Remarks of C.E. Andrews
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Committee on Commerce
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Chairman Dorgan, Senator Fitzgerald, Chairman Hollings, Senator McCain, Members of the Committee.

I am the managing partner for Andersen's global audit practice. I am here today because faith in our firm and in the integrity of the capital market system has been shaken. There is some explaining to do.

What happened at Enron is a tragedy on many levels. We are acutely aware of the impact this has had on investors. We also recognize the pain this business failure has caused for Enron's employees and others.

Many questions about Enron's failure need to be answered, and some involve accounting and auditing matters. I will do my best today to address those.

I ask that you keep in mind that the relevant auditing and accounting issues are extraordinarily complex and part of a much bigger picture. None of us here yet knows all the facts. Today's hearing is an important step in enlightening all of us. I am certain that together we will get to the facts.

If there is one thing you take away from my testimony, I hope it is this: The public's confidence is of paramount importance. Andersen will not shrink from its responsibilities. If our firm has made errors in judgment, we will acknowledge them. We will take the actions needed to restore confidence.

Today, I would like to address two issues that go to the heart of concerns about our role as Enron's auditor.

First, did we do our job? I want to explain what we knew and when we knew it on several key issues, keeping in mind that our own review – like yours – is still under way.

Second, did we act with integrity? I want to discuss the $52 million in fees we received and respond to concerns that have been raised.

I also would like to cover what I believe are some of the lessons we can already learn from Enron – for our firm, for the accounting profession, and for all participants in the financial reporting system. My firm has publicly discussed many of these already.

Let me start by telling you what we know about three particular accounting and reporting issues:

- the restatements caused by the consolidation of two Special Purpose Entities, known as SPEs, and the recording of previously "passed" adjustments as a required byproduct of the restatement;

- a $1.2 billion reclassification in the presentation of shareholders' equity during 2001 – of which $172 million was misclassified in the audited 2000 financial statement, and;

- the company's disclosures about its off-balance-sheet transactions and related financial activities.

I want to emphasize that my remarks are based on the information that is currently available. We have made our best efforts to be complete and accurate in describing what we know. But our review, like the work of the SEC, this Committee, Enron's board, and others, is not yet complete. It is always possible that new information could be developed that would change current understanding of events or uncover new events.

Consolidation of Special Purpose Entities

Let me begin with the Special Purpose Entities. SPEs are financing vehicles that permit companies, like Enron, to, among other things, access capital or to increase leverage without adding debt to their balance sheet. Wall Street has helped companies raise billions of dollars with these structured financings, which are well known to analysts and sophisticated investors.

Two SPEs were involved in Enron's recent restatement announcement. On one, the smaller of them, we made a professional judgment about the appropriate accounting treatment that turned out to be wrong. On the one with the larger impact, it would appear that our audit team was not provided critical information. We are trying to determine what happened and why.

Let's begin with the larger SPE, an entity called Chewco. What happened with Chewco accounted for about 80 percent of the SPE-related restatement.

In 1993, Enron and the California Public Employees Retirement System (Calpers) formed a 50/50 partnership they called Joint Energy Development Investments Limited, or JEDI for short. Among other factors, the fact that Enron did not control more than 50 percent of JEDI meant that that partnership's financial statements could not be consolidated with Enron's financial statements under the accounting rules. In 1997, Chewco bought out Calpers' interest in JEDI. Enron sponsored Chewco's creation as an SPE and had investments in Chewco.

The rules behind what happened are complex, but can be boiled down to this. The accounting rules dictate, among other things, that unrelated parties must have residual equity equal to at least 3 percent of the fair value of an SPE's assets in order for the SPE to qualify for non-consolidation. However, there is no prohibition against company employees also being involved as investors, provided that various tests were met, including the 3 percent test.

In 1997, we performed audit procedures on the Chewco transaction. The information provided to our auditors showed that approximately $11.4 million in Chewco had come from a large international financial institution unrelated to Enron. That equity met the 3 percent residual equity test. However, we recently learned that Enron had arranged a separate agreement with that institution under which cash collateral was provided for half of the residual equity.

