

**FINAL REGULATORY IMPACT ASSESSMENT
ON
THE USE OF FAIR VALUE ACCOUNTING FOR CERTAIN FINANCIAL
INSTRUMENTS FOR COMPANIES AND BUILDING SOCIETIES**

1. Proposal

1.1 The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 and the Building Societies (Accounts and Related Provisions) (Amendment) Regulations 2004 implementing the Fair Value Directive¹.

1.2 For companies, the implementation of the Modernisation Directive², options in the IAS Regulation³, and other changes necessary to ensure that the regulation is fully effective in Great Britain, is being taken forward in the same Statutory Instrument as these accounting amendments. For building societies, the implementation is being taken forward in two Statutory Instruments. This regulatory impact assessment discusses the costs and benefits of the implementation of the Fair Value Directive. The costs and benefits of the Member State options in the IAS Regulation and the Modernisation Directive are discussed in separate regulatory impact assessments⁴.

1.3 Unless stated otherwise, references in this regulatory impact assessment to “companies” should be taken to include companies, building societies, limited liability partnerships (“LLPs”) and certain banking and insurance undertakings.

2. Purpose and intended effect

(i) Objective

2.1 The Fair Value Directive requires Member States to enable companies to follow modern, more transparent accounting practices in the area of financial instruments that are consistent with International Accounting Standards (IAS).

¹ Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as banks and other financial institutions. OJ L283/28 of 27 October 2001

² Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Council Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674 on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings. OJ L 178/16 of 17 July 2003. (“the Modernisation Directive”)

³ Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of Ministers of 19 July 2002 on the application of international accounting standards (“the IAS Regulation”)

⁴ Final Regulatory Impact Assessment on the exercise of Member State option in the IAS Regulation, URN 04/1669 and Final Regulatory Impact on the Modernisation Directive for companies and building societies, URN 04/1667

2.2 The intention of this proposal is to permit all companies and certain other undertakings to account at fair value (essentially current market value) for certain types of financial instrument in both their individual and consolidated accounts. Where financial instruments are valued at fair value, changes in value are recorded in the profit and loss account, other than in certain limited circumstances. The proposal will also permit the valuation of assets and liabilities that qualify as hedged items under a fair value hedge accounting system at the specific amount required by that system.

2.3 Responsibility for company law matters lies with the Secretary of State for Trade and Industry, and for building society law matters with the Chancellor of the Exchequer. Company law and building society law are reserved areas under the Scottish and Welsh devolution legislation and therefore any resulting changes to company and building society legislation will also apply in Scotland and Wales. Building society law is also a reserved area under the Northern Ireland devolution legislation. In Northern Ireland, matters arising from the proposal would normally be the responsibility of the Northern Ireland Executive Ministers. Whilst the Northern Ireland Assembly and Executive are suspended, these functions will be discharged by the Northern Ireland Departments subject to the direction and control of the Secretary of State for Northern Ireland.

(ii) Background

EU accounting requirements

2.4 EU accounting requirements are based primarily on the four Accounting Directives: the Fourth Directive on the annual accounts of certain companies⁵, Seventh Directive on the consolidated accounts of certain companies⁶, the Directive on the annual and consolidated accounts of banks and other financial institutions⁷ (the Bank Accounts Directive), and the Directive on the annual and consolidated accounts of insurance undertakings⁸ (the Insurance Accounts Directive). The Fair Value Directive amends the Fourth Directive, the Seventh Directive and the Bank Accounts Directive. Companies are subject to these Directives. Building societies are not subject to the Fourth and Seventh Directives but the Bank Accounts Directive applies certain provisions of the Fourth Directive to credit institutions, including building societies. Fair Value amendments to the Insurance Accounts Directive have been made through the Modernisation Directive.

⁵ Fourth Council Directive of 25 July 1978 (78/660/EEC) based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies. OJ L222/11 of 14 August 1978.

