January 2006

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Accountants and Consultants

Financial Reporting

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SEC Year in Review

Significant 2005 Developments

In 2005, the Securities and Exchange Commission focused much of its attention on evaluating the results of issuers' and auditors' efforts to implement the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act. For the first time, accelerated filers and their auditors were required to report on the effectiveness of internal controls in their 2004 annual reports. Everyone involved in the process – management, auditors, the SEC and the Public Company Accounting Oversight Board – agreed that the first experience was difficult and costly, requiring more resources, people, and time than expected.

In April, the SEC held a public roundtable to obtain feedback on the first year of Section 404 implementation from many interested parties, including directors and officers of public companies as well as investors and auditors. Based on this feedback, the Commission, the PCAOB, and their staffs issued statements and guidance that address commonly encountered issues. They encourage a top-down, risk-based approach in planning, testing and evaluating controls and highlight the need for professional judgment in determining the nature, timing, and extent of testing and in evaluating deficiencies. They also encourage open dialogue between companies and auditors concerning internal control and accounting matters.

The Commission is particularly concerned about the costs and other difficulties that smaller companies and foreign companies face in preparing to implement Section 404. As a result, in March the Commission deferred the implementation date for non-accelerated filers and foreign private issuers for

a year – to 2006. As the year progressed, the SEC's Advisory Committee on Smaller Public Companies began its work and focused on this problem. Based largely on the Committee's recommendations to date, the SEC has already provided relief to smaller public companies in two ways. First, in September the Commission delayed for an additional year the requirement for domestic and foreign non-accelerated filers to report on internal control (to years ending on or after July 15, 2007). Second, in December the SEC modified the accelerated filer definition and filing due dates. The Commission created a new category of filers called "large accelerated filers," delayed or eliminated the final phase-in of accelerated filing requirements, and also made it easier for companies to exit accelerated filer status when they have subsequently decreased in size.

The Commission also completed a number of rulemaking initiatives in 2005. In June, it completed a multi-year effort to reform the securities offering process under the Securities Act. The new rules also change certain disclosure requirements in periodic reports filed under the Exchange Act. The Commission's staff has since issued two frequently asked questions documents that address a number of transition and interpretation issues.

Beginning in 2005, companies incorporated under the laws of a European Union member country, and whose securities are publicly traded within the EU, were generally required for the first time to prepare their consolidated financial statements under International Financial Reporting Standards. The Commission adopted rules that provide relief to these issuers by allowing them to provide two years of audited financial statements in the year in which they implement IFRS instead of the generally required three years.

During 2005 the Commission also completed other rulemaking and initiatives that had been proposed or started during 2004. It adopted rules designed to strengthen the registration and reporting requirements for shell companies and rules to establish a voluntary program to furnish tagged data using eXtensible Business Reporting Language in Commission filings. The Commission also followed through on its 2004 initiative to begin making staff comment letters and registrant responses publicly available on its website.

The Commission and its staff devoted significant attention to the implementation of Financial Accounting Standards Board Statement 123(R), *Share Based Payment*. Many companies faced the prospect of adopting Statement 123(R) during the third quarter of 2005. This raised concerns that implementing Statement 123(R) in a period other than the first quarter of a fiscal year could make compliance more complicated and comparisons of quarterly reports more difficult. In response to these concerns and to provide registrants with more time to develop the necessary internal controls, the Commission adopted rules that for many companies delayed the implementation date of Statement 123(R) to the first quarter of 2006. The Commission's staff also issued guidance on implementing Statement 123(R) in the form of Staff Accounting Bulletin 107.

In June, the Commission's staff reported the results of a major study of accounting for off-balance sheet arrangements, which was required by the Sarbanes-Oxley Act. The staff studied issuers' filings to determine the extent of off-balance sheet arrangements and whether current accounting standards result in financial statements that reflect the economics of such transactions in a transparent fashion. The staff took a broad view of the term "off-balance sheet" and addressed many topics besides special purpose entities, including investments in the equity of other entities, transfers of financial assets (where there is continuing involvement), certain retirement arrangements, leases, contingent obligations and guarantees, derivatives, and other contractual obligations.

The staff concluded that transparency in reporting has improved since the Sarbanes-Oxley Act was enacted, but there is still considerable room for improvement. The report identified several key initiatives to improve transparency in reporting, including: (1) discourage transactions and transaction structures primarily motivated by accounting and reporting concerns, rather than economics, (2) expand the use of objectives-oriented accounting standards, (3) improve the consistency and relevance of disclosures that supplement the basic financial statements, and (4) communicate financial information more effectively to investors. The staff also recommended specific changes to accounting and reporting standards to improve transparency in financial statements, including: (1) reconsider accounting and reporting standards for leases and defined benefit retirement plans, (2) continue work on consolidation policy, (3) continue to explore the feasibility of reporting all financial instruments at fair value, and (4) develop a disclosure framework that sets forth the objec-

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tives to be used in financial statement disclosures. The report is available on the SEC's website (*http://www.sec.gov/news/studies/soxoffbalancerpt.pdf*).

Of particular importance was the fact that the report identified reducing the complexity of accounting standards and financial reporting requirements as a method of increasing the transparency and understandability of financial statements. This focused regulators and standards setters on this issue, and as 2005 drew to a close, reducing the complexity of accounting standards and financial reporting took a prominent place on the priority list of the Commission, its senior staff, and the FASB, with FASB Chairman Robert Herz terming it no less than an issue of "national importance." It seems clear that this issue will continue to receive a great deal of attention in the years to come.

Both the SEC and the PCAOB experienced leadership changes. At the SEC, William Donaldson stepped down as Chairman and was replaced by Christopher Cox in August. Donald Nicolaisen, Chief Accountant, left the SEC in the fall, and Allan Beller, Director of the Division of Corporation Finance, will leave in early 2006. Replacements have not been named. At the PCAOB, Bill Gradison was named acting Chairman in December. He replaces William McDonough, who retired in November. The PCAOB also named a new Chief Auditor, Thomas Ray. Mr. Ray replaces Douglas Carmichael, who resigned effective in January 2006.

