the interest held by an existing limited partner of LJM1. The general partner of Southampton was an entity named "Big Doe, LLC." Kopper signed the agreement as a

member of Big Doe.[39] The limited partners were "The Fastow Family Foundation" (signed by Fastow as "Director"), Glisan, Mordaunt, Lynn, Yaeger Patel, and Michael Hinds (an LJM2 employee). The agreement shows that the capital contributions of the partners were $25,000 each for Big Doe and the Fastow Foundation, $5,800 each for Glisan and Mordaunt, and smaller amounts for the others—a total of $70,000.

Our understanding of Southampton is limited because, other than Mordaunt, none of the employees would agree to be interviewed in detail on the subject. Mordaunt said that she was approached by Kopper in late February or early March 2000. Kopper told her that management personnel of one of LJM1's limited partners had expressed an interest in buying out part of their employer's interest, and that Fastow and Kopper were forming a limited partnership to purchase part of the interest. Mordaunt says that Kopper assured her that LJM1 was not doing any new business with Enron. In a brief interview conducted at the outset of our investigation, Glisan told us that he was approached by Fastow with a proposal similar to what Mordaunt described as advanced by Kopper.[40]

We have not seen evidence that any of the employees sought a determination from the Chairman and CEO that their investment in Southampton would not adversely affect Enron's best interests. Mordaunt told us that she did not consider seeking consent because she believed LJM1 was not currently doing business with Enron, and that the

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[39] As described above in Section III, Big Doe also was a limited partner of LJM2's general partner.

[40] Yaeger Patel's legal counsel informed us that she had been told by her "superiors" that she would receive a "bonus" for her work at LJM, and that the bonus was paid to her and other LJM employees by allowing them to purchase a small interest in Southampton.

partnership was simply buying into a cash flow from a transaction that had been negotiated previously. (She also suggested, with the benefit of hindsight, that this judgment was wrong and that she did not consider the issue carefully enough at the time.)[41] Glisan told us that he asked LJM1's outside counsel, Kirkland & Ellis, whether the investment would be viewed as a related-party transaction with Enron, and was told that it would not. Neither Glisan nor Kirkland & Ellis consulted with Enron's counsel.[42]

We do not know whether Southampton actually purchased part of the LJM1 limited partner's interest.[43] It does appear from other documents, including the March 22 letter agreement between Enron and Swap Sub, that Southampton became the indirect owner of Swap Sub.[44] We do not know how this ownership interest was acquired or what consideration, if any, was paid.

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[41] In late October 2001, after there was considerable media attention devoted to the LJM partnerships, Mordaunt voluntarily disclosed the fact of her investment to Enron.

[42] Yaeger Patel's legal counsel informed us that she was told by her "superiors" and "internal company counsel advising LJM" that all necessary approvals or waivers for her LJM activities had been obtained.

[43] Our inquiry did identify some evidence that Chewco (described above in Section II) may have transferred $1 million to the account of Campsie, Ltd., an LJM1 limited partner, in March 2000 at or around the time of the unwinding of the Rhythms transaction.

[44] The letter agreement indicates that Southampton, L.P., of which Southampton Place is the general partner, owns 100% of the limited partner interests in Swap Sub and 100% of Swap Sub's general partner. At the time of the initial Rhythms transaction, the closing documents indicated that LJM1 was the limited partner of Swap Sub. Based on our interviews, none of the Enron employees involved in the Rhythms unwind noticed that Southampton appeared to have replaced (or supplemented) LJM1 as a limited partner.

Even based on the limited information we have, the Enron employees received massive returns on their modest investments. We have seen documents indicating that, in return for its $25,000 investment, the Fastow Family Foundation received *$4.5 million* on May 1, 2000. Glisan and Mordaunt separately told us that, in return for their small investments, they each received approximately *$1 million* within a matter of one or two months, an extraordinary return. Mordaunt told us that she got no explanation from Kopper for the size of this return. He said only that Enron had wanted to terminate the Rhythms options early. We do not know what Big Doe (Kopper), Lynn, or Yaeger Patel received. The magnitude of these returns raises serious questions as to why Fastow and Kopper offered these investments to the other employees.

In 2000, Glisan was involved on behalf of Enron in several significant transactions with LJM2. Most notably, he was a major participant in the Raptor transactions. He presented the Raptor I transaction to the Board, and was intimately involved in designing its structure. Enron approval documents show Glisan as the "business unit originator" and "person negotiating for Enron" in the Raptor I, II, and IV transactions. Glisan signed each of those approval documents. In May 2000, Glisan succeeded McMahon as Treasurer of Enron. Glisan told us that Fastow never asked him for any favors or other consideration in return for the Southampton investment.

Mordaunt is a lawyer. She was involved in the initial Rhythms transaction as General Counsel, Structured Finance. Later in 1999, she became General Counsel of Enron Communications (which later became Enron Broadband Services). To our knowledge, Mordaunt was involved in one transaction with LJM2 in mid-2000. She acted as Enron's business unit legal counsel in connection with the Backbone transaction

(which involved LJM2's purchase of dark fiber-optic cable from Enron and is discussed below in Section VI.B.1.). She signed the internal approval sheet. She told us she was never asked for, and never provided, anything in return for the Southampton investment.

Kopper, Lynn, and Yaeger Patel all were Enron employees in the Finance area. All three are specifically identified in the Services Agreement between Enron and LJM2 as employees who will do work for LJM2 during 2000 and receive compensation from both Enron and LJM2. At the time of their departures from Enron, Kopper was a Managing Director, Lynn was a Vice President, and Yaeger Patel was a non-officer employee.

V. THE RAPTORS

The transactions between Enron and LJM2 that had the greatest impact on Enron's financial statements involved four SPEs known as the "Raptors." Expanding on the concepts underlying the Rhythms transaction (described in the preceding Section of this Report), Enron sought to use the "embedded" value of its own equity to counteract declines in the value of certain of its merchant investments. Enron used the extremely complex Raptor structured finance vehicles to avoid reflecting losses in the value of some merchant investments in its income statement. Enron did this by entering into derivative transactions with the Raptors that functioned as "accounting" hedges. If the value of the merchant investment declined, the value of the corresponding hedge would increase by an equal amount. Consequently, the decline—which was recorded each quarter on Enron's income statement—would be offset by an increase of income from the hedge.

As with the Rhythms hedge, these transactions were not true economic hedges. Had Enron hedged its merchant investments with a creditworthy, independent outside party, it may have been able successfully to transfer the economic risk of a decline in the investments. But it did not do this. Instead, Enron and LJM2 created counter-parties for these accounting hedges—the Raptors—but Enron still bore virtually all of the economic risk. In effect, Enron was hedging risk with itself.

In three of the four Raptors, the vehicle's financial ability to hedge was created by Enron's transferring its own stock (or contracts to receive Enron stock) to the entity, at a discount to the market price. This "accounting" hedge would work, and the Raptors would be able to "pay" Enron on the hedge, as long as Enron's stock price remained

strong, and especially if it increased. Thus, the Raptors were designed to make use of forecasted future growth of Enron's stock price to shield Enron's income statement from reflecting future losses incurred on merchant investments. This strategy of using Enron's own stock to offset losses runs counter to a basic principle of accounting and financial reporting: except under limited circumstances, a business may not recognize gains due to the increase in the value of its capital stock on its income statement.

When the value of many of Enron's merchant investments fell in late 2000 and early 2001, the Raptors' hedging obligations to Enron grew. At the same time, however, the value of Enron's stock declined, decreasing the ability of the Raptors to meet those obligations. These two factors combined to create the very real possibility that Enron would have to record at the end of first quarter 2001 a $500 million impairment of the Raptors' obligations to it. Without bringing this issue to the attention of the Board, and with the design and effect of avoiding a massive credit reserve, Enron Management restructured the vehicles in the first quarter of 2001. In the third quarter of 2001, however, as the merchant investments and Enron's stock price continued to decline, Enron finally terminated the vehicles. In doing so, it incurred the after-tax charge of $544 million ($710 million pre-tax) that Enron disclosed on October 16, 2001 in its initial third quarter earnings release.

Enron also reported that same day that it would reduce shareholder equity by $1.2 billion. One billion of that $1.2 billion involved the correction of accounting errors relating to Enron's prior issuance of Enron common stock (and stock contracts) to the Raptors in the second quarter of 2000 and the first quarter of 2001; the other $200 million related to termination of the Raptors.

The Raptors made an extremely significant contribution to Enron's reported financial results over the last five quarters before Enron sought bankruptcy protection—*i.e.*, from the third quarter of 2000 through the third quarter of 2001. Transactions with the Raptors during that period allowed Enron to avoid reflecting on its income statement almost $1 billion in losses on its merchant investments. Not including the $710 million pre-tax charge Enron recorded in the third quarter of 2001 related to the termination of the Raptors, Enron's reported pre-tax earnings during that five-quarter period were $1.5 billion. We cannot be certain what Enron might have done to mitigate losses in its merchant investment portfolio had it not constructed the Raptors to hedge certain of the investments. Nonetheless, if one were to subtract from Enron's earnings the $1.1 billion in income (including interest income) recognized from its transactions with the Raptors, Enron's pre-tax earnings for that period would have been $429 million, a decline of 72%.

The following description of the Raptors simplifies an extremely complicated set of transactions involving a complex structured finance vehicle through which Enron entered into sophisticated hedges and derivatives transactions. Although we describe these transactions in some depth, even the detail here is only a summary.

A. Raptor I

1. Formation and Structure

In late 1999, at Skilling's urging, a group of Enron commercial and accounting professionals began to devise a mechanism that would allow Enron to hedge a portion of its merchant investment portfolio. These investments were "marked to market," with changes recorded in income every quarter for financial statement purposes. They had

increased in value dramatically. Skilling said he wanted to protect the value of these investments and avoid excessive quarter-to-quarter volatility. Due to the size and illiquidity of many of these investments, they could not practicably be hedged through traditional transactions with third parties.

With the logic and seeming success (at that time) of the Rhythms hedge fresh in mind, Ben Glisan, who became Enron's Treasurer in May 2000, led the effort. Accountants from Andersen were closely involved in structuring the Raptors.[45] Attorneys from Vinson & Elkins also were consulted frequently, particularly on securities law issues, and also prepared the transaction documents.

The first Raptor (Raptor I), created effective April 18, 2000, was an SPE called Talon LLC ("Talon"). Talon was created solely to engage in hedging transactions with Enron. LJM2 invested $30 million in cash and received a membership interest. Through a wholly-owned subsidiary named Harrier, Enron contributed $1,000 cash, a $50 million promissory note, and Enron stock and Enron stock contracts with a fair market value of approximately $537 million.[46] Because Talon was restricted from selling, pledging or hedging the Enron shares for three years, the shares were valued at about a 35% discount

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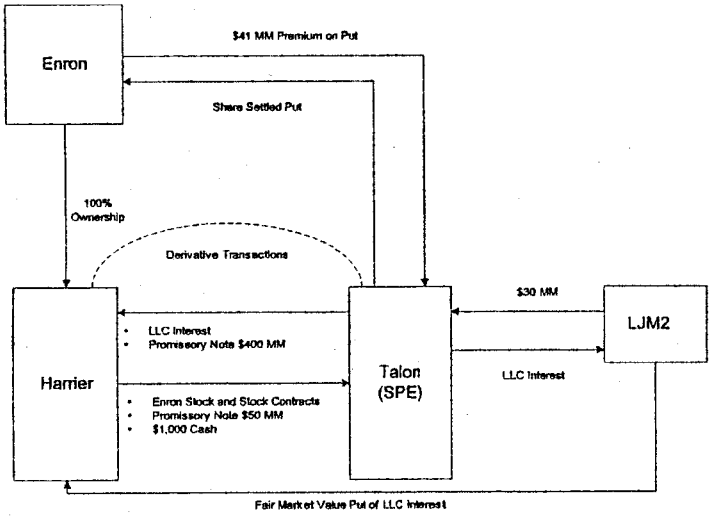
[45] Enron's records show that Andersen billed Enron approximately $335,000 in connection with its work on the creation of the Raptors in the first several months of 2000.

[46] The stock in Raptor I came from shares of Enron stock received from restructuring forward contracts Enron had with an investment bank, which released shares of Enron stock. (This was the same source as the Enron stock used in the Rhythms transaction.) The Enron "stock contract" in Raptor I consisted of a contingent forward contract held by a wholly-owned Enron subsidiary, Peregrine, under which it had a contingent right to receive Enron stock on March 1, 2003 from another entity, Whitewing, if the price of Enron stock exceeded a certain level.

to their market value. This valuation was supported by a fairness opinion provided by PwC. In return for its contribution, Enron received a membership interest in Talon and a revolving promissory note from Talon, with an initial principal amount of $400 million. Through a series of agreements, LJM2 was the effective manager of Talon.

A very simplified diagram of Raptor I appears below:



Once Talon received the contributions from Enron and LJM2, it had $30 million of "outside" equity to meet the 3% outside equity requirement for SPE treatment as an unconsolidated entity. Enron calculated that Talon theoretically could enter into derivatives with Enron up to approximately $500 million in notional value. By Enron's calculation, it also had what appeared to be a capacity to absorb losses on derivative contracts up to almost $217 million. This credit capacity consisted of LJM2's $30

million investment plus the $187 million value of the 35% discount on the Enron stock and stock contracts. Enron concluded that Talon could sell the Enron stock at its unrestricted value to meet Talon's obligations.

There was an additional important requirement before Talon could enter into hedging transactions with Enron. It was understood by those who structured Talon—although it is not reflected in the Talon documents or Board presentations—that Talon would not write any derivatives until LJM2 received an initial return of $41 million or a 30% annualized rate of return, whichever was greater, from income earned by Talon. Put another way, before hedging could begin, LJM2 had to have received back the entire amount of its investment plus a substantial return. This allowed LJM2 effectively to receive a return of its capital but, from an accounting perspective, leave $30 million of capital "at risk" to meet the 3% outside equity requirement for non-consolidation. If LJM2 did not receive its specified return in six months, it could require Enron to purchase its interest in Talon at a value based on the *unrestricted* price of Talon's Enron stock and stock contracts. These terms were remarkably favorable to LJM2, and served no apparent business purpose for Enron. Moreover, because Talon's Enron stock and stock contracts would have to decline in value by $187 million before Talon incurred any loss, LJM2 did not bear first-dollar risk of loss, as typically required for SPE non-consolidation. After LJM2 received its specified return, Enron then was entitled to 100% of any further distributions of Talon's earnings.[47] Thus, by the time any hedging began,

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[47] During Talon's existence, this changed slightly. After LJM2 received its initial $41 million return, it made an additional equity investment of $6 million and was entitled to receive a 12.5% return on that additional contribution, to the extent Talon had sufficient earnings.

LJM2 would have received a return that substantially exceeded its initial investment while retaining only a limited economic stake in the ongoing venture—principally the return of its original investment upon Talon's liquidation. In fact, Fastow told his limited partners in LJM2 that the Raptors were "divested investments" after LJM2 received its specified $41 million return.

To create the required $41 million of income for distribution to LJM2, Enron purchased from Talon a put option on Enron stock for a premium of $41 million. The put option gave Enron the right to require Talon to purchase approximately 7.2 million shares of Enron common stock on October 18, 2000, six months after the effective date of the transaction, at a strike price of $57.50 per share. The closing price of Enron stock was $68 per share when Enron purchased the put. As long as Enron's share price remained above $57.50, the put option would expire worthless to Enron, and Talon would be entitled to record the $41 million premium as income. It could then distribute $41 million to LJM2, but continue to treat Talon as an adequately capitalized, unconsolidated SPE.[48]

Enron's purchase of the put option for $41 million was unusual for two reasons. First, from an economic perspective—rather than merely a means to pay LJM2—the put option was a bet by Enron that its own stock price would decline substantially. Second, the price of the put was calculated by a method appropriate only if the transaction were

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[48] Economically, this $41 million distribution reflected a return of and on LJM2's initial investment, but for accounting purposes the distribution was a return *on* the original investment. Thus, LJM2 technically still had $30 million equity in Talon. Nevertheless, Fastow told his LJM2 investors in April 2001 that after settlement of the Enron puts, "LJM2 had already received its return of and on capital."

between two fully creditworthy parties. In fact, Talon was not sufficiently creditworthy. Other than the Enron stock and stock contracts, it had only $71 million of assets —the $30 million LJM2 investment and the $41 million premium— to meet its obligations on the put, but it had written a put on more than 7 million shares of Enron stock. If the Enron stock price declined below approximately $47 per share (about $10 per share below the strike price), Talon would owe Enron the entire $71 million, and Talon would be unable to meet its remaining obligations. Thus, the put provided only about $10 per share of price protection to Enron, and for that reason was worth substantially less than $41 million. The transaction makes little apparent commercial sense, other than to enable Enron to transfer money to LJM2 in exchange for its participation in vehicles that would allow Enron to engage in hedging transactions.

As it turned out, Enron did not have to wait six months for the put to expire and for hedging transactions to begin. At Fastow's suggestion, Causey, on behalf of Enron, and Fastow, on behalf of Talon and LJM2, settled the option early, as of August 3, 2000. Since Enron stock had increased in value and the period remaining on the put option had dwindled, the option was worth much less. Talon returned $4 million of the $41 million option premium to Enron, but nevertheless paid LJM2 $41 million. That left LJM2 with little further financial interest in what happened to Talon. This distribution resulted in an annualized rate of return that LJM2 calculated in a report to its investors at 193%. Enron also paid LJM2's legal and accounting fees, and a management fee of $250,000 per year. With LJM2 having received a $41 million payment, Talon was now available to begin entering into hedging transactions with Enron.

2. Enron's Approval of Raptor I

Although the deal-closing documents were dated April 18, 2000, the transaction did not receive formal approval from Enron's Management or Board until several weeks later.

The approval of Raptor I by Enron's Management is reflected in two documents, an "LJM2 Approval Sheet" and an Enron Deal Summary. Both were executed between May 22 and June 12, 2000, long after the transaction closed. The LJM2 Approval Sheet very briefly describes the transaction and the distribution "waterfall" of Talon's earnings (including the initial $41 million payment to LJM2), and reports that Kopper—a Managing Director of Enron—negotiated on behalf of LJM2. The Approval Sheet was signed by Glisan, Causey and Buy, but the signature line for Skilling was blank.[49] The LJM2 Approval Sheet refers to an "attached" DASH. A Deal Summary is attached, which is largely identical to the Approval Sheet, but added: "It is expected that Talon will have earnings and cash sufficient to distribute $41 million to LJM2 within six months, yielding an annualized return on investment to LJM2 of 76.8%" This document was signed only by Glisan and Scott Sefton, the General Counsel of Enron Global Finance, Fastow's group.

Glisan and Causey presented Raptor I to the Finance Committee of the Board on May 1, 2000, with Lay, Skilling, and Fastow in attendance. According to the minutes, Glisan described Raptor as "a risk management program to enable the Company to hedge

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[49] We discuss Skilling's role in the management and oversight of transactions with the LJM partnerships in Section VII, below.

the profit and loss volatility of the Company's investments." He explained that Enron and LJM2 would establish "a non-affiliated vehicle ... as a hedge counter-party to selected investments," explained how Talon would be funded, and explained "the level of hedging protection Talon could initially provide."

Although the minutes do not contain any detail regarding what Glisan told the Committee, it appears that his remarks were guided by a three-page written presentation provided to the Committee entitled "Project Raptor: Hedging Program for Enron Assets." The materials stated that Talon would be capitalized with $400 million in "excess [Enron] stock." It also stated that, "[i]nitially, [the] vehicle can provide approximately $200 million of P&L [profit and loss] protection to ENE. As ENE stock price increases, the vehicle's P&L protection capacity increases as well." The materials also disclosed LJM2's investment and expected return: "LJM2 will provide non-ENE equity and will be entitled to 30% annualized return plus fees," with Enron entitled to all upside after LJM2 received its return. The materials did not disclose that LJM2's contractually specified return was the *greater* of a 30% annualized return *or* $41 million.

The Finance Committee was also given information strongly suggesting, if not making perfectly clear, that the Raptor vehicle was not a true economic hedge. Notes on the presentation materials, apparently taken at the meeting by Enron's Corporate Secretary to assist her in preparing the minutes, state: "Does not transfer economic risk but transfers P&L volatility."[50]

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[50] This thought was repeated in a May 2000 presentation describing the Raptor hedging program prepared by Enron Global Finance for Enron Broadband Services. It

According to the minutes, Causey informed the Finance Committee that Andersen "had spent considerable time analyzing the Talon structure and the governance structure of LJM2 and was comfortable with the proposed transaction." Glisan apparently presented a chart identifying three principal "risks" of Raptor: (1) "accounting scrutiny"; (2) a substantial decline in Enron stock price; and (3) counter-party credit. For each of them, the chart also identified corresponding "[m]itigants:" (1) the transaction had been reviewed by Causey and Andersen; (2) Enron could negotiate an early termination of Talon with LJM2; and (3) the assets of Talon were subject to a "master netting agreement."

The Finance Committee voted to recommend Project Raptor to the full Board. The Board approved the transaction the following day, May 2, 2000.

3. Early Activity in Raptor I

The unwritten understanding was that Talon could not engage in hedging transactions with Enron until LJM2 received its initial $41 million return. After LJM2 received its $41 million, Talon then began to execute derivative transactions with Enron. With one exception, these transactions took the form of "total return swaps" on interests in Enron merchant investments—that is, derivatives under which Talon would receive the amount of any future gains in the value of those investments, but also would have to pay

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stated that a "substantial decline in the price of [Enron] stock will cause the program to terminate early and may return credit risk to Enron," and thus the Raptor program was "[n]ot an economic hedge; … credit risk retained with Enron Corp."

Enron the amount of any future losses. The total notional value of the derivatives was approximately $734 million.

All of the documentation for the derivative transactions between Enron and Talon was signed by Causey for Enron and by Fastow for Talon. They all were dated "as of" August 3, 2000. Contemporaneous documents, however, demonstrate that many, if not all, of the transactions were not finally agreed upon until sometime in mid-September, and were back-dated to be effective "as of" August 3, 2000. The purpose of dating the derivative transactions on the same day appears to have been administrative: Andersen required Enron to recalculate whether LJM2's equity investment constituted at least 3% of the Raptor's total assets each time the Raptor entered into a transaction with Enron. Treating each of the Raptor I transactions as if they all occurred on one day allowed Enron to make this calculation only once.

We have found no direct evidence explaining why August 3 was selected as the single date. We note, however, that August 3 was the date on which the stock of Avici Systems, a public company in which Enron held a very large stake, traded at its all-time high ($162.50 per share). By entering into a total return swap with Talon on Avici stock on that date, Enron was able to lock in the maximum possible gains. By September 30, 2000, the quarter end, the stock had declined to $95 per share. By dating the swap "as of" August 3, Enron was able to offset losses of nearly $75 million on its quarterly financial statements. If Enron had treated the swap on Avici as effective on September 15, 2000—approximately when the agreement between Enron and LJM2 actually occurred and when Avici was trading at $95.50 per share—Enron would not have been able to offset any significant losses on Avici in Enron's third quarter financial

statements. Because LJM2 had already received back from Talon its $30 million investment along with another $11 million, it had little economic incentive to resist dating or structuring transactions that would benefit Enron for income statement purposes at Talon's expense.

There is some evidence of a concern within Enron North America ("ENA"), which held almost all of the assets that were subject to Raptor derivative transactions, that ENA selected only assets that were expected to decline substantially in value. On September 1, 2000, an ENA attorney, Stuart Zisman, wrote (emphasis added):

> Our original understanding of this transaction was that all types of assets/securities would be introduced into this structure (including both those that are viewed favorably and those that are viewed as being poor investments). *As it turns out, we have discovered that a majority of the investments being introduced into the Raptor Structure are bad ones.* This is disconcerting [because] ... it might lead one to believe that the financial books at Enron are being "cooked" in order to eliminate a drag on earnings that would otherwise occur under fair value accounting . . . .

ENA's two most senior attorneys received this memorandum, as did several senior ENA business people. Zisman met with the senior ENA attorneys. He told them that, contrary to what the memorandum implied, he did not know whether only "bad" assets had in fact been selected for Raptor, but that he was concerned Raptor could be misused in that way. The senior ENA attorneys and the senior ENA business people who received Zisman's memorandum—for varying reasons and with varying levels of direct knowledge—believed the assertion in Zisman's memo to be untrue, so they did not take any further action.

4. Credit Capacity Concerns in the Fall of 2000

As the value of Enron's merchant investments declined in the fall of 2000, the amounts Talon owed Enron increased. This became a matter of significant concern at Enron. If Talon's total liabilities (including the amount owed to Enron) exceeded its total assets (which consisted almost entirely of the unrestricted value of Enron stock and stock contracts), Enron would have to record a charge to income based on Talon's credit deficiency. Consequently, Enron's accounting department kept track of Talon's credit capacity on a daily basis.

To protect Talon against a possible decline in Enron stock price—which would decrease the value of Talon's principal asset, and thereby decrease its credit capacity—on October 30, 2000, Enron entered into a "costless collar" on the approximately 7.6 million Enron shares and stock contracts in Talon.[51] The "collar" provided that, if Enron stock fell below $81, Enron would pay Talon the amount of any loss. If Enron stock increased above $116 per share, Talon would pay Enron the amount of any gain. If the stock price was between the floor and ceiling, neither party was obligated to the other. This protected Talon's credit capacity against possible future declines in Enron stock.

This collar was inconsistent with certain fundamental elements of the original transaction. Enron had originally transferred $537 million of its own stock and stock contracts to Talon. It discounted the value of that stock by approximately 35% because it

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[51] The collar was "costless" because Enron and LJM2 owed each other equal premiums for the transaction. Because the collar was indexed to Enron's own stock and met certain accounting criteria, Enron was not required to mark it to market. Instead, it was considered an equity transaction.

was restricted from being sold, pledged or hedged for a three-year period. These restrictions reduced the value of the stock, and were a key basis for PwC's fairness opinion. By agreeing to the collar, Enron had to lift, in part, the restriction that had justified the 35% discount on the stock ($187 million). Causey signed the document waiving the restriction.

Thus, on October 30, 2000, the value of Talon's principal asset, the Enron stock and stock contracts, was protected from future declines. Even so, the value of Enron's merchant investments was rapidly declining, so Talon's credit capacity was still in jeopardy.

B. Raptors II and IV

Enron and LJM2 established two more Raptors—known as Raptor II and Raptor IV—that were not materially different from Raptor I. (A fourth vehicle, Raptor III, is discussed in the next section.) Both Raptors II and IV received only contingent contracts to obtain a specified number of Enron shares.[52] Raptor II was authorized by the Executive Committee of the Board at its meeting on June 22, 2000. The minutes state

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[52] As noted above in Section V.A.1., Enron contributed to Raptor I a contingent forward contract held by a wholly-owned Enron subsidiary, Peregrine, under which Peregrine had a right to receive Enron stock on March 1, 2003 from Whitewing. Enron contributed similar contingent stock-delivery contracts to Raptors II and IV. In all, Enron sold the rights to 18 million contingent Enron shares, to be delivered in 2003, to Raptor I (3.9 million shares), Raptor II (7.8 million shares) and Raptor IV (6.3 million shares). The contingency was based on Enron stock price on March 1, 2003. If on that date the price of Enron stock was above $53 per share, Raptor I would receive all of its shares; if it was above $63 per share, Raptor II would receive all of its shares; and if it was above $76 per share, Raptor IV would receive all of its shares. If, on the other hand, the price of Enron stock on that date was below $63 per share, Raptor IV would receive no shares; if it was below $53 per share, Raptor II would receive no shares; and if it was below $50 per share, Raptor I would receive no shares.

that Fastow told the Committee that a second Raptor was needed because "there had been tremendous utilization by the business units of Raptor I." In fact, at that point there had been no derivative transactions between Talon and Enron. A presentation distributed to the Executive Committee stated: "Initially, the vehicle can provide approximately $200 million of P&L protection to ENE [Enron]. As ENE stock price increases, the vehicle's P&L protection capacity increases as well." The closing documents for Raptor II were dated June 29, 2000.

