TESTIMONY OF

ARNOLD C. HANISH

CHIEF ACCOUNTING OFFICER

ELI LILLY & COMPANY

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

&

DEVELOPMENTS CONCERNING INTERNATIONAL COVERGENCE

SEPTEMBER 9, 2004

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.

- <u>Documentation can supplement, but will not supplant, judgment and honesty</u>. 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 <u>why</u> 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 testimony[2].

<u>FEI's Cost Survey on Implementing Section 404</u>

[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.

<u>Small company concerns</u>

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.)

<u>Conclusion: The Need for Internal Control, and Innovation</u>

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.

March 2002

fei
financial executives international

financial executives international

FEI Observations and Recommendations

Improving Financial Management, Financial Reporting and Corporate Governance

Overview

Presented here are the views of Financial Executives International (FEI) on reforms aimed at strengthening financial management, reporting and corporate governance. We believe that most companies are governed and managed ethically and are fulfilling their fiduciary obligations to their stakeholders. However, the investing public and FEI share a common concern over the problems highlighted by the recent failures of corporate management, financial reporting, corporate governance, audit committees and independent audits. The U.S. capital markets are based, in large part, on trust in a checks-and-balances control system fundamental to good corporate governance. The weaknesses exposed in the system are highlighted in public documents, testimony before Congress, press interviews and special reports. We believe these revelations point to certain systemic issues and call for reform. FEI supports a clear and coordinated look at all areas of possible improvement. It is our intention to assist in this effort by making the following observations and recommendations.

We believe the following factors may have contributed to the recent problems observed in the areas of corporate governance, ethical management, financial reporting and external audits:

- Lack of ethical conduct and inappropriate “tone at the top”
- Failure of effective board oversight
- Lack of financial expertise on audit committees
- External audit failure due to compromised independence and failed quality control procedures
- Overly complex accounting standards
- Opaque financial reporting
- Emphasis on form over substance in applying accounting standards

We offer recommendations in four areas:

Strengthening financial management and commitment to ethical conduct

Rebuilding confidence in financial reporting, the accounting industry and the effectiveness of the audit process

Modernizing financial reporting, and reforming the accounting standards-setting process

Improving corporate governance and the effectiveness of audit committees

Recommendations

Strengthening Financial Management and Commitment to Ethical Conduct

Recommendation 1: All financial executives should adhere to a specialized code of ethical conduct.

FEI recommends that all senior financial professionals be required to adhere to a strong ethical code of conduct. For many years, members of FEI have signed such a code, thus committing to its principles. That code has been updated recently to include a call for all financial executives to acknowledge their affirmative duty to proactively *promote* ethical conduct in their organizations.

Whether or not they are members of FEI, all finance professionals should adhere to a code of ethical conduct containing all the elements of the FEI Code of Ethics. The Code states, for example, that financial arrangements involving actual or apparent conflicts of interest should be avoided.

FEI recommends that all senior financial officers, accounting officers, controllers, treasurers and chief investor relations officers annually sign a code containing all the elements of the FEI Code of Ethics and deliver it to their board or the board's designated committee. Further, we expect that best practice in this area will be that **all** finance, accounting, tax and investor relations personnel annually sign such a code.

The FEI Code is attached to this document as Appendix A.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

Recommendation 2: Companies should actively promote ethical behavior and provide employees with the means to report perceived violations of ethical standards without fear of reprisal.

FEI strongly endorses practices by which all companies adopt a code of conduct for their employees and conduct regular training sessions to assure understanding and compliance. We believe companies should provide support and broad protection to employees reporting code of conduct violations. Under such a framework, companies should:

- Adopt a written code of conduct for all employees
- Conduct employee orientation and training with respect to the code
- Provide employees with a mechanism (such as a hotline or help-line) to surface concerns about compliance with laws and regulations
- Adopt procedures for voluntary disclosure of violations of laws
- Participate in best practices forums
- Inform the public of the active commitment to implement these steps

We encourage all companies to set up "hotline" channels, providing employees with the means to report perceived violations of the code or of the law without fear of reprisal. Additionally, employees should be made aware of these lines of communication and be assured that the source of all calls will be kept confidential. Calls should go directly to a person, facilitator or committee specifically identified by the company's board. That designated person or entity should screen each call and initiate appropriate action within the company. The company's board of directors should be informed of calls made and their disposition on a regular basis.

