EXPLANATORY MEMORANDUM TO THE DRAFT COMPANIES ACT 1985 (INTERNATIONAL ACCOUNTING STANDARDS AND OTHER ACCOUNTING AMENDMENTS) REGULATIONS 2004

1. This explanatory memorandum has been prepared by the Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

1.1. This memorandum contains information for the Joint Committee on Statutory Instruments.

2. DESCRIPTION

2.1 This Statutory Instrument amends the Companies Act 1985 (the 1985 Act) to:

- permit companies to choose to use International Accounting Standards (IAS) rather than domestic accounting requirements;

- ensure that the use of IAS is fully accommodated within the 1985 Act; and

- update accounting requirements in certain areas.

3. Matters of special interest to the Joint Committee on Statutory Instruments.

3.1 The Government was required to implement the Fair Value Directive, one of the Directives being implemented by this instrument, by 1 January 2004[1]. Paragraphs 4.8 – 4.10 below explain why there has been a delay in implementation. The Government has undertaken to the European Commission to implement the Fair Value Directive by 1 January 2005.

3.2 Articles 1.14, 1.17 (part) and 2.10 of the Modernisation Directive amend the requirements regarding the annual report. These are being dealt with separately. There are some similarities between these provisions and the Government's proposals for a statutory Operating and Financial Review (OFR). Therefore, these particular amendments from the Modernisation Directive are being taken forward with the OFR proposals. The Government intends to lay draft regulations to implement the OFR by the end of 2004.

4. LEGISLATIVE BACKGROUND

4.1 This Statutory Instrument is being made to implement two separate pieces of European legislation:

- 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 of banks and other financial institutions, OJ L283/28 of 27 October 2001 (the "Fair Value Directive").

[1] The EC documents referred to in this memorandum are on the EC Commission's web site at http://europa.eu.int/comm/internal_market/accounting/index_en.htm.

- Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings, OJ L178/16 of 17 July 2003 (the "Modernisation Directive"), with the exception of articles relating to the directors' report.

4.2 The Statutory Instrument also makes provision to ensure the effective application in Great Britain of Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of International Accounting Standards, OJ L243/1 of the 11 September 2002 (the "IAS Regulation"), and implements Member State options in that Directive.

4.3 The IAS Regulation requires companies governed by the law of a Member State, whose securities are admitted to trading on a regulated market in any Member State in the EU ("publicly traded companies") to prepare their consolidated accounts on the basis of accounting standards issued by the International Accounting Standards Board (IASB) that are adopted by the European Commission.

4.4 The IAS Regulation applies directly to those companies caught by it and strictly speaking does not need to be implemented in domestic legislation. However, certain changes to the 1985 Act are necessary to ensure that it is fully effective. The IAS Regulation also permits Member States to extend use of IAS to the individual accounts of publicly traded companies and to the individual and consolidated accounts of other companies.

4.5 The Modernisation Directive amends the four EU Directives that form the basis of European accounting requirements:

- the Fourth and Seventh Directives on the annual and consolidated accounts of companies;

- the Bank Accounts Directive on the annual and consolidated accounts of banks; and

- the Insurance Accounts Directive on the annual and consolidated accounts of insurance companies.

It will enable companies and building societies to follow modern, more transparent accounting practices that are consistent with International Accounting Standards (IAS).

4.6 The Fair Value Directive amends the accounting directives to permit certain financial instruments to be recorded at fair value (essentially current market value), in line with international accounting practices.

4.7 Additional amendments are being made to the 1985 Act to change the requirements on disclosure of information about dividends and to make minor changes to reporting and filing requirements.

4.8 The IAS Regulation and the Modernisation Directive must be implemented by 1 January 2005. The Fair Value Directive has an implementation date of 1 January 2004, but the Government decided to defer implementation for one year in response to concerns raised by consultees over implementation for 2004, in particular because of the further far-reaching changes to company accounting taking effect on 1 January 2005 under the IAS Regulation.

4.9 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 a year.

4.10 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.

4.11 As a general rule when transposing this EU Legislation the Government has followed the wording of the Directives as closely as possible. Transposition Notes for the IAS Regulation, Modernisation Directive and Fair Value Directive are attached at Annexes A1, A2 and A3 respectively.

Scrutiny

4.12 **IAS Regulation** – DTI Explanatory Memorandum 6365/01 was submitted on 16 March 2001. The Commons European Scrutiny Committee considered it not legally or politically important and cleared it (Report No. 1, Item 22162, Session 00/01). The Lords Select Committee on the EU did not report on it (Progress of Scrutiny 13.04.01, Session 00/01).

4.13 **Modernisation Directive**
DTI Explanatory Memorandum 9730/1/02 REV1 COM (2002) 25912 Final was submitted on 26 February 2002. The Commons European Scrutiny Committee considered it politically important and cleared it (Report No 37, Item 23522, Session 01/02). The Lords Select Committee on the EU cleared it on 09.07.02 (Progress of Scrutiny 22.07.02, Session 01/02).

4.14 DTI Explanatory Memorandum OTNYREM was submitted on 05 December 2002. The Commons European Scrutiny Committee considered it politically important and cleared it (Report No. 5, Item 24060, Session 02/03). The Lords Select Committee on the EU did not report on it (Progress of Scrutiny 21.12.02, Session 02/03).

4.15 **Fair Value Directive -** DTI Explanatory Memorandum 6511/00 COM (2000) 80 Final was submitted on 10 April 2000. The Commons European Scrutiny Committee considered it not legally or politically important and cleared it (Report No. 14, Item 21048, Session 99/00). Lords Select Committee on the EU did not report on it (Progress of Scrutiny 21.04.00, Session 99/00).

5. EXTENT

5.1 This instrument applies to Great Britain.

6. EUROPEAN CONVENTION ON HUMAN RIGHTS

6.1 The Minister for Industry and the Regions and Deputy Minister for Women & Equality, Jacqui Smith has made the following statement regarding Human Rights:

In my view, the provisions of the Companies Act 1985(International Accounting Standards and Other Accounting Amendments) Regulations 2004 are compatible with the Convention rights.

7. POLICY BACKGROUND

IAS Regulation

7.1 During 1999, the European Commission published a communication on *"Financial Services: Implementing the Framework for Financial Markets: Action Plan"*. In March 2000, Ministers of Member States at the Lisbon European Council concluded that, in order to accelerate completion of the internal market for financial services, steps should be taken to enhance the comparability of companies' financial statements by 2005. The IAS Regulation is the main result of this decision.