Raptor IV was presented to the Finance Committee at its meeting on August 7, 2000.[53] With Skilling, Fastow, Buy and Causey in attendance, Glisan first discussed Raptors I and II. He "noted that Raptor I was almost completely utilized and that Raptor II would not be available for utilization until later in the year." (There is no indication that Glisan explained why Raptor II would not be available—under the unwritten agreement, Raptor II would not write derivatives with Enron until LJM2 received its specified $41 million or 30% return.) Glisan then informed the Committee that "the Company was proposing an additional Raptor structure . . . to increase available capacity." After a discussion that is not described in the minutes, the Finance Committee voted to recommend Raptor IV to the Board. Later that day, Skilling informed the Board that the Executive Committee had approved Raptor II at its June meeting, and that

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[53] The Finance Committee and Board minutes refer to this vehicle as "Raptor III," not "Raptor IV." However, as we explain below, another Raptor vehicle was activated after Raptor II and before what the Board referred to as "Raptor III." This Raptor vehicle, which is widely referred to as Raptor III by Enron employees involved in the transactions, was not brought to the Board for approval. In order to be consistent with the terms used by the parties at the time (and reflected in contemporaneous documents), we refer to what the Board called Raptor III as Raptor IV.

Raptor IV would "provide additional mechanisms to hedge the profit and loss volatility of the Company's investments." The Board then approved Raptor IV. The closing documents for Raptor IV were dated September 11, 2000.[54]

Just as it had done with Talon in Raptor I, Enron paid Raptor II's SPE, "Timberwolf," and Raptor IV's SPE, "Bobcat," $41 million each for share-settled put options. As in Raptor I, the put options were settled early, and each of the entities then distributed approximately $41 million to LJM2.[55] Although these distributions meant that both Timberwolf and Bobcat were available to engage in derivative transactions with Enron, Enron engaged in derivative transactions only with Timberwolf. These transactions, entered into as of September 22, 2000 and December 28, 2000, had a total notional value of $513 million. Enron did not make use of Bobcat because, as we explain below, concerns regarding the declining credit capacity of Raptors I and III led Enron to use Bobcat's available credit capacity to prop them up.

As in Raptor I, Enron entered into costless collars on the Enron stock contracts in Timberwolf and Bobcat to provide credit capacity support to the Raptors. Causey approved the collars. The Timberwolf shares were collared on November 27, 2000, at a floor of $79 and a ceiling of $112. The Bobcat shares were collared on January 24, 2001,

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[54] Skilling signed the LJM2 Approval Sheet for Raptor IV—the only such sheet he signed for the Raptors, and one of the few sheets he signed at all. Notably, the Approval Sheet was not signed by Skilling, Buy and Causey until March 2001, some six months after the deal had closed and the Board had approved the transaction.

[55] LJM2 made an additional equity investment of $1.1 million in Raptor II at the time the initial put terminated. LJM2 had a potential 15% return on that additional investment.

at a floor of $83 and a ceiling of $112. As in the case of Raptor I, this collaring was inconsistent with the premise on which the stock contracts had been discounted when they were originally transferred to Timberwolf and Bobcat. The shares were restricted for three years, and their value was thus discounted from market value. The collars, however, effectively lifted the restriction.

C. Raptor III

Raptor III was a variation of the other Raptor transactions, but with an important difference. It was intended to hedge a single, large Enron investment in The New Power Company ("TNPC").[56] Instead of holding Enron stock, Raptor III held the stock of the very company whose stock it was intended to hedge—TNPC. (Technically, Raptor III held warrants to purchase approximately 24 million shares of TNPC stock for a nominal price. These warrants were thus the economic equivalent of stock.) If the value of TNPC stock decreased, the vehicle's obligation to Enron on the hedge would increase in direct proportion. At the same time, its ability to pay Enron would decrease. Raptor III was thus the derivatives equivalent of doubling-down on a bet on TNPC. This extraordinarily fragile structure came under pressure almost immediately, as the stock of TNPC decreased sharply after its public offering.

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[56] When TNPC went public, its name changed to New Power Holdings, Inc., but Enron personnel continued to refer to the company as TNPC. In order to be consistent with the terms used by the parties at the time and contemporaneous documents, we refer to New Power Holdings as TNPC.

1. The New Power Company

TNPC was a residential and commercial power delivery company Enron created as a separate entity. Enron owned a 75% interest. It was not publicly traded in early 2000. Enron sold a portion of its holdings to an SPE, known as Hawaii 125-0 ("Hawaii"), that Enron formed with an outside institutional investor. Enron's basis in the warrants was zero. Enron recorded large gains in connection with the sales, and then entered into total return swaps under which Enron retained most of the economic risks and rewards of the holdings it had sold. As a result, Enron bore the economic risks and rewards of TNPC, and would have to reflect any gains or losses on its income statement on a mark-to-market basis. In July 2000, Enron also sold warrants for TNPC to other investors (including LJM2) for the equivalent of $10.75 per share.

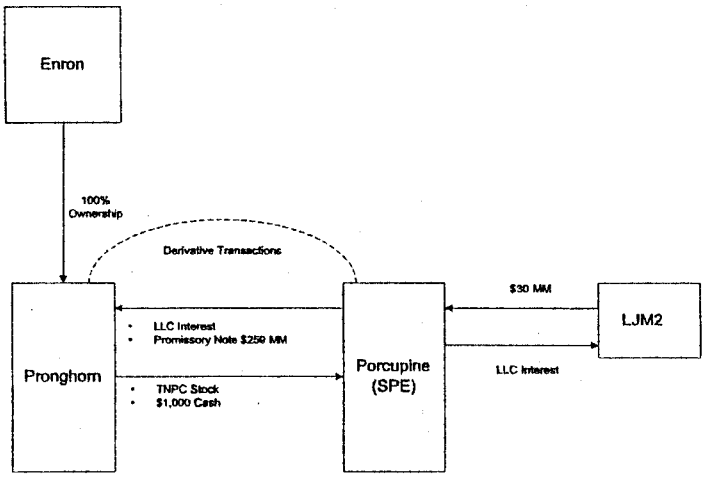
Enron contemplated an initial public offering of TNPC stock occurring in the Fall of 2000. Anticipating that the stock price would fluctuate—causing volatility in Enron's income statement—Enron wanted to hedge the risk it had taken on through its total return swaps with Hawaii. To "hedge" its accounting exposure, Enron once again used the Raptor structure.

2. The Creation of Raptor III

As in the creation of the other Raptors, internal Enron accountants worked closely with Andersen in designing Raptor III. Andersen's billings for work on Raptor III were approximately $55,000. Attorneys from Vinson & Elkins were also consulted and prepared the transaction documents. The structure of Raptor III, however, was different from the other Raptors because Enron did not have ready access to shares of its stock to

contribute to the vehicle. Rather than seeking Board authorization for new Enron shares, which would have resulted in dilution of earnings per share, Enron Management chose to contribute some of Enron's TNPC holdings to Raptor III's SPE, "Porcupine."

A very simplified diagram of Raptor III appears below:



Enron and LJM2 created Raptor III effective September 27, 2000. Unlike the other Raptor transactions, Raptor III was not presented to the Board or to any of its Committees, possibly because no Enron stock was involved. We have seen no evidence that the members of the Board, other than Skilling, were aware of the transaction. Nor have we seen any evidence that an LJM2 Approval Sheet, Enron Investment Summary, or DASH was prepared for this transaction.

As with the other Raptors, LJM2 contributed $30 million to Porcupine. It was understood that LJM2 would receive its substantial return before Porcupine would enter into derivative transactions with Enron. In Raptor III, LJM2's specified return was set at $39.5 million or a 30% annualized rate of return, whichever was greater. It received a return of $39.5 million in only one week.

On September 27 Enron delivered approximately 24 million shares of TNPC stock to Porcupine at $10.75 per share. Enron received a note from Porcupine for $259 million, which Enron recorded at zero because it had essentially no basis in the TNPC stock sold to Porcupine. Enron did not obtain a fairness opinion with respect to the transaction. We are told that Enron, after consulting with Andersen, reasoned that its private sale of TNPC interests several months earlier at $10.75 per share was adequate support for the price of its transfer to Porcupine. The "road show" for the TNPC initial public offering was already underway, and there is evidence that Enron personnel were aware that the offering was likely to be completed at a much higher price. Indeed, on September 22, 2000—five days before the transaction with Porcupine at $10.75 per share—Enron distributed a letter to certain of its employees offering them an opportunity to purchase shares of TNPC in the offering and noting that "the current estimated price range [for the shares] is $18.00 to $20.00 per share." Nonetheless, Enron, with Andersen's knowledge and agreement, concluded that the last actual transaction was the best indicator of the appropriate price in valuing the warrants sold by Enron to Porcupine. On October 5, *one week* after Enron contributed the warrants to Porcupine at a price equivalent to $10.75 per share, TNPC's initial public offering went forward at $21 per share.

On the day of the initial public offering, the TNPC shares (for which Porcupine had paid $10.75 five days earlier) closed at $27 per share. That same day, Porcupine declared a distribution to LJM2 of $39.5 million, giving LJM2 its specified return and permitting Porcupine to enter into a hedging transaction with Enron. LJM2 calculated its internal rate of return on this distribution as 2500%.

Enron and Porcupine immediately executed a total return swap on 18 million shares of TNPC at $21 per share. As a result, Enron locked in an accounting gain related to the Hawaii transactions of approximately $370 million. This gain, however, depended on Porcupine remaining a creditworthy counter-party, which in turn depended on the price of TNPC stock holding steady or increasing in value.

3. Decline in Raptor III's Credit Capacity

Although the initial public offering of TNPC was a success, the stock's value immediately began to deteriorate. After a week of trading, the share price had dropped below the offering price. By mid-November, TNPC stock was trading below $10 per share. This had a double-whammy effect on Porcupine: Its obligation to Enron on its hedge grew, but at the same time its TNPC stock—the principal, and essentially only, asset with which it could pay Enron—fell in value. In essence, Porcupine had two long positions on TNPC stock. Consequently, Enron's transaction with Porcupine was not a true economic hedge.

D. Raptor Restructuring

By November 2000, Enron had entered into derivative transactions with Raptors I, II and III with a notional value of over $1.5 billion. Enron's accounting department prepared a daily tracking report on the performance of the Raptors. In its December 29, 2000 report, Enron calculated its net gain (and the Raptors' corresponding net loss) on these transactions to be slightly over $500 million. Enron could recognize these gains—offsetting corresponding losses on the investments in its merchant portfolio—only if the Raptors had the capacity to make good on their debt to Enron. If they did not, Enron would be required to record a "credit reserve," reflecting a charge on its income statement. Such a loss would defeat the very purpose of the Raptors, which was to shield Enron's financial statements from reflecting the change in value of its merchant investments.

1. Fourth Quarter 2000 Temporary Fix

Raptor I and Raptor III developed significant credit capacity problems near the end of 2000. For Raptor I, the problem was that many of the derivative transactions with Enron resulted in losses to Talon, but the price of Enron stock had not appreciated significantly. The collar that Enron applied to the shares in Raptor I in October provided some credit support to Talon as Enron's share price dipped below $81 per share, but by mid-December the derivative losses surpassed the value of Talon's assets, creating a negative credit capacity.

Raptor III was faring no better. The price of TNPC stock had fallen dramatically from its initial public offering price, and was trading below $10 a share. Raptor III's assets had therefore declined substantially in value, and its obligation to Enron had increased. As a result, Raptor III also had negative credit capacity.

In an effort to avoid having to record a loss for Raptors I and III on its 2000 financial statements, Enron's accountants, working with Andersen, decided to use the "excess" credit capacity in Raptors II and IV to shore up the credit capacity in Raptors I and III. A 45-day cross-guarantee agreement, dated December 22, 2000, essentially merged the credit capacity of all four Raptors. The effect was that Enron would not, for year end, record a credit reserve loss unless there was negative credit capacity on a combined basis. Enron paid LJM2 $50,000 to enter into this agreement, even though the cross-guarantee had no effect on LJM2's economic interests. We have seen no evidence that Enron's Board was informed of either the credit capacity problem or the solution selected to resolve that problem. Enron did not record a reserve for the year ending December 31, 2000.[57]

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[57] At the time, Andersen agreed with Enron's view that the 45-day cross-guarantee among the Raptors to avoid a credit reserve loss was permissible from an accounting perspective. The workpapers that Andersen made available included a memorandum dated December 28, 2000, by Andersen's local audit team, which states that it consulted two partners in Andersen's Chicago office on the 45-day cross-guarantee. The workpapers also include an amended version of the December 28, 2000 memorandum, dated October 12, 2001, stating that the partners in the Chicago office advised that the 45-day cross-guarantee was *not* a permissible means to avoid a credit reserve loss.

2. First Quarter 2001 Restructuring

In the first quarter of 2001, the credit capacity of the Raptors continued to decline. By late March, it appeared that Enron would have to take a pre-tax charge against earnings of more than $500 million to reflect the shortfall in credit capacity of Raptors I and III. Enron did not take this charge, and the Board was not informed of the situation. Instead, Enron Management restructured the Raptors. The Board was not informed about that, either.

a. The Search for a Solution

The December cross-guarantee agreement was intended as a temporary remedy. In early January, a team of Enron accountants worked to find a more permanent solution. The need for a solution increased during the first quarter of 2001 because the values of both Enron and TNPC stock fell, and the Raptors' losses on their derivative transactions with Enron increased. The daily tracking reports that were circulated within the Global Finance, RAC, and Accounting Departments showed that the Raptors' credit shortfall grew to $504 million by the end of the quarter.

Senior Enron employees told us that Skilling, who became Enron's CEO during the first quarter of 2001, was aware of this problem and was intensely interested in its resolution. We were told that, during the first quarter of 2001, Skilling said that fixing the Raptors' credit capacity problem was one of the Company's highest priorities. When the Raptors' restructuring was accomplished, Skilling called one of the accountants who worked on the project to thank him personally. Skilling disputes these accounts. He told us that he recalls being informed in only general terms that there was a credit capacity

issue with the hedges in the Raptors due to the falling price of Enron stock and the assets being hedged, and that the problem could be solved. He told us he understood the matter to be an accounting issue, and that he recalls having no significant involvement in, or understanding of, the problem. Skilling also told us that, in his view, if it had been necessary to take a loss in the first quarter, Enron could have done so without undue harm to its stock price because many other companies at that time were reporting losses in high-tech investments.

We found no evidence that Lay, who stepped aside as CEO midway through the first quarter, was aware of these events. It is significant, however, that Skilling claims to have had only a passing involvement in the restructuring. The potential impact of the problem, and the chosen solution, were of considerable consequence to the Company in Skilling's first quarter as CEO. Either Skilling was not nearly as involved in Enron's business as his reputation—and his own description of his approach to his job—would suggest, or he was deliberately kept in the dark by those involved in the restructuring. Whichever is the case, Skilling now says that he has no recollection of the details of the restructuring transaction.

b. **The Restructuring Transaction**

The restructuring transaction, which was made effective as of March 26, 2001, consisted of two principal parts: a cross-collateralization of the Raptors and an additional infusion of Enron stock contracts.[58] By Enron's calculations, the restructuring allowed

[58] Each of the transaction documents is dated April 13, 2001—after the close of the first quarter—but say they are "effective as of March 26, 2001." A letter agreement was

Enron to record only a $36.6 million credit reserve loss for the first quarter of 2001, rather than the $504 million loss Enron would have recorded if the Raptors had not been restructured.

In the first part of the restructuring, Enron assigned its right to receive any distribution upon the termination of any Raptor to any other Raptor that lacked sufficient assets to pay its obligation to Enron. Thus, Enron agreed that if, for example, it were to receive a distribution from Timberwolf upon the termination of Raptor II, but Talon (Raptor I) lacked sufficient assets to back its obligation to Enron, Enron would allow Talon to use the distribution that otherwise would have gone from Timberwolf to Enron to satisfy Talon's obligations. This had the effect of shoring up the credit capacity of the vehicles with credit deficits, but only to the extent of the excess capacity in other Raptors.

But the credit deficiencies in Raptors I and III were too great for the other two Raptors to absorb. This problem was magnified by a risk that most of the Enron stock from the stock contracts included in the Raptors' capital could become unavailable. The source of shares for the stock contracts that Enron had originally transferred to Raptors I, II and IV was a contract that conditioned the availability of the shares on their stock trading at or above $50 per share on March 1, 2003. By March 22, 2001, however, Enron stock was trading at $55, so there was a concern that the shares would not be available to the Raptors. This would further erode their credit capacity.

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executed on March 30, 2001, which stated an intention to enter into an agreement, and set forth the agreement's material terms and conditions.

To make up for this potential shortfall, Enron entered into an extremely complex transaction with Raptors II and IV. The essence of the transaction was that Enron agreed to deliver up to 18 million additional Enron shares, if necessary, to Raptors II and IV to make up any Enron stock shortfall from the original stock contracts. In return, Raptors II and IV increased their notes payable to Enron by a total of approximately $260 million.

In addition, to add credit capacity to Raptors II and IV (which in turn supported Raptors I and III), Enron sold them 12 million shares of Enron stock, to be delivered on March 1, 2005, at $47 per share. In exchange, Raptors II and IV increased their notes payable to Enron by a total of $568 million. The $47 per share price for the Enron stock contracts represented a 23% discount to the current market price of $61 per share. The basis for this discount was that the shares could not be sold, pledged or hedged for a four-year period. This had the effect of increasing the credit capacity of the Raptors by approximately $170 million.

At the same time, however, Enron entered into an agreement with the Raptors to hedge those shares that the restriction agreement had prevented the Raptors from hedging. It did so through additional costless collar derivative transactions. This was inconsistent with having discounted the price of the shares by 23%. Enron did not obtain a fairness opinion on this transaction.[59] Enron based the 23% discount on an analysis done by its internal Research Group. However, the Research Group was not made aware of the collaring arrangement when it performed its analysis. When the group's head,

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[59] There is evidence that Enron accountants contacted outside investment banks seeking a fairness opinion and were unable to obtain what they regarded to be a suitable opinion.

Kaminski, learned several months later that the discounted shares had been simultaneously collared, he informed Andersen and the Enron accountants who had worked on the restructuring that this could not be reconciled with the discount.

Restructuring the Raptors allowed Enron to avoid reflecting the $504 million credit reserve loss in its first quarter financial statements. Instead, it recorded only a $36.6 million credit reserve loss.

E. **Unwind of the Raptors**

The complicated restructuring of the Raptors "solved" the problem only temporarily. By late summer of 2001, the continuing decline in Enron and TNPC stock caused a new credit deficiency of hundreds of millions of dollars. The collaring arrangements Enron had with the Raptors aggravated the situation, because Enron now faced the prospect of having to deliver so many shares of its stock to the Raptors that its reported earnings per share would be diluted significantly.

At the same time, an unrelated, but extraordinarily serious, Raptor accounting problem emerged. In August 2001, Andersen and Enron accountants realized that the accounting treatment for the Enron stock and stock contracts contributed to Raptors I, II and IV was wrong. Enron had accounted for the Enron shares sold in April 2000 to Talon (Raptor I), in exchange for a $172 million promissory note, as an increase to "notes receivable" and to "shareholders' equity." This increased shareholders' equity by $172 million in Enron's second, third and fourth quarter 2000 financial reports. Enron made similar entries when it sold Enron stock contracts in March 2001 to Timberwolf and Bobcat (Raptors II and IV) for notes totaling $828 million. This accounting treatment

increased shareholders' equity by a total of $1 billion in Enron's first and second quarter 2001 financial reports. Enron accountants told us that Andersen was aware of, and approved, the accounting treatment for the Enron stock contracts sold to the Raptors in the first quarter of 2001. Andersen did not permit us to interview any of the Andersen personnel involved.

In September 2001, Andersen and Enron concluded that the prior accounting entries were wrong, and the proper accounting for these transactions would have been to show the notes receivable as a reduction to shareholders' equity. This would have had no net effect on Enron's equity balance. Enron decided to correct these mistaken entries in its third quarter 2001 financial statements. At the time, Enron accounting personnel and Andersen concluded (using a qualitative analysis) that the error was not material and a restatement was not necessary. But when Enron announced on November 8, 2001 that it would restate its prior financials (for other reasons), it included the reduction of shareholders' equity. The correction of the error in Enron's third quarter financial statements resulted in a reduction of $1 billion ($172 million plus $828 million) to its previously overstated equity balance.[60]

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[60] Enron recorded a $1.2 billion reduction to shareholders' equity in its third quarter 2001 financial statement. One billion dollars of this reduction was due to correcting the overstatement of shareholders' equity that had been discovered in August. The additional approximately $200 million resulted from the fact that the notes receivable that Enron held for the stock and stock contracts sold to the Raptors were valued at a total of $1.9 billion, while the Enron stock and stock contracts held by the Raptors, which Enron took back when the Raptors were terminated, was valued at $2.1 billion. The $200 million difference was recorded as a reduction to shareholders' equity, and added to the $1 billion reduction that was recorded to correct the accounting error. Together, these two items accounted for the $1.2 billion reduction in shareholders' equity.

In mid-September, with the quarter-end approaching, Causey met with Lay (who had just recently reassumed the position of CEO because of Skilling's resignation) and Greg Whalley (Enron's COO) to discuss problems with the Raptors. Causey presented a series of options, including leaving the vehicles in place as they were, transactions to ameliorate the situation, and terminating the Raptors. Lay and Whalley directed Causey to terminate the Raptors.

Enron did so on September 28, 2001, paying LJM2 approximately $35 million. This purchase price apparently was the result of a private negotiation between Fastow (who had sold his interest in LJM2 to Kopper in July), on behalf of Enron, and Kopper, on behalf of LJM2. This figure apparently reflected a calculation that LJM2's residual interest in the Raptors was $61 million.

Enron accounted for the buy-out of the Raptors under typical business combination accounting, in which the assets and liabilities of the acquired entity are recorded at their fair value, and any excess cost typically is recorded as goodwill. However, Andersen told Enron to record the excess as a charge to income. As of September 28, 2001, Enron calculated that the Raptors' combined assets were approximately $2.5 billion,[61/] and their combined liabilities were approximately $3.2 billion. The difference between the Raptors' assets and liabilities, plus the $35 million

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61/ This valued the Enron stock and stock contracts, including the collars, in the Raptors at a restricted value of $2.1 billion. Unrestricted, the Enron stock would have been worth approximately $350 million more, but Andersen insisted that Enron calculate the value of the stock at its restricted value. While Enron's stock price at the termination had decreased significantly to $27 per share, the collars provided a floor on all of the stock and stock contracts at prices ranging from $61 to $83 per share.

payment to LJM2, resulted in a charge of approximately $710 million ($544 million after taxes) reflected in Enron's third quarter 2001 financial statements.

It is unclear whether the accounting treatment of the termination was correct. Enron's transactions with the Raptors had resulted in the recognition of earnings of $532 million during 2000, and $545 million during the first nine months of 2001, for a total of almost $1.1 billion. After taking the unwind charge of $710 million, Enron had still recognized pre-tax earnings from its transactions with the Raptors of $367 million. Thus, it may have been more appropriate for Enron to have reversed the full $1.1 billion of previously recorded pre-tax earnings when it bought back the Raptors.

F. Conclusions on the Raptors

The Raptors were an effort to use gains in Enron's stock price and restriction discounts to avoid reflecting losses on Enron's income statement. Were this permissible, a company with access to its outstanding stock could place itself on an ascending spiral: an increasing stock price would enable it to keep losses in its investments from public view; which, in turn, would spur further increases in its stock price; which, in turn, would increase its capacity to keep losses in its investments from public view.

Moreover, LJM2 invested $30 million in each of the Raptors, but promptly received back the amount of its original investment and much more. Fastow, a fiduciary to Enron and its shareholders, reported to the LJM2 investors in October 2000 that their internal rates of return on the four Raptors were 193%, 278%, 2500%, and a projected 125%, respectively. These extremely large returns were far in excess of the 30% annualized rate of return described in the May 1, 2000 presentation to the Finance

Committee. They were the result of very substantial and very rapid transfers of cash—about $41 million per Raptor, in less than six months each time—from the Raptors to LJM2. LJM2 was largely assured of a windfall from the inception of the transaction. Although LJM2 technically still had a $30 million investment in each of the Raptors, its original investment effectively had been returned.

The returns to LJM2 appear *not* to have been for a risk taken, but rather for a service provided: LJM2 lent its name to a vehicle by which Enron could circumvent accounting convention. The losses Enron incurred on its merchant investments were not hedged in any accepted sense of that term. The losses were merely moved from Enron's income statement to the equity section of its balance sheet. As a practical matter, Enron was hedging with itself. There was no interested counter-party in these transactions once LJM2 had been paid its initial return.

Proper financial accounting does not permit this result. To reach it, the accountants at Enron and Andersen—including the local engagement team and, apparently, Andersen's national office experts in Chicago—had to surmount numerous obstacles presented by pertinent accounting rules. Although they apparently believed that they had succeeded, a careful review of the transactions shows that they appear to violate or raise serious issues under several accounting rules:

1. Accounting principles generally forbid a company from recognizing an increase in the value of its capital stock in its income statement except under limited circumstances not present here. The substance of the Raptors effectively allowed Enron

to report gains on its income statement that were backed almost entirely by Enron stock, and contracts to receive Enron stock, held by the Raptors.

2. After the distribution of LJM2's specified initial return, LJM2 appears not to have had sufficient equity at risk in the Raptor transactions to satisfy the 3% requirement for unconsolidated SPEs. Fastow himself made this point in a private communication with LJM2 investors in April 2001 (emphasis added):

> After the settlement of the [Enron] puts, Enron and the Raptor vehicles began entering into derivative transactions designed to hedge the volatility of a number of equity investments held by Enron. *LJM2's return on these investments was not at risk to the performance of derivatives in the vehicles, given that LJM2 had already received its return of and on capital.*

This is particularly true for Raptor III, where the impending initial public offering makes any argument that the vehicle was at risk especially difficult to sustain. Indeed, for high-risk derivative transactions, such as the hedges involved here, it is not clear that 3%, which is the *minimum* acceptable third-party investment, would suffice even if it were at risk.

3. In light of Enron's influence over the Raptors, it is not clear that it was entitled to use the cost method of accounting, instead of the equity method. Had Enron used the equity method, any gains in the Raptor hedges would have been required to be eliminated and thus would not have provided Enron with the desired offset to its merchant investment losses.

4. It is not clear that the discount on the value of Enron stock and stock contracts created by the restriction on sale, assignment, transfer, or hedging should have been taken into account in calculating the credit capacity of the Raptors. This is

especially true after Enron subsequently collared the shares, effectively removing the justification for at least a portion of the original discount.

5. In the case of Raptor III, Enron did not record a note receivable on its balance sheet reflecting the amount owed it by the Raptor (Porcupine), and did not reduce Porcupine's net assets by the amount of that note ($259 million) in calculating Porcupine's credit capacity. By ignoring Porcupine's legal obligation to repay this note for purposes of calculating its credit capacity, Enron effectively overstated Porcupine's credit capacity by $259 million.

6. By issuing collars simultaneously with providing the Enron stock contracts in the Raptor restructuring, Enron effectively provided the vehicles a fixed return representing the difference between the sales price and the collar floor. It appears that this could have been treated for accounting purposes as a dividend paid to a stockholder, by reducing income available to shareholders in calculating earnings per share.

7. Even if the Raptor restructuring had been valid in other respects, it may not have permitted Enron to avoid reporting the $504 million impairment of the Raptor notes receivable in the first quarter of 2001. Proper accounting for this transaction should have given only prospective effect to the restructuring.

The creation, and especially the subsequent restructuring, of the Raptors was perceived by many within Enron as a triumph of accounting ingenuity by a group of innovative accountants. We believe that perception was mistaken. Especially after the

restructuring, the Raptors were little more than a highly complex accounting construct that was destined to collapse.

It is particularly surprising that the accountants at Andersen, who should have brought a measure of objectivity and perspective to these transactions, did not do so. Based on the recollections of those involved in the transactions and a large collection of documentary evidence, there is no question that Andersen accountants were in a position to understand all the critical features of the Raptors and offer advice on the appropriate accounting treatment. Andersen's total bill for Raptor-related work came to approximately $1.3 million. Indeed, there is abundant evidence that Andersen in fact offered Enron advice at every step, from inception through restructuring and ultimately to terminating the Raptors. Enron followed that advice. The Andersen workpapers we were permitted to review do not reflect consideration of a number of the important accounting issues that we believe exist.