Recommendation 3: Qualifications of the principal financial officer and principal accounting officer.

Management, in support of the audit committee and board of directors, should designate a principal financial officer and a principal accounting officer as those terms are used in the Securities Act of 1933. FEI believes the qualifications and roles of such persons should include the following:

- The principal financial officer should be that person with overall responsibility for the finance function within the reporting company, and should have knowledge in all areas of finance including, at a minimum, the requisite knowledge proposed for the financial experts of audit committees. The principal financial officer should be responsible for upholding compliance with ethical standards within the finance function.

- The principal accounting officer should be a licensed public accountant or possess equivalent knowledge and experience, and should be current and knowledgeable in the understanding of GAAP and the SEC's rules and regulations governing the preparation and audit of financial statements.

- The principal financial officer should report to the chief executive officer, and the principal accounting officer should report to the principal financial officer. It is further recommended that the principal financial officer and/or the principal accounting officer meet with the audit committee periodically (quarterly) to review significant financial statement issues, including key judgments, estimates and disclosure matters.

Rebuilding Confidence in Financial Reporting, the Accounting Industry and Effectiveness of the Audit Process

Recommendation 4: Create a new oversight body for the accounting profession staffed with finance and accounting professionals.

Enhanced oversight of public accounting firms by an independent body would increase public confidence in the audit process and effectiveness of the audit quality control process. This oversight board should be sponsored by the SEC and, recognizing the technical nature involved and the need to adequately understand the audit process, the majority of its members should be executives with knowledge in accounting and finance. These individuals should be clearly independent of public accounting firms or other audit industry organizations. We do not believe that a majority of members should be drawn from the audit profession.

This oversight board should oversee the peer review quality control process of the audit firms. Furthermore, the peer reviewers should be accountable to the oversight board for the scope of review, findings, recommendations and corrective actions.

We further recommend that a focused mission and scope will enhance the effectiveness of this body. Therefore, this new body should be principally tasked with the job of audit industry oversight and discipline. As FEI continues to support private-sector accounting standard setting, we believe that a separate and independent body should continue to oversee the FASB.

Recommendation 5: Place restrictions on certain non-audit services supplied by the independent auditor.

Even the appearance of a potential conflict of interest may now undermine an auditor's effectiveness. Therefore, we believe confidence in the integrity of the audit would be enhanced if certain non-audit services were prohibited for audit clients. In this regard:

- The independent auditor should no longer provide audit clients with internal audit services or consulting on computer systems used for financial accounting and reporting.
- Advisory services should be prohibited wherever the audit firm could be put in a position of relying on the work product resulting from such services.
- Tax advisory and compliance services, acquisition due diligence, audits of employee benefit plans and other statutory audits should be acceptable services for audit clients as they would not normally raise questions of conflict of interest. In the unusual instance where such services could present questions of a conflict of interest, such services should not be provided.

Importantly, in addition to the foregoing, we suggest that audit committees approve substantially all large non-audit services. In so doing, the audit committee should consider the impact of such services on the overall independence of the audit firm.

FEI also recommends that the SEC redefine the current classifications of audit and non-audit services to assure that the guidance is clear and that the distinction conveys a complete and meaningful picture to investors in regard to the proper characterization of audit and non-audit activities.

Recommendation 6: Restrict the hiring of senior personnel from the external auditor.

FEI recommends that companies adopt policies that restrict the hiring of engagement audit and tax partners, or senior audit and tax managers, who have worked on the company's audit for a period specified by the board of directors. FEI believes that this period should be no shorter than two years.

Modernizing Financial Reporting and Reforming the Accounting Standards-Setting Process

Recommendation 7: Reform the Financial Accounting Standards Board (FASB).

