

TESTIMONY OF
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BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES COMMITTEE

AT A HEARING ON

H.R. 3763

THE CORPORATE & AUDITING ACCOUNTABILITY, RESPONSIBILITY
AND TRANSPARENCY ACT OF 2002

March 20, 2002

My name is Philip Livingston, President & CEO of Financial Executives International (FEI). FEI is the leading advocate for the views of corporate financial management, representing 15,000 CFOs, controllers and treasurers worldwide.

The Committee is addressing a number of important issues – important to all of us who have a stake in the U.S. capital markets and the financial reporting systems. FEI lends its support for H.R. 3763 the “Corporate & Auditing Accountability, Responsibility and Transparency Act of 2002” and applauds this Committee’s leadership in identifying and addressing critical issues to improve the transparency of financial reporting and audit effectiveness.

This morning, FEI released its recommendations for ***Improving Financial Management, Financial Reporting & Corporate Governance***, which are complimentary to many of the provisions in H.R. 3763. I ask that the attached copy of these recommendations be included in and made a part of the record of this hearing. These recommendations reflect our view that while most companies are governed and managed in an ethical manner, there is still room for improvement in the management of our companies and the structural elements of corporate governance. Enron's collapse is a shameful failure on the part of its primary participants. However, this event has created a willingness and sincere desire to improve our own performance and the structure within which we operate. We should not waste this chance.

I would like to take the balance of my time to focus on a few of those recommendations as a way to verify FEI's support for H.R. 3763:

ADHERENCE TO A SPECIAL CODE OF ETHICAL CONDUCT FOR FINANCIAL OFFICERS (FEI'S RECOMMENDATION #1)

While H.R. 3763 includes many proposals to improve corporate governance – all of which FEI supports – we recommend that H.R. 3763 include a provision calling upon the SEC to work with the stock exchanges to develop a requirement that senior financial officers of all public companies adhere to a specialized “Code of Ethical Conduct,” similar to the one in use today by the FEI for its members. I have included a copy of FEI's Code of Ethical Conduct with my testimony today. We believe adherence to such a code is a crucially important cornerstone of

sound management, appropriate “tone at the top” and successful fiduciary stewardship. In order to reinforce management and board awareness and commitment to ethical conduct, and the maintenance of a strong ethical climate in a company, we strongly recommend that all senior financial officers annually sign such a code and deliver it to their board.

In fact, an FEI member who is CFO of a Fortune 100 company has required all of his company’s corporate financial professionals worldwide to sign the FEI Code of Conduct.

**HIGHER STANDARDS FOR AUDIT COMMITTEE “FINANCIAL EXPERTS”
(FEI’S RECOMMENDATION #9)**

Unfortunately, Enron once again demonstrates the need to improve audit committee effectiveness. Audit committees are generally not staffed with individuals capable of understanding today’s complex financial reporting standards. Three years ago the *Blue Ribbon Panel on Audit Committee Effectiveness* called for all audit committee members to be financially literate, and for each committee to have at least one financial expert. Unfortunately, the criteria for meeting the standard as a financial expert was set so low that no real change or addition to audit committee personnel actually occurred in the ensuing time leading up to Enron’s demise. We must now get on with truly raising the bar and adding real expertise to audit committees. We need Congress and the SEC to act on this matter too. The stock exchanges should be required to write tougher standards into their listing agreements. Explicit experience in financial

reporting must be required of such experts. For example, a financial expert should possess:

- An understanding of Generally Accepted Accounting Principles (GAAP) and audits of financial statements prepared under those principles. Such understanding may have been obtained either through education or experience. FEI believes it is important for someone on the audit committee to have a working knowledge of those principles and standards.
- Experience in the preparation and/or the auditing of financial statements of a corporation of similar size, scope and complexity to the one on whose audit committee the individual would serve. The experience would generally be as a chief financial officer, principal accounting officer, controller or auditor of a similar entity. This background will provide a necessary understanding of the transaction environment that produces financial statements. It will also bring an understanding of what is involved in making proper accounting estimates, accrual, reserve provisions, etc. and an appreciation of what is necessary to maintain a good internal control environment.
- Experience in the inner workings of the audit committee, obtained either as an audit committee member, a senior corporate manager responsible for answering to the audit committee or an external auditor responsible for reporting on the execution and results of the annual audits.

