Accounting and Auditing in the Current Economic Environment

Billy Daniel
Bill Godshall
FRAZIER & DEETER, LLC
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The ongoing financial crisis and its overall impact to our economy are unprecedented. Recent market events in December 2008 and January 2009 indicate further bad news may still be ahead of us, most notably:

- December 1 - The US recession is officially declared by the National Bureau of Economic Research, a leading panel including economists from Stanford, Harvard and MIT. The committee concluded that the US economy started to contract in December 2007.
- December 15 – Bernard Madoff confesses to orchestrating a $50 billion Ponzi scheme which was previously undetected by the SEC after several tips.
- December 16 - The US Federal Reserve slashes its key interest rate from 1% to a range of zero to 0.25% - the lowest since records were maintained.
- December 19 – President George says the US government will use up to $17.4 billion of the $700 billion meant for the banking sector to help the Big Three US carmakers, General Motors, Ford and Chrysler.
- January 8 - The Bank of England cuts interest rates to 1.5%, the lowest level in its 315-year history, as it continues efforts to aid an economic recovery in the UK.
- January 9 - Official figures show the US jobless rate rose to 7.2% in December, the highest in 16 years. The figures also indicate that more US workers lost jobs in 2008 than in any year since World War II.

Given these recent events and the perception that the situation is deteriorating, the popular Chinese proverb “May you live in interesting times” appears to have come to fruition. For accountants and auditors, these events will have significant ramifications on the audits of financial statements and internal control over financial reporting. In light of these events, the American Institute of CPAs (“AICPA”) recently issued a report titled “Current Economic Crisis: Accounting and Auditing Considerations 2009” which focuses on legal and regulatory actions taken to curtail the crisis as well as relevant accounting and auditing considerations.

The following provides some of the more significant elements of the AICPA audit risk alert.

Economic, Legislative and Regulatory Developments

The US economy has experienced and is expected to continue to experience significant instability. However, the US government has taken steps to mitigate these conditions by increasing the monetary programs available from the Federal Reserve, including the Emergency Economic Stabilization Act of 2008

("EESA") passed by Congress on October 3, 2008. The purpose of the EESA is to restore liquidity and stability to the US financial system through the allocation of $700 billion in funding. The EESA also required the Securities and Exchange Commission ("SEC") to conduct a study on the impact and effects of the Financial Accounting Standards Board ("FASB") Statement No. 157, *Fair Value Measurements*, the results of which are further discussed below. In addition to the EESA, other significant government interventions include the conversion of investment banks to bank holding companies, the conservatorship of Fannie Mae and Freddie Mac, and the $150 billion government bailout of AIG.

Accounting Issues and Developments

Due to the current economic crisis, there are numerous accounting and financial reporting issues which auditors should consider, including the following:

- Fair value, including fair value measurements in illiquid markets,
- Asset impairments, and
- Liquidity restrictions.

FASB Statement No. 157 has received a great deal of attention and some have argued it exacerbated the economic situation due to price disconnects (e.g., bid-ask spreads) present in today's market. Proponents of the standard claim it merely exposed the problem, but did not create the problem. However, all practitioners tend to agree additional guidance is required to properly apply this standard, primarily in illiquid markets. As a result, in October 2008, the FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*.

In late December 2008, the SEC released to Congress its mandated report on fair value accounting standards. The report recommends against the suspension of fair value accounting standards, but it does recommend improvements to existing practice, including reconsidering the accounting for impairments and additional guidance for determining fair value in inactive markets. The report also stated that fair value accounting did not appear to play a significant role in the bank failures of 2008.

Another important topic receiving increased attention in today's market is determining whether an investment is other-than-temporarily impaired. FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary and Its Application to Certain Investments*, addresses the determination of when an investment is considered impaired, whether the impairment is other-than-temporary, and the measurement of the impairment loss. Given the current economic situation, practitioners should also be alert for other types of asset impairments, including long-lived assets, goodwill, and deferred tax assets and the related accounting literature.

The AICPA has also issued a Technical Practice Aid (TPA TIS Section 1100.15) that addresses liquidity restrictions that may be imposed on money market or other short-term investment funds. The TPA discusses considerations when an entity is restricted from withdrawing its balance in one of these funds, including: (i) whether the assets subject to restriction qualify as cash equivalents or current assets, (ii) whether disclosures about risks and uncertainties should be made, and (iii) whether the restrictions trigger debt covenant violations or call into question an entity's ability to continue as a going concern.

Audit and Attestation Issues and Developments

In accordance with AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures." Obtaining this understanding in today's rapidly changing economic environment is critical and will require an auditor to design audit procedures responsive to assessed risks of material misstatement in order to reduce audit risk to an acceptably low level.

Due to the current crisis, audit risks that were previously identified may become more significant or new risks may exist. These risks and uncertainties may lead to questions about an entity's valuation, impairment or recoverability of assets and the completeness or valuation of liabilities. However, the most controversial area of auditing this year-end will be fair value accounting. As a result, it is very important for auditors to have adequate training on fair value accounting as we enter busy season, with particular emphasis on the significant estimates and assumptions, the choice and complexity of valuation techniques and models, and the extent of disclosure in the financial statements.

For additional information on this AICPA audit risk alert, please go to the AICPA website at: http://www.cpa2biz.com