

Insights

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Accounting

Proposed Classification Guidance for Options

Certain provisions in some share-based payment plans require or permit, at the holder's election, cash settlement of outstanding options upon the occurrence of certain contingent events, for example, a change in control of the entity or death of the holder. Under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, an entity would assess the probability of a cash settlement upon the occurrence of a contingent event. If the contingent cash settlement event is not considered probable of occurring and is outside the control of the employee, then equity classification of the option would be appropriate. FASB Statement No. 123 (revised 2004), *Share-Based Payment*, requires options or similar instruments to be classified as liabilities if the entity can be required under any circumstances to settle the option or similar instrument by transferring cash or other assets. Since an entity may be required in at least one circumstance (that is, a change in control) to settle its options or similar instruments issued as employee compensation in cash, the option or similar instrument would be classified as a liability pursuant to Statement No. 123(R).

The Financial Accounting Standards Board (FASB) has proposed to amend Statement No. 123(R) to incorporate the concept that a cash settlement feature that can be exercised only upon the occurrence of a contingent event that is outside the employee's control would not be classified as a liability until it becomes probable that the event will occur. Proposed FASB Staff Position (FSP) No. FAS 123(R)-d, *Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event*, stipulates that entities must assess the probability of the contingent cash settlement event occurring in determining the classification of the option or similar instrument. The FSP also proposes that an option or similar instrument that is classified as equity, but subsequently becomes a liability because the contingent cash settlement event is probable of occurring, would be accounted for similar to a modification from an equity to liability award. That is, on the date the contingent event becomes probable of occurring (and therefore the award must be recognized as a liability) the entity recognizes a share-based liability equal to the portion of the award attributed to past service (which reflects any provision for acceleration of vesting) multiplied by the award's fair value on that date. If the liability is not greater than the amount previously recognized in equity, the offsetting debit is a charge to equity. On the other hand, if the liability is more than the amount previously recognized in equity, the excess is recognized as compensation cost.

The guidance in this FSP is proposed to be effective upon initial adoption of Statement No. 123(R). An entity that adopted Statement No. 123(R) prior to the issuance of the FSP must apply the guidance in the FSP in the first reporting period beginning after the date the FSP is posted to the FASB website. If in applying Statement 123(R) an entity treated options or similar instruments that allow for cash settlement upon the occurrence of a contingent event in a manner inconsistent with the guidance in this FSP, that entity would be required to retrospectively apply the guidance in the FSP to prior periods.

The proposed FSP is available at http://www.fasb.org/fasb_staff_positions/prop_fsp_fas123r-d.pdf.

Proposed Fair Value Option

The Financial Accounting Standards Board (FASB) has issued a proposed Statement of Financial Accounting Standards, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115*. This proposed Statement would create an alternative fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. Per the Exposure Draft, however, the fair value option may not be elected for any of the following:

- An investment that would otherwise be consolidated;
- Employers' and plans' financial obligations for pension benefits, other postretirement benefits, post-employment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements;
- Financial liabilities recognized under lease contracts (however, this exclusion does not include a contingent obligation arising out of a cancelled lease or a guarantee of a third-party lease obligation);
- Written loan commitments that are not accounted for as derivative instruments; and
- Financial liabilities for demand deposit accounts.

The Exposure Draft would require separate display on the face of the balance sheet of those items valued at fair value from those measured under different attributes. Thus, an entity may either (a) display separate line items for the fair value and non-fair-value carrying amounts, or (b) present the aggregate of those fair value and non-fair-value amounts and parenthetically disclose the amount of fair value included in the aggregate amount. The proposed Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to require that securities reported at fair value in accordance with Statement No. 115 satisfy this financial statement presentation requirement. Furthermore, the proposal would require companies to provide additional information that would help investors and other users of financial statements to more easily understand the effect on earnings of changes in fair value. Notably, with respect to financial liabilities for which the fair value option has been elected, if significant changes in the fair values of those liabilities occur in any period presented (such as might be caused by a deterioration in the entity's own creditworthiness), an entity must disclose qualitative information about the reasons for those changes.