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What happened?

Very significantly, at the time of our 1997 procedures, the company did not reveal that it had this agreement with the financial institution. With this separate agreement, the bank had only one-half of the necessary equity at risk. As a result, Chewco's financial statements since 1997 were required to be consolidated with JEDI's which, in a domino effect, then had to be consolidated in Enron's financial statements. We identified the impact of this separate agreement on Enron's financial statements in the course of examining a number of documents provided to us by Enron management and the Board's special committee in November 2001. Kenneth Lay and Richard Causey have told us that they were not aware of this separate agreement until its discovery in November 2001 and we do not know of any contrary facts.

It is not clear why the relevant information was not provided to us in 1997. We and the Board's special committee are still looking into that.

We have notified Enron's audit committee of possible illegal acts within the company, as required under Section 10A of the Securities and Exchange Act. Because the special committee is investigating all of these matters, Section 10A does not require us to take any additional action until the special committee finishes its work and the Board acts upon any recommendations. We have not concluded that any illegal acts occurred.

Now, about the second SPE structure; specifically, a subsidiary of the entity known as LJM1. This transaction was responsible for about 20 percent -- or $100 million -- of Enron's recent SPE-related restatement.

In retrospect, we believe LJM1's subsidiary should have been consolidated. I am here today to tell you candidly that this was the result of an error in judgment. Essentially, this is what happened:

After our initial review of LJM1 in 1999, Enron decided to create a subsidiary within LJM1, informally referred to as Swap Sub. As a result of this change, the 3 percent test for residual equity had to be met not only by LJM1, but also by LJM1's subsidiary, Swap Sub.

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.

We are still looking into the facts. But given what we know now, this appears to have been the result of a reasonable effort, made in good faith. I do believe that we did a professional job overall and that this error did not cause Enron's collapse.

Adjustments previously not made to Enron's 1997 financial statement

As a result of the restatement for the SPEs, Enron was required to address proposed adjustments to its financial statements that were not made during the periods subject to restatement. Questions have been raised about certain of these "passed adjustments." Let me address that issue next.

As part of the audit process, the auditor proposes adjustments to the company's financial statements based on its interpretation of Generally Accepted Accounting Principles (GAAP). A company's decision to decline to make proposed adjustments does not mean that there has been an intentional effort to misstate. If the auditor believes that the company's actions result in either an intentional error or a material misstatement, it may not sign the audit opinion.

Often, there is a timing issue to consider. These adjustments typically are proposed by the auditor at the conclusion of the audit work – usually one or two months after the close of the year-end. Some companies, like Enron, choose to book those adjustments in the year after the auditor identifies them, when they are immaterial.

Questions have been raised about $51 million in adjustments not made in 1997 when Enron reported net income totaling $105 million. Some have asked how adjustments representing almost half of reported net income could have been deemed to be immaterial.

Auditing standards and SEC guidance say both qualitative and quantitative factors need to be considered in determining whether something is material. The Supreme Court has described this approach as the "total mix" of information that auditors must consider.

In 1997, Enron had taken large nonrecurring charges. When the company decided to pass these proposed adjustments, our audit team had to determine whether the company's decision had a material impact on the financial statements. The question was whether the team should only use reported income of $105 million, or should it also consider adjusted earnings before items that affect comparability – what accountants call "normalized" income?

We looked at "the total mix" and, in our judgment, on a quantitative basis, the passed adjustments were deemed not to be material, amounting to less than 8 percent of normalized earnings. Normalized income was deemed appropriate in light of the fact that the company had reported net income of $584 million one year earlier, in 1996, $520 million in 1995 and $453 million in 1994.

It is also important to remind you that the restatement analysis presented in Enron's recent 8-K filing was not audited. When Enron's audited restatement is issued, the $51 million in adjustments presented in 1997 will be reduced for the effect of adjustments proposed in 1996, which were recorded in 1997.

