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## Accounting

### **AICPA Practice Guide on FIN 48 Released**

The staff of the American Institute of Certified Public Accountants (AICPA) has released a practice guide, *Accounting for Uncertain Tax Positions under FIN 48*. The practice guide presents a summary of FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes. It also discusses some of the related implications for financial statement preparers, auditors and tax advisers. The practice guide is available at <http://tax.aicpa.org/NR/rdonlyres/8D2A444D-D158-4D5A-9F87-D8ED12A8A221/0/FIN48final.pdf>.

FIN 48 is effective for fiscal years beginning after December 15, 2006 and will require additional financial statement disclosures for all companies. Calendar-year-end SEC registrants must adopt FIN 48 January 1, 2007 and report the effects of adoption in its quarterly filings for March 31, 2007.

### **A Roadmap for Addressing the Accounting for Equity-Related Financial Instruments**

The Financial Accounting Standards Board (FASB) currently has a long-term project on its agenda to develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of liabilities and equity, in addition to several short-term projects under consideration. In the absence of a single comprehensive accounting standard for such instruments, the existing accounting literature was developed in a largely piecemeal fashion, by various standard-setting bodies. The accounting for financial instruments that are indexed to, and potentially settled in, a company's own stock is addressed in many places in the accounting standards and related interpretations. Practitioners often find it difficult to navigate these standards, particularly because two or three of these standards must often be considered in contemplation of one another before reaching a final conclusion on the appropriate accounting for a financial instrument.

The American Institute of Certified Public Accountants (AICPA) has issued a draft of a Technical Practice Aid (TPA), "Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments," to assist practitioners in identifying the scope of and the inter-relationships between the various relevant accounting pronouncements. The Practice Aid is a "roadmap" addressing the accounting considerations that should be considered in analyzing freestanding and embedded derivative financial instruments at issuance and on an ongoing basis. This roadmap comprises several parts - each of which is integral to the analysis and therefore should be used together:

- A description of the background and scope of the TPA;
- Two flowcharts (one for analyzing freestanding financial instruments indexed to and potentially settled in a company's own stock and one for analyzing financial instruments with embedded conversion options), each of which contains explanatory footnotes and illustrations;
- A glossary of terms; and
- A complete list of the authoritative literature referenced in the TPA.

The TPA working draft reflects what the authors believe is existing authoritative literature as of Dec. 1, 2006. The TPA has not been approved, disapproved, or otherwise acted on by any senior technical committee of the

AICPA, FASB or SEC and has no official or authoritative status. The TPA is available in full at <http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Working+Draft+of+Convertible+Debt+Convertible+Preferred+Shares+Warrants+and+Other+Equi.htm>.

The TPA was prepared by the Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments Task Force and the staff of the AICPA. The Task Force is chaired by Jay Hanson, the National Director of Accounting for McGladrey & Pullen, LLP.

### **Contributing Factors to Escalating Restatements**

The number of restatements of financial statements has increased dramatically over the years. Recently, an informal project was conducted by the staff of the SEC's Office of the Chief Accountant to review information on some of the restatements disclosed in filings with the SEC from 2003 to 2005 to see how often various factors appear to have contributed to the errors. The results of the project suggested that well over half of the errors that resulted in restatements were caused by ordinary books and records deficiencies or by simple misapplications of the accounting standards. Approximately one-third of the errors related to situations in which there were one or more contributing factors from outside the company.

Some statistics provided from the results of this informal project were as follows:

- The use of judgment in applying an accounting standard was cited as a contributing factor to the error in 15% of the restatements reviewed. These restatements related most often to inventory, reserves and allowances, taxes, and impairments of long-lived assets and intangible assets.
- Attributes of the accounting literature were an underlying factor that contributed to the error in 15% of the restatements reviewed. Errors that had such contributing factors most often involved financing transactions, such as the issuance of convertible securities with beneficial conversion features and the issuance of equity securities to third parties. Some of the troubling attributes were lack of clarity in the standards, difficulty in identifying all of the relevant accounting literature, and complexity of the literature.
- The areas of accounting literature most often identified as a contributing factor to the error were:
  - ♦ Industry practice in apply FASB Statement No. 13, Accounting for Leases
  - ♦ Judgment in applying FASB Statement No. 109, Accounting for Income Taxes
  - ♦ Proliferation of literature related to revenue recognition
  - ♦ Exceptions and bright lines in derivative accounting
  - ♦ Complexities related to convertible securities

Although the subject of the SEC's informal project was SEC filings, the insights gained from the project are most likely applicable to privately owned entities as well.

