

Heads Up

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SEC and PCAOB Update

by Deloitte & Touche LLP's Accounting Standards and Communications, Assurance Services, and SEC Services Groups

Introduction

While most of us were preparing for the holidays and the upcoming financial reporting season, the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) were busy issuing new and proposed guidance. In December, the SEC:

- **Proposed guidance** for management to consider in the evaluation of internal control over financial reporting.
- **Postponed the dates** by which non-accelerated filers and newly public companies must comply with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404").
- **Amended the executive and director compensation disclosures** to more closely align them with the requirements of FASB Statement No. 123(R), *Share-Based Payment*.

In the same month, the PCAOB issued the following **proposed guidance**:

- A proposed auditing standard on auditing internal control over financial reporting, which would replace PCAOB Auditing Standard No. 2 ("AS2").¹
- A proposed auditing standard on auditors' considerations regarding using the work of others in an audit.
- Proposed Rule 3525, Audit Committee Pre-approval of Services Related to Internal Control.
- Proposed amendments to its interim auditing standards

The proposals outlined above from the SEC and PCAOB were highly anticipated in light of the questions and concerns many constituents have raised about Section 404. However, we do not yet know when the provisions of these proposals, if adopted, would be effective. Read on for more details on this important new guidance.

¹ The proposed standard and AS2 are entitled, respectively, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* and *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*.

SEC's Management Guidance on the Assessment of Internal Control

In June 2003, the SEC adopted rules requiring that, over time, each annual report of a registrant, other than a registered investment company, contain (1) a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and (2) management's assessment, as of the end of the company's fiscal year, of the effectiveness of the company's internal controls and procedures for financial reporting. The SEC did not, however, provide any implementation guidance for management to consider in performing its evaluations. The proposed guidance was developed to make a company's annual assessment of internal control over financial reporting more efficient without compromising the effectiveness of the process.

According to SEC Chairman Christopher Cox, "[w]ith this guidance, management will be able to scale and tailor their evaluation procedures to fit their facts and circumstances, and investors will benefit from reduced compliance costs." At the same time, according to John W. White, Director of the SEC's Division of Corporation Finance, "the guidance maintains the important investor protection objectives of bringing information about material weaknesses into public view and fostering the preparation of reliable financial statements in an effective and efficient manner."

A Principles-Based Approach

The SEC emphasized that its top-down, risk-based proposal for management is intended to be scalable and flexible. The proposed guidance focuses companies on (1) controls necessary for the prevention or detection of material misstatements in the financial statements and (2) performing their evaluation procedures in accordance with a risk-based approach (i.e., the nature and extent of testing and documentation should coincide with the level of risk).

The principles-based approach emphasizes the use of judgment and provides additional guidance in the following four areas.

Identifying risks and controls to address those risks

Identifying an entity's financial reporting risks should involve management's determination of company-specific risks (both internal and external) concerning reliable financial reporting and whether controls are in place to mitigate such risks. The objective should be to identify only the controls needed to adequately address the risk of material misstatements, including entity level controls. Therefore, while controls such as "tone at the top" don't directly address the risk of material misstatement, such controls should still be considered in the assessment.

Evaluating the operating effectiveness of controls

Evaluating the operating effectiveness of controls should focus on controls necessary to adequately address the risk of material misstatement. Control deficiencies identified should be evaluated based upon both qualitative and quantitative factors surrounding the deficiency. The evaluation must consider whether a material misstatement could have occurred (as opposed to whether a material misstatement actually occurred). Management should consider compensating controls in its evaluation of whether a deficiency is a material weakness.

Reporting on the overall results of management's evaluation

When reporting on the overall results of its evaluation, management must indicate whether identified control deficiencies are material weaknesses. The presence of a material weakness would preclude a company from stating that its controls are effective. In addition, material weaknesses must be disclosed in management's annual assessment report. If a control deficiency is deemed to be a material weakness, management should not state that the internal controls over financial reporting are effective "except for" the material weakness.

Documenting

Management should document reasonable support for its assessment of controls deemed adequate to address the risk of material misstatements. The evidence required to support an individual control should correlate to the risk of material misstatement (i.e., as risk of material misstatement or risk of control failure rise, so too should the amount of evidence required to substantiate the effectiveness of the control). Thus, controls surrounding estimates, fraud risks, or relating to complex accounting transactions should be assessed at a greater than normal amount of risk and, therefore, will require greater evidence to support their effectiveness.

Associated Amendments

The SEC is seeking public comment on two related proposals in addition to the proposed interpretive guidance for management:

1. Amendments to Rules 13a-15(c) and 15d-15(c) of the Securities and Exchange Act of 1934 ("Exchange Act") to clarify that a company performing its internal control evaluation in accordance with the interpretive guidance would satisfy the requirements of management's assessment. However, the SEC explicitly stated that management need not follow the interpretive guidance, but could develop and use other methods that achieve the objectives of the Commission's internal control requirements.
2. Amendments to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to indicate that an auditor should express only a single opinion on the effectiveness of internal control over financial reporting. Under the current rules and auditing standard, the auditor opines both on management's assessment and the effectiveness of controls.

Comment Period

Want to provide feedback to the SEC on the proposal? Comments, due by February 26, may be submitted to the SEC through the internet, email, or mail. See the [SEC's Web site](#) for comment submission instructions.

Section 404 Relief for Non-Accelerated Filers and Newly Public Companies

The SEC also announced adoption of an August 2006 proposal to further extend the dates by which non-accelerated filers and companies that are new to Exchange Act reporting must comply with the requirements of Section 404. Smaller public companies (i.e., companies not meeting the Exchange Act definition of either an accelerated filer or a large accelerated filer) must provide management's assessment of internal control over financial reporting in their annual reports for fiscal years ending on or after December 15, 2007. An audit attestation of such assessments will not be required, however, until their annual reports are filed for fiscal years ending on or after Dec. 15, 2008.

