# New accounting standards

Advantages and disadvantages of the new fair value election **Interviewed by Leslie Stevens-Huffman**

Beginning with fiscal year 2008, companies may begin using fair value accounting standards to report financial assets and liabilities. Two new accounting standards: The Fair Value Option for Financial Assets and Financial Liabilities (FAS 159) and Fair Values Measurements (FAS 157) will provide business entities the option to report selected financial assets and liabilities at their fair value as opposed to reporting them under historical cost accounting approaches. The standards permit an entity to elect the fair-value option on an instrument-by-instrument basis, with one caveat — once the election is made, it's irrevocable.

In concept, FAS 159 tracks with recent trends in accounting principles. By allowing companies to value certain liabilities and assets at current market value — even though they haven't been sold — investors are provided with a real-time financial representation of the company. Also on the plus side, FAS 159 may enhance a company's ability to borrow funds by providing information on appreciated values. However, as with any change, CEOs should be aware that there are advantages and disadvantages associated with a move to reporting under a fair-value standard, says Diane Wittenberg, partner of Audit and Business Advisory Services at Haskell & White LLP.

"For certain companies this may be a better way to report because it is more reflective of current values," says Wittenberg. "However, there is a certain element of subjectivity in how the assets and liabilities are valued, so it may make it more difficult to track consistency from company to company for comparison purposes. Also, because the election decision is irrevocable, it's important to anticipate any future negative ramifications from switching to a fair-value reporting standard before making your decision."

*Smart Business* spoke with Wittenberg about what CEOs should know about reporting assets and liabilities on a fair value basis.

**Diane Wittenberg**
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**Are these changes mandatory and what impact will these standards have on my company's financial statements?**

FAS 159 offers companies the option of reporting certain items on a fair value basis, but doesn't require it. Because you estimate the fair value of your assets and liabilities, your financial statements may reflect a higher value for your company even though no transaction has taken place. The accompanying standard, FAS 157, defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This statement does not require any new fair value measurements.

**Do you foresee widespread adoption of these standards?**

It is yet to be determined if, or how fast, companies will get on board with this new concept. For some, it's a big change from historical reporting. For the time being, it is still an option, but it does seem that the Financial Accounting Standards Board is moving toward fair value accounting and away from historical cost accounting.

**What benefits are afforded to CEOs by fair value accounting?**

If your company has appreciated assets, you may be able to obtain greater lines of credit or more favorable borrowing terms given the more current information under these provisions. Also, if you're looking to sell your company or a portion of it, a current valuation of assets may improve your return and, at least, set the stage for negotiations. As CEOs consider acquisitions, it will be much easier to see the prospective business at its present value rather than having to extrapolate the numbers. Private equity investments or debt securities that are classified as held-to-maturity are examples of financial assets that can be updated to reflect their current values, and loans or notes are examples of liabilities that can be affected in a change to fair value accounting.

**Of what drawbacks should CEOs be aware?**

There is uncertainty inherent in all estimates and fair value measurements, and there's the risk that financial statements will be seen as more arbitrary with fair value because management has even more ability to affect the financial statements. Financial professionals coming into the workplace need to be trained on recognizing biases with respect to accounting estimates and fair value measurements so they can help CEOs with acquisition evaluations. They also need to be able to explain to prospective lenders and investors how they developed the company's asset and liability values. It will be important to demonstrate consistency in how you've applied the fair value principles and developed your valuations to enable you to maintain credibility with investors, lenders and auditors. Although CEOs may select which assets and liabilities they wish to value under the standard, outside parties will be looking for consistency in how the standard was applied.

Last, CEOs need to consider the future. Once you go down the fair value path, there's no turning back. Today, fair value standards may provide a great financial advantage for your company, but circumstances and market conditions change. Anticipate that change, estimate how long you will hold any asset and run predicative models to see if fair value will provide an ongoing advantage for your company.

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