Adoption of this proposed Statement would be effective as of the beginning of each reporting entity's first fiscal year that begins after December 15, 2006. The adjustment to reflect the difference between the fair value and the carrying amount of the existing financial assets and financial liabilities for which an entity irrevocably elected the fair value option as of the date of initial adoption would be accounted for as a cumulative-effect adjustment to retained earnings.

This proposed Statement was issued in connection with the first phase of the FASB's fair value option project, and does not apply to non-financial assets and non-financial liabilities. A second phase of the project will consider permitting the fair value option for certain non-financial assets and liabilities and some of the financial assets and liabilities excluded from the scope of this proposed Statement.

This Exposure Draft is available for comment until April 10, 2006 at http://www.fasb.org/draft/ed_fair_value_option.pdf.

Auditing

Proposed SSAE for Reporting on Internal Control

The Auditing Standards Board of the American Institute of Certified Public Accountants has issued an exposure draft of a Statement on Standards for Attestation Engagements (SSAE), *Reporting on an Entity's Internal Control Over Financial Reporting*. This exposure draft is intended to supersede the guidance in Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Standards: Revision and Recodification*. The proposed standard would be applicable for reporting on the internal control of an entity that is a nonissuer.

This exposure draft revises a prior exposure draft of the same name to reflect certain guidance from Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, that is appropriate for examinations of the internal control of nonissuers, and useful to regulated entities, such as financial institutions, insurance companies, and governmental entities. For example, the proposed SSAE incorporates the definitions of the terms *control deficiency* and *material weakness* used in PCAOB Auditing Standard No. 2, and replaces the term *reportable condition* with the term *significant deficiency* and its related definition in PCAOB Auditing Standard No. 2. Also, the scope of work required in the exposure draft is similar to that which would result from the application of PCAOB Auditing Standard No. 2 when engaged to examine the design and operating effectiveness of internal control over financial reporting.

The proposed SSAE is being issued to enhance the auditor's ability to identify and evaluate control deficiencies and to report on internal control. Among other guidance, the exposure draft provides assistance in evaluating:

- Management's basis or substantiation for making an assertion about an entity's internal control over financial reporting;
- Deviations in the design or operation of controls and whether they constitute control deficiencies; and
- The severity of control deficiencies, based on their nature, likelihood, and magnitude, including whether misstatements or potential misstatements are "more than inconsequential."

Accompanying the exposure draft is "A Framework for Evaluating Control Exceptions and Deficiencies," which is designed to help auditors in evaluating the significance of exceptions and control deficiencies. This version of the Framework was adapted from the original 2004 version, which was developed to assist auditors in evaluating control exceptions and deficiencies in audits of the internal control of issuers performed under PCAOB Auditing Standard No. 2, to make it applicable to examinations of the internal control of entities that are nonissuers.

The proposed SSAE also contains reporting guidance for examinations of the internal control of insured depository institutions subject to the internal control reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act.

The proposed standard would be effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006. The exposure draft is available for comments until May 19, 2006 at http://www.aicpa.org/download/exposure/ED_AT_501.pdf.

SEC

SEC Proposes Amendments to Executive Comp and Other Disclosure Requirements

The Securities and Exchange Commission has proposed rules that would expand the disclosure requirements for executive and director compensation, related-party transactions, and director independence. These proposed disclosure requirements would affect proxy statements, annual reports, Form 8-K reporting and registration statements. The proposals would require most of these disclosures to be provided in plain English. The proposed rules include the following:

- *Executive and Director Compensation*

A new "Compensation Discussion and Analysis" would be required to address the objectives and implementation of executive compensation programs. Following this new section, disclosure of the compensation for the principal executive officer, principal financial officer, and the three other highest paid executive officers would include their compensation over the last three years, holdings of outstanding equity-related interests received as compensation that are the source of future gains, and retirement plans and other post-employment payments and benefits. A dollar value would be required to be disclosed for all stock-based awards, including stock and stock options, measured at grant date fair value, computed pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*. The threshold for disclosing perquisites (as defined in the proposal) would be reduced to \$10,000.

A Director Compensation Table and related narrative would be required to disclose director compensation for the last year.

- *Related- Party Transactions*

The proposals include a disclosure requirement regarding policies and procedures for approving related-party transactions, a slight expansion of the categories of related persons, and an increase in the threshold for disclosure of related –party transactions to \$120,000.