Reclassification of $1.2 billion of shareholders' equity

Now let me turn to the issue of shareholders' equity. Shareholders' equity was incorrectly presented on Enron's balance sheet last year and in two unaudited quarters this year.

Auditors do not test every transaction and they are not expected to. To do so would be impractical and would be prohibitively expensive. EnronOnline alone handled over 500,000 transactions last year.

Auditing standards require an audit scope sufficient to provide reasonable – not absolute -- assurance that any material errors will be identified. This testing is based on a cost-effective and proven technique known as sampling. If appropriate accounting is found in a properly chosen sample, this generally provides reasonable assurance that the accounting for the whole population of transactions has been done in accordance with GAAP and is free of material misstatement.

Shareholders' equity was initially overstated last year for a transaction with a balance sheet effect of $172 million. This amount was recorded as an asset, but should have been presented as a reduction in shareholders' equity. We recognize that this is a large number in absolute terms, but our work as auditors requires us to put such numbers into their proper context. That amount, $172 million, was less than one third of one percent of Enron's total assets and approximately 1.5 percent of shareholders' equity of $11.5 billion. It was a very small item relative to total assets and equity and had no impact on earnings or cash flow. Accordingly, the transaction fell below the scope of our audit.

In the first quarter of this year, Enron accounted for several more transactions in a similar way, increasing the size of the incorrect presentation of shareholders' equity by about $828 million.

The quarterly financial statements of public companies are not subject to an audit, and we did not conduct an audit of Enron's quarterly reports. Consistent with the applicable standards, our work primarily was a limited review of the company's unaudited financial statements.

In the third quarter, Enron closed out the transactions that included the $172 million and the $828 million equity amounts, and we and Enron reviewed the associated accounting. This review included third-quarter impacts on the profit and loss statement and on the balance sheet. This is when the erroneous presentation of shareholders' equity came into focus. (The remaining $200 million of this adjustment in equity was the result of transactions that occurred during the third quarter of 2001.)

We had discussed the proper accounting treatment for other transactions affecting equity with Enron's accounting staff, and therefore, the scope of our work on the year 2000 audit and this year's quarterly reviews did not anticipate this sort of error. When we informed the company of the error, the company made the necessary changes in its financial statements.

Questions about disclosure

Questions have been raised about the sufficiency of Enron's disclosures, especially about unconsolidated entities. I ask you to keep in mind that the company disclosed in its financial statements that it was using a number of unconsolidated structured financing vehicles. Unconsolidated means, by definition, that the assets and liabilities of these entities were not recorded in Enron's financial statements. However, in certain circumstances, footnote disclosures are required.

With that disclaimer, let me offer one man's view of what investors were told. Enron had hundreds of structured finance transactions. Some were simple; others, very complex. The company did not disclose the details of every transaction, which is acceptable under GAAP, but it did disclose those involving related parties and unconsolidated equity affiliates.

- JEDI and other entities are listed in footnote nine of Enron's 2000 annual report.

- LJM1 and LJM2, involving the company's former CFO, both were described in the 1999 and 2000 annual reports and described more fully in its annual proxy statements.

- Enron's unaudited quarterly financial statements also disclosed transactions with LJM1 and LJM2.

In footnote 11 to the 2000 annual report, Enron also disclosed under the heading "Derivative Instruments" that it had derivative instruments on 12 million shares of its common stock with JEDI and 22.5 million with related parties.

Some people say we should have required the company to make more disclosures about contingencies, such as accelerated debt payments, associated with a possible decline in the value of Enron's stock or changes in the company's credit rating. The Company did disclose this possible risk in its Management's Discussion and Analysis, or MD&A, section of its annual report.

I ask you to keep in mind that the company's shares were coming off near record levels when we completed our audit for 2000. No one could have anticipated the sudden, rapid decline we witnessed in this stock and its credit ratings, and accounting rules don't require a company to disclose remote contingencies.

That said, we continue to believe investors would be better served if our accounting rules were changed to reflect the risks and rewards of transactions such as SPEs, not just who controls them. Putting more of the assets and liabilities that are at risk on the balance sheet would do more than additional disclosure ever could. We have advocated changes in these accounting rules since 1982.