FEI recommends that a "Blue Ribbon Committee" be formed to address FASB reform. While we support continuing private-sector standard setting through the FASB, substantive process and structural changes are long overdue. The Blue Ribbon Committee should complete its work promptly and produce initial recommendations within three months of its formation. The Committee should be guided by the basic principle of advancing financial reporting, notwithstanding divergent political interests. The Committee should address the following issues:

- FASB Organization
  - Board mission statement
  - Size of board
  - Length of board member terms
  - Voting majority
  - Staff effectiveness, accountability and structure
  - Restrictions on board member meetings ("Sunshine Rules")

- Timely Standard Setting
  - Timely standard setting with clearly defined priorities, objectives and milestones
  - Agenda management and accountability

- Financial Statement Content
  - A process for defining clear long-term objectives for financial statements produced under GAAP
  - Fair value accounting, in particular, needs to be addressed, given the absence of market values in many areas and the potential for such accounting concepts to create financial statement volatility

- Financial Accounting Standards
  - Reassess the conceptual framework as the basis for standard setting
  - Assure practical implementation of principle-based standards vs. specific, bright-line rules; examples of standard application and financial interpretations based on principles underlying standard
  - Impact of planned globalization of accounting standards
  - Review existing standards and disclosures
  - Address the need to increase the participation of the user and investment community and decrease tension with the preparer community

Recommendation 8: Modernize financial reporting.

FEI expresses strong support for the following improvements in financial reporting and recommends that committees be formed promptly to address these matters.

- Improve Management's Discussion and Analysis (MD&A)
  - FEI should take the lead in developing best practices for MD&A disclosure utilizing 2001 annual reports as a primary source for data.

- Implement "Plain English" financial reporting as the new language of professionals involved in investor relations and financial statement preparation.

- Promote voluntary disclosures of business performance metrics
  - FEI recommends that companies consider providing Web-based reporting of key performance measures used by management and specific to the industry on a quarterly basis. (A possible source for additional key performance measures is information shared at analyst presentations.)
  - In order to encourage the expansion of reporting additional measures, it is essential that safe harbor rules be strengthened to specifically encompass the additional reporting.

- Develop and complement Web-based financial reporting
  - Internet delivery of hierarchical financial reporting that employs scorecards, current key performance indicators and analytical tools offering differing accounting standards is the future. Industry, users and the SEC should move ahead aggressively to develop models of such reporting frameworks without reducing access for investors in the short term.
  - Mandatory Internet access to financial reports — public companies should make the information available on their Web sites concurrent with SEC filings.
  - Voluntary business performance reporting, discussed above, may be more easily implemented through Web-based reporting.

- Expanded use of reports on Form 8-K
  - Items typically included in these filings could be expanded; however, the SEC's revised guidance should be "principle-based" and the current list of additional items to be disclosed should be presented only as "examples."

- Enhance filing requirements for foreign filers
  - Many foreign filers currently provide quarterly financial statements on a voluntary basis. FEI recommends that the SEC require foreign filers to file quarterly.

- Assess transition impact on paper documents
  - FEI does not suggest that hard copy mailings be eliminated in the near term. However, the content of paper mailings to shareholders should be examined to determine what modifications can be made and over what timeframe.
  - Financial disclosure to shareholders via paper documents has vastly exceeded a user's ability to digest it. The availability of public filings on the Web and analysis of information accessed by users should assist in identifying what is considered important. The resulting information could serve as a basis to expand the disclosures most often accessed and reduce those disclosures that are of little or no interest. This should improve understanding and communication while reducing costs to corporations and, ultimately, to the shareholders.

Improving Corporate Governance and the Effectiveness of Audit Committees

Recommendation 9: Effective implementation of the 1999 Blue Ribbon Panel Recommendations re 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.

FEI recommends that the NYSE and the NASDAQ set **higher standards** for audit committee "financial experts." These criteria should call for explicit experience requirements in the credentials of such experts. 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. We believe 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 company of similar size, scope and complexity as the company on whose board the committee member serves. The experience would generally be as a chief financial officer, chief accounting officer, controller or auditor of a similar entity. This background will provide a necessary understanding of the transactional and operational environment that produces the issuer's financial statements. It will also bring an understanding of what is involved in appropriate accounting estimates, accruals, reserve provisions, etc., and an appreciation of what is necessary to maintain a good internal control environment.

- Experience in the internal governance and procedure of audit committees, 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 annual audits.

FEI strongly recommends that Congress and the SEC implement regulations that call for stock exchanges and markets to implement this recommendation through listing agreements.

Recommendation 10: Continuing professional education for audit committee members.

FEI recommends that all audit committee members attend continuing education in areas of financial reporting, risk management and/or accounting. Training can be "in-house" or via an outside provider. FEI, the National Association of Corporate Directors or an equivalent entity should establish the minimum content to be covered. Companies should disclose in the annual audit committee report whether members have undertaken such training. Non-audit committee directors are also urged to attend these sessions.

