

Insights

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Accounting

Training Opportunity: Implementing SFAS 123(R)

The date for most companies to implement Financial Accounting Standards Board (FASB) Statement No. 123, (revised 2004), *Share-Based Payment*, is upon us. Some companies have been studying the effects of this Standard for many months. Other companies have not spent much time on it and may think the implementation will not be very difficult. This Standard has many more complexities than most of us first realized, especially in the areas of liability award accounting, deferred income taxes and earnings per share. We believe it is very important for all public companies to get some training in the basics of this Standard, as well as the more difficult areas. Jay Hanson, National Director of Accounting for McGladrey & Pullen, has assisted The SEC Institute in writing a full-day course on SFAS 123R, and will be presenting a number of the sessions. This course is up-to-date with the most recent guidance from the FASB as well as the SEC. The class is being offered:

- Thursday, March 23 in New York (already full)
- Wednesday, March 29 in New York
- Friday, March 31 in Las Vegas and
- Monday, April 3 in Chicago (already full) and San Francisco.

There is already a wait list for the sessions that are full, and the remaining sessions are expected to fill quickly. You may register online at http://www.secinstitute.com/sched/menu_sfas123R.html. If the session you request is full, you will be added to a wait list and can obtain information directly about additional alternatives.

A Roadmap for International Convergence

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have published a Memorandum of Understanding that reaffirms the boards' shared objective of developing high-quality, global accounting standards for use in the world's capital markets. The Memorandum reveals a "roadmap" for removal of the need for the reconciliation requirement for non-U.S. companies that use International Financial Reporting Standards (IFRS) and are registered in the United States. The roadmap also addresses auditing and enforcement, topics that are not accounting standard-setting issues, and will require the cooperation of regulators and auditors.

Both the FASB and the IASB note that removing the current reconciliation requirements will require continued progress on the boards' convergence program. The boards first will reach a conclusion about whether major differences in focused areas should be eliminated through one or more short-term standard-

setting projects. The boards will jointly discuss major differences in U.S. and international accounting standards for impairment and income taxes. Topics to be examined for short-term convergence by the individual boards include:

Topics to be Examined by the FASB

Fair value option
Investment properties
Research and development
Subsequent events

Topics to be Examined by the IASB

Borrowing costs
Government grants
Joint ventures
Segment reporting

The FASB and the IASB also will seek to have made significant progress by 2008 on joint projects in other areas identified by both boards where accounting practices under U.S. generally accepted accounting principles and IFRS are regarded as candidates for improvement. Convergence topics already on the agendas of both boards include business combinations, consolidations, fair value measurement guidance, liabilities and equity distinctions, performance reporting, and revenue recognition.

The Memorandum of Understanding is available in full at http://www.fasb.org/mou_02-27-06.pdf.

FASB and IASB Seek Input on Financial Instruments

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have published a questionnaire to obtain input from users of financial statements about information on financial instruments that is useful to those making investment or credit decisions or advising others on investment or credit decisions. The term *financial instruments* includes not only debt securities, equity securities, and derivatives, but also loans and accounts payable or receivable, and almost any other amount payable or receivable.

Current accounting standards of both the FASB and IASB require that some financial instruments be reported at fair value (trading securities and derivatives, for example). Current IASB standards give companies the option of reporting other financial instruments at fair value, and the FASB recently issued an Exposure Draft of a Statement that would provide a similar option. These past standard-setting efforts focused on recognition and measurement of financial instruments, rather than on issues of display in financial statements and user information needs. Thus, the questionnaire addresses whether current standards provide the information that investors and creditors need to analyze companies that report some or all financial instruments at fair value.

There are many types of information that users may find helpful in their analyses. However, the benefit to users of that information must be balanced against the cost of preparing that information. Consequently, the Boards are interested in learning whether requiring more detailed information would improve financial analysis sufficiently to justify its cost and, if so, what types of information would be most useful.

The questionnaire is available at http://www.fasb.org/questionnaire_fin_instr.pdf. Responses to the questionnaire are due by April 14, 2006.

Seidman Reappointed to FASB

Leslie F. Seidman has been reappointed to a five-year term as a member of the Financial Accounting Standards Board (FASB), beginning July 1, 2006. Prior to joining the Board in 2003, Ms. Seidman managed a financial reporting consulting firm that served global corporations. Ms. Seidman also served the FASB during the late 1990's as an Industry Fellow, Project Manager and as Assistant Director of

Research. From 1987 to 1996 she held executive positions at J.P Morgan & Company, including serving as that firm's Vice President, Accounting Policy. She started her accounting career at Arthur Young & Company (now part of Ernst & Young).

Auditing

Risk Assessment Standards Issued

The AICPA Auditing Standards Board has issued a series of eight new Statements on Auditing Standards relating to the auditor's risk assessment process, which will bring significant changes to existing audit practice. As a result of these Standards, the audit process will start with a more robust understanding of the client and its environment, its business risk assessment process and its internal control. The auditor then will need to perform a more rigorous assessment of the risks of where and how the financial statements could be materially misstated. Most importantly, the auditor must be able to design further audit procedures responsive to the identified risks and document the linkage between the assessed risks and the design of further audit procedures.

Under the new standards, the auditor will be required to:

- Gain (and document) a more in-depth understanding of the client's business risk assessment process at the front-end of the audit, including an understanding of how the client responds to identified risks. The auditor will then need to decide which of those risks directly impact the financial statements.
- Determine the accounts, transactions and assertions that are impacted by these identified risks. The auditor then focuses on understanding the internal controls designed to mitigate the identified risk(s) at the significant account and relevant assertion level. In today's environment, many of the controls designed to mitigate such risks are automated or technology-driven, and thus, enhanced IT skills will be required of all auditors, not just internal control specialists. Although the auditor can document a basis for assessing control risk at the maximum, we can no longer default to that conclusion without a documented basis for that assessment.
- Determine which further audit procedures would be appropriate given the risks identified and the controls as we understand them. The auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to detect material misstatements at the relevant assertion level. The auditor must document the linkage between the assessed risks at the assertion level and the design of further audit procedures.
- Perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate evidence at the relevant assertion level.
- Consider the risk of misstatement not only at the level of the financial statements taken as a whole, and at individual account balance or class of transactions, but also at the disclosure level as well.

