TESTIMONY OF

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RECENT EVENTS RELATING TO ENRON CORPORATION

Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Oversight and Investigation, Committee on Financial Services

U.S. House of Representatives

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Chairman Baker, Chairwoman Kelly, Ranking Members Kanjorski and Gutierrez, and members of the Subcommittees:

I am pleased to appear before you on behalf of the Securities and Exchange Commission ("SEC" or "Commission") to testify concerning the recent events relating to Enron Corporation ("Enron"). I appreciate the opportunity to discuss the importance of transparent financial reporting to investors and our capital markets and several accounting issues raised by Enron's recent filings with the Commission.

Overview of the Effects of Enron on our System of Capital Markets

The SEC shares the Subcommittees' concern about the recent events surrounding Enron. The bankruptcy filing of a Fortune 10 company gives pause to all of us who care about financial reporting—and, more importantly, about its customers—the investing public. As Enron has disclosed in its public filings with the Commission, the SEC is investigating the Enron matter. Any further information relating to that investigation is nonpublic at this point and, accordingly, my statement will be confined to the public

record.[1] The Commission requests that the Subcommittees respect the confidential nature of the Commission's investigation and the Commission's reluctance to address in this public forum specific issues related to Enron's compliance with the federal securities laws.

Enron's announcement of its intention to restate its financial statements comes on the heels of several other widely publicized restatements. We share your concern that such restatements may shake investors' confidence in our system of financial reporting and our capital markets. We also recognize the devastating impact that such events can have on employees whose retirement funds are invested in the company's securities. In the coming weeks and months, we will all learn more about what transpired at Enron, as many of the details are unknown at this time. However, today I will discuss for the Subcommittees what has been announced publicly as well as some of the related disclosure and financial reporting issues.

In some of the staff's discussions with congressional staff, it has been suggested that a chronology of the public events as reflected in Enron's filings with the Commission might be useful to the Subcommittees. An understanding of these public events also may assist in understanding the company's accounting issues. A chronology, therefore, is attached to my testimony as Appendix A.

Transparent Financial Reporting Protects the Financial Markets

A primary goal of the federal securities laws is to promote honest and efficient markets and informed investment decisions through full and fair disclosure. Transparency in financial reporting – that is, the extent to which financial information about a company is visible and understandable to investors and other market participants–

[1] The information contained in this statement concerning the events surrounding the bankruptcy filing of Enron Corporation is based upon publicly available information. The Commission is currently conducting an investigation into a number of aspects of these events and has not made any findings or reached any conclusions related to these events. This statement does not discuss nonpublic matters relating to that investigation or that may become the subject of actions by the Commission or by other authorities.

plays a fundamental role in making our markets the most efficient, liquid, and resilient in the world.

Transparency enables investors, creditors, and the market to evaluate an entity. In addition to helping investors make better decisions, transparency increases confidence in the fairness of the markets. Further, transparency is important to corporate governance because it enables boards of directors to evaluate management's effectiveness, and to take early corrective actions, when necessary, to address deterioration in the financial condition of companies. Therefore, it is critical that all public companies provide an understandable, comprehensive and reliable portrayal of their financial condition and performance. If the information in financial reports is transparent, then investors and other users of the information are not surprised by unknown transactions or events.

Investors and creditors expect clear, reliable, consistent, comparable, and transparent reporting of events as they occur. Accounting standards provide a framework that is intended to present financial information in a way that facilitates informed judgments. For financial statements to provide the information that investors and other decision-makers require, meaningful and consistent accounting standards and comparable practices are necessary. Companies in like circumstances must apply such standards and practices in a like manner if the information is to be comparable.

The SEC Relies on an Independent Private Sector Standards-Setting Process that Is Thorough, Open, and Deliberative

While the Commission has the statutory authority to set accounting principles, [2] for over 60 years it has looked to the private sector for leadership in establishing and improving accounting standards.[3] The quality of our accounting standards can be attributed in large part to the private sector standards-setting process, as overseen by the

[2] See, e.g., section 19(a) of the Securities Act of 1933, 15USC 77s(a), and section 13(b)(1) of the Securities Exchange Act of 1934, 15 USC 78m(b)(1).

