

Current Developments for Audit Committees 2002 Supplement

To Our Clients and Friends

The collapse of Enron, the largest business failure in U.S. history, has seized the attention of the corporate world, federal government, and investing public. The Administration, Congress, and regulators have launched investigations, and managements and boards of directors are asking the fundamental questions, how could it have happened, and could it happen to our company?

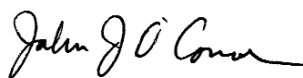
This Supplement to our recently issued *Current Developments for Audit Committees 2002* briefs boards of directors and audit committees, as well as managements, on the Enron failure. It highlights what happened, the nature and scope of the fallout, potential implications for your company, and what you will want to do at this time. It brings together information our partners have provided our clients over the past weeks and builds on ensuing discussions. As you peruse this report, you will want to keep in mind that information we have today undoubtedly will be seen differently tomorrow, with new or revised information and analyses becoming available. As facts surface and our knowledge base grows, our partners will continue the dialogue as it relates to individual circumstances.

We look first at what led to this massive failure, and the major business implications for companies. We then turn to the far-reaching financial reporting issues, and actions already taken by regulators and others that demand immediate attention. The SEC has made clear it expects expanded disclosures in 2001 annual reports, and audit committees to give them close attention. Risk factors have been identified for management, audit committees, and auditors for use in this year's filings.

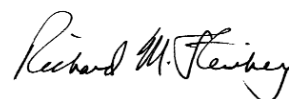
It is no exaggeration to say the very foundation of the capital markets has been shaken, with skepticism about the veracity of reported financial information available in the marketplace. The spotlight now, perhaps as never before, is on the total system of corporate performance, evaluation, and oversight—including management, analysts, credit rating agencies, external auditors, boards, audit committees, standard setters, and regulators. The public is skeptical about the usefulness of financial reports, and the independence and effectiveness of external auditors. There is movement toward developing a new regulatory structure providing oversight of the auditing profession. The United States has long been recognized as having the most transparent and effective financial reporting system in the world, with commensurate cost of capital advantage, and we must move quickly to ensure this continues long term. In this report we outline the program our firm recently announced to restore confidence in the system.

If you've had a chance to look over our report, *Current Developments for Audit Committees 2002*, you're aware of the development of new and more expansive financial reporting models, progress in financial statement accounting and disclosure, and expanded communication between auditors and audit committees. Clearly, additional progress is needed, quickly, in these and related areas, to make certain investors get the information they need and expect in order to make informed decisions, and to ensure the appropriate high confidence level in the reliability of that information. As you read this briefing, you may want to refer to that report for additional context.

In providing this Supplement, along with *Current Developments for Audit Committees 2002* and our guide, *Audit Committee Effectiveness – What Works Best*, we hope to provide you a comprehensive perspective on the financial reporting process, and the audit committee's role in it. And, we expect you to be actively involved, and challenge us as necessary, so that at the end of the day you are comfortable that your company's financial reports are comprehensive, reliable, understandable, and responsive to the needs of the investment community.



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What Happened at Enron

As the largest and among the most sudden business failures in U.S. history, Enron has been the subject of tremendous attention. The demand for information has been intense and immediate, with Enron employees and retirees, corporate America, Wall Street, government, the financial reporting community, and the general public justifiably wanting to know what happened.

Outlined here is what we've learned to date. This briefing is based on press reports and other publicly available information. No doubt new information will continue to surface virtually daily, although it may take substantial time before investigators and others fully understand important information about Enron's strategies and objectives around markets, operations, business structures, and specific transactions. While our understanding of what happened will be refined, if not overturned, having certainty about the causes of this tragic collapse is not as important as sharing, today, our present understanding of core aspects of the failure and the cautionary signals it sends.

In Summary

What happened at Enron? Here's a quick summary, based on the published reports.

- Enron's investments used large amounts of debt financing. But the investments—including a water-distribution business in the United Kingdom, gas pipeline and distribution operations in Brazil, power plant project in India, and fiber optics cable network in the United States—did not generate adequate profits and cash flows to support the company's debt load. Many of the investments and related financing were off-balance sheet, in the form of partnerships, limited liability companies, and corporate joint ventures, with Enron providing back-up guarantees and collateral. In some situations, the collateral was in Enron shares, with the company obligated to make cash payments in the event its stock price declined.
- Enron profited from the run-up in electric and gas prices, particularly in California, but the trend began to reverse in summer 2001. The resulting drop in Enron's revenue, decline in the value of investments described above, oversupply of broadband capacity in the United States, general economic decline, and increased competition drove down Enron's profits and stock price.
- In its third-quarter release, Enron reported a loss and announced nonrecurring charges associated with impaired investments and transactions with special-purpose entities (SPEs), the management of at least one of which involved Enron's CFO, who left the company in October. The company announced it would restate prior-period financial statements to consolidate certain previously unconsolidated SPEs, record a note receivable from an exchange of Enron stock as a reduction of shareholders' equity rather than as an asset, and record prior years' waived audit adjustments. A decline in Enron's stock price followed, triggering the cash payments described earlier.
- Enron's counterparties—whose confidence was key to its core trading operation—began to demand credit assurances, such as cash collateral and irrevocable letters of credit. With its deteriorating credit and inability to raise new capital, the company was unable to meet the demands. As a consequence, it was unable to continue entering into new trading contracts and couldn't generate cash flows sufficient to repay existing debt obligations. Considering that its value was driven by its trading business, once those business relationships deteriorated, the company began to collapse.

Enron filed for Chapter 11 bankruptcy protection on December 2, 2001, and on January 15, 2002 the New York Stock Exchange moved to delist Enron's shares.

Investigations Launched

A series of investigations have begun:

- Congress is looking into the factors surrounding the collapse, including issues related to special-purpose entities, adequacy of financial disclosure and accounting rules, regulation of accounting firms, lack of regulation over energy-trading activities, and campaign finance and pension plan reform.
- The SEC initiated investigations, and is calling for enhanced disclosures for public companies.
- The Federal Energy Regulatory Commission announced plans to expand disclosures required of energy-trading companies.
- The U.S. Justice Department opened an investigation.
- The Federal Trade Commission and the U.S. Labor Department have signaled they will be conducting investigations.

Investigations also have been announced or are being considered by others, including state bodies and regulatory agencies in other countries, and rating agencies reportedly are reconsidering aspects of their assessment practices.

Business Implications for Companies

Directors have been looking at their companies through a different lens, asking whether Enron-type risks are present. Typically the first question is, “Could it happen here?”—especially where the company uses inherently high-risk, complex financial instruments and structured finance transactions.¹

Managing the Risks

Business structures and transactions can be highly complex, with sophistication challenging even the most knowledgeable and experienced professionals. Nevertheless, management should be sure it is comfortable with the nature of the arrangements, and that their complexities don’t create barriers to a full understanding. And the board or audit committee, in its oversight role, needs to be comfortable that proper business purposes are served, and related risks are indeed understood and managed.

Where to begin? Where uncertainty exists, managements will want to re-review the arrangements, along with supporting contracts, both on- and off-balance sheet, to ensure they:

- Understand how each financing arrangement interrelates with other transactions, and how maturities of the instruments could be influenced by factors outside management control
- Determine whether scenarios exist that could accelerate some or all of the company’s outstanding debt, and develop plans to mitigate the risk or secure alternative financing
- Evaluate the potential for a liquidity crisis and loss of investor confidence
- Have a clear “big picture” perspective, especially where there are large numbers of structures and transactions
- Consider needed enhancement of processes for approving transactions, to ensure risks are fully addressed

Special attention should be given to counterparties. For example, to whether the counterparty is an off-balance sheet entity owned by a member of company management; a put option is embedded in the transaction, allowing the counterparty to “put” the assets or operations back to the company; or the company has provided credit support such as a debt guarantee. Other issues include whether the company’s management funded the counterparty’s independent equity, or the company is the administrative agent or manager of the counterparty.

Particular focus is warranted on off-balance sheet entities and other practices such as:

- Complex, interrelated off-balance sheet entities with investments in each other and transactions with each other and with the sponsor, including purchases/sales of assets, derivative transactions, and operating agreements

¹ Such arrangements are designed to achieve specific objectives, such as raising funds at lowest cost, obtaining off-balance sheet accounting treatment, or generating desired tax results. The transactions typically involve purchases/sales of assets, derivative transactions, and intricate operating agreements used to meet desired economic and financial reporting objectives. These may involve transfer of assets off-balance sheet or arranging for units to be acquired by special-purpose entities, joint ventures, limited liability corporations, or partnerships, with the company retaining substantially all the risks and rewards of ownership but without meeting the accounting definition of “control.”

