

**BDO Seidman, LLP**  
Accountants and Consultants



# Financial Reporting

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## SEC Year in Review

### Overview of Significant 2006 Developments

This letter summarizes many of the 2006 activities at the Securities and Exchange Commission that affect financial reporting. We begin with an overview and then discuss many of the activities in greater detail. Although not the focus of this letter, we also briefly discuss the 2006 activities of the Public Company Accounting Oversight Board, the PCAOB staff, and the SEC's Advisory Committee on Smaller Public Companies.

### Reporting on Internal Controls

In 2006, the SEC and its staff continued to focus on evaluating the results of issuers' and auditors' efforts to implement the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002. The 2005 reporting year was the second year that accelerated filers and their auditors were required to report on the effectiveness of internal controls in their annual reports. The second year was generally less difficult and less costly than the first year, but everyone involved in the process – management, auditors, the SEC, and the PCAOB – continued to believe that the process should and could be improved.

In May, the SEC and PCAOB held a public roundtable to obtain feedback from constituents on the second year of Section 404 implementation. Based on this feedback and their experience with the Section 404 requirements, the Commission and the PCAOB issued statements about steps they planned to

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take to improve implementation of internal control reporting.

The Commission outlined its action plan as follows:

- Issue guidance on management's assessment of internal control over financial reporting (ICFR) based on –
  - Information to be obtained from an SEC concept release on management's reports on ICFR and the Committee of Sponsoring Organizations' (COSO) guidance on how to apply its framework in smaller companies;
  - Feedback already obtained at the May roundtable; from the SEC's Advisory Committee on Smaller Public Companies; and from the U.S. Government Accountability Office April 2006 Report, *Sarbanes-Oxley, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*;
- Defer the 404 compliance dates for non-accelerated filers;
- Work with the PCAOB to revise Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting in Conjunction with an Audit of Financial Statements*, to make it work efficiently and effectively for audits of companies of all sizes; and
- Oversee the PCAOB inspection program that includes reviewing whether auditors have efficiently performed ICFR audits. The PCAOB's plan included:
  - Amend AS 2 to ensure that audits of the financial statements and ICFR are integrated and that ICFR audits use a top-down and risk-based approach;
  - Reinforce auditor efficiency through inspections;
  - Develop and implement guidance and training for auditors of small companies; and

- Continue PCAOB forums on auditing in the small business environment.

In November, the Committee on Capital Markets Regulation (also known as the Paulson Committee) provided input that targeted Congress as well as the SEC and other regulators. The Committee recommended that the SEC and other regulators move to a more risk-based regulatory process, and that regulators should rely on principles-based rules and guidance. Also, the Committee commented that small companies should be exempted from Section 404 if it's too burdensome to implement. (The Committee's recommendations are available at <http://www.capmksreg.org/index.html>.) The SEC's Advisory Committee on Smaller Public Companies had made a similar recommendation in April when it commented that smaller public companies should be exempted from Section 404 requirements until a cost-effective framework for assessing ICFR for these companies is developed.

The Commission is particularly concerned about the costs and other difficulties that smaller companies and foreign companies face in implementing Section 404. The SEC believes that it is inappropriate to require compliance with the 404 requirements before a cost-effective means of assessing and auditing the controls is developed. Consequently, the Commission deferred the auditor reporting on management's assessment of ICFR for accelerated foreign private issuers for one year, to years ending on or after July 15, 2008.

The SEC also finalized rule amendments to defer implementation of Section 404 for non-accelerated and newly public companies. The SEC extended the effective date

for the management of non-accelerated filers to report on ICFR five months to fiscal years ending on or after December 15, 2007, and deferred auditor reporting on management's assessment until fiscal years ending on or after December 15, 2008. The SEC also determined that reporting on internal control created an undue burden on newly public companies and amended the rules to allow such companies to begin providing management and auditor reports on ICFR in their *second* annual report.

In December, the SEC issued proposed interpretive guidance for management to assess ICFR that focuses on two primary tasks:

- The evaluation of the design of controls; and
- The gathering of evidence of operating effectiveness.

The SEC believes the assessment of the design of controls should use a top-down, risk-based approach that is focused on the possibility of material misstatement. The approach to evaluating operating effectiveness is based on the concept that the greater the risk of material misstatement the more robust the evidence should be, and that the evaluation methods need to be tailored to a company's specific facts and circumstances.