Recommendation 11: Periodic consideration of audit committee chair rotation.

FEI recommends that boards of directors periodically evaluate the need to rotate the individual holding the audit committee chair. Such evaluation may be done approximately every five years. FEI recognizes that outstanding audit committee chairs are valuable and difficult to replace. Yet there is also benefit in developing successors and additional financial experts on the audit committee. Therefore, rotation and successor development may further strengthen the overall governance mechanisms within the board.

Recommendation 12: Disclosure of corporate governance practices.

FEI recommends that all companies annually report their key corporate governance practices. Current best practice in many companies is to have a governance and nominating committee made up of independent directors.

Closing

FEI formed a task force of members to assemble this set of recommendations. The task force also had significant input from FEI's Committee on Corporate Reporting. These recommendations were then reviewed and approved by FEI's Executive Committee led by FEI Chairman David Young, CFO of Adaptec, Inc., and FEI Vice Chairman Ridge A. Braunschweig, CFO of Orion Corporation. FEI wishes to acknowledge and thank those involved in the preparation of this report. Also, special thanks to the contributions of Barry Brooks, partner, Paul, Hastings, Janofsky & Walker LLP.

TASK FORCE MEMBERS

Philip D. Ameen
General Electric Company
Vice President and Comptroller

Scott M. Boggs
Microsoft Corporation
Vice President and Corp. Controller

Fred Corrado
The Great Atlantic & Pacific Tea Co., Inc.
Retired Vice Chairman & CFO

John P. Jessup
E.I. du Pont de Nemours & Company
VP Finance and Controller

Dennis D. Powell
Cisco Systems, Inc.
Vice President and Corporate Controller

Bryan R. Roub
Harris Corporation
Senior Vice President and Chief Financial Officer

David H. Sidwell
J.P. Morgan Chase & Co.
Chief Financial Officer - Investment Bank

Peter R. Bible
General Motors Corporation
Chief Accounting Officer

Frank J. Borelli
Marsh & McLennan Companies
Retired CFO

David J. FitzPatrick
United Technologies Corp.
SVP and Chief Financial Officer

Philip B. Livingston
Financial Executives International
President and CEO

J. Pedro Reinhard
Dow Chemical
EVP and Chief Financial Officer

David L. Shedlarz
Pfizer, Inc.
EVP and Chief Financial Officer

APPENDIX A: Code of Ethics of Financial Executives International

FEI CODE OF ETHICS

FEI's mission includes significant efforts to promote ethical conduct in the practice of financial management throughout the world. Senior financial officers hold an important and elevated role in corporate governance. While members of the management team, they are uniquely capable and empowered to ensure that all stakeholders' interests are appropriately balanced, protected and preserved. This Code provides principles to which members are expected to adhere and advocate. They embody rules regarding individual and peer responsibilities, as well as responsibilities to employers, the public and other stakeholders. Violations of FEI's Code of Ethics may subject the member to censure, suspension or expulsion under procedural rules adopted by FEI's Board of Directors.

All members of FEI will:

- ✓ Act with honesty and integrity, avoiding actual or apparent conflicts of interest in personal and professional relationships.
- ✓ Provide constituents with information that is accurate, complete, objective, relevant, timely and understandable.
- ✓ Comply with rules and regulations of federal, state, provincial and local governments, and other appropriate private and public regulatory agencies.
- ✓ Act in good faith, responsibly, with due care, competence and diligence, without misrepresenting material facts or allowing one's independent judgment to be subordinated.
- ✓ Respect the confidentiality of information acquired in the course of one's work except when authorized or otherwise legally obligated to disclose. Confidential information acquired in the course of one's work will not be used for personal advantage.
- ✓ Share knowledge and maintain skills important and relevant to constituents' needs.
- ✓ Proactively promote ethical behavior as a responsible partner among peers, in the work environment and the community.
- ✓ Achieve responsible use of and control over all assets and resources employed or entrusted.

