

SAS 70 IN-FOCUS

Corporate Governance Considerations in Equity Compensation Outsourcing



INDUSTRY INSIGHTS

Never has accountability been more front and center for companies in the U.S. In the wake of corporate governance issues and a heightened focus on shareholder rights, sweeping regulatory changes are forcing companies to review and to validate the internal controls that impact their financial statements. This validation extends to outsource services providers (OSP). Companies choosing to outsource their stock plan administration are now faced with a unique dilemma: select an OSP that has gone through a recognized validation process or employ its external auditor to conduct the audit.

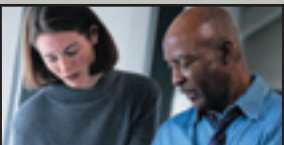
It is no small task complying with the new regulations, such as Sarbanes-Oxley section 404 and FAS 123, which require that company management take responsibility for the controls that impact their financial reporting. It is vital that organizations reach a high degree of confidence in their service provider's internal controls. Absent a widely recognized, external evaluation of a provider's internal controls and operating effectiveness, some companies feel as though there is additional risk and difficulty in using a third party service provider.

Fortunately there is an evaluation that an OSP can undergo in order to validate the accuracy and integrity of its operations to satisfy today's rigorous financial requirements. Statement on Auditing Standards No. 70 ("SAS 70"), an internationally recognized auditing standard developed by the American Institute of Certified Public Accountants (AICPA), reports on the processing of transactions by service organizations. This standard is extremely valuable in ensuring proper controls with respect to governance issues, and should factor into the selection of an outsource provider for stock plan administration.

SAS 70 – AN EFFECTIVE, INDEPENDENT EVALUATION

The SAS 70 standard involves an external, independent auditor's evaluation of a service organization's controls and the execution of those controls. The examination covers critical benchmarks, including the completeness, accuracy, and timeliness of services rendered.

The SAS 70 report, generated at the conclusion of the examination, is invaluable to a company's financial statement auditors. Without such a report, the auditors might have to conduct their own examination of the internal controls at the service organizations used by the company to support key financial transactions.



REPORTS

SAS 70 REPORTS

There are two types of SAS 70 reports. A Type I report includes the service organization's description of its controls at a specific point in time (e.g., June 30, 2004). A Type II report includes the service organization's description of its controls, but goes further to add rigorous testing of the service organization's controls over a minimum six-month period (e.g., January 1, 2004 to June 30, 2004).

A SAS 70 report may be issued as a "qualified" or "unqualified" auditor's opinion. A qualified opinion might indicate, among other things, that:

- A service organization's controls were not suitably designed to achieve a particular objective
- The controls were either not operating effectively or not operating at all
- The descriptions provided by the service organization did not fairly represent the relevant aspects of their controls

An unqualified report, on the other hand, reflects that the service provider has satisfied the requirements of Generally Accepted Auditing Standards (GAAS.)

A role in service provider selection

The SAS 70 standard provides critical guidance in the selection of a stock plan service provider. SAS 70 certification is a widely recognized indication that the organization has been through an in-depth, independent audit of its control activities. Moreover, an unqualified report offers a clear demonstration that the service provider has adequate controls and safeguards when it hosts or processes customer data.

That assurance can help companies comply with requirements such as Sarbanes-Oxley Section 404 and FAS 123. To comply with Sarbanes-Oxley Section 404, a company's management must make an annual assertion as to the effectiveness of the internal controls over its financial reporting. That assertion must also cover equity-based compensation, since the proposed

FASB accounting standards contained in FAS 123 will require that companies expense their stock options. As a result, financial reporting on those options under FAS 123 (including data from third-party vendors), must also comply with Sarbanes-Oxley Section 404.

In order to comply with these requirements, company management must document and evaluate all controls deemed significant to the company's financial reporting process. In the case of companies that outsource to third-party service providers, management must consult the service organization for information on the design and operating effectiveness of the service organization's controls. The SAS 70 report provides precisely this type of information, and saves the company from having its auditors conduct additional examinations.



If the service provider had not gone through a SAS 70 examination, the company may incur additional risks and costs in using that provider. Increased costs may include the added cost of paying the company's auditors to examine the service organization's controls. In addition, a service provider that hasn't gone through a SAS 70 examination could have weak internal controls, potentially leading to service failures such as missed deadlines, pricing errors, or even fraudulent transactions.

Ultimately, a SAS 70 examination reflects a service provider's true commitment and ability to take proactive control over its processes. An unqualified opinion, such as the one received by Fidelity Stock Plan Services, differentiates a service provider from its peers by demonstrating the establishment of effectively designed control objectives and control activities. That creates a strong sense of trust and offers peace of mind to the service organization's clients.

Solutions with high standards

SAS 70 is a very important standard for plan sponsors, with respect to their compliance activities and their confidence in their service providers. Fidelity's Stock Plan Services group has received an unqualified, Type II SAS 70 report, demonstrating our commitment to meeting our clients' needs.

The selection of a stock plan service provider should be based on unparalleled service and the potential to improve your organization's bottom line. Fidelity's global, integrated service solutions are designed to meet these high standards, to exceed your expectations, and to reward your decision to outsource your stock plan administration.

Fidelity Stock Plan Services' unqualified, Type II SAS 70 report demonstrates its leadership in compliance. We believe that Fidelity Stock Plan Services' unqualified, Type II SAS 70 report is the first of its kind among stock plan service providers. This report confirms that we have internal controls that are suitably designed and operating effectively to administer stock compensation plans. It also affords clients who use our comprehensive FAS solution greater confidence in and more control over their own financial reporting.