As a companion to the SEC's proposed guidance, the PCAOB issued a proposed new auditing standard that will replace (not amend) AS 2. The objective of the standard is to increase ICFR audit effectiveness and efficiency by focusing the audit, eliminating unnecessary procedures, scaling the audit for smaller companies, and simplifying the audit requirements. The proposed standard is designed to address concerns that AS 2 is too prescriptive and to allow for focus and scalability.

## Executive Compensation Disclosure

In August, the Commission completed new executive compensation disclosure rules. These rules redefine the executives whose compensation must be disclosed, require a new total in the Summary Compensation Table; supplement the Summary Compensation Table with a Grants of Plan-Based Awards Table; require a new MD&A-like analysis of compensation – Compensation Discussion and Analysis; add five tables – Outstanding Equity Awards at Fiscal Year End, Option Exercises and Stock Vested, Pension Benefits, Nonqualified Deferred Compensation, and Director Compensation; and require narrative disclosure of post-employment compensation payments. The Commission modified these disclosures in December to conform the disclosure in the Summary Compensation Table of stock and option awards costs to the costs reported in the financial statements over the requisite service period in accordance with FASB Statement No. 123 (Revised 2004), *Share-Based Payment*.

## Stock Options

In September, the Chief Accountant of the SEC explained the staff's views on the accounting consequences of issues that can arise when investigating past stock option granting practices. The staff's views were provided in a letter that focused on the accounting consequences under APB Option No. 25, *Accounting for Stock Issued to Employees*, of options granted with backdated award dates, administrative delays, uncertain validity, and other related issues. (See <http://www.sec.gov/info/accountants/stafflet>

[http://www.sec.gov/info/accountants/staffletters/fei\\_aicpa091906.htm](http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm).) In January 2007, the staff of the Division of Corporation Finance provided guidance on filing amendment and disclosure requirements when financial statements for multiple years must be restated. (See <http://www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm>.)

## Materiality

Also in September, the staff provided long-anticipated guidance on evaluating materiality of errors in financial statements in Staff Accounting Bulletin (SAB) No. 108, *Quantifying Misstatements in Financial Statements*. The SAB requires issuers to use both of the two approaches (iron curtain and rollover) that are currently used. It requires issuers to adjust their financial statements if either approach results in a conclusion that an error is material. The SAB could significantly affect many companies' financial statements.

## XBRL

Chairman Cox is very interested in using technology to improve the usefulness of financial information to investors and in furthering the use of Extensible Business Reporting Language (XBRL) for financial reporting. Chairman Cox and the Commission hope to expand participation in the voluntary program to provide XBRL financial information, and announced a \$54 million initiative to transform the SEC's electronic filings database into an interactive tool based on XBRL.

## IFRS

The Commission and its staff will continue to review the implementation of International Financial Reporting Standards. The staff has already begun its review of the first

wave of financial statements prepared on the basis of IFRS for 2005, the first year that many European companies were required to implement IFRS in their primary financial statements. Based on the SEC's action plan for U.S. and IFRS convergence (also known as the "roadmap"), IFRS could coexist without reconciliation to U.S. GAAP in the U.S. capital markets by 2009.

## Personnel Changes

Both the SEC and the PCAOB have had leadership changes. At the SEC, Kathleen Casey became a Commissioner in July, replacing outgoing Commissioner Cynthia Glassman. John White, a securities lawyer, became the Director of the Division of Corporation Finance in March. Conrad Hewitt became Chief Accountant in July, and Zoe-Vonna Palmrose became Deputy Chief Accountant for Professional Practice in August. Scott Taub, another Deputy Chief Accountant, left the Commission staff in January 2007. At the PCAOB, Mark Olson was named Chairman in July.

## New Commission Rules

### Deferral of Internal Control Reporting for Non-Accelerated Filers, Accelerated Foreign Private Issuers, and First-Time Filers

**(Releases 33-8760 and 33-8730A)**

Entering 2006, non-accelerated filers were scheduled to begin reporting on the effectiveness of ICFR in fiscal years ending on or after July

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15, 2007. During 2006, the SEC finalized a further deferral for non-accelerated filers, both domestic and foreign, extended the deadline for auditor reporting on management's evaluation of ICFR for accelerated foreign private issuers, and deferred internal control reporting for newly public companies until their *second* annual report.

In December, the SEC extended the deadline for the management of non-accelerated filers to report on ICFR by five months to fiscal years ending on or after December 15, 2007. The SEC's rulemaking release noted that if the Commission has not issued additional guidance for management on how to assess internal control over financial reporting in sufficient time, it will consider further postponing this compliance date.