7.2 The IAS Regulation introduces important changes in the way certain companies across the EU prepare their financial statements. It will apply directly to the consolidated accounts of EU publicly traded companies. The Government welcomes the adoption of the Regulation and strongly supports the European move to use IAS. Global markets require high quality globally agreed accounting standards to work more effectively. For publicly traded companies, adherence to global accounting standards should help to reduce the cost of capital by making their accounts more accessible to potential investors across the EU and worldwide. For potential investors, creditors and other users of financial statements, global standards provide a single means by which to compare performance and prospects on a like-for- like basis. Global standards should also help to promote financial stability.

7.3 The Government has therefore decided that publicly traded companies should also be permitted to use IAS for their individual accounts, and that all other companies should be permitted to use IAS for their individual and/or consolidated accounts. Ministers have decided to extend the use of IAS on a permissive rather than mandatory basis because of the potential burden it could impose. In particular, IAS do not as yet offer a simplified regime for smaller companies comparable to that provided by the UK system. Also, IAS are in a state of transition and their impact on companies' profits (and tax liabilities) is therefore uncertain at present. However, the ultimate aim is to have a single accounting regime, which will provide greater consistency and transparency. The position will be reviewed around 2008 to see if the time is right to move to mandatory use of IAS.

7.4 There is considerable interest in the move to IAS among larger companies and the specialised business and accountancy press, but little interest among smaller companies (who are less likely to want to use IAS) and the general media. There is a general view that IAS is the way forward. Over 90% of those who responded to the original 2002 consultation on whether use of IAS should be extended were in favour of some extension. The summary of responses can be found at www.dti.gov.uk/cld/iassummary.pdf. There was less interest in the technical details of how the IAS Regulation should be implemented (consulted on in March 2004). The proposals were broadly supported overall, although there were differing views among respondents on certain issues. Further details can be found at in the summary of responses at www.dti.gov.uk/cld or in the RIA attached at Annex B1.

The Modernisation Directive

7.5 The Modernisation Directive is designed to:

- remove conflicts between the accounting directives and IAS in existence at the time it was drawn up; and

- ensure that optional accounting treatments currently available under IAS in existence at 1 May 2002 are available to EU companies which continue to have the accounting directives as the basis of their accounts (i.e. those companies which will not prepare their accounts in accordance with the IAS Regulation).

7.6 In general, the Modernisation Directive amendments are technical amendments to existing accounting requirements. The Government's general approach to implementing the Modernisation Directive is to facilitate greater convergence between UK accounting standards and IAS, without imposing unnecessary burdens.

7.7 Interest in these changes is largely confined to larger companies, accountants, and the specialist press. Those who responded to the consultation were largely supportive of the proposals. For further details, see the summary of responses www.dti.gov.uk/cld or in the RIA attached at Annex B2.

Fair Value Directive

7.8 The Fair Value Directive amended the accounting directives to permit certain financial instruments to be recorded at fair value in accordance with IAS 32 (*Financial Instruments: Disclosure and Presentation*) and IAS 39 (*Financial Instruments: Recognition and Measurement*). Member States have options on how far they extend the use of fair value accounting, and whether this is on a permissive or mandatory basis. The Government is permitting all companies to use fair value accounting for certain financial instruments in both their annual and consolidated accounts. As stated in the June 2003 Fair Value Accounting consultation document on implementing the Fair Value Directive, the Government believes a flexible, enabling approach is appropriate at this time.

7.9 This issue is of interest primarily to large companies, accountants, and the specialist press. Over 90% of those who responded to the consultation were in favour of the policy proposal, but concerned about the timing. Implementation has been delayed a year in response to these concerns. Further details can be found in the summary of responses at www.dti.gov.uk/cld/pdfs/fair_sum.pdf or in the RIA attached Annex B3.

Dividends

7.10 This amendment has the same objectives as the Modernisation Directive amendments: to bring accounting requirements into line with international requirements. It is a technical amendment, which requires information on dividends to be disclosed in slightly more detail and in a different location within financial statements. It is of interest to all companies that pay dividends. It has been exposed to consultation twice and attracted many comments. The details of the proposal have been amended in response to comments. Further details are in the summary of responses at www.dti.gov.uk/cld/pdfs/fair_sum.pdf and www.dti.gov.uk/cld or in the RIA attached at Annex B2.

Further amendments to the 1985 Act on reporting and filing requirements

Repeal of the current 3-month extension for laying and delivering accounts for all companies that have overseas interests

7.11 Section 244(3) of the 1985 Act currently allows, subject to notice, an automatic 3-month extension for companies with overseas business or interests of the period allowed for laying accounts and reports before the company in general meeting, and delivering them to the registrar of companies. This automatic extension was introduced in 1976; it is no longer justifiable in an era of rapid global communications.

7.12 This issue was covered in the *Modernising Company Law* White Paper, Cm 5553-1, July 2002. This can be found at www.dti.gov.uk/cld/review.htm. Interest was minimal. Those who responded commented that it was still the case that local business or cultural conditions overseas could impact on a company's ability to file accounts on time; the ability to seek an extension would help in these circumstances. The issue has attracted some interest in the media recently. There have been complaints that some companies are using the provision to keep information out of the public domain for as long as possible. These responses can be found at http://www.dti.uk/cld/modern/audit.pdf (responses to paragraph 4.52 covering both the overall reductions in filing times for public and private companies and the repeal of the three month extension).

7.13 Any company that anticipates real difficulty in meeting the reduced deadline may apply for a discretionary extension to be granted under section 244(5). Under this provision the Secretary of State may grant extensions where there are special reasons for a likely delay in the timely laying and filing of accounts. Unlike the automatic extension under section 244(3), this option is open to all companies, not only those with overseas business or interests. The amendment will therefore put all companies on an equal footing.

Voluntary revision of summary financial statements

7.14 Section 245 of the 1985 Act allows companies to issue voluntary revisions to their annual accounts or directors' report (for example to correct errors). It will be amended to extend voluntary revision to summary financial statements, which the 1985 Act does not currently specifically permit. However, there is nothing to stop companies voluntarily revising their summary financial statements outside of the 1985 Act. The amendment is therefore essentially a tidying-up measure to clarify existing practice.

Summary Financial Statements

7.15 Section 251 of the 1985 Act allows listed public companies to provide summary financial statements to their shareholders, in such cases as may be specified by the Secretary of State. This provision is being extended to allow the Secretary of State to permit any company to provide summary financial statements. The Government proposes to consult on making use of this extended power of specification in 2005.