### **TPAs Released for Investment Companies**

The Accounting Standards Team of the American Institute of Certified Public Accountants (AICPA) has released four Technical Practice Aids (TPAs) relating to investment companies. The TPAs address a variety of issues applicable to investment companies to which the provisions of the AICPA Audit and Accounting Guide, *Audits of Investment Companies*, apply:

- TPA 6910.21, *Recognition of Premium/Discount on Short Positions in Fixed-Income Securities*. This TPA concludes that an investment company is required under generally accepted accounting principles to amortize the premium or discount when it enters into a short position on fixed-income securities, where the short sale price is at a premium or discount to the par value of the bonds.
- TPA 6910.22, *Presentation of Reverse Repurchase Agreements*. This TPA concludes that an investment company should present its obligations under reverse repurchase agreements at the amount payable and not at

fair value.

- TPA 6910.23, *Accounting Treatment of Offering Costs Incurred by Investment Partnerships*. This TPA concludes that an investment partnership that continually offers its interests (as that phrase is defined in TPA 6910.24 following) should defer offering costs incurred prior to the commencement of operations and then amortize them to expense over the period that it continually offers its interests, but not for a period exceeding twelve months, with amortization being computed by the straight-line method. If the offering period ends earlier than expected, the unamortized balance should be charged to expense.
- TPA 6910.24, *Meaning of “Continually Offer Interests.”* The phrase “continually offers its interests” (see TPA 6910.23 preceding) is defined in this TPA as follows: An investment partnership is deemed to continually offer its interests if an eligible, new investor may enter into an agreement to purchase an interest in the partnership on any business day or on a series of specified business days over a continuous period of time. A new investor is one that does not already own any interest in the investment partnership at the time of purchase.

For further information about the above TPAs, please go to [http://www.aicpa.org/download/acctstd/final\\_IC\\_TPAs.pdf](http://www.aicpa.org/download/acctstd/final_IC_TPAs.pdf).

### **Accounting for Certain Liquidated Damages**

“Liquidated damages” represent contractual payments to a buyer of property, plant, and equipment (PP&E) for the nondelivery or noncompletion of construction of PP&E by a stated completion date. The amount is specified in advance by contract (for example, a stated amount per day of delay), rather than a computation of actual losses of the buyer caused by the delay. Liquidated damages are negotiated to represent compensation for a reasonable estimate of the buyer’s costs associated with a delay.

The Accounting Standards Team of the American Institute of Certified Public Accountants has released Technical Practice Aid (TPA) 2210.28, *Accounting for Certain Liquidated Damages*, to provide guidance about how a buyer of PP&E should account for liquidated damages. Per the TPA, a buyer typically records liquidated damages as a reduction of the payments it has made to the vendor for the PP&E - that is, a reduction of the cost of the PP&E. Amounts of liquidated damages in excess of the total cost of PP&E would be recognized by the buyer as income.

TPA 2210.28 is available in full at [http://www.aicpa.org/download/acctstd/Liquidated\\_Damages\\_Final.pdf](http://www.aicpa.org/download/acctstd/Liquidated_Damages_Final.pdf).

### **Accounting for Contributions to Certain Nonprofit Scholarship Funding Organizations**

Some states’ corporate income taxpayers are allowed a credit against their state corporate income tax of 100 percent of eligible contributions made during the year to a nonprofit scholarship funding organization. Unused credits in these states may be carried forward up to three years. The taxpayer may not convey, assign, or transfer the credit to another entity unless all of the assets of the taxpayer are conveyed, assigned, or transferred in the same transaction. A question has arisen as to whether corporate income taxpayers should report contributions that qualify for the tax credit as contributions or as income tax expense in income statements prepared in accordance with generally accepted accounting principles.

