

Insights

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Accounting

Proposed Technical Corrections for FASB Statement No. 123(R)

The Financial Accounting Standards Board (FASB) has issued proposed FASB Staff Position (FSP) No. FAS 123(R)-f, *Technical Corrections of FASB Statement No. 123 (R)*. The FSP proposes three amendments to FASB Statement No. 123(R), *Share-Based Payment*.

- Paragraph A240(d)(1) would be amended to explicitly exempt nonpublic entities from the requirement to disclose the aggregate intrinsic value of outstanding fully vested share options (or share units) and share options expected to vest at the latest balance sheet;
- The amount of compensation cost that must be recognized in paragraph A102 of Illustration 4(b) would be revised to be consistent with the recognition provisions in paragraph 42; and
- Paragraph A170 of Illustration 13(e) would be amended to clarify that on the date that a company decides to close a plant and terminate employees, the service condition of the illustrative award is not expected to be satisfied and the awards are no longer probable of vesting because the employees cannot render the requisite service. Therefore, any compensation cost previously recognized as of the date of the plant closing should be reversed.

If finalized, the provisions of this FSP are expected to be applied in the first reporting period beginning after the date the final FSP is posted to the FASB Web site. The proposed FSP is available for comment until September 2, 2006 at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas123r-f.pdf.

Auditing

Proposed Statement on Quality Control Standards

The Auditing Standards Board of the American Institute of Certified Public Accountants has issued an exposure draft of a proposed Statement on Quality Control Standards (SQCS) entitled *A Firm's System of Quality Control*. The proposed Statement deals comprehensively with a firm's quality control practices in the areas of audits, reviews and compilations and other attestation engagements. It would replace all existing SQCSs.

The proposed Statement differs from existing SQCSs in several ways, including the following:

- The Statement defines the *engagement quality control review* (often referred to as a concurring review) and requires firms to establish criteria to determine which engagements are to be subject to an engagement quality control review.

- The Statement also defines the terminology to be used to describe the degrees of responsibility that the requirements in SQCSs impose on firms. Both *unconditional requirements* and *presumptively mandatory requirements* must be followed in all cases in which the circumstances exist to which the requirement applies; however, in rare circumstances, the firm may depart from a presumptively mandatory requirement provided the firm documents its justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.
- The Statement recognizes the importance of a quality-oriented internal culture, and requires firms to assign its management responsibilities so that commercial considerations do not override the objectives of the system of quality control, and to design its policies and procedures addressing personnel performance evaluation, compensation and promotion to demonstrate the firm's overarching commitment to quality.
- More detailed guidance is provided regarding independence, client acceptance and continuance, engagement supervision and review, engagement documentation, and consultation policies and procedures.
- Policies and procedures are required for resolving differences of opinions and for dealing appropriately with complaints and allegations of non-compliance with professional standards or with the firm's system of quality control.

The proposed Statement is available for comment until September 30, 2006 at http://www.aicpa.org/download/members/div/auditstd/ED_SQCS.pdf.

Financial Institutions

Recent Developments Regarding AT 501

When reporting on a financial institution's internal control over financial reporting pursuant to the requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the auditor's attestation engagement is required to be performed in accordance with American Institute of Certified Public Accountants (AICPA) Statement on Standards for Attestation Engagements No. 10, Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting" (AT 501). Earlier this year, the AICPA's Auditing Standards Board (ASB) issued an Exposure Draft of a new AT 501 that would have substantially conformed AT 501 to Public Company Accounting Oversight Board (PCAOB) Auditing Standard (AS) No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. The proposed effective date of the new AT 501 was for calendar 2006 FDICIA engagements; however, there have been recent developments relative to the proposed revisions to AT 501.

On May 17, 2006, the PCAOB announced its intentions to amend certain aspects of AS2 to improve its implementation. Because the forthcoming changes to AS2 would be relevant to the revision of AT 501, the ASB, with the agreement of various banking regulators, has decided that it would be prudent to defer action on the final issuance of the new AT 501 pending the outcome of the PCAOB's amendments to AS 2. As a result of the ASB's deferral of acting on the final issuance of the proposed revisions to AT 501, and with the agreement of various banking regulators, the proposed AT 501 will not be effective in 2006. It is expected that the new AT 501 (as revised to reflect PCAOB amendments to AS 2) will be issued and will be effective in 2007.