I offer an additional observation about Enron's disclosures. Press reports indicate that some who analyzed the company's public disclosures came to the conclusion that perceptions about the company – and thus the market's valuation of Enron – were not supported by what was in the company's public filings.

Fees paid to Andersen

Some are questioning whether the size of our fees, $52 million, and the fact that we were paid $27 million for services other than the Enron audit, may have compromised our independence. I understand that the size of fees might raise questions, and I think our profession must be sensitive to that perception.

With that in mind, it would be helpful for the Committee to have a deeper understanding of the nature of the work we did for Enron, and how the fees for that work were reported.

As a starting point, Enron was a big, complex company. Enron had $100 billion in sales last year. It operated 25,000 miles of interstate pipeline and an 18,000-mile global fiber optic network. Enron did business in many countries. Its EnronOnline trading system was the world's largest web-based eCommerce system and handled more than half a million transactions last year – for 1,200 products. Enron was the seventh largest company on the Fortune 500.

This was not a simple company. It was not a simple company to audit. In addition to its operations and trading, Enron, as we know, engaged in sophisticated financial transactions -- hundreds of them. Assets worldwide totaled $65 billion, both before and after Enron adjusted for the restatements

Given this complexity, it should not surprise anyone that the fees paid to our firm for Enron's audit were substantial. The $25 million fee for Enron's audit last year is comparable to the amounts that General Electric and Citigroup, two sophisticated financial services providers, paid for their audits. It is slightly more than the audit fees paid by two others -- JPMorgan Chase and Merrill Lynch.

Additional questions have recently arisen about whether Andersen served as Enron's internal auditor.

Enron has engaged Andersen to issue two separate reports: (1) a report on Enron's financial statements, and (2) a report on management's assertions about the reliability of Enron's system of internal control. Andersen is Enron's external auditor in preparing both types of reports. This second report is not required by federal law but has long been recognized – by the GAO, among others – as a best practice for large, complex companies like Enron. The standards for issuing such reports on internal controls, which are a type of attest work, are covered in the auditing literature. The fees associated with our report on Enron's system of internal control were part of our engagement as Enron's external auditor. These fees were properly reported as "audit" fees in Enron's proxy statement since Andersen performed the work as part of a single integrated audit.

From 1994-1998, Enron outsourced parts of its internal audit function to Andersen. That arrangement ended in 1998. Enron then began to add to its existing internal audit function under the umbrella of Enron Assurance Services (EAS). Enron's Risk Assessment and Control group also performs internal audit-type work.

From time to time after 1998, we were asked by Enron to perform certain consulting projects related to prospective changes to the control system. The fees for these projects in 2000 were disclosed as "non-audit" fees in Enron's proxy statement.

It is important to understand that internal auditing is not the same as bookkeeping. Internal auditors do not prepare a company's financial statements; those statements are prepared by the company – at Enron, by the accounting and financial reporting function led by the company's Chief Accounting Officer. An internal auditor does some of the same activities that an external auditor does, such as testing the company's system of internal control to assess whether it provides "reasonable assurance" that the company is accurately recording transactions on its books. Internal auditors can also perform additional functions such as operational auditing and reviews of prospective changes to the control system.

Next, I would like to address questions about our fees for non-audit services. Because of the way the fee categories for new proxy statement disclosures on auditor fees were defined, many services traditionally provided by auditors – and in many cases *only* provided by auditors – now are classified as "Other." Regrettably, without knowledge of the underlying facts, this leads some to believe that such fees are for "consulting" services. That is incorrect.

In fact, $2.4 million of the $27 million in “other” fees reported by Enron last year related to work we did on registration statements and comfort letters. This is work only a company’s audit firm can do.

Another $3.5 million was for tax work, which has never been mentioned as a conflict with audit work. Audit firms almost always do tax work for clients.