- Off-balance sheet debt arrangements collateralized by the sponsor’s shares—either common shares or preferred shares convertible into common
- Put options written on the sponsor’s own common stock to support off-balance sheet debt
- Repurchases of assets previously sold to special-purpose entities
- Use of a trust, financed by loans from institutional investors backed by the sponsor’s share-trust/share-collateral arrangement (including a “top-up” cash guarantee), as a vehicle to acquire a public company
- Intent to recognize either income on derivative trades with thinly capitalized unconsolidated special-purpose entities, or gains on sales of assets and related fees for services after the sale of the assets to thinly capitalized unconsolidated special-purpose entities. These and other financial reporting issues are discussed further in a later section.

Related party transactions call for scrutiny, especially where the company has relationships with unconsolidated entities controlled by management employees. Also, attention is needed where special-purpose entities invest in stock or warrants of the company or in start-ups where the company has the ability to acquire control when the operation turns profitable. Corollary issues include whether a transaction truly benefits the company, or rather compensates the executive, and whether such employee participation makes good business sense.

There are still other circumstances that should trigger attention, such as using credit-linked notes, including debt securities with embedded written interest rate options, to convert bank borrowings into debt securities in order to increase borrowing capacity and reduce borrowing costs; using monetization transactions to remove assets and associated debt from the balance sheet, while retaining income statement upside but also retaining significant risk; and proper recording of notes received in connection with issuance of equity.

It’s evident that business structures and transactions can be highly complex, and their purpose not always readily apparent. Nevertheless, senior management and boards of directors must be positioned to understand the basic structure of transactions with significant implications, along with the underlying business purposes. If that understanding is not present—for whatever reason—then something may be awry. The communication process needs to continue until clarity is sufficient, and the business purpose deemed appropriate.

Managements and boards or their audit committees also should determine whether internal controls are appropriate to achieve the company’s operating, financial reporting, and compliance objectives. The control environment needs to be conducive to effective operation of control activities, and risks should be identified and managed within the context of an enterprise-wide risk management process.² Some of the more directly relevant areas on which to focus are provided in the exhibit.

² For guidance on enterprise risk management, refer to our reports, *Current Developments for Audit Committees 2002* and *Corporate Governance and the Board – What Works Best*.

Best Practices for Off-Balance Sheet and Similarly Complex Transactions

Formal, established controls are built into the evaluation and approval of investments, joint ventures, structured finance arrangements, and other complex transactions, ensuring:

- Financial reporting, operational, and compliance risks associated with each transaction are considered
- All needed input is obtained from relevant functional departments, such as treasury, accounting, operations, and legal departments
- Approval authority is defined, and transactions needing board approval are identified

A transaction-approval committee, consisting of experts in relevant disciplines (business, financial, and operational), is established to:

- Develop approval criteria
- Assess transaction risks
- Approve transactions

A central monitoring group continually:

- Monitors the business impact of the company's deals/transactions
- Evaluates interrelationships among transactions/investments
- Develops models to quantify (1) the impact of deals/transactions on the company's financial condition/liquidity in the event the company's share price or credit rating declines, or other triggers are activated, (2) the probability of such declines or triggers, and (3) related risks
- Presents regular status updates to management and the board
- Communicates current, clear, and informative disclosures to the financial community, avoiding surprises
- Assesses when certain structured finance transactions are no longer beneficial and, if necessary, proposes that the company unwind them

Operational Issues

Companies' operations may be affected by the fallout of the Enron collapse, and attention should be given to potentially significant impacts. For example, an assessment should be made of the possibility that:

- Transaction costs may increase, straining liquidity
- Customers and counterparties may demand higher standards with respect to the company's credit and collateral
- Availability of certain types of derivatives could be reduced, potentially increasing volatility in earnings and cash flows
- Companies may encounter more difficulty obtaining funding for aggressive expansion plans
- Investors may give greater attention to cash flow generation and working-capital management

Credit Ratings

Rating agencies are reassessing companies in industries with risks similar to Enron's. Some companies heavily involved in electricity generation and energy trading already have been downgraded to a rating below investment grade. Rating agencies also are reassessing companies with off-balance sheet and other structured finance arrangements.

Specifically, rating agencies are zeroing in on rating “triggers” that accelerate due date or cash-payment requirements and “cash top-up” arrangements, in which a company's shares collateralize off-balance sheet borrowing, obligating the company to cover in cash any shortfall between the value of the shares provided as collateral and the actual liability amount. Management and the board will want to stay on top of any potential changes in rating agency concerns or assessments.

A Disciplined Approach

Managements of most companies engaging in complex business structures and transactions should already have a comprehensive knowledge of their purpose, related risks, and risk management techniques. For managements that do not have such knowledge, or where a more disciplined approach is desired, an inventory should be conducted of all off-balance sheet and other similar arrangements, with information such as identified in the exhibit.

Suggested Information

- The business purpose and economic rationale for each arrangement, as well as a list of equity investors
- Risks inherent in the transactions
- A list of any affiliated or related party equity investors in off-balance sheet entities, along with documentation of all cross-ownership
- Description of any transactions between the company and the off-balance sheet entities, along with a summary of the accounting for the transactions
- A summary of key provisions of outstanding debt and lines of credit for off-balance sheet entities, with particular attention to (1) any rating triggers, (2) “cash top-up” arrangements, (3) other guarantees that could result in debt acceleration or a requirement to provide additional collateral or cash, and (4) guarantees to be funded by the company's equity shares, which could affect the company's earnings per share
- Assessment of interrelationships among covenants in all financing arrangements, including financial covenants in operating leases, executory contracts, and other nonfinancial commitments that could trigger default; cross-default provisions; and any possible scenarios in which a “death spiral” could occur—regardless of probability
- Description of credit and collateral that customers and counterparties require the company to provide when conducting transactions, along with a description of how the company's ability to meet those requirements could be adversely affected by changes in its credit rating or the market's perception of its ability to meet its commitments
- Any other information needed for expanded financial reporting disclosure requirements

Oversight

Boards of directors and audit committees are probing managements on issues related to the Enron failure. As noted, the immediate concern is whether “it could happen here.” Answering that question usually is neither quick nor easy, but rather requires an extended dialogue with management. Understanding the company in the context of the above discussion will provide information, insight, and a basis for decision making. In summary, directors can work toward gaining the necessary comfort level by:

- Recognizing the factors causing Enron’s collapse
- Requesting assessments of similar transactions the company may have undertaken, the risks therein, and any provisions possibly resulting in accelerated cash claims against the company
- Discussing the company’s exposure to Enron, or Enron-like transactions, and additional steps needed
- Recognizing potential economic and operational effects of the Enron fallout on the company
- Re-evaluating the company’s current internal controls over Enron-like transactions and, if necessary, requesting enhancements
- Expanding communications with the auditors on risks associated with complex transactions
- Looking at the need for expanded disclosure requirements in public financial reports

Pension Plans

Publicity surrounding the Enron collapse also has focused on the inability of participants in its 401(k) plan to reallocate investments in their individual participant accounts for a period of time. During this period, when the company was changing its administrative service provider and the price of Enron stock was dropping, participants were unable to sell the stock. The company said it provided advance notification of this “black out” period, although uncertainty remains about the effectiveness of communications to participants.

Many companies’ 401(k) plans have time periods when plan participants are unable to make investment transactions, typically when there is a change in service provider. And plans often allow holdings of company stock, which sometimes is provided as a “match” to employee contributions. There might be restrictions limiting sale of company stock provided by the matching program until the participant reaches a specified age, such as 50.

The Department of Labor is considering whether legislative or regulatory changes should be made. In the meanwhile, managements and boards of directors may want to consider their plans’ provisions in light of the Enron situation.

Focus on Financial Reporting

The Enron collapse, along with revelations of misstated financial statements, has focused a great deal of attention on the financial reporting process. Investor confidence has been shaken, and regulators and others are moving quickly to shore up confidence. In addition to the investigations identified above and guidance on companies' issuance of pro forma information (together with a recent enforcement proceeding), the SEC has taken a number of actions. It issued two releases related to Management's Discussion and Analysis (MD&A), and announced it will be looking at all *Fortune* 500 company annual report filings. These initiatives, along with increased attention to revenue recognition policies and compliance, will affect 2001 financial reports.