fei
financial executives international

10 Madison Avenue
PO Box 1938
Morristown, NJ 07962-1938
973.898.4600
www.fei.org

Attachment 2: January, 2004 Survey Results

www.fei.org

FEI Survey on Sarbanes-Oxley Section 404 Implementation
©January 2004

Executive Summary

In response to numerous inquiries about the implementation costs for Sarbanes-Oxley Section 404 compliance (internal controls), FEI conducted a survey of members from public companies, and received responses from 321 companies during the week of January 26. The size of the responding companies, measured by annual revenues, tended to be large, with 20% of the companies having more than $5 billion in annual revenues, and only 3% of the companies having less than $25 million in annual revenues:

Annual Sales Revenues	Percentage of Respondents
Less than $25 million	3.3%
$25 to $99 million	9.7%
$100 to $499 million	19.3%
$500 to $999 million	17.3%
$1 to $4.9 billion	30.0%
Over $5 billion	20.3%

Almost 38% of the responding companies were from the manufacturing sector, with tech, retail, financial services and transportation, among other industries, also represented.

Question 1a
How many internal people hours do you expect to need to comply with Section 404/Management Report on Internal Controls?
Companies expect to spend an average of 12,265 people hours internally to comply with Section 404/Management Report on Internal Controls. The number of hours is directly proportional to the size of the company. For example, companies with less than $25 million in revenues expect to spend an average of 1,150 hours, while companies with over $5 billion in revenues expect to spend an average of 35,000 hours.

Question 1b
How many external people hours do you expect to pay for to comply with Section 404/Management Report on Internal Controls?
In addition, companies also expect to pay for an average of 3,059 external people hours (excluding fees for auditor attestation) to comply with Section 404/Management Report on Internal Controls. These external hours exclude auditor's fees for attestation. Again, the number of hours is directly proportional to the size of the company. For example, companies with less than $25 million in revenues expect to pay for an average of 846

hours, while companies with over $5 billion in revenues expect to pay for an average of 6,197 hours.

Question 2

What is your estimated cost, in thousands, for external consulting, software, and other vendor charges needed to comply with Section 404 (excluding auditor's fees for attestation)?

In total, responding companies expect to pay an average of $732,100 for external consulting, software, and other vendor charges to comply with Section 404. These vendor charges are before annual auditor attestation fees, and are proportional to the size of the company. For example, companies with less than $25 million in revenues expect to pay an average of $170,000, while companies with over $5 billion in revenues expect to pay an average of $1,390,100.

Question 3a

What is the additional audit fee you expect to pay for the public auditor attestation report required by Section 404?

For the Section 404 annual auditor attestation, responding companies expect to pay an average of $590,100 in fees. Again, these fees are proportional to the size of the company by revenues. For example, companies with less than $25 million in revenues expect to pay an average of $52,200, while companies with over $5 billion in revenues expect to pay an average of $1,531,400.

Question 3b

What percentage is this fee of your total annual financial statement audit fee?

The incremental fee for the annual Section 404 auditor attestation represents an average increase of 38% over current audit fees. This percentage is similar regardless of the size of the company in annual revenues.

Question 4

What percentage of your processes are you documenting to comply with Section 404?

Much of the additional internal people hours will be used to document company internal control processes. Responding companies expect to document an average of 80% of their processes. This percentage is similar regardless of the size of the company in annual revenues. However, one in five companies will document 100% of their processes.

Question 5

What percentage of your documented processes do you expect your external auditor to actually test?

Responding companies expect that their external auditors will test an average of 57% of their processes. Smaller companies, those companies with less than $25 million in revenues, expected the least number of process tests by the auditors, expecting them to test an average of 42% of their processes. However, 27% of the companies expect their auditor to test 80 to 100% of their processes.

Question 6a
At what percentage of your company's physical locations will you document internal control processes?
Companies say that they will document internal control processes at an average of 79% of their physical locations. This percentage is inversely proportional to company size based on revenues. Companies with less than $25 million in revenues expect to document processes at an average of 87% of their locations, while companies with over $5 billion in revenues expect to document processes at an average of 78% of their locations.

Question 6c
What percentage of total revenues is covered by your documentation?
Companies say that this documentation covers an average of 92% of total revenues. This percentage is similar regardless of the size of the company in annual revenues.

Question 8
When do you expect to deploy a permanent tool solution for Section 404 compliance?
Only 25% of the responding companies have already deployed their permanent tool solution for Section 404 compliance. Another 52% of the companies plan to deploy their solution sometime during 2004, and 10% plan to deploy after 2004. However, almost 14% of the companies have no specific plans to implement a solution tool at this time.