The standards are effective for audits of financial statement for periods beginning on or after December 15, 2006.

Manufacturing Industry Audit Alert Issued

The American Institute of Certified Public Accountants (AICPA) recently issued an Audit Risk Alert, *Manufacturing Industry Developments – 2005/06*. Some of the highlights from the Alert include:

- High-level discussion of economic and industry developments in the past year;
- Discussion of considerations related to Hurricane Katrina, including references to various AICPA technical practice aids concerning natural disasters;
- Discussion of certain regulatory developments within and outside of the United States, such as the EU Waste Electrical and Electronic Equipment directive, and their implications; and
- A summary of professional accounting and auditing pronouncements in the past year. (This may duplicate similar material found in other publications, but would be beneficial if a reader had not stayed current with these pronouncements.)

Dohrer Appointed to AICPA Assurance Services Executive Committee

Robert Dohrer, partner in the National Office of Audit and Accounting, was recently appointed to the AICPA Assurance Services Executive Committee (ASEC). He will serve as the ASEC liaison to the AICPA Auditing Standards Board. The Committee's mission is to assure the quality, relevance and usefulness of information, covering both internal and external reporting. It will focus on developing guidance that will enable CPAs in industry and public practice to implement new assurance methodologies and services.

Dohrer is a member of the AICPA Auditing Standards Board and several AICPA task forces. He earned his Bachelor of Science in Accounting from Black Hills State University and his Master of Professional Accountancy from the University of South Dakota.

SEC

Comments Requested on Advisory Committee Recommendations

About a year ago, the SEC established the Advisory Committee on Smaller Public Companies to examine the impact of the Sarbanes-Oxley Act of 2002 (SOX) and other federal securities laws on smaller public companies. The Committee conducted its work with a view of protecting investors, considering whether the costs imposed by the current securities regulatory system for smaller public companies are proportionate to the benefits, identifying methods of minimizing costs and maximizing benefits, and facilitating capital formation by smaller companies. Recently, the Committee released a draft of its final report to the SEC. It is important for smaller public companies and their investors to read and comment on this report.

The primary recommendation in the draft report is to establish a system of scaled securities regulation for "smaller public companies", generally those with market capitalization of less than \$787 million. Smaller public companies would then be stratified into two groups - "microcap" companies (those with market capitalization of less than \$128.2 million) and "smallcap" companies (those with market capitalization between \$128.2 million and \$787.1 million). It is the Committee's belief that this overarching scaling principal could be incorporated into existing and new securities regulations.

Other primary recommendations of the Committee include the following:

- Until a framework for assessing internal control over financial reporting is developed that recognizes the unique characteristics of smaller public companies, microcap companies with less than \$125 million in annual revenue and smallcap companies with less than \$10 million in annual product revenue should be exempt from all of the SOX 404 internal control reporting requirements, subject to achieving certain corporate governance standards and the reporting of any known material weaknesses. Smallcap public companies with less than \$250 million in annual revenue but greater than \$10 million in annual product revenue and microcap companies with between \$125 and \$250 million in annual revenue should be exempt from the external audit requirement of SOX 404, but be required to complete management's assessment of internal controls under SOX 404 and achieve certain additional corporate governance standards.
- A private offering exemption that would not prohibit general solicitation and advertising for transactions with certain purchasers should be adopted.
- Permission should be granted for microcap companies to apply the same effective dates that the Financial Accounting Standards Board provides for private companies in implementing new accounting standards.
- Additional guidance should be considered for all public companies with respect to materiality related to previously issued financial statements.
- A de minimis provision in the application of the SEC's auditor independence rules should be implemented.

Joseph (Leroy) Dennis, Executive Partner of McGladrey & Pullen, LLP and a member of the SEC Advisory Committee, commented on the release of the draft report, "I would like to hear from smaller public companies and their shareholders since most of the comments so far have come from investors in billion dollar companies. The Committee will carefully review all comments received and consider them prior to issuing the final report." The final report is expected to be closely reviewed by the SEC; however, the Committee's recommendations will not change current rules or regulations unless formally adopted by the SEC.

The draft report is available in full at <http://www.sec.gov/rules/other/33-8666.pdf>. Comments on the report may be submitted until April 3, 2006. You may contact the Committee electronically by using the submission form at <http://www.sec.gov/info/smallbus/acspc.shtml> or by sending an e-mail message to rule-comments@sec.gov, referring to File Number 265-23 on the subject line.

If you have questions or need further information about the Committee's draft report, our Firm will be pleased to help. Please call us at 1.866.776.5276. Your active involvement in these issues will be welcomed. Smaller public companies are encouraged to contact their shareholders and ask them to comment on the recommendations.

The comments made in this article do not necessarily reflect the views of the SEC or the SEC Advisory Committee on Smaller Public Companies.

International

Interpretation on the Reassessment of Embedded Derivatives

The International Financial Reporting Interpretations Committee (IFRIC) has issued an Interpretation, IFRIC 9, *Reassessment of Embedded Derivatives*, to clarify whether the accounting treatment of an embedded derivative under International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*, needs to be reassessed subsequent to certain events occurring. IFRIC 9 concludes that reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. Reassessment of the accounting treatment of an embedded derivative due to changes in market prices or other external events is prohibited.

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