It should be noted, however, that the ASB has certain conforming changes to the existing AT 501 which require that when performing and reporting on an AT 501 engagement, the auditor should use the definitions of *control deficiency*, *significant deficiency*, and *material weakness* as defined in AICPA Statement on Auditing Standards No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (SAS 112). The following changes have been made to AT 501 to bring that standard into conformity with corresponding aspects of SAS 112:

- Deleting the term *reportable condition* and its definition;
- Replacing the definition of the term *material weakness*;
- Defining the terms *control deficiency* and *significant deficiency*;
- Replacing the guidance on evaluating control deficiencies with the relevant guidance from SAS 112;
- Identifying areas in which a control deficiency ordinarily is at least a significant deficiency in internal control;
- Identifying indicators of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control;
- Requiring written communication of significant deficiencies and material weaknesses to management and those charged with governance; and
- Revising the illustrative reports contained in AT 501 to be consistent with the changes enumerated in the preceding bullets.

These conforming changes are effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006. The conformed version of AT 501 is available in full at <http://www.aicpa.org/download/members/div/auditstd/AT-00501.PDF>.

Public Sector

Audit Risk Alert Issued for Not-For-Profit Organizations

The American Institute of Certified Public Accountants has issued an Audit Risk Alert, *Not-For-Profit Organizations Industry Developments - 2006*. This Alert may provide useful information to clients and is a "must read" for auditors to gain an understanding of how recent economic, industry, technical, regulatory, and professional developments affect not-for-profit organizations.

SEC

SEC Proposes SOX 404 Extension for Smaller Companies

Currently, a company that is not required to file annual and quarterly reports on an accelerated basis (i.e., a non-accelerated filer) must first comply with the internal control requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404) for its first fiscal year ending on or after July 15, 2007. Recently, the SEC proposed to further extend that compliance date for smaller companies. The SEC's proposal would affect the initial compliance date for management's report on their assessment of the effectiveness of internal control over financial reporting and the auditor's attestation report on internal control over financial reporting as follows:

- A non-accelerated filer would not be required to provide management's report on internal control over financial reporting until it files an annual report for a fiscal year ending on or after December 15, 2007; and
- The auditor's attestation report on internal control over financial reporting would not be required until a non-accelerated filer files an annual report for a fiscal year ending on or after December 15, 2008.

The SEC also proposed a one-year grace period for newly public companies before they become subject to compliance with the SOX 404 requirements. Under the proposal, a company would not be required to provide either management's report on internal control over financial reporting or an auditor attestation report on internal control over financial reporting until it has previously filed one annual report with the SEC. This relief would apply to any company that has become public through an initial public offering or a registered exchange offer, or that otherwise becomes subject to the Exchange Act reporting requirements. It also would include a foreign private issuer that is listing on a U.S. exchange for the first time.

The SEC seeks public comment on these proposals, which can be found in full at <http://www.sec.gov/rules/proposed/2006/33-8731.pdf>. We want to emphasize that these are proposals and therefore have not been issued as final rules as of yet. You should monitor the SEC's Web site or McGladrey & Pullen's Web site for updates and current events.

Alert: Matters Related to Option Grants

Recent reports about the back dating of stock option grants indicate that some companies' actual practices in granting options may not be consistent with the manner in which these transactions are recorded and disclosed. As a result of these practices, some registrants have announced restatements of previously issued financial statements. In addition, some of these practices could result in legal and other contingencies that may require recognition of additional expense or disclosure in financial statements.

As a result of the above, the Public Company Accounting Oversight Board has issued Staff Audit Practice Alert No. 1, *Matters Related to Timing and Accounting for Option Grants*. The purpose of the Practice Alert is to advise auditors about the implications that the back dating of options may have for audits of financial statements or of internal control over financial reporting. The Practice Alert discusses the effects of options-related matters on planned or ongoing audits, auditor involvement in registration statements, and the effects of option-related matters on previously issued opinions.

Auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in its internal control over financial reporting. For audits currently underway or to be performed in the future, the auditor should acquire sufficient information to assess the nature and potential magnitude of these risks. An auditor must use professional judgment in making these assessments and in determining whether to apply additional procedures in response. The Practice Alert discusses considerations in making these judgments, including applicable financial accounting standards, evaluation of materiality, and the possibility of illegal acts.

The Practice Alert is available in full at http://www.pcaobus.org/News_and_Events/News/2006/07-28_Release.pdf.

Changes to Disclosure Requirements Concerning Executive Compensation

The SEC has adopted changes to the rules requiring disclosure of executive and director compensation, related-person transactions, director independence and other corporate governance matters, and security ownership of officers and directors. These changes affect disclosure in proxy statements, annual reports and registration statements, as well as the current reporting of compensation arrangements. Generally, compliance with these provisions is effective for fiscal years ending on or after December 15, 2006.