Additional Questions

When do you expect to deploy a permanent tool solution for Section 404 compliance?

	Number	Percent	95% CI
Already completed	76	25.1 %	± 4.9 %
1st Quarter, 2004	47	15.5 %	± 4.1 %
2nd Quarter	52	17.2 %	± 4.3 %
3rd Quarter	35	11.6 %	± 3.7 %
4th Quarter	21	6.9 %	± 3.0 %
2005 or later	31	10.2 %	± 3.5 %
No plans at this time	41	13.5 %	± 3.9 %
Total	303	100.0 %	

Missing Cases = 18
Response Percent = 94.4 %

Responses by Industry

	Number	Percent	95% CI
Manufacturing	113	37.9 %	± 5.4 %
Tech [Software/Biotech]	36	12.1 %	± 3.7 %
Other	32	10.7 %	± 3.6 %
Retail/Wholesale	29	9.7 %	± 3.4 %
Banking/Finance/Insurance	24	8.1 %	± 3.2 %
Transportation/Energy	23	7.7 %	± 3.1 %
Communications/Media	17	5.7 %	± 2.8 %
Service/Consulting	15	5.0 %	± 2.7 %
Mining/Construction	9	3.0 %	± 2.3 %
Total	298	100.0 %	

Missing Cases = 23
Response Percent = 92.8 %

By Sales Revenue

	Number	Percent	95% CI
Less than $25 million	10	3.3 %	± 2.4 %
$25-99 million	29	9.7 %	± 3.4 %
$100-499 million	58	19.3 %	± 4.5 %
$500-999 million	52	17.3 %	± 4.3 %
$1-4.9 billion	90	30.0 %	± 5.1 %
Over $5 billion	61	20.3 %	± 4.5 %
Total	300	100.0 %	

Missing Cases = 21
Response Percent = 93.5 %

By Number of Employees

	Number	Percent	95% CI
Fewer than 100	10	3.6 %	± 2.4 %
100-499	29	10.5 %	± 3.4 %
500-999	22	8.0 %	± 3.1 %
1000-2499	43	15.6 %	± 4.0 %
2500-4999	41	14.9 %	± 3.9 %
5000-9999	42	15.2 %	± 4.0 %
Over 10,000	89	32.2 %	± 5.1 %
Total	276	100.0 %	

Missing Cases = 45
Response Percent = 86.0 %

By Headquarters

	Number	Percent	95% CI
Midwest	83	27.3 %	± 5.0 %
Northeast	82	27.0 %	± 5.0 %
Pacific	63	20.7 %	± 4.6 %
South Central	35	11.5 %	± 3.7 %
South Atlantic	24	7.9 %	± 3.2 %
Mountain	12	3.9 %	± 2.5 %
Outside U.S.	5	1.6 %	± 2.1 %
Total	304	100.0 %	

Missing Cases = 17
Response Percent = 94.7 %

Attachment 3: July, 2004 Survey Results

FEI Special Survey on Sarbanes-Oxley Section 404 Implementation
Executive Summary (July 2004)

In response to numerous requests, FEI has surveyed its public member companies twice in 2004 about their implementation costs for compliance with Sarbanes-Oxley (SOX) Section 404. The first survey was conducted during the week of January 26, 2004, to find out what costs companies expected to pay, both internally and externally. The second survey was conducted during the week of July 12, 2004, by which time companies had presumably received quotes from their external auditors for their first annual Section 404 audit.

Total estimated average "year one" costs for compliance with Section 404, per company, increased from almost $2 million in January to over $3 million in July, while "year one" costs as estimated by companies with over $5 billion in revenues almost doubled from $4.6 million to over $8 million.

In July, 224 companies responded to the survey. The size of these companies, measured by annual revenues, tended to be large, with almost 27% of the companies having more than $5 billion in annual revenues, and 16% of the companies having less than $100 million in annual revenues:

Annual Sales Revenues	Percentage (July)	Percentage (January)
Less than $100 million	16.1%	13.1%
$100 to $499 million	17.9%	19.3%
$500 to $999 million	12.1%	17.3%
$1 to $4.9 billion	27.4%	30.0%
Over $5 billion	26.5%	20.3%

Almost 32% of the companies responding in July were from the manufacturing sector, with tech, retail, financial services and transportation, among other industries, also represented.

