TESTIMONY

THE COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

WRITTEN STATEMENT BY LYNN TURNER

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Mr. Chairman, Senator Thompson, Members of the Committee:

Thank you for the invitation to share my thoughts on our system of accounting and the role it played in the Enron saga.

In business, we use numbers to report to investors, lenders, regulators and other users of the financial statements, the economic performance of a company. The numbers in the financial statements, just like a score on a college student's test, tell investors how a company has performed in comparison to expectations of management, the markets and competitors. Without these historical numbers, it is difficult, if not impossible, to gage the future prospects for a company. Without accurate numbers, investors are likely to be misled into making make wrong decisions. When this occurs with increasing frequency, as we have seen in recent years, investors question whether they can invest with confidence without losing their money.

Two Key Issues

Enron does highlight two issues I want to focus on today. The first is that accounting standards are meaningless unless fully complied with, and enforced through a rigorous, unbiased and independent audit. The second is that our accounting standard setting process needs to be improved so as to yield more timely and higher quality standards. But keep in mind that no matter how quickly information is reported to the public, or what information is reported, if it is inaccurate, its value is lost.

A Lack of Compliance

To the first issue, we know that under the *existing* rules, Enron's financial statements should have presented a much clearer picture than they did when first presented to investors. Based on filings the company made with the Securities and Exchange Commission (SEC) in November of last year, there were four instances of noncompliance with *existing* rules.

Stock issued for a note

The first error involves the company issuing approximately $1.2 billion of its stock and in return, receiving back a note receivable. Accounting rules of the SEC and Financial Accounting Standards Board (FASB) that have existed for over fifteen years prohibit a company from counting stock that has not been paid for, as equity on its balance sheet. This is because the company has not yet received cash (that is, the equity) it can use in the business. Enron notes this in their November 2001 filing with the SEC which correctly states: "Enron now believes that, under generally accepted accounting principles, the note receivable should have been presented as a reduction to shareholders' equity…The net effect of this initial accounting entry was to overstate both the note receivable and shareholders' equity…"

Materiality

The second error for which the company restated its financial statements resulted from the company failing to book audit adjustments decreasing income by $51 million or 48.6% of the reported net income of $105 million in 1997. This is not the first time I have seen a company and its auditor rationalize why such a large number would not be considered important information to investors. As a result, in 1999, the SEC staff reiterated the rules on materiality in the form of a Staff Accounting Bulletin that I believe will prevent such abuses in the future, if properly followed.

Special Purpose Entities

The third error involves the company failing to include in its financial statements certain partnerships it had established for specific structured transactions. Special purpose entities or SPE's are typically designed for a specific transaction. SPE's come in various forms including partnerships like Enron established, corporations or even trusts. SPE's are used for many purposes such as financing buildings and equipment, raising capital by transferring receivables into an SPE that in turn raises capital, and providing capital to a bank that has troubled loans that are shifted out of the bank and into the SPE so as to facilitate improving its capital base. While SPE's are sometimes used for legitimate business purposes, they are too often used to hide liabilities from the unwary investor.

SPE's usually involve at least four parties when they are set up. The company who sets it up called the sponsor (Enron), the SPE itself (such as LJM1, Chewco or JEDI), a lender who is willing to finance the activities of the SPE, and an investor(s) who will own the SPE. In a nutshell, the sponsor establishes the SPE, which in turn acquires or builds an asset, the funding which is provided by the lender, who in turn may look to the sponsor for some form of support for the loan such as a guarantee or credit enhancement. The SPE is owned by an independent investor and who puts up in the form of equity, at least three percent of the amount of capital needed to acquire the asset. The debt of the lender is then paid back through lease payments or securitization of the SPE's assets.

A very simplified version of an SPE is as follows. Assume your household is a business and you own a home that has a mortgage on it. You want to go out and buy a second home in the Colorado mountains that will cost you $200,000 and you will need to finance it. But you are concerned that if you take out a second mortgage on the mountain home, lenders will think your balance sheet has too much debt on it and will turn you down or charge you more to finance future purchases you are planning. So you go out and set up a partnership, and get a close friend to agree to put in 3% of the cost of the house, or $6,000 in return for all the ownership of the partnership capital. The partnership goes to a mortgage company who agrees to finance the remaining 97% or $193,000 of the transaction. You agree to guarantee the debt, or find someone who will, in return for you paying a fee. You also enter into a lease agreement and agree to make payments to the partnership that will be used to pay the mortgage in addition to a return to your friend on his capital. Assuming (i) you structure the terms of the lease properly, (ii) a third party (your friend) puts equity in the partnership for which he has risk of loss in a sufficient amount, (accounting practice says at least 3%) and (iii) the majority ownership of the partnership is held by someone other than yourself, you do not have to report the mortgage or maintenance costs on the second house on your balance sheet or income statement. By keeping this debt off your balance sheet, it looks to potential lenders as if your credit worthiness is better than if you had the additional $200,000 loan on it. Accordingly, you are able to get a better credit report and additional financing on better terms.