⁶ Seventh Council Directive of 13 June 1983 (83/349/EEC) based on Article 54(3)(g) of the Treaty on consolidated accounts. OJ L193/1 of 18 July 1983.

⁷ Council Directive of 8 December 1986 (86/635/EEC) on the annual and consolidated accounts of banks and other financial institutions. OJ L372/1 of 31 December 1986.

⁸ Council Directive of 19 December 1991 (91/674/EEC) on the annual and consolidated accounts of insurance undertakings. OJ L274/7 of 31 December 1991.

2.5 The Fair Value Directive is part of the EU's objective of enabling companies to use modern accounting practices that are consistent with IAS issued by the International Accounting Standards Board ("IASB").

2.6 The EU Regulation on IAS requires EU companies whose securities are admitted to trading on a regulated market to prepare their consolidated accounts on the basis of IAS from 1 January 2005. Following consultation on Member State options⁹ the Government has decided to extend the Regulation so that publicly traded companies and building societies that issue listed securities will be permitted (but not required) to prepare their individual accounts, and all other companies will be permitted (but not required) to prepare their individual and consolidated accounts using IAS. Following a further consultation¹⁰, the Government has decided to extend the Regulation in a similar manner for building societies. The Modernisation Directive is designed to bring European accounting practices into line with modern accounting practices. This will enable companies to follow modern, more transparent accounting practices that are consistent with IAS.

Accounting for financial instruments

2.7 The nature of international financial markets has now resulted in the widespread use of not only traditional financial instruments such as shares and bonds, but also various forms of derivative financial instruments such as futures, options, forward contracts and swaps. These relatively complex financial instruments are used mainly by the largest industrial companies across all sectors of the European economy as tools to manage financial risks that their businesses are exposed to from movements in variables such as interest rates, currency rates or equity or commodities prices. However, the use of these instruments for risk management purposes can itself bring significant associated risks for the companies that use them, and as a result some companies are now using financial instruments that can transform their financial position and risk profile overnight. The growth in the use of such financial instruments has outstripped the development of guidance for their accounting, including the guidance in the Accounting Directives. The present form and substance of the financial reporting on these instruments does not always reflect their impact and associated risks¹¹.

2.8 In response to the increasingly widespread use of these complex financial instruments, IAS 39 (*Financial Instruments: Recognition and Measurement*) and the related standard IAS 32 (*Financial Instruments: Disclosure and Presentation*) were developed by the International Accounting Standards Committee to cover fair value accounting for financial instruments. IAS 39 defines "fair value" as "the amount for which an asset could be

⁹ International Accounting Standards, A consultation on the possible extension of the European Regulation on International Accounting Standards, DTI, URN 02/1158

¹⁰ Modernisation of Accounting Directives/IAS infrastructure, A Consultation Document. DTI, URN04/733.

¹¹ Source: The Explanatory Memorandum prepared by the European Commission that accompanied the proposed Fair Value Directive.

exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction¹². "Financial instrument" includes cash, receivables, payables, equity and debt securities as well as financial derivatives such as futures, options and swaps.

2.9 Companies that account for their financial instruments at fair value must comply with certain disclosure requirements by providing information on: the items stated at fair value; the fair value of those items and their purchase prices, and; the method used to determine fair value. Companies that do not account at fair value for such instruments must in any case disclose the fair value of any derivative financial instruments that they hold. Small companies will be exempted from the requirement to provide this information. In addition, building societies, if they do not account for their financial instruments at fair value, will not be required to disclose in their notes to the accounts the fair value of any derivative financial instruments they hold. Building societies, listed companies, banks and similar institutions applying Financial Reporting Standard (FRS) 13 (Derivatives and other Financial Instruments: Disclosures) already have to make more extensive disclosures than those required by the Directive in the notes to their accounts.

2.10 Directives are not directly applicable in Member States but must be implemented through national law, in this case requiring changes to the Companies Act 1985 and the Building Societies (Accounts and Related Provisions) Regulations 1998. It is proposed that these changes will be applied to LLPs, and to certain banking undertakings and insurance undertakings (including certain industrial and provident societies and friendly societies), with minor amendments where appropriate.

