

TESTIMONY OF

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ON BEHALF OF

FINANCIAL EXECUTIVES INTERNATIONAL

BEFORE THE

U.S. SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

AT A HEARING ON

THE IMPACT OF THE SARBANES-OXLEY ACT

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DEVELOPMENTS CONCERNING INTERNATIONAL COVERGENCE

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Thank you Chairman Shelby, Ranking Member Sarbanes and Members of the Committee for this opportunity to appear before you today.

My name is Arnold Hanish and I am the Chief Accounting Officer for Eli Lilly & Company. I am here this afternoon as Vice Chairman of Financial Executives International's ("FEI's") Committee on Corporate Reporting ("CCR"). FEI is the leading advocate for the views of corporate financial management, representing financial executives who hold positions of critical importance in the integrity of financial reporting, such as Chief Financial Officers, Treasurers and Controllers. We take this responsibility very seriously, and I am pleased to have the opportunity to share our views with you today on the important issue of the impact of the Sarbanes-Oxley Act (the "Act"). My remarks will largely focus on Section 404 of the Act, which addresses internal control over financial reporting.¹

Strengthening Corporate Governance, Internal Controls

First, FEI strongly supports the goals of the Sarbanes-Oxley Act, as it has enhanced the role of corporate financial executives and created a greater appreciation for that role within the corporate environment and among the public generally. It has also strengthened the ability of financial executives to institute continuous improvements in internal controls and financial reporting, and to gain enhanced buy-in by all employees of the need for strong internal controls. Specifically, the Act has resulted in the following positive developments:

¹ FEI was among the first organizations to make constructive comments to Congress by issuing, in March 2002, "FEI[s] Observations and Recommendations [on] Improving Financial Management, Financial Reporting & Corporate Governance". Several of these recommendations were ultimately incorporated in the Sarbanes-Oxley Act. (Attachment 1).

- Strengthening the tone at the top by requiring certifications of financial statements by CEOs and CFOs, and by requiring management and auditors' reports on internal controls over financial reporting.
- Strengthening the incentives for high quality financial reporting that can be relied upon by the public, by increasing penalties for doing otherwise, including, importantly, the federal sentencing guidelines for criminal conduct in connection with fraudulent financial reporting.
- Strengthening the requirements for audit committees, which play such a critical role in corporate governance on behalf of the investing public. We are particularly pleased to see enhanced requirements for independence of the members of audit committees, financial literacy requirements to enable them to better understand and participate in the corporate governance process, and to engage committee members more actively in the audit committee meetings. In addition, the length and frequency of audit committee meetings have increased as a result of Sarbanes-Oxley, which is a positive result for corporate governance and the investing public.
 - At my own company, Eli Lilly & Co., we have held education sessions for members of our audit committee to build their awareness of important accounting and reporting issues and their financial accounting expertise. In addition, the number of audit committee meetings has increased from 4 to 9 per year, with a corresponding increase in length of the meetings.
- Making the internal control process more rigorous, and heightening accountability.
- Limiting transactions such as loans to officers, which is part and parcel of good corporate governance.

- Strengthening the ability of accounting professionals to look at all levels of reporting deficiencies, multi-dimensionally; that is, individually and collectively, and in a particular time period, as well as cumulatively over time. Further, the Act has raised the bar on the need to correct deficiencies in a timely manner. As such, the Act has increased the awareness of all levels of employees about internal control deficiencies and the need to correct them before they become significant deficiencies or material weaknesses.

Before Sarbanes-Oxley, companies had internal control processes in place, tested them, and corrected deficiencies. Companies have long had what are referred to as “management letters” from their auditors in which certain internal control weaknesses are noted, in addition to reports of their internal audit staff. In addition, companies in regulated industries such as mine, are subject to an additional level of inspection from their respective regulators, and receive reports from their regulators on internal control related matters. These inspection reports are in addition to management reports from their internal and external auditor. In this regard, the advent of the Act has not added something entirely new, particularly for highly regulated industries. But, it has added gravitas to the impact of any reports of substantive internal control weaknesses and the need to correct them by raising the bar of public disclosure of material weaknesses. Public companies must take appropriate action to issue “clean” reports, that is, showing that the system of internal control over financial reporting is “effective,” and without material weaknesses. At the same time, the criminal penalties provide a strong disincentive for fraudulent attempts to circumvent these requirements.