8. IMPACT

8.1 Transposition Notes are attached to this Explanatory Memorandum as follows:

- IAS Regulation — Annex A1
- Modernisation Directive — Annex A2
- Fair Value Directive — Annex A3

8.2 Regulatory Impact Assessments are attached to this Explanatory Memorandum as follows:

- IAS Regulation — Annex B1
- Modernisation Directive — Annex B2
- Fair Value Directive — Annex B3

8.3 There is no impact on the public sector as this Statutory Instrument only applies to companies.

9. CONTACT

Valerie Carpenter at the Department of Trade & Industry, Telephone: 020 7215 0225 or email valerie.carpenter@dti.gsi.gov.uk can answer any queries regarding the instrument.

DEPARTMENT OF TRADE AND INDUSTRY

Annex A1

TRANSPOSITION NOTES – INTERNATIONAL ACCOUNTING STANDARDS REGULATION

THE COMPANIES ACT 1985 (INTERNATIONAL ACCOUNTING STANDARDS AND OTHER ACCOUNTING AMENDMENTS) REGULATIONS 2004

Introduction

1. The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004amend the Companies Act 1985 ("the 1985 Act") in order:

- to ensure the effective application of Regulation (EC) no1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards ("the IAS Regulation")[2].

- to exercise Member State options conferred by Article 5 of the IAS Regulation.

3. Under Article 4 of the IAS Regulation, companies governed by the law of a Member State, whose securities are admitted to trading on a regulated market in any Member State of the European Union ("publicly traded companies"), will be required to prepare their consolidated accounts on the basis of international accounting standards issued by the International Accounting Standards Board (IASB) that

[2] O.J. No. L243/1 of 11th September 2002.

are adopted by the European Commission. This will apply to financial years commencing on or after 1 January 2005 and is directly applicable in the UK.

4. Under Article 5 of the IAS Regulation, Member States may extend use of adopted IAS on a permissive or a mandatory basis to the individual accounts of companies subject to Article 4, and to the individual and consolidated accounts of other companies. Following public consultation in 2002[3], the Government decided that GB companies would be permitted to choose whether to prepare their accounts using adopted IAS or continue to prepare their accounts in accordance with the 1985 Act and UK Generally Accepted Accounting Practice (UKGAAP).

Transposition Details: The IAS Regulation

In all cases responsibility for measures taken to give full effect to the IAS Regulation and to implement the options in it lies with the Secretary of State for Trade and Industry.

Article		
5	Article 5(a) provides that Member States may permit or require the companies governed by Article 4 to prepare their individual accounts in accordance with adopted IAS. Article 5(b) provides that Member States may permit or require other companies to prepare their consolidated accounts and/or their individual accounts in accordance with adopted IAS.	Part 2 of the Regulations inserts new sections 226 and 226A into the Companies Act 1985 permitting companies to prepare individual accounts in accordance with adopted IAS. New section 226B requires disclosure in the notes to the accounts where individual accounts are prepared in accordance with adopted IAS. . Part 2 of the Regulations also inserts new sections 227 and 227A permitting companies not governed by Article 4 of the IAS Regulation to prepare group accounts in accordance with adopted IAS. New section 227B requires disclosure in the notes to the accounts where group accounts are prepared in accordance with adopted IAS. New section 227C makes

3 "International Accounting Standards", 30 August 2002. URN 02/1158.

		provision for consistency of accounts within a group. Regulation 3 of and Schedule 1 to the Regulations make consequential amendments to the 1985 Act to ensure the full effectiveness of Article 4 and of the exercise of the Member State options in Article 5

Annex A2

TRANSPOSITION NOTES – THE MODERNISATION DIRECTIVE

THE COMPANIES ACT 1985 (INTERNATIONAL ACCOUNTING STANDARDS AND OTHER ACCOUNTING AMENDMENTS) REGULATIONS 2004

Introduction

1. The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 ("the 2004 Regulations") implement 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/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings ("the Modernisation Directive"), with the exception of articles 1.14, 1.17 (in part) and 2.10. The 2004 Regulations also give full effect to, and implement certain Member State options in, the IAS Regulation[4] and implement the Fair Value Directive[5].

2. These transposition notes deal with the implementation of the Modernisation Directive. The implementation of the Fair Value Directive and the IAS Regulation by the 2004 Regulations are the subject of separate transposition notes. Articles 1.14, 1.17(in part) and 2.10 of the Modernisation Directive making changes to the directors' report will be implemented in separate regulations which will introduce a related report - the Operating and Financial Review.

3. European Union (EU) accounting requirements are based primarily on four Accounting Directives; the Fourth[6] and Seventh[7] Directives on the annual and consolidated accounts of companies:

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[4] Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards (OJ L243/1 of 11 September 2002).

[5] 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).

[6] Fourth Council Directive of 25 July 1978 (78/660/EEC) on the annual accounts of certain types of companies (OJ L222/11 of 14.8.1978).

[7] Seventh Council Directive of 13 June 1983 (83/349/EEC) on consolidated accounts (OJ L193/1 of 18.7.1983).

the Directive on the annual and consolidated accounts of banks and other financial institutions[8] ("the Bank Accounts Directive"); and the Directive on the annual and consolidated accounts of insurance undertakings[9] ("the Insurance Accounts Directive").

4. The Modernisation Directive amends the Accounting Directives by removing conflicts between the Accounting Directives and international accounting standards ("IAS") in existence at the time it was drawn up, and ensuring that optional accounting treatments available under IAS in existence at 1 May 2002 are available to EU companies which continue to have the Accounting Directives as the basis of their accounts (ie those companies which will not prepare their accounts in accordance with the IAS Regulation). The Modernisation Directive also amends the Insurance Accounts Directive to allow Member States to permit or require insurance companies to account at fair value for some of their financial instruments. The provisions for building societies and for Lloyd's are the subject of separate regulations and separate transposition notes. Similar provisions on fair valuation for other companies are contained in the Fair Value Directive.

6. The Accounting Directives have been transposed into national law by the Companies Act 1985 ("the 1985 Act"). The transposition of the Modernisation Directive therefore takes the form of amendments to the 1985 Act. In particular, the 2004 Regulations amend Part 7 of the 1985 Act and its attendant Schedules - Schedules 4 (form and content of company accounts), 4A (form and content of group accounts), 8 (form and content of accounts prepared by small companies), 8A (form and content of abbreviated accounts of small companies delivered to Registrar), 9 (special provisions for banking companies and groups), and 9A (form and content of accounts of insurance companies and groups).