The Accounting Standards Team of the American Institute of Certified Public Accountants has released Technical Practice Aid (TPA) 5700.01, *Income Tax Accounting for Contributions to Certain Nonprofit Scholarship Funding Organizations*. This TPA states that corporate income taxpayers should report such contributions as contributions in their income statements in accordance with FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. The tax ramifications of such contributions should be reported in accordance with FASB Statement No. 109, *Accounting for Income Taxes*.

TPA 5700.01 is available in full at [http://www.aicpa.org/download/acctstd/Tax\\_credit\\_TPA.pdf](http://www.aicpa.org/download/acctstd/Tax_credit_TPA.pdf).

### **Accounting for Registration Payment Arrangements**

An entity may issue financial instruments, such as equity shares, stock purchase warrants or debt instruments, which are subject to a registration payment arrangement. Under such an arrangement, the issuer agrees to endeavor

(1) to file a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of those financial instruments and (2) for the registration statement to be declared effective by the SEC within a specified grace period. In some registration payment arrangements, the issuer may be required to endeavor to maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity). If the registration statement is not declared effective within the grace period or its effectiveness is not maintained for the specified period, the issuer must transfer consideration to the counterparty.

Because of the potential significance of the consideration that may become payable under registration payment arrangements, questions have arisen as to the accounting for those arrangements. Questions also have arisen about whether the existence of a registration payment arrangement affects the accounting for the financial instruments subject to the registration payment arrangement, particularly when the financial instrument or instruments are accounted for in accordance with Emerging Issues Task Force Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock." The Financial Accounting Standards Board (FASB) therefore has issued FASB Staff Position (FSP) No. EITF 00-19-2, *Accounting for Registration Payment Arrangements*, which addresses an issuer's accounting for registration payment arrangements as follows:

- The FSP defines a "registration payment arrangement" as one meeting both of the following characteristics:
  - (a) it specifies that the issuer will endeavor (i) to file a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the SEC (or other applicable securities regulator) within a specified grace period, and/or (ii) to maintain the effectiveness of the registration statement for a specified period of time, and (b) it requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained.
- The FSP specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, would be separately recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*.
  - ♦ If the transfer of consideration under a registration payment arrangement is probable and can be reasonably estimated at inception, the contingent liability under the registration payment arrangement should be included in the allocation of proceeds from the related financing transaction using the measurement guidance in Statement No. 5. The remaining proceeds should be allocated to the financial instruments issued in conjunction with the registration payment arrangement based on the provisions of other applicable generally accepted accounting principles (GAAP).
  - ♦ If the transfer of consideration under a registration payment arrangement becomes probable and can be reasonably estimated subsequent to the inception of the arrangement or if the measurement of a previously recognized contingent liability increases or decreases in a subsequent period, the initial recognition of the contingent liability or the change in the measurement of the previously recognized contingent liability should be recognized in earnings.
- The FSP further clarifies that a financial instrument subject to a registration payment arrangement should be separately recognized and measured in accordance with other applicable GAAP (for example, APB Opinion No. 21, *Interest on Receivables and Payables*, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, or Issue No. 00-19) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.
- The issuer of a registration payment arrangement is required to provide certain disclosures about each registration payment arrangement or each group of similar arrangements, regardless of the probability of having to make such payments.

- The FSP is not to be applied by analogy to the accounting for contracts that are not registration payment arrangements.

The FSP is effective immediately for registration payment arrangements and the financial instruments subject to those arrangements that are entered into or modified subsequent to December 21, 2006. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to December 21, 2006, the guidance is effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years. However, an entity should not apply the guidance in this FSP to registration payment arrangements that are no longer outstanding upon adoption of the FSP.

The FSP is available in full at [http://www.fasb.org/fasb\\_staff\\_positions/fsp\\_eitf00-19-2.pdf](http://www.fasb.org/fasb_staff_positions/fsp_eitf00-19-2.pdf).