The SEC provided further relief to non-accelerated filers by allowing them to take a sequential approach to internal control reporting, with management reporting in the first year and auditor reporting deferred until the second year. The Commission extended the date that non-accelerated filers are required to provide an auditor's report on ICFR by seventeen months to fiscal years ending on or after December 15, 2008. The Commission added a

requirement that non-accelerated filers clearly disclose in the first report that management's assessment of internal control has not been attested to by the auditor if it is providing only management's report in the first year. In addition, first year management-only ICFR reports will be deemed furnished rather than filed. The SEC's rulemaking release noted that it will also consider postponing this date further after considering the anticipated revisions to the PCAOB's AS 2.

The SEC also postponed the 404 compliance date for first-time filers. The deadline for newly public issuers to provide managements' and auditors' reports on internal control over financial reporting was extended one year to the filing of a newly public issuer's second annual report.

In September, the SEC published rules that deferred internal control reporting by auditors of accelerated foreign private issuers. As a result:

- The deadline for accelerated foreign private issuers to provide an auditor's report on internal control over financial reporting was extended by one year to fiscal years ending on or after July 15, 2007. The deadline for an accelerated foreign private issuer's management to report on internal

control over financial reporting remains unchanged at fiscal years ending on or after July 15, 2006.

- The deadline for large (filers with \$700 million or more in market float) accelerated foreign private issuers to comply with 404 was retained. Management and auditors must report on internal control in fiscal years ending on or after July 15, 2006.

To maintain consistency with domestic filers, the SEC adopted the same disclosure requirement for accelerated foreign private issuers that initially report on management's report on internal control over financial reporting without an auditor's report. That is, the Commission added a requirement that accelerated foreign private issuers clearly disclose in the first report that management's assessment of internal control has not been attested to by the auditor if it is providing only management's report in the first year.

The current deadlines are summarized in the table below.

The December Release is available on the SEC's website at: <http://www.sec.gov/rules/final/2006/33-8760.pdf>; the September Release is available at: <http://www.sec.gov/rules/final/2006/33-8730A.pdf>.

### Internal Control Over Financial Reporting – Due Dates

	Due Date Before the Amendment	Extended Due Date	Due Date Before the Amendment	Extended Due Date
<b>Type of Filer</b>	Management Reporting		Auditor Reporting	
	<b>Fiscal years ending on or after</b>			
<b>Non-accelerated Issuer</b>	July 15, 2007	Dec. 15, 2007	July 15, 2007	Dec. 15, 2008
<b>Newly Public Issuer</b>	First 10-K	Second 10-K	First 10-K	Second 10-K
<b>Accelerated Foreign Private Issuer</b>	July 15, 2006	Unchanged	July 15, 2006	July 15, 2007
<b>Large Accelerated Foreign Private Issuer</b>	July 15, 2006	Unchanged	July 15, 2006	Unchanged

## Executive Compensation Disclosure

### (Releases 33-8765 and 33-8732A)

In August, the SEC published new rules regarding executive and director compensation disclosure. The SEC noted that the purpose of the rules is to require disclosure of *all* components of executive and director compensation – not to require any particular practice or regulate the amounts of compensation. The rules as issued required registrants to report the entire grant date fair value of option and stock awards to executives and directors in the Summary Compensation Table (SCT) and Director Compensation Table (DCT) in the year of the grant, regardless of the extent to which the award had vested.

In December, the SEC amended the disclosure requirements for stock and option awards to make the disclosures more consistent with the amounts reported for financial statement purposes under Statement No. 123(R). That is, the revised rules require registrants to report option and stock awards costs over the requisite service period in the SCT and the DCT. The disclosure of the entire grant date fair value will still be required, but in a different location. Now registrants will report the entire grant date fair value of each equity award for executives in the Grants of Plan-Based Awards Table and for directors in the footnotes to the DCT.

The rules (including the rule amendment) – and all the disclosures – are effective for Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006 and for registration and proxy or information statements filed on or after December 15, 2006 that are

required to include stock compensation disclosures for fiscal years ending on or after December 15, 2006. This means that calendar year-end filers will be required to make the new disclosures in their annual reports for 2006. The new rules also apply to small business issuers, but require less extensive disclosure. The disclosure requirements for foreign private issuers are not affected by the new rules.

