

## SFAS 157 – FAIR VALUE MEASUREMENTS

SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements.

As defined in the Statement, fair value is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” The Statement also clarifies several key points in the definition of fair value including the price, the principal market and the market participants.

The framework introduced by the Statement discusses a number of key concepts including unit of account, exit price, the valuation premise, highest and best use, principal market, market participant assumptions, and the fair value hierarchy, which form the foundation of the fair value measurement approach to be utilized for financial reporting purposes.

Statement 157 requires expanded disclosures about fair value measurements that are designed to provide users of financial statements with additional transparency regarding the extent to which fair value is used to measure assets and liabilities, the inputs and assumptions used in measuring fair value, and the effect of fair value measurements on earnings.

SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007,

and interim periods within those fiscal years. The effective date is deferred for one year for all nonfinancial assets and nonfinancial liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

The following are examples of items for which this Statement is deferred:

- ▶ Nonfinancial assets and nonfinancial liabilities measured at fair value in a business combination. These are not measured at fair value in subsequent periods and therefore are nonrecurring fair value measurements.
- ▶ Reporting units measured at fair value in Step 1 or Step 2 of a goodwill impairment test.
- ▶ Indefinite-lived intangible assets.
- ▶ Long-lived assets measured at fair value in a Step 2 impairment test under SFAS 144.
- ▶ Asset retirement obligations measured at fair value at initial recognition but not in subsequent periods.
- ▶ Liabilities for exit or disposal activities that are initially measured at fair value but are not measured at fair value in subsequent periods.

## DETERMINING THE STOCK OPTION GRANT DATE

Numerous issuer restatements speak to the critical nature of stock option dating. Many of these restatements have occurred to correct errors related to the determination of the measurement date for share-based awards under the Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Many of the issues surrounding the determination of the grant date are equivalent, or even more stringent, under SFAS 123(R), *Share-Based Payment*.

The definition of the grant date of an award under SFAS 123(R) has several aspects:

- ▶ The employer and employee have reached a mutual understanding of the terms and conditions of the award.
- ▶ The awards that are subject to approval are not deemed granted until approval is obtained, unless the approval is essentially a formality.
- ▶ The grant date is the date that an employee begins to benefit from, or be adversely affected by changes in the price of the employer's shares.

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## DETERMINING THE STOCK OPTION GRANT DATE

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Errors can result from poorly controlled granting policies as well as a lack of understanding of stock based compensation accounting literature. The most common errors in measuring the grant date of share-based awards resulting in restatements are summarized as follows:

- ▶ **Grants of “pools” of awards.** Sometimes, a pool of awards may be authorized or approved without the allocation being made to the individual employees. The grant date is not known until grants to individuals, including the relevant terms, are known.
- ▶ **Failure to obtain and document approvals.** It is essential to obtain and document all required approvals prior to recognition of the grant date.
- ▶ **Measurement before employment begins.** This error occurs frequently on the date an offer letter is mailed or an employee accepts an offer. Measurement at either of these dates would be an incorrect measurement of compensation cost of an award.
- ▶ **Automatic grants to directors.** Sometimes, these grants are incorrectly measured on dates other than those specifically identified in the pre-approved plan.
- ▶ **Modifications of awards.** Employee terminations with severance pay or leaves of absence can sometimes create a modification of an award as the employee is no longer providing service to the company.
- ▶ **Inconsistent practices for determining the share price on the measurement date.** A consistent measurement of opening price, average price or closing price, etc. should be used.
- ▶ **Communication of the award to the employee.** Employers are allowed to measure awards on the approval date and before communication to employees if the certain conditions are met; however, the award must be communicated to the employee within a relatively short time period.

It is essential that the stock option grant date be determined accurately so that the options can be valued and recorded properly in the Employer’s financial statements.