### **FASB Proposes Expanded Disclosures for Derivatives and Hedging Activities**

The Financial Accounting Standards Board has issued a proposed Statement, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The proposed Statement would amend and expand existing disclosure requirements in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to require:

- Discussion of objectives and strategies for using derivative instruments by, at a minimum, the instrument's primary underlying risk that the reporting entity is intending to modify.
- Tabular disclosure by primary underlying risk, accounting designation, and purpose of:
  - ♦ The notional amounts and fair values of derivative instruments,
  - ♦ The location and fair values of derivative instruments and related gains and losses reported in the balance sheet and income statement, and
  - ♦ The location and amount of gains and losses reported in the income statement on hedged items designated and qualifying in hedging relationships.
- Disclosure of:
  - ♦ Instances in which derivative instruments contain leverage factors.
  - ♦ The existence and nature of contingent features in derivative instruments, the aggregate fair value amount of derivative instruments that contain those features, and the aggregate fair value amount of assets that would be required to be posted as collateral or transferred in accordance with the provisions associated with the triggering of the contingent features.
  - ♦ Counterparty credit risk in derivative instruments.
  - ♦ The aggregate fair value of derivative instruments in asset positions on both a gross basis and net of collateral posted by the counterparty.
- Cross-referencing to other footnotes in which derivative-related information is disclosed.

The requirements of the proposed Statement would be effective for financial statements issued for fiscal years and interim periods ending after December 15, 2007, with early application encouraged. The proposed Statement would encourage but would not require disclosures for earlier periods at initial adoption. In years after initial adoption, the proposed Statement would require disclosures for earlier periods.

The proposed Statement is available for comment until March 2, 2007 at [http://www.fasb.org/draft/ed\\_derivatives\\_disclosure.pdf](http://www.fasb.org/draft/ed_derivatives_disclosure.pdf).

### **Proposed Conforming Amendments Resulting from Statement No. 158**

FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, amended the recognition provisions of Statement No. 87, *Employers' Accounting for Pensions*, Statement No. 88,

*Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, and Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, to require recognition of the funded status of defined benefit postretirement plans in an employer's balance sheet. However, Statement No. 158 did not amend the illustrations contained in Appendix B of Statement No. 87, Appendix B of Statement No. 88, or Appendix C of Statement 106; nor did it amend the questions and answers contained in the FASB Special Reports related to those Statements. Therefore, the Financial Accounting Standards Board has issued proposed FASB Staff Position (FSP) No. FAS 158-a to provide conforming amendments to these illustrations and Special Reports. The FSP also incorporates the questions and answers contained in the Special Reports into the respective Statements as appendices. The FSP therefore will supersede the FASB Special Reports related to Statements No. 87, 88 and 106.

The conforming amendments made by this proposed FSP are expected to be effective as of the effective dates of Statement No. 158. The FSP is available for comment until January 8, 2007 at [http://www.fasb.org/fasb\\_staff\\_positions/prop\\_fsp\\_fas158a.pdf](http://www.fasb.org/fasb_staff_positions/prop_fsp_fas158a.pdf).

### **Proposed Amendments to FASB Interpretation No. 39**

FASB Interpretation (FIN) No. 39, *Offsetting of Amounts Related to Certain Contracts*, defines conditional contracts as "those whose obligations or rights depend on the occurrence of some specified future event that is not certain to occur and that could change the timing of the amounts or of the instruments to be received, delivered, or exchanged." Exchange contracts are defined as "those that require a future exchange of assets or liabilities rather than a one way transfer of assets." Examples of conditional or exchange contracts include forwards, interest rate swaps, currency swaps and options. Questions have been raised about whether a contract whose obligations or rights depend solely on the occurrence of a default or termination would meet the definition of a conditional contract. The Financial Accounting Standards Board has proposed FASB Staff Position (FSP) No. FIN 39-a, *Amendment of FASB Interpretation No. 39*, to replace the terms conditional contracts and exchange contracts with the term derivative instruments as defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Questions also have been raised about whether a reporting entity can offset the receivable or payable recognized upon payment or receipt of cash collateral against the fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with paragraph 10 of FIN 39. Paragraph 10 permits a reporting entity to offset fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement without applying the condition that a reporting entity intends to set-off. Proposed FSP No. FIN 39-a would amend FIN 39 to permit a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement that have been offset in accordance with paragraph 10 of FIN 39.