The ASB's convergence programme

2.11 In the UK, accounting standards issued by the Accounting Standards Board (ASB) apply to all UK companies and building societies; they are also used by a variety of other entities. The ASB and IASB standards are in many cases very similar, although there are also a number of differences. The ASB's standards will continue to apply to all UK companies and building societies and certain other reporting entities that do not report under the IAS Regulation (whether directly or by extension). The ASB does not believe it is a credible option, except in the short term, to retain two different sets of standards in use in the UK. It therefore aims to bring UK standards into line with IASB standards. In March 2004 the ASB published a discussion paper¹³ setting out proposals for achieving this.

¹² "International Accounting Standards 2003", published by the International Accounting Standards Board. Page 39-15.

¹³ A Strategy for Convergence with IFRS, 183/173.

(iii) Risk Assessment

2.12 The Government was required to implement the Fair Value Directive by 1 January 2004. The Government decided to defer implementation for one year in response to concerns raised by some consultees over implementation for 2004. In particular, the Government noted that from 1 January 2005 the group accounts of companies with securities traded on a regulated market would be required to be prepared in accordance with IAS. Other companies would have the option to apply IAS as an alternative to UK GAAP. Most of the requirements of the Fair Value Directive will not apply to accounts prepared in accordance with IAS. The Government decided that it would be undesirable to introduce accounting changes in law that would in some cases only apply for one year. Further, the Government considered that the new legislative provisions should preferably be supported by accounting standards. The relevant international standard (IAS 39) has been undergoing substantial revision, which has prevented the UK's Accounting Standards Board from implementing a UK standard based on it. The Government was persuaded by the arguments of consultees that it was advisable to defer implementation until the accounting standards were more settled. The Government has given an undertaking to the European Commission to implement the Fair Value Directive by 1 January 2005.

2.13 There are risks that if UK companies are not permitted to value financial instruments at fair value, they will not be able to follow the modern accounting practices in the accounting for financial instruments that will make balance sheets more transparent and create greater confidence for investors.

3. Options

3.1 The Fair Value Directive gives Member States options to:

- permit or require the valuation of financial instruments at fair value;
- extend the permission or requirement to all companies or restrict it to any class of company;
- restrict the permission or requirement to consolidated accounts only;
- permit the valuation of assets and liabilities that qualify as hedged items under a fair value hedge accounting system at the specific amount required by that system.

Member States also have the option to exempt small companies from certain disclosure requirements relating to financial instruments.

3.2 The Member State options mean there are numerous permutations of how the Fair Value Directive could be implemented. The Government does not propose to require companies to value financial instruments at fair value, restrict the class of company or restrict to consolidated accounts the valuation of financial instruments at fair value. For simplicity, only the 2 main

overarching options of “doing nothing” and “full permissive extension” are discussed below.

3.3 During public consultation¹⁴ respondents were asked if they agreed with the Government’s overall approach to implementation of the Fair Value Directive. 25 of the 26 substantive responses to that question were in favour of the Government’s proposals. Comments on the details of the proposals were received and (although not specifically requested) no alternative proposals were put forward by respondents.

Option 1:

3.4 *Do nothing.*

3.5 It is not feasible to “do nothing” as the UK is under an EC obligation to implement the Fair Value Directive. The risks of doing nothing are discussed at paragraphs 2.12 and 2.13 above.

Option 2:

3.6 Extend fair value and hedge accounting to all companies and all accounts on a permissive basis rather than as a requirement, and take advantage of all exemptions for small companies.

3.7 Using fair value accounting will give more transparency to the balance sheet and should give greater confidence to the investor although it may also lead to the balance sheets and results of some companies being more volatile than at present. This is because the use of current market values in annual accounts will result in regular changes in values, which will be dealt with in the profit and loss account in most cases. Investors will become used to the volatility of balance sheets resulting from the change in accounting practice and any loss of investor confidence will be short-term. Loss of investor confidence was not raised as a concern during the consultation.