The SEC also has requested the FASB to move forward expeditiously in developing new accounting standards, and is looking to speed development of new financial reporting models. When implemented, these would provide additional information on business issues and risks, as well as more relevant asset valuations, to provide investors and other stakeholders with better information for decision making. These and other matters relevant to sound financial reporting are discussed here.

Critical Accounting Policies

The most immediate focus is on companies' critical accounting policies. A particular concern is that current financial disclosures don't sufficiently convey the significant impact certain accounting policies can have on reported results. The SEC acted on this issue through its interpretive release, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*. In it, the SEC says:

Reported financial position and results often imply a degree of precision, continuity and certainty that can be belied by rapid changes in the financial and operating environment that produced those measures. As a result, even a technically accurate application of generally accepted accounting principles ("GAAP") may nonetheless fail to communicate important information if it is not accompanied by appropriate and clear analytic disclosures to facilitate an investor's understanding of the company's financial status, and the possibility, likelihood and implication of changes in the financial and operating status.

We encourage public companies to include in their MD&A this year full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure is consistent with the objective of MD&A.

The SEC calls for a four-step process:

- 1. Each company's management and auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements.** As part of the normal audit process, auditors must obtain an understanding of management's judgments in selecting and applying accounting principles and methods. Special attention to the most critical accounting policies will enhance the effectiveness of this process. Management should be able to defend

the quality and reasonableness of the most critical policies, and auditors should satisfy themselves thoroughly regarding their selection, application and disclosure.

- 2. Management should ensure that disclosure in MD&A is balanced and fully responsive. To enhance investor understanding of the financial statements, companies are encouraged to explain in MD&A the effects of the critical accounting policies applied, the judgments made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail.*
- 3. Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies. Consistent with auditing standards, audit committees should be apprised of the evaluative criteria used by management in their selection of the accounting principles and methods. Proactive discussions between the audit committee and the company's senior management and auditor about critical accounting policies are appropriate.*
- 4. If companies, management, audit committees or auditors are uncertain about the application of specific GAAP principles, they should consult with our accounting staff. We encourage all those whose responsibility it is to report fairly and accurately on a company's financial condition and results to seek out our staff's assistance. We are committed to providing that assistance in a timely fashion; our goal is to address problems before they happen.*

This calls for greater audit committee involvement than typically has been the case in the selection, application, and disclosure of accounting principles. Following this guidance, audit committees will need to obtain more information about accounting policies and their implications. This continues the trend of the SEC calling for still more proactive involvement by audit committees in the financial reporting process.

The guidance reinforces and expands the importance of early audit committee involvement in addressing issues. The SEC has long encouraged those responsible for reporting to consult with the SEC staff on accounting and financial reporting issues, especially those involving unusual, complex, or novel transactions for which there is no clear authoritative guidance. But new policies now have been instituted to make the pre-clearance process more effective, efficient, and user-friendly. And, the SEC wants the audit committee involved. The SEC staff has indicated it can respond quickly when, among other things, the written submission includes the audit committee's views on the subject. Previous guidance suggested that submissions include only whether the question had been discussed with the audit committee, and the committee's view, if any. This new protocol calls for management to engage the audit committee early in the process, and for the audit committee to formulate a view on management's proposed accounting before it is submitted to the SEC staff.

The new pre-clearance protocol and the suggested disclosure regime are key elements in the SEC's quest to advance investors' interests by "working together to get it right the first time."

As noted, all of this draws audit committees closer to the workings of the financial reporting process. This is made perhaps most clear by SEC Chairman Pitt, in calling for more meaningful investor protection by audit committees, when he said:

Audit committees must be proactive, not merely reactive, to ensure the quality and integrity of corporate financial reports.... 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.

Enhancing MD&A Disclosures

As part of the accounting profession's response to Enron, the five largest accounting firms, with the endorsement of the AICPA, petitioned the SEC to issue an interpretive release providing guidance for public companies in preparing their MD&A covering 2001 filings. The SEC addressed this request by issuing an interpretive release for companies' consideration in preparing year-end and interim financial reports and other disclosures made after January 22, 2002. The release sets forth the SEC's views on disclosures in three areas.

1. Liquidity and capital resources, including off-balance sheet arrangements

The release indicates that current disclosures provide limited insight into a company's liquidity, sometimes omitting relevant factors adversely affecting liquidity. It prompts companies to identify circumstances "reasonably likely" to affect liquidity—factors such as market price fluctuations, economic downturns, and contraction of operations—and disclose related material effects.

It also suggests disclosing off-balance sheet arrangements with unconsolidated, limited-purpose entities that could expose the company to current or future liability, obligations, expenses, cash flow impacts, or asset impairment, or affect revenue recognition. If a company has numerous similar arrangements, disclosures could be aggregated.

And while companies now disclose future payments, the disclosures may be scattered throughout the filings, not aggregated in one location. The guidance suggests companies provide aggregated information on contractual obligations and commercial commitments—in one location, preferably in table form. This would give a comprehensive picture of obligations, better enabling readers to understand the company's liquidity and capital resources, including timing and amounts of contractual and potential demands on liquidity and capital resources.

Specific disclosure suggestions are described in the exhibit.

Suggested Disclosures

Liquidity

- Provisions in financial guarantees or commitments, debt or lease agreements, or other arrangements that could trigger a requirement for early payment, additional collateral support, changes in terms, or acceleration of maturity, such as adverse changes in credit ratings, financial ratios, earnings, cash flows, or stock price
- Circumstances that could impair the ability to continue to engage in certain financially or operationally critical transactions, such as the inability to maintain a specified investment grade credit rating, or specified level of earnings, earnings per share, financial ratios, or collateral

Suggested Disclosures (cont.)

Liquidity (cont.)

- Factors specific to the company and its markets that, based on information obtained from rating agencies or other expert sources, are given significant weight in the determination of the company's credit rating or otherwise affect its ability to raise short-term and long-term financing
- Guarantees of debt or other commitments to third parties
- Written options on nonfinancial assets, such as real estate puts

Off-Balance Sheet Arrangements

- The business purpose of the arrangement, economic substance, key terms and conditions of any commitments, initial and ongoing relationships with the company and its affiliates, and exposures resulting from contractual or other commitments
- Total amount of assets and obligations of the entity together with a description of assets and obligations and including separate identification of the class and amount of any debt or equity securities issued by the company
- The effects of the entity's termination if it has a finite life or it is reasonably likely the company's arrangement with it may be discontinued in the foreseeable future
- Amounts receivable or payable and revenues and expenses and cash flows resulting from the arrangements
- Extended payment terms of receivables, including loans and debt securities, resulting from the arrangements and related uncertainties as to realization or repayment contingent on future performance
- The amounts and key terms and conditions of purchase and sale agreements between the company and counterparties
- The amounts of any guarantees, lines of credit, standby letters of credit or commitments, or take or pay contracts, throughput contracts, or other similar types of arrangements that could require the company to provide funding of any obligations under the arrangements, including provisions to guarantee repayment of obligors of parties to the arrangements, make whole agreements, or value guarantees

2. *Certain trading activities involving non-exchange traded contracts accounted for at fair value*

Of concern is a lack of transparency in commodity-trading activities, particularly those lacking market price quotations, for which fair value must be estimated. While financial statement disclosure is required currently for companies materially engaged in energy- or weather-trading activities, or non-exchange traded commodity-trading contracts that are marked to fair value through earnings, the information alone is not sufficient to provide readers with a robust understanding of the trading activities.

The release suggests companies consider providing information about trading activities, contracts, and modeling methodologies, assumptions, variables, and inputs, along with an

explanation of the different outcomes possible under different circumstances or measurement methods. In particular, the release suggests information that:

- Disaggregates realized and unrealized changes in fair value
- Identifies changes in fair value resulting from changes in valuation techniques
- Disaggregates estimated fair values at the latest balance sheet date based on whether they are determined by quoted market prices or are estimated
- Indicates maturities of contracts at the latest balance sheet date (such as within one year, in years one through three, in years four and five, and after five years)

3. *Effects of transactions with related and certain other parties*

Both GAAP and the SEC require disclosure about transactions with related parties. But the disclosures might not explain fully the importance of the relationships to the company's results. Also, information is found lacking about other parties not encompassed by the definition of "related parties," but with a relationship allowing the company to negotiate transactions on terms that would not be available from clearly independent third parties. An example is an entity owned by a former senior company official.