The guidance in this proposed FSP is expected to be effective for fiscal years beginning after December 15, 2006. The effects of applying the proposed FSP are to be applied as a change in accounting principle through retrospective application for all financial statements presented unless it is impracticable to do so. The proposed FSP is available for comment until January 31, 2007 at [http://www.fasb.org/fasb\\_staff\\_positions/prop\\_fsp\\_fin39a.pdf](http://www.fasb.org/fasb_staff_positions/prop_fsp_fin39a.pdf).

As a note of caution, if the proposed FSP is issued as exposed, its provisions will be effective on January 1, 2007 for a calendar-year entity.

### **Proposed Guidance Related to Foreign Currency Hedges**

A company may seek to mitigate its economic exposure to movements in foreign exchange rates prior to the issuance of foreign-currency-denominated debt. To achieve this, the company could enter into a forward exchange contract that locks in the amount of functional-currency-equivalent proceeds to be received. A question has been raised as to whether the variability in functional-currency-equivalent proceeds to be received from the forecasted

issuance of foreign-currency-denominated debt is eligible for designation as a hedged transaction in a cash flow hedge of foreign currency risk. In response to this question, the Financial Accounting Standards Board (FASB) staff has issued proposed implementation guidance on FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* in Implementation Issue No. H17, *Foreign Currency Hedges: Hedging Functional-Currency-Equivalent Proceeds to Be Received from a Forecasted Foreign-Currency-Denominated Debt Issuance*. This proposed Statement 133 Implementation Issue clarifies that the variability in functional-currency-equivalent proceeds expected to be received from the forecasted issuance of debt denominated in a currency other than the reporting entity's functional currency is ineligible for designation as the hedged transaction in a cash flow hedge of foreign currency risk.

Implementation Issue No.H17 represents a tentative conclusion. The status of the guidance will remain tentative until it is formally cleared by the FASB. If finalized by the FASB, the effective date of the guidance will be the first day of the first fiscal quarter beginning after the final guidance is posted on the FASB website. The proposed Implementation Issue is available for comment until February 2, 2007 at <http://www.fasb.org/derivatives/12-28-06.pdf>.

### **Proposed Interim Guidance for Certain Fair Value Measurements Withdrawn**

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 157, *Fair Value Measurements*. This Statement did not require any new fair value measurements, but rather, it provided enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. While finalizing Statement No. 157, the FASB became aware of diversity in practice about the measurement of nonfinancial assets that are required to be measured at fair value in business combinations and impairment tests. This diversity primarily relates to the circumstances in which a reporting entity uses entity-specific assumptions, rather than the assumptions of market participants, in a fair value measurement. Diversity in practice also relates to the appropriate measurement attribute for certain assets acquired and liabilities assumed in a business combination.

The FASB staff identified certain wording in FASB Statements No. 141, *Business Combinations*, No. 142, *Goodwill and Other Intangible Assets*, and No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which may have contributed to this diversity. As a result, on October 23, 2006, the FASB issued proposed FASB Staff Position (FSP) No. FAS 141-b, 142-e, and 144-b, *Fair Value Measurements in Business Combinations and Impairment Tests*, to clarify the current requirements for fair value measurements under those Statements until Statement No. 157 is adopted by the reporting entity. After considering the comment letters received on proposed FSP FAS 141-b, 142-e, and 144-b at its meeting on December 13, 2006, the FASB decided not to issue a final FSP and to remove the project from its agenda.

## **Public Sector**

### **GASB Proposes to Revise Pension Disclosure Requirements**

The Governmental Accounting Standards Board (GASB) has issued an Exposure Draft of a proposed Statement that would bring current pension disclosure requirements for governments and governmental pension plans into line with those recently issued for other post-employment benefits. The proposed Statement would amend GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, by requiring:

- Disclosure of the current funded status of the plan as of the most recent actuarial valuation date in the notes to the financial statements of pension plans and certain employer governments to be presented in addition to funded status data currently presented as required supplementary information
- Disclosure by governments that use the aggregate actuarial cost method of the funded status and a multiyear schedule of funding progress using the entry age actuarial cost method as a surrogate
- Additional note disclosures about actuarial methods and assumptions used in the valuations underlying information reported about the annual required contribution and funded status of the pension plan

- Disclosure by governments participating in cost-sharing pension plans of how the contractually required contribution rate is determined
- Presentation by governments in cost-sharing plans of the required schedule of funding progress if the plan does not issue a GAAP-compliant report that includes required supplementary information or if the plan is not included in a publicly available financial report of another entity.

