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1900 N.W. Corporate Blvd.
Suite 300E
Boca Raton, FL 33431
(561) 994-5050 Voice
(561) 241-0071 FAX
(954) 429-8555 Broward

Not All Material Weaknesses Are Created Equal

By Paul Feuerberg, CPA, Audit Partner

When you think of a “material weakness in internal controls,” what comes to mind? High-profile corporate scandals? Fraudulent financial reporting? These are certainly the ugliest faces of corporate finance, but there are numerous other breaches of internal controls.

In a December 2005 presentation before the American Institute of Certified Public Accountants, an SEC Accounting Fellow reported that almost 15% of the first year Section 404 filers reported material weaknesses and that the percentage of companies reporting such weaknesses tends to increase as market capitalization decreases.

The most frequent types of material weaknesses identified among 261 companies by Ge Weile of the University of Michigan and Sarah McVay of New York University (*The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act*, May 2005) were the following deficiencies: account-specific, training, period-end/accounting policies, revenue recognition, segregation of duties, account reconciliation, subsidiary specific, senior management, and technology issues.

While these weaknesses must be disclosed by public company CEOs and CFOs subject to Section 302 certifications, they do not have equal impacts on company operations and/or shareholder value. Weaknesses that cause restatement of financial results are obviously very serious, but account-specific weaknesses such as certain inventory processes may be more acceptable when potential losses are compared to remediation costs. Obviously, compliance is expensive, so the importance, likelihood of occurrence, and correction costs of each weakness must be considered before taking action.

If you have any questions or comments about this article or any other aspect of the Sarbanes-Oxley Act, please contact me by telephone at (561) 994-5050 or e-mail me at pfeuerberg@goldsteinlewin.com.

Paul Feuerberg, CPA, has over 35 years of experience, including 20 with international and national accounting firms and 25 as an Audit Partner. In 1992, he joined Goldstein Lewin & Co. where he provides audit services to public, private and non-profit entities. He has extensive experience in SEC offerings and reporting as well as other regulatory filings. Licensed to practice in the states of Florida and New York, he was honored for Excellence in Accounting in 2004.

Whistleblowers — Heroes or Troublemakers?

Is this "the age of whistleblowers" as claimed by PCAOB board member Charles Niemeier in an interview with the Associated Press? At a time when Sarbanes-Oxley is reshaping corporate governance standards, have we developed a culture that values rather than punishes whistleblowers?

In a radical departure from tradition, *Time* magazine featured three whistleblowers on its December 2002 cover as People of the Year - Cynthia Cooper of Worldcom, Coleen Rowley of the pre 9/11 FBI, and Sherron Watkins of Enron. There are also some recent well publicized cases heard before US Department of Labor Administrative Law Judges upholding whistleblower claims.

David Welch, former CFO of Cardinal Bancshares who was fired after alleging that the CEO had tampered with internal controls, was ordered reinstated with back pay and interest. After proving that she was terminated for refusing to change a stock rating, research analyst Margot Getman of Southwest Securities was awarded the balance of her contract plus bonuses due.

Yet far from being considered heroes, many whistleblowers find their jobs threatened, their finances depleted, their home lives adversely affected, and their emotional well-being turned upside down.

And recent rulings show that whistleblowers are not globally admired. Judge Levin H. Campbell of the First US Circuit Court of Appeals asserted that SOX whistleblower protection does not extend to foreign workers employed in overseas subsidiaries of US firms. Ruben Carnero, an Argentinean who worked for two Brazilian subsidiaries of Boston Scientific, claimed that he was fired in retaliation for revealing false invoices and inflated sales figures. In France both McDonalds France and CEAC were denied approval for ethics hotlines. Wal-Mart's proposed whistleblower procedures were overturned by a German court because they violate existing labor laws.

According to an Associated Press report (February 2005), since SOX took effect workers have filed over 144 claims with the Department of Labor alleging retaliation by employers for revealing financial mismanagement. Dan Westman, an attorney with Shaw Pittman LLP in McLean, Virginia, recently stated that cases brought by Sarbanes-Oxley whistleblowers comprise the fastest growing category of cases handled by the Department of Labor.

Big Four Expect SOX Costs to Drop

According to a recent study, completed by consulting group CRA International and commissioned by the Big Four accounting firms, Sarbanes-Oxley Section 404 related costs, after considering start-up and one-time factors, should fall about 40 percent for both large and small companies in FY 2005.

Larger companies are expected to report a 42% average decline in annual SOX-related costs.

The larger companies surveyed, 96 of which were Fortune 1,000 firms, are expected to report an average decline in annual Sarbanes-Oxley related costs of 42 percent. For smaller companies, with market caps from $75 million to $700 million, annual costs are expected to drop 39 percent.

In a letter to the SEC, the Big Four noted that audit fees played only a small role in first year Sarbanes-Oxley costs – representing no more than one-third of the total costs. Costs were attributed to high labor hours, including the hiring and training of new personnel, third party providers other than audit firms, and new software expenditures with related implementation costs.

Are Boards Becoming Major Players?

Leadership is critical to today's Boards. When a CEO controls a Board, it cannot become a change agent. And Board and committee meeting agendas are important methods of control.

Yet, according to a survey conducted by *Corporate Board Member* and PricewaterhouseCoopers, 74% of 1,103 respondents said that the CEO establishes Board meeting agendas.

Roles are reversed in the case of committee meetings. Nearly 3/4 of chairpersons develop agendas for their committee (audit, compensation, and nominating) meetings, while the CEO sets the agenda in 10% of the cases cited.

Some Board members actively seek information. GE directors meet alone with management and employees of different business units. Edward Kingman, head of the Audit Committee at InCode, has unlimited access to the CFO and Treasurer.

As TK Kerstetter, president of *Corporate Board Member* observes, "There is no question that the CEO should lead the corporation in his or her vision, but the board needs its own independent leadership to effectively meet its responsibilities to the shareholders."