The guidance urges companies to describe these special relationships and transactions, as well as transactions with defined "related parties." The descriptions should allow readers to understand the business purpose and economic substance of transactions, their effects on the financial statements, and special risks or contingencies arising from them. The discussion could include:

- The business purpose of the arrangement
- Identification of the related parties transacting business with the company
- How transaction prices were determined by the parties
- If transactions have been evaluated for fairness, a description of how the evaluation was made
- Any ongoing contractual or other commitments as a result of the arrangement

Review of Annual Report Filings

SEC's Division of Corporation Finance recently said that it plans to review the 2001 annual reports of all *Fortune* 500 registrant companies. This represents an effort to assess the response of the preparer community to the foregoing recommendations, or considerations related to the Enron matter. It will be focusing on accounting and disclosure practices that conflict with generally accepted accounting principles or SEC rules, appear to be materially deficient, or lack clarity.

Financial Reporting for Complex Transactions

Transactions involving special-purpose entities require special attention because of complicated accounting and disclosure rules, with different rules applying to *qualifying* versus *nonqualifying* SPEs. Ownership structure and transaction terms are critical to determining whether off-balance sheet treatment is appropriate under generally accepted accounting principles. Adequate footnote disclosure also is vital, since the potential impact of these transactions is rarely evident from the face of the financial statements.

Impact of the Current Economic and Business Environment on Financial Reporting

The five largest accounting firms, working with the AICPA, completed three initiatives aimed at enhancing the quality of financial reporting. The first was development of a petition for additional disclosures in MD&A for 2001 filings, submitted to the SEC and discussed above. The second entailed developing a toolkit to assist accountants and auditors in better understanding current issues pertaining to related parties and related party transactions, including a sample audit program and disclosure checklist.

The third is a document outlining critical risk factors for the key participants in the financial statement preparation process—management, audit committees, and external auditors. This report, *Impact of the Current Economic and Business Environment on Financial Reporting*, is designed for use in preparing and auditing 2001 financial statements.

This report provides participants in financial reporting with information relevant to the current financial reporting environment. It considers circumstances surrounding the Enron failure, in the context of the current economic downturn and events of September 11, which combine to create a financial reporting environment unlike any in recent memory. The document considers this difficult business environment and presents an assessment of risk factors to consider during the current reporting cycle. Because these risk factors apply not only to auditors, but also to other participants in the financial reporting process, it highlights actions management, auditors, and audit committees can take to effectively address the risks and produce reliable financial reporting.

The report identifies and discusses environmental factors:

- ***Difficult economic times***, with the slowing economy putting pressure on earnings, and capital markets especially sensitive to bad news
- ***Pressures to perform***, with Wall Street and sometimes managements or boards of directors applying pressure to meet performance goals, in some cases causing adoption of overly aggressive practices
- ***Complexity and sophistication of business structures and transactions***, which incorporate new and different types of risks, challenging clear reporting
- ***Complex and voluminous standards***, with a vicious cycle of tighter rule making, companies structuring complex transactions creatively looking for a way around the rule, and still more technical and complex rules

The report recognizes that the fundamental objective of financial reporting is to provide useful information to investors, creditors, and others in making rational decisions—and that information should be comprehensible to those with a reasonable understanding of business and economic activities and willing to study the information with appropriate diligence. In that context, it presents key financial reporting risk issues especially relevant in the current environment:

- ***Liquidity and viability issues***, which may arise rapidly and could lead to a going concern issue. The current business environment and market conditions might lead to rapidly deteriorating operating results and liquidity challenges, particularly where access to capital is reduced. Conditions to consider include negative trends such as recurring operating losses or working-capital deficiencies, financial difficulties in the form of loan defaults or denial of credit from suppliers, dependence on the success of a particular product that is not selling well, legal

proceedings, loss of a principal customer or supplier, destabilization of a trading partner or contract counterparty, and excessive reliance on external financing rather than funds generated from operations.

- ***Changes in internal control***, as staff reductions and restructuring may cause previously effective controls to deteriorate. Factors include layoffs, notifications to employees of impending termination, and remaining employees overwhelmed by workloads or lacking time to complete tasks and consider decisions. Also, rapid business expansion, changes in business strategies, and integration of different businesses may outstrip the ability of a company's financial systems to remain under effective internal control, and controls at business units whose divestiture has been announced may be disrupted.
- ***Unusual transactions***, which might not be subject to normal checks and balances, and can have a significant impact on reported results. Among common sources of financial reporting risk are significant adjustments or unusual transactions occurring at or near quarter- or year-end. Unusual transactions might include asset sales outside the ordinary course of business, significant or unusual period-end revenues, introduction of new period-end sales promotion programs, and disposal of a business segment.
- ***Transactions with related parties***, which may be manipulated to achieve performance targets during difficult economic times. Increased pressures on management to maintain or achieve financial targets heighten risks. Related party transactions lack the normally independent negotiations as to structure and price. Difficult economic times increase the possibility that the economic substance of transactions is other than their legal form, or that transactions lack economic substance. Parties without independent substance may be unable to carry out transactions or stand behind agreements.
- ***Transactions involving off-balance sheet arrangements, including special-purpose entities***, with special challenges for ensuring application of appropriate accounting standards. These may be unconsolidated, nonindependent, limited-purpose entities, which may be used to provide financing, liquidity, or market risk or credit support, or involve leasing, hedging, or research and development services. The arrangements or entities can result in contractual or other commitments by the company, such as requirements to fund losses, provide additional funding, or purchase capital stock or assets, or otherwise have financial impacts resulting from performance or nonperformance of the other party.
- ***Materiality***, which although used in judgments in financial reporting, shouldn't be used as an excuse to avoid correcting known errors in financial information. Both quantitative and qualitative factors should be evaluated when assessing materiality of misstatements, focusing on individual and aggregate misstatements and their impact on key financial statement line items, totals, and ratios. Key factors include whether a misstatement increases management's compensation by satisfying requirements for incentive awards, or masks a change in earnings or other trends or hides a failure to meet analysts' consensus expectations. Also relevant are misstatements with an impact on compliance with financial statement-related debt covenants, indicative of intentionally misleading financial reporting or illegal acts, or particularly important to a segment of the business.
- ***Adequacy of disclosure***, including recent calls by the SEC for improved discussion of critical accounting policies and clear explanations of reported pro forma results. Do disclosures in MD&A simply repeat financial statement captions or list changes without providing meaningful information about underlying reasons and what might happen in the future? Or does MD&A provide relevant information on material trends, events, or uncertainties, along with implications for methods, assumptions, and estimates used for recurring and pervasive

accounting measurements? And what about information on loss of a significant customer; impairments of long-lived assets; business restructurings; factors affecting the cost or availability of insurance coverage or energy; declines in values of investment securities or pension plan assets; violations, amendments, or waivers of debt covenants; credit or market risks; and effects of related party transactions?

- **Specific financial statement risks**, including issues related to revenue recognition, accounting estimates, asset valuation, and so on.

In addition to discussing risk factors, the document recommends actions by participants in the financial reporting process, shown in the exhibit.

Recommended Actions

Management

- Ensure the proper tone at the top and an expectation that only the highest-quality financial reporting is acceptable.
- Review all elements of the company's internal control—control environment, risk assessment, control activities, information and communication, and monitoring—in light of changes in the company's business environment and with particular attention to significant financial statement areas.
- Ensure that appropriate levels of management involvement and review exist over key accounting policy and financial reporting decisions.
- Establish a framework for open, timely communication with the auditors and the audit committee on all significant matters.
- Strive for the highest-quality, most transparent accounting and disclosure—not just what is acceptable—in both financial statements and MD&A.
- Make sure estimates and judgments are supported by reliable information and the most reasonable assumptions in the circumstances, and that processes are in place to ensure consistent application from period to period.
- Record identified audit differences.
- Base business decisions on economic reality rather than accounting goals.
- Expand the depth and disclosure surrounding subjective measurements used in preparing financial statements, including the likelihood and ramifications of subsequent changes.
- When faced with a “gray” area, consult with others, consider the need for SEC pre-clearance, and focus on the transparency of financial reporting.