As we note above, Enron's use of the Raptors allowed Enron to avoid reflecting almost $1 billion in losses on its merchant investments over a period spanning just a little more than one year. Without the Raptors, and excluding the $710 million pre-tax charge Enron took in the third quarter of 2001, Enron's pre-tax earnings from the third quarter of 2000 through the third quarter of 2001 would have been $429 million, rather than the $1.5 billion that Enron reported. Quarter by quarter, the Raptors' contribution to Enron's pre-tax earnings (in millions) is shown below:

Quarter	Reported Earnings	Earnings Without Raptors	Raptors' Contribution to Earnings
3Q 2000	$364	$295	$69
4Q 2000	$286	($176)	$462
1Q 2001	$536	$281	$255
2Q 2001	$530	$490	$40
3Q 2001*	($210)	($461)	$251
TOTAL	$1506	$429	$1,077

* Third quarter 2001 figures exclude the $710 million pre-tax charge to earnings related to the termination of the Raptors.

VI. OTHER TRANSACTIONS WITH LJM

In addition to Rhythms and the Raptors, Enron and the LJM partnerships engaged in almost twenty transactions from September 1999 through July 2001, when Fastow sold his interest in LJM2 to Kopper.[62] Many of these transactions illustrate well the difficulty Enron encountered, and failed to resolve, when it engaged in related-party transactions with the LJM partnerships.

On the surface, these transactions appear to be consistent with Enron's purpose in permitting Fastow to manage the partnerships: Enron sold assets to a purported third party without much difficulty, which permitted Enron to avoid consolidating the assets and record a gain in some cases. But events after many of these sales—particularly those that occurred near the end of the third and fourth quarters of 1999—call into question the legitimacy of the sales themselves and the manner in which Enron accounted for the transactions. In particular: (1) After the close of the relevant financial reporting period, Enron bought back five of the seven assets sold during the last two quarters of 1999, in some cases within three months; (2) the LJM partnerships made a profit on *every* transaction, even when the asset it had purchased appears to have declined in market value; and (3) according to a presentation Fastow made to the Board's Finance Committee, those transactions generated, directly or indirectly, "earnings" to Enron of $229 million in the second half of 1999. (This figure apparently includes the Rhythms

[62] A timeline of Enron's transactions with the LJM partnerships appears at Appendix B.

transaction, but we have not been able to confirm Fastow's calculation.) Enron recorded $570 million total in pre-tax earnings ($549 million after tax) for that period.

There is some evidence that Enron employees agreed, in undocumented side deals, to insure the LJM partnerships against loss in three of these transactions. There are also plausible, more innocent explanations for Enron's repurchases. What seems clear is that the LJM partnerships were not simply potential buyers of Enron assets on par with other third parties. Rather, Enron sold assets to the LJM partnerships that it could not, or did not wish to, sell to other buyers. The details of six transactions follow.

A. Illustrative Transactions with LJM

1. Cuiaba

In September 1999, Enron sold LJM1 a 13% stake in a company building a power plant in Cuiaba, Brazil. This was the first transaction between Enron and LJM1 after the Rhythms hedge. This sale, for approximately $11.3 million, altered Enron's accounting treatment of a related gas supply contract and enabled Enron to realize $34 million of mark-to-market income in the third quarter of 1999, and another $31 million of mark-to-market income in the fourth quarter of 1999. In August 2001, Enron repurchased LJM1's interest in Cuiaba for $14.4 million.

As of mid-1999, Enron owned a 65% stake in a Brazilian company, Empresa Productora de Energia Ltda ("EPE"), with a right to appoint three directors. A third party owned the remainder, with a right to appoint one director. Enron's Brazilian business unit wanted to reduce its ownership interest, but had difficulty finding a buyer, in part

because the plant was experiencing significant construction problems. In June 1999, Glisan, who reported to Fastow, advised the employee handling the sale effort that LJM1 would purchase an interest in EPE.

This employee negotiated the transaction with LJM1 on behalf of Enron. It is indicative of the confusion over roles that a second employee, whom the first employee believed was negotiating on behalf of LJM1, says she too was functioning as an Enron employee. The second employee, who worked in Enron Global Finance and reported to Fastow, said she believed she was an intermediary between the other Enron employee and Fastow, and that Fastow negotiated for LJM1.

The transaction was effective September 30, 1999. The terms were that LJM1 would pay Enron $11.3 million for a 13% interest in EPE and certain redeemable preference shares in an Enron subsidiary. LJM1 also would have the right to appoint one member of EPE's Board of Directors. LJM1 granted Enron the exclusive right to market LJM1's interest to other buyers. If the sale occurred before May 9, 2000, LJM1's return would be capped at 13%, and Enron would keep any excess amount. If the sale occurred after May 9, 2000, LJM1's return would be capped at 25%.[63]

Enron took the position that, as a result of the decrease in its ownership interest, it no longer controlled EPE and was not required to consolidate EPE in its balance sheet. This permitted Enron to mark-to-market a portion of a gas supply contract one of its

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[63] The date at which the cap increased was later extended to August 9, 2000, for a $240,000 fee paid to LJM1.

subsidiaries had with the project, enabling Enron to realize a total of $65 million of mark-to-market income in the second half of 1999.

After the sale to LJM1, the Cuiaba project encountered serious technical and environmental problems. Despite the fact that the value of the interest purchased by LJM1 likely declined sharply due to these problems, Enron bought back LJM1's interest on August 15, 2001, for $14.4 million. The price was calculated to provide LJM1 its maximum possible rate of return. This was not required by the terms of Enron's agreement with LJM1, which had set a maximum, not a minimum, amount that LJM1 could earn on its investment.

We were told two reasons why Enron paid this amount. The Enron employee who negotiated the buy-back said that it had become critical to Enron to gain back the board seat controlled by LJM1. He said that LJM1 had not appointed a director due to liability concerns, which left only three board members. Disputes had arisen between Enron and the third party because of cost overruns, and the third party's director could stymie action merely by leaving Board meetings and denying the Board a quorum. Skilling told us that he was not surprised that Enron bought the interest back because personnel in Enron's Brazilian subsidiary had made misrepresentations to LJM1 in connection with the original sale, and that he would have authorized a buyback with any outside party under these circumstances.

On the other hand, the Enron employee reporting to Fastow who participated in the negotiation of the original transaction told us that Fastow had told her there was a clear understanding that Enron would buy back LJM1's investment if Enron were not

able to find another buyer for the interest. We are not able to resolve the differences in recollections. LJM1's equity investment could not have been "at risk" within the meaning of the relevant accounting rule if Enron had agreed to make LJM1 whole for its investment. In that case, Enron would have been required to consolidate EPE, and could not have recognized the mark-to-market gains from the gas supply contract.

2. ENA CLO

On December 22, 1999, Enron North America ("ENA") pooled a group of loans receivable into a Trust. It sold approximately $324 million of Notes and equity, providing the purchasers certain rights to the cash flow from repayment of the loans. The securities representing these rights are known as collateralized loan obligations ("CLO's"). There were different classes, or "tranches," of these securities, representing an order of preference in which the tranches were entitled to repayment. The tranches were rated by Fitch, Inc., and marketed to institutional investors by Bear Stearns.

The lowest-rated tranches—those with last claim on the repayments of the loans in the pool—were extremely difficult to sell. It is our understanding that no outside buyer could be found. Eventually, the lowest tranche of Notes was sold to an affiliate of Whitewing (an investment partnership in which Enron is a limited partner) and LJM2. The equity tranche, which was last in line on claims to the funds flow, was bought by LJM2 for $12.9 million. LJM2 paid a total of $32.5 million for its investment. The investors in Whitewing (in which LJM2 also held an interest) were required to approve its purchase of the Notes. An Enron employee who worked on the transaction told us that

the head of the ENA finance group told one of the Whitewing investors that if the Notes defaulted, Enron would find a way to make the investor whole.

Two days before LJM2 paid $32.5 million for its interests in the CLO's Notes and equity, another Whitewing affiliate loaned LJM2 $38.5 million. This loan agreement was signed on behalf of the Whitewing affiliate by an Enron employee who had assisted in the effort to sell the CLO tranches. The employee told us she does not recall the loan transaction. We are unable to determine whether the loan was intended to fund LJM2's acquisition of the CLO securities, although the amount and timing is suggestive. This may cast doubt on the economic substance of LJM2's investment.

This CLO sale did not result in recognition of income by Enron because Enron carried the loans at fair value. However, because the loans were sold without recourse to Enron, Enron was no longer subject to the credit exposure. The loans in the CLO Trust performed very poorly; shortly after being transferred into the CLO Trust, several loans defaulted. On September 1, 2000, Enron provided credit support to the CLO Trust by giving it a put option with a notional value of $113 million. Enron did not charge the CLO Trust a premium for this option. A substantial portion of the risk related to this put option—which did not exist until September 1, 2000—was "hedged" in Raptor I, effective August 3, 2000.

The put option proved insufficient to support the CLO because the loan portfolio continued to deteriorate. In order to protect its reputation in the capital markets, in May and July 2001 Enron repurchased all of the outstanding Notes at par plus accrued interest. Enron also repurchased LJM2's equity stake at cost.

This transaction provides additional evidence (1) of a general understanding that LJM2 was available to purchase assets that Enron wished to sell but that no outside buyer wished to purchase; (2) that Enron would offer the financial assistance necessary to enable LJM2 to do this; and (3) that Enron protected LJM2 against suffering any loss in its transactions with Enron.

3. Nowa Sarzyna (Poland Power Plant)

On December 21, 1999, Enron sold to LJM2 a 75% interest in a company that owned the Nowa Sarzyna power plant under construction in Poland. Enron did not want to consolidate the asset in its balance sheet. While Enron had intended to sell the asset to a third party or transfer it to an investment partnership it was attempting to form, Enron was unable to find a buyer before year-end. Enron settled on LJM2 as a temporary holder of the asset. LJM2 paid a total of $30 million, part of it in the form of a loan and part an equity investment. Enron recorded a gain of approximately $16 million on the sale.

When this transaction closed, it was clear this would be only a temporary solution. The credit agreement governing the debt financing of the plant required Enron to hold at least 47.5% of the equity in the project until completion. Enron was able to obtain a waiver of that requirement, but only through March 31, 2000. It was unable to obtain a further waiver and, after the plant malfunctioned during a test, Enron was unable to find a buyer for LJM2's interest. On March 29, 2000, Enron and Whitewing bought out LJM2's equity interest and repaid the loan for a total of $31.9 million. This provided LJM2 approximately a 25% rate of return.

4. MEGS

On December 29, 1999, Enron sold to LJM2 a 90% equity interest in a company, MEGS LLC, that owned a natural gas gathering system in the Gulf of Mexico. Enron had attempted to sell this interest to another party, but was unable to close that transaction by year-end. Closing the transaction by the end of the year would enable Enron to avoid consolidating the asset for year-end financial reporting purposes. LJM2 purchased a $23.2 million note of MEGS for $25.6 million and an equity interest in MEGS for $743,000.

The parties apparently expected to find a permanent buyer within 90 days. The terms of the sale gave Enron an exclusive right to market the LJM2 interest for that period of time, and capped LJM2's return on any such sale at a 25% rate of return.

We were told that early reports indicated that the gas wells feeding the gathering system were performing above expectations. On March 6, 2000, Enron (though a different subsidiary) repurchased LJM2's interests. It paid LJM2 an amount necessary to give it the maximum allowed return. Subsequently, Enron recorded an impairment on the gas wells in 2001 due to diminished performance.

The decision to buy back LJM2's interests in MEGS was reflected on a DASH. Jeff McMahon, then Enron's Treasurer, at first declined to sign. Under the signature block he wrote: "There were no economics run to demonstrate this investment makes sense. Therefore, we cannot opine on its marketability or ability to syndicate." McMahon told us he did not see any sense in Enron purchasing this asset, which would simply add to Enron's balance sheet and provide only a very modest return.

5. Yosemite

In November 1999, Enron and an institutional investor paid $37.5 million each to purchase all the certificates issued by a trust called "Yosemite." In late December, Enron determined that it needed to reduce its holdings of the Yosemite certificates from 50% to 10% before the end of the year. This was so that it could avoid disclosing its ownership of the certificates in its "unconsolidated affiliates" footnote to its 1999 financial statements on Form 10-K. The plan, apparently, was for an affiliate of Whitewing, called "Condor," ultimately to acquire the Yosemite certificates Enron was selling. But for reasons that are unclear—and that none of the Enron employees who we interviewed could explain—Enron did not feel it could sell the certificates directly to Condor. Enron needed to find an intermediate owner of the certificates.

With only a short time before year-end, the Enron employees responsible for selling the Yosemite certificates believed they had no real option other than to offer the certificates to LJM2. They approached LJM2, which apparently insisted on a very large fee—$1 million or more—for LJM2 to purchase the certificates before reselling them to Condor. The Enron employees, believing that some fee was appropriate for LJM2's services, offered $100,000. Fastow then called one of the employees to complain that he was negotiating too hard about the fee, and that he was holding up a transaction that was important for Enron to complete before year-end. The employee went to McMahon, his supervisor. McMahon says he confronted Fastow about pressuring the employee. Following this discussion, LJM2 retreated and the deal closed with Enron paying the fee it originally offered.

Even apart from Fastow's intervention, the transaction itself is unusual in several respects. First, it was widely understood that LJM2 was involved simply to hold the Yosemite certificates briefly before selling them to another entity. The LJM2 Approval Sheet (which was not prepared until February 2000) clearly states, with emphasis in the original, that "*LJM2 intends to sell this investment to Condor within one week of purchase.*" Second, the legal documents show Enron selling the certificates to LJM2 on December 29, 1999, and then LJM2 selling the certificates to Condor the next day, December 30, 1999—thus disposing of the certificates before year-end. It is not clear how this would achieve Enron's financial disclosure goals. Finally, the *actual* transaction does not appear to have occurred in late December 1999 but, instead, on February 28, 2000. The transaction involved Condor loaning $35 million to LJM2, which then immediately used the proceeds to purchase the Yosemite certificates from Enron, which LJM2 immediately passed on to Condor, which resulted in the original loan to LJM2 being repaid. In other words, Condor bought the certificates from Yosemite, with the money and certificates passing—ever so briefly—through LJM2. For that, LJM2 earned $100,000 plus expenses.

6. Backbone

In the late 1990s, Enron Broadband Services ("EBS") embarked on an effort to build a nationwide fiber optic cable network. It laid thousands of miles of fiber optic cable and purchased the rights to thousands of additional miles of fiber. In mid-May 2000, EBS decided to sell by the end of the second quarter a portion of its unactivated "dark" fiber. There was substantial pressure to close the transaction so that

EBS could meet its second quarter numbers. With the quarter-end approaching, the EBS business people felt they had no choice other than to approach LJM2.

The proposed terms called for EBS to remarket the fiber after LJM2 purchased it, and capped LJM2's return on the resale at 18%. Initially, Kopper negotiated on behalf of LJM2. But as the negotiations were nearing a conclusion in late June, Fastow inserted himself in the process. He was angry that EBS proposed to sell LJM2 dark fiber that was not certified as usable, and that it might take as long as a year for it to be certified. He first confronted EBS' general counsel, Kristina Mordaunt, the former general counsel to Fastow's group and his recent partner in the Southampton Place partnership. Fastow complained to her that EBS was the most difficult business unit with which to negotiate. Fastow then complained directly to two of the lead negotiators for EBS, telling them that EBS was putting LJM2 in a difficult position by selling it uncertified fiber.

Fastow's involvement caused great distress for the EBS team. They understood that their job was to get the best deal possible for Enron, but driving a hard bargain for Enron drew the ire of Enron's CFO. The EBS team went to Causey and Ken Rice, the CEO of EBS, for assistance. Together, they decided to accommodate Fastow's concern by sweetening EBS' original offer by providing LJM2 with a 25% capped return if EBS did not resell the fiber within two years. Ultimately, the transaction closed on those terms, with LJM2 promised an 18% capped return if Enron resold the fiber within two years, and a 25% capped return if Enron sold the fiber after two years. The additional term did not come into play because the fiber was sold within two years.

The EBS business people involved in the transaction believe they obtained a good result for EBS notwithstanding Fastow's intercession. Enron recorded a $54 million gain as a result of the transaction with LJM2. Moreover, we are told that all the fiber ultimately was sold later for cash (or letters of credit) to substantial industry participants. Nonetheless, the episode illustrates well the fundamental dilemma of the Company's CFO serving concurrently as the managing partner of a business transacting with the Company.

Finally, this transaction is notable for one other reason. It is the only LJM transaction in which Lay signed the DASH and LJM2 Approval Sheet.

B. Other Transactions with LJM

Enron engaged in several other transactions in 1999 and 2000 with the LJM partnerships. A majority of these transactions involved debt or equity investments by LJM in Enron-sponsored SPEs. These SPEs owned, directly or indirectly, a variety of operating and financial assets. These transactions also included direct or indirect investments by LJM in Enron affiliates. The effect on Enron's financial statements from these transactions varied. The dates, amount of LJM's investments, and summary descriptions of these transactions are provided in the following table:

Date	Amount (in millions)	Transaction	Description
September 1999	$15	Purchase of Osprey Trust certificates	Purchase of equity in limited partner of Whitewing
December 1999	$3	Investment in Bob West Treasure	Purchase of a portion of Enron's equity in an entity that provided financing for the acquisition of natural gas reserves
January 2000	$0.7	Investment in Cortez	Purchase of equity in an SPE that held the voting rights to 25% of TNPC common stock
March 2000	$12.5	Investment in Rawhide	Purchase of equity in an SPE, which was a monetization of a pool of Enron North America and Enron International assets
May 2000	$11.3 (1)	Blue Dog	Sale of call option to Enron on contracts to purchase two gas turbines
June 2000	$10	Investment in Margaux	Purchase of equity in an SPE, which was a monetization of European power plant investments
July 2000	$42.9 (2)	Coyote Springs	Sale of put option agreement with a utility that had previously purchased Enron's right to acquire a gas turbine
July 2000	$50	Investment in TNPC	Purchase of warrants exercisable for stock of TNPC in a private placement offering
July 2000	$26	Purchase of Osprey Trust certificates	Purchase of equity in an affiliate of Whitewing
October 2000	$6.5	Purchase of Osprey Associates certificates	Purchase of equity in an affiliate of Whitewing

December 2000	$8 (3)	Investment in Fishtail	Purchase of equity in an SPE that would receive preferred economics of Enron's pulp and paper trading business
December 2000	$1	Investment in JGB Trust (Avici)	Provide equity in an SPE, which was used to monetize Enron's equity investment in Avici, which was being hedged in Raptor I
December 2000	$1.8	Investment in LAB Trust (Catalytica)	Provide equity in an SPE, which was used to monetize Enron's equity investment in Catalytica, which was being hedged in Raptor I

(1) Amount represents the notional amount under the option agreement. Enron paid $1.2 million for this option. The option was subsequently exercised by Enron.

(2) Amount represents the notional amount under the option agreement. The utility paid a premium of $3.5 million to LJM2 for this option. Subsequently, the utility assigned its rights to acquire the turbine to an Enron subsidiary.

(3) Amount represents the equity in an SPE that held the rights to paper and pulp trading operations for 5 years. Enron monetized its retained interest and recorded a $115 million gain.

VII. OVERSIGHT BY THE BOARD OF DIRECTORS AND MANAGEMENT[64]

Oversight of the related-party transactions by Enron's Board of Directors and Management failed for many reasons. As a threshold matter, in our opinion the very concept of related-party transactions of this magnitude with the CFO was flawed. The Board put many controls in place, but the controls were not adequate, and they were not adequately implemented. Some senior members of Management did not exercise sufficient oversight, and did not respond adequately when issues arose that required a vigorous response. The Board assigned the Audit and Compliance Committee an expanded duty to review the transactions, but the Committee carried out the reviews only in a cursory way. The Board of Directors was denied important information that might have led it to take action, but the Board also did not fully appreciate the significance of some of the specific information that came before it. Enron's outside auditors supposedly examined Enron's internal controls, but did not identify or bring to the Audit Committee's attention the inadequacies in their implementation.

A. Oversight by the Board of Directors

Enron's Board of Directors played a role in approving and overseeing the related-party transactions. This section examines the involvement of the Board and its Committees, where they were involved, in (1) the Chewco transaction, (2) permitting

[64] The portions of this Section describing and evaluating actions of the Board and its Committees are solely the views of Powers and Troubh.

Fastow to proceed with LJM1 and LJM2 despite his conflict of interest, (3) creating the Raptor vehicles, and (4) overseeing the ongoing relationship between Enron and LJM.[65]

1. The Chewco Transaction

We found no evidence that the Board of Directors (other than Skilling) was aware that an Enron employee, Kopper, was an investor in or manager of Chewco.[66] Because substantial Enron loan guarantees were required to permit Chewco to acquire CalPERS' interest in JEDI, the Chewco transaction was brought before the Executive Committee of the Board (by conference call) on November 5, 1997. Fastow made the presentation. According to the minutes of the meeting, Fastow reviewed "the corporate structure of the acquiring company." The minutes and the interviews we conducted do not reveal any disclosure to the Executive Committee of Kopper's role, and they do not indicate that the Executive Committee (or Lay) was asked for or made the finding necessary under Enron's Code of Conduct to permit Kopper to have a financial interest in Chewco. Both Fastow and Kopper participated in the telephonic meeting. Each had an obligation to bring Kopper's role to the Committee's attention. Fastow and Kopper have declined to be interviewed on this subject.

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[65] We have not seen any evidence that any member of the Board of Directors had a financial interest in any of the partnerships that are discussed here.

[66] Skilling said he was aware that Kopper had a managerial role in Chewco, but not that Kopper had a financial interest. He said he believes he disclosed this to the Board at some point, but we found no other evidence that he did. We also saw no evidence that the Board, other than possibly Skilling, was aware of Enron's repurchasing Chewco's interest in JEDI or of the associated tax indemnity payment.

2. Creation of LJM1 and LJM2

The Board understood that LJM1 and LJM2, both recommended by Management, presented substantially different issues. The Board discussed the advantages and disadvantages of permitting Fastow to manage each of these partnerships. The Board also recognized the need to ensure that Fastow did not profit unfairly at Enron's expense, and adopted substantial controls. Nevertheless, these controls did not accomplish their intended purpose.

LJM1. LJM1 came before the Board on June 28, 1999. The Board believed it was addressing a specific, already-negotiated transaction, rather than a series of future transactions. This was the Rhythms "hedge." It was presented as a transaction that would benefit Enron by reducing income statement volatility resulting from a large investment that could not be sold. The Board understood that (1) the terms were already fixed, (2) Enron would receive an opinion by PricewaterhouseCoopers as to the fairness of the consideration received by Enron, and (3) Fastow would not benefit from changes in the value of Enron stock that Enron contributed to the transaction. The Board saw little need to address controls over already-completed negotiations. Indeed, the Board's resolution specified that Lay and Skilling—neither of whom had a conflict of interest—would represent Enron "in the event of a change in the terms of [the Rhythms] transaction from those presented to the Board for its consideration."[67]

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[67] In fact, there were subsequent changes in the Rhythms transaction, including the additional put and call options in July 1999 and the change in the LJM1 payment from $50 million to $64 million. We found no evidence that either Lay or Skilling was

When it approved LJM1, the Board does not appear to have considered the need to set up a procedure to obtain detailed information about Fastow's compensation from or financial interest in the transactions. This information should have been necessary to ensure that Fastow would not benefit from changes in the value of Enron stock, as Fastow had promised. Even though the Board was informed that "LJM may negotiate with the Company regarding the purchase of additional assets in the Merchant Portfolio," it did not consider the need for safeguards that would protect Enron in transactions between Enron and LJM1. In fact, LJM1 did purchase an interest in Cuiaba from Enron in September 1999.

LJM2. In the case of LJM2, the proposal presented to the Board contemplated creation of an entity with which Enron would conduct a number of transactions. The principal stated advantage of Fastow's involvement in LJM2 was that it could then purchase assets that Enron wanted to sell more quickly and with lower transaction costs. This was a legitimate potential advantage of LJM2, and it was proper for the Board to consider it.[68]

Nevertheless, there were very substantial risks arising from Fastow's acknowledged conflict of interest. First, given Fastow's position as Enron's CFO, LJM2 would create a poor public appearance, even if the transactions had been immaculate and

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advised of or approved these changes, despite the Board's resolution requiring their approval of any changes.

[68] The Board was apparently not informed of the involvement of other Enron employees in LJM2, including Kopper's financial stake and the extent of the role played by other Enron employees under the Services Agreement between Enron and LJM2.

there had been sound controls. The minutes do not reflect discussion of this issue, but our interviews indicate that it was raised. During the rising stock market, analysts and investors generally ignored Fastow's dual roles and his conflict of interest, but when doubts were cast on Enron's transactions with LJM1 and LJM2 in connection with Enron's earnings announcement on October 16, 2001, this appearance became a serious problem.

Second, Fastow's position at Enron and his financial incentives and duties arising out of LJM1 and LJM2 could cause transactions to occur on terms unfair to Enron or overly generous to LJM1 and LJM2.[69] The Board discussed this issue at length and concluded that the risk could be adequately mitigated. The Directors viewed the prospective LJM2 relationship as providing an additional potential buyer for assets in Enron business units. If LJM2 offered a better price than other buyers on asset purchases or other transactions, Enron would sell to LJM2. This could occur because Fastow's familiarity with the assets might improve his assessment of the risk, or might lower his transaction costs for due diligence. In our interviews, several Directors cited these benefits of permitting Fastow to manage LJM2. If a better price was available elsewhere, Enron could sell to the higher bidder. Based on Fastow's presentation, the Directors envisioned a model in which Enron business units controlled the assets to be sold to

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[69] The presentation to the Board on LJM1 discussed the structure by which Fastow would be compensated, and therefore provided the Board with a basis for forming an expectation about the level of his compensation. The presentation to the Board on LJM2 did not. It provided only that "LJM2 has typical private equity fund fees and promote [sic]," targeted at "$200 + million institutional private equity." When LJM2 was initially approved, it does not appear that there was discussion at the Board level about a much larger fund and the levels of compensation Fastow would receive, although it was discussed later.

LJM2 (or alternative potential buyers) and would be negotiating on behalf of Enron. Because each business unit's financial results were at stake, the Board assumed they had an incentive to insist that the transactions were on the most favorable terms available in the market. This was a plausible assumption, but in practice this incentive proved ineffective in ensuring arm's-length dealings.

Moreover, several Directors stated that they believed Andersen would review the transactions to provide a safeguard. The minutes of the Finance Committee meeting on October 11, 1999 (apparently not attended by representatives of Andersen) identify "the review by Arthur Andersen LLP" as a factor in the Committee's consideration of LJM2. Andersen did in fact (1) provide substantial services with respect to structuring and accounting for many of the transactions, (2) review Enron's financial statement disclosures with respect to the related-party transactions (including representations that "the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties"), and (3) confirm Andersen's involvement in representations to the Audit and Compliance Committee at its annual reviews of the LJM transactions. The Board was entitled to rely on Andersen's involvement in these respects. In addition, one would reasonably expect auditors to raise questions to their client—the Audit and Compliance Committee—if confronted with transactions whose economic substance was in doubt, or if controls required by the Board of Directors were not followed, as was the case here.[70]

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[70] We are unable to determine why Andersen did not detect the various control failures described below. At its meeting with the Audit and Compliance Committee on May 1, 2000, an Andersen representative identified related-party transactions as an area

Further, the Board adopted, or was informed that Management had adopted, a number of controls to protect Enron's interests. When the LJM2 proposal was brought to the Finance Committee and the Board in October 1999, two specific controls were recommended and adopted:

- Enron's Chief Accounting Officer, Rick Causey, and Chief Risk Officer, Rick Buy, would review and approve all transactions between Enron and LJM2.
- The Audit and Compliance Committee of the Board would annually review all transactions from the last year "and make any recommendations they deemed appropriate."

In addition, the Board noted that Enron had no "obligation" to engage in transactions with LJM. The Board also was told that disclosures of individual related-party asset sales was "probably" required in periodic SEC filings and proxy solicitation materials, which would mean involving Enron's internal lawyers, outside counsel at Vinson & Elkins, and Andersen to review the disclosures.