The SEC made changes in the executive compensation disclosure rules that encompass the following:

- **Named Executive Officers** – The five included in the Summary Compensation Table now add the principal financial officer to the principal executive officer (PEO) and continue to include the three other most highly compensated executives.
- **Compensation Discussion and Analysis (CD&A)** – This MD&A-like analysis requires discussion of compensation policy and decisions and provides context for the compensation tables. The Commission structured the CD&A to support compliance with the rules by requiring companies to “file” rather than “furnish” the information and include the information in materials covered by the CEO and CFO certifications.
- **Compensation Committee Report** – This report has been retained and now requires the committee to state whether it has reviewed and discussed the CD&A with management. Further, the committee must state in the report whether, based on the review and discussions, it has recommended to the board of directors that the CD&A be included in the company’s annual report. The report must include the names of the committee members.
- **Summary Compensation Table** – The SCT adds a “total compensa-

tion” column. The table requires three years of compensation information. That requirement phases in, so only one year is required in the first year of disclosure. The stock and option awards are listed in the SCT on the same basis as the costs reported in the financial statements (over the requisite service period). The SCT also reports changes in pension value and above-market earnings on non-qualified deferred compensation. All other compensation is disclosed in the SCT and includes perks that must be reported at the incremental cost to the company. Once the total of the perks exceed \$10,000, the perks must be identified.

- **Grants of Plan-Based Awards Table** – Includes both cash and equity awards. For each equity award, this table reports the number of shares underlying the award, the exercise or base price, the estimated future payout, and the entire grant date fair value. The table includes additional columns with incremental information if either of the following events occurred: (1) the grant date of the award is different from the date on which the compensation committee took action, or (2) the exercise price of an option grant is lower than the company’s closing price on that date.
- **Outstanding Equity Awards at Fiscal Year-End Table** – Includes information on equity awards previously granted that remain outstanding, unexercised, unvested, or unearned at fiscal year end. This table provides a snapshot of the awards at a point in time.
- **Option Exercises and Stock Vested Table** – Discloses the number of shares acquired as well as the amount realized when a

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named executive exercises options or has stock vest during the most recent fiscal year. This table provides the “flow” of awards over the past year.

- Pension Benefits Table and Deferred Compensation Table – These new tables provide pension benefit and nonqualified deferred compensation information.
- Other Postemployment Payments Narrative – Requires disclosure of payments due to named executive officers at termination or change in control.
- Director Compensation Table – Adds this table for director compensation. It is substantially similar to the SCT, but requires only one year of information.

*Small Business Issuers* – The disclosure requirements for small business issuers are less extensive than for regular issuers and include:

- The SCT and accompanying narrative disclosure;
- The Outstanding Awards at Fiscal Year-End Table; and
- The DCT.

Small business issuers must provide the Summary Compensation Table information for the CEO and the two other most highly compensated officers for only the two most recent fiscal years. Small business issuers are not required to provide a CD&A or the related Compensation Committee Report. Small business issuers must provide narrative disclosure addressing defined benefit plans, defined contribution plans, and other postemployment arrangements for named executive officers. However, these issuers are not required to provide pension plan information for these executives in the Summary Compensation Table.

The releases are available on the SEC’s website at: <http://www.sec.gov>

[rules/final/2006/33-8765.pdf](http://www.sec.gov/rules/final/2006/33-8765.pdf) and <http://www.sec.gov/rules/final/2006/33-8732A.pdf>. In October, the SEC staff issued an FAQ document containing guidance on these new rules, and it is available on the SEC’s website at: <http://www.sec.gov/divisions/corpfin/faqs/execcompqa.pdf>. See our September 2006 *Financial Reporting* letter at: <http://www.bdo.com/about/publications/assurance/FRLExecComp-9-06-3.pdf> for further details.

## E-Proxy Delivery

### (Release 34-55146)

In December, the SEC adopted final rules to allow (not require) companies to furnish proxy materials to shareholders through a “notice and access” model using the Internet. An issuer that chooses to follow this model must post its proxy materials on an Internet website and send a notice of Internet availability of proxy materials to shareholders at least 40 days before the meeting date. The rules are effective July 1, 2007 and early adoption is not allowed.

The Release is available on the SEC’s website at: (<http://www.sec.gov/rules/final/2007/34-55146.pdf>).

## Proposals

### Management’s Report on Internal Control over Financial Reporting

#### (Release 33-8762)

In May, the SEC announced the steps it planned to take for improving the implementation of the Section 404 internal control requirements of the Sarbanes-Oxley Act. This announcement was made one week after the roundtable that the Commission and PCAOB had

organized for constituents to share their second-year experiences with internal control reporting and auditing. The table on the next page lists the steps and their status as of December.