7. In all cases responsibility for the measures described in this transposition note taken to implement the Modernisation Directive lies with the Secretary of State for Trade and Industry.

8. The Table below describes where the substantive amendments made by the Modernisation Directive are being implemented in the 2004 Regulations.

[8] Council Directive of 8 December 1986 (86/635/EEC) on the annual accounts and consolidated accounts of banks and other financial institutions. OJ L372/1 of 31 December 1986.
[9] Council Directive of 19 December 1991 (91/674/EEC) on the annual accounts and consolidated accounts of insurance undertakings. OJ L374/7 of 31 December 1991.

Article	Objective	Implementation
	Amendments to the Fourth Directive (78/660/EEC)	
1.1	A new subparagraph in Article 2(1) allows Member States to permit or require the inclusion of other statements in the annual accounts in addition to the profit and loss account, balance sheet and notes to the accounts.	Member State option not being exercised.
1.2	New paragraph 6 in Article 4 allows Member States to permit or require the presentation of amounts within items in the profit and loss account and balance sheet to have regard to the substance of the reported transaction or arrangement rather than its legal form. Such permission or requirement may be restricted to certain classes of company and/or to consolidated accounts as defined in the Seventh Directive.	Member State option being exercised as a requirement. Schedule 2, paragraph 3 inserts a new paragraph 5A into Schedule 4 (form and content of company accounts) to the 1985 Act. Schedule 3, paragraph 3 inserts a new paragraph 5A into Schedule 8 (form and content of accounts prepared by small companies) to the 1985 Act. Schedule 5, paragraph 3 inserts a new paragraph 8A into Schedule 9 (special provisions for banking companies and groups) to the 1985 Act. Schedule 6, paragraph 3 inserts a new paragraph 6A into Schedule 9A (form and content of insurance companies and groups) to the 1985 Act.
1.3, 1.6, 1.13 and 1.21	A new paragraph in Article 8 allows Member States to permit or require companies to adopt the presentation of the balance sheet set out in article 10a (as inserted by Article 1.6) as an alternative to the layouts otherwise prescribed or permitted. New Article 10a allows Member States to permit or require companies, or certain classes of company, to present balance sheet items on the basis of a distinction between current and non-current items, as in IAS rather than as in Articles 9 and 10, provided that the information given is at least as equivalent.	Member State option not being exercised.
1.4, 1.5, 1.7, 1.9 and 1.10	These Articles make changes in terminology relating to provisions to facilitate the application of IAS 37 *Provisions, contingent liabilities and contingent assets*.	Schedule 2, paragraphs 4, 5, 8, 9 and 12 amend Schedule 4 (form and content of company accounts) to the 1985 Act. Schedule 3, paragraphs 4, 5, 8 and 11 amend Schedule 8 (form and content of accounts prepared by small companies) to the 1985 Act. Schedule 4, paragraph 2 amends Schedule 8A (form and content of abbreviated accounts of small companies delivered to Registrar) to the 1985 Act. Schedule 5, paragraphs 4, 5, 9 and 12 amend Schedule 9 (special provisions for banking companies and groups) to the 1985 Act. Schedule 6, paragraphs 4, 5, 10 and 13 amend Schedule 9A (form and content of accounts of insurance companies and groups) to the 1985 Act. Consequential amendments are made in

		Schedule 7 paragraphs 2, 3, 8, 9 and 11.
1.8	A new paragraph in Article 22 allows Member States to permit or require all companies or any classes of company, to present a statement of their performance instead of the presentation of profit and loss items, provided the information given is at least equivalent.	Member State option not being exercised.
1.10	In Article 33(1)(c) "Revaluation of tangible fixed assets and financial fixed assets" is replaced with "Revaluation of fixed assets". This expands the scope of the fixed assets that can be revalued, in line with IAS.	Member State option not being exercised as Schedule 4 paragraph 31 to the 1985 Act already permits intangible fixed assets other than goodwill to be included at current cost.
1.12 and 1.23	Article 1.12 inserts new Articles 42e and 42f. New Article 42e allows Member States to permit or require for all companies or any classes of company, the valuation of specific categories of assets (other than financial instruments) at amounts determined by reference to their fair value. The permission or requirement can be restricted to consolidated accounts. Article 42f allows Member States to permit or require that any change in the fair value is included in the profit and loss account.	Schedule 2, paragraph 6(3) inserts new paragraphs 34D, 34E and 34F and paragraph 7(3) inserts new paragraph 45D into Schedule 4 (form and content of company accounts) to the 1985 Act. New paragraph 34D permits all companies to use fair valuation for investment property and living plants and animals in their individual and consolidated accounts. New paragraphs 34E and 34F deal with changes in the fair value of these assets. New paragraph 45D requires information about the use of fair value to be disclosed in a note to the accounts. Schedules 3 (paragraphs 6(3) and 7(3)), 5 (paragraphs 7 and 8(3)) and 6 (paragraphs 6, 7(1) and 8) make parallel amendments to Schedules 8 (form and content of accounts prepared by small companies), 9 (special provisions for banking companies and groups) and 9A (form and content of accounts of insurance companies and groups) to the 1985 Act.
1.15, 1.16 and 1.18	The requirement in Article 48 for a statement in the published auditors' report of whether the accounts have been qualified or not reported on is deleted. The requirement in Article 49 regarding the disclosure of audit information when accounts are not published in full has been expanded. It must be disclosed whether the audit report was qualified, unqualified or adverse or whether no opinion was given. It must also be disclosed whether auditors have drawn attention in their report to any matter without qualifying the audit report.	Regulation 6 amends section 235 of the 1985 Act, Regulation 7 amends section 236 of the 1985 Act and Regulation 8 amends section 240 of the 1985 Act to implement Articles 1.15, 1.16 and1.18.