Additional controls were added, or described as having been added, at later meetings. A year later, on October 6 and 7, 2000, respectively, the Finance Committee and the full Board considered a proposal with respect to a new entity, LJM3.[71] Fastow informed the Directors, in a meeting at which Skilling, Causey and Buy were present,

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to be given "high priorit[y] due to the inherent risks that were present." Moreover, in the engagement letter between Andersen and Enron dated May 2, 2000, the engagement partner wrote that Andersen's work would "consist of an examination of management's assertion that the system of internal control of Enron as of December 31, 2000, was adequate to provide reasonable assurance as to the reliability of financial statements. . . ." Because Andersen declined to permit its representatives to be interviewed, we do not know what, if any, steps Andersen took in light of these observations.

[71] LJM3 was never created.

that additional controls over transactions between Enron and LJM1 and LJM2 had been put in place. These included:

- Fastow expressly agreed that he still owed his fiduciary responsibility to Enron.
- The Board or the Office of the Chairman could ask Fastow to resign from LJM at any time.
- Skilling, in addition to Buy and Causey, approved all transactions between Enron and the LJM partnerships.
- The Legal Department was responsible for maintaining audit trails and files on all transactions.
- A review of Fastow's economic interest in Enron and LJM was presented to Skilling.

One Director also proposed that the Finance Committee review the LJM transactions on a quarterly basis. Another Director proposed that the Compensation and Management Development Committee review the compensation received by Fastow from the LJM partnerships and Enron. Both proposals were adopted by the Finance Committee.

Finally, the Finance Committee (in addition to the Audit and Compliance Committee) was informed on February 12, 2001, of still more procedures and controls:

- The use within Enron of an "LJM Deal Approval Sheet"—in addition to the normal DASH—for every transaction with LJM, describing the transaction and its economics, and requiring approval by senior level commercial, technical, and commercial support professionals. (This procedure had, in fact, been adopted by early 2000.)
- The use of an "LJM Approval Process Checklist" that included matters such as alternative sales options and counter-parties; a determination that the transaction was conducted at arm's length, and any evidence to the contrary; disclosure obligations; and review not only by Causey and Buy but also by Skilling.
- LJM senior professionals do not ever negotiate on behalf of Enron.
- People negotiating on behalf of Enron "report to senior Enron professionals apart from Andrew Fastow."

- Global Finance Commercial, Legal and Accounting Departments monitor compliance with procedures and controls, and regularly update Causey and Buy.
- Internal and outside counsel are regularly consulted regarding disclosure obligations and review any such disclosures.

These controls were a genuine effort by the Board to satisfy itself that Enron's interests would be protected.

At bottom, however, the need for such an extensive set of controls said something fundamental about the wisdom of permitting the CFO to take on this conflict of interest. The two members of the Special Committee participating in this review of the Board's actions believe that a conflict of this significance that could be managed only through so many controls and procedures should not have been approved in the first place.

3. Creation of the Raptor Vehicles

The Board authorized Raptor I in May of 2000. The Board was entitled to rely on assurances it received that Enron's internal accountants and Andersen had fully evaluated and approved the accounting treatment of the transaction, but there was nevertheless an opportunity for the members of the Board to identify flaws and pursue open questions.[72]

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[72] The Board cannot be faulted for lack of oversight over the most troubling Raptor transactions: Raptor III and the Raptor restructuring. With the possible exception of Skilling, who says he recalls being vaguely aware of these particular events, the members of the Board do not appear to have been informed about these transactions. Neither the minutes nor the witnesses we interviewed indicate that Raptor III was ever brought to the Board or its Committees. This may have been because no Enron stock was issued. Raptor III also does not appear to have been disclosed at the February 2001 meetings of the Audit and Compliance Committee or the Finance Committee. The list presented at the February 2001 meetings refers generally to "Raptors I, II, III, IV," but the Finance Committee had reason to believe the transactions referred to as Raptors III and IV were

Raptor I was presented to the Finance Committee on May 1, 2000. It was presented to the Board the following day. The Committee and Board were not given all of the details, but they were given a substantial amount of information. They understood this transaction to be another version of the Rhythms transaction, which they had approved the previous year and believed to have performed successfully. They were informed that the hedging capacity of Raptor I came from the value of Enron's own stock, with which Enron would "seed" the vehicle. They were informed that Enron would purchase a share-settled put on approximately seven million shares of its own stock. Handwritten notes apparently taken by the corporate secretary suggest that the Committee was informed that the structure "[d]oes not transfer economic risk but transfers P&L volatility." At least some members of the Committee understood that this was an accounting-related transaction, not an economic hedge. On a list the Committee (and, it appears, the Board) was shown about the risks posed by the Raptor vehicle, the first risk was of "[a]ccounting scrutiny." The list said that this risk was mitigated by the fact that the "[t]ransaction [was] reviewed by CAO [Causey] and Arthur Anderson [sic]."

We believe that each of these elements should have been the subject of detailed questioning that might have led the Finance Committee or the Board to discover the fundamental flaws in the design and purpose of the transaction. The discussion, if accurately described by the handwritten notes, suggested an absence of economic substance: a hedge that does not transfer economic risk is not a real hedge. While it is often the case that *sales* to SPEs transfer only limited economic risk, a *hedge* that does

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substantially identical to Raptor I. Raptor III, as described earlier in this Report, was not presented to or authorized by the Board.

not transfer economic risk is not a meaningful concept. Enron's purchasing a "put" on its own stock from Talon (Raptor I)—a bet against the value of that stock—had no apparent business purpose. The statement that the first risk to be considered was that of "[a]ccounting scrutiny" was a red flag that should have led to the Board's referring the proposal to the Audit and Compliance Committee for careful assessment of any controversial accounting issues, and should have led that Committee to conduct a probing discussion with Andersen.

The involvement of Enron's internal accountants, and the reported (and actual) involvement of Andersen, gave the Finance Committee and the Board reason to presume that the transaction was proper. Raptor was an extremely complex transaction, presented to the Committee by advocates who conveyed confidence and assurance that the proposal was in Enron's best interests, and that it was in compliance with legal and accounting rules. Nevertheless, this was a proposal that deserved closer and more critical examination.

4. Board Oversight of the Ongoing Relationship with LJM

Two control procedures adopted by the Board (and indeed sound corporate governance) called for specific oversight by Committees of the Board. These were periodic reviews of the transactions and of Fastow's compensation from LJM.[73]

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[73] Enron's Board of Directors met five times each year in regular meetings, and from time to time in special meetings. The regular meetings typically involved committee meetings as well. The Finance Committee and the Audit and Compliance Committee each generally met for one to two hours the afternoon before the Board meeting.

Committee Review. In addition to the meetings at which LJM1 and LJM2 were approved, the Audit and Compliance Committee and the Finance Committee reviewed certain aspects of the LJM transactions. The Audit and Compliance Committee did so by means of annual reviews in February 2000 and February 2001. The Finance Committee did so by means of a report from Fastow on May 1, 2000 and an annual review in February 2001.

The Committee reviews did not effectively supplement Management's oversight (such as it was). Though part of this may be attributed to the Committees, part may not. The Committees were severely hampered by the fact that significant information about the LJM relationship was withheld from them, in at least five respects:

First, in each of the two years in which the February annual review occurred, Causey presented to the Committees a list of transactions with LJM1 and LJM2 in the preceding year. The lists were incomplete (though Causey says he did not know this, and in any event a more complete presentation may not have affected the Committee's review): the 1999 list identified eight transactions, when in fact there were ten, and the 2000 list of transactions omitted the "buyback" transactions described earlier. Knowledge of these "buyback" transactions would have raised substantial questions about the nature and purpose of the earlier sales.

Second, Fastow represented to the Finance Committee on May 1, 2000, that LJM2 had a projected internal rate of return on its investments of 17.95%, which was consistent with the returns the Committee members said they anticipated for a "bridge" investor such as LJM2. In contrast, at the annual meeting of LJM2 limited partners on

October 26, 2000, Fastow presented written materials showing that their projected internal rate of return on these investments was 51%. While some of this dramatic increase may have been attributable to transactions after May 1—in particular the Raptor transactions—there is no indication that Fastow ever corrected the misimpression he gave the Finance Committee about the anticipated profitability of LJM2.

Third, it appears that, at the meeting for the February 2001 review, the Committees were not provided with important information. The presentation included a discussion of the Raptor vehicles that had been created the preceding year. Apparently, however, the Committees were not told that two of the vehicles then owed Enron approximately $175 million more than they had the capacity to pay. This information was contained in a report that was provided daily to Causey and Buy, but it appears that neither of them brought it to either Committee's attention.

Fourth, it does not appear that the Board was informed either that, by March of 2001, this deficit had grown to about $500 million, or that this would have led to a charge against Enron's earnings in that quarter if not addressed prior to March 31. Nor does it appear that the Board was informed about restructuring the Raptor vehicles on March 26, 2001, or the transfer of approximately $800 million of Enron stock contracts that was part of that transaction. The restructuring was directed at avoiding a charge to earnings. While these transactions may or may not have required Board action as a technical matter, it is difficult to understand why matters of such significance and sensitivity at Enron would not have been brought to the attention of the Board. Causey and Buy, among others, were aware of the deficit and restructuring. Skilling recalls being only

vaguely aware of these events, but other witnesses have told us that Skilling, then in his first quarter as CEO, was aware of and intensely interested in the restructuring.

Fifth, recent public disclosures show that Andersen held an internal meeting on February 5, 2001, to address serious concerns about Enron's accounting for and oversight of the LJM relationship. The people attending that meeting reportedly decided to suggest that Enron establish a special committee of the Board of Directors to review the fairness of LJM transactions or to provide for other procedures or controls, such as competitive bidding. Enron's Audit and Compliance Committee held a meeting one week later, on February 12, 2001, which was attended by David B. Duncan and Thomas H. Bauer, two of the Andersen partners who (according to the public disclosures) had also been in attendance at the Andersen meeting on February 5. We are told (although the minutes do not reflect) that the Committee also conducted an executive session with the Andersen representatives, in the absence of Enron's management, to inquire if Andersen had any concerns it wished to express. There is no evidence that Andersen raised concerns about LJM.

There is no evidence of any discussion by either Andersen representative about the problems or concerns they apparently had discussed internally just one week earlier. None of the Committee members we interviewed recalls that such concerns were raised, and the minutes make no mention of any discussion of the subject. Rather, according to the minutes and to written presentation materials, Duncan reported that "no material weaknesses had been identified" in Andersen's audit and that Andersen's "[o]pinion

regarding internal control ... [w]ill be unqualified."[74] While we have not had access to either Duncan or Bauer, the minutes do not indicate that the Andersen representatives made any comments to the Committee about controls while Causey was reviewing them, or recommended forming a special committee to review the fairness of the LJM transactions, or recommended any other procedures or review.

The Board cannot be faulted for failing to act on information that was withheld, but it can be faulted for the limited scrutiny it gave to the transactions between Enron and the LJM partnerships. The Board had agreed to permit Enron to take on the risks of doing business with its CFO, but had done so on the condition that the Audit and Compliance Committee (and later also the Finance Committee) review Enron's transactions with the LJM partnerships. These reviews were a significant part of the control structure, and should have been more than just another brief item on the agenda.

In fact, the reviews were brief, reportedly lasting ten to fifteen minutes. More to the point, the specific economic terms, and the benefits to LJM1 or LJM2 (or to Fastow), were not discussed. There does not appear to have been much, if any, probing with respect to the underlying basis for Causey's representation that the transactions were at arm's-length and that "the process was working effectively." The reviews did provide the Committees with what they believed was an assurance that Causey had in fact looked at the transactions—an entirely appropriate objective for a Board Committee-level review

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[74] The written materials included "Selected Observations" on financial reporting. "Related party transactions" were one of five areas singled out in this section. Andersen's comments were that "Relationship issues add scrutiny risk to: [j]udgmental structuring and valuation issues [and] [u]nderstanding of transaction completeness" and "Required disclosures reviewed for adequacy."

of ordinary transactions with outside parties.[75] But these were not normal transactions. There was little point in relying on Audit and Compliance Committee review as a control over these transactions if that review did not have more depth or substance.[76]

Review of Fastow's Compensation. Committee-mandated procedures required reviewing Fastow's compensation from LJM1 and LJM2. This should have been an important control. As much as any other procedure, it might have provided a warning if the transactions were on terms too generous to LJM1 or LJM2. It might have indicated whether the representation that Fastow would not profit from increases in the price of Enron stock was accurate. It might have revealed whether Fastow's gains were inconsistent with the understanding reported by a number of Board members that he would be receiving only modest compensation from LJM, commensurate with the approximately three hours per week he told the Finance Committee in May 2000 he was spending on LJM matters.

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[75] Or. St. § 60.357(2) (1999) ("a director is entitled to rely on information, opinions, reports or statements including financial statements and other financial data, if prepared or presented by: . . . [o]ne or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented [and] legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence . . . .").

[76] The need for careful scrutiny became even greater in May 2000, when Fastow asserted to the Finance Committee that transactions between Enron and the two LJM entities had provided earnings to Enron during 1999 of $229.5 million. Enron's total net income for the two quarters of 1999 in which the LJM partnerships had been existence was $549 million. The following year, Enron's 2000 Form 10-K disclosed that it had generated some $500 million of revenues in 2000 (virtually all of it going directly to the bottom line) from the Raptor transactions alone, thereby offsetting losses on Enron merchant investments that would otherwise have reduced earnings. These were very substantial contributors to Enron's earnings for each of those periods.

We have seen only very limited information concerning Fastow's compensation from the LJM partnerships. As discussed above in Section IV, we have seen documents indicating that Fastow's family foundation received $4.5 million in May 2000 from the Southampton investment. We also have reviewed some 1999 and 2000 Schedules K-1 for the partnerships that Fastow provided. At a minimum, the K-1s indicate that Fastow's partnership capital increased by $15 million in 1999 and $16 million in 2000, for a total of over $31 million, and that he received distributions of $18.7 million in 2000.

The Board's review apparently never occurred until October 2001, after newspaper reports focused attention on Fastow's involvement in LJM1 and LJM2. (The information Fastow provided orally to members of the Board in October 2001 is generally consistent with the figures discussed above.) The only references we have found to procedures for checking whether Fastow's compensation was modest, as the Board had expected, are in the minutes of the October 6, 2000 meeting of the Finance Committee. There, Fastow told the Committee (in Skilling's presence) that Skilling received "a review of [Fastow's] economic interest in [Enron] and the LJM funds," and the Committee then unanimously agreed that the Compensation Committee should review Fastow's compensation from LJM1 and LJM2. Although a number of members of the Compensation Committee were present at this Finance Committee meeting, it does not appear that the Compensation Committee thereafter performed a review. Moreover, Skilling said he did not review the *actual* amount of Fastow's LJM1 or LJM2 compensation. He said that, instead, he received a handwritten document (from Fastow)

showing only that Fastow's economic stake in Enron was substantially larger than his economic stake in LJM1 and LJM2.[77]

Some witnesses expressed the view that direct inquiry into Fastow's compensation would have been inappropriate or intrusive, or might have compromised the independence of LJM. We do not understand this reticence, and we disagree. First, the Board apparently *did* require inquiry into Fastow's compensation, but it either was not done or was done ineffectively. Second, we do not believe that requiring Fastow to provide a copy of his tax return from the partnerships, or similar information, would have been inappropriate. The independence of LJM was not predicated on Fastow's independence from Enron; rather, it was predicated on the existence of a structure within LJM that created limited partner control because Fastow *was* technically viewed as being controlled by Enron. Thus Enron's scrutinizing Fastow's compensation was not inconsistent with the independence of LJM.

B. Oversight by Management

Management had the primary responsibility for implementing the Board's resolutions and controls. Management failed to do this in several respects. No one

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[77] Skilling reasoned that Fastow's comparatively larger economic stake in Enron relative to his interest in the LJM partnerships would create an incentive for Fastow to place Enron's interests ahead of those of LJM1 and LJM2. This was the objective of the exercise, as Skilling saw it. While we understand this explanation, we do not believe that the reasoning is valid. Even if Fastow's economic interest in Enron were far greater than his interest in LJM1 and LJM2, his potential benefits from even one transaction that favored LJM1 or LJM2—in which he had a direct and substantial stake—might far outweigh any detriment to him as a holder of stock or options in Enron, on which the transaction could be expected to have minimal financial impact.

accepted primary responsibility for oversight, the controls were not executed properly, and there were apparent structural defects in the controls that no one undertook to remedy or to bring to the Board's attention. In short, no one was minding the store.

The most fundamental management control flaw was the lack of separation between LJM and Enron personnel, and the failure to recognize that the inherent conflict was persistent and unmanageable. Fastow, as CFO, knew what assets Enron's business units wanted to sell, how badly and how soon they wanted to sell them, and whether they had alternative buyers. He was in a position to exert great pressure and influence, directly or indirectly, on Enron personnel who were negotiating with LJM. We have been told of instances in which he used that pressure to try to obtain better terms for LJM, and where people reporting to him instructed business units that LJM would be the buyer of the asset they wished to sell. Pursuant to the Services Agreement between Enron and LJM, Enron employees worked for LJM while still sitting in their Enron offices, side by side with people who were acting on behalf of Enron. Simply put, there was little of the separation and independence required to enable Enron employees to negotiate effectively against LJM2.

In many cases, the safeguard requiring that a transaction could be negotiated on behalf of Enron only by employees who did not report to Fastow was ignored. We have identified at least 13 transactions between Enron and LJM2 in which the individuals negotiating on behalf of Enron reported directly or indirectly to Fastow.

This situation led one Fastow subordinate, then-Treasurer Jeff McMahon, to complain to Skilling in March 2000. While McMahon's and Skilling's recollections of

their conversation differ, McMahon's contemporaneous handwritten discussion points, which he says he followed in the meeting, include these notations:

- "LJM situation where AF [Andy Fastow] wears 2 hats and upside comp is so great creates a conflict I am right in the middle of."
- "I find myself negotiating with Andy [to whom he then reported] on Enron matters and am pressured to do a deal that I do not believe is in the best interests of the shareholders."
- "Bonuses do get affected -- MK [Michael Kopper], JM [Jeff McMahon]"[78]

McMahon's notes also indicate he raised the concern that Fastow was pressuring investment banks that did business with Enron to invest in LJM2.

Skilling has said he recalls the conversation focusing only on McMahon's compensation. Even if that is true, it still may have suggested that Fastow's conflict was placing pressure on an Enron employee. The conversation presented an issue that required remedial action: a solution by Management, a report to the Board that its controls were not working properly, or both. Skilling took no action of which we are aware, and shortly thereafter McMahon accepted a transfer within Enron that removed him from contact with LJM. Neither Skilling nor McMahon raised the issue with Lay or the Board.

Conflicts continued. Indeed, the Raptor transactions, which provided the most lucrative returns to LJM2 of any of its transactions with Enron, followed soon after McMahon's meeting with Skilling. The Raptor I transaction was designed by Ben

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[78] McMahon says this was a reference to his perception that Kopper, who had worked closely with Fastow, had received a very large bonus, while McMahon felt he had been penalized for his resistance with respect to LJM.

Glisan—McMahon's successor as Treasurer—who reported to Fastow, and by others in Fastow's Global Finance Group. Another Enron employee responsible for later Raptors was Trushar Patel. He was in the Global Finance Group and married to Anne Yaeger Patel, an Enron employee who assisted Fastow at LJM2. Both Yaeger Patel and Glisan also shared in the Southampton Place partnership windfall, during the same period the Raptor transactions were in progress.

The Board's first and most-relied-on control was review of transactions by the Chief Accounting Officer, Causey, and the Chief Risk Officer, Buy. Neither ignored his responsibility completely, but neither appears to have given the transactions anywhere near the level of scrutiny the Board understood they were giving. Neither imposed a procedure for identifying all LJM1 or LJM2 transactions and for assuring that they went through the required procedures. It appears that some of the transactions, including the "buybacks" of assets previously sold to LJM1 or LJM2, did not even come to Causey or Buy for review. Although Buy has said he was aware that changes were made to the Raptors during the first quarter of 2001, he also said he was not involved in reviewing those changes. He should have reviewed this transaction, like all other transactions with LJM2.

Even with respect to the transactions that he did review, Causey said he viewed his role as being primarily determining that the appropriate business unit personnel had signed off. Buy said he viewed his role as being primarily to evaluate Enron's risk.[29] It

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[29] Buy and a subordinate who assisted him on certain of the transactions have said that in cases where Enron was selling to LJM2 an interest in an asset that Enron had acquired, they checked to see that the sale price was consistent with the acquisition price.

does not appear that Causey or Buy had the necessary time, or spent the necessary time, to provide an effective check, even though the Board was led to believe they had done so.

Skilling appears to have been almost entirely uninvolved in overseeing the LJM transactions, even though in October 2000 the Finance Committee was told by Fastow—apparently in Skilling's presence—that Skilling had undertaken substantial duties.[80] Fastow told the Committee that there could be no transactions with the LJM entities without Skilling's approval, and that Skilling was reviewing Fastow's compensation. Skilling described himself to us as having little or no role with respect to the individual LJM transactions, and said he had no detailed understanding of the Raptor transactions (apart from their general purpose). His signature is absent from many LJM Deal Approval Sheets, even though the Finance Committee was told that his approval was required. Skilling said he would sign off on transactions if Causey and Buy had signed off, suggesting he made no independent assessment of the transactions' fairness. This was not sufficient in light of the representations to the Board.

It does not appear that Lay had, or was intended to have, any managerial role in connection with LJM once the entities became operational. His involvement was principally on the same basis as other Directors. By the accounts of both Lay and

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This appears to be the one point in the review process at which there was an appropriate examination of the substance of the transactions; in fact, the price of the assets sold by Enron to LJM2 does not appear to have been where the problems arose.

[80] The minutes of the October 6, 2000 meeting of the Finance Committee report Fastow saying that "Buy, Causey and Skilling review all transactions between the Company and the LJM funds." The minutes state that Skilling, along with Buy and Causey, "attended the meeting." Skilling told us that he may not have been present for Fastow's remarks.

Skilling, the division of labor between them was that Skilling, as President and COO (later CEO) had full responsibility for domestic operational activities such as these. Skilling said he would keep Lay apprised of major issues, but does not recall discussing LJM matters with him. Likewise, the Enron employees we interviewed did not recall discussing LJM matters with Lay after the entities were created other than at Board and Board Committee meetings, except in two instances after he resumed the position of CEO in August and September of 2001 (the Watkins letter, discussed in Section VII.C, and the termination of the Raptors, discussed in Section V.E.). Still, during the period while Lay was CEO, he bore ultimate management responsibility.

Still other controls were not properly implemented. The LJM Deal Approval Sheet process was not well-designed, and it was not consistently followed. We have been unable to locate Approval Sheets for some transactions. Other Approval Sheets do not have all the required signatures. The Approval Sheet form contained pre-printed check marks in boxes signifying compliance with a number of controls and disclosure concerns, with the intention that a signature would be added to certify the accuracy of the pre-printed check-marks. Some transactions closed before the Approval Sheets were completed. The Approval Sheets did not require any documentation of efforts to find third party, unrelated buyers for Enron assets other than LJM1 or LJM2, and it does not appear that such efforts were systematically pursued. Some of the questions on the Approval Sheets were framed with boilerplate conclusions ("Was this transaction done strictly on an arm's-length basis?"), and others were worded in a fashion that set unreasonably low standards or were worded in the negative ("Was Enron advised by any third party that this transaction was not fair, from a financial perspective, to Enron?"). In

practice, it appears the LJM Deal Approval Sheets were a formality that provided little control.

Apart from these failures of execution, perhaps the most basic reason the controls failed was structural. Most of the controls were based on a model in which Enron's business units were in full command of transactions and had the time *and* motivation to find the highest price for assets they were selling. In some cases, transactions were consistent with this model, but in many of the transactions the assumptions underlying this model did not apply. The Raptor transactions had little economic substance. In effect, they were transfers of economic risk from one Enron pocket to another, apparently to create income that would offset mark-to-market losses on merchant investments on Enron's income statement. The Chief Accounting Officer was not the most effective guardian against transactions of this sort, because the Accounting Department was at or near the root of the transactions. Other transactions were temporary transfers of assets Enron wanted off its balance sheet. It is unclear in some of the cases whether economic risk ever passed from Enron to LJM1 or LJM2. The fundamental flaw in these transactions was not that the price was too low. Instead, as a matter of economic substance, it is not clear that anything was really being bought or sold. Controls that were directed at assuring a fair price to Enron were ineffective to address this problem.

In sum, the controls that were in place were not effectively implemented by Management, and the conflict was so fundamental and pervasive that it overwhelmed the controls as the relationship progressed. The failure of any of Enron's Senior Management to oversee the process, and the failure of Skilling to address the problem of Fastow's influence over the Enron side of transactions on the one occasion when, by

McMahon's account, it did come to his attention, permitted the problem to continue unabated until late 2001.

C. The Watkins Letter

In light of considerable public attention to what has been described as a "whistleblower" letter to Lay by an Enron employee, Sherron Watkins, we set out the facts as we know them here. However, we were not asked to, and we have not, conducted an inquiry into the resulting investigation.

Shortly after Enron announced Skilling's unexpected resignation on August 14, 2001, Watkins sent a one-page anonymous letter to Lay.[81] The letter stated that "Enron has been very aggressive in its accounting—most notably the Raptor transactions." The letter raised serious questions concerning the accounting treatment and economic substance of the Raptor transactions (and transactions between Enron and Condor Trust, a subsidiary of Whitewing Associates), identifying several of the matters discussed in this Report. It concluded that "I am incredibly nervous that we will implode in a wave of accounting scandals." Lay told us that he viewed the letter as thoughtfully written and alarming.

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[81] Watkins, through her counsel, declined to be interviewed by us. From other sources, we understand that she is an accountant who spent eight years at Andersen, both in Houston and New York. She joined Enron in October 1993, working for Fastow in the corporate finance area. Over the next eight years, she worked in several different positions, including jobs in Enron's materials and metals operations, Enron International, and broadband. She left Enron as part of a downsizing in the spring of 2001, but returned in June 2001 to work for Fastow on a project of listing and gathering information about assets that Enron may want to consider selling.

Lay gave a copy of the letter to James V. Derrick, Jr., Enron's General Counsel. Lay and Derrick agreed that Enron should retain an outside law firm to conduct an investigation. Derrick told us he believed that Vinson & Elkins ("V&E") was the logical choice because, among other things, it was familiar with Enron and LJM matters. Both Lay and Derrick believed that V&E would be able to conduct an investigation more quickly than another firm, and would be able to follow the road map Watkins had provided. Derrick says that he and Lay both recognized there was a downside to retaining V&E because it had been involved in the Raptor and other LJM transactions. (Watkins subsequently made this point to Lay during the meeting described below and in a supplemental letter she gave to him.) But they concluded that the investigation should be a preliminary one, designed to determine whether there were new facts indicating that a full investigation—involving independent lawyers and accountants—should be performed.

Derrick contacted V&E to determine whether it could, under the legal ethics rules, handle the investigation. He says that V&E considered the issue, and told him that it could take on the matter. Two V&E partners, including the Enron relationship partner and a litigation partner who had not done any prior work for Enron, were assigned to handle the investigation. Derrick and V&E agreed that V&E's review would not include questioning the accounting treatment and advice from Andersen, or a detailed review of individual LJM transactions. Instead, V&E would conduct a "preliminary investigation," which was defined as determining whether the facts raised by Watkins warranted further independent legal or accounting review.

Watkins subsequently identified herself as the author of the letter. On August 22, one week after she sent her letter, she met with Lay in his office for approximately one hour. She brought with her an expanded version of the letter and some supporting documents. Lay recalls that her major focus was Raptor, and she explained her concerns about the transaction to him. Lay believed that she was serious about her views and did not have any ulterior motives. He told her that Enron would investigate the issues she raised.[82]

V&E began its investigation on August 23 or 24. Over the next two weeks, V&E reviewed documents and conducted interviews. V&E obtained the documents primarily from the General Counsel of Enron Global Finance. We were told that V&E, not Enron, selected the documents that were reviewed. V&E interviewed eight Enron officers, six of whom were at the Executive Vice President level or higher, and two Andersen partners. V&E also had informal discussions with lawyers in the firm who had worked on some of the LJM transactions, as well as in-house counsel at Enron. No former Enron officers or employees were interviewed. We were told that V&E selected the interviewees.