[3] Accounting Series Release (ASR) No. 4 (April 1938) and ASR No. 150 (December 1972).

SEC. The primary private sector standards-setter is the Financial Accounting Standards Board (the "FASB"), which was established in 1972. An oversight body that represents its core constituency of investors, business people, and accountants appoints the members of the FASB. The FASB's standards are designated as the primary level of generally accepted accounting principles ("GAAP"), which is the framework for accounting. FASB standards set forth recognition, measurement, and disclosure principles to be used in preparing financial statements.

In setting standards, the FASB follows a thorough, open, and deliberative process. For major projects, that process can include: (i) wide distribution of discussion memoranda; (ii) public hearings; (iii) publication of exposure drafts; (iv) solicitation of comment letters; (v) public deliberation on comment letters; and (vi) use of field tests to test standards before their adoption.

The SEC oversees the FASB and its accounting standards-setting process. Specifically, the SEC staff evaluates each project and proposed standard to make sure that the FASB standard-setting process is being administered in an open, fair, and impartial manner, and that each standard adopted is within an acceptable range of alternatives that serve the public interest and protect investors. The SEC staff: (i) monitors the FASB's project developments; (ii) meets with the FASB and its staff on a regular basis to discuss pending FASB projects; (iii) reviews comment letters received by the FASB on its projects; and (iv) after a standard is adopted, continues to consult with the FASB, its staff, and its interpretative body, the Emerging Issues Task Force ("EITF"),[4] on implementation issues.

The Self-Regulatory Processes Administered by the American Institute of Certified Public Accountants ("AICPA")

[4] The EITF is a committee of accounting practitioners that assists the FASB in providing timely guidance on emerging issues and the implementation of existing standards. If the EITF reaches a consensus solution to an emerging or implementation issue, Commission or FASB action may not be considered necessary. The SEC Chief Accountant participates as an observer at EITF meetings.

The SEC staff also monitors the activities of the standard setting functions of the AICPA's Auditing Standards Board ("ASB") and the AICPA's self-regulatory programs, designed to enhance public confidence in the audit process.

Regarding the ASB, the SEC staff attends many of the ASB's public meetings, reviews exposure drafts of proposed auditing standards and selected comment letters responding to those exposure drafts, and periodically meets with representatives of the ASB to discuss current and future projects and other matters of mutual concern. Recently, the ASB was placed under the oversight of the Public Oversight Board ("POB"), which is chaired by former Comptroller General of the United States, Charles A. Bowsher.[5]

The POB was created in 1977 to oversee and report on the self-regulatory programs of the AICPA's SEC Practice Section, which until recently consisted principally of the AICPA's peer review and quality assurance programs. Under the peer review program, accountants from outside the member firm assess the firm's quality control systems over its accounting and auditing practice and test compliance with those systems. Under the quality control inquiry process, a committee of professionals reviews allegations of audit failure contained in litigation filed against a member firm for indications of needed improvements in the firm's quality control systems.

Starting in 2001, the POB's responsibilities have been expanded to include not only oversight of the peer review, quality control inquiry, and auditing standards setting functions, but also to improve the communication and coordination among the various bodies that make up the self-regulatory process and to conduct oversight reviews and other projects that are deemed to be appropriate to protect the public interest.

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[5] Other members of the POB include former FASB Chairman, Donald Kirk; the Chairman of the Executive Committee for Lockheed and former Under Secretary of the Army, Norman Augustine; former Counselor to the President and former Secretary of Defense, Melvin Laird; and former SEC Commissioner, Aulana Peters.

An example of the POB's projects that benefit the public interest occurred in 2000 when the POB, at the SEC staff's request, sponsored the Panel on Audit Effectiveness ("Panel"). Although the Panel found that the audit process is fundamentally sound, the Panel's report contained approximately 200 recommendations for the accounting profession, standard setters, audit committees and regulators. The AICPA and others are working to implement those recommendations, including: revising the auditing standards for detecting material misstatements in financial statements that may be due to fraud, enhancing the peer review process, and strengthening the AICPA's disciplinary processes.

