US
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Glass half empty accounting

It's official – we are in a global recession. For public companies with a June 30 fiscal year or for companies beginning to think ahead to their second quarter 10-Q, this is likely to mean their audit committees and auditors will pay heightened attention to accounting issues that may be thought of as signs of the times.

As companies scramble to keep creditors and stockholders satisfied, meet earnings estimates whenever possible, and generally prosper during difficult times, it is only natural to expect that the first instinct of many involved in the financial reporting chain will be to take an optimistic view of close financial and accounting questions. The desire to see the glass as half full is basic to human nature. Since auditors understand this, they will, where relevant, be looking closely at several issues.

Particularly for financial institutions, audit committees and auditors will review the company's exposure to off-balance entities, as well as the timing and size of write-downs associated with subprime or other mortgage related securities. Similarly, companies holding auction rate securities will have to consider valuation and liquidity questions carefully. While most auction rate securities continue to pay current interest, there is no liquid market for these securities.

In this environment, fair value accounting principles have made it challenging for reporting companies with mortgage related securities, auction rate securities or other now illiquid assets in their portfolios. The character and quality of the valuation procedures for such instruments may not produce valuations that are based on reliable data. Fair value accounting requires that management consider inputs to valuation, from level 1 inputs, which are quoted prices in active markets (which may not exist), to level 3 inputs, which requires that where no active markets exist, preparers of financial statements turn to other indicia of value, including making informed predictions about future liquidity. Audit committees and management will want to consider carefully any assumptions regarding future liquidity.

In addition, for all reporting companies, audit committees and management will be focused on the adequacy of current liquidity and cash management procedures, the quality of receivables, the financial health and solvency of suppliers, the ability to access additional capital, and the quality of management's plans and procedures to monitor and address all of these issues.

We are in the process of alerting our reporting clients to expect that their audit processes are likely to be more involved, more intense and more challenging than in past years. And also more costly.