In December, the SEC completed step 3 of the plan and proposed interpretive guidance for management in assessing ICFR. The proposal provides guidance for management to use in evaluating ICFR. The guidance focuses on two primary tasks:

- The evaluation of the design of controls; and
- The gathering of evidence of operating effectiveness.

The proposed guidance addresses four aspects of performing these tasks: identification of risks to reliable financial reporting, evaluation of operating effectiveness, results of management’s evaluation, and documentation.

The SEC also proposed amendments to its rules to clarify that performance by management in accordance with the guidance would satisfy the SEC’s requirements for the annual evaluation of ICFR. Further, the SEC proposed changes to Regulation S-X to clarify the auditor’s reporting requirement under Section 404(b) of the Sarbanes-Oxley Act. Basically, the rule would state that when conducting an audit of ICFR, the auditor is required to only express an opinion on the effectiveness of ICFR, and is not required to express an opinion on the process followed by management in its evaluation.

The Release is available on the SEC’s website at: <http://www.sec.gov/rules/proposed/2006/33-8762.pdf>.

## E-Proxy Delivery

### (Release 34-55147)

In December, the SEC proposed rules that would require companies

<b>Internal Control Over Financial Reporting – SEC Implementation Plan</b>		
<b>Step</b>	<b>Status</b>	<b>Reference</b>
<b>1. Defer compliance dates</b>		
Non-accelerated filers	Complete	<a href="http://www.sec.gov/rules/final/2006/33-8760.pdf">http://www.sec.gov/rules/final/2006/33-8760.pdf</a>
Newly public companies	Complete	<a href="http://www.sec.gov/rules/final/2006/33-8760.pdf">http://www.sec.gov/rules/final/2006/33-8760.pdf</a>
Accelerated foreign private issuers	Complete	<a href="http://www.sec.gov/rules/final/2006/33-8730a.pdf">http://www.sec.gov/rules/final/2006/33-8730a.pdf</a>
<b>2. Obtain feedback and implementation information:</b>		
SEC Advisory Committee on Smaller Public Companies	Complete	<a href="http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf">http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf</a>
GAO Report – Sarbanes-Oxley Act – Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies	Complete	<a href="http://www.gao.gov/new.items/d06361.pdf">http://www.gao.gov/new.items/d06361.pdf</a>
SEC Concept Release	Complete	<a href="http://www.sec.gov/rules/concept/2006/34-54122.pdf">http://www.sec.gov/rules/concept/2006/34-54122.pdf</a>
COSO Guidance for Smaller Public Companies	Complete	<a href="http://www.coso.org/Publications/SB_Executive_Summary.pdf">http://www.coso.org/Publications/SB_Executive_Summary.pdf</a> and <a href="http://www.coso.org/Publications/SB_FAQs.pdf">http://www.coso.org/Publications/SB_FAQs.pdf</a>
<b>3. Issue guidance on management assessment</b>		
	Proposal Issued	<a href="http://www.sec.gov/rules/final/2006/33-8762.pdf">http://www.sec.gov/rules/final/2006/33-8762.pdf</a>
<b>4. Work with PCAOB on revising AS 2</b>		
	Proposal Issued	<a href="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</a>
<b>5. Oversee the PCAOB inspection program</b>		
	In process	

to furnish proxy materials to shareholders through a “notice and access” model using the Internet. The approach would be the same as in the final rules discussed above except the approach would be mandatory for all matters except voting on business combination transactions.

The Release is available on the SEC’s website at: <http://www.sec.gov/rules/proposed/2007/34-55147.pdf>.

## **Foreign Private Issuer Deregistration**

### **(Release 34-55005)**

In December, the SEC repropoed rules to allow foreign private issuers to deregister and terminate their reporting obligations under the

Securities Exchange Act of 1934. The Commission was not satisfied with the deregistration model in Release 34-53020 as originally proposed in December 2005. The proposed deregistration model is based on a foreign private issuer’s average daily trading volume in the U.S. being no greater than 5% of its average daily trading volume in its primary market over a recent 12 month period.

The proposed rules would provide U.S. investors with access to material information about a deregistered foreign private issuer of equity securities through the Internet.

The Release is available on the SEC’s website at: <http://www.sec.gov/rules/proposed/2006/34-55005.pdf>.

