

Insights

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Accounting

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 amended 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. FASB Staff Position (FSP) No. FAS 123(R)-4, *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 states 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, must 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 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 (February 3, 2006). 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 Board acknowledges the approach taken in the FSP is a practical accommodation. The FSP is available at http://www.fasb.org/fasb_staff_positions/fsp_fas123r-4.pdf.

Public Sector

Proposed Accounting for Pollution Remediation

The Governmental Accounting Standards Board has issued an Exposure Draft to provide guidance for the accounting and reporting of obligations and costs related to pollution remediation. This proposed Statement addresses accounting and financial reporting standards for obligations to address the current or potential detrimental effects of *existing* pollution by participating in pollution remediation activities such as site assessments and cleanups. The scope of the statement would not include pollution *prevention* or *control* obligations with respect to current operations, or future pollution remediation activities that are required upon retirement of an asset, such as landfill closure and post-closure care. According to the proposal, a government would be required to report a liability related to pollution remediation if any of the following occur:

- Pollution poses an imminent danger to the public or environment and a government has little or no discretion to avoid fixing the problem;
- A government has violated a pollution-prevention-related permit or license;
- A regulator has identified (or evidence indicates a regulator will do so) a government as responsible (or potentially responsible) for cleaning up pollution, or for paying all or some of the cost of the clean up;
- A government is named in a lawsuit (or evidence indicates that it will be) to compel it to address the pollution; or
- A government begins to clean up pollution or conducts related remediation activities (or the government legally obligates itself to do so).

Most pollution remediation outlays do not qualify for capitalization and would be accrued as a liability (subject to modified accrual provisions in governmental funds) and expenditure or expense, as appropriate, when a range of expected outlays is reasonably estimable. In addition to the liabilities, expenses, and expenditures which would be estimated using an "expected cash flows" measurement technique and reported in the financial statements, the proposed standard would require governments to disclose information about their pollution clean up efforts in the notes to the financial statements.

The requirements of this proposed Statement would be effective for financial statements for periods beginning after June 15, 2007, with measurement of pollution remediation liabilities required at the beginning of that period so that beginning net assets can be restated. However, governments that have sufficient objective and verifiable information to apply the expected cash flow technique to measurements in prior periods would be required to apply the provision retroactively for all such prior periods presented.

The Exposure Draft is available for comment until May 1, 2006 at http://www.gasb.org/exp/ed_pollution_remediation_obligations.pdf.

SEC

SEC Approves Auditing Standard No. 4

The SEC has approved Public Company Accounting Oversight Board (PCAOB) Auditing Standard (AS) No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. This Standard establishes requirements that apply when an auditor is engaged to report on whether a material weakness in internal control over financial reporting that was described previously in an auditor's report issued pursuant to PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, continues to exist. AS 4 institutes a stand-alone engagement that is entirely voluntary, performed only at the company's request.

Similar to any other attestation service, an auditor's report under this Standard is based on an evaluation of management's assertion that the material weakness no longer exists. Among other requirements, management must present a written report that will accompany the auditor's report and that contains specified elements. The auditor's objective in this type of an engagement is to obtain reasonable assurance about whether the previously reported material weakness exists as of a date specified by management and to express an opinion thereon.

Unlike an auditor's report on internal control over financial reporting, in which the assessment is required to be as of the date of the annual financial statements, an auditor's report on whether a material weakness continues to exist may be as of any date set by management. The "as of" date of management's assertion represents the day the company believes the material weakness no longer exists and that the company has adequately assessed the effectiveness of the specified controls that address the material weakness. The auditor's opinion relates to the existence of a specifically identified material weakness as of a specified date and does not relate to the effectiveness of the company's internal control over financial reporting overall.