Looking forward to 2006, the Commission can be expected to continue to focus on the implementation of internal control reporting, particularly for smaller public companies. The Committee of Sponsoring Organizations of the Treadway Commission is scheduled to issue implementation guidance for smaller companies. In addition, the Advisory Committee on Smaller Public Companies is scheduled to present its recommendations to the Commission in April. In December 2005, the Committee preliminarily decided to recommend eliminating the external audit requirement related to internal control over financial reporting for smaller public companies (management's assessment would still be required) and exempting the smallest public companies from internal control reporting altogether.

Other areas of focus that are high on Chairman Cox's agenda are improving executive compensation disclosure and using technology to improve the usefulness of financial information to investors. In January 2006, the Commission proposed rules to give shareholders more information – in plain English – on executive compensation. The rules would require improved narratives and more details about stock options, perquisites and severance and retirement packages. If adopted, the changes would be the most significant in 14 years in the rules covering what issuers must disclose about how much top executives and directors are paid. The proposal is available on the SEC's website (*http://www.sec.gov/rules/proposed/33-8655.pdf*). The Commission hopes to expand participation in the voluntary program to provide tagged data referred to above and in January 2006 offered expedited filing reviews to registrants that volunteer to participate.

The Commission and its staff will also be reviewing the implementation of IFRS. They will be evaluating the consistency in the manner in which the standards are applied as well as the transparency and overall effectiveness of IFRS. This will be the beginning of an effort to evaluate whether the Commission might be able to eliminate the currently required reconciliation from IFRS to U.S. GAAP by the end of this decade. Former Chief Accountant Donald Nicolaisen provided his views on the convergence of IFRS and U.S. GAAP and possibility of eliminating the reconciliation requirement in an article that is available on the Commission's website (*http://www.sec.gov/news/speech/spch040605dtn.htm*).

The staff has been working for over a year on a project to develop guidance on evaluating the materiality of errors in financial statements. The goal is to get all registrants to do so in a consistent and appropriate manner. If the staff completes this project, it has the potential to significantly affect many companies' financial statements.

This letter summarizes many of the 2005 Commission and staff activities described above. We discuss rulemaking initiatives finalized in 2005 first, followed by those still in the proposal stage as of December 31, 2005. Although not the focus of this letter, we also briefly discuss certain 2005 activities of the Advisory Committee on Smaller Public Companies, COSO, and the PCAOB and its staff.

New Commission Rules and Initiatives

Deferral of Internal Control Reporting (Releases 33-8545 and 33-8618)

At the beginning of 2005, non-accelerated filers and foreign private issuers were scheduled to begin reporting on the effectiveness of

their internal controls in years ending on or after July 15, 2005. During 2005, the SEC delayed the compliance date twice. In March, the Commission postponed the compliance date until the annual report for the first fiscal year ending on or after July 15, 2006. In September, the Commission extended the compliance date for non-accelerated filers for an additional year, until the first fiscal year ending on or after July 15, 2007. The September postponement does *not* extend to foreign private issuers that meet the definition of an accelerated filer (i.e. foreign private issuers that have been a reporting company for at least 12 months, filed at least one annual report, and have a world-wide public equity float of $75 million or more). A foreign private issuer that meets the definition of an accelerated filer must adhere to the compliance date adopted in March and begin to comply with the Section 404 requirements in its first fiscal year ending on or after July 15, 2006.

The March Release is available on the SEC's website at *http://www.sec.gov/rules/final/33-8545.htm*; the September Release is available at *http://www.sec.gov/rules/final/33-8618.pdf*.

Revisions to Accelerated Filer Definition and Accelerated Filing Deadlines (Release 33-8644)

In December, the SEC adopted rules to modify the accelerated filer definition and filing deadlines. The rules the Commission adopted:

- Created a new category of issuer called a "large accelerated filer." A company becomes a large accelerated filer when it has a public equity float of $700 million or more as of the end of its second quarter and meets the other tests included in the definition of an accelerated filer. The existing definition of an "accelerated filer" was changed to include companies that have at least $75 million but less than $700 million in public equity float.
- Will accelerate the Form 10-K reporting deadline (but not the Form 10-Q reporting deadline) for large accelerated filers. Large accelerated filers will become subject to a 60-day Form 10-K filing deadline next year (i.e., in fiscal years ending on or after December 15, 2006). Until that time, the Form 10-K filing deadline will remain at 75 days after year-end. The current 40 days after quarter-end deadline for quarterly reports on Form 10-Q will remain in place permanently.

  The Commission had proposed accelerating the due date of large accelerated filers' Form 10-Ks to 60 days in years ending on or after December 15, 2005, but decided to give these filers an additional year of filing on the current schedule primarily to enable them to more effectively transition to internal control reporting.
- Eliminate the final phase-in of accelerated filing dates for all other accelerated filers. The current 75-day Form 10-K deadline and 40-day Form 10-Q deadline will remain in place for all other accelerated filers.
- Make it easier for an issuer to move to a less accelerated filing category. Previously, an accelerated filer was required to meet the definition of a small business issuer (i.e., public equity float and annual revenues of less than $25 million at the end of two consecutive years) in order to exit accelerated filing status in the subsequent year. The new rules permit an accelerated filer whose public equity float has dropped below $50 million at the end of its second quarter to file an annual report on a non-accelerated basis for that *same* fiscal year. In addition, a large accelerated filer is permitted to exit large accelerated filer status in the *same* year as its public equity float has dropped below $500 million at the end of its second quarter.

  The tests to determine an issuer's filing category are made at year-end based in part on information as of the issuer's most recent second fiscal quarter. Thus, the first report an issuer files under a new filing category is always an annual report. For example, if in 2006 the public equity float of an accelerated filer with a December year-end drops below $50 million on the last day of its second fiscal quarter, the issuer is still required to file its Form 10-Qs for the quarters ending June 30 and September 30, 2006 on an accelerated basis (within 40 days of quarter-end) but may file its Form 10-K for the year ending December 31, 2006 on a non-accelerated basis (within 90 days of year-end).

As discussed above, the determination of whether a registrant must report on internal control is currently based on whether it is an accelerated filer. Therefore, a registrant that is able to exit accelerated filer status under the amended definition will no longer be required to provide management and auditor reports on internal control over financial reporting.