In this regard, the AICPA recently amended its self-regulatory processes to require member firms to have specific quality controls related to maintaining their independence from audit clients, to provide for "continuous" peer reviews of the largest accounting firms (which provides for the performance of certain peer review procedures in the two years between the firm's triennial peer reviews), and, in the event of litigation alleging deficiencies in the audit of a public company, in certain situations to terminate, remove from audits of public companies, or subject to additional oversight the individual involved.

As shown by these recent changes, the self-regulatory process can, and does, change over time in response to the needs of investors. In view of the events surrounding Enron, the profession and the Commission are considering what further improvements should be made.

For example, last week the managing partners of the five largest accounting firms issued a joint statement that they intend to work with the SEC and others to evaluate and improve the profession's self-regulatory process, and to enhance disclosures and audit procedures concerning related party transactions, special-purpose entities, and issues related to market risks, including those related to energy contracts.[6] They also indicated

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[6] See, "Statement From Big Five CEOs," dated December 4, 2001.

their support for the modernization of the financial reporting system, as previously announced by Chairman Pitt.[7] Similarly, AICPA Chairman James Castellano stated that the AICPA is committed to working with the SEC and accounting firms to make needed changes to the self-regulatory process and to provide improved guidance to auditors and to modernize the financial reporting system.[8]

Role of the SEC in Reviewing Filings

As noted above, the Commission is responsible for administering the federal securities laws. These laws are designed to protect investors by requiring full and fair disclosure of all material information about publicly traded securities. Full disclosure ultimately benefits both investors and the capital markets. By enhancing investors' confidence in the completeness and accuracy of information about public companies, these full disclosure requirements encourage investor participation in the capital markets.

The Commission does not have authority to approve or disapprove a security or a transaction on its merits. If a transaction appears to involve a high degree of risk to investors or if a company involved in a transaction is experiencing financial difficulty, we do not, and we cannot, stop the transaction from proceeding on that basis. Rather, the Commission's job is to ensure that the company fully discloses these risks and fully informs investors of its financial condition so that investors can make informed investment decisions. This system is designed to maintain market transparency. It allows market forces rather than regulatory controls to determine what transactions will proceed and at what prices a company's securities will trade. In this way, even small companies and companies with financial difficulties may have access to the public capital markets on an equal footing with larger or more financially secure companies. Full and

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[7] See, e.g., Remarks by SEC Chairman Harvey L. Pitt at the Fall Meeting of the ABA's Committee on Federal Regulation of Securities, dated November 16, 2001.

[8] "AICPA Statement of James G. Castellano, AICPA Chair, Barry Melancon, AICPA President and CEO," dated December 4, 2001.

fair disclosure allows markets to assign an appropriate value for the securities of all public companies.

Under the securities laws, public companies file registration statements, periodic reports and other disclosure documents with the Commission. The Commission's Division of Corporation Finance ("DCF") has primary responsibility for overseeing disclosures by issuers of securities. The SEC, however, does not have sufficient resources to review all registration statements and other filings that are made with the Commission. Therefore, in 1980, the SEC implemented a "selective review" program by which the DCF reviews some, but not all, of the filings that are made with the Commission.[9] When a filing is made, it is routed to the appropriate industry group within the DCF and it is then "screened" to determine if it will be subjected to a full financial and legal review, a partial review for specific issues only, or no review. In order to preserve the integrity of the selective review process, the Commission does not publicly disclose its screening criteria for filing reviews.

The SEC does not audit public companies. If the DCF has significant concerns or becomes aware of information that suggests that a company may have violated the securities laws, the DCF may refer the matter to the Commission's Division of Enforcement. The SEC has broad authority to investigate possible violations of the securities laws and may bring actions against a company if information in its registration statement or other filings proves to have been materially false or misleading, including actions to stop the sale of securities.

As Chief Accountant, I am the principal advisor to the Commission on accounting and auditing matters arising from the administration of the federal securities laws. My

[9] All registration statements potentially are subject to review by the staff of the DCF. Given the volume of filings each year, we fulfill this obligation by selectively reviewing registration statements and other documents that companies file with the Commission when they engage in public offerings and other transactions in publicly traded securities. We also selectively review periodic reports, such as those on Forms 10-K and Forms 10-Q, which public companies are required to file with the Commission, and current reports on Forms 8-K. These reports are designed to keep investors apprised of the companies' financial condition and results of operations on a periodic basis.

staff also works closely with domestic and international private sector accounting and auditing standards-setting bodies, consults with registrants, auditors, and other Commission staff, such as the staff in the DCF and the Division of Enforcement, regarding the application of accounting standards and financial disclosure requirements, and assists in addressing problems that may warrant enforcement actions.