The requirements of the proposed Statement would be effective for periods beginning after June 15, 2007, with early implementation encouraged. The Exposure Draft is available for comment until February 28, 2007 at [http://www.gasb.org/exp/ed\\_pension\\_disclosures.pdf](http://www.gasb.org/exp/ed_pension_disclosures.pdf).

### **Guidance Proposed for Accounting for Intangible Assets**

The Governmental Accounting Standards Board has proposed accounting and financial reporting guidance for intangible assets. The proposal describes an intangible asset as an asset that lacks physical substance, is nonfinancial in nature, and has an initial useful life extending beyond a single reporting period. Examples of intangible assets include easements, computer software, water rights, timber rights, patents, and trademarks.

The proposed Statement, Accounting and Financial Reporting for Intangible Assets, would:

- Require that all intangible assets subject to its provisions be classified as capital assets. Accordingly, existing authoritative guidance related to the accounting and financial reporting for capital assets would be applied to these intangible assets, as applicable.
- Provide authoritative guidance that specifically addresses the unique nature of intangible assets, including:
  - ♦ Requiring that an intangible asset be recognized in the statement of net assets only if it is considered identifiable;
  - ♦ Establishing a specified-conditions approach to recognizing intangible assets that are internally generated;
  - ♦ Providing guidance on recognizing internally generated computer software; and
  - ♦ Establishing guidance specific to intangible assets related to amortization.

The proposed Statement would be effective for financial statements for periods beginning after June 15, 2009. The provisions of the proposed Statement generally would be required to be applied retroactively.

The proposed Statement is available for comment until March 23, 2007 at [http://www.gasb.org/exp/ed\\_intangible\\_assets.pdf](http://www.gasb.org/exp/ed_intangible_assets.pdf).

## **SEC**

### **SOX 404 Extension for Smaller Companies**

The SEC has further extended the dates for smaller companies to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404). SEC Final Rule 33-8760 affects 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 public company that is not required to file annual and quarterly reports on an accelerated basis (i.e., a non-accelerated filer) is not 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 is not required until a non-accelerated filer files an annual report for a fiscal year ending on or after December 15, 2008.

Companies that only provide management's report during their first year of compliance in accordance with these

rules must state in the annual report that the report does not include the auditor's attestation report and that the company's registered public accounting firm has not attested to management's report on the company's internal control over financial reporting. Before non-accelerated filers will be expected to comply with the internal control reporting requirements, the SEC also has proposed guidance that will likely change the way in which management evaluates internal control over financial reporting. (See "SEC Proposes SOX 404 Interpretive Management Guidance" below.) If such guidance is not issued in time to be of sufficient assistance in connection with annual reports filed for fiscal years ending on or after December 15, 2007, the SEC will consider whether to further postpone the compliance date. The SEC also will consider postponing the auditor's attestation requirement after considering a new auditing standard to be proposed by the Public Company Accounting Oversight Board, which is anticipated to supersede Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*.

In Final Rule 33-8760, the SEC also provided a transition period for a newly public company before it becomes subject to the internal control over financial reporting requirements. Under the new amendments, a company will not become subject to these requirements until it either had been required to file an annual report for the prior fiscal year with the SEC or had filed an annual report with the SEC for the prior fiscal year. A newly public company is required to include a statement in its first annual report that the annual report does not include either management's assessment on the company's internal control over financial reporting or the auditor's attestation report.

Final Rule 33-8760 is available in full at <http://www.sec.gov/rules/final/2006/33-8760.pdf>.