The due dates for Forms 10-K and 10-Q under the previous rules and the new rules are shown in Table 1 on the next page. The new rules are effective for fiscal years ending on or after December 15, 2005.

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Table 1 – Due Dates for Forms 10-K and 10-Q

Category of Filer	**Previous Rules** Deadlines for Reports Beginning with Annual Report for Fiscal Years Ending on or after 12/15/05		Category of Filer	**New Rules** Deadlines for Reports Beginning with Annual Report for Fiscal Years Ending on or after 12/15/05	
	10-K Deadline	10-Q Deadline		10-K Deadline	10-Q Deadline
Accelerated Filer ($75M or more)	60 days	35 days	Large Accelerated Filer ($700M or more)	75 days (Years ending on or after 12/15/06 – **60 days**)	40 days
			Accelerated Filer (between $75M and $700M)	75 days	40 days
Non-Accelerated Filer (Less than $75M)	90 days	45 days	Non-Accelerated Filer (Less than $75M)	90 days	45 days

The Release is available on the SEC's website (*http://www.sec.gov/rules/final/33-8644.pdf*).

Securities Offering Reform (Release 33-8591)

In June, the SEC completed a multi-year effort to modernize the securities offering process under the Securities Act of 1933. The primary focus of the rules is on three aspects of the offering process: (1) communications about registered offerings, (2) the registration process, and (3) the delivery of information to investors. Certain additional disclosures in annual reports on Form 10-K and other Exchange Act reports were adopted as well. The new rules took effect on December 1, 2005. They do not apply to securities offerings involving business combinations. The major changes are summarized below.

Categories of Issuers – The new rules categorize issuers as follows:

- *Well-Known Seasoned Issuers* (WKSIs), a new category of issuers, receive the most benefit from the rule changes. WKSIs are the largest and most active issuers in the U.S. public capital markets. In 2004, they represented approximately 30% of listed issuers and accounted for approximately 95% of U.S. equity market capitalization. A WKSI is an issuer that meets the registrant requirements of Form S-3 or Form F-3 and has either (1) a worldwide market value of common equity held by non-affiliates of $700 million or more or (2) during the past three years issued at least $1 billion aggregate principal amount of non-equity, non-convertible securities in registered primary offerings for cash (i.e., not counting securities issued in registered exchange offers).
- *Seasoned Issuers* are eligible to use Form S-3 or Form F-3 to register a primary offering of their securities.
- *Unseasoned Issuers* are required to file Exchange Act reports but are not eligible to use Form S-3 or Form F-3 to register a primary offering of their securities.
- *Non-Reporting Issuers* are not required to file Exchange Act reports. This category includes voluntary filers.
- *Ineligible Issuers* do not qualify as WKSIs or for many other benefits of the new rules. Several events or characteristics can render an issuer ineligible. Examples include not being current in filing Exchange Act reports and violating the anti-fraud provisions of the federal securities laws.

Communications about Registered Securities Offerings – The new rules relax the "gun-jumping" and "quiet period" provisions related to registered offerings. These provisions have inhibited communications by a company that is conducting a securities offering because they might be construed to be prohibited offers. The new rules allow issuers to make several types of communications with certainty that they will not constitute prohibited offers.

- WKSIs are permitted to engage at any time in oral and written communications, including the use at any time of a new type of written communication called a "free writing prospectus" (a written offer made outside the statutory prospectus);
- All other issuers and offering participants are permitted to use a free writing prospectus after a registration statement is filed. Unseasoned and non-reporting

issuers must provide a statutory prospectus to investors before or at the same time as they provide a free writing prospectus;

- Reporting issuers may continue to publish regularly released factual business information and forward-looking information at any time;
- Non-reporting issuers may continue to publish factual business information that is regularly released to persons other than in their capacity as investors or potential investors at any time;
- Communications by issuers more than 30 days before the filing of a registration statement will not be considered prohibited "gun-jumping" so long as they do not reference the offering; and
- A broader category of routine communications regarding issuers, offers, and procedural matters is allowed.

In many cases, free writing prospectuses must be filed with the SEC. Companies are still liable under the securities laws for material misstatements or omissions in communications about an offering.

Registration Process – The new rules streamline the shelf registration process. Shelf registration is a process by which an issuer can register an offering of securities that will be made on a delayed or continuous basis (in contrast to an offering that will commence immediately and be completed within a short period of time). After the SEC staff declares a registration statement effective, the securities can generally be taken "off the shelf" and offered without further clearance by the SEC staff. The new rules streamline the shelf registration process in the following ways:

- The information that can be excluded from a base prospectus (the prospectus included in the effective registration statement) has been expanded and codified in a new rule (Rule 430B). Information omitted from a base prospectus pursuant to Rule 430B may subsequently be included by (1) filing a post-effective amendment, (2) filing a prospectus supplement or (3) including the information in a current or periodic Exchange Act report that is incorporated by reference to the prospectus.
- New Rule 430B also permits a seasoned issuer to omit from a prospectus covering a resale offering the identity of the selling security holders and the amount of securities registered on their behalf, provided certain conditions are met.
- Immediate (rather than delayed) takedowns of securities covered by shelf registration statements are permitted once the registration statement becomes effective.
- The requirement that an issuer register only securities it intends to sell within two years has been eliminated.
- For WKSIs, a more flexible version of shelf registration, referred to as "automatic shelf registration," has been established. Registration statements and post-effective amendments filed under the automatic shelf registration process are automatically effective upon filing (i.e., without the possibility of SEC staff review). The automatic shelf registration process also provides more flexibility regarding the amounts and classes of securities that can be included in a single shelf registration.
- The new rules also streamline the registration process for reporting issuers conducting offerings on Forms S-1 and F-1. These forms have been amended to permit issuers to incorporate previously filed Exchange Act reports by reference, so long as the reports are available on the issuers' websites and the prospectus identifies all reports and materials incorporated by reference. Forms S-2 and F-2 have been eliminated, as they are no longer necessary.

Timing of Liability – The new rules codify the SEC's view that, for purposes of evaluating whether adequate information was delivered to an investor to avoid liability under Section 12(a)(2) of the Securities Act (i.e., whether the information includes a material misstatement or omission), the assessment of the information delivered is made at the time an investment decision is made – not later, when a revised prospectus or prospectus supplement is filed. The new rules also extend the date to which issuers are subject to Section 11 liability to make it consistent with the date to which underwriters are subject to such liability. A prospectus supplement now creates a new effective date and extends Section 11 liability for issuers (but not for officers and directors or experts, such as independent auditors).