Having now reviewed the role of the SEC and the FASB in the financial reporting process, I would like to discuss three accounting issues that were raised by Enron in its November 8, 2001 Form 8-K filing: (1) restating previously issued financial statements, (2) accounting for special-purpose entities, and (3) the reduction in Enron's shareholders' equity in connection with the receipt of notes receivables. Finally, as requested by some members of the Subcommittees, I will give a brief overview of a subject that is not mentioned in Enron's filing – mark to market accounting as it applies to nonderivative energy-trading contracts.

Restating Previously Issued Financial Statements

In its November 8, 2001 Form 8-K filing, Enron announced its intention to restate previously issued financial statements dating back to 1997. Various groups have reported increases in the number of companies restating their financial statements over the last several years, with one study citing 233 restatements in 2000.[10] Let me briefly explain the accounting and auditing literature regarding restatements.

Management is responsible for the preparation and presentation of financial statements in conformity with GAAP. If management discovers an error in previously issued financial statements, it should account for the error in accordance with Accounting Principles Board Opinion No. 20 (APB 20), *Accounting Changes*. APB 20 concludes that correction of an error related to a prior period discovered after the issuance of financial statements for that period should be reported as a prior period adjustment.

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[10] Two separate studies by Financial Executives International and Arthur Andersen indicate increases in the number of restatements by public companies over the past four years.

Pursuant to Generally Accepted Auditing Standards ("GAAS"), an auditor has responsibilities when an error is discovered regardless of whether the auditor or its client discovers the error. Statement of Auditing Standards No. 1, which is part of GAAS, sets forth the procedures an auditor should follow when, subsequent to the date of the audit report, the auditor becomes aware that facts may have existed at the date of the report that might have affected his or her report. When subsequently discovered information is found both to be reliable and to have existed at the date of the audit report, the auditor should advise the client to make appropriate disclosure of the newly discovered facts and their impact upon the financial statements in cases where the auditor believes: (a) the audit report would have been effected if the information had been known at the date of the report, and (b) there are persons currently relying upon the financial statements who would attach importance to the information.

Our capital markets are much more efficient if, instead of correcting information in restatements, the original financial statements reflect appropriate accounting policies and contain appropriate disclosures the first time. To that end, the staff of the SEC wants to work together with the corporate community, the accounting profession, and private sector standard-setting bodies to advance, not just protect, the interests of investors by helping companies to get financial reporting right the first time.

Accounting for Special-Purpose Entities

Enron's Form 8-K filing discloses that three previously unconsolidated special-purpose entities ("SPEs") should have been included in Enron's consolidated financial statements. An SPE is an entity created by a sponsor to carry out a specified purpose or activity, such as to consummate a specific transaction or series of transactions with a narrowly defined purpose. SPEs are commonly used as financing vehicles in which assets are sold to a trust or similar entity in exchange for cash or other assets funded by debt issued by the trust. In many cases SPEs are used in a structured transaction or series of transactions to achieve off-balance sheet treatment. In addition, use of SPEs can provide a lower cost of financing and can create tax advantages. An SPE, however, is

expensive to set up and maintain. Therefore, SPE activities usually occur on a large scale so the impact of the reduced interest rate more than offsets the costs.

To illustrate, here is an example of how an SPE might work. A third party investor unrelated to a transferor may set up an SPE for the benefit of a transferor, which is the company that transfers or contributes the assets to the SPE. The investor will control the activities of the SPE and retain the substantive risks and rewards like common stockholders in a "normal" corporation. The SPE will hold assets and finance them through debt and equity issued to institutional investors or public shareholders. To reduce the interest rate paid on the debt, the SPE will obtain credit enhancements (for example, guarantees or similar derivative arrangements) often from the transferor and or other third parties. This spreading of the risk through the credit enhancements, coupled with the fact that the SPE's securities are usually liquid and easily traded, generally reduces the cost of the borrowing to a level below what it would have been had the transferor directly borrowed money from a bank or the market.