## **Executive Compensation Disclosure**

### **(Release 33-8655)**

In August, the Commission excluded from the final executive compensation disclosure rules the narrative disclosures that it proposed in the so-called “Katie Couric clause.” This clause would have required disclosures for up to three non-executive employees whose total compensation is greater than any of the five named executive officers. Instead, the Commission repropoed modified disclosure requirements. The disclosures would be restricted to employees of large accelerated filers who have significant policy-making responsi-

bilities and are located at a principal operating unit or a significant subsidiary. The modified disclosure would exclude employees such as actors, athletes, and traders.

The Release is available on the SEC's website at: <http://www.sec.gov/rules/proposed/33-8655.pdf>.

## Staff Guidance

### SAB 108 - Quantifying Misstatements in Financial Statements

In September, the SEC staff outlined the approach it believes issuers should use to quantify the misstatement of current year financial statements that results from misstatements of prior year financial statements. The staff communicated its views in SAB No. 108 (Topic 1N). Implementing the approach outlined in SAB 108 may require an issuer to make significant adjustments in its 2006 annual financial statements. An issuer may also need to disclose the expected effect of applying SAB 108 in the interim financial statements it files before it implements the SAB 108 approach.

As discussed further below, the SAB will change practice by requiring issuers to use both of the approaches for quantifying misstatements that are currently used. The SAB requires issuers to adjust their financial statements if either approach results in a conclusion that an error is material. The staff recognizes that this combined approach represents a change in practice for many issuers. Consequently, the staff will not require issuers that followed an acceptable approach in the past to restate prior years' historical financial statements. Instead, these issuers can

report the cumulative effect of adopting the new approach as an adjustment to the current year's beginning balance of retained earnings. If the new approach is adopted in a quarter other than the first quarter, financial statements for prior interim periods within the year of adoption may need to be restated. SAB 108 is effective for fiscal years ending after November 15, 2006. Thus calendar year issuers are required to adopt the new approach in the year ending December 31, 2006.

#### Dual Approach

To evaluate whether financial statements are materially misstated, issuers and auditors typically follow a two-step process. They (1) identify and quantify misstatements that have not been corrected and (2) evaluate whether the effects of those misstatements are material. SAB No. 99 (Topic 1M), *Materiality*, provides guidance for performing the second step in the process. SAB 108 addresses the first step.

The SAB discusses the two approaches for quantifying errors most commonly used in practice:

- The "rollover" approach – Focuses on the income statement and quantifies an error as the amount by which the current year income statement is misstated. Because the rollover approach focuses on the income statement, consistent use of it may result in the accumulation of significant misstatements in the balance sheet; and
- The "iron curtain" approach – Focuses on the magnitude of the misstatement to the current balance sheet. If a prior year misstatement is corrected in the current year (e.g., the current period effect of a prior period cut-off error), this approach does not consider the current year finan-

cial statements to be misstated, because the current balance sheet is correct. Thus, this approach may not prevent significant misstatements in the income statement.

The staff believes that issuers should quantify the effects of all errors, including the effects of correcting prior misstatements, on each of the financial statements and related disclosures. To accomplish this objective, the staff advises issuers to quantify and evaluate errors using a "dual" approach that includes both an income statement *and* a balance sheet approach to quantifying misstatements. This means that an issuer that historically used the rollover approach must also consider whether correcting misstatements of the balance sheet that may have built up over many years are material to the income statement. It also means that if an issuer corrects an error in the current year that was immaterial in prior years and the effect of the correction is material to the current year, the issuer should restate its prior year financial statements. The staff notes in the SAB that since the error was immaterial in prior years, the issuer can restate prior year financial statements without amending previously filed reports (i.e., the issuer can restate prior years in its current filing). This approach is consistent with the staff's position on reporting accounting changes not retroactively applied due to immateriality (see SAB Topic 5F).

The staff views quantifying errors and assessing materiality as an accounting issue for which an issuer has primary responsibility. After the issuer has prepared materially correct financial statements, then the auditor must also quantify and eval-

uate errors identified in the process of the audit.

### Effective Date and Transition

*Existing Issuers* – SAB 108 is effective for fiscal years ending after November 15, 2006. Although restating prior years' financial statements is permitted, it is not required if management:

- Properly applied its previous assessment approach (iron curtain or rollover); and
- Considered all relevant *qualitative* factors in its assessment of previous errors.

These issuers can report the cumulative effect of adopting the SAB 108 approach as an adjustment to the opening balance of assets and liabilities, with an offsetting adjustment to the opening balance of retained earnings in the fiscal year of adoption. (For calendar year companies, the adjustment would be reported as of January 1, 2006.) Also, issuers are required to disclose:

- The nature and amount of each *individual* error being corrected in the cumulative effect adjustment;
- When and how each error being corrected arose; and
- The fact that the errors had previously been considered immaterial.