Final Prospectus Delivery – The new rules modernize the prospectus delivery process by creating an "access equals delivery" model. Filing a final prospectus with the SEC and complying with other conditions satisfies the final prospectus delivery requirements. Issuers no longer have to print and deliver final prospectuses.

Additional Disclosures in Exchange Act Reports – The Exchange Act periodic reporting requirements were modified to require the following:

- Disclosure of risk factors in Form 10-K and Exchange Act registration statements on Form 10 (updated information is required in Form

10-Q when material changes have occurred);

- Disclosure in Forms 10-K, 10-KSB and 20-F of an issuer's status as a voluntary filer of Exchange Act reports;
- For accelerated filers (including foreign private issuers that meet the definition of an accelerated filer), disclosure in Form 10-K or Form 20-F of unresolved comments from the SEC staff that the issuer believes are material and that were more than 180 days old as of year-end; and
- Disclosure in Forms 10-K and 20-F of whether or not an issuer is a WKSI.

These disclosures are required beginning with annual reports for fiscal years ending on or after December 1, 2005. The disclosures in Form 10-Q regarding material changes to risk factors must be provided only after the issuer is first required to include risk factor disclosure in its Form 10-K.

The Release is available on the SEC's website (*http://www.sec.gov/rules/final/33-8591.pdf*).

In September, the SEC staff issued a frequently asked questions document addressing questions related to transition to the new rules. The FAQ document is available on the SEC's website (*http://www.sec.gov/divisions/corpfin/transitionfaq.htm*).

In November, the staff issued a second FAQ document addressing interpretation questions of ongoing relevance. That FAQ document is available on the SEC's website at *http://www.sec.gov/divisions/corpfin/faqs/securities_offering_reform_qa.pdf*.

Use of Form S-8 and Form 8-K by Shell Companies (Release 33-8587)

In June, the SEC adopted final rules amending Forms S-8, 8-K, and 20-F, as well as defining the term "shell company." The rules (1) prohibit a shell company from using Form S-8 and (2) require one to disclose additional information when it ceases to be a shell company. Domestic issuers must provide the disclosures on Form 8-K within 4 business days of the event. The information required is equivalent to that which would be required in a registration statement (i.e., Form 10). Foreign private issuers are required to provide the same information, also within 4 business days. Because foreign private issuers are not subject to Form 8-K reporting requirements, they must provide the information on Form 20-F. A shell company may not use Form S-8 until 60 days after it has ceased being a shell company and filed the required information. The rules are designed to assure that investors in shell companies that acquire operations or assets have timely access to the same kind of information as is available to investors in public companies with prior operations.

The Commission also amended Forms 10-Q, 10-QSB, 10-K, 10-KSB, and 20-F to require companies to complete a cover page checkbox to indicate whether they are a shell company.

The Release is available on the SEC's website (*http://www.sec.gov/rules/final/33-8587.pdf*).

Public Release of Comment Letters

In May, the SEC began the process of publicly releasing staff comment letters and registrant responses relating to filings made after August 1, 2004. It has taken longer to post the correspondence than was expected because the staff needs to make sure the correspondence to be posted does not contain information covered by a confidential treatment request. The staff began posting the letters to the Commission's website in batches and continues to do so.

Comment letters are accessible on the SEC's website at *http://www.sec.gov/cgi-bin/srch-edgar*. To search for comment letters, enter the search string "upload". To search for company responses, enter the search string "corresp".

See our January 2005 *Financial Reporting* letter for further details regarding this initiative (*http://www.bdo.com/about/publications/assurance/FRL2004Review1-05-3.pdf*).

Delay of Statement 123(R) Implementation (Release 33-8568)

In April, the SEC delayed the effective date of FASB Statement 123(R), *Share-Based Payment*, for public companies.

The effective dates of Statement 123(R) were such that some companies could have been required to first apply it in an interim period other than the first fiscal quarter. (For registrants other than small business issuers, Statement 123(R) was effective as of the beginning of the first *interim or* annual period beginning after June 15, 2005. For small business issuers, it was effective as of the beginning of the first *interim or* annual period beginning after December 15, 2005.) In response to concerns that implementing Statement 123(R) in a period other than the first quarter of a fiscal year could make compliance more complicated and comparisons of quarterly reports more difficult, the Commission changed the effective date to allow adoption at the beginning of a fiscal year. Registrants that are not small business issuers may delay implementation of Statement 123(R) until the begin-

ning of their first fiscal *year* that begins after June 15, 2005, and small business issuers may delay implementation until the beginning of their first fiscal *year* that begins after December 15, 2005.

The Release is available on the SEC's website (*http://www.sec.gov/rules/final/33-8568.pdf*).

First-Time Application of IFRS (Release 8567)

Public companies in the European Union were required to adopt International Financial Reporting Standards for their 2005 financial years. Other countries, including Australia, have adopted similar requirements calling for mandatory use of IFRS in periods beginning after January 1, 2005. To facilitate the adoption of IFRS by foreign private issuers, in April the SEC adopted amendments to Form 20-F that provide a one-time accommodation that permits them, in the year they adopt IFRS, to provide two years of audited financial statements instead of the currently required three years in a registration statement or annual report filed on Form 20-F. The amendments do not eliminate the requirement that a foreign private issuer reconcile its financial statements to U.S. GAAP. Eligible companies must reconcile their IFRS financial statements to U.S. GAAP for each year presented.

To qualify for the accommodation, the issuer's most recent audited financial statements included in the filing must be for the 2007 financial year or earlier. In addition, the issuer must have adopted IFRS for the first time by an explicit and unreserved statement of compliance with IFRS and its auditors' report must be unqualified.

The accommodation also extends to the financial statements of a foreign business other than the issuer that must be included in the issuer's filing pursuant to Rules 3-05 (acquired businesses), 3-09 (equity method investees), 3-10 (guarantors) and 3-16 (collateral entities) of Regulation S-X and to the financial statements of a target company in a business combination transaction that are included in a registration or proxy statement.