After completing this initial review, on September 10, V&E interviewed Watkins. In addition, V&E provided copies of Watkins' letters (both the original one-page letter and the supplemental letter that she gave to Lay at the meeting) to Andersen, and had a follow-up meeting with the Andersen partners to discuss their reactions. V&E also conducted follow-up interviews with Fastow and Causey.

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[82] Andersen documents recently released by a Congressional committee indicate that, on August 20, Watkins contacted a friend in Andersen's Houston office and orally communicated her concerns.

On September 21, the V&E partners met with Lay and Derrick and made an oral presentation of their findings. That presentation closely tracked the substance of what V&E later reported in its October 15, 2001 letter to Derrick. At Lay's and Derrick's request, the V&E lawyers also briefed Robert Jaedicke, the Chairman of the Audit and Compliance Committee, on their findings. The lawyers made a similar presentation to the full Audit and Compliance Committee in early October 2001.

V&E reported in writing on its investigation in a letter to Derrick dated October 15, 2001. The letter described the scope of the undertaking and identified the documents reviewed and the witnesses interviewed. It then identified four primary areas of concern raised by Watkins: (1) the "apparent" conflict of interest due to Fastow's role in LJM; (2) the accounting treatment for the Raptor transactions; (3) the adequacy of the public disclosures of the transactions; and (4) the potential impact on Enron's financial statements. On these issues, V&E observed that Enron's procedures for monitoring LJM transactions "were generally adhered to," and the transactions "were uniformly approved by legal, technical and commercial professionals as well as the Chief Accounting and Risk Officers." V&E also noted the workplace "awkwardness" of having Enron employees working for LJM sitting next to Enron employees.

On the conflict issues, V&E described McMahon's concerns and his discussions with Fastow and Skilling (described above), but noted that McMahon was unable to identify a specific transaction where Enron suffered economic harm. V&E concluded that "none of the individuals interviewed could identify any transaction between Enron and LJM that was not reasonable from Enron's standpoint or that was contrary to Enron's best interests." On the accounting issues, V&E said that both Enron and Andersen

acknowledge "that the accounting treatment on the Condor/Whitewing and Raptor transactions is creative and aggressive, but no one has reason to believe that it is inappropriate from a technical standpoint." V&E concluded that the facts revealed in its preliminary investigation did not warrant a "further widespread investigation by independent counsel or auditors," although they did note that the "bad cosmetics" of the Raptor related-party transactions, coupled with the poor performance of the assets placed in the Raptor vehicles, created "a serious risk of adverse publicity and litigation."

V&E provided a copy of its report to Andersen. V&E also met with Watkins to describe the investigation and go over the report. The lawyers asked Watkins whether she had any additional factual information to pass along, and were told that she did not.

With the benefit of hindsight, and the information set out in this Report, Watkins was right about several of the important concerns she raised. On certain points, she was right about the problem, but had the underlying facts wrong. In other areas, particularly her views about the public perception of the transactions, her predictions were strikingly accurate. Overall, her letter provided a road map to a number of the troubling issues presented by the Raptors.

The result of the V&E review was largely predetermined by the scope and nature of the investigation and the process employed. We identified the most serious problems in the Raptor transactions only after a detailed examination of the relevant transactions and, most importantly, discussions with our accounting advisors—both steps that Enron determined (and V&E accepted) would not be part of V&E's investigation. With the exception of Watkins, V&E spoke only with very senior people at Enron and Andersen.

Those people, with few exceptions, had substantial professional and personal stakes in the matters under review. The scope and process of the investigation appear to have been structured with less skepticism than was needed to see through these particularly complex transactions.[83]

[83] We note that by the time of Watkins' letter—August 2001—all of the Raptor transactions were complete with the exception of their termination, which occurred in September 2001.

VIII. RELATED-PARTY DISCLOSURE ISSUES

Enron, like all public companies, was required by the federal securities laws to describe its related-party transactions to shareholders and to members of the investing public in several different disclosure documents: the periodic reports filed with the SEC on a quarterly and annual basis, and the annual proxy solicitation materials sent to shareholders. We found significant issues concerning Enron's public disclosures of related-party transactions.

Overall, Enron failed to disclose facts that were important for an understanding of the substance of the transactions. The Company did disclose that there were large transactions with entities in which the CFO had an interest. Enron did not, however, set forth the CFO's actual or likely economic benefits from these transactions and, most importantly, never clearly disclosed the purposes behind these transactions or the complete financial statement effects of these complex arrangements. The disclosures also asserted without adequate foundation, in effect, that the arrangements were comparable to arm's-length transactions. We believe that the responsibility for these inadequate disclosures is shared by Enron Management, the Audit and Compliance Committee of the Board, Enron's in-house counsel, Vinson & Elkins, and Andersen.

A. Standards for Disclosure of Related-Party Transactions

The most basic standards governing Enron's disclosure to investors and to the market are familiar: companies must not make untrue statements of material fact, or omit material facts necessary to make the statements made, in light of the circumstances in which they were made, not misleading. Specific guidelines also govern disclosure of

transactions with related parties in proxy statements and periodic SEC filings, and in financial statement footnotes.

Item 404 of SEC Regulation S-K sets out the requirements for disclosing related-party transactions in the non-financial statement portions of SEC filings, including proxy statements and the annual reports on Form 10-K. (As many public companies do, Enron addressed the disclosure requirements of Item 404 in its 10-Ks by incorporating the discussion from the proxy statement by reference.) Item 404(a) requires disclosure of, among other things, transactions exceeding $60,000 in which an executive officer of the company has a material interest, "naming such person and indicating the person's relationship to the registrant, the nature of such person's interest in the transaction(s), the amount of such transaction(s) and, where practicable, the amount of such person's interest in the transaction(s)." The instructions to this section provide: "The materiality of any interest is to be determined on the basis of the significance of the information to investors in light of all the circumstances of the particular case. The importance of the interest to the person having the interest, the relationship of the parties to the transaction with each other and the amount involved in the transactions are among the factors to be considered in determining the significance of the information to investors."

Public companies must also provide financial statements in periodic quarterly and annual SEC filings. Statement of Financial Accounting Standards No. 57 sets forth the requirements under generally accepted accounting principles ("GAAP") concerning disclosures of related-party transactions in financial statements. Simply put, the financial statements must disclose material related-party transactions, and must include certain specific information: "(a) The nature of the relationship(s) involved; (b) A description of

the transactions, . . . and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements; (c) The dollar amounts of transactions . . . [and] (d) Amounts due from or to related parties . . . ." The standard provides that, "[i]n some cases, aggregation of similar transactions by type of related party may be appropriate," and that, "[i]f necessary to the understanding of the relationship, the name of the related party should be disclosed." SEC Regulation S-X, § 4-08(k), provides that "[r]elated party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows." These disclosures are typically provided in a footnote to the consolidated financial statements.

Following the original release of FAS 57, public companies and their professional advisors and auditors have received little guidance from the accounting profession or the SEC concerning how these standards should be applied to disclosures of particular types of transactions. Enron Management and its auditors and outside counsel were required to make many judgment calls in deciding what entities qualified as a "related party," and when and how to report transactions with them. Indeed, in light of the Enron experience, the "Big-5" accounting firms petitioned the SEC on December 31, 2001, for guidance in preparing disclosures in annual reports in several areas, including "relationships and transactions on terms that would not be available from clearly independent third parties." On January 22, 2002, the SEC issued a statement urging companies, among other things, to "consider describing the elements of the transactions that are necessary for an understanding of the transactions' business purpose and economic substance, their effects on the financial statements, and the special risks or contingencies arising from these

transactions." The SEC emphasized, however, that its guidance was meant "to suggest statements that issuers should consider in meeting their *current* disclosure obligations" and "does not create new legal requirements, nor does it modify existing legal requirements" (emphasis added).

B. Enron's Disclosure Process

Enron's related-party disclosures in its proxy statements, as well as in the financial statement footnotes in its periodic reports, resulted from collaborative efforts among Enron's Senior Management, employees in the legal, accounting, investor relations, and business units, and outside advisors at Andersen and Vinson & Elkins. Nevertheless, it appears that no one outside of Enron Global Finance, the entity principally responsible for the related-party transactions, exercised significant supervision or control over the disclosure process concerning these transactions.

The initial drafts of the footnotes to the financial statements in the periodic reports on Forms 10-Q and 10-K were prepared by Enron corporate accountants in the Financial Reporting Group. The Director of Financial Reporting circulated drafts to a large group of people, including Rex Rogers, an Enron Associate General Counsel responsible for securities law matters, in-house counsel at Enron Global Finance, the transaction support groups who worked on the transactions at issue, the Investor Relations Department, and Vinson & Elkins and Andersen. Vinson & Elkins informed us that they may not have seen all of the filings in advance. The Financial Reporting Group collected comments from the various reviewers, made changes, and distributed revised versions. This process was repeated until all outstanding issues had been resolved. We were told that Causey,

Enron's Chief Accounting Officer, was the final arbiter of unresolved differences among the various contributors to the financial reporting process. Causey told us that, while he signed the public filings and met with Andersen engagement partner Duncan to resolve certain issues, he relied on the Financial Reporting Group, lawyers, and transaction support staff for the disclosures. The Audit and Compliance Committee reviewed drafts of the financial statement footnotes and discussed them with Causey. During the relevant period, Skilling reviewed the periodic filings after the accountants and lawyers had agreed on the proposed disclosures. Causey signed the Forms 10-Q and 10-K as the Chief Accounting Officer. All of the Directors and Fastow signed the 10-Ks as well.

Preparation of the related-party transaction disclosures followed this general pattern, with one major exception: we were told that, because the related-party transactions were often extremely complex, the Enron Corp. accountants and lawyers responsible for financial reporting relied heavily on—and generally deferred to—the officers and employees in Enron Global Finance who were closer to the transactions and actually knew the details. The Financial Reporting Group circulated drafts of the related-party footnotes internally, and both Andersen and Vinson & Elkins commented on these disclosures. Causey, who was charged by the Board with approving the transactions with the LJM partnerships, paid attention to the related-party transaction footnotes, and we were told that he made the final decisions on their contents. Skilling said that he consistently looked at the discussions of related-party transactions.

While accountants took the lead in preparing the financial statement footnote disclosures, lawyers played a more central role in preparing the proxy statements, including the disclosures of the related-party transactions. This process was organized by

Associate General Counsel Rogers and lawyers working for him, with substantial advice from Vinson & Elkins. James Derrick, Enron's General Counsel, reviewed the final drafts to look for obvious errors, but otherwise had little involvement with the related-party proxy statement disclosures. He said that he relied on his staff, Vinson & Elkins, and Andersen to make sure the disclosures were correct and complied with the rules. Enron's in-house counsel say they relied on advice from Vinson & Elkins in deciding whether the proposed disclosures were adequate, particularly with respect to related-party transactions.

As with the financial statement footnotes, drafts of the proxy statements were circulated repeatedly to a wide group. The Financial Reporting Group checked the draft proxy statements to make sure that the amounts reported in the proxies were supported by the information in the financial statements, but generally was not otherwise involved in the drafting. Senior Management and the Board of Directors were given an opportunity to comment on proxy statement drafts, and they appear to have paid comparatively more attention to the proxy statements than to the financial statements in the periodic reports. We were told that members of the Board focused particular attention to the disclosures about themselves, and were not directed specifically to the related-party disclosures by Management. Lay was generally involved in the disclosure process only to the same extent as the outside directors.

There was no systematic procedure in place for ensuring identification of all transactions with related parties that needed to be disclosed in financial statement footnotes or proxy statements. In the case of the financial statement footnotes, the Financial Reporting Group included transactions of which it was aware in the first draft,

and relied on the comment process to identify any transactions that had not been included. For the proxy statements, the lawyers and accountants with Enron Global Finance generally provided the lists of relevant transactions. It does not appear that the LJM Approval Sheets or files in the legal department were consulted to ensure that all of the transactions in the period were covered by the related-party disclosures (although, as noted above, it also does not appear that the Approval Sheets were complete).

C. Proxy Statement Disclosures

1. Enron's Disclosures

The "Certain Transactions" sections of Enron's proxy statements in 2000 and 2001 included disclosures of transactions with the LJM partnerships.

Enron described the establishment of LJM1 and LJM2 in its May 2000 proxy statement. Each was described as "a private investment company that primarily engages in acquiring or investing in energy and communications related investments." Concerning LJM1, Enron disclosed that "Andrew S. Fastow, Executive Vice President and Chief Financial Officer of Enron, is the managing member of LJM1's general partner. The general partner of LJM1 is entitled to receive a percentage of the profits of LJM1 in excess of the general partner's proportion of the total capital contributed to LJM1, depending upon the performance of the investments made by LJM1." Essentially the same disclosure was repeated with respect to LJM2. The proxy statement did not give the amount of compensation Fastow had received, or specify the compensation formula in any more detail.

The 2000 proxy statement discussed the Rhythms transaction with LJM1 by describing the details of the "effect" of "a series of transactions involving a third party and LJM Cayman, L.P." The disclosures identified the number of shares of Enron stock and other instruments that changed hands, but did not describe any purpose behind the transactions. The disclosures said that, "[i]n connection with the transactions, LJM1 agreed that Mr. Fastow would have no pecuniary interest in such Enron Common Stock and would be restricted from voting on matters related to such shares."

The proxy statement next disclosed that, "[i]n the second half of 1999, Enron entered into eight transactions with LJM1 and LJM2," and then described them in general terms:

> In six of these transactions, LJM1 and/or LJM2 acquired various debt and equity securities of certain Enron subsidiaries and affiliates that were directly or indirectly engaged in the domestic and/or international energy business. The aggregate consideration agreed to be paid to Enron pursuant to these six transactions was approximately $119.3 million. In the seventh transaction, LJM2 paid $12.9 million for an equity interest in an Enron securitization vehicle (that owned approximately $300 million of merchant assets) and loaned $19.6 million to such vehicle. In the eighth transaction, LJM2 borrowed $38.5 million from an Enron affiliate, which loan was outstanding at year end.

The 2000 proxy statement also included representations concerning the arm's-length nature of the transactions with LJM. Concerning LJM1, Enron stated that "[m]anagement believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties." With respect to LJM2, Enron included the same representation and added that "[t]hese transactions occurred in the ordinary course of Enron's business and were negotiated on an arm's-length basis with senior officers of Enron other than Mr. Fastow."

Enron's 2001 proxy statement again identified Fastow as the managing member of LJM2's general partner and repeated the assertion that the transactions with LJM2 "occurred in the ordinary course of Enron's business and were negotiated on an arm's length basis with senior officers of Enron other than Mr. Fastow." The transactions themselves were discussed in two groups, and for each Enron combined a general description of the purpose of the transactions with an aggregated summary of the terms. Concerning the acquisition by LJM2 of Enron assets, the proxy statement said:

> During 2000, [Enron] entered into a number of transactions with [LJM2] . . . primarily involving either assets Enron had decided to sell or risk management activities intended to limit Enron's exposure to price and value fluctuations with respect to various assets . . . . In ten of these transactions LJM2 acquired various debt and equity securities, or other ownership interests, from Enron that were directly or indirectly engaged in the domestic and/or international energy or communication business, while in one transaction LJM2 acquired dark fiber from an Enron subsidiary. The aggregate consideration to be paid to Enron pursuant to these eleven transactions was approximately $213 million. Also during 2000, LJM2 sold to Enron certain merchant investment interests for a total consideration of approximately $76 million.

Concerning the derivative transactions with LJM2, the proxy statement said:

> Also, during 2000, Enron engaged in other transactions with LJM2 intended to manage price and value risk with regard to certain merchant and similar assets by entering into derivatives, including swaps, puts, and collars. As part of such risk management transactions, LJM2 purchased equity interests in four structured finance vehicles for a total of approximately $127 million. Enron, in turn, contributed a combination of assets, Enron notes payable, restricted shares of outstanding Enron stock (and the restricted right to receive additional Enron shares) in exchange for interests in the vehicles. Enron and LJM2 subsequently entered into derivative transactions through these four vehicles with a combined notional amount of approximately $2.1 billion.

2. Adequacy of Disclosures

Given the circumstances in which Enron now finds itself, it is difficult to avoid coloring a review of prior disclosure documents with the benefit of 20/20 hindsight. We have tried to avoid that impulse. Indeed, there were substantial disclosures regarding most of the related-party transactions at issue here, including their magnitude and even some of the "mechanics" of the transactions. Any reader of those disclosures should have recognized that these arrangements were complex, the dollar amounts involved were substantial, and the transactions were significant for evaluating the Company's financial performance. Nevertheless, the disclosures were fundamentally inadequate.

Fastow's Compensation. The failure to set forth Fastow's compensation from the LJM transactions and the process leading to that decision raise substantial issues. Item 404 of Regulation S-K required the disclosure "where practicable" of "the amount of [Fastow's] interest in the transactions." We have been told that there was significant discussion, both within Enron Management and with outside advisors, about whether Enron could avoid disclosing Fastow's compensation from the related parties in the face of that fairly clear language. The consensus of people involved in drafting the proxy disclosures was to accommodate the strong desire of Fastow (and others) to avoid disclosure if there was a legitimate basis to do so.

For the 2000 proxy statement, the issue was discussed among members of Enron's Senior Management, its in-house counsel, its lawyers at Vinson & Elkins, and Andersen. In the end, the proxy statement simply noted that the general partner of LJM1 and LJM2, of which Fastow was the managing member, was entitled to a share of the

profits in excess of its proportional capital investment in the partnership. The rationale, as memorialized in a memorandum written by Jordan Mintz, the General Counsel of Enron Global Finance, was that the "where practicable" language of Item 404 (referred to above) provided the basis for not setting forth the amount of Fastow's compensation from LJM. Because the majority of transactions between Enron and LJM1 or LJM2 were "open" during the proxy reporting period—that is, the ultimate and final determination of obligations and payments remained uncertain—the in-house and outside counsel concluded it was not "practicable" to determine what Fastow had earned as the managing member of the general partner.

The same rationale applied to the multiple "open" transactions in place at the time the 2001 proxy statement was prepared, although it was acknowledged that some of the transactions had closed in 2000 or early 2001 and the rationale would have little force once most of the transactions closed. The lawyers apparently did little if any investigation into what proportion of the transactions remained open at the time of the 2001 proxy statement filing.

The Rhythms transaction had terminated in early 2000, however, and the lawyers understood that Fastow had received compensation from LJM1 for that transaction. Enron therefore needed a different basis or theory to support the decision not to disclose. The Enron lawyers and Vinson & Elkins began with the assumption that the 2000 proxy statement had already met all disclosure requirements related to the Rhythms transaction, even without reference to the economic interest of Fastow. The 2001 proxy would have covered the compensation Fastow received from the unwind in 2000 of the Rhythms position. The lawyers reasoned that the Rhythms transaction had terminated in 2000

"pursuant to terms allowed for under the original agreement" entered into in 1999. Because the prior proxy statement had addressed the disclosure requirements relating to the Rhythms transaction, they decided that no financial information regarding what Fastow earned in the transaction had to be disclosed in 2001—notwithstanding that it was now more "practicable" to do so.

It turns out that the factual premise on which the lawyers based this analysis in the Memorandum—that "there was no new transaction involving LJM1 and Enron in the year 2000"—was wrong. In fact, Enron gave an in-the-money put option to LJM Swap Sub in 2000 in connection with the unwinding of the Rhythms transaction. Even without this new put option, however, it was questionable to say that the termination simply "occurred under conditions permitted in the original agreement." That statement was true to the extent that nothing in the original agreement prohibited an early termination, but the agreement did not prescribe a termination process or terms. At least some lawyers involved in the disclosure process knew that the unwind of the Rhythms transaction had been carefully negotiated in 2000.

Beyond this factual problem, the non-disclosure rationale seems to have missed the point. Although the precise amount of compensation to which Fastow ultimately was entitled may still have been subject to adjustment, the magnitude of the amount was knowable and should have been disclosed. Furthermore, the instructions to Item 404 provide that "[t]he amount of the interest of any person [subject to disclosure] . . . shall be computed without regard to the amount of the profit or loss involved in the transaction(s)." This instruction, in addition to the basic purpose of the proxy disclosure rules on the interests of Management in transactions with the Company, seems to have

been lost. Enron had an obligation to disclose the "amount of [Fastow's] *interest* in the transaction(s)" (emphasis added), not just his income. The lawyers apparently searched for and embraced a technical rationale to avoid that disclosure.

It appears that the in-house Enron lawyers and Vinson & Elkins agreed with these disclosure decisions, although Mintz wrote that "[t]he decision not to disclose in this instance was a close call; arguably, the more conservative approach would have been to disclose." The memorandum he wrote suggests that "other pertinent (and competing) issues" that Fastow had raised led or contributed to the non-disclosure decision, which was only possible because of a quirk of timing. As the memorandum said, "[i]t was, perhaps, fortuitous that the RhythmsNet transaction extended over two proxy filing years and our knowledge of certain facts was delinked by two separate filings; thus, we have relied on two different arguments for avoiding financial disclosure for you as the LJM1 general partner in 1999 and 2000." We have been told that a number of people expressed varying degrees of skepticism about the rationales for not disclosing the amount of Fastow's compensation, but that none objected strongly.[84]

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[84] Mintz did warn Fastow that it was highly likely that his compensation from the LJM transactions would have to be disclosed in Enron's 2002 proxy statement. It is unclear to what extent this warning contributed to Fastow's decision to sell his interest in LJM2 in the third quarter of 2001. In May 2001, Mintz also retained an outside law firm (Fried, Frank, Harris, Shriver & Jacobson from Washington, D.C.) to examine Enron's relationship with the LJM partnerships, Enron's prior disclosures, and the disclosures that might be required even after Fastow sold his interest in LJM2. In June 2001, Fried, Frank provided a summary of the relevant standards, raised some questions concerning prior disclosures, and made some preliminary recommendations for future filings in light of Fastow's decision to sell his interest in LJM2. From what we have seen, Fried, Frank did not take particular issue with the prior disclosure decisions concerning Fastow's compensation.

The disclosure decisions concerning Fastow's interest in the LJM transactions were also made without the key participants knowing the amount—or even the magnitude—of the interest in question. This is because no one—not members of Senior Management (such as Lay, Skilling or Causey), not the Board, and not Vinson & Elkins—ever pressed for the information, and Fastow did not volunteer it.[85/] The amount of the interest should have weighed in the disclosure decision. Senior Management apparently permitted Fastow to avoid answering the relevant portion of the questionnaires designed to collect information from all executives and directors for the proxy statement disclosures. In 2000, Fastow responded to the questionnaire by attaching an addendum at the suggestion of the lawyers referring the reader to the then-General Counsel of Enron Global Finance for information on Fastow's interests in LJM1 and LJM2. In 2001, Fastow attached an addendum approved by in-house and outside counsel saying only that "the nature of my relationship between LJM1 and LJM2 (including payments made, or proposed to be made, between such entities and Enron) are [sic] described in the Company's 1999 and 2000 Proxy Disclosure under 'Certain Transactions.'"

Descriptions of the Transactions. Item 404(a) of Regulation S-K also requires a description of the related-party transactions in which the amount of the transaction exceeds $60,000 and an executive has a material interest. All of Enron's transactions

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85/ As we have explained (see Section VII.A.), the Finance Committee of the Board in October 2000 asked the Compensation Committee to review the compensation received by Fastow from the LJM partnerships. This request reflected a recognition that the compensation information was important for the Board and management to know, but the review apparently was not conducted.

with the LJM partnerships discussed in this Report met this threshold and had to be disclosed.

For the most part, the Company's proxy statement descriptions of the related-party transactions with LJM1 and LJM2 were factually correct, as far as they went. Nevertheless, it is difficult for a reader of the proxy statements to understand the nature of the transactions or their significance. The disclosures omit several important facts. The 2001 proxy, for example, refers to the sale by LJM2 of certain merchant investments to Enron in 2000 for $76 million. This disclosure, however, omits the fact that these transactions were buybacks of assets that Enron had sold to LJM2 the year before in what were described (in the prior year's proxy statement) as arm's-length transactions. And, while Enron contributions to the Raptor entities are mentioned, the document does not disclose that, by the terms of the deal, $82 million was distributed to LJM2 (and therefore to its partners) from Raptors I and II in 2000, even before those entities began derivative transactions with Enron. This last fact is of critical importance to any fair assessment of the transaction.

D. Financial Statement Footnote Disclosures

1. Enron's Disclosures

Enron included a footnote concerning "Related Party Transactions" to the financial statements in its reports on Forms 10-Q and 10-K beginning with the second quarter of 1999, when the transactions with the LJM partnerships began, through the second quarter of 2001. The disclosures in those footnotes fall into several categories.

Structure of LJM1 and LJM2. The description of LJM1 in the 10-Q for the second quarter of 1999 was similar to the one the Company used in the 2000 proxy statement, described above. The footnote said that "[a] senior officer of Enron is managing member of LJM's general partner." This footnote did not identify Fastow as the "senior officer of Enron," nor did the financial statement disclosure in any subsequent period. The disclosure also did not detail how LJM or Fastow would be compensated in the transactions, although it did say that "LJM agreed that the Enron officer would have no pecuniary interest in . . . Enron common shares and would be restricted from voting on matters related to such shares or to any future transactions with Enron." Substantially the same disclosures were made in the third quarter 10-Q and in the 1999 10-K.

The Company first described LJM2 in the 1999 10-K. Enron stated that "LJM2 Co-Investment, L.P. (LJM2) was formed in December 1999 as a private investment company which engages in acquiring or investing in primarily energy-related or communications-related businesses" and that LJM2 "has the same general partner as LJM[1]."

In the 10-Q for the second quarter of 2000, Enron described the LJM partnerships as follows: "In the first half of 2000, Enron entered into transactions with limited partnerships (the Related Party), whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron." From the second quarter of 2000 forward, Enron did not identify LJM1 or LJM2 by name in the financial statement disclosures, using the generic term "Related Party" instead. This description was substantially unchanged until the second quarter of 2001, when the 10-Q reflected the sale of Fastow's interest in LJM by stating that "the senior officer,

who previously was the general partner of these partnerships, sold all of his financial interests as of July 31, 2001, and no longer has any management responsibilities for these entities" and that, "[a]ccordingly, such partnerships are no longer related parties to Enron."

In the 10-Qs for the first and second quarters of 2001, Enron represented that "[a]ll transactions with the Related Party are approved by Enron's senior risk officers as well as reviewed annually by the Board of Directors."

Descriptions of Transactions. Significant portions of the financial statement footnotes on related-party transactions were devoted to descriptions of transactions between Enron and the LJM partnerships.

Beginning with the 10-Q filed for the second quarter of 1999, Enron discussed the Rhythms transaction with LJM1 much as it did in the 2000 proxy statement. The disclosures identified the number of shares of stock and other instruments that changed hands; the description in the 1999 10-K removed the numbers of shares. In the 10-Q for the first quarter of 2000, the footnote described the April 2000 termination of the Rhythms transaction with a number of the transaction particulars.

Beginning with the 1999 10-K, Enron disclosed in each periodic filing that LJM1 and/or LJM2 acquired, directly or indirectly, merchant assets and other investments from Enron. These assets were not specifically identified in the disclosures; instead, Enron gave only the approximate dollar value of the assets, either individually or by groupings of similar transactions. We were told that Enron had a general corporate policy, not limited to related-party transactions, against identifying counter-parties in financial

statement footnotes. The Financial Reporting Group maintained backup materials to support the figures in the financial statement footnotes, and to identify the specific transactions that were covered by the related-party disclosures.

Enron introduced the first Raptor transactions in the 10-Q for the second quarter of 2000, and provided more detailed disclosures for all four Raptor vehicles in the 10-Q for the third quarter and in the 2000 10-K. These disclosures had two main parts: a fairly detailed description of the contributions Enron made to the Raptor Vehicles (referred to as the "Entities") at their creation, and a discussion of the derivative transactions between Enron and the Raptor Vehicles through which Enron sought to hedge certain merchant investments and other assets. In the third quarter 10-Q and the 10-K, Enron disclosed that it had recognized revenues of approximately $60 million and $500 million, respectively, related to the derivative transactions, which offset market value changes of certain merchant investments. (The 10-Qs for the first, second, and third quarters of 2001 included corresponding sets of disclosures.) The 10-Qs for the first and second quarters of 2001 identified instruments that the various parties to the Raptor restructuring transactions received.