Most SPE transactions are off-balance sheet. This means that financial information about the SPE, including its assets and liabilities, does not appear in the financial statements of the transferor.

The accounting literature regarding SPE consolidation is found in materials issued by the EITF.[11] In order to achieve off-balance sheet treatment of an SPE pursuant to GAAP, two conditions must be met. First, the assets must be sold to the SPE (be legally isolated from the transferor) and, second, an independent third party owner that has made a substantive capital investment (which amounts to at least 3% of the SPE's total capitalization) must both control the SPE and possess the substantive risks and rewards of owning the SPE's assets. If executed properly, the legal isolation and the control by a third party reduce the risk of the creditor, as discussed above. Thus, off-balance sheet

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[11] See: EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*; EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities;* and EITF Topic No. D-14, *Transactions involving Special-Purpose Entities.*

treatment of an SPE involves more than just sufficient third-party equity. This equity must be "at risk" from the investor's perspective. If the investor's return is guaranteed or not "at risk," the transferor would be required to consolidate the SPE in its financial statements.

As noted in the Form 8-K filing, Enron has concluded that three previously unconsolidated SPEs did not qualify for nonconsolidation pursuant to GAAP. Thus, Enron plans to restate its financial statements to reflect these entities in the consolidated statements of financial position and results of operations.

The SEC, as noted in its Annual Report to Congress for 2000, has urged the FASB to continue their efforts to provide consolidation guidance concerning SPEs. The FASB has announced its intention to concentrate on developing guidance for dealing with several consolidation issues that would resolve many problems encountered in present practice, including issues related to special-purpose entities. We will continue to urge the FASB to address SPE consolidation issues to increase financial statement transparency.

Reduction in Shareholders' Equity

Part of Enron's announced restatement includes a $1.2 billion reduction in shareholders' equity. Enron created four SPEs in 2000 and, as part of their initial capitalization and a series of ongoing transactions, issued its own common stock in exchange for notes receivable. At the time, Enron increased notes receivable and shareholders' equity to reflect these transactions. However, in announcing its restatement Enron disclosed that it had concluded that pursuant to GAAP[12] these notes receivable should have been presented as a reduction of shareholders' equity. GAAP generally requires that notes receivable arising from transactions involving a company's capital stock be presented as deductions from stockholders' equity and not as assets. Enron has

[12] EITF Issue No. 85-1, *Classifying Notes Received for Capital Stock*, and SEC Staff Accounting Bulletin No. 40, Topic 4-E, *Receivables from Sale of Stock*.

indicated that they overstated both total assets and shareholders' equity by $172 million due to a transaction first reported in the financial statements for the quarter ended June 30, 2000, and by an additional $828 million due to a transaction first reported in the quarter ended March 31, 2001. As a result, Enron has announced it intends to restate the financial statements for the second and third quarters in 2000 and its annual financial statements for 2000 for $172 million. The aggregate restatement for the first and second quarters for 2001 will be $1.0 billion

Enron also has disclosed that in the third quarter of 2001, it purchased a limited partnership's equity interest in an SPE, and that transaction resulted in a further reduction of shareholders' equity by $200 million. Enron also disclosed, without further explanation, that the $200 million related to the excess of the fair value of contracts deliverable by Enron over its notes receivable.

Mark-to-Market Accounting

Some members of the Subcommittees have requested that I also discuss mark-to-market accounting issues as applied to energy contracts. It should be noted, however, that Enron has not indicated that it intends to restate its financial statements due to mark-to-market accounting issues.

Entities commonly enter into contracts for the purchase and sale of energy commodities. Historically, most energy contracts were settled by physical delivery. However, in recent years companies have entered into energy contracts, at rapidly increasing rates, to speculate on market movements, to conduct hedging transactions, or otherwise to generate gains from market price differences.