Previous GAAP *Financial Statements* – The rules allow, subject to certain additional disclosure requirements, an issuer that switches to IFRS to include (or incorporate by reference) prior financial statements that were prepared under the GAAP it previously used. However, a side-by-side presentation of previous GAAP and IFRS basis financial statements is prohibited, and issuers that elect to include or incorporate previous GAAP financial statements must provide cautionary language with respect to the data to avoid inappropriate comparison with information prepared under IFRS.

Other Disclosures – In a registration statement that is dated more than nine months after the end of the most recent fiscal year, foreign private issuers must generally provide consolidated interim financial statements that cover at least the first six months of the current fiscal year and the comparative period for the prior year. In other situations, these unaudited interim statements must be prepared on the same basis of accounting as the audited financial statements that appear in the filing. However, the amendments provide an initial adopter of IFRS with alternatives for providing such interim statements.

Compliance with EU GAAP – The new rules clarify that the accommodation extends to issuers applying "EU GAAP" (i.e., IFRS as adopted by the EU, which endorses IAS 39, *Financial Instruments: Recognition and Measurement*, with the certain exceptions). A first-time adopter of EU GAAP must provide an audited reconciliation from EU GAAP to IFRS (which includes footnote disclosure equivalent to that required under IFRS) and an audited reconciliation from EU GAAP to U.S. GAAP for the two years for which EU GAAP statements are provided.

Disclosures Regarding Exceptions to IFRS – IFRS 1, *First Time Adoption of International Financial Reporting Standards*, provides for various optional and mandatory exceptions to retroactive application of some aspects of other standards upon initial adoption of IFRS. The new rules require certain qualitative disclosures relating to any of the mandatory or elective exceptions under IFRS 1.

The Release is available on the SEC's website (*http://www.sec.gov/rules/final/33-8567.pdf*).

XBRL Voluntary Reporting Program (Release 33-8529)

XBRL (eXtensible Business Reporting Language) is a standardized format for tagging financial information so computers can extract, exchange, analyze, and display it. Using computers to perform these tasks allows them to be performed more quickly, cheaply, and accurately than if they are performed manually.

In February, the SEC adopted new rules to establish a voluntary program to facilitate tagged data reporting using XBRL. The program allows registrants to voluntarily furnish certain financial data from a related Exchange Act or Investment Company Act filing as an exhibit in XBRL format. The SEC launched the program in March 2005 to receive 2004 calendar year financial information.

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To participate in the program, registrants must furnish the XBRL document as an exhibit, either with the filing which reported the information or with a Form 8-K or 6-K. Registrants are not permitted to submit an XBRL document before they file the related official filing.

XBRL documents must contain certain mandatory content and may contain additional optional content. Mandatory content consists of a complete set of information for all periods presented in the corresponding official EDGAR filing from one or more of the following categories:

- The complete set of financial statements (not including footnotes, schedules and auditors' reports);
- Earnings information set forth in Items 2.02 or 8.01 of Form 8-K or in Form 6-K; and
- For registered investment companies only, financial highlights or condensed financial information.

Additional optional information that may be included as part of an XBRL document includes audit opinions, certifications and management's discussion and analysis of financial condition.

XBRL data must reflect the same information that is in the corresponding official filing (i.e., it may not be changed, deleted, or summarized in any way). In addition, the data in XBRL documents must be tagged using the appropriate "standard taxonomy."

XBRL documents will not be considered "filed" and therefore will not be subject to certain liability provisions of the Exchange Act and Investment Company Act.

The Release is available on the SEC's website (*http://www.sec.gov/rules/final/33-8529.htm*).

In addition, the SEC staff has issued frequently asked questions and "spotlight" documents regarding the program (which are available at *http://www.sec.gov/info/edgar/xbrlfaq032105.htm* and *http://www.sec.gov/spotlight/xbrl.htm*), and the PCAOB staff has issued a frequently asked questions document that provides guidance to auditors performing attest engagements related to the accuracy of XBRL data. (Companies are not required to obtain auditor attestations covering XBRL data.) This document is available on the PCAOB's website at *http://www.pcaobus.org/standards/staff_questions_and_answers/2005/05-25%20.pdf*.

Thus far, participation in the program has been limited. In an effort to increase participation, in January 2006 the SEC offered expedited filing reviews to registrants that volunteer to participate. Further information about these incentives is available at *http://www.sec.gov/news/press/2006-7.htm*.

Annual Report Disclosure of Certain Tax Penalties (Rev. Proc. 2005-51)

The American Jobs Creation Act of 2004 added section 6707A to the Internal Revenue Code to (1) provide a monetary penalty for the failure to include on any tax return any information required to be disclosed with respect to certain "reportable" transactions, as described in Section 1.6011-4(b) of the Income Tax Regulations, and (2) require SEC registrants to disclose any such penalties they are required to pay. In August, the Internal Revenue Service issued Revenue Procedure 2005-51 to provide more detailed guidance with respect to the required disclosures under section 6707A. (The requirements are not reflected in any of the SEC's rules or forms.)

Companies must disclose these tax penalties in Item 3 (Legal Proceedings) of Form 10-K. While Revenue procedure 2005-51 only specifies a disclosure requirement in Form 10-K, Section 6707A of the Code specifies that the disclosure requirement applies to all persons required to file periodic reports under section 13 or 15(d) of the Exchange Act. This would also include companies that are required to file annual reports on Forms 10-KSB, 20-F and 40-F. Companies that incur these penalties and file annual reports on forms other than Form 10-K should consult with their tax advisors and legal counsel as to the need for and appropriate way to make the required disclosures.

The disclosure must include the following:

- The amount of the penalty;
- Whether the penalty has been paid in full;
- The Code section under which the penalty was determined;
- A description of the penalty imposed; and
- Under certain circumstances, the requirement to pay the 40% accuracy-related penalty described in Section 6663(h).

Companies must make the disclosures in the Form 10-K that relates to the fiscal year in which the IRS sends notice and demand for payment of the penalty. If a company pays the penalty before the IRS issues the notice, it must disclose the penalty in the Form 10-K for the fiscal year in which the payment is made. Companies that do not disclose the penalties as required will face additional penalties, which will be imposed for each successive Form 10-K that is filed without the required disclosure. The additional penalties must be disclosed as well.