Assertions That Transactions Were Arm's-Length. In each of the financial statement footnote disclosures concerning the transactions with LJM, Enron made a representation apparently designed to reassure investors that the transactions were fair to the Company. The language of this disclosure changed a number of times during the period at issue.

Enron stated in the 10-Q for the second and third quarters of 1999 that "[m]anagement believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties." The 10-K for 1999, however, removed the assertion that the transactions were "reasonable" and represented instead only that "the terms of the transactions with related parties are *representative of terms that would be negotiated* with unrelated third parties" (emphasis added). The reasonableness assertion reappeared in the disclosures for the first quarter of 2000, modifying the 1999 10-K version to read: "the terms of the transactions with related parties were reasonable and are representative of terms that would be negotiated with unrelated third parties." Enron used this formulation until the 10-K for 2000, which conditioned the assertion of reasonableness to claim only that "the transactions with the Related Party were reasonable *compared to those which could have been negotiated* with unrelated third parties" (emphasis added).

Although the paper trail details the iterations through which these management assertions passed during the drafting process, it is unclear who was responsible for the changes, or to what extent these changes were intended to reflect substantive differences in the characterizations of the transactions. We also do not know what steps Management or Andersen took to verify that the assertions were true before they were made. Handwritten notes next to the management assertion on drafts of the 1999 10-K read "need positive evidence" and "needs research."

We learned that some consideration was given to expanding the discussion of the fairness of the related-party transactions to Enron by describing certain advantages that had been identified at the time that Board approval was sought. Handwritten notes on

drafts of the 10-K for 2000 suggest adding that "transacting with the Related Party provides Enron with additional benefits related to the speed of execution and a counterparty who has a better understand[ing] of complex transactions." In the end, however, the drafters of the disclosures decided against including these or other similar reasons for the related-party transactions.

2. Adequacy of Disclosures

The financial statement footnote disclosures in the periodic reports were comparatively more detailed (except with respect to Fastow's interest in the transactions) than the proxy statement disclosures. Nevertheless, the footnote disclosures failed to achieve a fundamental objective: they did not communicate the essence of the transactions in a sufficiently clear fashion to enable a reader of the financial statements to understand what was going on. Even after months of investigation, and with access to Enron's information, we remain uncertain as to what transactions some of the disclosures refer. The footnotes also glossed over issues concerning the potential risks and returns of the transactions, their business purpose, accounting policies they implicated, and contingencies involved. In short, the volume of details that Enron provided in the financial statement footnotes did not compensate for the obtuseness of the overall disclosure. FAS Statement No. 57 required Enron to provide "[a] description of the transactions, . . . *and such other information deemed necessary to an understanding of the*

effects of the transactions on the financial statements" (emphasis added). We think that Enron's related-party transaction disclosures fell short of this goal.[86]

Beyond this general point, our investigation found two particular problems with the related-party disclosures in the financial statement footnotes:

First, Enron lacked the factual basis required by the accounting literature to make the assertions in each SEC filing concerning how the LJM transactions compared to transactions with unrelated third parties. We were told by Enron officers and employees that they believed this management assertion to be *required* under the accounting literature. In fact, the accounting literature provides: "Transactions involving related parties *cannot* be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related-party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated." Statement of Financial

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[86] In June 2001, outside lawyers from the Fried, Frank firm, who had been asked by Mintz to look over the related-party transaction disclosures around the time of Fastow's sale of his interest in LJM2, reported the following concerning disclosure of LJM transactions: "Prior 10-Q disclosure appeared to leave some informational gaps, which were noted by those who commented on the Company's filings. We want to emphasize that we are not in a position to evaluate whether material information was omitted from the prior statements, and have not done so. However, from the standpoint of closing the discussion of these matters once and for all, we would consider supplementing the prior disclosures, where it is possible to do so, especially on such points as the purpose of the specific transactions entered into and the 'bottom-line' financial impact on the Company and the LJM partners."

Accounting Standards No. 57, ¶ 3 (emphasis added).[87] We have not been able to identify any steps taken by Enron Management, Andersen, or Vinson & Elkins to substantiate the assertions that the LJM transactions were "representative of" or "reasonable compared to" similar transactions with unrelated third parties—even though notes on some drafts refer to questions being raised about factual support for these representations.[88] Indeed, based on the terms of the deals, it seems likely that many of them could *only* have been entered into with related parties.

Second, the publicly filed financial statement disclosures omitted a number of key details about the transactions. For example, the Company disclosed in the 2000 10-K that "Enron paid $123 million to purchase share-settled options from the [Raptor] Entities on 21.7 million shares of Enron common stock." What it did not disclose, however, was that Enron purchased *puts* on Enron stock. It likely would have been relevant to investors that

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[87] Auditors are under an obligation not to agree to such disclosures without substantiation: "Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or, assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he or she should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality . . . ." AICPA, Codification of Statements on Auditing Standards, § 334.12, Related Parties.

[88] The Fried, Frank review in June 2001 identified this issue as well, urging the company to identify what members of "management" had reviewed the transactions and what they had done. The firm also suggested to Mintz that the Audit and Compliance Committee, or a special committee of the Board appointed for this purpose, conduct "a review of the fairness of the terms of the transactions to the Company" to bolster the documentation for these representations. It does not appear that such a review was undertaken.

Enron had entered into a derivative transaction that was, on its face, predicated on the assumption that its stock price would decline substantially. Another example: Enron explained that the LJM partnerships bought merchant assets from Enron, but the footnote disclosures failed to mention that Enron repurchased some of these assets—sometimes within a matter of months, and sometimes before the periodic filing was made. No one interviewed in our inquiry could provide a plausible explanation why the repurchases from the related parties should not have been disclosed in the same manner as the original sales. It is fair to conclude that disclosure of the repurchases so close in time to the original transactions could have called the economic substance of the reported transactions with LJM into question.[89]

E. Conclusions on Disclosure

Based on the foregoing information, the Committee has reached several general conclusions concerning the disclosures of related-party transactions in Enron's proxy statements and in the financial statement footnotes in the Company's periodic filings.

First, while it has been widely reported that the related-party transactions connected to Fastow involved "secret" partnerships and other SPEs, we believe that is not

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[89] Enron explained in the 10-Q for the second quarter of 2001 that "the senior officer, who previously was the general partner of these [LJM] partnerships, sold all of his financial interests . . . and no longer has any management responsibilities for these entities." It did not disclose, however, that the interest was sold to Kopper, then a former employee of Enron, and therefore gave an impression that the interest would be held more independently from Enron than it was. We were told that Vinson & Elkins recommended disclosure of this fact, but that Enron's Investor Relations Department objected, and the Vinson & Elkins lawyers felt that they could not say it was legally required.

generally the case. Although Enron could have, and we believe in some respects should have, been more expansive under the governing standards in its descriptions of these entities and Enron's transactions with them, the fact remains that the LJM partnerships, the Raptor entities, and transactions between Enron and those entities all were disclosed to some extent in Enron's public filings.

Second, Enron's disclosures and the information we have about how they were drafted reflect a strong predisposition on the part of at least some in the Company to minimize the disclosures about the related-party transactions. Fastow made clear that he did not want his compensation from the LJM partnerships to be disclosed, and the process reflected a general effort to say as little as possible about these transactions. While we recognize that Enron was not alone in seeking to say as little as the law allowed, particularly on sensitive subjects, we were told by more than one person that the Company spent considerable time and effort working to say as little as possible about the LJM transactions in the disclosure documents. It also appears that Enron Management structured some transactions to avoid disclosure (such as the Chewco and Yosemite transactions described above). That impulse to avoid public exposure, coupled with the significance of the transactions for Enron's income statements and balance sheets, should have raised red flags for Senior Management, as well as for Enron's outside auditors and lawyers. Unfortunately, it apparently did not.

Third, the inadequate disclosures concerning the related-party transactions resulted, at least in part, from the fact that the process leading to those disclosures appears to have been driven by the officers and employees in Enron Global Finance, rather than by Senior Management with ultimate responsibility, in-house or outside

counsel, or the Audit and Compliance Committee. In fairness, the complexity of the transactions in question made it difficult for those not involved in their actual negotiation or structuring to have been sufficiently steeped in the details to allow for a complete understanding of the essence of what was involved. Nevertheless, the in-house and outside lawyers should have been familiar with the securities law disclosure requirements and should have exercised independent judgment about the appropriateness of the Company's statements. Causey was the Chief Accounting Officer and was specifically charged by the Board with reviewing Enron's transactions with the LJM partnerships. Causey should have been in a unique position to bring relative familiarity with the transactions to bear on the disclosures. The evidence we have seen suggests he did not. Similarly, the Audit and Compliance Committee reviewed the draft disclosures and had been charged by the Board with reviewing the related-party transactions. It appears, however, that none of these people independent of the Enron officers and employees responsible for the transactions provided forceful or effective oversight of the disclosure process.

Fourth, while we have not had the benefit of Andersen's position on a number of these issues, the evidence we have seen suggests Andersen accountants did not function as an effective check on the disclosure approach taken by the Company. Andersen was copied on drafts of the financial statement footnotes and the proxy statements, and we were told that it routinely provided comments on the related-party transaction disclosures in response. We also understand that the Andersen auditors closest to Enron Global Finance were involved in the drafting of at least some of the disclosures. An internal Andersen e-mail from February 2001 released in connection with recent Congressional

hearings suggests that Andersen may have had concerns about the disclosures of the related-party transactions in the financial statement footnotes. Andersen did not express such concerns to the Board. On the contrary, Andersen's engagement partner told the Audit and Compliance Committee just a week after the internal e-mail that, with respect to related-party transactions, "[r]equired disclosure [had been] reviewed for adequacy," and that Andersen would issue an unqualified audit opinion on the financial statements.

APPENDIX A

GLOSSARY

balance sheet

a financial report that shows the company's assets, liabilities, and shareholders' equity as of the close of a reporting period

call

an option that entitles the option holder to buy from the counter-party a commodity, financial instrument, or other asset at an exercise or strike price throughout the option term or at a fixed date in the future (the expiration date)

collar

a derivative transaction combining a put and a call (one written and one purchased) that effectively sets a limit on the gain and the loss that the holder of the contract will realize

consolidated financial statement

a financial statement that brings together all the assets, liabilities, and operating results of a parent company and its subsidiaries, as if the group were a single enterprise

cost method of accounting

an accounting method whereby an investor records an investment at the cost it paid, and does not record any gains or losses until receiving a distribution or disposing of that investment

costless collar

a collar in which the premiums payable on the put and the call equal one another, so neither party pays the other at the inception of the transaction

credit capacity

a counter-party's ability to meet its financial obligations

derivative

a contract whose value is based on the performance of an underlying financial asset, index, or other investment

equity method of accounting

an accounting method whereby an investor initially records an investment in an entity at cost and then, in contrast to the cost method of accounting, adjusts that amount to recognize its share of the entity's earnings or losses The investor does not recognize any gains or losses resulting from its transactions with the entity

fair value

the amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties

fairness opinion

professional judgment on the fairness of the price being offered in a transaction

Form 10-K

annual report filed with the Securities and Exchange Commission providing a comprehensive overview of the registrant's business and filed within 90 days after the end of the company's fiscal year

Form 10-Q

quarterly report filed with the Securities and Exchange Commission for each of the first three fiscal quarters of the company's fiscal year and due within 45 days of the close of the quarter

forward contract

a contract to purchase or sell a specific quantity of a commodity, currency, or financial instrument at a specified price with delivery and settlement at a specified future date

hedge

a strategy used to minimize price risk

income statement

a summary of the revenues, costs, and expenses of a company during an accounting period

in the money

a call option is in-the-money if the price of the underlying commodity, financial instrument, or other asset exceeds the strike or exercise price; a put option is in-the-money if the strike or exercise price exceeds the price of the underlying commodity, financial instrument, or other asset

joint venture

an enterprise owned and operated by a limited number of parties (the joint venturers) as a separate and specific business or project for their mutual benefit

merchant investment

an investment in a public or private equity, debt security, loan, or an interest in a limited partnership that is carried at fair value

notional value or notional amount

the face value of the underlying instrument on which a derivative is contracted

option premium

amount paid for the right to either buy or sell the underlying commodity, financial instrument, or other asset at a particular price within a certain time period

promissory note

written promise committing the party writing the note to pay the holder of the note a specified sum of money, either on demand or at a certain date, with or without interest

proxy statement

information that the Securities and Exchange Commission requires companies to provide to shareholders before they vote by proxy on company matters

put

an option that entitles the option holder to sell to the counter-party a commodity, financial instrument, or other asset at an exercise or strike price throughout the option term or at a fixed date in the future (the expiration date)

share-settled derivative

a derivative contract in which the party with a loss delivers to the party with a gain shares or units of the underlying commodity, financial instrument, or other asset

special purpose entity (or special purpose vehicle)

typically an entity created for a limited purpose, with a limited life and limited activities, and designed to benefit a single company

total return swap

an arrangement whereby one party agrees to pay the other party the appreciation from an asset and receive payments from the other party for the depreciation of an asset

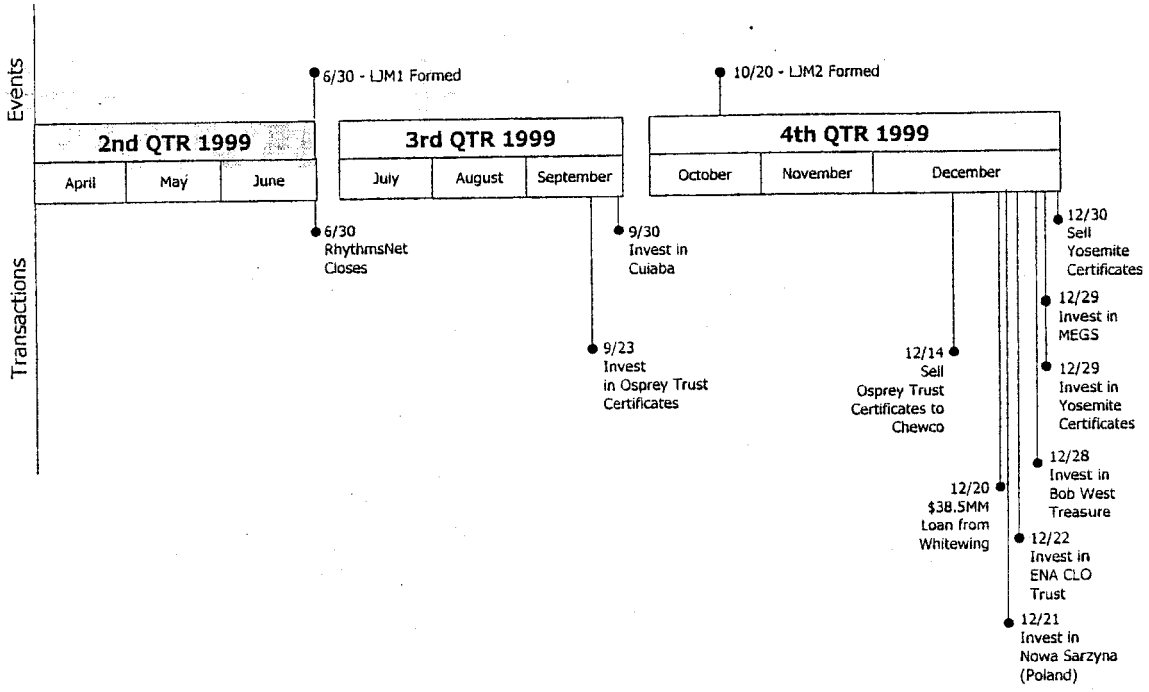
warrant

option to purchase a specified number of shares of stock at a stated price for a specific time period

APPENDIX B

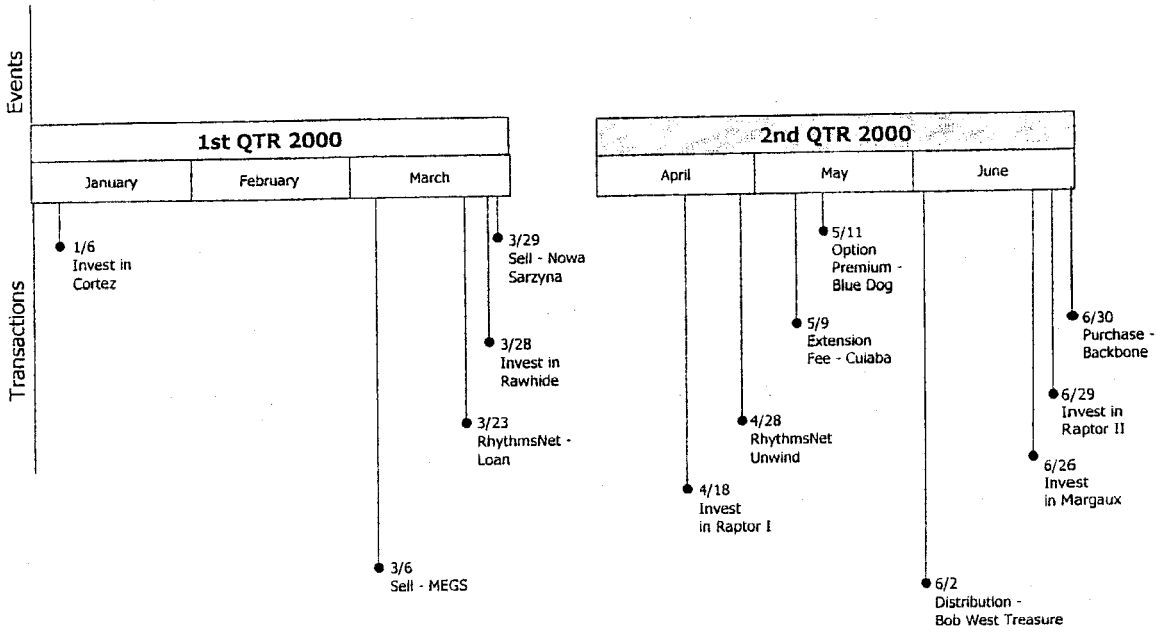
Timeline

June – December 1999



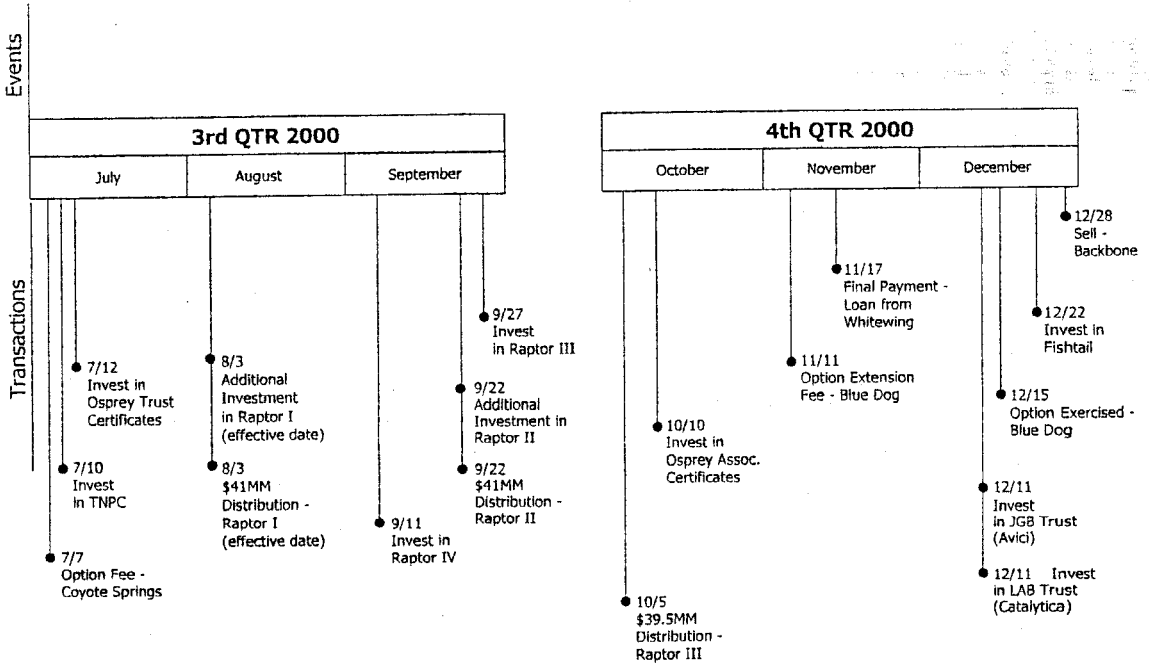
Timeline

January – June 2000



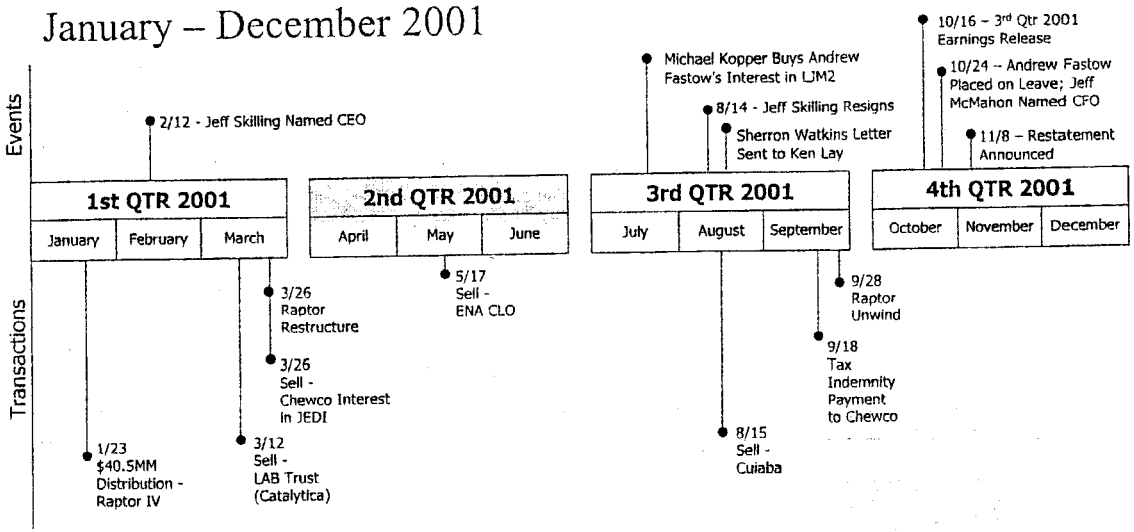
Timeline

July – December 2000



Timeline

January – December 2001



A P P E N D I X

February 5, 2002

Statement of Congressman Michael N. Castle
House Financial Services Committee Hearing on Enron
February 5, 2002

As more and more troubling facts are revealed about Enron's collapse, there is one point in particular that many Americans find most disturbing and that is the ability of a group of inside players at the top of a corporate structure to work the entire system to their advantage while millions of small investors, including the ordinary Enron employees and their life savings, were in effect trapped in this moving vehicle as it headed off the cliff - long after the drivers themselves had escaped.

Investors, be they multi-millionaires or individuals and small investors, trying to make the most of their life savings need to rely on some sort of an objective review of those who have control of their money. They need an independent opinion and review of the practices and the legality of those who are managing their money. We normally expect independent accountants and auditors to provide this function.

It is very troubling when it becomes apparent that the supposed independent auditors at Enron apparently completely failed at their assigned task of independently verifying the truthfulness of Enron's financial practices. The auditors are in the game with the players, but they have the authority to call time out and say these financial practices do not make sense and we are not going to endorse them until they are clarified. At the very least, Arthur Andersen did not perform this role adequately in the case of Enron. The worst case scenario is even grimmer.

Independent press reports and now the Powers report indicate that there was a complete breakdown in appropriate corporate behavior that extends from Enron's management to its Board and to its auditor, Arthur Andersen. We are trying to determine if Andersen and its experienced accountants were duped by Enron or were actively involved in constructing their evasive financial practices. Thus far, Anderson's explanations have been incomplete and unconvincing.

If a group of auditors have let investors down and have helped create uncertainty in the entire financial market about corporate accounting standards, we're obligated to try to work out new procedures, new rules, a new framework that will help prevent this from happening again. We are here to help develop the solution to this tremendously serious problem in our financial system. We hope there are not "other Enrons" out there, but it is quite possible there are.

Arthur Andersen has a long way to go to address questions about its role in Enron's collapse and to provide meaningful proposals for real change in corporate accounting. I hope that process can start today.

Statement of the Honorable Wm. Lacy Clay before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprise, Tuesday, February 5, 2002

Good morning Mr. Chairman, members of the subcommittee and witnesses.

The success of our financial markets depends on the free flow of accurate and reliable information. This is particularly important as more and more Americans invest in the stock market and as more and more companies sponsor market-based 401(K) retirement accounts. It is particularly crucial to the debate Congress will invariably have regarding the privatization of Social Security.

Therefore, in the wake of the Enron collapse, Congress must investigate why the supposed safeguards in the system did not work. Along with many of my fellow Committee members here today, I will avoid forming any conclusions about the causes of Enron's collapse until all of the evidence has been presented. However, in seeking federal remedies -- including the possible amendment of pension laws and/or overhaul of the current financial-disclosure system -- I hope to have some of the following questions answered:

Does the current way of reporting financial information portray accurate information to investors or were Enron's stockholders purposely misled concerning Enron's financial stability and long-term health? We must analyze whether the responsibilities of auditors, analysts and consultants were compromised by dueling interests and whether their supposedly well-reasoned financial statements and predictions were easily-manipulated, self-serving deceptions instead.

Should federal pension laws be adjusted so that company's sponsoring 401(K)s cannot invest more than a certain percentage of the plan's assets into the company's own stock? Enron employees reportedly lost up to 90 percent of their retirement investments, with many of them losing everything they had. The Employee Retirement Security Act of 1974 only allows employers to invest 10 percent of a regular pension plan's assets in the employer's own stock.

Were any pension laws broken when Enron locked employees out of their 401(K) plans? During a three-week-period in late October and early November, Enron stock prices plummeted while employees were denied the ability to sell. But there are currently no federal laws, which regulate how long -- or indeed when -- such lockdowns can occur.

Finally, I would like to ask representatives of Enron to tell us about their understanding of the Enron business model and about what information they asked to be reported to them. I would also ask that they explain the sort of information they, as CEOs, felt they needed to have in order to make appropriate decisions about the firm. Then I would like for them to explain whether it is appropriate for a CEO to make decisions for a firm like they did without the sort of fundamental knowledge they claim they lacked?

Remarks of Joseph F. Berardino
Managing Partner – Chief Executive Officer, Andersen Worldwide

U.S. House of Representatives
Committee on Financial Services
February 5, 2002

Chairman Oxley, Congressman LaFalce, Chairman Baker, Congressman Kanjorski, Members of the Committee.

Andersen and this Committee share common goals – to get to the truth about what happened at Enron and to help develop policies that will improve our capital markets, enhance audit quality and better protect the investing public. That is why I am here today – my second time before this Committee in less than two months.

We continue to learn a great deal since my last appearance before this Committee seven weeks ago. We are continuing our investigation of the Enron matter and, as I have made clear, we will take all appropriate actions.

We have a better sense of the tragic effects that the collapse of Enron has had on the company's employees and investors. We have a better understanding of the strategic business decisions that led to the failure. We have heard a good deal about failures in corporate governance on a number of levels.

And we have learned more about the relevant accounting issues. I will address some of those today.

Equally important, we have had an opportunity to reflect on the kinds of steps that might be taken – at Andersen and elsewhere – to strengthen and safeguard investors, our capital markets, and our economy.

At the outset, let me make one important observation. While no one yet has all the facts, it is clear that something very tragic and disturbing happened at Enron. Thousands of people have lost the savings they built up over years of hard work. Many people have lost their jobs. All involved with Enron must face up to what happened and take appropriate responsibility.