PLACE RESTRICTIONS ON CERTAIN NON-AUDIT SERVICES PROVIDED BY INDEPENDENT AUDITORS (FEI'S RECOMMENDATION #5)

Another recommendation found in FEI's proposed recommendations to strengthen corporate management and governance concerns the issue of auditor

independence. As recently as last year, I testified before the Senate Banking Committee in opposition to former Chairman Levitt's proposal to split audit and non-audit functions and services that are being provided by accounting firms. It is still my strong personal opinion that consulting services do not corrupt the integrity of independent audits. The truth in my view is exactly the opposite. Consulting projects enable the auditor to get out of the accounting department and learn about the intricacies of the business and in the end conduct a more effective audit. However, the accounting profession is clearly suffering from post-Enron crisis of confidence. Therefore, certain restrictions should now be imposed on non-audit services supplied by the independent auditor. FEI believes that the independent auditor should no longer provide audit clients with internal audit services or consulting on computer systems used for financial accounting and reporting.

However, we continue to maintain that other advisory services such as tax advisory and compliance services, acquisition due diligence, audits of employee benefit plans and other statutory audits are considered to be acceptable services for audit clients as not normally raising questions of conflict of interest. We do however, strongly recommend that audit committees approve all large non-audit services provided by the auditor.

Following is a concise summary of the balance of FEI's recommendations:

1. Provide means for employees to surface compliance concerns and actively promote ethical behavior.

Mechanisms should include a written code of conduct, employee orientation and training, a hotline or helpline that employees can use to surface compliance concerns without fear of reprisal, and procedures for voluntary disclosure of violations.

2. Designate the principal financial officer and principal accounting officer as defined in the Securities Act of 1933.

The principal financial officer should report to the CEO and the principal accounting officer to the principal financial officer. One or both should meet periodically (quarterly) with the audit committee to review significant financial statement issues, including key judgments, estimates and disclosure matters.

3. Create a new oversight body for the accounting profession.

The SEC should sponsor an independent body with members experienced in accounting and finance but independent of public accounting firms or other accounting industry organizations.

4. Restrict hiring of senior personnel from the external auditor.

Corporations should adopt policies restricting the hiring of audit and tax partners or senior audit or tax managers.

5. Reform the Financial Accounting Standards Board (FASB).

Form a committee to recommend within three months FASB reforms in the areas of organization, financial statement content and timeliness of standard setting.

6. Modernize financial reporting.
Steps here include developing best practices for Management Discussion and Analysis (MD&A) and providing Web site access to financial reports.
7. Continue professional education for audit committee members.
Companies should disclose in the audit committee report in the annual proxy statement whether members have undertaken such training.
8. Periodic consideration of rotation of the audit committee chair.
Corporations should evaluate the need to rotate the individual holding the audit committee chair approximately every five years.
9. Disclose corporate governance practices.
Public companies should provide a report of key corporate governance practices. Current best practice is to have a governance and nominating committee made up of independent directors.

SHAREHOLDER APPROVAL OF STOCK OPTION PLANS

Unfortunately, the current crisis has encouraged some to attempt opportunistic initiatives to advance narrow and unconstructive agendas with little regard for the important matters in front of us. These very tactics were too often employed over the last ten years and are at the core of many of our problems. Unusable accounting standards and dysfunctional financial statements result from processes and regulatory environments unable to recognize the real problems, yet set out to achieve narrow political or governance related objectives.

Stock option accounting is such a case. This debate has a long and acrimonious history between shareholder activists enraged by cases of excessive executive compensation and the corporate preparers of financial statements that find employee stock options as hard to measure accurately as an Enron energy contract or “put” agreement to sell broadband capacity. A charge to the income statement for stock options is the Trojan horse in the battle over governance control of options and executive compensation.