The new disclosures are required for penalties that relate to a tax

return or statement due after October 22, 2004.

Revenue Procedure 2005-51 may be accessed via Internal Revenue Bulletin 2005-33, which is accessible at *http://www.irs.gov/irb/*.

Proposed Rules

Deregistration by Foreign Private Issuers (Release 34-53020)

In December, the SEC proposed new rules that would relax the conditions a foreign private issuer must meet to be permitted to exit the Exchange Act reporting regime.

Under current rules, a foreign private issuer may suspend or, in some cases, terminate its Exchange Act reporting obligation if its registered classes of securities have fewer than 300 record holders who are U.S. residents (or 500 holders who are U.S. residents, if the issuer's total assets were less than $10 million at the end of its last three fiscal years). Under these rules, a foreign private issuer may find it difficult to stop filing Exchange Act reports despite the fact that there is relatively little investor interest in the U.S. The proposed rules would ease the conditions under which a foreign private issuer could deregister a class of securities and terminate (not just suspend) its reporting obligations under the Exchange Act. For equity securities, the proposed conditions would vary depending on whether the registrant is a well-known seasoned issuer and include tests based on the issuer's Exchange Act reporting history, its offering and listing history, its public float, and its trading volume.

The release is available on the SEC's website (*http://www.sec.gov/rules/proposed/34-53020.pdf*).

Internet Availability of Proxy Materials (Release 34-52926)

In November, the SEC proposed for public comment new rules that would allow issuers and other persons to use the internet to satisfy proxy material delivery requirements. The SEC expects the proposal to result in a substantial decrease in printing and postage costs incurred to comply with the proxy rules.

Current rules require proxy materials (i.e., a proxy statement and, if the shareholders meeting is one at which directors are to be elected, an annual report to shareholders) to be delivered to shareholders with or prior to a proxy solicitation. The proxy materials must be in paper form or, if the shareholder consents, they may be delivered electronically. The proposed rules would allow issuers conducting proxy solicitations to post their proxy materials on a publicly available internet website (other than the SEC's website). Issuers would be required to send a paper notice to shareholders informing them of the availability of the proxy materials. The notice would have to be sent at least 30 days prior to the shareholders meeting to which the proxy materials relate, and would have to contain a prominent legend in bold-faced type that includes the following information:

- The date, time and location of the shareholders meeting;
- The address of the website where shareholders can access the related proxy materials;
- A toll-free number and e-mail address that shareholders can use to request paper copies of the proxy materials free of charge; and
- A clear and impartial description in plain English of the matters to be considered at the meeting and the company's recommendations regarding those matters.

The proposed rules also contain the following procedural requirements:

- The proxy voting card would have to be accompanied by, and delivered through the same medium (paper or electronic) as either the notice or the proxy statement;
- Issuers would be required to respond to a shareholder's request for paper copies of proxy material within two days of the request;
- No information other than that specified in the rules would be permitted to be included in the notice, and no other shareholder communications could be sent with the notice;
- Additional soliciting materials that are distributed after the notice is sent would have to be posted on the website specified in the notice; and
- Banks, brokers and other intermediaries that hold securities for beneficial owners would be required to forward the notice to those beneficial owners.

The proposed rules would have no impact on any state law obligation regarding proxy solicitations or annual meetings. Further, the proposed rules would not apply to business combination transactions.

The proposed notice and access model would also be available to persons other than the issuer who are soliciting proxies. Such persons would be required to deliver a notice substantially similar to that required by issuers by the later of 30 days before the shareholders meeting or 10 days after the issuer filed its proxy materials.

The proposed rules are not expected to be finalized until sometime after the 2006 proxy season. The Release is available on the

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SEC's website (*http://www.sec.gov/rules/proposed/34-52926.pdf*).

Commission and Staff Guidance

SAB 107

In March, the Commission's staff issued Staff Accounting Bulletin 107. The SAB provides guidance for implementing Statement 123(R). Subsequently, the Commission delayed the implementation dates for Statement 123(R) as discussed above. Following are highlights of the guidance in SAB 107:

Choice of Valuation Models – Statement 123(R) expresses no preference for either of the two categories of option pricing models currently used in practice (i.e., closed form models, like Black-Sholes, or lattice models, like binomial) and SAB 107 confirms that either is acceptable for registrants. SAB 107 also notes that an issuer may switch from a closed form model to a lattice model and this change would be a change in estimate, not a change in the method of applying an accounting principle. Accordingly, a registrant would not need a preferability letter from its independent accountants.

Assumptions About Expected Volatility of Stock Price – One of the key assumptions for option pricing models is an assumption about the expected volatility of the stock price over the expected term of the option. SAB 107 notes that estimating expected volatility is difficult. It provides guidance on measuring historical volatility, using implied volatility, and determining volatility for companies that recently became public. In addition, the staff reminds registrants that it is inappropriate to use the volatility of a stock market index in place of the volatility of their own stock, because the averaging inherent in indexes causes the volatility of an index to be lower than the volatility of the component shares.

Assumptions About the Expected Term of Employee Options – SAB 107 discusses the staff's expectations about how companies should develop historical data about the average terms of past stock options. The staff notes academic research indicating that employee exercise behavior is influenced by the rate of increase in the price of the employer's shares, and cautions that past behavior in different stock price environments should be used with caution in projecting the future. If a registrant lacks sufficient experience, it may use information about similar companies' employee exercise behavior. The staff notes that information about other companies may not be readily available now, although the staff expects compensation consultants to build databases over the next couple of years. In the interim, if a registrant has neither relevant experience of its own nor relevant experience of similar companies, the staff will not object to use of an expected term equal to the midpoint between the vesting date and the expiration date of the option.

Analysis of Prior Credits to Capital from Excess Tax Benefits – Under Statement 123(R) an income tax benefit from an income tax deduction in excess the tax benefit from compensation expense for financial reporting purposes is credited to shareholders' equity. When the reverse happens, the shortfall is charged against shareholders' equity to the extent of prior credits, and the remainder of the shortfall, if any, is charged to the provision for income taxes. Under Statement 123(R), the pool of prior credits to shareholders' equity for this purpose is not the actual amount the employer credited to shareholders' equity in prior years. Instead, it is the hypothetical amount that the employer would have credited to shareholders' equity since 1995 if it had followed the fair value method of original Statement 123.