### **PCAOB Proposes Revised Auditing Standard on Internal Control Over Financial Reporting**

The Public Company Accounting Oversight Board (PCAOB) has proposed for public comment a new standard on auditing internal control over financial reporting, *An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements*. This standard would supersede PCAOB Auditing Standard (AS) No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. Among other revisions, the proposed standard would:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment;
- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness;
- Clarify the role of materiality, including interim materiality, in the audit;
- Remove the requirement to evaluate management's process;
- Permit consideration of knowledge obtained during previous audits;
- Direct the auditor to tailor the audit to reflect the attributes of smaller and less complex companies;
- Refocus the multi-location testing requirements on risk rather than coverage; and
- Recalibrate the walkthrough requirement.

In addition to the proposed internal control standard, the PCAOB also proposed for public comment a new auditing standard on considering and using the work performed by internal auditors, management and others in an integrated audit of financial statements and internal control, or in an audit of financial statements only. This proposed standard is intended to further clarify how and to what extent an independent auditor may use that work to reduce the work the auditor otherwise would have to perform. Further, the PCAOB proposed to revise the independence requirement that currently is embedded in the text of AS 2, which requires the auditor to seek specific pre-approval by the audit committee of any internal control related service. Proposed Rule 3525 would recognize that audit committees may pre-approve the provision by their independent auditor of internal control-related services on an ad hoc basis, or pursuant to committee-approved policies and procedures.

The proposed standards are available for comment until February 26, 2007 at [http://www.pcaob.org/Rules/Docket\\_021/2006-12-19\\_Release\\_No.\\_2006-007.pdf](http://www.pcaob.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf). The PCAOB's proposed new standards do not change current rules or regulations unless formally adopted by the SEC.

### **SEC Proposes SOX 404 Interpretive Management Guidance**

Under current SEC rules, a public company that is not required to file annual and quarterly reports on an accelerated basis (i.e., a non-accelerated filer) is not required to provide management's report on internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404) until it files an annual report for a fiscal year ending on or after December 15, 2007. The auditor's attestation report on internal control over financial reporting is not required until a non-accelerated filer files an annual report for a fiscal year ending on or after December 15, 2008. Before non-accelerated filers will be expected to comply with the internal control reporting requirements, the SEC has proposed guidance that will likely change the way in which management evaluates internal control over financial reporting.

The proposed guidance is organized around two principles - materiality and risk. First, management should evaluate the design of the controls that it has implemented to determine whether there is a reasonable possibility that a material misstatement in the financial statements would not be prevented or detected in a timely manner. Second, management should gather and analyze evidence about the operation of the controls being evaluated based on its assessment of the risk associated with those controls. Because smaller public companies often have less complex internal control systems than larger public companies, this proposed approach would enable smaller public companies in particular to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances.

The proposed guidance addresses four specific areas:

- Identification of risks to reliable financial reporting and the related controls that management has implemented to address those risks.
- Evaluation of the operating effectiveness of controls.
- Reporting the overall results of management's evaluation.
- Documentation.

The SEC also has proposed amendments to make the auditor's reporting requirement pursuant to SOX Section 404(b) consistent with the new auditing standard to be proposed by the Public Company Accounting Oversight Board, which is anticipated to supersede Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. The proposed amendments to Rule 2-02 (f) of Regulation S-X would require a company's registered independent public accounting firm to only provide one opinion on the effectiveness of the company's internal controls. The auditor's attestation report on management's evaluation required under SOX 404(b) would be subsumed within the auditor's opinion on the effectiveness of the company's internal controls.

We want to emphasize that these are proposals and therefore have not been issued as final rules as of yet. Y

### **Current Accounting and Disclosure Issues**

The Division of Corporation Finance of the Securities and Exchange Commission has published its Current Accounting and Disclosure Issues. This document discusses recent rules, proposed rules, interpretive bulletins and other accounting and disclosure issues. It is available in its entirety at <http://www.sec.gov/divisions/corpfinc/facctdisclosureissues.pdf>.