¹⁴ Fair Value Accounting, A consultation document, DTI, June 2003, URN 03/960

4. Benefits

Option 1:

4.1 It could be argued that not implementing the Fair Value Directive would have the benefit of avoiding volatility and would maintain investor confidence avoiding the risks described at paragraph 3.7 above; those arguments are discussed in that paragraph. Permitting companies to choose to account for financial instruments at fair value will allow companies to choose for themselves whether they will benefit (see paragraphs 4.2 and 4.3 below).

Option 2:

4.2 The proposals have the benefit of allowing choice and flexibility in the use of fair value accounting. Companies look to accounting standards for more detailed requirements on how to account in particular situations. The guidance in the standards on fair value accounting is complex and may change in the future. A permissive approach rather than a requirement is therefore more helpful for companies at this stage. Allowing companies to use fair value accounting in both their individual and consolidated accounts will help the efficient preparation of consolidated accounts and ensure greater consistency. All companies that use financial instruments should have the opportunity to follow modern accounting practice and account for them at fair value. This proposal will allow companies using IAS and companies using UK GAAP to value financial instruments on a similar basis. Small companies will benefit from exemptions on certain disclosure requirements.

4.3 It is difficult to quantify these benefits. However, the Government believes the proposal will make balance sheets more transparent at the balance sheet date and that this will create greater confidence for investors. Respondents to the public consultation support the Governments approach to fair value in permitting companies to follow accounting best practice.

Business Sectors Affected

4.4 This amendment will potentially affect all companies in Great Britain that use financial instruments and UK GAAP to account for them at fair value. Publicly traded companies and building societies that issue listed securities and are required to produce consolidated accounts will not be affected by these regulations as they will be required to account for financial instruments at fair value under the IAS Regulation. Following the European Commission's Business Test Panel review which showed that the Fair Value Directive would mostly affect large companies¹⁵ the Government estimates that 50% of large companies (5,700 approx), 20% of medium-sized companies (4,800 approx)

¹⁵ Source: The Explanatory Memorandum prepared by the European Commission that accompanied the proposed Fair value Directive

and 1% of small companies (11,500 approx) are likely to use fair value accounting for financial instruments.

4.5 The cost of using fair value accounting are discussed at paragraphs 5.2 to 5.10 below.

4.6 This amendment will also potentially affect all building societies in the United Kingdom. There are currently 63 building societies registered with the Financial Services Authority (“FSA”). It is not possible to say how many of these will account for their financial instruments at fair value.

4.7 The proposal will particularly affect accounting firms in that they will need to take account of the change in accounting practice for fair value accounting and train staff accordingly. There are over 64,000 UK businesses or firms operating primarily in the accounting area. In addition, the Government estimates that there are some 22,000 companies that will also need to take account of the change. In addition, firms should be aware that building societies, listed companies, banks and similar institutions complying with the UK accounting standard FRS 13 (Derivatives and other Financial Instruments: Disclosures) already have to make fair value disclosures in the notes to their accounts.

Issues of Equity and Fairness

4.8 The Department considers that the proposal will be neutral in its effect and the change to fair value accounting in the accounts of companies will not bring disproportionate benefits or have disproportionate effects on particular groups.

5. Costs

(i) Compliance costs

Option 1:

5.1 There would be no compliance costs on companies in the “do nothing” option.

Options 2:

5.2 The Government considers that the proposal does not impose compliance costs on companies in general as they will be permitted rather than required to use fair value accounting for their financial instruments, although companies (but not building societies) that do not account at fair value for such instruments must in any case disclose the fair value of any derivative financial instruments that they hold.

5.3 There will be some cost to some companies in deciding whether to use fair value accounting. The cost would be in management time spent considering the issue, and possibly the cost of attending seminars or purchasing information on fair value accounting. It is very difficult to estimate how many companies would spend a significant amount of time deciding whether to use fair value accounting, or quantify how much this would cost. However, the costs of training courses, given below, may give some indication.