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## AUDIT COMMITTEE RESPONSIBILITIES

Audit committees of public companies have responsibilities as required by Sarbanes-Oxley and the stock exchanges as well as disclosures required by the SEC. Best practices, however, reflect expanded responsibilities beyond those that are required. General responsibilities, including best practices, can be grouped into the following categories:

- ▶ Oversight of the financial reporting process to include a review of annual and quarterly financial statements as well as disclosure of Management Discussion and Analysis (MD&A) with management and the external auditors; a review of earnings press releases is also included in this category
- ▶ Monitoring the choice of accounting policies and principles including discussions with the external auditors regarding the quality of the accounting principles applied by management
- ▶ Monitoring the system of internal control including compliance with legal and regulatory requirements, monitoring risk assessment, oversight of compliance with the code of ethics, oversight of the internal auditors and approval of all related party transactions
- ▶ Openly communicating with management, the external auditors and the internal auditors
- ▶ Hiring and monitoring the performance of the external auditors including pre-approval of audit and non-audit fees, oversight of auditor independence, ensuring auditor qualifications, discussing matters required by Generally Accepted Auditing Standards (GAAS), reviewing the scope of the audit as well as the plan and results; the resolution of disagreements between the external auditors and management is also included in this category

The Sarbanes-Oxley Act requires that all audit committee members be independent and that one member have accounting or financial management expertise. It also requires that the audit committee have the authority and funding to use outside experts to investigate various matters.

Audit committees are accountable to the shareholders they represent and must disclose the responsibilities that they have assumed including whether or not those responsibilities have been carried out.

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# PRIVATE COMPANY RISK ASSESSMENT STANDARDS – CHANGES TO THE FISCAL 2007 AUDIT PROCESS

In February of 2006, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) issued eight new Statements on Auditing Standards (SAs) collectively referred to as the Risk Assessment Standards. These new Risk Assessment Standards were developed to fill in gaps in widely used audit methodologies such as the “balance sheet” approach. For more than twenty-five years, auditors have utilized the “balance sheet” approach to perform successful audits which included a thorough testing of all material balance sheet accounts and an analytical review and other specific procedures related to the statement of operations. Additionally, auditors gained an understanding of the business and the control environment and major cycles. Although this method was effective, the perception was that it often led to “cookie cutter” audits and disjointed audit documentation files and potentially did not sufficiently modify audit procedures based on the financial controls at specific companies. To remedy this, the ASB issued the new Risk Assessment Standards which are effective for audits of financial statements for periods beginning after December 15, 2006. This means that all privately-held businesses will be subject to a process that will include an emphasis on reviewing financial controls for all fiscal year 2007 audits.

## **Objectives of the New Risk Assessment Standards.**

The ASB designed the new Risk Assessment Standards with the following three objectives in mind.

- (1) For auditors to obtain a more in depth understanding of the audited entity and its environment, including internal control;
- (2) For auditors to perform a more rigorous assessment of the risks of where and how financial statements could be materially misstated;
- (3) For improved linkage (and better documentation of this linkage) between the auditor's assessed risk and the nature, timing and extent of audit procedures performed in response to identified risks.

The standards, which have succeeded in improving the fundamental building blocks of the audit process, also introduce an audit methodology that differs in subtle, yet significant ways from the audit methodology used by a majority of audit firms.

**A Better Understanding of the Entity.** Auditors are already required to obtain an understanding of the audited entity, so what does the ASB mean by “a more in-depth understanding?” Essentially, auditors are now required to increase the breadth (i.e. what they know) and depth (i.e. how well they know it) of their understanding of the audited entity. For example, while performing the new audit method-

ology, an auditor should obtain detailed information concerning the entity's capital structure, ownership and governance as well as how certain industry practices and/or government regulations will affect the organization.

**A Better Understanding of Internal Control.** Arguably, the most significant change brought about by the new standards is the auditor's requirement to understand their client's internal control environment. In the past, auditors invested a limited amount of time on internal controls. This was due to the fact that very few audit firms placed any reliance on an audited entity's internal controls. This allowed firms to assess control risk at “maximum” and, therefore, perform the audit relying primarily on substantive procedures. Internal control memos in most audit files usually focused on process flow (i.e. how sales are recorded, billed and subsequently collected) and allocated limited time to addressing the controls over each process. Under the new Risk Assessment Standards, auditors are no longer allowed to default to maximum control risk. If an auditor believes control risk for their client should be assessed at maximum, they must now document their justification for this assessment.