Executive and director compensation

The amendments require a new Compensation Discussion and Analysis, which should address the objectives and implementation of executive compensation programs. A new furnished Compensation Committee Report will require a statement of whether the compensation committee has reviewed and discussed the Compensation Discussion and Analysis with management and, based on this review and discussion, recommended that it be included in the company's Form 10-K and proxy statement. Following the Compensation Discussion and Analysis, executive compensation disclosure will be organized into three broad categories:

- *Compensation over the last three years for each named executive officer*

The Summary Compensation Table will include a column reporting total compensation and columns for salary, bonus, stock awards, stock option awards, compensation under non-equity incentive plans, the annual change in the actuarial present value of accumulated pension benefits and above-market or preferential earnings on nonqualified deferred compensation, and the aggregate amount of all other compensation not reported in the other columns of the table (including perquisites, unless the aggregate amount of perquisites is less than \$10,000).

- *Holdings of outstanding equity-related interests received as compensation that are the source of future gains*

The Outstanding Equity Awards at Fiscal-Year End Table must show outstanding awards representing potential amounts that may be received in the future, including the amount of securities underlying options and the exercise prices and the expiration dates for each outstanding option. The Option Exercises and Stock Vested Table must show amounts realized on equity compensation during the last fiscal year.

- *Retirement plans, deferred compensation and other post-employment payments and benefits*

The Pension Benefits Table will require disclosure of the actuarial present value of each named executive officer's accumulated benefit under each pension plan. The Nonqualified Deferred Compensation Table will require disclosure with respect to nonqualified deferred compensation plans of executive contributions, company contributions, withdrawals, earnings for the year and the year-end balance. Disclosures also must include a narrative description of any arrangement that provides for payments or benefits at, following, or in connection with any termination of a named executive officer, a change in responsibilities, or a change in control of the company, including quantification of these potential payments and benefits.

Disclosure regarding option grants will require clear tabular presentations of option grants including the grant date, fair value, closing market price on the grant date if it is greater than the exercise price of the award; and the date the compensation committee or full board of directors took action to grant the award if that date is different than the grant date. Further, if the exercise price of an option grant is not the grant date closing market price per share, the rules will require a description of the methodology for determining

the exercise price. Companies must discuss the reasons a company selects particular grant dates for awards or the methods a company uses to select the terms of awards, such as the exercise prices of stock options.

The rules will modify the disclosure requirements in Form 8-K to capture some employment arrangements and material amendments thereto only for named executive officers. The rules will also consolidate all Form 8-K disclosure regarding employment arrangements under a single item. New disclosures required on Forms 8-K are effective for triggering events that occur 60 days or more after publication of the new rules in the Federal Register.

Director compensation for the last fiscal year will be required in a Director Compensation Table (along with related narrative), which will be similar in format to the Summary Compensation Table.

Related-person transactions

Changes to the related-person disclosure requirement include:

- Increasing the threshold for transactions required to be disclosed from \$60,000 to \$120,000;
- Requiring disclosure of a company's policies and procedures for the review, approval or ratification of related-person transactions;
- Eliminating the distinction between indebtedness and other types of related-person transactions, and eliminating requirements for disclosure of specific types of director relationships; and
- Specifying exceptions for some categories of transactions that do not fall within the principle for disclosure under the related-person transaction disclosure requirement.

Director independence and other corporate governance matters

A new Item 407 of Regulations S-K and S-B will consolidate existing disclosure requirements regarding director independence and related corporate governance matters, in most cases without substantive change, and will also update disclosure requirements regarding director independence to reflect current requirements and current listing standards.

Security ownership of officers and directors

The amendments will require disclosure of the number of shares pledged by management, and the inclusion of directors' qualifying shares in the total amount of securities owned.

The full text of the detailed release concerning these items will be posted to the SEC Web site as soon as possible.

Relief from Section 404(b) Compliance Date for Certain Foreign Private Issuers

Currently, a foreign private issuer that is an accelerated filer and that files annual reports on Form 20-F or Form 40-F must begin to comply with the with the internal control requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404) and related requirements in the annual report for its first fiscal year ending on or after July 15, 2006. The SEC has extended the compliance date for foreign private issuers that are accelerated filers, but not large accelerated filers, so that they will not need to comply with the SOX 404 Section 404(b) requirement to provide the registered public accounting firm's attestation report until they file a Form 20-F or 40-F annual report for a fiscal year ending on or after July 15, 2007. However, this group of issuers will continue to be required to comply only with the Section 404(a) requirement to include management's report on their assessment of the effectiveness of internal control

over financial reporting in the Form 20-F or 40-F annual report filed for their first fiscal year ending on or after July 15, 2006.

The SEC did not change the date by which a foreign private issuer that is a large accelerated filer must comply with both the Section 404(a) and (b) requirements. These filers are required to include both a report by management and an attestation report by the issuer's registered accounting firm on internal control over financial reporting in their Form 20-F or 40-F filed for a fiscal year ending on or after July 15, 2006.

The Final Rule regarding the extension is available in full at <http://www.sec.gov/rules/final/2006/33-8730.pdf>.

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