- *Director Independence*

A proposed new item would require disclosure of whether each director and director nominee is independent, a description of any relationships not otherwise disclosed that were considered when determining whether each director and director nominee is independent, and disclosure of any audit, nominating and compensation committee members who are not independent.

The full text of these proposed rules will be posted to the SEC's Web site when they are available.

Forums on Auditing in the Small Business Environment

The Public Company Accounting Oversight Board (PCAOB) has announced the continuation of its Forums on Auditing in the Small Business Environment. These forums, which began in 2004, are designed to help share important information concerning the PCAOB with registered public accounting firms and public companies operating in the small business community. Directors and financial executive officers of small public companies are invited to attend one of the remaining 2006 programs that will address PCAOB issues affecting smaller public companies:

- Fort Lauderdale, Florida - February 28
- San Antonio, Texas - May 3
- New York, New York - November 8

While there is no fee charged to participants for these events, pre-registration is required. Registration information is available at http://www.pcaobus.org/About_the_PCAOB/Small_Business_Forum/index.aspx.

International

Interpretation to Clarify Scope of IFRS 2

The International Financial Reporting Interpretations Committee (IFRIC) has issued an Interpretation, IFRIC 8, *Scope of IFRS 2*. The Interpretation clarifies that International Financial Reporting Standard (IFRS) 2, *Share-based Payment*, applies to arrangements where an entity makes share-based payments for apparently nil or inadequate consideration. IFRIC 8 explains that, if the identifiable consideration given appears to be less than the fair value of the equity instruments granted or liability incurred, this situation typically indicates that other consideration has been or will be received. IFRS 2 therefore applies.

Draft Interpretation for Interim Accounting for Impairment

International Accounting Standard (IAS) 36, *Impairment of Assets*, and IAS 39, *Financial Instruments: Recognition and Measurement*, require the assessment of goodwill for impairment at every reporting date and the assessment of investments in equity instruments and financial assets carried at cost for impairment at every balance sheet date, respectively. At a subsequent interim reporting or balance sheet date, conditions may change so that the impairment loss would have been reduced or would have been avoided had the impairment assessment been made only at that date. However, IAS 34, *Interim Financial Reporting*, requires an entity to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, which generally require that impairment losses not be reversed in subsequent periods.

The International Financial Reporting Interpretations Committee (IFRIC) has drafted Interpretation D18, *Interim Financial Reporting and Impairment*, to clarify the interaction between the interim financial reporting standard and the standards dictating the accounting for impairment. The proposed Interpretation concludes that an entity cannot reverse an impairment loss recognized in a previous interim period in respect of goodwill, an investment in an equity instrument or a financial asset carried at cost. The draft interpretation is available for comment until March 31, 2006 at http://www.iasb.org/uploaded_files/documents/8_39_IFRICDraftInterpretationD18.pdf.

IASB Proposes to Align Segment Reporting Requirements with U.S. GAAP

The International Accounting Standards Board (IASB) has published an Exposure Draft of an International Financial Reporting Standard (IFRS) - ED 8, *Operating Segments*. ED 8 would align international accounting principles for segment reporting with U.S. generally accepted accounting principles (GAAP) found in FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. The proposed IFRS would replace International Accounting Standard (IAS) 14, *Segment Reporting*.

ED 8 would require an entity to adopt the 'management approach' set out in FASB Statement No. 131 for reporting on the financial performance of its operating segments. Generally, the information to be reported would be what management uses internally for evaluating segment performance and deciding how to allocate resources to operating segments. The Exposure Draft would require reconciliations of total reportable segment revenues, total profit or loss, total assets, and other amounts disclosed for reportable segments to corresponding amounts in the entity's financial statements.

This Exposure Draft would extend the scope of segment reporting to include entities that hold assets in a fiduciary capacity for a broad group of outsiders as well as entities whose equity or debt securities are publicly traded and entities that are in the process of issuing equity or debt securities in public securities markets. The proposed IFRS would apply to the annual financial statements for periods beginning on or after January 1, 2007, with earlier application encouraged.

The Exposure Draft will be available for comments until May 19, 2006 on the IASB Web site at www.iasb.org.

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