In addition, under the new standards, an auditor must now obtain an understanding of each company's entity level controls (i.e. management's control over the entity as a whole) as well as their activity level controls (specific controls over revenue/receivables, purchases/payables, inventory/cost of sales, etc). Each auditor must obtain a sufficient understanding of controls to be able to determine if each control is properly designed and appropriately implemented. How will this information be obtained? The new standards give three options: (1) inquiry, (2) observation and (3) re-performance. Inquiry alone, however, is no longer sufficient. No longer will an auditor simply ask management about topics such as their attitude towards financial reporting, their operating philosophy or their commitment to competence. Auditors are now required to corroborate management's responses by either observation or re-performance.

**A More Rigorous Assessment of the Risk of Material Misstatement.** Under the new standards, the planning meeting has been emphasized and because of the new risk assessment standards is one of the most important steps in the new audit methodology and is a high priority for all team members.

As the audit team increases the breadth and depth of their understanding of the audited entity and its internal control environment, the audit team then uses this information to make a better determination of where the risks of material misstatements are most

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## PRIVATE COMPANY RISK ASSESSMENT STANDARDS

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likely to reside. While each team member is gathering information about the entity's environment, conducting interviews with personnel about the process and controls over significant cycles, and observing or re-performing certain key controls, they must also be on the lookout for "what could go wrong."

The new standards assume that if the process of gathering information about an entity's environment and internal controls over key cycles is done to the extent now required, then the audit team will be better equipped to assess the areas of highest risk for each entity. It is during the planning meeting that the audit team synthesizes their information and assesses the areas of highest risk.

**Improved Linkage Between Assessed Risk and Audit Procedures Performed.** Finally, after the audit team has successfully determined "what could go wrong" and assessed risk, the last step in the process is to determine exactly what audit procedures will be performed in response to all identified risks. Traditionally, most audit firms have used pre-packaged audit programs with few, if any, modifications. If an audit program step was not considered necessary, it was not typically removed from the program. Instead, it was annotated as "not considered necessary" or "not applicable" and there was rarely a clear link between why certain audit procedures were performed or were not performed. Now, under the new standards, there is a direct and well documented link between assessed risk and the audit procedures performed.

### **Noticeable Changes to the Fiscal 2007 Audit Process.**

What changes will be most noticeable to privately-held companies during their upcoming fiscal 2007 audit? First and foremost, their auditor will appear to be more curious about their business. Although most firms have a good understanding of each of their clients, the new standards require auditors to more thoroughly and systematically document information about a wide range of topics that affect the entity's environment. As a result, many clients will probably spend a significant amount of time with their auditors discussing items such as management's philosophy and operating style, how current economic conditions are affecting the entity and whether or not the entity plans to implement any significant new marketing programs during the next year.

Secondly, auditors will be asking more detailed and specific questions about processes and internal controls over significant accounting cycles. Fortunately, these new standards do not require auditors to test controls over every accounting cycle. But, for those cycles that are deemed to be significant, clients should expect to discuss them in detail with their auditor. It is also possible that their auditor will test certain controls over those cycles.

Finally, each client can expect an auditor who better understands the unique aspects of their business.

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## SEC ISSUES FINAL RULES ON MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The SEC has issued final interpretive guidance on management's evaluation of internal control over financial reporting under Section 404(a) of the Sarbanes-Oxley Act of 2002. The guidance focuses on two principles: (1) management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner; and (2) management's evaluation of evidence about the operation of its controls should be based on its assessment of risk.

The SEC also amended two rules as follows: (1) the term material weakness is defined in the final rule as "a deficiency, or a combination of deficiencies, in

ICFR such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis;" and (2) the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting were revised to more clearly convey that the auditor is not evaluating management's assessment process but is opining directly on internal control over financial reporting.

This interpretive guidance was effective on June 27, 2007, and the final rule amendments were effective on August 27, 2007.

## SEC ADOPTS RULE AMENDMENTS FOR SMALLER REPORTING COMPANIES

The SEC has adopted several amendments aimed at providing regulatory relief to smaller reporting companies.

