Adding the CEO's sign-off means that he or she will insist on a rigorous process.

ing my associates at WorldCom that we shouldn't complain as we were the ones that caused the new law!

For the other boards, the feeling was that the accounting firms overreacted for a couple of years to the point that they were almost unwilling to give their advice on an accounting issue. That led to an unnecessarily adversarial atmosphere, but things settled down after a time and a more constructive working relationship now generally exists along with the necessary independence of the auditors.

In retrospect, has it accomplished what it set out to do?
From a company perspective, I think the two most positive things that came from Sarbanes-Oxley are (1) the required attestation by the CEO and the CFO; and (2) better internal control procedures and documentation.

While the CFO's responsibilities for financial reporting always seemed clear, even that was more implicit than explicit in some companies. And adding the CEO's sign-off means that he or she will insist on a rigorous process to ensure the highest possible quality of reporting.

With respect to internal controls, even those companies that considered themselves to be very well controlled prior to Sarbanes-Oxley found that documentation often was weak or that some parts of the system needed improvement. By now, most of that effort has become relatively routine but having strong controls are still essential if a company wants to ensure that it achieves its objectives.

VIEWPOINT

We Were There

FEI's Role in Shaping The Sarbanes-Oxley Act of 2002

By Philip B. Livingston

The Enron Corp. scandal put Financial Executives International front and center in 2001 and 2002. The criminal acts of Andy Fastow, Enron's chief financial officer, blatant accounting manipulation and fraudulent financial reporting — as well as ineffective audit committee oversight and auditor Arthur Andersen's failed audit — were all factors that called for a regulatory overhaul in areas central to FEI's mission and purpose.

As president and CEO of FEI at the time, I believed the situation called for proactive leadership along with strong public advocacy on behalf of the membership.

In response, we put together a task force of leading chief financial officers and controllers from FEI's membership. That group met regularly to develop draft recommendations. FEI's prestigious Committee on Corporate Reporting added and amended the recommendations as they came into final form.

In the early days of the scandal, we emphasized the lack of ethical conduct and the inappropriate "tone at the top" as key causes of the Enron bankruptcy. The front line failure of the management team was so shocking and blatant that it drew highlighted attention to the complete failure of the external audits and board oversight.

We ultimately outlined 12 recommendations that included creating a new oversight body for auditor regulation (the eventual Public Company Accounting Oversight Board); restricting the hiring of senior personnel from the external auditor (Enron and Andersen had a revolving door of personnel and auditors from Andersen actively sought lucrative positions at Enron); reforming the Financial Accounting Standards Board; stronger qualification standards for public company CFOs and principal accounting officers; and recommendations to modernize financial reporting.

The full list of the 12 recommendations are in the sidebar on page 43.

Phil Livingston (left), then-president and CEO, Financial Executives International, pictured with Sen. Paul Sarbanes (D-Md.) at the signing of the law.

FEI's Legislative Priorities

FEI lobbied for three major legislative priorities as the bill gained momentum. The first was to eliminate the provision that called for external audit of the internal control system. It was a provision that the audit firms had pursued since the 1980s, and one that corporate America had fought off successfully in the past.

Second, we called for the implementation of higher standards for financial experts on audit committees (which would eventually become Section 407 of the law). Finally, we felt that all companies should require senior management to sign a code of ethical conduct (the eventual Section 406), acknowledging their financial reporting obligations and agency duty while overseeing the corporation's assets.

The internal control audit — the provision that became the infamous Section 404 — was especially troubling to our membership, and our letter to Congress and the regulators called for its removal. I recall the meeting of FEI's Committee on Corporate Reporting in which one of our members was the first to point out that the onerous provision had been inserted into the earliest drafts of the bill. We pointed to the impracticality of the concept, as well as the cost it would create.

Looking back it provides little solace to know that we were among the few to object, given our ultimate inability to remove the provision from the final legislation.

And, though FEI opposed Section 404 during the drafting of the bill, since adoption the very large cap companies have found it useful in improving internal controls, while the mid-cap and small companies have struggled significantly from both a cost and usefulness perspective. Ongoing postponements and changes as how to apply the provision to smaller companies highlight these problems.

