

# fair to SMEs

The new International Financial Reporting Standard for small and medium-sized entities offers the option of applying full-blown accounting rules for financial instruments, such as the fair value option. But as [Dave Marlow](#) explains, the benefits and pitfalls need careful consideration.

## TIPS FOR SMES

The International Accounting Standards Boards new International Financial Reporting Standard (IFRS) for small and medium size enterprises (SMEs) precludes the selective use of IFRS, with the exception of International Accounting Standard (IAS) 39. This offers SMEs the option of applying full-blown accounting rules for financial instruments, such as the fair value option. The following tips can help finance directors to decide whether this is the right approach for their particular organisation.

- Examine whether the benefits outweigh the disadvantages for your organisation.
- Remember that IASB guidelines stress that the relevant credit risk is the risk associated with each particular liability, with a well-collateralised liability having less risk than other liabilities. The FD can decide to fair value certain liabilities and leave the rest at amortised cost if that best fits the needs of the organisation, but it is important these decisions are applied consistently over time.
- Bear in mind the potential downsides in terms of corporate reputation and relations with stakeholders. How will you communicate the change?
- Changes in fair value should not be allowed to significantly distort the perceived performance of the company.
- Remember - this is not a one-off exercise and you will need to be consistent through good times and bad. When the value of the company's liabilities increases, you will need to book a debit to income.



Fair valuing own debt for own credit risk is a particularly controversial topic among accountants. There is no common agreement on what should be fair valued, nor on how fair value should be defined to achieve a reliable and comparable result across companies, industries and territories. The International Accounting Standards Board recently issued a new discussion paper on this topic, to try and build consensus. So what is all the fuss about?

Existing IFRS require profit or loss resulting from changes in 'own credit risk' to be recognised in the income statement when debt is fair valued. If the company's credit rating is impaired because of concerns over the organisation's financial health, then the value of its debt is likely to diminish. The debt would be re-measured by marking the liability to market and the difference between the debt's carrying value and its new 'fair value' is recorded as a debit to liabilities and a credit to income. In other words, a company may be able to improve its balance sheet and income statement position by fair valuing its liabilities in times of difficulty.

This is best illustrated by leading banks such as Barclays, which booked a £1.66bn contribution to profit in 2008 as a result of fair valuing its own debt. This improved the income statement when Barclays needed to prove it could remain independent, but it was also an admission that market sentiment was turning away from the group and the banking sector. So this is not a panacea for a deeply troubled organisation, as illustrated

by Lehman's adoption of fair value prior to its ultimate demise. So when and why should small and medium-sized entities (SMEs) consider fair valuing their own liabilities for own credit risk?

Fair valuing own debt is optional, so finance directors need to decide whether it benefits the organisation, or its stakeholders. First and foremost, fair value can help the company to better match its assets and liabilities. Some financial assets – like certain shareholdings in other companies – must be held at fair value under current accounting rules, so deciding to value the organisation's liabilities in the same way will better reflect any natural hedge that exists. Moreover, it can be used to book a contribution to the income statement if the company is likely to struggle in coming years.

However, there are problems with fair valuing liabilities. Its complexity means it takes up more of the accountant's time than the alternative, amortised cost accounting, and this increase in cost and effort may be problematic for SMEs. Similarly, it can impact on perceptions of the credibility of the organisation. Stakeholders will want to know why this accounting treatment was adopted and may suspect it is a precursor to poor business performance in the future.

Last, but not least, finance directors must be consistent: you cannot chop and change accounting treatments when the business environment changes, so the company may need to book losses when it is doing well.

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