Question 1a
How many internal people hours do you expect to need to comply with Section 404/Management Report on Internal Controls?

In January, companies expected to spend an average of 12,265 people hours internally to comply with Section 404/Management Report on Internal Controls. By July, when companies were well into their documentation process, this number had more than doubled to an average of 25,668 hours. Companies of all sizes increased their estimates of internal people hours that would be required for compliance.

As in January, the number of internal people hours reported in July was directly proportional to the size of the company. For example, companies with less than $100 million in annual revenues will spend an average of 2,143 hours, while companies with over $5 billion in revenues expect to spend an average of 73,312 hours.

Question 1b
What percent of these internal people hours represents work performed by internal audit staff?

The Public Company Accounting Oversight Board (PCAOB) permits external auditors to rely on the work of the company's internal auditors, to a certain extent. So companies were asked, in July, what percentage of the internal people hours represented work performed by internal audit staff. Overall, companies said that an average of 27.4% of their total internal people hours represented the work of internal audit staff.

The bottom line for the responding companies is that less than one-third of the additional time spent internally will represent work to be done by the internal audit staff, whose normal responsibilities include internal control documentation. The majority of the additional internal time dedicated to Section 404 compliance will be spent by non-internal audit staff.

Question 2
How many external people hours do you expect to pay for to comply with Section 404/Management Report on Internal Controls?

In January, companies expected to pay for an average of 3,059 external people hours (excluding hours paid for auditor attestation) to comply with Section 404/Management Report on Internal Controls. By July, when companies were probably working with outside consultants and other auditing firms to document their internal controls, this number had increased by almost two-thirds to 5,067.

As in January, the number of external people hours reported in July was directly proportional to the size of the company. For example, companies with less than $100 million in revenues expect to pay for an average of 837 external hours, while companies with over $5 billion in revenues expect to pay for an average of 10,834 hours.

Question 3
What is your estimated cost, in thousands, for external consulting, software, and other vendor charges needed to comply with Section 404 (excluding auditor's fees for attestation)?

In January, responding companies expected to pay an average of $732,100 for external consulting, software, and other vendor charges to comply with Section 404. These vendor charges were calculated excluding annual auditor attestation fees. By July, when companies had begun to hire consultants and purchase software, the total reported cost had increased by 41% to $1,037,100. This increase was driven by the increased estimates of companies with over $5 billion in revenues, which increased their expected vendor costs by over 70% from an average of $1,390,100 in January to an average of $2,389,900 in July.

Again, these vendor costs are proportional to the size of the company. For example, companies with less than $100 million in revenues will pay an average of $192,000, while companies with over $5 billion in revenues will pay an average of $2,389,900.

Question 4a
What is the additional audit fee you expect to pay for the public auditor attestation report required by Section 404?

In January, responding companies expected to pay an average of $590,100 in Section 404 annual auditor attestation fees. By July, when companies had most likely begun receiving actual quotes from their auditors, the average expected fees increased by almost 40% to $823,200.

Again, these expected audit fees are proportional to the size of the company by revenues. For example, companies with less than $100 million in revenues expect to pay an average of $259,500, while companies with over $5 billion in revenues expect to pay an average of over $2,000,000.

Question 4b
What percentage is this fee of your total annual financial statement audit fee?
In January, the incremental fee for the annual Section 404 auditor attestation was expected to represent an average increase of 38% over current audit fees. By July, the incremental fee for attestation was expected to represent an increase of over 53%.

As in January, this percentage is similar regardless of the size of the company in annual revenues.

Question 5
What percentage of total revenues is covered by your documentation?

In January, companies said that their Section 404 documentation would cover an average of 92% of total revenues. By July, there was very little change in this estimate.

Again, as in January, this percentage is similar regardless of the size of the company in annual revenues.

Total Year One Costs of Compliance

The total "year one" cost of compliance is defined as the sum of internal staff costs (each staff professional is assumed to work 2,000 hours per year and earn $100,000 per year in salary and benefits), costs of external consultants and vendors, and additional auditor attestation fees.

On average, the total year one cost of compliance per company was estimated to be almost $2 million in January 2004, but by July 2004 that cost had increased by more than 60% to over $3 million. This average increase was again driven by the estimates of companies with over $5 billion in revenues, which increased their expected year one costs by over 70% from an average of $4.6 million in January to an average of over $8 million in July.