	New Article 51a states what should be included in the auditors' report, incorporating deletions from the previous Articles. The most significant new requirement is that the auditor must identify the financial reporting framework used and say whether the accounts give a true and fair view in accordance with that framework.	
1.17 (first part)	The first part of new Article 51(1) requires that auditors of company accounts be approved by Member States to carry out statutory audits on the basis of the 8th Council Directive 84/253/EEC of 10.4. 1984.	Implemented by Part 2 of the Companies Act 1989.
1.20	The Fourth Directive provides a number of exemptions to lessen the burden of disclosure for companies below certain size criteria. New Article 53a provides that companies whose securities are admitted to trading on a regulated market of any Member State may no longer benefit from these exemptions.	All public companies are already prevented from benefiting from these exemptions by sections 247A, 248 and 249B of the 1985 Act.
	Amendments to the Seventh Directive (83/349/EEC)	
2.1	The definition of "subsidiary undertaking" in Article 1.2 is amended to bring it into line with IAS 27 *Consolidated financial statements and accounting for investments in subsidiaries,*	Regulation 12 amends section 258(4) of the 1985 Act to implement this requirement.
2.2, 2.4b , 2.5, 2.6 and 2.9	Article 14 is deleted. This provided for the exclusion of a subsidiary undertaking from the consolidated accounts of the parent if its activities were so incompatible with those of the parent that inclusion would fail to meet the requirement to give a true and fair view of the undertakings included in the consolidation taken as a whole.	Regulation 5(b) deletes section 229(4) of the 1985 Act. Consequential amendments are made by Schedule 7 paragraphs 5, 6, 10 and 12.
2.3a and, 2.12	This replaces paragraph 4 of Article 6 to provide that a company whose securities are admitted to trading on a regulated market of any Member State within	No action necessary. Already encompassed by section 248 of the 1985 Act.

	the meaning of Article 1(13) of Directive 93/22/EEC of 10 May 1993 on investment services in the securities field cannot be exempt from the requirement to prepare consolidated accounts. The amendment in Article 2.12 means that such companies cannot be exempt from publishing consolidated accounts.	
2.3b and 2.4a	Delete spent provisions.	No action necessary.
2.4c	Article 2.4c amends Article 7 paragraph 3 by replacing the words "…companies the securities of which have been admitted to official listing on a stock exchange established in a Member State" with "…companies whose securities are admitted to trading on a regulated market of any Member State within the meaning of Article 1(13) of Directive 93/22/EEC". Such companies cannot be exempt from the requirement to prepare consolidated accounts.	Implemented by Schedule 7, paragraph 4. In addition regulation 4 adds a new section 228A after section 228 of the 1985 Act to implement Article 11 of the 7th Directive.
2.7	Adds a new subparagraph to Article 16(1) allowing Member States to permit or require the inclusion of other statements in the consolidated accounts in addition to the consolidated balance sheet, the consolidated profit and loss account and the notes to the accounts.	Member State option not being exercised.
2.11	This Article amends Article 37 in respect of the requirements on auditing of consolidated accounts in the same way that Articles 1.15 – 1.18 amend the requirements on individual accounts.	See Article 1.18 above.
	Amendments to the Bank Accounts Directive 86/635/EEC	
3.	This Article makes equivalent amendments to those made by Articles 1 and 2 of the Modernisation Directive to the 4th and 7th Directives.	Where amendments are required to be made for banking companies and groups, the notes against Articles 1 and 2 indicate this. For those banking undertakings not governed by the Companies Act, implementation will be by means of the Bank Accounts Directive (Miscellaneous Banks) Regulations 1991 (to be

		amended following these Regulations).
	Amendments to the Insurance Accounts Directive 91/674/EEC	
4.1	This Article applies the bulk of Article 1 of the Modernisation Directive to the Insurance Accounts Directive. Article 4.1 inserts a new paragraph 1 into Directive 91/674/EEC on insurance company accounts. Among other things, this applies the fair value provisions in new Section 7a (Articles 42a to 42f) of Directive 78/660/EEC (inserted by Directive 2001/65/EEC) to insurance companies.	See the notes against Articles 1 and 2 above. See also the separate transposition notes for the fair value provisions. For those insurance undertakings not governed by the Companies Act, implementation will be by means of the Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 1993 (to be amended following these Regulations).
4.2 and 4.6	Article 4.2 replaces Article 4 with a new Article 4. New Article 4.1 applies the Insurance Accounts Directive to the association of underwriters known as Lloyd's and for the purposes of the Directive both Lloyd's and Lloyd's syndicates are deemed to be insurance undertakings. This is necessary as the Annex of provisions relating to Lloyd's has been deleted. New Article 4.2 is a derogation from Article 65(1) requiring Lloyd's to prepare aggregate accounts instead of consolidated accounts.	A requirement. This is to be the subject of separate transposition notes.
4.4	Article 46(5) is amended to allow Member States to permit or require insurance companies to use different valuation methods for different elements of an investment item. Article 46(6) provides that where such different valuation methods are applied, the notes to the accounts are required to include a description of the methods used and the amount so determined.	Member State option not being exercised.
	When the Modernisation Directive comes into force.	
5	This Article requires Member States to implement the Modernisation Directive by 1 January 2005.	Regulation 1 provides for the 2004 Regulations to apply to financial years beginning on or after 1 January 2005.

TRANSPOSITION NOTES – THE FAIR VALUE DIRECTIVE

THE COMPANIES ACT 1985 (INTERNATIONAL ACCOUNTING STANDARDS AND OTHER ACCOUNTING AMENDMENTS) REGULATIONS 2004

Introduction

1. The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 implement 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 of banks and other financial institutions (OJ L283/28, 27 October 2001) **("the Fair Value Directive").**

2. European Union (EU) accounting requirements are based primarily on four Accounting Directives: the Fourth[10] and Seventh[11] Directives on the annual and consolidated accounts of companies; the Directive on the annual and consolidated accounts of banks and other financial institutions[12] (the Bank Accounts Directive); and the Directive on the annual and consolidated accounts of insurance undertakings[13] (the Insurance Accounts Directive).

3. The Fair Value Directive was the first major amendment to the Accounting Directives. It is part of the EU's objective of enabling companies to use modern accounting practices that are consistent with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) (as future IAS will be called) issued by the International Accounting Standards Board (IASB). The amendments will allow fair value accounting (essentially current market value) to be used for certain financial instruments by all companies in their balance sheets. The use of fair value will result in regular changes in values, which will be dealt with in the profit and loss account (or in reserves in some cases). This will make financial statements more transparent, but may also lead to the balance sheets and reported profits of some companies being more volatile than at present. The Fair Value Directive also requires disclosure in the directors' report about a company's use of financial instruments, and requires information about fair valuation to be given in the notes to a company's accounts.

4. The Fair Value Directive amends the Fourth Directive, the Seventh Directive and the Bank Accounts Directive as regards the valuation rules for the annual and consolidated accounts of certain types of companies, banks and other financial institutions. It does not amend the Insurance Accounts Directive. Similar amendments were made to this Directive by the Modernisation Directive [14], which is also being transposed by these Regulations.

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[10] 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).

[11] 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).

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

[13] Council Directive of 19 December 1991 (91/674/EEC) on the annual accounts and consolidated accounts of insurance undertakings (OJ L374/7 of 31 December 1991).