To determine the proper accounting for these contracts pursuant to GAAP, a multi-step process must be undertaken. The first step is to evaluate whether a contract is

a derivative[13] in its entirety (as defined by GAAP). If the contract is not a derivative, then the company would determine if the contract is an energy-trading contract. [14]

If the contract is determined to be an energy-trading contract, then GAAP requires that the nonderivative energy-trading contract be marked to market with gains and losses included in earnings and separately disclosed in the financial statements or footnotes thereto. GAAP provides a set of indicators to consider when determining whether an operation's energy contracts are entered into for trading purposes.

Consistent with GAAP for financial instruments such as debt and equity securities and derivatives, GAAP does not specify how to compute fair value for energy trading contracts, other than that it should be done on an individual contract basis. Instead, GAAP provides a general principle, stating that fair value is the amount at which a contract could be bought or sold in a current transaction with willing parties, that is, other than in a forced or liquidation sale.

Pursuant to GAAP, a quoted market price in active markets is considered the best evidence of fair value and shall be used as the basis for the measurement, when available. If a quoted market price is not available, GAAP requires companies to estimate fair value based on the best information available in the circumstances. As quoted market prices may not exist for many energy trading contracts, companies must consider prices for similar energy contracts and the results of valuation techniques to the extent available in the circumstances. When valuation techniques or models are used, the best information for companies to consider includes recent spot prices and forward prices. An energy price curve is constructed by compiling forward prices of what the energy commodity is expected to be one to five years in the future. Specifically, observable forward prices are

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[13] A derivative is an instrument whose value is derived, in part, by reference to a stated index or other means. Derivative instruments are defined in Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

[14] EITF Issue No. 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities*. These criteria require an analysis of many factors including capacity, customers, volume, internal controls and the contracts themselves.

generally available up to three years into the future. In addition, broker-dealer prices are often available four to five years into the future. As a result, similar energy contracts with similar durations of five years or less have observable fair values within a narrow range.

However, a wide range of fair value estimates may result as the duration of an energy contract exceeds five years. Forward prices beyond the fifth year must be estimated, so the assumed rate of volatility has an important role in the assignment of fair value. Generally, prices are less volatile in the long run than in the short run. However, the current accounting guidance is not specific as to the application of fair value methods, so the assumed volatility of energy prices may vary, potentially leading to a wider range of assessed fair values.

Enron applies mark-to-market accounting for its energy trading activities. Enron has disclosed that the market prices it used to value its energy trading contracts reflect "its best estimate considering various factors including closing exchange and over-the-counter quotations, time value and volatility factors underlying the commitments."

Enron disclosed that it engages in price risk management activities for both trading and non-trading purposes. Enron's net assets from price risk management activities were approximately $1,088 million and $300 million at December 31, 2000 and 1999, respectively. While Enron discloses that it reports changes in its market values as part of other revenues (total other revenues were $7.2 billion for the year ended December 31, 2000), it is unclear from its public filings what portion of its revenues comes from the changes in values. In its statement of cash flows, however, Enron notes that approximately $763 and $395 million of income was recognized from price risk management activities that did not result in the receipt of cash in 2000 and 1999, respectively.

Improving the Disclosure and Regulatory System

In an "Op Ed Discussion" in the December 11, 2001 issue of The Wall Street Journal, Chairman Pitt has enumerated many initiatives for improving and modernizing the current disclosure and regulatory systems. A copy of the article is attached as Appendix B. Chairman Pitt, with significant input from those inside and outside the Commission, began development of these initiatives prior to the announcements by Enron. These initiatives, not yet adopted by the Commission, include:

- More current disclosure, including "real-time" disclosure of unquestionably material information,
- Disclosure of significant trend data and more "evaluative" data,
- Financial statements that are more clear and informative for investors,
- Disclosure of the accounting principles that are most critical to the company's financial status and that involve complex or subjective decisions by management,
- Private sector standard setting that is more responsive to the current and immediate needs of investors,
- A regulatory environment that continues, as always has been the case, to encourage public companies and the auditors of their financial statements to seek the advice of the SEC staff on new or unusual accounting questions so that they may "get it right the first time" and avoid restatements and the possibility of enforcement proceedings,
- A comprehensive and effective self-regulatory process for the accounting profession, as discussed above, with effective oversight by the Commission and its staff,
- More involvement by audit committees with management and the auditors regarding the selection and application of accounting principles used by the company, and
- Analysts not expressing views or recommendations when they do not have an adequate data foundation or when confused by company presentations.