5.4 The main cost of the proposal will be the cost to accounting firms in training on the new requirements. We estimate this to be a one-off cost for one days training for three people in the region of £2,850, broken down as follows:

Cost of training course	£750 x 3
Cost of staff time	£100 x 2 (assuming staff pay of £25,000 per annum approximately)
Cost of partner time	£400 (assuming partner pay of £100,000 per annum approximately)

5.5 There are over 64,000 accounting businesses in the UK, giving a total training cost for accountancy firms of £182.4m. If the Fair Value Directive was implemented in a less flexible way, by restricting use of fair value accounting to larger companies, the total costs may be reduced, as those accountancy firms that did not deal with companies permitted to use fair value accounting would not necessarily need to train staff. However, a training cost for some accountancy firms is an unavoidable result of the Directive itself, regardless of the method of implementation.

5.6 There would also be a training cost to those companies who wish to use fair values and have in-house accountants. We estimate this to be a one-off cost for one day's training in the region of £850, broken down as above (cost of training, cost of staff time). It is difficult to estimate how many companies would be in this position. If, as estimated at paragraph 4.4, there were some 22,000 companies opting to account at fair value, the total cost would be around £18.7 million.

5.7 The on-going cost of using fair value accounting would depend entirely on the circumstances of the company. It is unlikely that most small companies would have financial instruments whose fair value needs to be calculated. Where companies do make use of financial instruments there will be costs. These costs will vary greatly depending on the extent and type of financial instrument used. These costs could be in the region of up to £1,000 per company per annum but may be on average £500. Given the estimate of some 22,000 companies making use of fair value accounting (see paragraph

4.4 above) the Government estimates that the ongoing cost to companies would be in the region of £11m to £22m).

5.8 There may also be some cost in updating IT systems, although this is not thought to be significant and will be absorbed in the regular updating of software packages to take account of changes in accounting standards.

(ii) Other costs

5.9 The Government considers that there are no costs imposed on sectors other than business.

(iii) Costs for a typical business

5.10 There would be a cost in training staff in the accountancy sector and in-house accountants, estimated to be in the region of £1,500 and £850 respectively.

6. Consultation with small business: The Small Firm's Impact Test

6.1 Discussion with small accountancy firms serving the small business sector indicated that the impact on small businesses would be minimal. They are not required to use fair value accounting, and it is unlikely that many will choose to do so. While some small businesses may dismiss the use of fair value accounting out of hand because it is not a requirement, others will wish to study the subject before deciding. It is difficult to quantify how many businesses will choose to use fair value, and the cost of informing themselves. However, the cost to an individual business is not thought to be significant. Although there may not be much take up of fair value accounting from small businesses, small accountancy firms will still need to familiarise themselves with the new requirements, as they would with any other development in accounting practice (see paragraph 5.4 for an estimation of training costs). Companies must in any case disclose the fair value of any derivative financial instruments that they hold.

7. Competition Assessment

7.1 The proposal has the potential to affect all public and private companies and LLPs in all markets, where the business has to account for financial instruments. It is not anticipated that the proposal will: affect some of those businesses more than others; affect market structure; change the number or size of those businesses; lead to higher set-up costs for those businesses; or lead to higher on-going costs, than at present. The main business sector identified as being affected by this change is the accounting sector.

8. Enforcement and Sanctions

8.1 In Great Britain there is already a well-regarded enforcement regime in place for ensuring that company financial statements meet the requirements of existing legislation. In addition to criminal penalties, currently the Financial Reporting Review Panel (“FRRP”) has legal authority to review companies’ accounts and if necessary to go to court to compel a company to revise its accounts. The FRRP shares this responsibility with the Secretary of State. By administrative agreement the FRRP deals with the accounts of public and large private companies, and the Secretary of State (through Companies House) with the rest.