As such, we believe the heightened emphasis on internal controls, corporate governance, and the enhanced role of financial executives in this process, have all been very positive outcomes of the Sarbanes-Oxley Act.

However, there are growing concerns by many FEI members about particular issues that are becoming increasingly evident now that we have the benefit of real experience in implementing the Act. The remainder of my statement will address these issues.

Substance Over Form

FEI would like to suggest some important guidelines, based on its members' experiences in implementing the SEC, PCAOB, and listing standards resulting from Sarbanes-Oxley

- Testing of internal control must follow standard of "reasonable assurance". The SEC and PCAOB rules implementing Sarbanes-Oxley allow for testing and assessments of internal control over financial reporting in line with the long-held standard of "reasonable assurance". The concept of "reasonable assurance" has been chosen over "absolute assurance" because the cost of obtaining "absolute assurance" if there even is such a thing would be astronomical, and some debate whether Sarbanes-Oxley as written is so costly as to be causing some public companies to go private, or deterring private companies from going public. Thankfully, the Sarbanes-Oxley Act and the resulting regulations did not seek "absolute assurance" regarding internal controls, but there remains a fine line being walked by preparers and auditors between "reasonable assurance" and "absolute assurance".

In addition, while the Sarbanes-Oxley Act was created to try to prevent the kinds of egregious financial reporting fraud that flashed across the headlines, it is important to recognize that internal control and documentation alone will not necessarily eliminate or remove the risk to financial reporting posed by management override. It is integrity, above all, that will be the driving force in combating fraudulent financial reporting. And it is the threat of being paraded across the television screen in handcuffs, and the dual threat of increased jail time, that serves as the strongest deterrent to financial reporting fraud, not the many levels of documentation which can become an end in itself, rather than a means serving an end, to support high quality, reliable financial reporting.

- Documentation can supplement, but will not supplant, judgment and honesty. This is the area in which FEI would like to stress the fundamental concept that has held the test of time, which is generally referred to as “substance over form”. In the rush to implement Sarbanes-Oxley, there has developed what seems to be an overemphasis on certain additional or duplicative levels of documentation, with a declining value in terms of how much that additional documentation would add to the effectiveness of internal control.

Let me give you an example where the focus on documentation is so great, it seems to be overcoming the focus on the substance of the matter being documented. If a meeting of a company’s disclosure committee is held to discuss a financial reporting matter, in our new post-Sarbanes-Oxley world, there can be so much focus on testing for documentation that the meeting was held, that there is insufficient attention paid to reviewing the substantive nature of what was discussed. The reason why the meeting was held can be overshadowed by the need to search for a piece of paper documenting that meeting.

- There are of course additional burdens on companies with multinational operations, in extrapolating these controls, testing and documentation. At my company, we had tried to “spread the pain” by moving it from the top down through divisions and subsidiaries, to the ultimate process owners. Some would argue that the processes were fine and the controls were in place, but we now must go through what some believe are documentation exercises that are bordering on the excessive and do not serve the intent of Sarbanes-Oxley. Many gaps identified related again to the signoff or documentation that an activity took place.
- In grappling with implementation of the Act, some are falling into the trap of overemphasizing form over substance, which ultimately is a use of time and resources that does not benefit the reliability of internal control, and does not benefit investors.

Make no mistake about it, documentation for documentation’s sake will not deter financial fraud. In reality, the increased sentencing guidelines will probably provide the single-most important disincentive for committing material financial reporting fraud. As we all move to implement the SEC and PCAOB standards under the Sarbanes-Oxley Act, we must remember that documentation should supplement, but does not supplant, management’s judgment, integrity and honesty.

Cost-Benefit of Implementation

Let me address the overall cost-benefit of the Sarbanes-Oxley Act. The degree of testing and documentation of internal controls forms the largest part of the cost, and incorporates the need to pay internal staff, both finance and internal audit, as well as the external auditor, and other external experts such as software consultants and so forth, to enhance systems related

to testing, documenting, and reporting on internal controls. The benefit side of the equation, while it includes the strengthening of the role of the financial reporting and internal control process and individuals involved in that process, is still largely an intangible benefit, always more difficult to measure and quantify, such as “increased shareholder confidence”. And while FEI certainly supports such benefits, we believe that part of good corporate governance encompasses not only strong internal controls, but also an eye toward budget, profitability, and as such, cost-benefit issues.