Another $3.2 million of the “other” fees related to a review of the controls associated with a new accounting system – a service highly relevant to the auditor’s understanding of the company’s financial reporting system. Another Big Five firm installed that financial accounting system -- for about $30 million. The scope and amount of this work, which is a type of work sometimes performed by a company’s internal auditors, complied with the AICPA professional standards and the SEC rules governing internal audit outsourcing which take effect next August.

Finally, $4 million of the fees listed as having been paid to Andersen were, in fact, paid to Andersen Consulting, now known as Accenture. As most of you know, our firms formally separated last August and had been operating as independent businesses for some time. Nevertheless, the rules said Enron had to report any fees it paid to Andersen Consulting as having been paid to its audit firm.

If you take all these factors into account, the total fees that our firmreceived from Enron last year amounted to $47.5 million. And of this, about $34.2 million, or 72 percent, was audit-related and tax work. Total fees for other services paid to our firm amounted to $13.3 million. This was for several projects, none of which was for systems implementation or for more than $3 million.

Some may still assert that even $13 million of consulting work is too much – that it weakens the backbone of the auditor. There is a fundamental issue here. Whether it’s consulting work or audit work, the reality is that auditors are paid by their clients. For our system to work, you and the investing public must have confidence that the fees we are paid, regardless of the nature of our work, will not weaken our willingness to do what is right and in the best interest of the investors as represented by the audit committee and the board.

I do not believe the fees we received compromised our independence. Obviously, some will disagree. And I have to deal with the reality of that perception. I am acutely aware that our firm must restore the public’s trust. I do not have all the answers today. But I can assure you that we are carefully assessing this issue and will take the steps necessary to reassure you and the public that our backbone is firm and our judgment is clear.

Lessons for the Future

When a calamity happens, it is absolutely appropriate to ask what everyone involved could have done to prevent it. By asking the other witnesses and me to testify today, the committee is working hard, in good faith, to understand the issues involved and to help prevent a recurrence with another company.

I believe that there is a crisis of confidence in my profession. This is deeply troubling to me, as I believe it is a concern for all of the profession's leaders and, indeed, all of our professionals. Real change will be required to regain the public's trust.

Andersen will have to change, and we are working hard to identify the changes that we should make.

The accounting profession will have to reform itself. Our system of regulation and discipline will have to be improved. Our CEO discussed some of the issues that the profession faces in an op-ed in the *Wall Street Journal*, which is attached to my testimony.

Other participants in the financial reporting system will have to do things differently as well – companies, boards, audit committees, analysts, investment bankers, credit analysts, and others.

We all must work together to give investors more meaningful, relevant and timely, information.

But our work starts with our firm. We are committed to making the changes needed to restore confidence.

A day does not go by without new information being made available, and I would observe that all of us here today -- and many others who are not here -- have a responsibility to seek out and evaluate the facts and take needed action. My firm will continue to do our part. I hope that my participation today has been helpful to your efforts.

Thank you.

Enron : A Wake - Up Call
By Joe Berardino
12/04/2001 The Wall Street Journal Page A18

A year ago, Enron was one of the world's most admired companies, with a market capitalization of $80 billion. Today, it's in bankruptcy.

Sophisticated institutions were the primary buyers of Enron stock. But the collapse of Enron is not simply a financial story of interest to major institutions and the news media. Behind every mutual or pension fund are retirees living on nest eggs, parents putting kids through college, and others depending on our capital markets and the system of checks and balances that makes them work.

My firm is Enron 's auditor. We take seriously our responsibilities as participants in this capital-markets system; in particular, our role as auditors of year-end financial statements presented by management. We invest hundreds of millions of dollars each year to improve our audit capabilities, train our people and enhance quality.

When a client fails, we study what happened, from top to bottom, to learn important lessons and do better. We are doing that with Enron . We are cooperating fully with investigations into Enron . If we have made mistakes, we will acknowledge them. If we need to make changes, we will. We are very clear about our responsibilities. What we do is important. So is getting it right.