SAB 107 allows for a practical approach that a registrant can use to develop the pool of credits to shareholders' equity. Under this approach, a registrant only needs to know about the pool of prior credits to shareholders' equity if and when an employee award results in an income tax deduction less than compensation expense for financial reporting purposes. If and when that occurs, the employer needs to determine whether it has enough prior credits to absorb the shortfall in the income tax deduction by working backwards from 2004 until it has enough cumulative credits. If a registrant's stock price generally rises after the adoption of Statement 123(R), it may never need to go all the way back to 1995. (Subsequently, the FASB addressed this issue in FSP FAS 123(R)-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*, which provides a practical transition election related to accounting for the tax effects of share-based payment awards to employees.)

Interaction of Statement 123(R) with the SEC's Redeemable Equity Rules – A grant may qualify as an equity transaction (rather than a liability) under Statement 123(R), because it is settled in shares, but the shares are redeemable upon the occurrence of events outside the control of the issuer. SAB 107 clarifies that the SEC's rules requiring such securities to be reported outside of shareholders' equity apply. If the grant

vests over time, the amount reported outside of shareholders' equity would be the amount ordinarily required by the SEC's rule multiplied by the portion of employee service that was rendered prior to the balance sheet date.

Capitalization of Compensation from Share-Based Payment Transactions – Some registrants grant share-based awards to employees whose cash compensation is capitalized as part of the cost of inventory or self-constructed plant. The share-based compensation for those employees should similarly be capitalized. SAB 107 states that a registrant can estimate the amount of share-based compensation that would be capitalized using inventory turnover or other measurements.

Applicability of Statement 123(R) to Options Granted to Nonemployees – In SAB 107 the staff notes that share-based payment awards to nonemployees should be measured based on the fair value of the services received or the fair value of the award, whichever can be estimated more reliably. If the fair value of the award can be estimated more reliably, which is ordinarily the case for a registrant, then EITF Issue No. 96-18 is the appropriate guidance to use in accounting for the award. That guidance would take precedence over Statement 123(R)'s guidance about when to measure fair value. However, EITF Issue No. 96-18 does not provide guidance on some classification and measurement issues. SAB 107 suggests that the guidance in Statement 123(R) should be followed if there is no conflicting guidance in the EITF consensus. Most significantly, and in a change from prior staff guidance, fair value should be estimated based on the expected term, rather than the contractual term, for nonemployee awards that have nontransferability and nonhedgeability characteristics like employee awards. Awards to individuals may have these characteristics, whereas awards to companies typically do not.

Similarly, the staff indicates that the guidance in Statement 123(R) about whether an award is classified as a liability or as an equity instrument applies to nonemployee awards.

Acceleration of Vesting before Adopting Statement 123(R) – SAB 107 repeats the SEC staff's views about the need for robust disclosure in MD&A about the impact of accelerating vesting and the business reasons why a company accelerated vesting.

Transition Requirements for Companies that Become Public Companies after Adopting Statement 123(R) – Generally, when a formerly nonpublic entity becomes a public company, the staff believes that the fair value of equity awards should not be adjusted, because fair value is estimated at grant date and is not adjusted for subsequent developments. This guidance to not adjust the fair value of equity awards would apply both to (1) awards granted prior to adoption of Statement 123(R) and (2) awards granted after adoption of Statement 123(R) but before becoming a public company. However, the value of liability awards is adjusted every period until exercise, settlement, or expiration, so a newly public company should adjust the value of liability awards to Statement 123(R)'s public company fair value model.

Classification of Compensation and Non-GAAP Financial Measures – SAB 107 notes that it would be inappropriate to classify the compensation expense from share-based payment transactions in a caption different from the other components of employee compensation. If a registrant wants to highlight the amount of non-cash compensation expense arising from such awards, it can do so by parenthetic notation in the caption on the income statement or by disclosure in the notes.

In addition, a measure of earnings that excludes compensation expense from share-based payment transactions is a non-GAAP financial measure which must adhere to the requirements of Regulation G and (if included in an SEC filing) Regulation S-K Item 10(e).

Discussion in MD&A – The adoption of Statement 123(R) will create non-comparability between pre- and post-adoption financial statements. SAB 107 reminds registrants that MD&A should discuss that non-comparability and help readers understand the effects of the accounting change. SAB 107 specifically mentions the following items that should be discussed:

- The prior method used to record compensation (APB 25 or original Statement 123);
- The transition method used to adopt Statement 123(R) (modified prospective or modified retrospective);
- One-time effects of adoption, if any;
- Changes in option valuation models or assumptions that would cause the fair-value-based compensation previously disclosed in the notes to financial statements to differ from the fair-value-based compensation recorded in earnings under Statement 123(R);
- Changes in the mix of employee compensation, for example, decreased option grants and increased cash salaries or increased restricted stock awards after adoption of Statement 123(R);

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- Changes in the terms of share-based payment awards, for example, shorter option lives, faster vesting, or the addition of performance conditions; and
- Total fair-value-based compensation expense associated with prior awards that are not vested at the adoption of Statement 123(R) and the weighted average period over which that compensation will be recorded in earnings.

SAB 107 is available at *http://www.sec.gov/interps/account/sab107.pdf*.

Use of Market Instruments in Valuing Employee Stock Options

In September, the SEC issued informal staff progress reports from the SEC's Chief Accountant and the staff of the SEC's Office of Economic Analysis regarding using market instruments to value stock options.

In his report, the Chief Accountant encouraged continued research on methods to obtain estimates of the fair value of employee stock options. However, he indicated that the SEC is not currently aware of any instruments that have been sold in the market to obtain an observable market price for valuing employee stock options. In addition, the Chief Accountant cautioned that if an instrument were designed for purposes of producing an appropriate value in a market-based transaction, but the actual market price varied significantly from the price obtained through broadly-accepted option modeling techniques, questions would arise about the use of the instrument in determining fair value of the option. The Chief Accountant advised that early users of market based transactions will have to address and resolve these questions to their satisfaction and to that of their auditor before the transaction price for a market instrument could be used as the only basis to estimate the fair value of employee stock options.