When the Act and resulting SEC and PCAOB standards were being drafted, FEI urged regulators to maintain flexibility and judgment that would promote efficiencies rather than redundancies, and minimize extraneous, labor-intensive procedures that were time consuming and expensive. Now that companies have one year of implementation behind them, FEI is hopeful that reasonable approaches will be developed that will make future year compliance of the Sarbanes-Oxley Section 404 less costly. However, whether it will be less costly of course remains to be seen, but it is our hope that reasonableness will prevail, particularly in the roll forward of continuous testing and documentation in future years after this first year baseline is established.

Over the past two years since the Sarbanes-Oxley Act was passed, FEI has surveyed its membership as to expected costs for implementing Section 404 of the Act. I have attached a copy of the January 2004 and July 2004 survey results to my testimony².

FEI's Cost Survey on Implementing Section 404

² See Attachments 2 and 3 for results of the January 2004 and July 2004 FEI surveys, respectively.

FEI's most recent survey of the cost of implementing Sarbanes-Oxley §404 was conducted in July 2004. FEI surveyed 224 public companies, with average revenues of \$2.5 billion, (the range being under \$100 million to over \$5 billion in revenues) to gauge Section 404 compliance cost estimates. Highlights of survey results are as follows:

- The total cost of compliance with Sarbanes-Oxley Section 404 is now estimated at \$3.14 million for the average company.
- This represents a 62% increase versus the earlier estimate, from our January 2004 survey, of \$1.92 million for the average company.
- We anticipate these estimated costs for Year One implementation will continue to rise as we close out this first year of implementation.

Breaking down the overall 62% increase in estimated costs between the January and July estimates, we saw a 109% rise in estimated internal costs (such as internal audit and other internal costs), a 42% jump in external costs other than the auditor (such as, costs of external consultants and software packages), and a 40% increase in estimated audit fees attributable specifically to the 404 internal control attestation. In total, companies surveyed estimate a total incremental increase in audit fees of 53% for the attestation on internal control over financial reporting, versus their annual audit fee for their financial statement audit. In raw dollars, this represents an incremental audit fee estimated at \$823,200 for the audit of internal control over financial reporting, for the average company.

Small company concerns

While all companies are feeling the impact of the Sarbanes-Oxley Act on their bottom line, FEI recognizes the concern about the impact the statute will have on smaller companies. At my company, I am fortunate to have an extremely competent staff of CPAs with 5-10 years

experience, but many smaller companies do not have a staff of that level of depth and breadth, these smaller companies don't always have excess resources to pull from, and potential costs of outsourcing these services could be particularly burdensome. And while FEI's survey of 224 companies did not indicate a disproportionate impact on smaller companies, logic tells me that this is an area that should be closely monitored for a burden that may be too great, and where the costs are so high, that being a public company may not seem to justify the costs.

Regulators and Cost-Benefit Concerns

As a result of the passage of Sarbanes-Oxley in July 2002, there has been an extremely high volume of rules, regulations, accounting and audit standards generated. This "regulation overload" required by the Act, has been created because all the regulations and standards became effective within a relatively short period of time. It has been a huge struggle for companies and auditors to digest all these new regulations and standards let alone implement them. FEI wants to acknowledge the efforts on the part of the regulators and standard-setters for not only recognizing this "regulation overload", but also for taking steps to provide relief.

SEC

FEI would also like to point out and acknowledge the SEC's recognition of the burden its accelerated filing deadlines for 10-K's and 10-Q's proposal could have placed on some companies, and the Commission's willingness to postpone final implementation of the accelerated filing deadlines to allow companies to devote their resources to Sarbanes-Oxley §404 implementation.

FEI would further like to acknowledge the SEC's efforts to provide additional implementation guidance on its Sarbanes-Oxley §404 related rulemaking by issuing their Frequently Asked Questions or "FAQ" document in June which provided additional guidance. This guidance has proven to be extremely helpful to both preparers and auditors as they work to comply with §404 requirements.

PCAOB

Similarly, FEI would like to acknowledge the efforts of the PCAOB, in their issuance of implementation guidance relating to their respective standard on the audit of internal control over financial reporting, in the form of Staff Questions & Answers or "Q&A's" issued by the PCAOB in June. We applaud these efforts to issue implementation guidance to clarify standards and thereby reduce implementation burdens. At the same time, we believe that such guidance should not preempt the amount of flexibility and principles-based approach that is necessary for substantive implementation of the rules envisioned under the Act. That is, regulators should not take an overly rules-based approach as they contemplate standards.