### **Executive Compensation Disclosures Amended**

On July 26, 2006, the SEC adopted enhanced executive compensation disclosure requirements for proxy statements, registration statements, and annual reports filed by public companies. On December 22, 2006, the SEC announced

an amendment to these executive and director compensation disclosure rules, which will align the reporting of equity awards in the Summary Compensation Table and the Director Compensation Table to the amounts that are disclosed in the company's financial statements under FASB Statement No. 123 (revised 2004), *Share-Based Payment*.

Statement No. 123 (R) requires recognition of the costs of equity awards over the period in which an employee is required to provide service in exchange for the award. Using this same approach in the executive compensation disclosure will give investors a better idea of the compensation earned by an executive or director during a particular reporting period, consistent with the principles underlying the financial statement disclosures. Under the SEC's amendment:

- The dollar values required to be reported in the Stock Awards and Option Awards columns of the Summary Compensation Table and the Director Compensation Table are revised to disclose the compensation cost of those awards, before reflecting forfeitures, over the requisite service period, as described in Statement No. 123(R). Forfeitures are required to be described in accompanying footnotes.
- The Grants of Plan-Based Awards Table is revised to require disclosure of the grant-date fair value of each individual equity award, computed in accordance with Statement No. 123(R), and the Director Compensation Table required under Item 402 of Regulation S-K is revised to require footnote disclosure of the same information.
- The Grants of Plan-Based Awards Table is revised to require disclosure of any option or stock appreciation right that was repriced or otherwise materially modified during the last completed fiscal year, including the incremental fair value, computed as of the repricing or modification date in accordance with Statement No. 123(R), and the Director Compensation Table required under Item 402 of Regulation S-K is revised to require footnote disclosure of the same incremental fair value information.

The compliance dates for the amendment will be the same as the compliance dates for the amendments to Item 402 of Regulations S-K and S-B that were adopted on July 26, 2006. Compliance with the Item 402 amendment is required for proxy statements, information statements and registration statements filed on or after December 15, 2006, that are required to include Item 402 disclosure for fiscal years ending on or after December 15, 2006, and for Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006.

The amendment is available in full at <http://www.sec.gov/rules/final/2006/33-8765.pdf>.

## International

### Enhanced Written Representations Proposed

The International Auditing and Assurance Standards Board (IAASB) recently proposed a new standard to enhance the written representations that auditors request from management, those charged with governance, and others. Proposed International Standard on Auditing (ISA) 580 (Revised and Redrafted), *Written Representations*, would provide for general written representations regarding the financial statements, including internal control, and the completeness of information made available to the auditor, and for written representations about specific assertions in the financial statements.

The IAASB also recently issued five Exposure Drafts of proposed ISAs as part of its comprehensive program to enhance the clarity of international standards:

- ISA 230 (Redrafted), *Audit Documentation*;
- ISA 540 (Revised and Redrafted), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*;
- ISA 560 (Redrafted), *Subsequent Events*;

- ISA 610 (Redrafted), *The Auditor's Consideration of the Internal Audit Function*; and
- ISA 720 (Redrafted), *Reading Other Information in Documents Containing Audited Financial Statements*.

The Exposure Drafts form part of the IAASB's program to redraft existing standards and to develop new and revised standards following the new drafting conventions, which were developed after extensive consultation with interested parties, such as the IAASB's Consultative Advisory Group and national auditing standard setters, and public consultation. Key elements of the new drafting conventions include: basing each standard on the objective of the auditor with respect to the subject matter of the standard; separating the requirements that the auditor is required to follow from guidance on their application; eliminating the present tense to describe actions by the auditor, which raised ambiguity about whether such actions were required; and other structural and drafting improvements to enhance the overall readability and understandability of the standards. Standards redrafted in this way are described as "redrafted." If further revision has been undertaken, a standard is described as "revised and redrafted."

Proposed ISA 540 (Revised and Redrafted) is a combination of ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)* and ISA 545, *Auditing Fair Value Measurements and Disclosures*.

Comments on the Exposure Drafts of proposed redrafted ISAs 230, 560, 610 and 720 are requested by March 31, 2007. Comments on the exposure drafts of proposed revised and redrafted ISAs 580 and 540 are requested by April 30, 2007. The Exposure Drafts are available in full at <http://www.ifac.org/EDs>.

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