But our recommendation for higher financial expertise on audit

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FEI's 12 Recommendations for Improving Financial Management, Financial Reporting and Corporate Governance

In the wake of the Enron accounting scandal, FEI released a set of 12 recommendations developed by a member task force to facilitate industry and accounting reform. The report, issued in March 2002, was shared with leaders on Capitol Hill, at the U.S. Securities and Exchange Commission and the stock exchanges, and was instrumental in helping shape the Sarbanes-Oxley Act signed into law four months later. Here are proposals for reform as offered by FEI:

1 **Have financial executives adhere to a specialized code of ethical conduct.** The revised FEI Code of Ethical Conduct now calls on financial professionals to acknowledge their affirmative duty to proactively promote ethical conduct in their organizations.

2 **Provide means for employees to surface 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.

3 **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.

4 **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.

5 **Place restrictions on certain non-audit services supplied by the independent auditor.** Any instance where services could present conflict-of-interest questions should be avoided. In addition to internal audit and consulting on computer systems used for financial accounting and reporting, these would include services where the audit firm could be put in a position of relying on the work product.

6 **Restrict hiring of senior personnel from the external auditor.** Corporations should adopt policies restricting the hiring of engagement audit and tax partners or senior audit or tax managers.

7 **Reform the Financial Accounting Standards Board (FASB).** Form a blue ribbon committee to recommend within three months FASB reforms in the areas of organization, financial statement content and timeliness of standard setting.

8 **Modernize financial reporting.** Steps here include developing best practices for Management Discussion and Analysis (MD&A), implementing plain English financial reporting and providing website access to key performance measures.

9 **Require the stock exchanges to include in their listing agreement a mandate that at least one member of a public company's audit committee be a "financial expert," as recommended by the 1999 Blue Ribbon Panel.** In setting higher standards for "financial expertise," the NYSE and NASDAQ should

require explicit knowledge of GAAP obtained through education or experience and require experience in the preparation or audit of financial statements for a company of similar size, scope and complexity.

10 Require continuing professional education for audit committee members. Companies should disclose in the audit committee report statement whether members have undertaken such training.

11 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.

12 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.

Continued from page 43

committees did get into the bill as Section 407, much as we proposed it. In the final days of drafting and negotiation, the stock exchanges raised objections to this provision. In the end, the bill called for U.S. Securities and Exchange Commission registrants to disclose whether or not they have a qualified financial expert on their audit committee.

This allowed companies some leeway in compliance, but forced them to tell shareholders explicitly if they did not comply with the standard for financial experts. We drew this adjustment from the United Kingdom regulatory model that often uses a "comply or disclose" model.

It is my view that the financial expert provision has had a significant impact on the composition of boards, how boards conduct themselves and on the quality of financial reporting. Audit committee financial expertise was too often missing in auditor oversight, missing in setting the tone at the top and oversight of the financial reporting process.

Today, board members look to their financial expert when financial reporting and internal control issues arise. The external auditor is also empowered having a knowledgeable director to deal with.

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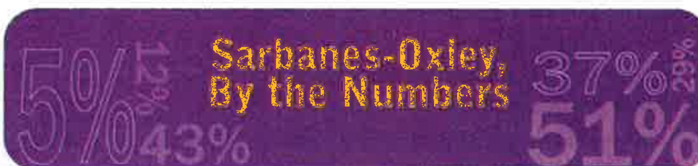

In its Audit Fee survey this year, Financial Executives Research Foundation asked FEI members about their company's compliance experiences with Section 404 of the Sarbanes-Oxley Act of 2002.

Question: **Has your company experienced an increase or decrease in its internal costs of compliance with Sarbanes-Oxley Section 404 within the past three years?**

29% Increase
48% Decrease

Question: **If an increase, check all the reasons why (some respondents gave more than one answer):**

47% The company has completed a large acquisition with additional systems.
43% The company has implemented a new IT system.
7% The company experienced a material weakness or significant deficiency, requiring additional Section 404 testing.
40% Other
- Total hours are higher because of PCAOB interpretations of rules.
- In reaction to prodding by the PCAOB, our auditors have requested we expand the scope of our work.
- Increased audit fees, personnel costs and new systems and processes included in scope as the company continues to grow.

Question: **If a decrease, check all the reasons why (some respondents gave more than one answer):**

47% The company has implemented more automated controls.
41% The company has restructured its business and financial systems.
12% The company has sold a significant segment of the business.
41% Other
- Previous material weakness has been remediated; overall ICFR environment improved; shift of resources back to internal.
- Drive efficiencies through testing and better compliance.
- The company outsourced its internal audit function two years ago at a cost savings.