Shareholders should be able to approve all stock option plans and control abusive levels of shareholder dilution in the few cases that it occurs. Because of the intense controversy around this subject, Congress can do a great service to the public by mandating shareholder approval for employee stock option plans.

Employee stock option issues are a corporate governance matter and the decision to offer employee stock options should rest with the shareholders. When recently asked about the ongoing accounting debate, Sarah Teslik, the CEO of the Council of Institutional Investors was quoted in the New York Times as saying, “If we can’t vote on these things, then we have to punish them on the balance sheet.” Her comments reflect the reality of this issue – it’s about the practices and quantities of option grants, not the quality of the income statement.

Recent studies have reported a significant growth in the use of employee stock option programs by companies both in the U.S. and internationally. The National Center for Employee Ownership has estimated that ten times as many

employees received stock options in 2001 with those who received them in 1992. FEI believes that this is because corporations find employee stock option plans to be effective tools for recruiting and retaining talented employees, and to be among the most effective tools available for aligning management interests with those of the shareholders.

PUBLIC SECURITIES LITIGATION REFORM ACT

Briefly, FEI would like to add its continuing support for the Public Securities Litigation Reform Act (PSLRA). FEI testified before the Senate Banking on July 21, 1993, in support of reform because of the abuses of the litigation system -- and our position has not changed. The PSLRA was enacted because plaintiffs' lawyers were bringing strike suits against hi-technology companies whenever the stock price fell for any reason. This type of abusive behavior needed to be corrected. The PSLRA is working today and there is no need to change or modify the current law. Enron's employees and shareholders will not be hindered by the PSLRA in seeking restitution of their losses. Once again, now is the time for real reform, not opportunistic presses of narrow agenda items.

INCREASED APPROPRIATIONS FOR THE SECURITIES & EXCHANGE COMMISSION

FEI recommends that a significant portion of the additional funds for the SEC be earmarked for attracting new, high caliber professional staff. Our members believe that the Commission needs increased funds in order to offer pay packages that will compete effectively with those available in the private sector.

The structure and financing of today's global corporations continues to increase in sophistication and complexity and the Commission needs professionals who can operate comfortably in that environment. The ability to understand and identify problems and resolve them expeditiously is imperative if investors' interests are to be protected without unnecessarily impairing corporations in their efforts to successfully compete in today's global economy.

ESTABLISHMENT OF A NEW PUBLIC REGULATORY ORGANIZATION

FEI supports the creation of a new independent regulatory organization for the auditing profession, as proposed in H.R. 3763. However, FEI believes it is important to clarify that the two-thirds of members who are "not members of the accounting profession" be further defined as individuals who are not currently practicing CPA's or affiliated with the AICPA other than through mere professional membership but that these members are expected to have extensive education and experience in financial management of public companies, auditing or accounting.

We believe this technical background requirement is essential to the PRO's ability to understand and effectively probe the specific audit quality issues reported through a peer review process. Further, FEI recommends that consideration be given by the Committee to structuring the PRO such that a portion of the members are designated as coming from professional organizations that represent constituent interests (e.g. the SIA representing the

securities industry, the FEI, financial executives, the AAA, accounting educators, etc.)

In addition, to maximize the effectiveness of the PRO, FEI recommends that it be made responsible for approving the selection of the audit firms engaged to conduct each peer review, and that the PRO directly receive copies of all draft peer review reports. This will assure that the PRO is directly involved in the review process.

CONCLUSION

In closing, FEI wants to again lend its support for H.R. 3763 because of its commitment to achieve improvements in the transparency of corporate disclosures and audit effectiveness. We believe that this legislation will help point the way toward the improvements necessary to strengthen our financial reporting, accounting and auditing and help assure the continued confidence of investors worldwide in the U.S. capital markets and reported corporate results.

That concludes my remarks. I would like to thank the Chairman and the members of the Committee for allowing FEI the opportunity to testify.