As noted above, the accounting profession has announced its intention to assist the Commission in these efforts.

Conclusion

While the Commission's work relating to the Enron matter is just beginning, it is clear that with losses this sudden and deep to one of our largest reporting companies, we must look carefully at the adequacy of the current system of financial reporting. You can rest assured that the Commission and its staff are approaching this inquiry with an open mind and a firm intention to find out exactly what occurred and to deter, where possible, similar occurrences in the future. Should we conclude that any legislative solutions seem appropriate or helpful, we will seek the assistance of this Committee and your Subcommittees. We very much appreciate your prompt action and interest in having scheduled this hearing today and inviting us to participate.

Appendix A

Chronology of the Public Events Surrounding Enron

Enron, based in Houston, Texas, describes itself as a provider of products and services related to natural gas, electricity, and communications to wholesale and retail customers.

In 1999, a series of private investment limited partnerships, LJM Cayman, L.P. ("LJM1") and LJM2 Co-Investment, L.P. ("LJM2"), were created with Enron's then Executive Vice President and Chief Financial Officer serving as the managing member of the general partners. The CFO operated these partnerships as the managing member of the general partners while at the same time serving as an Enron senior executive.

In July 2001, the CFO relinquished his operating position in LJM1 and LJM2 and sold his interests to a non-executive officer of an Enron division who had previously reported to the CFO. This individual resigned from Enron immediately before purchasing the CFO's interests in the partnerships.

In August 2001, the President and CEO of Enron resigned citing personal reasons while acknowledging the pressure associated with the decline in the price of Enron's common stock during his six-month tenure as CEO. The current Chairman and former CEO reassumed the CEO title.

On October 16, 2001, Enron announced that it had recorded a $1.01 billion after-tax charge to its third-quarter earnings to recognize asset impairments, restructuring costs, and losses associated with certain investments. Enron subsequently disclosed that $35 million of this charge was related to transactions with LJM2.

In a conference call on October 16, 2001, Enron disclosed that shareholders' equity was reduced in the third quarter by $1.2 billion related to the company's repurchase of its

common stock, which previously had been issued as part of a series of transactions involving special-purpose entities associated with LJM2. In subsequent disclosures, Enron has characterized the reduction in shareholders' equity as the correction of accounting errors.

On October 24, 2001, Enron replaced the CFO. He subsequently was terminated.

On November 8, 2001, Enron filed a Form 8-K with the Commission. In the Form 8-K, Enron announced, among other matters, the following:

- Its intention to voluntarily restate its financial statements for the years ended December 31, 1997 through 2000 and the quarters ended March 31 and June 30, 2001 reducing previously reported net income for the last four and one-half years by $569 million, or 16% of reported net income for those four and one-half years. In connection with that announcement, Enron alerted investors not to rely upon the previously issued financial statements for these periods, including the audit reports of Arthur Andersen LLP covering the year-end financial statements for 1997 to 2000.
- Its intention to file a restatement recording: (1) a previously announced $1.2 billion reduction to shareholders' equity reported by Enron; (2) various income statement and balance sheet adjustments as the result of a determination by Enron and its auditors that three unconsolidated entities should have been consolidated in the financial statements pursuant to generally accepted accounting principles ("GAAP"); and (3) prior-year proposed audit adjustments and reclassifications (that were previously not recorded because they were determined to be immaterial in the year originally proposed and therefore never recorded).
- A Special Committee of the Board of Directors had been formed to investigate the matters disclosed in the Form 8-K and the Committee's investigation might result in additional or different information.

The restated financial statements that Enron indicated it would file have not yet been filed with the Commission.

On November 9, 2001, Dynegy Inc. announced its intention to acquire Enron for approximately $9 billion in Dynegy Inc. stock and the assumption of $13 billion in debt.