Question: **How would you best describe your company's compliance with Section 404?**

51% Better internal control, worth the added expense.
37% Better internal control, but not worth the added expense.
5% No increase in internal control.
7% Cost of compliance far exceeds any additional internal control.

Repercussions of Sarbanes-Oxley

The passage of the Sarbanes-Oxley Act in some form was unavoidable given the sequence of events that included the technology bubble collapse in 2000, the scandal of Enron in 2001 and then WorldCom's failure in 2002.

In 2002 President George W. Bush publicly called for a bill to be delivered to his desk from a divided Congress. As public radio broadcast his speech to a national audience, I was asked to comment on his talk as it was delivered live. My comments noted the scolding tone of the president's talk as if one CEO were talking directly to a large group of his peers.

For me (on behalf of FEI), the post-Enron period included many television and radio appearances, letters to the editor and op-ed pieces as well as countless speaking engagements before a variety of groups outlining FEI's 12-point recommendations for reform.

The entire experience is without a doubt the highlight of my professional career. FEI members looked to us for leadership, and I believe we were proactive in support of change, but also clear that the front-line failures (the management teams) were principally due to unethical and illegal personal behavior.

Unfortunately, the intense media focus and the resulting legislative scramble to act on the public's behalf led to a poor implementation of the provisions of Sarbanes-Oxley. Section 404 was never field tested or properly scoped. Initially, the auditing firms extended the reach of Sarbanes-Oxley to every miniscule part of the internal control system, rather than only those that impacted financial reporting.

Huge costs were incurred and many business priorities got pushed back as a result of 404 implementations. That provision is unfortunately what most executives think about when they think about the Sarbanes-Oxley Act.

But the most important and far-reaching provision of the bill, and the most important intent of the bill, was the formation of a new independent regulatory agency to oversee the public company auditors. The creation of the PCAOB is easily two-thirds of the bill. Prior to Sarbanes-Oxley, the audit industry had a peer-review quality control system that lacked the frequency, intensity and independence needed.

My view is that the PCAOB has been successful in improving audit quality. Auditors now know that their work has a significant chance of direct review by an independent third party, and that there are repercussions for poor financial statement audits. As a result of the recent Bernard Madoff fraud, the PCAOB's powers were broadened to include all audit firms that opine on the financial statements of broker-dealers.

> Though FEI opposed Section 404 during the drafting of the bill, since adoption the very large cap companies have found it useful in improving internal controls while the mid-cap and small companies have struggled significantly from both a cost and usefulness perspective.

FEI's Participation and a Past-President's Personal Insights

Overall FEI played a significant role in the adoption of Sarbanes-Oxley. Sen. Paul Sarbanes (D-Md.) cited our group's participation on CNBC the night his committee reported out the bill. Grace Hinchman — then FEI's vice president of Government Relations and the key player in our lobbying efforts — and I attended the White House bill signing ceremony. *The Washington Post* ran a photo of Sen. Sarbanes and me speaking at the White House just after President Bush spoke and signed the bill. (Photo on page 42.)

Other memorable events from that time included an important meeting with SEC Chairman Harvey Pitt and his staff at the peak of the crisis. Phil Ameen, then-corporate comptroller of General Electric Co., David Shedlarz, then-chief financial officer of Pfizer Inc., and Pedro Reinhard, who was CFO of Dow Chemical Co., and I offered some practical recommendations and encouraged the chairman to be vocal and proactive to restore public confidence in the markets.

I also testified on the main panel when Rep. Michael Oxley's (R-Ohio) House Financial Services Committee considered its draft bill. The reruns on CSPAN brought many phone calls from old friends. Appearing on "Moneyline" with Lou Dobbs was also an incredible experience.

My best memories though are still from the many FEI chapter meetings and financial reporting conferences in which I outlined FEI's 12 recommendations. The questions and conversations that ensued were important to the public dialogue.

The corporate governance, auditing and financial reporting failures that happened during that time and that continue to occur periodically point to the critical and unique role that financial executives play in our economy.

While regulation and oversight can mitigate risk to some extent, it is still professionalism and ethical conduct on the part of front line corporate management that forms the trust that makes free markets work. CFOs and controllers have a tough job. They have to be savvy business partners, but they also have to be the "no" voice when lines get crossed. Enron and WorldCom put the spotlight on our profession, and Sarbanes-Oxley was tough medicine. But now — 10 years later — I believe we emerged stronger for it.

Philip B. Livingston is CEO of LexisNexis Martindale-Hubbell. He served as FEI president and CEO from 1999 to 2003.