*Initial registrations (e.g., IPOs)* – The approach in SAB 108 must be applied if the registration statement is not effective on or before November 15, 2006. The transition approach is significantly different from the one existing issuers are permitted to use. If the effect of applying the SAB 108 approach is material, the issuer must restate the financial statements for all periods that are materially misstated in accordance with paragraph 25 of FASB Statement No. 154, *Accounting Changes and Error Corrections*.

SAB 108 is available on the SEC website at: <http://www.sec.gov/interps/account/sab108.pdf>.

See our December 2006 *Financial Reporting* letter, SAB 108 Implementation, at: <http://www.bdo.com/about/publications/assurance/FRLSAB108-12-06-3.pdf> and our September 2006 *Financial Reporting* letter, SEC Issues SAB No. 108 on Quantifying Misstatements in Financial Statements, at: <http://www.bdo.com/about/publications/assurance/FRLSAB108-9-06-3.pdf>.

## PCAOB Developments

During 2006, the PCAOB and its staff continued to focus on the implementation of AS 2. As noted above, the PCAOB action plan issued after the May roundtable included revising AS 2.

### Proposals

In December, the PCAOB voted to propose new auditing standards on:

- Internal control;
- Using the work of others;
- Independence and non-audit services; and
- Related amendments to interim standards.

The PCAOB proposed revisions with the objective of making the replacement of AS 2 more efficient. The revisions include:

- Focusing the audit on the most important controls using the top-down approach and emphasize risk assessment;
- Eliminating unnecessary procedures, including the requirement to evaluate management's process, permit consideration of knowledge obtained during previous audits, and remove barriers to using the work of others;

- Scaling the audit for smaller companies; and
- Simplifying requirements.

The proposing release on internal control is available on the PCAOB's website at: [http://www.pcaobus.org/Rules/Docket\\_021/index.aspx](http://www.pcaobus.org/Rules/Docket_021/index.aspx).

### Final Rules

AS No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* provides the structure for a new voluntary engagement in which auditors report on the elimination of a material weakness in a company's internal control over financial reporting. AS 4 was issued in response to management and user concerns about the need for a mechanism to provide assurance on management's assertion concerning the elimination of a material weakness. Such engagements are not required by the Sarbanes-Oxley Act of 2002 or other securities law and are voluntary.

This standard is available on the PCAOB's website at: [http://www.pcaobus.org/Rules/Rules\\_of\\_the\\_Board/Auditing\\_Standard\\_4.pdf](http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_4.pdf).

The PCAOB issued new rules relating to tax services, contingent fees, and certain general ethics independence standards. Under these rules, a registered public accounting firm is not independent of a publicly held audit client if:

- The accounting firm provides assistance in planning or providing tax advice on certain type of potentially abusive tax transactions to the client;
- Subject to certain exceptions, the accounting firm provides a tax service to a member of management of the client who serves in a financial reporting oversight role; or
- The accounting firm receives directly or indirectly a contingent fee or commission from the client

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for providing any service or product.

Also, the new rules require registered public accounting firms to provide certain information to audit committees in connection with pre-approval to provide tax services.

The rules are available on the PCAOB's website at: [http://www.pcaobus.org/Rules/Docket\\_017/index.aspx](http://www.pcaobus.org/Rules/Docket_017/index.aspx).

## Guidance

### Adjustment to Prior Period Financial Statements Audited by a Predecessor Auditor

The PCAOB issued a Staff Question and Answers document that provides the staff's opinions related to adjustments to prior period financial statements audited by a predecessor auditor. The staff offers guidance to both predecessor and successor auditors that audit and report on adjustments to the prior period audited by the predecessor auditor.

The guidance is available on the PCAOB's website at: [http://www.pcaobus.org/Standards/Staff\\_Questions\\_and\\_Answers/2006/QA\\_Adjustments.pdf](http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2006/QA_Adjustments.pdf).

### Matters Related to Timing and Accounting for Option Grants

The PCAOB staff announced that it would begin publishing Audit Practice Alerts (Alerts) on an as-needed basis. Alert No. 1, *Matters Related to Timing and Accounting for Option Grants*, was issued to discuss practices related to the timing of option grants and how these practices affect whether the grants in question were properly recorded or disclosed. The Alert discusses the implications of such practices on financial statement audits and audits of internal control over financial reporting, and it examines fac-

tors that may be relevant to auditors in assessing the risks related to these practices.