### SMALLER REPORTING COMPANY REGULATORY RELIEF AND SIMPLIFICATION

The category of “small business issuers” (registrants with public float of less than \$25 million) will be expanded to provide reporting and disclosure relief to a new category of issuers, the “smaller reporting company.” Smaller reporting companies with public float of less than \$75 million can use the reduced disclosure and reporting requirements of Regulation S-B, which will be integrated into Regulation S-K. The final rule also eliminates the five current small business forms 10-KSB, 10-QSB, SB-1, SB-2 and 10-SB.

The result of this amendment will be to combine the existing categories of “small business issuers and “nonaccelerated filers.” The SEC estimates that approximately 1,600 companies will be eligible for reduced disclosure under this amendment. After the effective date of February 4, 2008, companies currently qualifying as “small business issuers” under Regulation S-B have the option to file their next annual report for a fiscal year ending on or after December 15, 2007, on either Form 10-KSB or on Form 10-K using the new scaled disclosure requirements. After that annual report, issuers will be required to file quarterly reports on Form 10-Q and annual reports on Form 10-K, and may elect to comply with the new scaled disclosure requirements of Regulation S-K.

### REVISIONS TO SECURITIES ACT RULES 144 AND 145

The revisions to Rules 144 and 145 include, among others, a shortened holding period for the resale of restricted securities from one year to six months, if the issuer of the securities is subject to the Securities Exchange Act of 1934. The revisions also raise the filing threshold for Rule 144 sales by affiliates from the current threshold of 500 shares or \$10,000 to 5,000 shares or \$50,000. The purpose of these revisions is to reduce the cost of capital and increase access to capital for smaller reporting companies. These amendments are effective February 15, 2008.

### EXEMPTION OF COMPENSATORY EMPLOYEE STOCK OPTIONS FROM REGISTRATION UNDER SECTION 12(G) OF THE EXCHANGE ACT

The amendments became effective December 7, 2007, and serve to:

- (1) exempt a private company from having to register compensatory employee stock options using Form 10 just because it has more than 500 option holders, provided it meets certain conditions; and
- (2) exempt issuers from registration for compensatory stock options. These exemptions apply only to compensatory stock options and will not extend to the class of securities underlying those options.

## NEW REQUIREMENTS FOR AVAILABILITY OF PROXY MATERIALS

The SEC has adopted a final rule requiring issuers to make their proxy materials available on the Internet, except in connection with a proposed business combination. Issuers must provide notice to their shareholders that the proxy materials are available on the Internet and explain how to access those materials. An issuer may select from two delivery options to provide proxy materials to shareholders.

- (1) **Notice Only Option.** The “notice only option” occurs when the issuer posts proxy materials on the Internet and sends notice to shareholders informing them of availability at least forty (40) days before the shareholders meeting. Under this option, the issuer must respond to shareholder requests for paper or e-mail copies of proxy materials.
- (2) **Full Set Delivery.** The “full set delivery” option occurs when the issuer delivers a full set of proxy materials to shareholders along with the notice.

It is important to note that issuers are not required to choose the same delivery option for all shareholders. The effective date of this requirement is January 1, 2008, for proxy materials issued for large, accelerated filers and January 1, 2009, for all other issuers.

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▶ **KBA's RISK ADVISORY SERVICES**  
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For more information about these services, or any of KBA Group's service offerings, contact:

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Founded in 1982, KBA Group LLP is one of the top ten certified public accounting firms in the Dallas/Fort Worth Metroplex, and the third-largest locally-based firm. The Firm's professionals provide audit, tax, risk advisory and other valued-added services to emerging growth and middle market public and private companies, in a variety of industries.

KBA professionals have significant experience dealing with audit, accounting and public filing issues related to public companies. We routinely perform Form 10-K and 10-KSB audits as well as Form 10-Q and 10-QSB reviews. We regularly participate in registration statement and Form 8-K filings, and have taken a number of companies public. Our audit methodology brings a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. This enhances our ability to deal with audit/accounting issues related to our private company clients as well. KBA's audit professionals possess the depth of experience required to handle clients with complex accounting issues and transactions, or simply complete the necessary SEC regulatory filings in an efficient manner.

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The Firm's other value added services include, but are not limited to the following: transaction advisory, business services, profit enhancement, SBIC regulatory consulting & compliance, and family owned business services.

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