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Heads Up

Audit and Enterprise Risk Services

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In This Issue:

This issue of *Heads Up* contains two topics:

PCAOB Issues Staff Guidance on Auditing Fair Value of Share Options Granted to Employees

FASB Statement No. 123(R), *Share-Based Payment* (revised 2004), requires many companies, for the first time, to recognize compensation expense for employee stock options on a fair value basis. Last week, the Public Company Accounting Oversight Board (PCAOB) issued a series of "staff questions and answers" (Q&As), effective upon issuance, to provide direction to CPAs who audit a public company's estimates of the fair value of employee stock options.

Editor's Note: Last July, the PCAOB issued Staff Audit Practice Alert No.1, *Matters Related to Timing and Accounting for Option Grants*.

Not intended to provide new guidance, the Q&As are limited to auditing the grant-date fair value of employee stock options associated with determining compensation cost (as opposed to auditing all types of share-based payments). According to Tom Ray, PCAOB Chief Auditor and Director of Professional Standards, "the staff questions and answers were developed to help auditors apply the existing auditing standards [AU Section 342, "Auditing Accounting Estimates," and AU Section 328, "Auditing Fair Value Measurements"] to this area appropriately and consistently."

General Audit Considerations

The Q&As provide specific guidance to assist auditors in performing certain audit procedures (listed in the Appendix). These include procedures related to (1) obtaining an understanding of the company's process to develop the estimate of fair value (e.g., procedures used by the company to obtain accurate and relevant data and develop appropriate assumptions) and (2) considering circumstances or conditions that might indicate increased risk of misstatements in the financial statements.

Accounts consisting of amounts derived from accounting estimates, such as compensation costs that are based on fair value measurements of employee share options, often have an increased risk of misstatement. The Q&As provide examples of certain circumstances or conditions that could indicate increased risk and might indicate a risk of fraud (e.g., situations in which adjustments are made to historical information that have the effect of reducing fair value).

Guidance Related to Assumptions Used in Option-Pricing Models

The Q&As provide specific guidance for auditors related to each of the six Statement 123(R) assumptions (see the Appendix) used in option pricing models. The guidance places particular emphasis on auditing the expected term and the expected volatility assumptions because these two assumptions require the most judgment and often have the largest impact on the fair value calculation.

> **Editor's Note:** A majority of companies use the Black-Scholes-Merton option-pricing formula to determine the fair value of the employee stock options. Typically, this model is inappropriate for certain complex stock options arrangements (e.g., an award that becomes exercisable based upon the achievement of a specified stock price). For complex arrangements, a lattice, or binomial, option-pricing model would often be more appropriate.

Guidance Related to the Role of Specialists

When understanding management's process for developing a fair value estimate, auditors also consider how management used a fair value specialist (internal or external). When specialists are involved, auditors will, among other things, evaluate the specialist's qualifications.

Appendix

Audit Procedures

The PCAOB staff questions and answers outline the steps that auditors generally perform when auditing the fair value of employee share options as follows:

- Obtain an understanding of the process used to develop the estimated fair value of employee share options.
- Assess the risk of misstatement related to the fair value of employee share options.
- Perform testing on the company's estimated value of employee share options. Testing includes:
  - Evaluating the consistency of the process,
  - Evaluating the reasonableness of (1) the company's model and (2) the assumptions used in the model, such as expected term and expected volatility, and
  - Verifying the accuracy and completeness of the data underlying the fair value measurements.

Statement 123(R) Assumptions

Statement 123(R) lists six assumptions that, at a minimum, are used in the option-pricing model. They include the following:

- Expected term of the option (in a lattice model, expected term is an output of the model).
- Expected volatility of the price of the underlying share for the expected term of the option.
- Exercise price of the option.
- Current price of the underlying share.
- Risk-free interest rate(s) for the expected term of the option.
- Expected dividends of the underlying share for the expected term of the option.

IRS Announces Initiative to Resolve Uncertain Tax Positions Prior to Entities' Adoption of Interpretation 48

To address certain implications of FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109," last week the IRS announced an initiative to expedite the resolution of uncertain tax positions taken or expected to be taken in tax returns. Interpretation 48 clarifies the accounting for uncertainty in income taxes and aims to increase comparability in financial reporting of income taxes.

According to Frank Ng (IRS Deputy Commissioner, Large and Mid-Size Business, International), the IRS is ready to work with taxpayers who request accelerated examination and resolution of outstanding audit issues before the new financial accounting rules take effect (see below). The IRS has issued instructions to the field that allow more leeway in resolving audit issues quickly, but it cautions that the IRS will not compromise with respect to compliance during this process. These instructions can be found on the Tax Information for Business page of the IRS Web site. While the IRS is showing greater flexibility, it also made clear that taxpayers would need to cooperate and act with transparency.

Enterprises must adopt Interpretation 48 at the beginning of their first fiscal year that begins after December 15, 2006. Therefore, for calendar-year enterprises, Interpretation 48 is effective at January 1, 2007. See Deloitte & Touche LLP's *Heads Up*, "Uncertainty in Income Taxes," issued July 14, 2006, for an in-depth description of the requirements of Interpretation 48.

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