Andersen has done exactly that. But there is another story to be told. A story of Andersen's 85,000 employees in 84 countries around the world; 28,000 of them in the United States. The vast majority of them had nothing to do with Enron. These talented and dedicated people serve clients every day, offering the highest quality work, delivered with integrity, objectivity and skill. They know it; our clients know it. And that

dedication, that quality, and that integrity will continue to be our core values for years to come.

Having said that, I do not mean to, and I could never, minimize the profound effect that Enron's collapse has had on our firm. Legitimate and important questions about what happened have been raised by the public, by our clients, by bodies like this Committee – and, not least, by Andersen's own partners and employees. We must answer those questions when we have the facts. We've tried to do that over the past two months, and I will continue to try here today.

The Enron experience has been painful – but instructive in many ways. We at Andersen have been forced to look inward, to rethink how we do our jobs as auditors and what our jobs ought to be. We have been brutally honest – with ourselves, with our clients and with leading policymakers. We have asked the hard questions about what happened at Enron, and about the roles and responsibilities of all involved. The true test of leadership is to ask the toughest questions, follow the answers to wherever they lead, acknowledge where judgments have erred and – armed with that knowledge – build a better future.

When I last appeared before this Committee, I did more than address specific Enron accounting issues. I also pledged that Andersen would face up to its responsibilities, get to the bottom of what happened at Enron, and think honestly about the changes that must be made within our firm to reaffirm the public's confidence in our integrity. Let me tell you how we are living up to the pledge.

Setting the Stage for Fundamental Changes in Andersen's Audit Practice

At the outset, I can tell you about the steps Andersen has taken, and will take, to restore the public's trust as we move forward.

First, as we announced two days ago, former Federal Reserve Board Chairman Paul A. Volcker has agreed to chair an Independent Oversight Board (IOB) to work with Arthur Andersen LLP to evaluate the need for fundamental changes in our audit practice. We are pleased that Mr. Volcker has agreed to help us, without remuneration, in this effort. As the committee well knows, Paul Volcker is one of the most independent and innovative thinkers in American finance. Andersen, our clients and America's investors will jointly benefit from his active participation and leadership.

The Independent Oversight Board will be provided with a professional staff and assured free access to all information relevant to a full review of the policies and procedures of our firm. To assure the quality and credibility of the firm's auditing process, the IOB will have full authority to mandate changes in such practices, as it may find necessary and desirable.

As Mr. Volcker said the other day, the IOB and the Andersen partners "will together reaffirm Andersen's commitment to quality auditing."

Second, to address concerns about potential conflicts of interest, Andersen will no longer accept assignments from publicly traded US audit clients for the design and implementation of financial information systems. The firm will, of course, fulfill existing commitments.

Third, Andersen will no longer accept engagements to provide internal audit outsourcing to publicly traded US audit clients. The firm will fulfill existing commitments or, if clients prefer, immediately enter discussions to develop an appropriate transition.

There may well be legislation adopted, or regulations implemented, that address these two "scope of service" issues some time later this year. We have great respect for the processes that may ensue and the public policymakers who will lead them. But Andersen has chosen not to wait. A crisis of confidence such as that existing today demands immediate action.

Eighteen months ago, as I am sure you know, Andersen opposed a proposed SEC rule that would have prohibited providing the non-audit services I mentioned earlier to audit clients. Will some be cynical about this change in position? Surely they will. But that should not stop us. Today is a new day. Our profession – and Andersen – is living in a new environment that is dramatically different. Public confidence has eroded and one of the main issues that has contributed to this erosion is perception about potential auditor conflicts of interest. Because restoring and maintaining the public's confidence in our integrity is essential, we have determined to take this step.

Fourth, Andersen will work with the management and audit committee of each publicly traded US audit client to establish a formal process for determining the company's acceptable scope and level of fees for those non-audit services that we continue to provide.

Fifth, Andersen will establish a new Office of Audit Quality comprised of senior specialists with the sole mission of driving audit quality. This new office will be responsible for developing expertise, guidance, and review programs to assure quality, completeness, and transparency of financial statements audited by Arthur Andersen LLP.

Sixth, Andersen will create a new independent Office of Ethics and Compliance to investigate, on a confidential basis, any concerns of Arthur Andersen partners, employees or individuals from outside the firm relating to issues of audit or auditor quality, integrity, independence and compliance.

Seventh, Andersen will report to audit committees more comprehensively than currently required and include quality of results, industry comparisons and performance indicators.

These changes are being implemented alongside regulatory changes affecting the profession as a whole that I will mention later.

I told this committee in December that restoring the public's trust was our top priority. The actions we have announced thus far are first steps toward fulfilling that mission. Andersen's initiatives – the creation of an independent board that will report publicly on the firm's performance, voluntary restrictions on the scope of our practice, and other measures I have discussed – are dramatic and unprecedented for a U.S. professional services firm. They are part of a broad re-examination of our firm and our profession. The overriding purpose of these measures – and those that will follow – will be to provide assurance to clients and the investing public that changes to be implemented achieve one essential objective: quality auditing.

The Accounting and Auditing Dilemma

Andersen's reforms, however, are not the end of the matter – within our firm and beyond. The changes we have announced are meaningful, significant and helpful. But with the accounting profession in crisis, we all need to do something more fundamental. We cannot do it alone. All of us have to work together to accomplish these changes. We must transform both the ways in which auditors conduct and report audits, which is addressed in GAAS (Generally Accepted Auditing Standards), and the ways in which companies report their financial results, which is addressed in GAAP (Generally Accepted Accounting Principles).

Many participants in the system have lots of crucial information about companies; that information tells us a lot about a company's likely future performance. Management and boards must have this information to effectively discharge their responsibilities. We auditors have certain of that information. So do the analysts and credit rating agencies. So do investment banks and other financial institutions. But this crucial information is simply not communicated to the public.

Our basic problem is this: The current reporting system fails to communicate essential information about the real risks facing companies to the people – investors – who need it most. The result is that we have a system in which auditors – and the others I have mentioned – have what must be considered a very inefficient and ineffective conversation with boards, with management, and with shareholders. Figuring out how to change that is our current and pressing challenge.

Unless we make that basic change, the simple reality is that, even if all audit firms adopted reforms like the ones I've described today, there still would be allegations –

sometimes accurate allegations – that accounting treatments were misleading and that investors had been left in the dark.

In fact, I'll go further than that: such allegations would not disappear even if *every* audit conducted by *every* accounting firm was technically perfect.

How can that be? The answer is that the fundamental problem facing the accounting profession today lies in the role of the auditor and the nature of the service that auditors offer. We are asked to make sure that companies comply with the accounting rules – Generally Accepted Accounting Principles – and we as a profession generally do a very good job at that. But as Floyd Norris correctly noted in *The New York Times* last week, "[e]very accountant knows that there is good GAAP and bad GAAP. For many transactions, companies have a choice of accounting methods that can change the numbers that are reported." It is *not* the auditor who makes that choice: it is the company's management. And as every accountant also knows, some companies do the bare minimum to meet GAAP requirements, while others are much more prudent in their accounting decisions and disclosures.

Yet, the public sees only pass-fail grades. Those that satisfy GAAP get a pass. Those that don't, fail. We have a system that allows – indeed, requires – auditors to give the "same grade to every company that barely meets accounting standards," quoting the *Times* again. A noted accounting expert, Baruch Lev, made the same point recently in *The Wall Street Journal*: under existing rules and practice, all of our audit opinions are "uniformly bland."

What can an auditor do when financial statements prepared by management barely pass the current test – when they comply with GAAP but push the edge of the accounting envelope when they disclose required information but not other information that would be meaningful for investors? The auditor can go to the company's board through its audit committee. In fact, we do that often. But that does not always solve the problem. The fact remains that we cannot put in our audit opinion what we have informed the board about accounting risks and the quality of the accounting principles management has selected.

What else can the auditor do when a client only squeaks by? Our only other option is to resign the engagement. Yet that is not a practical answer. Resigning an engagement may destroy a company that is fundamentally sound. At a minimum, the share price almost certainly will plummet. And for its troubles, the auditor may also be sued. This is not, to put it charitably, an appealing prospect, and it certainly does nothing to protect shareholder interests.

So those are our choices when faced with a client whose accounting treatments are risky: give it a pass or give it the death penalty.

This situation is very frustrating for auditors. We rate all of our clients for risk and assign them a rating, from the riskiest to least risky quartile. It therefore was surprising to us when, like Capt. Renault in *Casablanca*, many people expressed shock that Andersen memoranda struggled with difficult accounting issues or labeled certain Enron practices "intelligent gambling." It is standard and essential practice for auditors to engage in just such frank analyses of risks related to a company's business transactions. The difficulty is that, if GAAP is satisfied, there is nothing that we can do publicly with that information.

This system is bad for everyone. It is bad for investors most of all. They do not get all of the information they need, or would like, to make informed decisions. Indeed, there is a significant danger that they may be led astray by our "pass-fail" report. If investors do not adjust financial statements for risk – or, worse yet, if they believe that our audit opinions vouch for the soundness of the company's business practices – they may be misled. But if investors discount *all* financial statements because they simply can't tell whether the company's accounting deserved more than a passing grade, companies that employ "best of breed" accounting practices resulting in high quality financial reporting get no benefit for acting responsibly.

The system also is bad for auditors, although perhaps not for the reasons you would expect. I am concerned that the current role we assign auditors is damaging the health and future vitality of the profession. We are not asked to be on the cutting edge of business. We are told to produce a standard report that effectively discourages differentiation among audit firms. And for this, we are faced with the virtual certainty of being sued whenever one of our audit clients fails. It is no wonder that auditing firms are finding it increasingly difficult to recruit the most talented individuals at business schools and universities. If we are to revitalize the profession, attracting the best and most innovative young people, we must ask them to produce a more useful and intellectually challenging report.

Of course, it is true that GAAP today is hardly perfect. As I testified in December, the rules governing SPE accounting must be changed to adopt a risk and reward approach. Other changes in current GAAP rules are also required.

But simply changing GAAP is not an answer to all of these problems. Accounting rules could try to present a comprehensive, accurate, and realistic historical picture of where the company has been. Or they could – more usefully, in my opinion – describe trends and paint a picture of where the company is going. But the GAAP rules are now betwixt and between: they don't do either of these jobs well. So GAAP doesn't put investors either at the baseline or at the net; it leaves them scrambling somewhere in the middle.

Tweaking, or even a wholesale rewriting, of GAAP would not cure this problem. It would not end risky accounting choices and it would not make audit opinions more informative. For one thing, many issues that arise under GAAP often have no precise answer; they require the exercise of judgment. In any event, a fundamental change in GAAP that is designed to squeeze all risk out of financial statements would result in rules that are vastly more complex and Byzantine than the already confusing ones that exist now. And new business practices would be sure to arise that would quickly make such changes obsolete. The simple fact is that GAAP in anything like its current form does not provide investors the kind of nuanced disclosure they need in the current economy.

It seems to me that we must do something more basic. To begin with, we should take a fresh look at the structure of the accounting rules, and at how auditors communicate the work they perform and the conclusions they reach.

I wouldn't purport to offer a complete answer to this set of problems here today, nor would I purport to have all the answers. And you will undoubtedly hear from others about whether any or all of the ideas that I will set out make sense. Not all of my partners, nor my colleagues within the profession, would necessarily agree with all of them. But I can say one thing with certainty: our system of financial disclosure – and thus, ultimately, the integrity of our markets – will face increasing stress until we start to look at these sorts of basic changes.

Modernize the Auditors' Communications With the Public

Let me start the dialog with these thoughts. We might consider expanding auditors' reports in several different ways.

We could deal with the content of the auditor's report, which today in almost all situations is a standard, three paragraph letter that provides no real insight to the investors. What investors need to make informed decisions is information allowing them to understand the *future* prospects of the company. That information is not provided today either in the financial statements or the auditor's report. Later, I will deal with the financial reporting reforms, but now let's deal with possible reforms to what the auditor can report. Investors need information about the risks and quality of the financial reporting.

I would suggest that we replace the current "pass/fail" system with an auditor's report that grades the quality of the company's accounting practices. As discussed above, this change will give investors important guidance in how to assess the company's financial statements, the information contained in those statements and related financial risk.

Modernize the Financial Reporting Model on a System-Wide Basis

But if we truly are to get at the information deficit that now plagues investors, we cannot stop with a consideration of audit opinions. We need to address this question: what is the purpose of the financial reporting model? Enron's collapse, like the dot-com meltdown, also is a reminder that our financial reporting model – with its emphasis on historical information and a single earnings-per-share number – is out of date and unresponsive to today's new business models, complex financial structures, the speed with which information is disseminated, and associated business risks.

As tragic and unnerving as the collapse of Enron is, we can help America's investors if we use this as an opportunity for systemic reform. We need to move to a more dynamic and richer financial reporting model. We need to provide several streams of relevant information.

For example, companies could disclose more about the imprecision of certain amounts in financial statements. As you know, financial statements list the types of assets and liabilities that a company owns and owes. Accountants can measure some of those assets and liabilities with great precision. One example is the amount of cash the company has in the bank. Other measurements, however, are inherently imprecise, such as the estimated value of a complex and long-term financial instrument that is not market traded.

Companies could help investors by disclosing the range of values for those assets or liabilities that are imprecisely measured. For example, consider a complex financial instrument that is settled 10 years in the future, and that is reported in financial statements at its fair value. As is often the case with these instruments, there is no deep and liquid market that provides daily evidence of the instrument's value. Rather, accountants must estimate the value using sophisticated models that provide an estimate of the instrument's value. In that case, the company could disclose the range of possible values and the key assumptions in the valuation model that drive those values.

Helping investors understand which assets and liabilities are imprecisely measured and the amount of that imprecision could help investors better assess a company's risks and opportunities. It could also relieve some of the pressure related to meeting earnings per share targets to the penny.

A second opportunity for companies to improve financial reporting is to disclose more information about the effects of unusual transactions and events. In too many cases, because of insufficient disclosure, the effects of unique transactions or events obscure key trends – and the quality of investor's analysis suffers as a result.

Here's a simple example. Let's assume that a company's core ongoing business is stable but not growing. However, in the current year, the company has entered into certain non-recurring transactions that have temporarily improved sales and profits. Without disclosure about those one-time transactions, investors could get a misleadingly rosy picture about the company's growth prospects and real trends.

Financial reporting needs to better distinguish between the financial effects of a company's core, recurring, and sustainable activities on the one hand, and peripheral, non-recurring or unsustainable activities on the other. We understand that the FASB has this topic on its agenda and we recommend that the Board give it a top priority.

A third area for change relates to so called segment reporting. For investors analyzing a company involved in diverse businesses, information about business segments is as important as information about the company as a whole. Segment reporting is a proven tool to identify and analyze opportunities and risks that diverse companies face. Further, for a diverse company, investors may find it more effective to project earnings or cash flows on a segment-by-segment basis than on the basis of the company as a whole. Segment data thus provides for a more refined valuation than otherwise would be possible. Accordingly, why not report on more business segments and provide more information on each, including MD&A information by segment? I should note that this issue is controversial, because some companies believe that revealing this information would compromise sensitive and confidential information.

Along these same lines, we need to expand the number of key performance indicators, beyond earnings per share, to present the information investors really need to understand a company's business model, business risks, financial structure, and operating performance. Doing so would reduce the near mythical status that earnings per share now holds and provide investors better and more informative data. Would investors be so focused on whether EPS is off by a penny if they were told outright that analysts' estimates of earnings per share covered a wide range and the financial statements contained "stress-testing" of the company's EPS by demonstrating the effect of varying key estimates of assumptions? If we reduced this myopic focus on EPS, wouldn't management be less pressured to hit the mark? And wouldn't management bring less pressure to bear on audit committees and auditors to accept borderline accounting?

In addition, investors need to identify *trends* in reported information, which is key to valuing companies and understanding risks. Unfortunately, today's reporting model does not give investors enough information on this. In too many cases, the effects of unique transactions or events obscure key trends, and the quality of investors' analyses and insight suffers as a result. Financial reporting needs to better distinguish between the financial effects of a company's core recurring and sustainable activities on the one hand, and peripheral, non-recurring, or unsustainable activities on the other.

We could also insist on "plain English" financial statements. In 1998, the SEC introduced the concept of plain English sections of some SEC filings. Why? To help investors understand the disclosures required by securities laws and make more informed investment decisions. The SEC's rules on plain English, however, do not apply to financial statements. If we want investors to make informed decisions, we have to give them financial statements and notes that are free of jargon and vague, boilerplate explanations.

Strengthen the Role of Audit Committees and Assuring the Integrity of Audit Information

A number of suggestions have been made in recent years regarding audit committees, and progress has been made in this area. At the same time, I would urge consideration of a number of ideas that will further engage committee members in ensuring the integrity of accounting decisions. The audit committee is the representative of the shareholders. They should engage management and the auditor to ensure that risk is managed, and it must ensure that crucial information – whether it originates with management, the auditor, a credit rating agency, or any other source – is communicated to the shareholders in an intelligible way.

Insure that Auditors Get Full and Accurate Information

We should give serious thought to strengthening the penalties for misleading auditors – specifically, making it a felony to lie, mislead or withhold information from the auditor. I want to be clear on this. The overwhelming majority of corporate managements make good-faith, diligent efforts to provide their auditors with all information relevant to the audit. But that cooperative attitude, unfortunately, is not universal. And audits are only as good as the information on which they are based. As we all have learned painfully from the Enron experience, a company's failure to disclose important material to its auditor may have catastrophic consequences. I urge the committee to look seriously at this issue.

Reform the Accounting Profession's Regulatory Model

We also must reform our patchwork regulatory model. An range of institutions – from the AICPA (American Institute of Certified Public Accountants) to the SEC and the ASB (Auditing Standards Board), EITF (Emerging Issues Task Force), the FASB (Financial Accounting Standards Board), state regulatory boards – all have important roles in the accounting profession's regulatory framework. They are all made up of smart, diligent, well-intentioned people. But the system simply is not keeping up with the problems raised by today's complex financial issues.

So far as accounting standards are concerned, standard-setting is too slow. The FASB has great technical expertise. But its processes are impossibly cumbersome in an economic environment that is as changeable and fast-moving as ours. It can take years for FASB to react even to the most pressing issues. Enron should teach us that this simply is not acceptable.

At the same time, responsibility for administering discipline is too diffuse and slow, and punishment is not sufficiently certain to promote confidence in the profession. Too many institutions – the SEC, the AICPA, 51 state accountancy boards – now have a role. This gives us the worst of both worlds. On the one hand, having so many regulators and confusing lines of responsibility means that some things warranting regulatory attention may fall through the cracks altogether; we welcome a firm hand to enforce standards, but an effective system must have certainty, uniformity, and consistency. On the other hand, having multiple regulators places auditors at risk of double, triple, or quadruple jeopardy. A healthy debate on some of these issues has begun with the SEC's recent proposal to create a Public Accountability Board.

Improve Accountability Across our Capital Markets System

The fact is that we need to consider the responsibilities and accountability of all players in the system as we review what happened at Enron and the broader issues it raises. Millions of individuals now depend in large measure on the integrity and stability of our capital markets for personal wealth and security.

Of course, investors look to management, directors, the company's professional advisers, and auditors – as well they should. But they also count on investment bankers to structure financial deals in the best interest of the company and its shareholders. Investors trust analysts who recommend stocks, and fund managers who buy stock for investors, to do their homework – and to walk away from companies they don't understand. They count on bankers and credit agencies to dig deep and act responsibly. For our system to work in today's complex economy, these checks and balances must function properly.

A different and more robust reporting system might have shed earlier light on the fundamental business failures that caused Enron to collapse. As the Committee knows, Enron leadership turned to the use of special purpose entities ("SPEs") as the company changed the focus of its operations from its core energy trading business to volatile and untested markets, such as broadband and water, as well as a variety of overseas assets. Financing these risky new lines of business required very substantial amounts of capital; to raise the necessary funds, Enron made increasing use of structured finance vehicles, including SPEs. One of the primary assets supporting the off-balance sheet debt of these entities was unissued Enron stock. This approach may have seemed like a good idea to the company when Enron stock was trading at $90 per share and the company predicted

that it would go to $150 per share. Leading financial institutions competed to provide Enron with funds.

As we all now know, however, these new and exotic businesses ultimately proved unsuccessful. The investments made by Enron were themselves unprofitable. Compounding the problem, the SPE deals negotiated by Enron management contained contingencies that exposed the company to liabilities should the Enron stock price fall or its credit rating decline. This overall decline in the stock market, coupled with Enron's lackluster business performance, led the company's share price to decline by approximately 65 percent between January and October 2001, *before* the earnings restatement and the cascade of bad news that preceded the declaration of bankruptcy. A liquidity crisis ensued when the share price collapse caused a downgrade in Enron's credit rating, which resulted in the company's off-balance sheet debt becoming current. Investors lost confidence as it became clear that the company had too much debt supported by too few assets; creditors insisted on a greater share of assets pledged; trading counterparties refused to deal with the company. This loss of confidence created a "run on the bank" that made it impossible for the business to survive. Enron's performance thus mirrored that of the other Internet companies that, in many ways, it closely resembled.

In this regard, you might have thought that the function of disclosing risk was performed by the credit rating agencies. In fact, as many have noted in connection with Enron's collapse, the agencies had complete, unfettered access to Enron's financial data, and their actions played a significant role in the company's ultimate failure. Their sophisticated analysts reviewed proprietary information to which ordinary investors had no access. The agencies were charged with using this information to assess company risk. Yet the agencies are under no mandate to, *and do not*, disclose the analysis that underlies their ratings decisions. As we consider how to make auditors' reports more informative, we might think about the rating agencies' role as well.

Report of Enron's Special Investigative Committee

Some of the questionable decisions that led Enron into this debacle are touched on by the report issued on February 2 by the Special Investigative Committee established by Enron's Board of Directors.

This document is over 200 pages long and took more than three months to produce. I have not yet had a chance to study the document carefully myself. However, we have experts within the firm who have been assigned the task of analyzing and investigating the allegations in the report. They are doing that now.

The report acknowledges the restrictions on time and resources that limited the scope of the Special Investigative Committee's review. Furthermore, the report notes the lack of

access to people and documents that the Committee admits may have information relevant to the report's conclusions.

The Committee did *not* speak to people at Andersen. Although the report suggests that we did not cooperate with the investigation, nothing could be further from the truth. We believe that our record of cooperation with the numerous investigations into the Enron collapse – and, I hope, my presence here today – speaks for itself. The truth is that our people made a number of attempts to communicate with the Special Investigative Committee, their investigators, and their accounting advisers. We thought that this made sense so that we could both assist the investigation and be in a position to assess the impact of any new information arising from the investigation on a timely basis. Those attempts were declined.

However, the report also cites numerous instances of possible additional secret arrangements among the company and the related-party special purpose entities. The report says that there are indications of hidden side agreements and undocumented understandings that may have altered significantly the economic substance of certain transactions between Enron and the SPEs. We need to investigate the accuracy of these alleged matters. Only then can we assess whether they affect the original accounting for these transactions.

Our investigation of these matters, and others, is ongoing. We will continue to pursue these matters and I promise to share our conclusions with the Committee at the appropriate time.

Accounting Issues Related to Chewco

Let me conclude by turning to some specific questions the Committee asked me to address.

The first of these involves an expansion and clarification of details of the testimony that I presented to the Committee on December 12.

Those details relate to my description of Enron's 1997 transaction with the special purpose entity known as Chewco. Many of us have had tutorials on SPEs in recent weeks, and have come to know that a company may avoid consolidating its financial statement with that of an SPE only if a requisite amount of independent equity capital is at risk in the SPE. Against that background, the two central points I made about Chewco in my December testimony were accurate:

- First, we at Andersen were not provided critical information about the nature of Chewco's arrangements with Barclays, the major financial institution that was

represented to us as being the source of the independent equity capital at risk in Chewco.

- Second, had we been provided that information in 1997, we would have objected to the accounting treatment used by Enron during the period 1997 through the first two quarters of 2001 for this transaction. Thus, there would not have been any need for the Chewco/JEDI portion of Enron's restatement.

My remarks should, however, be clarified in one respect. Based on documents we did not have in 1997 but that were made available to us in early November 2001, we now know that the $11.4 million "equity interest" provided by Barclays was, in fact, in the form of yield certificates the bank purchased from two intermediary entities, Big River Funding LLC and Little River Funding LLC. If these facts had been known to us in 1997, a key issue would have been the terms of the certificates. Depending on the terms, Enron could have been required to treat the capital as debt rather than equity, disqualifying the SPE from non-consolidation.

When I last appeared before this Committee I was not aware of the details of these intermediary relationships. In fact, Little River Funding LLC held interests in Big River Funding LLC. Big River Funding LLC, in turn, held interests in Chewco. It was my understanding at the time of my testimony that Barclays' interest was direct. These facts, however, were not at the root of our conclusion that Enron's accounting for Chewco was in error.

The reason for that conclusion was that, under a separate agreement between JEDI and Chewco dated December 30, 1997 – which was not provided to our team in 1997 when we asked for all Enron and JEDI documents – JEDI agreed to deposit $6 million into a reserve funding account that was established for the benefit of Barclays. In my testimony on December 12, I stated that this agreement was between Enron and the bank. It appears that the deposit was in fact a condition upon funding of the Barclays certificates. The cash collateral agreement, whether from Enron or JEDI, meant that only about half of the required three percent equity was actually at risk. This alone meant that Chewco did not qualify as an unconsolidated SPE.

Because the establishment of the reserve funding account was sufficient by itself to cause Enron's accounting for Chewco and JEDI to be incorrect, we did not complete – and still have not completed – our analysis of the accounting implications of the terms of the intermediary investment vehicles or the yield certificates. We advised Enron of our conclusion immediately, and the disclosure made by Enron that it would be restating its financial statements reflect that advice.

I appreciate the opportunity today to provide this clarification, which is also reflected in a letter I sent to Chairman Oxley, at his request, on January 21, 2002. And I want to

personally thank Chairman Oxley for the fair, thoughtful, and open manner in which he handled this issue.

Recent Developments in the Markets and Boardrooms

The Committee also requested that I address whether Andersen has asked clients to disclose more details about the creation of SPEs, related party transactions, and mark-to-market accounting; and what other developments we have seen in the markets and boardrooms as a result of Enron's collapse.

We encourage our clients to enhance financial statement disclosure to ensure full transparency. For example, under circumstances where GAAP may allow a range of disclosure, we encourage disclosure that will enhance the reader's ability to fully understand the business purpose and financial impacts of the transactions involved. With respect to SPEs and related party transactions, we have reiterated the need for full and clear disclosure of structures and transactions, their financial attributes, including contingent liabilities, and other disclosures, such as related party involvement that may be relevant to users of financial statements.

We have taken substantive steps to address accounting standards related to SPEs, mark to market accounting, and related party transactions. On December 31, 2001, we joined with the other Big 5 accounting firms in sending a petition to the SEC asking the Commission to issue guidance related to improving Management's Discussion and Analysis in annual reports and on Form 10-K for 2001. Our petition, which also was endorsed by the AICPA, included a draft of an interpretive release that proposed guidance in three critical areas:

1. Liquidity and capital resources – effects of off-balance sheet arrangements and other commitments.
2. Financial position and results of operations – effects of certain energy and commodity trading activities.
3. Financial position and results of operations – effects of transactions with certain parties that are not clearly independent.

The SEC released interpretive guidance on January 22, 2002, addressing the Big 5 petition and draft guidance. We fully expect the SEC to act on this petition within the next few weeks and believe it is likely that any resulting guidance would be effective for the upcoming 10-Ks of registrants with December 31, 2001, year-ends.

Similarly, we perceive increasing concern by management and boards about the adequacy of their company's internal controls, accounting and disclosures so as to avoid Enron-type problems.

But with that said, I must add that, in my opinion, the current controversy over SPEs is a symptom of the broader problems affecting our financial disclosure system. SPEs are the issue of the day. We can change accounting rules to address them. But that will not avoid future controversies. FASB will labor for two years to reform one accounting rule; clever investment bankers, lawyers – and, yes, clever accountants – will find a way to circumvent the new rule in two days. It is literally the case that there is a cottage industry of accountants and bankers at major financial institutions who devote themselves, in effect, to reverse engineering transactions so that they technically comply with GAAP. Indeed, many of the most talented accountants find it more challenging and intellectually rewarding to engage in that sort of work than to issue the pass-fail grades that, as I have detailed, is the usual product of audit firms. I hope that will change if we chart a serious course for reform.

