

TESTIMONY OF

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BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
FINANCIAL SERVICES COMMITTEE

AT A HEARING ON

H.R. 3763

THE COPROATE & AUDITING ACCOUNTABILITY, RESPONSIBILITY
AND TRANSPARENCY ACTS OF 2002

March 20, 2002

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

The Committee is today 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 wishes to lend its support for H.R. 3763 the “Corporate & Audit Accountability, Responsibility and Transparency Act of 2002” and applauds this Committee’s leadership in identifying and addressing the critical issues to improve transparency of corporate disclosures and audit effectiveness.

This week, FEI released its recommendations for Improving *Financial Management, Financial Reporting & Corporate Governance*, which complements 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. I would like to take the balance of my time and focus on a couple of specific recommendations as a way to verify FEI's support for H.R. 3763:

CODE OF ETHICAL CONDUCT

While H.R. 3763 includes many proposals to improve corporate governance – all of which FEI supports – H.R. 3763 lacks a provision calling upon the SEC to work with the stock exchanges to develop a requirement that the principal financial officer and principal accounting officers of all listed 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 for stakeholders. The financial officers of any company should proactively promote ethical conduct in the work environment as well as the community.

HIGHER STANDARDS FOR AUDIT COMMITTEE “FINANCIAL EXPERTS”

There needs to be a much higher standard established for audit committee “financial experts”. FEI has called upon the SEC to work with the stock exchanges to require listing agreements to include specific financial expertise for such audit committee

financial experts. In 1999 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. These criteria should “raise the bar” for explicit experience for 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 of an external auditor responsible for reporting on the execution and results of the annual audits.

NON-AUDIT SERVICES BY INDEPENDENT AUDITORS

Another recommendation found in FEI's proposed reforms 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. That was before Enron, which revealed certain systemic issues that now require reform. Because of Enron, certain systemic issues were revealed in the accounting industry and its credibility of the audit process requires that certain reforms be imposed on some non-audit services supplied by the independent auditor.

It is unfortunate but recent failures of corporate management, financial reporting and independent audits, have violated the public's trust in the checks and balances control system fundamental to good corporate governance. 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.

SHAREHOLDER APPROVAL OF STOCK OPTION PLANS

Congress should mandate changes to shareholder approval requirements for employee stock option plans currently under consideration by the NYSE and NASDAQ. FEI has been a longtime proponent of revising the rules requiring shareholder approval of broad-based employee stock option plans in which directors and officers participate.

Employee stock option issues is a corporate governance matter and that the decision for companies to offer stock options to their employees should rest with the stakeholders of that company. 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 interested with those of the shareholders.

Unfortunately, conflicting interests have prevented the stock exchanges from setting these standards for their listing companies and as a result, appearances of self-dealing on the part of company officers and directors persist. FEI strongly believes that the stock exchanges need to step in and provide leadership for their listing companies during this critical time.

PUBLIC SECURITIES LITIGATION REFORM ACT

Briefly, FEI would like to add its voice to 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 there is no need to change or modify the current PSLRA.

CONCLUSION

In closing, FEI wants to again lend its support for H.R. 3763 because of its commitment to achieve improvements in the transparency or 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 of the members of the Committee for allowing FEI the opportunity to testify.