To communicate clearly the narrow focus of this engagement, AS 4 requires the auditor's report to describe the material weakness, identify all of the specified controls that management asserts address the material weakness, and identify the stated control objective achieved by these controls. The report also is required to include language to emphasize that the auditor has not performed procedures sufficient to reach conclusions about the effectiveness of any other controls or provided an opinion regarding the effectiveness of internal control over financial reporting overall. Because of the narrow focus of this engagement, qualified opinions are not permitted - the auditor's opinion as to whether a previously reported material weakness continues to exist may be expressed as either "the material weakness exists" or "the material weakness no longer exists."

Small Business Capital Formation Forum Releases Report

The Small Business Capital Formation Forum has recently published its 2005 Final Report summarizing the recommendations resulting from its annual forum and providing background, planning and other information. The Forum was hosted by the SEC in conjunction with a meeting of the SEC Advisory Committee on Smaller Public Companies on September 19 and 20, 2005. Roundtable sessions were held at the concurrent meetings with members of the Advisory Committee participating in the discussions.

In the Final Report, the five Forum breakout group leaders compiled the 20 securities regulation recommendations of the Forum. The two priority recommendations were that an appropriate definition of smaller public companies reflect several categories of issuers and that new rules be adopted to legitimize the role of finders in the small business capital formation process. The consensus among the Forum

participants was that significant distinctions should be drawn between different companies based on size and other identifiable economic variables. The Forum generally concurred with the Advisory Committee's recommendation for a three-tiered classification system for public companies consisting of micro-cap companies, smaller public companies, and well-known seasoned issuers. Also, the Forum supported the use of market capitalization as the initial criterion for defining small companies that may be eligible for regulatory relief, but recommended further measures.

Some of the other recommendations of the 2005 Forum included the desire for:

- Modification of the criteria for deregistration from the SEC reporting system;
- Elimination of independent auditor certifications pursuant to Section 404 of the Sarbanes-Oxley Act for micro-cap companies;
- Guidance for companies when they transition between market segments;
- Delayed implementation of new accounting pronouncements for micro-cap and smaller public companies;
- Guidance on materiality in a financial reporting context;
- Guidance on permissible advice of independent certified public accountants; and
- Modification of independence standards related to consents of predecessor auditors.

It is important to note that these recommendations are solely the responsibility of the Forum participants and do not represent any type of final rule, regulation or policy. The 2005 Forum Final Report is available in full at <http://www.sec.gov/info/smallbus/gbfor24.pdf>.

EDGAR Filer Manual Updated

The SEC has adopted revisions to the Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) Filer Manual as of February 6, 2006. The revisions were made primarily to support the amended rules and forms adopted by the SEC requiring that certain open-end management investment companies and insurance company separate accounts identify in their EDGAR submissions information relating to their investment company type, series and classes (or contracts, in the case of separate accounts), and ticker symbols. Also, revisions were made to complete the removal of the submission types rescinded on December 1, 2005 as a result of the adoption of securities offering reform initiatives.

International

Proposed Amendments to IFRS 2

The International Accounting Standards Board has released a proposal to amend International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. The Exposure Draft proposes guidance on two features of share-based payment arrangements:

- Currently, IFRS 2 states that vesting conditions include service conditions and performance conditions, but is silent on whether other features of a share-based payment are vesting conditions. (Vesting conditions are the conditions that an individual or an organization must satisfy to receive an entity's shares under a share-based payment arrangement.) The proposal clarifies that vesting conditions should be restricted to service conditions and performance conditions only. Under IFRS 2, features of a share-based payment that are not vesting conditions must be included

in the grant date fair value of the share-based payment (the fair value also includes market-related vesting conditions).

- Under IFRS 2, a failure to meet a condition, other than a vesting condition, is a cancellation. IFRS 2 specifies the accounting treatment of cancellations by the entity, but does not give guidance on the treatment of cancellations by parties other than the entity. This amendment proposes that all cancellations, whether by the entity or by other parties, should receive the same accounting treatment.

The proposed amendments would apply for annual periods beginning on or after January 1, 2007, with earlier application encouraged. The Exposure Draft is available for comment until June 2, 2006 at <http://www.iasb.org/>.

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