Conclusion

Mr. Chairman, we have an opportunity to make some good here from what is otherwise a tragedy on many levels. We should act wisely, responsibly, and boldly.

Tinkering on the edges will not be enough. If, for example, we limit ourselves to fiddling with particular GAAP rules, I fear that, in a few years, this Committee will be holding another hearing like this one – although I very much hope that I will not be the one sitting in this chair. We must go further. As discussed above, I would suggest that we replace the current "pass/fail" system with an auditor's report that grades the quality of the company's accounting practices. This change will give investors important guidance in how to assess the company's financial statements, the information contained in those statements and related financial risk.

I do not mean to be alarmist in my comments here today. I am not suggesting that the financial statements of America's leading companies are a minefield strewn with hidden booby traps. I have no doubt that our markets are the world's strongest, our system of financial reporting the world's most transparent, and our accounting profession by far the soundest.

But we can do better – much better. Our current reporting system is almost 70 years old. In that time, the world has changed; our economy has changed; my profession has changed. The system must change, too.

I will, however, offer you a guarantee of one thing that will *not* change. When he founded his firm almost 90 years ago, Arthur Andersen promised that it would "think straight and talk straight." The 85,000 dedicated professionals who now work at that firm strive to fulfill this pledge every day. We are determined to convert our current challenge into an opportunity: we will clearly reaffirm Arthur Andersen's principles for a new century, serving our clients – and the public that relies on our work – with unflinching

candor and integrity. The steps that I have described earlier today start that process. All of us at Andersen will work with you in the weeks, months and years ahead to continue it.

FI 6045 277

January 16, 1996

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
File Reference No. 154-D
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Lucas:

This letter contains our comments on the FASB's Exposure Draft (ED) entitled, Consolidated Financial Statements: Policy and Procedures. We continue to support the Board's efforts to clarify the accounting guidance relating to consolidation policy. However, we believe that the vast majority of consolidation decisions today are straight-forward and unambiguous. As we indicated in our response to the Board's Preliminary Views (PV) document, entities generally know whether a parent/subsidiary relationship exists and report accordingly. Most of the consolidation problems we encounter result from circumstances that can be described as "at the margin" or relate to non-corporate investees and special purpose entities (SPEs). We believe the ED will not satisfactorily resolve the problems that exist today and will create a host of new problems. As a result, we do not support the proposed changes to the consolidation policy requirements proposed in the ED (which focus on what entities to consolidate). Further, as stated in detail later in this letter, we believe the conclusions in the ED will cause more variation in practice and, unless amended, we would prefer the Board not issue any guidance on this topic.

In our response to the PV, we suggested the Board make relatively minor changes to the current procedures used in consolidation (which focus on how to consolidate). We continue to support those changes but for reasons stated later in this letter, ask the Board to not issue any changes to current consolidation procedures at this time. We are strongly opposed to the changes in consolidation procedures proposed in the ED.

The remainder of this letter explains our continued opposition to the proposed changes in consolidation policy, the basis for our changed position on consolidation procedures, specific changes that we believe should be made to the ED, and a list of questions the Board may want to consider should the Board decide to issue the proposed standard in final form.

Consolidation Policy

The Arthur Andersen Approach

We continue to support the approach we described in our previous letters on this project. The consolidation decision has three criteria (all of which must be met) that determine whether an entity's results of operations, financial position and changes therein, should be included in the financial statements of the parent on a consolidated basis. Those criteria are:

> Control -- The parent has the ability to initiate policies that determine how the entity obtains, uses and finances its resources and to hold the entity's management responsible for carrying out those policies.
>
> Not Temporary -- The parent has the current intent and ability to maintain control (i.e., the evidence does not indicate an intent to discontinue control and it is not probable the parent will be unable to maintain control).
>
> Residual Interests -- The parent has the ability and is expected to participate in a significant portion of the reasonably expected risks and rewards of the residual equity interests of the entity. A parent that is not the nominal holder of the entity's equity has this ability if contractual provisions grant it a significant portion of the risks and rewards of the residual equity interests.

We believe that approach would resolve most of the problems that exist "at the margin" today without creating new problems. We recognize that the consolidation decision requires judgment, that judgment may result in some continuing lack of uniformity in applying any standard that relies on other than strict quantitative criteria and that our approach will not eliminate all inconsistencies in application resulting from differing professional judgments.

Comments on the FASB Approach

Control. We continue to disagree that the decision to consolidate can be made solely on the basis of control. Although the definition of control in the ED has been improved from that contained in the PV, we believe that the consolidation criteria must contain a requirement for the parent to be able to participate in a significant portion of the reasonably expected residual interests. Further, we do not find the Board's explanation of why the "Level of Economic Benefits" should not be a criterion for consolidation in paragraphs 11, 12 and 83 through 87 to be persuasive. From our perspective, the participation in a significant portion of the expected residual interests is the basis for differentiating between not consolidating in those circumstances in which control exists without such participation (e.g., the trustee of a trust without beneficial interest or a manager) and those circumstances in which all three criteria for consolidation are met and consolidation is required.

We suspect that the Board may find the decision to exclude a level of economic benefits from its consolidation criteria easier and more logical because of the interaction of its position on consolidation procedures and its definition of the economic entity. That is, if the reporting entity follows the economic entity approach in which the focus of the financial statements is from the point of view of all shareholders of the entity - whether controlling or noncontrolling - then whether the controlling entity participates in a significant portion of the residual equity interests becomes less important and may be argued to be moot. Under that approach, the residual equity interests will be allocated to an equity holder regardless of the amount allocated to the parent equity holders.

However, the importance of requiring the parent to participate in a significant portion of the residual equity interests becomes very important if the focus of the consolidated financial statements is the shareholders of the parent (the approach we continue to support as discussed later). Under the parent company approach, the focus of the reporting entity is to inform the parent company shareholders. Noncontrolling shareholders must rely on the separate financial statements of the subsidiary for information concerning their investment. Relying solely on control in a parent company approach in our

view creates the potential for providing financial statements that are not meaningful at best and potentially misleading. Therefore, we continue to urge the Board to require explicitly that the parent participate in a significant portion of the residual equity interests of the subsidiary before consolidation is appropriate.

Assessing the Existence of Control. We continue to agree that legal control as defined in the ED constitutes control of the subsidiary. We also continue to agree that a parent can have control without having legal control; however, control in our view must embody the unilateral ability of the parent to exert control and that control should not be based on the apathy of other shareholders. That is, whether the parent has control cannot be based on factors outside of its control. As a result, we do not agree that the criteria in paragraphs 14 a. and b. create a presumption of control because the apathetic shareholders can overrule the decisions of the large minority shareholder if the previously apathetic shareholders disagree with a decision of that large minority shareholder.

We agree with the presumption contained in paragraph 14 c. and believe that the unilateral ability to obtain the majority voting interest when the holder has the current right to obtain the majority and the financial ability to exercise that right, and exercising that right would be economic to the holder. (See our response to the PV for a full discussion on the issue.) This criterion focuses on one of the areas that we referred to above as being "at the margin." For example, if an acquiring company invests in 48% of the outstanding voting common stock of a target and also purchases sufficient convertible securities to obtain a majority of the voting securities and did so to avoid current consolidation, the criterion in paragraph in 14 c. may provide a basis for requiring consolidation. However, the decisions are difficult to apply in a uniform manner. We suggest the final document provide examples of how and when this paragraph would or would not be applied.

The requirements of paragraph 14 d. focus on one of the areas that in our view needs additional guidance - SPEs. The guidance as written, however, may raise more questions than it answers. For example, what if the entity with which the SPE has a relationship does not create the SPE? If the SPE has voting stock or voting member rights (which to our knowledge most have - - albeit limited), does the guidance in paragraph 14 d. apply at all or must the reader revert to the indicators of effective control in paragraph 158? How should the determination that an arrangement provides "substantially all future net cash inflows or other future economic benefits to its creator" be determined? Perhaps we would be better able to answer these questions if more examples were provided to clarify the Board's intent. As the guidance stands, we believe the application of the final statement will contain more variation than the Board desires and will not improve practice.

The requirements in paragraph 14 e. generally would lead us to a presumption that consolidation is appropriate. We assume that the unilateral right must exist currently.

We agree that the sole general partner of a limited partnership should be presumed to control the partnership (but we would require the general partner to have nontemporary control and significant residual equity to consolidate). We also agree that the presumption can be overcome if facts indicate that the general partner is not in control as indicated in paragraph 156. Once again, however, we disagree with the discussion in paragraph 156 that indicates that the dispersion of the limited partnership interests has an impact on whether the general partner has control. In our view, the limited partners either have the ability to overrule the control of the general partner or not. Control does not depend on the probability that the limited partners will be able to get together enough votes to override a general partner decision.

In summary, we are very concerned that the guidance in the ED (1) will not improve practice in those limited areas in which we believe further guidance is needed and (2) will create variation in areas in which current practice is uniform and, in our view, representationally faithful to the economics of the transaction. We would prefer that the Board focus on SPEs and those transactions at the margin. We

would be happier with practice as it stands today than with the changes proposed in the ED.

Temporary

In our response to the PV, we did not support the Board's approach to temporary control and cited several reasons that served as a basis for our disagreement. The Board has addressed some of those concerns and we consider the definitive nature of the Board's approach to overcome the remaining concerns that we expressed previously. Therefore, we support the definition of temporary contained in the ED.

Consolidation Procedures

We strongly oppose the Board's position in the ED relating to consolidation procedures. In our view, the problems that should be addressed in this project are limited to consolidation policy issues and not with the mechanics and approach to consolidation. The Board is proposing to fix a problem that with one exception does not exist in current practice as far as we can determine. We have not found any explanation of why the Board is proposing this radical change except for the discussion in the ED that indicates that the Board's conceptual framework does not have a place for minority interest outside of owners' equity.

We agree that minority interest is not a liability based on the definition in FASB Concepts Statement No. 6. However, the disruption to financial reporting and practice and the bizarre accounting results caused by adopting the economic unit approach cannot be justified by the desire to issue a document that conforms with the Board's conceptual framework. The Board could retain the parent company perspective that is well known and understood in current practice, and merely put minority interests in equity, properly labeled, to avoid showing minority interest as a liability. The goal is providing information that reflects the economics of the relationship as those economics are understood by most users of financial statements. Our sense is the parent company approach reflects the understanding of the relationship by most users and preparers (not withstanding the comments contained in the AIMR position paper).

The one area in which we think guidance would be helpful is that contained in paragraphs 19 through 21 of the ED relating to the elimination of intercompany transactions and balances. This area, however, is not a large practice problem and does not require a sweeping change in consolidation procedure.

We are also concerned that the change the Board proposes will create significant new opportunities for "financial statement engineering" and accounting results that are contrary to the economics. For example, the conclusion that all transactions in the stock of a subsidiary are equity transactions leads to the following possible situation:

> Assume parent buys 40% of Target for $40 and concludes it should consolidate Target. Target is a service company with minimal identifiable assets ($2). In consolidation, Parent records identifiable assets of $2, goodwill of $39.20 and noncontrolling interests of $1.20. A year later (not part of a planned transaction), Parent buys the remainder of Target for $60. Parent's consolidated financial statements now show assets of $2, goodwill of $39.20, noncontrolling interest of $0 and a reduction additional paid-in capital of $58.80. Unlike today's accounting, goodwill relating to the second purchase is not reported. The amount of goodwill recorded can be managed by the timing of the amount of investment in the subsidiary necessary to obtain control. A year later (assuming no goodwill amortization), Parent sells Target for $100 and reflects a gain of $58.80 when the proceeds on the sale were exactly equal to the purchase price!

Not only does this approach result in answers that are not intuitive, but it opens the door to timing of

transactions to achieve questionable financial statement results that are not possible today.

In our response to the Board's Discussion Memorandum (DM), we suggested that certain changes should be made to the consolidation procedures in use today. Those changes were:

1. Record the portion of the subsidiary acquired at its purchase price including purchased goodwill. If the purchase occurred in steps, record each step at its purchase price including purchased goodwill, net of amortization or accretion since date of purchase.

2. Record the minority interest in the subsidiary's identifiable tangible and intangible assets and liabilities at their fair value at the date consolidation first occurs. Do not record goodwill relating to the minority interest.

3. The minority interest would be reported outside of consolidated shareholders' equity.

4. At dates subsequent to first consolidation, purchases of minority interest would be reported as acquisitions of additional ownership in the subsidiary. The assets and liabilities purchased as well as any resulting goodwill should be recorded at their then fair values in consolidation. Any remaining minority interest would continue to be reported based on the amounts established at the date of first consolidation of the subsidiary. Minority interest in net income would be calculated on a "pushdown" basis and deducted in computing consolidated net income.

We continue to believe this approach would improve the reporting of purchased subsidiaries in consolidation (see our justification for these changes in our response to the DM). Since we made those suggestions, however, the AICPA Special Committee on Financial Reporting has published its report and the only discussion in the report concerning consolidation related to off-balance-sheet financing and the need to improve the disclosure relating to SPEs. Users are not asking for changes in the procedures used to prepare consolidated financial statements. Based on the conclusions in the report and our inability to determine the problem the Board is trying to correct, we believe no changes are justified to the consolidation procedures used in practice today. As a result, we do not support the Board's issuance of the portion of the ED relating to consolidation procedures.

Other Comments

Although we do not support the issuance of the ED in its current form, we realize the Board may see fit to issue a final standard with substantially the same conclusions. If so, we have the following specific comments concerning the contents of the ED:

Transition. The Board properly exempts from restatement the requirements in paragraphs 19 -21 and 26-33 if restatement is not practicable. The Board, however, should reconsider carefully its requirement to restate all periods presented for the other requirements of the ED. Prior consolidation decisions were based on the rules in place at the time and relationships among entities often were crafted carefully to meet those requirements. The format of transactions would have been different had the proposed rules been in place at the time. Our experience is that managements are very concerned with the financial statement impacts of interentity relationships and consider carefully the impacts of all transactions. To require restatement of the financial statements based on these new rules will provide results that managements did not intend and could have avoided if the proposed rules were in place.

Further, when the FASB issues new financial statements requirements, managements often use the period between the issuance of the new statement and the effective date to change those transactions or relationships that can be changed in consideration of the effective date. Entities that modify the characteristics of existing relationships or terminate relationships as a result of this new statement will

have to go through the effort of consolidating those situations in prior financial statements even though the relationship no longer exists or exists but no longer requires consolidation.

Finally, the ED does not indicate whether the restatement would require all secondary effects of consolidation to be reflected in the restatement. For example, the amount of interest capitalized using the equity method may be different in the consolidated financial statements. If the Board intends to require these effects to be reported, the requirement should be stated explicitly.

Scope. We agree that, if issued, the new statement should apply to all business enterprises and not-for-profit organizations regardless of the legal form of the controlling and controlled entities. We also support the exclusion of entities that report substantially all their assets and liabilities at fair value. The Board's description of the exempt entities is too restrictive however. The requirement indicates that exempt entities should report substantially all assets and liabilities at fair value. We believe that circumstances exist in which entities (e.g., venture capitalists) currently report their investments on a fair value basis but do not report substantially all their liabilities at fair value. From our perspective, the important consideration in exempting entities from the consolidation is that GAAP for those entities is to record substantially all their assets at fair value.

Conforming Accounting Changes. We disagree with the ED's conclusion that the accounting policies of the parent and subsidiary must be conformed in all circumstances unless GAAP allows different accounting methods for the same transactions or events. The key consideration relating to conformity is whether the accounting followed at the subsidiary truly is appropriate for the subsidiary and is not an attempt to create a different accounting result by creating a separate legal entity. For example, EITF 85-12 describes a circumstance in which the specialized accounting for an SBIC subsidiary is reflected in the consolidated financial statements. If the accounting truly is appropriate in the subsidiary's circumstances and is not a "sham", the subsidiary's accounting should be allowed to flow-through to the consolidated financial statements.

Transition from SFAS 115 Investments to Equity and Consolidation. We disagree with ED's proposed requirement that unrealized gains and losses on available-for-sale securities carried at fair value should be considered realized when the reporting entity makes an additional investment that results in an investment that is accounted for on the equity method or consolidation. As stated earlier, we support recording all identifiable assets and liabilities at their fair value at the date consolidation is appropriate and recording only the goodwill purchased by the controlling entity. Our position is that the cost of the controlled entity should be the sum of the amount paid by the controlling entity for its investment. If the investment occurred in steps, the cost should be the sum of the amounts paid (after appropriate amortization).

The accounting in SFAS 115 does not report as realized the changes in the fair value of available-for-sale securities until those securities are considered trading or are sold (ignoring impairments). In our view, the gains and losses on these securities are not realized, and should not be treated as if realized when the investor increases its investment to a level that requires equity method or consolidation accounting. In fact, gain or loss has moved further from realization because the investor has made a decision to keep the investment for the longer term. Reporting a gain on a security that is not sold when the investor makes an additional investment would be a dramatic and unnecessary change in current GAAP.

We also believe that the cost of an equity method or consolidated entity should be the same regardless of whether the original investment was a marketable security. If the Board's approach is that the cost of the investment should include the fair value of all securities owned prior to applying the equity method or consolidation, the approach should apply to nonmarketable and marketable securities alike. We prefer, however, that the basis be cost and that the unrealized gains and losses on available-for-sale securities not be accounted for as realized.

Finally, we realize that if the security was classified as trading that the basis of the investment will have changed and gains and losses will have been reflected in income. We would not reverse those gains and losses and would consider the recorded amount as the cost of the securities for consolidation purposes. That is, we would not reverse in income the properly reported gains and losses on trading securities.

Accounting for the Operations of a Temporarily-Controlled Entity. The ED states that the accounting for temporary investments in entities should follow the accounting for assets held for sale in SFAS 121. That guidance addresses the measurement of the balance sheet amount of the purchased entity but does not address the accounting for the results of operations of the held-for-sale entity. Some guidance in this area would be helpful.

Income Tax Accounting The last sentence of paragraph 19 addresses the tax impacts of intercompany transactions that are eliminated in consolidation. The approach should be to defer the seller's total tax effect of the transaction. The seller's total tax effect would include the tax effects of (1) the taxable gain or loss on the transaction, (2) changes in temporary differences and (3) use of carryforwards, all net of changes in valuation allowances directly caused by the intercompany transaction. We are not sure the language in the ED is clear. Also, paragraph 33 of SFAS 109 refers to a "more-than-50-percent-owned subsidiary." However, under the proposed standard, control is the real key to the distinction made in the statement. As a result, any final statement should modify SFAS 109 to apply to all subsidiaries and not just those that are more than 50 percent owned.

Impact of Minority Veto Rights on Control of a Subsidiary. The ED's focus on control will increase the current concern of the impact of minority interests' veto rights on the ability to consolidate. These questions occur most frequently in nonpublic situations in which the minority investor retains the right to veto certain, but not all, decisions normally thought to be the right of the controlling entity. For example, if an entity has legal control but grants the minority interest the right to approve significant asset sales and purchases or dividend levels, does the legally controlling entity consolidate the subsidiary? We see this question frequently and ask the Board to provide guidance on the level of minority veto that is permitted over the parent's power of decisions before control for consolidation purposes is considered not to exist. Perhaps an example illustrating the Board's intent could be included in the final statement.

Clarify Guidance with ED on Securitizations. Paragraphs 14 d. and 158 e. provide guidance leading to a presumption that an SPE created by an entity in which it retains certain rights should be consolidated. The Board's ED on securitizations contains language concerning consolidation of the SPE used in the securitization process and makes reference to the consolidation ED. We had hoped in implementing the Board's approach to securitizations that it would be clear that if the transferor met the criteria for securitizations that the entity would be able to derecognize the asset and not be required to consolidate the SPE. Any final standard should contain examples that clarify the Board's intent.

Expanded Guidance on Appropriate Accounting for SPEs. The guidance concerning the application of the proposed standard to SPEs does not provide enough detail for preparers to know how the Board intends for the proposed standard to be applied. For example, Tax Increment Financing Entities (TIFEs) were addressed in EITF 91-10 and that document gives guidance concerning when the debt of the TIFE should be reported in the financial statements of the company that created it. How does the ED impact the accounting by the company that creates a TIFE? Another example is owner trust securitization vehicles structured as partnerships. In this case, the vehicle is structured as a limited partnership for tax purposes and the owner/seller is the general partner. However, the general partner has almost none of the rights normally associated with general partners but receives most of the economics from the transaction including the residual. Some have expressed confusion as to how the ED should be applied in this circumstance.

The guidance also would be clearer if example 5 contained more explanation of the attributes that were determinative in the decision to consolidate. For example, which fact is determinative of the need to consolidate - the creation of the entity by Corporation I, the fact that Corporation I has use and control of the assets via a lease, the existence of a fixed price purchase option or the fact that all decisions relating to the entity were made at its inception?

In our view, the guidance relating to SPEs will be one of the most contentious and difficult to apply. The Board should consider expanding significantly the examples in any final document so that the guidance can be applied in the manner intended.

Effective Control Issues. If the guidance on effective control is retained, especially the guidance in paragraphs 14 a. and b., additional guidance will be needed relating to the "flip-flop" problem. Since control in these circumstances relies on the apathy of other shareholders, the significant minority investor potentially will be subjected to being presumed to be in control in one period, not in control the next and not knowing whether the control relied on today will last for any significant period of time. In addition, how will a significant minority shareholder know whether it should consider itself to be in control at the date the investment is made?

We doubt that consolidating and deconsolidating will occur frequently, but preparers and auditors will be better served if an arbitrary time period for how long control should be probable of continuing was provided. Such a time period would make the application of the criteria more uniform.

Other Questions

We have the following other questions:

- Does the ED impact SFAS 68?
- Does the ED impact the AICPA Notice to Practitioners on ADC Loans?
- We assume the ED's requirements on consolidation procedures will apply to preferred stock of a subsidiary, even mandatorily redeemable preferred stock of an SPE. Is this correct?
- If a tax benefit occurs relating to the incremental "goodwill" in a step acquisition that is charged to equity under the ED, we assume the tax benefit would be credited to equity. Is this correct?
- The ED creates some new entries to equity. Do any of them impact the computation of earnings per share applicable to the majority interests (similar to preferred stock that is called at a premium)?
- How will the ED impact poolings of interests? The ED will create many new entries to equity. Each of the entries will have to be considered in any pooling transaction. For example, does the acquisition of minority interest by a controlling entity create a treasury stock problem?
- Does the ED impact the consensus of EITF 88-16 ? This EITF is based on step acquisition accounting which will be changed dramatically by the conclusions in the ED.
- How do we judge whether a transaction is at "arm's length" as indicated in the amendment to paragraph 19(a) of APB 18 ? We question the operationality of this change.
- What happens under the ED if a less than wholly-owned the subsidiary has negative equity? What is the appropriate accounting if that subsidiary pays a dividend?
- How does the ED impact the accounting when a subsidiary issues stock to purchase a business? Does the subsidiary record 100% of the goodwill of the acquired entity and the consolidated financial statements only reflect a portion of the goodwill (similar to the acquisition of less than 100% of a company)?

We appreciate the opportunity to comment on the ED and are prepared to discuss our conclusions at your convenience.

LEVEL 1 - 1 OF 1 STORY

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HEADLINE: ENRON'S MANY STRANDS: EARLY WARNING;
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BYLINE: This article was reported by Edmund L. Andrews, Neela Banerjee and Andrew Ross Sorkin and written by Ms. Banerjee.

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BODY:

Three years ago, a German company pieced together a picture of the Enron Corporation's finances so troubling that it helped persuade the company to call off a merger with Enron, executives in Germany and the United States said.

The 1999 deal would have combined Enron and Veba, a utility company based in Dusseldorf, Germany, in a so-called merger of equals. The negotiations collapsed amid a clash of egos between the Germans and the Americans and the growing sense at Veba that Enron was actually going to take it over, executives involved in the talks recalled.

But Veba also became concerned about the levels of debt Enron had and with what a senior executive said were Enron's "aggressive accounting practices." Consultants from PricewaterhouseCoopers told Veba that Enron, through complex accounting and deal making, had swept tens of millions of dollars in debt off its books, making the company's balance sheet look stronger than it really was, according to people involved in analyzing the failed deal.

The consultants drew on public sources like trade publications and securities filings, these people said. It could not be determined if the talks reached the stage at which the companies exchanged confidential financial information.

It was similar questions about partnerships and other devices used by Enron to shift debt off its books that precipitated the company's financial collapse last fall. Securities experts said the fact that a potential merger partner had such doubts years earlier suggested the problems might have been apparent if Wall Street or federal regulators had been looking more closely.

PricewaterhouseCoopers was one of several banks and consulting firms that worked on the Veba-Enron deal. Other advisers included Goldman, Sachs, Credit Suisse First Boston and McKinsey & Company, bankers and consultants said.

The auditing arm of PricewaterhouseCoopers is listed in an offering document as the accountant for the LJM2 partnership that was run by Enron's chief financial officer. A spokesman for the firm said, however, that

PricewaterhouseCoopers had "never been the auditor of any of the partnerships." He said he could not confirm details of the firm's involvement as an adviser to Veba.

Press officers for the other advisory firms declined to comment on the Veba-Enron deal.

In the wake of Enron's collapse, it has become apparent that many financial firms -- from Enron's lenders to Wall Street bankers who underwrote the company's partnerships to investment houses that bought into them to the accountants who reviewed their books -- knew more about Enron's condition than the company publicly disclosed.

But for many reasons, that knowledge did not translate into action to put the brakes on Enron's deal making or to force the company to disclose more about its finances until last fall, when Enron was already under investigation by the Securities and Exchange Commission.

Securities laws, for example, put restrictions on how information can be shared inside investment firms. Many of the congressional committees examining Enron's collapse are looking at whether loopholes in disclosure and accounting rules made it possible for Enron to hide its true condition.

Still, there was enough information available to make Veba dubious about Enron.

"We were wondering why this wasn't common knowledge, or why it wasn't discovered by those people whose business it was to discover these things," said one of the people who worked on analyzing the deal. He agreed to discuss the episode on the condition that his firm not be identified.

Both Enron and Veba were looking to make acquisitions in 1999, when Europe, like the United States, was deregulating its energy markets. Veba later merged with another company to form E.ON, Germany's second-largest power company.

E.ON and Enron declined to comment on the details of the talks, which the companies have never disclosed.

But several people involved in the failed transaction said that the negotiators talked about basing the combined company in Dusseldorf. Ulrich Hartmann, the head of Veba and now the chief executive of E.ON, would have been in charge, and Jeffrey K. Skilling, then Enron's president, would have been his No. 2 and heir apparent.

As part of Veba's due diligence effort -- the detailed financial and legal analysis that precedes any deal -- a team from PricewaterhouseCoopers worked for about two weeks, people with knowledge of the effort said, scouring trade publications and S.E.C. filings for information about Enron's deals. They eventually pieced together a picture of a highly leveraged company far different from the glittering industry leader that the rest of the equities market saw.

Veba concluded that Enron had shifted so much debt off its balance sheet accounts that the company's total debt load amounted to 70 to 75 percent of its value as expressed in its debt-to-equity ratio, executives said.

In March 1999, debt rating agencies would have probably calculated Enron's debt level at about 54.1 percent, based on the information that the company disclosed in regular reports to the S.E.C., according to John E. Olson, a longtime critic of Enron and the head of equities research at Sanders Morris Harris, a Houston-based securities firm.

Had regulators like the S.E.C. and rule makers at the Financial Accounting Standards Board demanded more information from companies like Enron, Mr. Olson said, its parlous finances would have been apparent much earlier.

"When you have so many moving parts like Enron had, not even an analyst worth his salt could have figured the company out," he said. "What would have helped is full disclosure by Enron. Accounting mandates by the F.A.S.B. and the S.E.C. would have saved the company from itself and from bankruptcy."

Veba's advisers found that many people in the energy industry knew about Enron's complex accounting practices, if in a piecemeal fashion, but few were willing to ask hard questions about it.

"When things were going well," said one of the people involved in analyzing the deal, "the view among those who knew about this kind of stuff was that Enron was being Enron, which meant being clever."

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GRAPHIC: Photo: Ulrich Hartmann would have been chief of a merged Veba-Enron. (Reuters)(pg. 32)

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