FASB

The private-sector standard setter, the FASB, also has a fundamental requirement to consider the cost-benefit of its rules, and to seek to issue standards that can reasonably be implemented. FEI's Committee on Corporate Reporting (CCR), supports the private-sector standard-setting process, and sent a letter of such support earlier this year.

We appreciate the role that the private sector can play in the standard-setting process, and we take an active role in commenting on proposed standards as well as participating on FASB task forces and advisory bodies. The main general concern we have recently

expressed to the FASB, is that they need to follow careful and thoughtful due process in developing standards, and that sufficient time be allowed for comment on proposed standards, and for implementation of final standards. This concern has been especially great during Sarbanes-Oxley implementation, including, but not limited to, Section 404, and the myriad of SEC and PCAOB rules that have been promulgated as a result of the Act. We hold periodic discussions with members of the FASB, and have strongly encouraged them to be reasonable in allowing sufficient time for its constituents to give thoughtful analysis to proposed standards, and that they consider major reporting deadlines when they issue proposed and final standards. We have also commented about the volume of proposed standards and recently finalized standards that require more attention from management and auditors, and are also of keen interest to users of financial statements. For this year-end in particular, we have strongly encouraged the FASB to avoid requiring the year-end implementation of standards issued in the fourth quarter, in order to provide sufficient time to implement those standards. We have discussed with the FASB that just because an Exposure Draft of a proposed standard has been out for a substantial period, does not mean that companies would be prepared to implement that Exposure Draft quickly, should the FASB decide to issue a final standard. As is often the case with many FASB standards, the final standard often differs sufficiently from the Exposure Draft, that it requires wholesale changes in implementation versus what would have been required for the Exposure Draft.

We would like to acknowledge the FASB's recent decision to extend due process on its Revenue Recognition project, due to a significant change in the project's scope. We asked the FASB to allow for more time to consider and provide feedback on the direction the project is headed, and wish to thank the FASB for their recent decision to provide the opportunity for more thoughtful contemplation and discussion of the underlying concepts being considered.

We believe this delay will allow companies to focus on Sarbanes-Oxley implementation this year, and will bring the FASB's deliberations on revenue recognition into a more parallel mode with the IASB, which plans to issue a preliminary views document on revenue recognition later this year. (The FASB similarly recently decided to issue a preliminary views document as a first step.)

Conclusion: The Need for Internal Control, and Innovation

Unquestionably, FEI continues to fully support the spirit and intent of Sarbanes-Oxley. FEI believes the statute has strengthened the role of financial reporting and internal control and, in doing so, has strengthened confidence in the capital markets.

In closing, let me share a story about the founder of my company, Colonel Eli Lilly, and what I believe he might have thought of the Sarbanes-Oxley Act. A veteran of the Civil War, Colonel Eli Lilly was also a pharmacist, and was highly concerned about a common practice of his era - that people would purchase purported medicines with no verification of safety or effectiveness. In response to that state of affairs, Colonel Lilly chose to start his own small company. His goal was to produce medicines that passed high standards and protected the public's health, safety, and interest. He further believed that medicine should most properly be purchased on the advice of doctors, not from traveling salesmen.

From this beginning, quality control and its counterpart, internal control, have always been a part of Lilly's tradition. And it's the same way for my counterparts in FEI.

But in addition to its emphasis on quality control, Eli Lilly & Co. is also known for another major tradition: innovation. As with so many organizations, the pursuit of quality improvement

led directly to the quest for major advances that would be new and better. Our products, as those of our peer companies in FEI and beyond, help raise the quality of life and standard of living in the United States and around the world.

If Colonel Eli Lilly were here today, my guess is he would probably applaud the Sarbanes-Oxley Act for its emphasis on internal controls in providing quality assurance in financial reporting. He would recognize the role of the external auditor in providing third party, independent attestations on these financial reports. But he would also remind people of the importance of innovation. We cannot lose sight of the forest for the trees. We must not let internal control testing and related documentation take over so much of our time that we lose focus on the operational and strategic planning on which our companies and the stakeholders depend.

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