Auditors

- Understand how a company is affected by changes in the current business environment.
- Understand the stresses on the company's internal control over financial reporting, and how they may impact its effectiveness.
- Identify key risk areas, particularly those involving significant estimates and judgments.
- Approach the audit with objectivity and skepticism, notwithstanding prior experiences with or belief in management's integrity.

Recommended Actions (cont.)

Auditors (cont.)

- Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.
- Consider whether additional specialized knowledge is needed on the audit team.
- Make management aware of identified audit differences on a timely basis.
- Question the unusual and challenge anything that doesn't make sense.
- Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.
- When faced with a “gray” area, perform appropriate procedures to test and corroborate management's explanations and representations, and consult with others as needed.

Audit Committees

- Evaluate whether management exhibits the proper tone at the top and fosters a culture and environment that promote high-quality financial reporting, including addressing internal control issues.
- Question management and auditors about how they assess the risk of material misstatement, what the major risk areas are, and how they respond to identified risks.
- Challenge management and the auditors to identify the difficult areas (e.g., significant estimates and judgments) and explain fully how they each made their judgments in those areas.
- Probe how management and the auditors have reacted to changes in the company's business environment.
- Understand why critical accounting principles were chosen and how they were applied and changed, and consider the quality of financial reporting and the transparency of disclosures about accounting principles.
- Challenge management for explanations of any identified audit differences not recorded.
- Understand the extent to which related parties exist and consider the transparency of the related disclosures.
- Read the financial statements and MD&A to see if anything is inconsistent with your own knowledge.
- Consider whether the readers of the financial statements and MD&A will be able to understand the disclosures and risks of the company without the access to management that the committee enjoys.
- Ask the auditors about pressure by management to accept less than high-quality financial reporting.
- When faced with a “gray” area, increase the level of communication with management and the auditors.

Financial Reporting Model

There is little question that, longer term, there is need for an enhanced, more robust financial reporting model. Reality is that historical cost-based financial statements have become increasingly complex. Adding to this are the increasing disconnects between the financial statements, information disclosed outside the financial statements, and information management uses to run its business. In today's environment where much business activity is knowledge-based, the financial statements fall short of revealing the value created by a company's management.

What's the solution? We believe that while historical financial statements need to be a key component of any improvements, we also believe that, in the near term, there needs to be better integration of information disclosed outside the financial statements with information reported within them, better disclosures providing more relevant information, and a "safe harbor" to create a freer flow of information. In the longer term, we believe that the financial reporting model should be expanded into a business model capable of capturing and disclosing values derived from the business and its transactions. Our ValueReporting™ is one such model. Also, standards should be clear and not unnecessarily complex, and be set more timely.

For a discussion of progress being made in developing enhanced financial reporting models, see *Current Developments for Audit Committees 2002*.

Audit Quality Under Scrutiny

As noted, the Enron collapse has sharply focused attention on the financial reporting process—by lawmakers, regulators, and others. Implications and actions underway by regulators, standard setters, and the accounting profession to shore up confidence in accounting and disclosure are discussed above under “Focus on Financial Reporting.” With respect to the accounting profession, the Enron fallout has put a bright spotlight on audit quality, along with questions about what further actions are needed.

These questions need to be addressed directly and fully, and changes are needed to be sure that the investment community and all stakeholders have confidence in the reliability of financial reporting. This is essential to maintaining the advantages enjoyed by the U.S. capital markets. We at PricewaterhouseCoopers recognize this need and, as discussed further in the next section, are active participants in making the needed changes.

Regulating the Profession

How is the U.S. accounting profession now regulated? A variety of regulatory and oversight mechanisms are in place. A central focus is the self-regulatory mechanisms of the AICPA and its SEC Practice Section of Firms, which have responsibility for quality control reviews and disciplinary processes, and the Public Oversight Board (POB), which has oversight responsibility for monitoring audit quality. Accounting standards are set by the Financial Accounting Standards Board, and auditing standards by the AICPA’s Auditing Standards Board. The SEC provides oversight and in some cases direction, and takes enforcement actions as deemed necessary. Standing Congressional committees oversee matters pertaining to accounting standards, the accounting profession, and the SEC, and individual states regulate licensing. And, the legal system is called upon on a case-by-case basis when failures are alleged.

In the face of Enron, as well as a greater number of financial statement restatements, at least some of these mechanisms have come under attack. Critics argue that stronger and more independent oversight is needed. In response, the SEC recently unveiled a proposal for a new regulatory system, designed to meet four primary objectives—increased public participation, better transparency, greater effectiveness, and improved timeliness. It calls for:

- **Key functions within the AICPA to be moved to a new independent body.** Disciplinary functions and audit quality reviews presently conducted by or under the auspices of the AICPA would be vested in a newly created independent regulatory board with a substantial majority of public members. The present oversight functions of the current POB would be transitioned to the new board with broader responsibilities. The new board would have responsibility for the disciplinary and audit quality monitoring programs, and would be funded through a foundation, maintain its own offices, and hire a dedicated staff to execute its programs. The SEC would undertake rule making to require participation in the board’s processes as a precondition to performing public company audits.
- **Strengthened discipline.** Responsibility to investigate and discipline auditors of public companies for professional and ethical violations would shift from the AICPA to the new board. It would be empowered to perform investigations, bring disciplinary actions against individual auditors or firms, publicize results of proceedings, and restrict the right of individuals and firms to audit public companies. Public members would constitute at least a two-thirds supermajority with respect to disciplinary matters. The SEC would refer auditor discipline matters to the board,

except in cases where the SEC found a violation of law, which would be investigated by the SEC. Disciplinary investigations would proceed expeditiously.

- **Enhanced audit quality monitoring.** The current triennial firm-on-firm peer review process would be replaced with more frequent audit quality monitoring. The board would direct a more focused and timely quality monitoring process and would have flexibility to tailor monitoring to address specific areas of audit quality concern. In order to audit public companies, a firm would need to meet the requirements of the board's audit quality monitoring process.

Soon after the SEC's announcement, the POB announced its intention to cease operations. It set a date no later than March 31, 2002, to allow for transition of responsibilities to the new board. The SEC indicated that its proposed framework is put forth to begin public discussion of how best to restructure the regulatory system that governs the accounting profession and that it seeks and welcomes the POB's assistance. PricewaterhouseCoopers supports the SEC's conceptual approach, and will be working with the SEC and others over the coming months to further develop the proposal and bring about meaningful change.

Mechanisms for Ensuring Audit Quality

With the Enron failure and audit committees asking, "Could it happen here?" the focus is extending beyond those in the company preparing the financial statements, to the auditing firm that conducts the independent audit. Questions being raised deal with not only the nature, scope, and quality of the audit, but also quality control mechanisms within the auditing firm. We appreciate the direct questions, which for company-specific issues are best answered by the engagement partners. Here, we address firm-wide controls that serve to ensure the appropriately high level of audit quality.

Each of the largest auditing firms has similar processes, although they are implemented in somewhat different fashion to suit the firms' individual approaches and cultures. Here we summarize the quality control mechanisms at PricewaterhouseCoopers. We believe direct questions call for direct answers, and we share with you here the processes in place and implementation issues within the reality of the environment in which we operate.

- **Our people.** Quality begins with our people, and we have carefully designed protocols for recruiting, developing, promoting, assigning responsibility, and managing and overseeing the work of our people. Each individual from hiring onwards receives thorough grounding in the firm's culture and values, with performance measured against values-based benchmarks by peers and direct reports, as well as by those directing their work. Our ethics and business conduct program includes confidential communications channels to voice questions and concerns, ensuring that the appropriate technical and risk management resources are identified and consulted. These policies and practices have been proven and enhanced over time, and we believe the quality and performance of our professionals are unsurpassed.
- **Client acceptance and retention.** Our client acceptance and retention standards and procedures have been referred to by the POB as a "best practice." They are designed to identify risks of a client or prospective client, and determine whether the risks are manageable. Our processes involve the engagement teams, industry leaders, and risk management partners in considering such matters as board effectiveness, management incentives to manipulate reported results, significant transactions structured to achieve revenue recognition, unusually aggressive or creative accounting, transactions that have undue complexity, attitudes toward disclosure, and transactions with related parties. Upon acceptance or retention of a client, the

results of the assessments are incorporated and used in the audit process. We have not been reluctant to decline to propose or to accept or retain work when the risks were considered not to be manageable or when the client/prospective client did not agree on the scope of the work required.