[14] Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 amending Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC on the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings (OJ L178/16 of 17 July 2003).

5. The Accounting Directives have been transposed into national law by the Companies Act 1985 (“the 1985 Act”). Amendments therefore need to be made to 1985 Act to transpose the Fair Value Directive and those parts of the Modernisation Directive which amend the Insurance Accounts Directive regarding fair value accounting. This requires changes to Schedules 4, 7, 8, 8A, 9 and 9A to the 1985 Act. (The rest of the Modernisation Directive is also being transposed by the Regulations, and this is the subject of a separate transposition note.)

Transposition Details: The Fair Value Directive

In all cases, responsibility for the measures taken to implement the Directive lies with the Secretary of State for Trade and Industry.

Articles	Objectives	Implementation
1.1	Article 1.1 inserts a new Section 7a comprising new Articles 42a to 42d into Directive 78/660/EEC on individual accounts.	Articles 1.1 and 1.2 are implemented by a series of amendments to Schedule 4 (individual accounts), Schedule 8 (small company accounts) and Schedule 9 (banking company accounts) to the 1985 Act. In general terms, the Regulations achieve these amendments as follows: • In respect of individual accounts, paragraphs 6, 7 and 10 of Schedule 2 to the Regulations insert new paragraphs 34A to 34F, 35A, 45A to 45D, 76A and 76B into Schedule 4 to the 1985 Act. These new paragraphs are collectively referred to below as the **"new Schedule 4 paragraphs"**. • In respect of small company accounts, paragraphs 6, 7 and 9 of Schedule 3 to the Regulations insert new paragraphs 34A to 34F, 35A, 42A to 42C, 52A and 52B into Schedule 8 to the 1985 Act. These new paragraphs are collectively referred to below as the **"new Schedule 8 paragraphs"**. • In respect of banking company accounts, paragraphs 7, 8 and 11 of Schedule 5 to the Regulations, insert new paragraphs 44A to 44F, 50A, 58A to 58D, 82A and 82B into Schedule 9 (banking company accounts) to the 1985 Act. These new paragraphs are collectively referred to below as the **"new Schedule 9 paragraphs"**.
1.1	New Article 42a(1) requires Member States to permit or require all companies or any class of companies to use fair value accounting for their financial instruments, subject to certain restrictions. The permission or requirement may be restricted to consolidated accounts.	The first part of new Article 42a(1) is implemented: • in the new Schedule 4 paragraphs , by new paragraph 34A(1); • in the new Schedule 8 paragraphs, by new paragraph 34A(1); and • in the new Schedule 9 paragraphs, by new paragraph 44A(1). The second part of new Article 42a(1) is not being implemented, as the permission to use fair value accounting is not being restricted to consolidated accounts.

1.1	New Article 42a(2) provides that certain commodity-based contracts shall be considered to be derivative financial instruments (and thereby subject to this Directive) except in the circumstances defined.	New Article 42a(2) is implemented: • in the new Schedule 4 paragraphs, by new paragraphs 76A and 76B; • in the new Schedule 8 paragraphs, by new paragraphs 52A and 52B; and • in the new Schedule 9 paragraphs, by new paragraphs 82A and 82B.
1.1	New Article 42a(3) provides that fair value accounting shall only be used for liabilities that are part of a trading portfolio or derivative financial instruments.	New Article 42a(3) is implemented: • in the new Schedule 4 paragraphs, by new paragraph 34A(2); • in the new Schedule 8 paragraphs, by new paragraph 34A(2); and • in the new Schedule 9 paragraphs, by new paragraph 44A(2).
1.1	New Article 42a(4) provides that fair value accounting shall not be used for certain specified financial instruments.	New Article 42a(4) is implemented: • in the new Schedule 4 paragraphs, by new paragraph 34A(3); • in the new Schedule 8 paragraphs, by new paragraph 34A(3); and • in the new Schedule 9 paragraphs, by new paragraph 44A(3).
1.1	New Article 42a(5) confers an option on Member States to permit companies to value assets and liabilities in accordance with a fair value hedge accounting system.	**New Article 42a(5) is implemented:** • in the new Schedule 4 paragraphs, by new paragraph 34C; • in the new Schedule 8 paragraphs, by new paragraph 34C; and • in the new Schedule 9 paragraphs, by new paragraph 44C.
1.1	New Article 42b sets out how the fair value of a financial instrument should be determined.	**New Article 42b is implemented:** • in the new Schedule 4 paragraphs, by new paragraph 34B; • in the new Schedule 8 paragraphs, by new paragraph 34B; and • in the new Schedule 9 paragraphs, by new paragraph 44B.

1.1	New Article 42c(1) provides that changes in the value of financial instruments shall be included in the profit and loss account, except in certain specified circumstances where they shall be included in a fair value reserve.	New Article 42c(1) is implemented: • in the new Schedule 4 paragraphs, by new paragraph 34E, sub-paragraphs (1) to (3); • in the new Schedule 8 paragraphs, by new paragraph 34E,sub-paragraphs (1) to (3); and in the new Schedule 9 paragraphs, by new paragraph 44E, sub-paragraphs (1) to (3).
1.1	New Article 42c(2) allows Member States to permit or require a change in the value of a specific type of financial instrument to be included in the fair value reserve.	New Article 42c(2) is implemented: • in the new Schedule 4 paragraphs, by new paragraph 34E, sub-paragraph (4); • in the new Schedule 8 paragraphs, by new paragraph 34E, sub-paragraph (4); and • in the new Schedule 9 paragraphs, by new paragraph 44E, sub-paragraph (4).
1.1	New Article 42c(3) provides that amounts shall be transferred from the fair value reserve when they are no longer necessary.	New Article 42c(3) is implemented: • in the new Schedule 4 paragraphs, by new paragraph 34F; • in the new Schedule 8 paragraphs, by new paragraph 34F; and • in the new Schedule 9 paragraphs, by new paragraph 44F.
1.1	New Article 42d requires that, where financial instruments have been valued in accordance with fair value, certain specified information has to be disclosed in the notes to the annual accounts.	New Article 42d is implemented: • in the new Schedule 4 paragraphs, by new paragraph 45A; • in the new Schedule 8 paragraphs, by new paragraph 42A; and • in the new Schedule 9 paragraphs, by new paragraph 58A.
1.2	This article amends Article 43(1)14(a) and (b) of Directive 78/660/EEC. It requires the disclosure in the notes to the accounts of certain specified information about any derivative financial instruments that have not been valued at fair values and certain financial fixed assets	Article 1.2 is implemented: • in the new Schedule 4 paragraphs, by new paragraphs 45B and 45C; • in the new Schedule 8 paragraphs, by new paragraph 45B (reflecting the amendment to Article 43(1)(14)(b) only); and • in the new Schedule 9 paragraphs, by new