In the case of Enron, its SPE's did not meet the test for adequate capitalization under accounting guidelines that have been in existence since 1991. In its filing with the SEC in November 2001, the company notes that its previously issued financial statements were in error as three SPE partnerships named LJM1, Chewco and JEDI did not qualify "as an adequately capitalized unconsolidated special purpose entity…" or should have been consolidated because of "…inadequate capitalization." In 1991, the staff of the SEC wrote to the profession and stated: "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." This is a test that Enron did not meet.

Related party disclosures

The fourth question raised with respect to the financial statements of Enron involves the adequacy of the disclosures of the transactions Enron entered into with related parties such as its SPE's. In 1982, the FASB adopted SFAS No. 57, *Related Party Disclosures*. This is a broad general standard that requires a company to disclose (i) the nature of the relationships it has entered into, (ii) a description of the transaction, (iii) the dollar amount of the transaction impacting the income statement and (iv) the amounts due to or from the related party and how they are to be settled. Yet the description and discussion of related party transactions are in significantly greater detail in the November 2001 filings than had previously been disclosed. One can only ask why now? Why not before?

New accounting rules were not needed to prevent the restatements of Enron's financial statements or improve the quality of some of its disclosures. Compliance with and enforcement of the accounting rules that have been on the books for years would have given investors a timely and more transparent picture of the trouble the company was in.

While Enron has correctly been described as a business failure, it was also a failure that the audited numbers did not report the true economic condition of the company in an accurate and timely manner to investors.

To correct this lack of compliance with accounting standards, I hope you will consider the imperative need for an effective independent regulatory oversight body for the accounting profession, that has these critical elements:

1. It is conducted by an adequately funded organization,

2. Its members are drawn from the public rather than the profession,

3. It has the ability to investigate and discipline those who fail to follow the rules,

4. It has the power to establish auditing and quality control standards that serve the interests of investors as opposed to the interest of the profession, and

5. It inspects the work of auditors on an ongoing basis to ensure they have made the investing public, not the amount of consulting fees they can generate, their number one priority.

Enhancing Our Accounting Standards

Let me move on to the second issue I want to cover today. I believe our financial reporting system, including the accounting standards we use in assembling the numbers, remains the best in the world. That is difficult to comprehend in light of Enron, but one only has to examine closely the Asian crisis of a few years back to appreciate the quality of our financial reporting.

Yet our rules and processes can and should be improved to provide investors and regulators with greater transparency. The accounting standards need to be enhanced to ensure that the actual economics of transactions are reflected in a timely manner in financial statements. And the process for developing the standards needs to be more focused, timely and guided by a mission of improving transparency for investors.

We need to enhance disclosures regarding events and transactions that, should they occur, would result in a company being required to make payments to a third party. I believe the nature, terms, range of potential exposure and key assumptions used to determine that range should be disclosed. Investors have the right to know if a company could in fact face a meltdown as we have now seen occur with both Long Term Capital Management and Enron.

With respect to SPE's, the SEC first raised the issue in 1985 when it asked the FASB to consider the accounting for financial instruments, along with the accompanying structures that were often used. In the late 1980's, the SEC staff repeatedly stated concerns and asked a private sector task force of the FASB, the Emerging Issues Task Force (EITF) to address the issue. The end result was a set of weak rules that continue to mask from investors many off balance sheet transactions. The SEC has again highlighted its concern in its 2000 Annual Report to Congress, after a lack of success by the FASB in recent years in resolving the issue. If the SEC is to continue to look to the private sector to set accounting standards, which I strongly support, then the SEC and investors have the right to expect timely resolution of this and other important issues.

We cannot afford to wait another fifteen years. If the FASB were unable to rectify this issue by the end of 2002, then I would urge the SEC to act promptly. Hopefully the FASB will accomplish this goal, unimpeded by the traditional lobbying of special interests running to some members of Congress for their intervention in order to keep investors in the dark about their numbers.

The EITF is comprised of representatives of industry and the accounting profession. It's mission does not mandate standards that result in the most transparent reporting for investors and in fact, it has at times seemed to be more intent on grand fathering poor accounting from the past. It lacks representation from the public and investors and that is reflected in its standards. This should change.

And finally, one of the stark realities the FASB has faced in the past when setting standards is that before the ink dries, the investment banking community and accountants are joining forces to find ways to structure transactions to get around the new rules. And while the spirit of a rule may clearly say no, I have heard time and time again from a Chief Financial Officer or auditor, "where in the rules does it say I can't do it." It is time to get away from this mentality and a good starting point would be to prohibit auditors from designing and structuring transactions, such as SPE's, that result in less, rather than more, transparency for those they are reporting to.

Closing

One out of every two adult Americans have invested in the U.S. capital markets that are the crown jewel of our economy. They have done so because they had trust and confidence in a system that provides the numbers investors need to make wise investment decisions. They have trusted that an independent public watchdog was on the beat.

But that trust now lies shattered and will not be easily restored. In the two hundred plus year history of the markets, every time that confidence has been shattered, our markets have sustained losses, investors have fled to safer havens and the capital vital to funding American business and job opportunities has dried up. We cannot let that happen again. We must act quickly to make real, not just cosmetic changes that will restore the confidence of investors and the American public. The public deserves nothing less from Congress, the accounting profession, regulators, analysts and other members of the financial community.

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