- **Audit methodology.** Our audit methodology is used for all audit engagements to ensure uniformity and consistency in approach, with compliance regularly reviewed and evaluated. Comprehensive policies and procedures governing our accounting and auditing practice—covering professional and regulatory standards as well as implementation issues—are constantly updated for new professional developments and emerging issues, needs, and concerns of the practice.
- **Independence.** Our people must adhere to strict regulatory, professional, and firm independence requirements related to investments or business relationships with clients. Several years ago we learned of certain inadequacies in compliance, and we have since instituted new firm-wide compliance programs, including IT-based control monitoring systems considered state of the art in the profession.
- **Concurring partner.** Each public company audit has an assigned concurring partner, approved to have the appropriate experience and industry expertise, who conducts a preissuance review of all significant issues. The engagement partner and concurring partner discuss issues as needed during the engagement, including audit procedures performed and accounting treatments. The concurring partner reviews the financial statements, including disclosures, and conclusions reached for adherence to generally accepted auditing standards and fair presentation under generally accepted accounting principles.
- **Risk management partner.** Every client has an assigned risk management partner who is selected based on a record of quality work, experience, and judgment. He/she is an integral part of the client acceptance and retention process, responsible for assessing risk qualitatively and quantitatively, and consulted on issues and judgments such as materiality and going concern considerations.
- **SEC review specialists.** Public company clients with active shelf-registration statements or expecting to engage in capital raising transactions have their financial reports reviewed by designated technical specialists in our SEC services group.
- **Resolution of differences of view.** Differences in professional view occasionally arise among members of an engagement team on accounting or auditing matters. Our policy provides a robust process of resolving such differences in a healthy professional environment, under an open-door philosophy. Each professional has the right, and indeed the obligation, to form his or her own conclusions and is responsible for ensuring that those views receive adequate consideration. Differences are brought upstream to higher levels within the firm, including to the national level where necessary for consultation with senior technical partners.
- **Partner rotation.** The engagement partner on each public company audit client is rotated, at least on a seven-year basis, to ensure a fresh look without sacrificing institutional knowledge.
- **Partner compensation.** Partner compensation recognizes the quality of the partner's performance in conducting audits, together with performance in developing the firm's people and promoting teamwork, as well as the partner's participating in proactively identifying client needs and determining whether PwC has the expertise to address them. Partners have been and will continue to be recognized for identifying inappropriate accounting and financial reporting treatments, and with consultation (discussed immediately below), for communicating to the

client that the treatment is not acceptable—even if it means losing or withdrawing from a client. We call it “holding the line on quality,” which is a key part of our culture.

- **National office consultation.** Consultations by engagement teams, typically with senior national office partners unaffiliated with the audit engagement, are required in particular circumstances involving auditing, accounting, or reporting matters. Working with engagement teams and experienced PricewaterhouseCoopers industry leaders, our national office partners use their expertise in existing and emerging accounting and auditing practices to address these issues. Our consultative culture results in engagement teams also having consultations with these national office partners beyond those that are required.
- **Document retention.** Our policy is to retain all documents needed to support our professional work for the *current period* plus six years. For documents extending over a number of years—such as leases or contracts—the *current period* means the effective life of the document. One key exception is files subject to pending litigation or subpoena—we retain such files indefinitely, and their ultimate destruction requires specific approval of our Office of General Counsel (OGC). OGC has provided additional guidance on how to ensure that all documents, including electronic documents, are retained in the event of a pending SEC investigation.
- **Quality control reviews.** Reviews of audits are conducted by experienced partners and professional employees not otherwise connected with either the office performing the audit or the audit itself. The program is managed by a separate national office unit. Reviews of a partner’s work are conducted at least every three years. Our inspection process includes periodic testing of the effectiveness of our quality controls and continuous improvement program.
- **External peer reviews.** As noted, peer reviews are performed triennially by another public accounting firm for the purpose of independently evaluating the systems in place to ensure audit quality. For the latest peer review, we received an unqualified report, together with a letter of comment. We have been fully responsive to the several recommendations received. The peer review report, letter of comment, and our response are available to you.

Embedded in these processes is our consultative culture, reflecting the value we place on teamwork. We have an entire national and centralized quality and risk management organization that not only ensures that the appropriate expertise is applied and that our values are being practiced—but also gives “early warnings” so issues can be dealt with appropriately and timely. We have a “no tolerance” policy for any behavior that does not support our high standards. Risk management and quality are part of our partner evaluation and compensation process. Conduct inconsistent with our culture and values is dealt with appropriately and resolved swiftly.

Does this mean there will never be a problem in the performance of our work? Probably not—reality is that no quality system is perfect. But we do strive for and are committed to excellence. Perhaps the best protection is our culture and core values, which we believe bring to life our commitment to audit quality. Our core values are quality, excellence, leadership, trust, and teamwork—and we apply them in everything we do. We are committed to standing firm for what we believe in—integrity and objectivity—to serve our clients and the public interest, and ensure that the PricewaterhouseCoopers brand continues to be recognized for quality.

Renewed Focus on Nonaudit Services

With increased scrutiny of the auditing profession, the Enron fallout includes renewed attention to auditing firms providing nonaudit services to audit clients. Critics point to Enron’s most recent proxy statement disclosing that during 2000 fees charged for the audit were \$25 million, while

“All Other Fees” amounted to \$27 million, stating or implying that this jeopardized audit quality. Shareholder proposals have been put forth to several companies seeking to prohibit the companies from engaging their auditing firms to provide nonaudit services, and legislative initiatives restricting nonaudit services have been announced.

Reopening the issue is understandable, though we believe there are sound reasons why companies engage their auditing firm to provide professional services in addition to the audit. With a few exceptions, nonaudit services are permissible under the independence rules, which were revised recently by the SEC after an extensive review of all relevant factors. Nevertheless, clearly there are continuing concerns over the appearance of a conflict of interest between auditing and consulting, especially with management consulting services involving large-scale information technology design and implementation. Our positions, along with actions we are taking now, are described below under “PricewaterhouseCoopers’ Call for Action.”

It is worth noting that, in disclosures of nonaudit services in company proxy statements, the category “all other fees” as defined by the proxy rules includes many services that are closely related to or are an outgrowth of the audit. Examples include services related to registration statements and other SEC filings, additional audit testing performed at the company’s request, agreed-upon procedures, carve-out financial services, evaluation of internal control and risk management systems, SAS 70 engagements, director examinations for financial institutions, audits of pension and other employee-benefit plans, forensic auditing, tax planning and compliance services, and, in some cases, audits of company affiliates and statutory audits.

We believe not only does performing these types of nonaudit services for audit clients have sound rationale and sufficient safeguards, but audit quality often is promoted through an extended understanding of the company’s business, operations, and risks, which further enhances the ability to identify and react to relevant audit issues. For a fuller discussion of safeguards and issues related to nonaudit services, refer to *Current Developments for Audit Committees 2002* and *Understanding the SEC’s New Independence and Proxy Disclosure Rule*.

Inquiries About Audit Quality

We are aware of one legal advisor suggesting that audit committees review certain matters relating to audit quality, specifically, resumes of the key partners and managers on the audit, a description of the firm’s quality control procedures, and a report from the firm describing any material issues raised by the most recent “quality control review” and describing the steps the firm has taken to deal with any reported problems.

We have long emphasized the importance of audit committees being comfortable with the quality of the external auditor’s work, and we will readily provide this and other information our clients’ audit committees may require in order to carry out their oversight responsibilities. As to the specific suggestions, the most recent peer review report on our firm’s systems ensuring audit quality and the related letter of comment and our response are available to you, as noted earlier. Similarly, we will be pleased to provide resumes of members of engagement teams, although we believe that a resume alone is not the best indicator of competence or quality of performance. Particularly for ongoing clients, audit committee members’ direct experience with the engagement partner is probably the most reliable basis on which to satisfy questions about competence. In any event, we will be pleased to provide further information about engagement team members to ensure the audit committee is comfortable with any and all of our people.

Another recommendation put forth is that companies adopt a policy of not hiring a partner or manager who worked on the engagement during the past three years. Because the importance of a three-year timeframe is questionable, companies might instead consider adopting a policy that would preclude their employees from entering into discussions with the audit firm's personnel during the conduct of the audit.