		paragraphs 58B and 58C.
1.3	This article amends Article 44(1) of Directive 78/660/EEC to allow Member States to exempt small companies from the requirement to disclose information about derivative financial instruments not valued at fair value.	Schedule 5, paragraph 7 implements Article 1.3 by not requiring small companies to make the disclosures required by Article 43(1)(14)(a).
1.4	This article amends Article 46(2) of Directive 78/660/EEC by inserting a new requirement to disclose information in the directors' report about the company's financial risk management objectives and policies and its exposure to risk, in relation to its use of financial instruments.	Regulation 13(1) inserts new paragraph 5A into Schedule 7 to the 1985 Act to implement Article 1.4. Small companies will be exempted from this requirement by regulation 13(2).
2.1 – 2.2	Articles 2.1 and 2.2 make corresponding amendments to Directive 83/349/EEC on consolidated accounts as are made by Articles 1.1 – 1.3 to Directive 78/660/EEC.	No specific amendments are required to implement these parts of Article 2 given the general provision in paragraph 1(1) of Schedule 4A to the 1985 Act that group accounts shall comply as far as practicable with the provisions on individual accounts as if the group were a single company.
2.3	This article amends Article 36 of Directive 83/349/EEC by inserting a new requirement to disclose information in the directors' report about the company's financial risk management objectives and policies and its exposure to risk, in relation to its use of financial instruments .	Regulation 13 inserts new paragraph 5A into Schedule 7 to the 1985 Act to implement Article 2.3.
3	Article 3 applies the provisions in Article 1 to Directive 86/635/EEC on the accounts of banks and other financial institutions.	The notes against Article 1 indicate how Article 3 is implemented in Schedule 9 to the 1985 Act. For those banking undertakings not governed by the Companies Act, Article 3 will be implemented through the Bank Accounts Directive (Miscellaneous Banks) Regulations 1991 (to be amended following these Regulations).
4.1	This article requires Member States to implement the Fair Value Directive by 1 January 2004.	These Regulations will apply to companies' financial years commencing on or after 1 January 2005.

<u>Transposition Details: The Modernisation Directive (provisions relating to fair value)</u>

In all cases, responsibility for the measures taken to implement the Directive lies with the Secretary of State for Trade and Industry.

Articles	Objectives	Implementation
4.1 and 4.5	Article 4.1 inserts a new paragraph 1 into Directive 91/674/EEC on insurance company accounts. Among other things, this applies the fair value provisions in new Section 7a (Articles 42a to 42f) of Directive 78/660/EEC (inserted by Directive 2001/65/EEC) to insurance companies. Article 4.5 inserts new Article 46a into Directive 91/674/EEC on insurance company accounts containing certain provisions specific to the circumstances of the fair valuation of insurance companies' assets and liabilities. Articles 4.5(1) and 4.5(2) are equivalent provisions to the bulk of Article 1.1 (inserting new Articles 42a-c) of the Fair Value Directive. They permit insurance companies to use fair value accounting for financial instruments (with the same exceptions) and set out the rules governing how fair value may be used.	Articles 4.1 and 4.5 are implemented by means of amendments to Schedule 9A to the 1985 Act (insurance company accounts). These amendments are made by Schedule 6 to the Regulations, which amends Schedule 9A to the 1985 Act by: • inserting new paragraph 19A and deleting paragraph 20 (paragraph 6); • inserting a new section BA (paragraph 7); • inserting new paragraphs 65A to C (paragraph 9); and • inserting new paragraphs 81A and 81B (paragraph 12) **to implement the fair value provisions for insurance companies.** For those insurance undertakings not governed by the Companies Act, implementation will be by means of the Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 1993 (to be amended following these Regulations).

Annex B1

FINAL REGULATORY IMPACT ASSESSMENT
ON
THE EXERCISE OF MEMBER STATE OPTIONS IN THE INTERNATIONAL ACCOUNTING STANDARDS (IAS) REGULATION

1. Proposal

1.1. The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004 and the Building Societies Act 1986 (International Accounting Standards and Other Accounting Amendments) Order 2004 implementing the IAS Regulation[15].

1.2. For companies the implementation of the Fair Value Directive[16], the Modernisation Directive[17] and other changes to ensure 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 exercise of Member State options in the IAS Regulation. The costs and benefits of the Fair Value and the Modernisation Directives are discussed in separate regulatory impact assessments[18].

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.

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15 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards. OJ L 243/1 of 11 September 2002

16 Directive 2201/65/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.

17 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

18 Final Regulatory Impact Assessment on the use of Fair Value accounting for certain financial instruments for companies and building societies, URN 04/1668 and Final Regulatory Impact Assessment on the Modernisation Directive for companies and building societies, URN 04/1667

2. Purpose and intended effect

(i) Objective

2.1. The objective of the proposal is to increase comparability, consistency and transparency of accounts, while keeping the burden on business to a minimum.

2.2. The IAS Regulation requires companies and building societies whose securities are admitted to trading on a regulated market in any EU Member State ("publicly traded companies") to prepare their consolidated accounts in accordance with International Accounting Standards issued by the International Accounting Standards Board (IASB) and adopted by the European Commission. In addition, all companies (with the exception of charities) and building societies will be permitted to prepare their individual accounts, and non-publicly traded parent companies and building societies will be permitted to prepare their consolidated accounts in accordance with adopted IAS instead of with UK Generally Accepted Accounting Practice (UK GAAP) from 1 January 2005.

2.3. For publicly traded companies and building societies with listed securities, adherence to adopted IAS may help to reduce the cost of capital because their accounts will be more accessible to potential investors across the EU and worldwide. For potential investors, creditors and other users of financial statements, adopted IAS will provide a consistent accounting framework to facilitate comparison of the performance and prospects of companies and building societies across the EU. For non-publicly traded companies and building societies without listed securities, adopted IAS may in some cases reduce barriers to growth by allowing them to prepare their accounts under IAS prior to application for listing.

2.4. In the UK, accounting standards issued by the Accounting Standards Board (ASB) apply to all 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. (UK GAAP has a simpler accounting regime for smaller companies and for subsidiaries.) 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 accounting standards in the UK. It therefore aims to bring UK standards into line with IASB standards. In March 2004 the ASB published a discussion paper[19] setting out proposals for achieving this. Therefore, in the future, companies and building societies which choose to continue to prepare their accounts under UK GAAP may nonetheless be applying standards which are very similar to adopted IAS.