These extensions will allow smaller companies and their auditors time to consider the anticipated effects of the proposed standards as well as to prepare for expected implementation guidance from the PCAOB for auditors of smaller companies. Companies that are new to Exchange Act reporting will not be required to comply with Section 404 requirements in the first annual report they file after becoming an Exchange Act reporting company.

The table that follows summarizes the revised effective dates of Section 404:

Revised Compliance Dates and Final Rules Regarding the Internal Control Over Financial Reporting Requirements			
	Accelerated Filer Status	Management's Report	Auditor's Attestation
U.S. Issuer	Large Accelerated Filer OR Accelerated Filer (\$75M or more)	Already complying (annual reports for fiscal years ending on or after November 15, 2004)	Already complying (annual reports for fiscal years ending on or after November 15, 2004)
	Non-accelerated Filer (less than \$75M)	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
Foreign Issuer	Large Accelerated Filer (\$700M or more)	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2006
	Accelerated Filer (\$75M or more and less than \$700M)	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2007
	Non-accelerated Filer (less than \$75M)	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
U.S. or Foreign Issuer	Newly Public Company	Second Annual Report	Second Annual Report

SEC Amendments to Executive Compensation Disclosures

Calendar year-end companies take note. The SEC has amended the executive compensation and disclosure rules that are effective for 2006 Form 10-Ks (see Deloitte & Touche LLP's August 21, 2006, [Heads Up](#) for more information) and registration/proxy statements filed after December 15, 2006.² The amendments change the amount of compensation for stock option grants reported in the primary disclosure tables (the Summary Compensation Table for executive officers and the Director Compensation table for directors).

Why the change? In contrast to the original disclosures, which required the tables to reflect the full grant date fair value of the awards, the amendments more closely align the disclosures to the expense recorded in the financial statements under Statement 123(R).³ Therefore, the amendments will have the effect of minimizing swings in total compensation — so that the identification of the named executive officers will be more consistent from year to year, facilitating the investor's ability to track their compensation.

There are many differences between the full grant date fair value of an award and the current-year Statement 123(R) expense. The following are some highly simplified examples:

- Under Statement 123(R), the grant date fair value is recognized over the requisite service period. That is, if a named executive is granted an award on January 1, 2006, with a grant date fair value of \$100 that cliff-vests at the end of five years, under Statement 123(R), each year \$20 will be recognized as compensation expense.⁴ Under the original disclosures, \$100 would have been disclosed as compensation in 2006 and \$0 would have been disclosed in the following four years. Under the amended disclosures, \$20 will be disclosed as compensation in each of the five years beginning in 2006, "matching" the income statement.
- Performance-based awards would have been reported as compensation in the original rules even if the performance criteria were not probable of being met. Under the amended rules, compensation is disclosed only if the performance condition is probable of being met in accordance with Statement 123(R).

² The disclosures must be provided in Forms 10-K and 10-KSB for fiscal years ending after December 15, 2006, and in proxy statements, information statements, and registration statements filed after December 15, 2006.

³ The modified prospective transition method must be used for disclosure purposes regardless of the method used in the financial statements.

⁴ Ignoring the effect of forfeitures and taxes.

The amended disclosure is not identical to the income statement expense calculated under Statement 123(R) because Statement 123(R) requires the company to estimate forfeitures in calculating the grant date fair value and to update these estimates each period. The amended rules assume that the executive officer will perform the requisite service to vest in the award and therefore do not allow an estimate of forfeitures. Forfeitures are required to be described in the accompanying footnotes. Also, compensation disclosed in the Summary Compensation Table will include both the amounts included in the income statement as well as any amounts that have been capitalized in the balance sheet for the fiscal year.

Under the amendments, the full grant date fair value of awards is still disclosed — it is moved from the Summary Compensation Table to the Grants of Plan-Based Awards Table. Also to be disclosed in that table, according to the amendment, is the incremental fair value of any option or stock appreciation right that was repriced or modified during the fiscal year. Since there is no “Grants of Plan-Based Awards Table” for Directors, the Director Compensation table is amended to require footnote disclosure of both the full grant date fair value of awards as well as any incremental fair value related to repricings or modifications.

The Commission has adopted the amendments as interim final rules, meaning that although the rules are final upon publication in the Federal Register (expected shortly), the SEC is interested in receiving comments, which it will accept for consideration until January 28, 2007, and will make any amendments if necessary.

PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements*

Over the past two years, implementing the requirements set forth in Section 404 has yielded two key benefits: (1) companies are more focused on improving corporate governance and internal processes and controls and (2) the quality of financial information for investors has improved. However, the implementation has been more costly than many expected. In response to concerns associated with the cost of Section 404, the PCAOB is proposing to replace AS2, which was the original PCAOB pronouncement that provided auditors with professional standards on how to conduct an audit of internal control over financial reporting. According to PCAOB Chairmain Mark Olson:

Today's proposal is the result of the PCAOB's experience with the first two years of auditors' implementation of the internal control provisions of the Sarbanes-Oxley Act. The Board's goal has been to apply the feedback we've received and our observations of implementation to create an auditing standard that preserves the intended benefits without resulting in unnecessary effort and costs. We believe the new standard will result in audits that are more efficient, risk-based and scaled to the size and complexity of each company. We look forward to comments on the proposal.

Designed to be more principles based, the proposed standard seeks to achieve the following four objectives:

- Focus the audit on the matters most important to internal control.
- Eliminate unnecessary procedures.
- Scale the audit for smaller companies.
- Simplify the requirements.

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