In this connection, it is worth noting that independence safeguards relative to this issue already are in place within our firm. Our independence policy, which is compliant with SEC and AICPA independence requirements, is designed to protect the public and our clients against independence questions that could arise if firm personnel were considering employment with a client. These include:

- Immediate removal of the professional from the engagement until the employment offer is rejected or employment is no longer sought
- Separate documentation of audit procedures already performed by the professional
- Documentation by the individual leaving the firm of all discussions held with the client regarding potential employment and the time period over which the discussions took place
- A review of the professional's work to assess whether he/she exercised appropriate skepticism during the engagement; the review is performed by someone at least one level higher than the departing professional or, if a partner, another partner designated by the industry leader
- If the professional accepts employment with the client, the ongoing engagement team must consider the need to modify the audit plan to adjust for the related risk

PricewaterhouseCoopers' Call for Action

As discussed in this report, a serious crisis of confidence has developed in the accounting profession due to the Enron failure and deeply disturbing events around it. As noted, Congressional committees, the SEC, the Department of Justice, and others have launched investigations, and critics are questioning key components of the U.S. capital markets—the rules for disclosure, the actions of analysts, the responsibilities of outside directors, and the ability and will of the accounting profession to protect investors and the integrity of our capital markets.

Described here are our firm's views, recently put forth by our Chairman, on what is needed to restore public confidence in the accounting profession, and actions we are taking at PwC to ensure that you can continue to be absolutely confident about the quality of our work and our resolute commitment to independence and objectivity.

The Financial Reporting and Auditing System

Much of the recent debate has focused on the regulatory model that governs our profession, and there is no question the current regulatory structure is in need of reform. Certain changes are especially critical:

- Active oversight must come from outside the accounting profession. The investing public demands oversight that is both rigorous and independent.
- Oversight must include an intensive and regular review of our quality processes and a rigorous, transparent discipline structure that can act when quality is found to be lacking.
- The regulatory structure must go beyond oversight to a substantially more participative review by staff independent of the accounting firms, replacing the current firm-on-firm peer review.
- The regulatory structure needs teeth: If an independent oversight body finds quality procedures lacking, it must have the right to revoke an individual's or firm's right to practice.

As noted, the Enron collapse also has re-opened the debate on whether there is an inherent conflict of interest when auditors provide management consulting services to their audit clients. We do not believe there is an inherent conflict, but we are very concerned that investors think there might be. That is why, eighteen months ago, we vigorously supported former SEC Chairman Arthur Levitt's proposal to ban the provision of large-scale information technology design and implementation services by auditors to their audit clients, a proposal that was dropped in the course of the rule-making process.

We have acted to address concerns over the appearance of a conflict of interest between auditing and consulting. We have been very clear on our commitment to separating our management consulting business as soon as possible and we have recently announced our plan to move forward with an initial public offering this spring of PricewaterhouseCoopers Consulting. In addition to those services that auditors are now barred by SEC rules from providing to audit clients, we support prohibiting the provision of large-scale information technology design and implementation services and internal audit services by auditors to their audit clients, with a timetable that allows for the orderly exit of these businesses.

In addition, the accounting standard-setting process in the United States must be overhauled. We advocate replacing the current, cumbersome standard-setting process with a single, private-sector,

standard-setting organization whose goal is to establish principles-based accounting standards. These standards should focus on the substance of transactions and be consistent with providing financial information that is transparent, understandable, and written in plain English.

Further, the current reporting model needs to be broadened. What is needed is an integrated framework in which all relevant financial and nonfinancial information is presented in a way that is understandable and decision-useful, and permits meaningful comparisons within and between entities.

Changes Within Our Firm

Improving external regulation of the profession, addressing the scope of services issue, overhauling the standard-setting process, and broadening the current reporting model are essential if confidence in the profession is to be restored. At the same time, while we believe the quality of our work is exceptional, in the current, questioning environment, there are a number of steps we at PwC plan to take in the coming months so that our clients can continue to be completely confident that their auditors meet the highest standards of quality, independence, and objectivity.

- First, as mentioned above, we intend to exit the management consulting business through an initial public offering of PwC Consulting as soon as possible.
- Second, beginning this fiscal year, we will issue an annual report to our clients on our financial performance, quality practices and initiatives, and other relevant matters. In addition, we will add three outside, independent directors to our board. These outside directors will be charged with the responsibility of overseeing our auditing quality, independence, and objectivity.
- Third, we will share our partner evaluation and compensation policies with client audit committees. Audit committees need to have complete trust and confidence that our audit partners are rewarded for audit performance.
- Fourth, we will develop an “annual engagement contract” with audit committees that will lay out in detail our role in supporting audit committees as they discharge their fiduciary responsibilities.

Quality is and always has been a hallmark of our firm’s service to clients. These initiatives are designed to create a higher standard for PricewaterhouseCoopers than what will be required by regulation or achieved through consensus. We want you to have complete confidence in your auditors and the assurance that investors will have the highest regard for our opinion. In the current environment, confidence will not be won by rhetoric. Quite simply, we ask that you judge us by what we do.

Going Forward

This report is designed to brief boards of directors and their audit committees, as well as managements, of our clients and other interested parties on the Enron failure and related fallout. Our aim is to advise you of the implications for your company and the broader business and financial reporting issues, and provide guidance on what you can do.

We at PricewaterhouseCoopers are committed to working with you and bringing you the full benefit of our knowledge and resources in helping you and your company deal effectively with the issues you face.

Appendix— Implications for Companies Doing Business with Enron

Companies doing business with Enron or its subsidiaries have an entire additional set of issues with which to deal, requiring still greater attention. That Enron has filed for bankruptcy protection has dramatic implications for companies doing business with it.

What the Bankruptcy Filing Means

Issues related to bankruptcy³ are complex for any company. Because Enron has contractual and other relationships with thousands of companies, both domestically and internationally, including related party entities, it will take months just to sort out the affected parties and years to determine Enron's versus others' rights and obligations. While certain Enron entities, including Enron Corp., the lead filer, filed for Chapter 11 protection on December 2, 2001, since then a number of additional subsidiaries have done so, and we can expect others to file for separate Chapter 11 petitions.

Bankruptcy alters companies' rights to receivables, payables, leases, and other contracts. The bankruptcy courts now will begin to sort through a multitude of transactions and claims being filed against Enron and its subsidiaries under Chapter 11 (referred to as the Chapter 11 entities). The courts will scrutinize transactions before and after December 2, and may modify or cancel transactions, with ripple effects. The complicated bankruptcy rules and Enron's size and complexity will lead to extensive litigation and proceedings lasting many years.

As a starting point, company managements should identify all contracts with Enron, target any areas of nonperformance, and work toward calculating potential losses. Bankruptcy counsel should assess the company's rights and financial risks vis-à-vis the Enron proceedings, especially if the company has significant exposures to Enron entities subject to bankruptcy or similar proceedings in foreign jurisdictions.

Companies with significant exposures will need to monitor developments in the proceedings to protect their interests and maximize recovery or mitigate losses. Managements need to consider the impact of proposed transactions, such as the sale of portions of Enron's business, on potential recoveries and losses. Some of the more common relevant issues are described more fully in the exhibit.

³ The information herein does not constitute nor provide legal advice; readers should consult their legal advisors for their own particular circumstances.

Issues Relating to the Enron Bankruptcy

Right of Offset

Certain amounts *due from* the Chapter 11 entities can be offset against amounts *due to* the same entities provided the offset is permitted under state law or related agreement. However, the offset provisions extend only to prepetition transactions, in this case predating December 2, 2001. Prepetition receivables cannot be offset against postpetition liabilities, even for the same legal entities.

Business contracts cannot be offset. Charges for contract performance after a Chapter 11 filing are deemed administrative claims, provided the contracts are not rejected.

Preferences and Avoidance Actions

A creditor that improved its position by (1) receiving a payment, (2) obtaining a new lien, (3) perfecting an existing lien, or (4) obtaining additional collateral in the 90 days prior to the December 2 filing may be required to relinquish such “preference” improvement, instead receiving an unsecured claim.

Claims Against Enron

The Chapter 11 entities will submit a list of amounts due to creditors, as reflected in their books and records. These amounts (which may be subsequently updated) likely will differ from amounts recorded in creditors’ books and records. Creditors can file proofs of claims, which, after an investigation and settlement, become the basis for determining permitted claims under the bankruptcy proceedings. Creditors should compare amounts recorded in their books and records with amounts reported by the Chapter 11 entities, and file proofs of claim on a timely basis.