The guidance is available on the PCAOB's website at: [http://www.pcaobus.org/news\\_and\\_events/news/2006/07-28\\_release.pdf](http://www.pcaobus.org/news_and_events/news/2006/07-28_release.pdf).

### Auditing the Fair Value of Share Options

The PCAOB issued a Staff Question and Answers document that provides guidance for auditing the fair value of share options granted to employees. The guidance applies to the audit of share-based payments accounted for under Statement 123(R) and SAB No.107 (Topic 14), *Share-Based Payment*.

The guidance is available on the PCAOB's website at: [http://www.pcaobus.org/Standards/Staff\\_Questions\\_and\\_Answers/2006/Stock\\_Options.pdf](http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2006/Stock_Options.pdf).

### Implementation of Standards Relating to Fraud

The PCAOB issued a report that discusses auditors' implementation of interim standards regarding the auditor's responsibility with respect to fraud. The report addresses the following topics based on observations made during the Board's inspection process:

- Auditor's overall approach to the detection of financial fraud;
- Required brainstorming sessions and fraud-related inquiries;
- Auditor's response to fraud risk factors;
- Financial statement misstatements; and
- Fraud associated with management override of controls.

The report does not change or propose changes to any existing standards or provide new interpretations. The Board issued the report to provide information that audit committees may find useful in working with their auditors and to

focus auditors on being diligent about their responsibilities as they relate to fraud.

The report is available on the PCAOB's website at: [http://www.pcaobus.org/Inspections/Other/2007/01-22\\_Release\\_2007-001.pdf](http://www.pcaobus.org/Inspections/Other/2007/01-22_Release_2007-001.pdf).

## SEC's Advisory Committee on Smaller Public Companies

In April, the SEC's Advisory Committee on Smaller Public Companies finalized its recommendations on improving the regulatory system for smaller companies. The Committee was established by the SEC in December 2004, and its four subcommittees (internal control, accounting standards, corporate governance and disclosure, and capital formation) met several times in 2005 and early 2006.

The Committee's recommendations are targeted at the regulation of smaller public companies, defined as companies whose aggregate market capitalization comprises the bottom 6% of U.S. equity market capitalization (this equates to an equity market capitalization of below \$787 million). Some of the recommendations apply only to microcap companies, a subset of "smaller public companies" as defined above, which the Committee defines as companies whose aggregate market capitalization comprises the bottom 1% of U.S. equity market capitalization (this equates to an equity market capitalization of below \$128 million).

The Committee's final recommendations include the following:

### Internal Control Reporting

- Exempt microcap companies from all internal control reporting requirements if they have revenues of less than \$125 million.
- Exempt other smaller public companies from the outside audit requirements of Section 404 if they have revenues of less than \$250 million. (However smaller public companies would still be required to perform a self assessment and issue a management report on the effectiveness of internal controls.)
- In the event that the recommendation to exempt smaller public companies from the outside audit requirements is not adopted, then alternatively, develop a new auditing standard and approach based on auditor testing of only the design (not the effectiveness) of internal controls.

### Accounting Standards

- Reduce the number of years of financial statements smaller public companies must provide in SEC filings from three to two.
- Change the auditor independence rules to permit de minimis violations.

- Permit microcap companies to apply the same effective dates for adopting new accounting standards as the FASB provides for private companies.
- Consider additional guidance regarding materiality that would apply when correcting errors in previously issued financial statements.
- Develop a “safe harbor” protocol for accounting for transactions that would protect well-intentioned preparers from regulatory or legal action when the process is appropriately followed.

### Corporate Governance and Disclosure

- As a condition to the relief from internal control reporting, require (1) additional disclosure regarding internal controls and (2) additional audit committee corporate governance standards.
- Increase the thresholds requiring registration and permitting deregistration under Sections 12(g) and 15(d) of the Exchange Act of 1934.
- Allow smaller public companies to use Form S-3 and eliminate the timely filing requirements of Form S-3.

### Capital Formation

- Adopt a new private offering exemption that does not prohibit general solicitation and advertising for transactions with certain persons.
- Make it easier for microcap companies to go private.  
Information about the Committee's activities is available on the SEC's website at: <http://www.sec.gov/info/smallbus/acspc.shtml>.

### For Further Information

If you would like further information or to discuss the implications of these matters, please contact the BDO Seidman, LLP engagement partner serving you or one of the following partners:

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