8.2 In terms of building societies, the Building Societies Act 1986 and subsequent Regulations made under this Act contain a number of important requirements on accounting and auditing. Breaches of the most important of these requirements are criminal offences for which both the building society and any of its officers in default can be prosecuted and fined. Building societies are also subject to supervision and regulation by the FSA. The FSA receives a copy of each society’s annual accounts and has a flexible range of sanctions at its disposal to ensure compliance with the statutory requirements.

9. Monitoring and Review

9.1 The EU Contact Committee on the Accounting Directives will keep the Fair Value Directive under review and consider the need for further changes in EU Accounting Directives.

10. Consultation

(i) Within Government

10.1 The Department for Trade & Industry and HM Treasury have consulted with the Small Business Service, the Inland Revenue and the Financial Services Authority.

(ii) Public consultation

10.2 On 12 June 2003, the Department for Trade & Industry published a consultation document on the use of Fair Value Accounting for certain financial instruments and the disclosure of dividends. The consultation was sent to approximately 700 businesses, professional bodies, representative organisations and individuals. In addition, the consultation document was made available on the DTI’s website. The deadline for comments was 5 September 2003.

10.3 On 5 September 2003, Her Majesty’s Treasury published a consultation document on the use of Fair Value Accounting for certain financial instruments for building societies. The consultation was sent to approximately 100 societies, representative organisations and individuals. In addition, the consultation

document was published on the HM Treasury's website. The deadline for responses was 31 October 2003.

10.4 A total of 27 responses were received to the DTI consultation. 24 respondents were broadly in favour of the proposal. The 3 remaining respondents did not express a view. A number of respondents raised concerns about the timing of implementation. These are discussed at paragraph 2.11 above. A total of 6 responses were received to the HM Treasury consultation. 5 respondents were broadly in favour of the proposal with the one remaining not expressing a view. A number of responses to both consultation documents raised concerns about the timing of implementation. These are discussed at paragraph 2.11 above.

10.5 Respondents were asked to comment on the costs and benefits of the proposal to permit all companies and certain other undertakings to account at fair value for certain types of financial instrument in both their individual and consolidated accounts. The general consensus was that the costs are hard to quantify, although they were probably underestimated in the consultation document. It is difficult to quantify the time taken to read the information on fair value accounting and to both isolate and assign costs to fair value specifically, given the other developments in accounting at the moment. These comments have been taken into account in preparing this regulatory impact assessment. A Summary of Responses to the DTI consultation document is available on the DTI website at www.dti.gov.uk/cld/fairvalue.htm. A summary of Responses to the HM Treasury consultation document is available on the HM Treasury website.

11. Summary and Recommendation

11.1 The table below shows a summary of the costs and benefits of the proposal:

Option	Total cost per annum	Total benefit per annum
1. "The do nothing option"	None	None
2. Allow current market value of financial instruments to be used by <u>all</u> companies in their financial statements	One-off training cost of £2,850 for each accountancy firm – Total cost £182.4 million (£2,850 X 64,000 accountancy firms) One-off cost of training £850 for	Allow all companies to use most up-to-date accounting practice for their financial instruments. More relevant and reliable information for users of accounts. Facilitate convergence of UK accounting standards with IAS

	<p>each company – Total cost £18.7m (£850 X 22,000 companies)</p> <p>Ongoing costs £11m to £22m (22,000 companies X £500 and X £1,000)</p>	
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11.2 The Government proposes to permit but not require all companies to use fair value accounting for their financial instruments in both their individual and consolidated accounts, and permit valuation under a fair value hedge accounting system. It believes this flexible, permissive approach is most appropriate for businesses at this time. It also proposes to take advantage of the exemptions from disclosure requirements for small companies that choose to account for their financial instruments at fair value, in order to reduce the burden on them.

11.3 This regulatory impact assessment has been approved by HM Treasury.

I have read the Regulatory Impact Assessment and am satisfied that the benefits justify the costs.

..... Date:

Jacqui Smith, Minister of State for Industry and the Regions, Deputy Minister for Women and Equality

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