Assessing Recoverability of Claims

Recovering amounts due from the Chapter 11 entities depends on whether a claim is prepetition or postpetition, and whether secured or unsecured.

Postpetition claims have priority over prepetition claims. In assessing recoverability of prepetition *secured* claims, management should consider (1) the value of any collateral, (2) court-imposed limitations on when the creditor can obtain control of the collateral, (3) whether any collateral was obtained through an inappropriate preference or avoidance action, and (4) any disputes with the debtor. Deficiency between the amount of the allowed claim and the value of collateral is treated as an unsecured claim.

Unsecured prepetition claims generally are not fully recovered, although the extent of recoverability will not be known until the debtor emerges from Chapter 11. Accordingly, many companies will need to reserve or write off some or all of these claims. In assessing recoverability, management should consider the value of the assets of the individual Chapter 11 entities (not Enron as a whole), the amount of postpetition liabilities that have priority over prepetition liabilities, the prepetition secured claims, and the aggregate unsecured claims. We understand that a market has already developed for purchase and sale of these claims. If management intends to sell the claims, the net claim receivables should be written down to the estimated selling price less cost to sell.

Companies with interest-bearing loans and advances to the Chapter 11 entities would continue to accrue interest if the loan was secured and the underlying collateral’s value exceeded the value of the loan and accrued interest. If there is concern the loan will not be collected in full, companies

Issues Relating to the Enron Bankruptcy (cont.)

Assessing Recoverability of Claims (cont.)

should consider deferring or permanently suspending recognition of interest income. Unsecured creditors should not record interest income, since it's likely their claims will be impaired.

Terminated Contracts

The Chapter 11 entities may seek recovery from counterparties for a "termination" or "breach of contract" if contracts were inappropriately terminated prior to a Chapter 11 filing. Some contracts may include provisions that "automatically" terminate upon Enron's default, a credit rating downgrade, or Chapter 11 filing. Managements should determine how a termination affects any obligations to the Chapter 11 entities, and should be aware that bankruptcy courts or regulatory bodies may scrutinize contract terminations prior to December 2 if those terminations improved the counterparty's position.

Master Agreements and Confirmations

Since trading arrangements often are entered into via master agreements with various subagreements or confirmations to be executed throughout the term of the contract, there will likely be questions about whether the master agreement or subsequent confirmation is legally binding. This issue is especially important where a master agreement was entered into before Enron filed for bankruptcy, resulting in a series of confirmations being executed after the filing. Master agreements with Enron may have a material impact on counterparties and therefore should be carefully reviewed by legal counsel to assess a company's overall claims and financial losses.

Equity Securities and Subordinated Securities

Because equity and subordinated debt securities are last in priority, it's possible security holders will recover minimal amounts. Therefore, companies should consider recording impairment losses for such securities because of this "other than temporary" decline in value.

Enron's Sale of Businesses or Assets

Some of Enron's assets and businesses will be sold to third parties. In assessing loss exposures, managements should not presume that purchasers will assume obligations and contractual arrangements.

Derivative Contracts

Companies that entered into derivative contracts with Enron may be able to offset derivatives in a loss position against those in a gain, as long as the derivatives on both sides are between the same legal entities. Companies with net-gain derivatives are likely to suffer losses, since they will become unsecured creditors and have to "stand in line" with other unsecured creditors. Even companies holding collateral may find those assets encumbered, impairing timely collection or collection altogether.

From an accounting standpoint, derivatives designated as hedges will no longer be effective. Consequently, hedge accounting should not be applied from the time there was more than a remote chance of Enron defaulting. Managements need to identify derivative contracts affected

by the Enron situation, assess whether hedges' effectiveness is impaired, and amend accounting practices, as needed.

Under derivative accounting, companies are permitted exceptions if they intend to take physical delivery on a contract. To the extent Enron's bankruptcy filing indicates it is no longer probable a physical delivery will occur and instead the contract may be net-settled, the "normal purchases and normal sales" exception may no longer be applied. As a result, contracts with Enron that contain net-settlement provisions, which previously were not recorded, may have to be marked to market in the financial statements.

Enron's Special-Purpose Entities

Companies may have invested in or otherwise have exposure to Enron-sponsored SPEs. Management should analyze those investments, including loans, to determine possible impairment. Considerations include (1) whether recovery depends directly or indirectly on guarantees, or business or other contractual relationships, between the company and Enron, and (2) whether there is sufficient collateral to allow for recovery of the investments. Also, the assets of some SPEs consist of Enron stock or of derivatives related to Enron's stock, and so are impaired.

Enron's Contract Performance

Companies may have entered into contracts—for energy-management outsourcing, long-term supply agreements, storage, and engineering and construction—under which Enron is obligated to provide services or products or has provided guarantees or letters of credit. The Chapter 11 entities may reject these contracts, subject to approval of the bankruptcy court, or Enron's other subsidiaries and affiliates may be unable to perform under the contracts. Those companies may incur additional costs and experience disruptions in operations, and management should consider whether assets have been impaired and liquidity adversely affected.

Relevant questions related to key financial statement implications of transactions with Enron are summarized in the exhibit.

Accounting and Disclosure Implications – Key Questions

- Has the company assessed bad debt write-offs, including the timing and amount to be recognized and extent to which collateral exists?
- Does the company have financial guarantees and letters of credit provided by Enron that might no longer be supported because of the bankruptcy filing?
- Does the company have exposure to default risk by counterparties other than Enron that were relying on contracts with Enron for their supply source?
- Have security investments in Enron and related companies become impaired, and when did the decline in value become "other than temporary"?
- Does the company have joint investments, derivatives, or long-term contracts (such as electricity or gas supply contracts) with Enron that provided critical support for the ongoing profitability of fixed assets, equity investments, and operations, and that now might be impaired?

Accounting and Disclosure Implications – Key Questions (cont.)

- Are potential contingent liability disclosures required related to long-term contracts with Enron?
- Has the company considered the appropriate timing of and method for ceasing the application of hedge accounting for Enron derivatives?
- Has the company considered financial statements and MD&A disclosures with respect to risks and uncertainties, possible disruption in operations, liquidity issues, and other implications resulting from the bankruptcy of a significant supplier/customer, service provider, lessor/lessee, debtor, financial guarantor, investor/investee, joint venture partner, derivative counterparty, or trading partner?

Necessary Actions

As suggested above, managements should prepare a detailed inventory of all relationships with Enron. The inventory should include:

- Outstanding receivables and payables, including those pertaining to derivative transactions
- Joint ventures and other investments
- Supply or sales agreements
- Guarantees made or received
- The company's participation in loss-sharing arrangements with exposure
- The impact on key suppliers and customers with exposure

It makes sense to now identify other, Enron-like entities having similar operating and risk characteristics with which the company has relationships—particularly those with credit adversely affected by the increased focus on liquidity issues and other risks in the aftermath of Enron's collapse—and prepare an additional inventory of exposures related to those entities.

Similarly, prudence calls for identifying other companies, with which your company conducts business, that have been doing business with Enron where the Enron fallout might have damaged their ability to fulfill agreements.

This process may be enlightening, even if it appears at first glance that the company has limited exposure to Enron.

A Fluid Situation

The December 2 filing covers many of the several hundred entities controlled by or affiliated with Enron, including the wholesale trading division and trading operations that supported Enron Online. But other subsidiaries—in transportation, pipeline, energy transmission, and power generation businesses—are not in Chapter 11 at the date of this writing. All foreign entities are excluded from the filing, although some are in similar proceedings in their home countries. Additional filings may yet be made.

Claims against Enron entities that have not filed for Chapter 11 are not subject to court supervision, nor are there legal impediments to creditors seeking to enforce their rights through litigation or other means. But creditors should bear in mind that a subsequent filing could invalidate attempts at preference. In any event, in evaluating potential impairment of claims and investments, such entities should be considered distressed. With respect to claims against Enron entities not in Chapter 11, consideration should be given to whether:

- The entity pledged assets as collateral to the Chapter 11 entities' creditors.
- The entity's assets include claims against or receivables from the Chapter 11 entities or other Enron-related entities.
- The entity's operations rely on contracts with Enron or its affiliates.
- The entity had guaranteed obligations of any Enron-related entities.

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