Enron has admitted that it made some bad investments, was over-leveraged, and authorized dealings that undermined the confidence of investors, credit-rating agencies, and trading counter-parties. Enron 's trading business and its revenue streams collapsed, leading to bankruptcy.

If lessons are to be learned from Enron , a range of broader issues need to be addressed. Among them:

-- Rethinking some of our accounting standards. Like the tax code, our accounting rules and literature have grown in volume and complexity as we have attempted to turn an art into a science. In the process, we have fostered a technical, legalistic mindset that is sometimes more concerned with the form rather than the substance of what is reported.

Enron provides a good example of how such orthodoxy can make it harder for investors to appreciate what's going on in a business. Like many companies today, Enron used sophisticated financing vehicles known as Special Purpose Entities (SPEs) and other off-balance-sheet structures. Such vehicles permit companies, like Enron , to increase leverage without having to report debt on their balance sheet. Wall Street has helped companies raise billions with these structured financings, which are well known to analysts and investors.

As the rules stand today, sponsoring companies can keep the assets and liabilities of SPEs off their consolidated financial statements, even though they retain a majority of the related risks and rewards. Basing the accounting rules on a risk/reward concept would give investors more information about the consolidated entity's financial position by having more of the assets and *liabilities that are at risk on the balance sheet; certainly more information than disclosure alone could ever provide. The profession has been debating how to account for SPEs for many years. It's time to rethink the rules.*

-- Modernizing our broken financial-reporting model. Enron 's collapse, like the dot-com meltdown, 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, and associated business risks.

Enron disclosed reams of information, including an eight-page Management's Discussion & Analysis and 16 pages of footnotes in its 2000 annual report. Some analysts studied these, sold short and made profits. But other sophisticated analysts and fund managers have said that, although they were confused, they bought and lost money.

We need to fix this problem. We can't long maintain trust in our capital markets with a financial-reporting system that delivers volumes of complex information about what happened in the past, but leaves some investors with limited understanding of what's happening at the present and what is likely to occur in the future.

The current financial-reporting system was created in the 1930s for the industrial age. That was a time when assets were tangible and investors were sophisticated and few. There were no derivatives. No structured off-balance-sheet financings. No instant stock quotes or mutual funds. No First Call estimates. And no Lou Dobbs or CNBC.

We need to move quickly but carefully to a more dynamic and richer reporting model. Disclosurs needs to be continuous, not periodic, to reflect today's 24/7 capital markets. We need to provide several streams of relevant information. 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 and its business risks, financial structure and operating performance.

-- Reforming our patchwork regulatory environment. An alphabet soup 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) and FASB (Financial Accounting Standards Board) to the POB (Public Oversight Board) -- all have important roles in our profession's regulatory framework. They are all made up of smart, diligent, well-intentioned people. But the system is not keeping up with the issues raised by today's complex financial issues. Standard-setting is too slow. Responsibility for administering discipline is too diffuse and punishment is not sufficiently certain to promote confidence in the profession.

All of us must focus on ways to improve the system. Agencies need more resources and experts. Processes need to be redesigned. The accounting profession needs to acknowledge concerns about our system of discipline and peer review, and address them. Some criticisms *are off the mark, but some are well deserved. For our part, we intend to work constructively with the SEC, Congress, the accounting profession and others to make the changes needed to put these concerns to rest.*

-- Improving accountability across our capital system. Unfortunately, we have witnessed much of this before. Two years ago, scores of New Economy companies soared to irrational values then collapsed in dust as investors came to question their business models and prospects. The dot-com bubble cost investors trillions. It's time to get serious about the lessons it taught us.

In particular, 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 and accountants. But they also count on investment bankers to structure financial deals in the best interest of the company and its shareholders. They trust analysts who recommend stocks and fund managers who buy on their behalf to do their homework -- and walk away from companies they don't understand. They count on bankers and credit agencies to dig deep. For our system to work in today's complex economy, these checks and balances must function properly.

Enron reminds us that the system can and must be improved. We are prepared to do our part.

Mr. Berardino is managing partner and CEO of Andersen.