On November 19, 2001, Enron filed its Form 10-Q for the quarter ended September 30, 2001. The company updated some of the disclosures made in its November 8, 2001 Form 8-K and disclosed that it had initiated an action plan for the restructuring of its business that would negatively impact its fourth quarter earnings. Enron also disclosed that a note payable in the amount of $690 million related to a limited partnership had been accelerated due to a downgrade in Enron's debt rating. In addition, Enron disclosed additional debt amounts that would be accelerated if the company's debt rating fell below investment grade. The filing noted that the auditor of Enron's financial statements was unable to finalize its required review of the quarterly financial statements prior to filing with the Commission due to an ongoing investigation by the Special Committee.

On November 28, 2001, several rating agencies lowered Enron's long-term debt to below investment grade. Shortly after the downgrade, Dynegy terminated the merger agreement, citing breaches of representations, warranties, covenants and agreements in the merger agreement including a material adverse change provision.

On December 2, 2001, Enron filed for Chapter 11 bankruptcy protection and simultaneously sued Dynegy for $10 billion alleging breach of contract in connection with Dynegy's wrongful termination of its proposed merger.

As noted previously, the Commission's investigation into these matters is continuing.

APPENDIX B

How to Prevent Future Enrons
By Harvey L. Pitt

12/11/2001
The Wall Street Journal
Page A18
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The Securities and Exchange Commission is investigating **Enron** 's meltdown and its tragic consequences. Until all the facts are known, there is nothing that can or should be said about who may be responsible for this terrible failure. The public can be confident, however, that we will deal with any wrongdoing and wrongdoers swiftly and completely, to ensure full protection of investor interests.

Even before the **Enron** situation, we were working to improve and modernize our disclosure system -- to make disclosures more meaningful, and intelligible, to average investors. Our immediate concern in the wake of this tragedy should be to understand how to prevent more events like this. Of course, those with intent and creativity can override any system of checks or restraints. Believing that we can create a foolproof system is both illusory and dangerous. But investors are entitled to the best regulatory system possible, and we can achieve more than we presently do if we focus attention on finding solutions instead of scapegoats.

Our current reporting and financial disclosure system has needed improvement and modernization for quite some time. Disclosures to investors are now required only quarterly or annually, and even then are issued long after the quarter or year has ended. This creates the potential for a financial "perfect storm." Information investors receive can be stale on arrival and mandated financial statements are often arcane and impenetrable.

To reassure investors and restore their confidence, the public and private sectors must partner to produce a sensible and workable approach that includes, in addition to our existing after-the-fact enforcement actions:

-- 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 Generally Accepted Accounting Principles 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.

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

-- Conscientious identification and assessment by public companies and their auditors of critical accounting principles. Public companies and their advisers should 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 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.

-- Private-sector standard setting that responds expeditiously, concisely and clearly to current and immediate needs. A lengthy agenda that achieves its goals too slowly, or not at all, like good intentions, paves a road to the wrong locale.

-- An environment that encourages public companies and auditors to seek our guidance in advance. The SEC must be, and must appear to be, a constructive resource and hospitable sounding board for difficult and complex accounting issues before mistakes are made. We will always need, and utilize, after-the-fact enforcement, and we can, and will, improve our review of financial reports. But by now it is painfully clear that preventing problems is infinitely superior, and far less damaging, than acting after investor funds, retirement accounts or life savings are dissipated.

-- An effective and transparent system of self-regulation for the accounting profession, subject to our rigorous, but non-duplicative, oversight. As the major accounting firm CEOs and the American Institute of Certified Public Accountants recently proposed, the profession, in concert with us, must provide assurances of comprehensive and effective self-regulation, including monitoring adherence to professional and ethical standards, and meaningfully disciplining firms or individuals falling short of those standards. Such a system has costs, but those who benefit from the system should help absorb them.

-- 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 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. Analysts and their employers should eschew expressing views without an adequate data foundation, or when confused by company presentations.

Our system can be improved and modernized. In a crisis, some seek easy answers to difficult problems by pointing fingers. But true reform requires rigorous analysis, respect for competing views, and compromise and statesmanship by all concerned. 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 and honestly. We are committed to that end, and we seek participation from everyone with an interest in our capital markets. Together, in partnership, we can make a difference. That is our vision, and our mission.

Mr. Pitt is chairman of the Securities and Exchange Commission.

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