The report from the staff of the OEA summarizes their evaluation of possible approaches to the design of a market instrument that could be used to value employee stock options. The approaches fall into two categories: (1) the "tracking approach" and (2) the "terms and conditions approach." The OEA concluded that of the two approaches, only the tracking approach may produce a reasonable marketplace estimate of the fair value of employee stock options.

The reports are available at *http://www.sec.gov/news/press/2005-129.htm*

Statement on Internal Control Reporting

In May, the Commission and its staff released statements on the first year of internal control reporting. Views expressed at the April roundtable discussed above were cited as an important source of input. These statements were intended to provide additional guidance and clarification of certain issues and complement the guidance the PCAOB released on the same date (which is discussed below). The guidance focuses on the need for flexibility and judgment in approaching internal control reporting, stating, "An overarching principle of this guidance is the responsibility of management to determine the form and level of controls appropriate for each organization and to scope their assessment and testing accordingly. One size does not fit all and control effectiveness is affected by many factors." The staff guidance addresses the following areas: the purpose of internal control, the concept of reasonable assurance, the use of a risk-based approach, the scope of assessment and testing, evaluation and disclosure of deficiencies and weaknesses, information technology issues, communications with auditors, and issues related to small businesses and foreign private issuers.

With regard to communications with auditors, the Commission and staff encourage more open dialogue between companies and auditors concerning internal control matters and accounting matters. In its Statement, the staff states that "as long as management, and not the auditor, makes the final determination as to the accounting used, including determination of estimates and assumptions, and the auditor does not design or implement accounting policies, such auditor involvement is appropriate and is not of itself indicative of a deficiency in the registrant's internal control over financial reporting. Further, timely dialogue between management and the auditor may positively impact audit quality and the quality of financial reporting."

The news release and additional statement materials can be found at: *http://www.sec.gov/news/press/2005-74.htm*.

Recommendations of the Advisory Committee on Smaller Public Companies

In December 2004, the SEC established its Advisory Committee on Smaller Public Companies to assess the regulatory system for smaller companies and recommend changes. The Committee and its four subcommittees (internal control, accounting standards, corporate governance and disclosure, and capital forma-

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tion) met several times in 2005 and preliminarily decided on its recommendations in December. The recommendations are targeted at smaller public companies, which the Committee defines 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 $700 – 750 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 $100 – 125 million). The Committee is expected to finalize its recommendations in March and is scheduled to submit a report of final recommendations to the SEC in April. Highlights of the Committee's tentative recommendations are as follows:

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*.

PCAOB Developments

During 2005, the PCAOB and its staff also continued to focus on the implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting in Conjunction with an Audit of Financial Statements*. Following the April Roundtable discussed above, the PCAOB issued a policy statement regarding audits of internal controls, emphasizing that auditors should:

- Integrate their audits of internal control with their financial statement audits;
- Exercise judgment and tailor their audit plans to the risks facing individual clients;
- Use a top-down risk-based approach;
- Take advantage of the work of others; and
- Communicate with audit clients who seek the auditors' views on accounting or internal control issues.

The policy statement can be found at: *http://www.pcaobus.org/Rules/Docket_008/2005-05-16_Release_2005-009.pdf*.

Since the adoption of AS 2 in June 2004, the PCAOB staff has released a series of questions and answers that provide guidance on various implementation issues. In May the PCAOB staff released additional Q&A guidance (questions 38 through 55). The May Q&As respond to the issues raised by companies and auditors, primarily related to the costs of performing internal control audits. Topics addressed include:

- Using a top-down risk-based approach;

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- The extent of procedures required;
- The impact of risk assessment on the nature, timing, and extent of procedures;
- Varying the tests of controls from year to year;
- The auditor's reliance on company self-assessment;
- The roll-forward of interim control tests to year-end;
- The sufficiency of evidence that the control operated;
- Using the work of others; and
- The auditor's quarterly responsibilities regarding management's certifications.

The PCAOB staff's guidance can be found on the PCAOB's website (*http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2005/05-16.pdf*).

In November, the PCAOB released its report on the initial implementation of AS 2. The report was based largely on the PCAOB's summer 2005 inspections of internal control audits of the larger accounting firms. The report focuses on the need for improving the efficiency and effectiveness of internal control audits. The report is available on the PCAOB's website (*http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf*).

Additionally, in July the PCAOB adopted an auditing standard that would provide the foundation for a new voluntary engagement in which auditors would report on the elimination of a material weakness in a company's internal control over financial reporting. The standard is 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 would not be required by the Sarbanes-Oxley Act of 2002 or other securities laws and would be purely voluntary. This standard, which will not become effective until approved by the SEC, is available on the PCAOB's website (*http://www.pcaobus.org/Rules/Docket_018/2005-07-26_Release_2005-015.pdf*).

Also in July the PCAOB adopted new rules relating to tax services, contingent fees, and certain general ethics independence standards. Under the new PCAOB rules, a registered public accounting firm is not independent of a publicly held audit client if (1) the accounting firm provides assistance in planning or providing tax advice on certain types of potentially abusive tax transactions to the client, (2) 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 (3) the accounting firm receives directly or indirectly a contingent fee or commission from the client for providing any service or product. In addition, 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 PCAOB also adopted two new general rules requiring registered public accounting firms (1) to be independent of their audit clients throughout the audit and professional engagement period, and (2) to not violate the Sarbanes-Oxley Act of 2002, the PCAOB rules and standards, the rules of the SEC, and all other professional standards.

The new rules will not take effect until approved by the SEC. They are available on the PCAOB's website (*http://www.pcaobus.org/Rules/Docket_017/2005-07-26_Release_2004-014.pdf*).

Proposed COSO Guidance for Smaller Public Companies Reporting on Internal Control

In October, the Committee of Sponsoring Organizations of the Treadway Commission released proposed guidance in the form of an Exposure Draft entitled *Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting*. The proposed guidance is meant to serve as a supplement to COSO's *Internal Control – Integrated Framework* originally published in 1992, and was developed to assist smaller public companies with regard to compliance with the internal control requirements of Section 404 of the Sarbanes-Oxley Act. The proposed guidance can be found at *http://www.ic.coso.org/*.

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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