(ii) Devolution

[19] A Strategy for Convergence with IFRS, 183/173.

2.5. 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 and building society law is a reserved area 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 matter 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.

(iii) Background

2.6. During 1999, the European Commission published a communication on "Financial Services: Implementing the Framework for Financial Markets: Action Plan". In March 2000, at the Lisbon European Council, Ministers of Member States concluded that, in order to accelerate completion of the internal market for financial services, steps should be taken to enhance the comparability of financial statements by 2005.

2.7. Consequently, in February 2001 the European Commission published a proposal for a Regulation on the application of IAS in the EU, as a key element of its Financial Services Action Plan. It aimed to harmonise financial reporting in the EU on the basis of globally agreed accounting standards by 2005. The IAS Regulation was adopted on 7 June 2002.

2.8. The IAS Regulation contains options allowing Member States to permit or require:

- publicly traded companies to prepare their individual accounts in accordance with adopted IAS;
- some or all non-publicly traded companies to prepare their consolidated and/or individual accounts in accordance with adopted IAS.

2.9. The obligation in Article 4 of the IAS Regulation for publicly traded companies and building societies that issue listed securities to prepare their consolidated accounts in accordance with adopted IAS has the force of law in each Member State. Consequently no legislative action is required in Member States, other than to ensure that the Regulation is fully effective – eg by amending enforcement provisions. However, legislation is required to take advantage of the options conferred by the Regulation. For companies and building societies covered by the IAS Regulation and extension to it, adopted IAS will replace all the detailed provisions on the contents of accounts contained in the Accounting Directives[20]. These provisions have been transposed into British legislation by Part 7 of the Companies Act 1985 and by the Building Societies Act 1986 and regulations made under it.

(iv) Risk Assessment

[20] The 4th and 7th Directives on the annual and consolidated accounts of companies (Directives 78/660/EEC and 83/349/EEC respectively); the Directive on the annual and consolidated accounts of insurance undertakings (Directive 91/674/EEC); and the Directive on the annual and consolidated accounts of banks and other financial institutions (Directive 86/635/EEC)

2.10. There is evidence from those EU countries that have already moved to IAS that not extending the application of the IAS Regulation, at least to some companies and building societies, could create an artificial barrier to growth. For example, non-publicly traded companies and building societies without listed securities to which the IAS Regulation did not apply might be deterred from obtaining admission to trading on a regulated market by the need to restate their past accounts to adopted IAS to provide the necessary three year record. It would also be more complicated for publicly traded parent companies and building societies with listed securities to prepare group accounts if they and their subsidiary companies were unable to prepare their individual accounts to adopted IAS.

2.11. On 10 December 2003, the Chancellor announced in his Pre-Budget Report that those companies that choose to use IAS in their individual accounts will be able to use those accounts as the starting point for their tax computations, and will not have to prepare separate UK GAAP accounts just for tax purposes. This will also apply to building societies.

3. Options

3.1. There are many permutations of the Member State options for extending the application of the IAS Regulation, from no extension, through extension to companies and building societies of certain types, size, or business sector, to full extension to all companies and building societies. Extension can be either permissive or mandatory. The main options are listed below, with comments on the risks of not taking up the option:

Option 1: No extension to the application of the IAS Regulation.

3.2. The risks of not extending the application of the IAS Regulation are discussed at paragraph 2.10 above.

Option 2(i): Extension of the application of the IAS Regulation to the individual accounts of publicly traded companies and building societies with listed securities.

3.3. It would be more complicated to prepare group accounts if the parent company or building society accounts were prepared under UK GAAP while consolidated accounts were prepared under adopted IAS.

Option 2(ii): Option 2(i) plus extension of the application of the IAS Regulation to the individual accounts of subsidiaries of publicly traded companies and building societies with listed securities.

3.4. The risks of not extending the application of the Regulation to the individual accounts of subsidiary undertakings are similar to those discussed for parent company and building society accounts at paragraph 3.3 above.

Option 2(iii): Extension of the application of the IAS Regulation to the individual accounts of publicly traded companies and building societies with listed securities that do not produce consolidated accounts.

3.5. Not extending the application of the Regulation to these companies and building societies may disadvantage them and hamper comparability, especially if their competitors on home or overseas markets could prepare accounts using adopted IAS.

Option 2(iv): Options 2(i), 2(ii) and 2(iii) plus extension of the application of the IAS Regulation to large and medium-sized non-publicly traded companies and building societies without listed securities (all companies above those small companies that could apply the ASB's Financial Reporting Standard for Smaller Entities (FRSSE) and equivalent sized building societies).

3.6. A two-tier accountancy profession already exists where accountants dealing with medium, large and listed businesses have the specialist knowledge to prepare complex accounts, while accountants working with small businesses are more used to dealing with simple accounts. This option may have the unintended consequence of exacerbating this split.

Option 2(v): Extension of the application of the IAS Regulation to all companies and building societies.

3.7. If this option was pursued on a mandatory rather than permissive basis, it could increase the burden on small companies and building societies. IAS has many reporting requirements that are more suitable for larger businesses, and there is currently no international equivalent of the ASB's reporting standard for small companies (the FRSSE[21]).

Option 2(vi): Sector specific option: Extension of the application of the IAS Regulation to companies and building societies prudentially regulated under the Financial Services and Markets Act 2000.

3.8. Extending only to this particular sector may disadvantage other businesses and hamper comparability if their competitors on home or overseas markets could prepare accounts to adopted IAS.

4. Benefits

Option 1:

4.1. The benefit to business in not extending application of the IAS Regulation is that no potential cost burden will fall on companies and building societies other than those who will be required by the IAS Regulation to use adopted IAS in the preparation of their consolidated financial statements.

Options 2(i), 2(ii), 2(iii), 2(iv), 2(iv), 2(v) and 2(vi):

4.2. A benefit of extension generally is that for companies and building societies that do business or seek capital across borders compliance with adopted IAS would make their accounts more comparable with those of their competitors who are permitted or required to use IAS. This comparability would assist

[21] Financial Reporting Standard for Smaller Entities.

shareholders, analysts and other users of accounts. There could also be cost savings as a result of not having to prepare different accounts according to different national standards.

4.3. A benefit of extension for options 2(i) and (2ii) is that groups of companies and building societies would not have to prepare their accounts using two accounting methods. Both individual and consolidated accounts would be prepared in accordance with adopted IAS.

4.4. A benefit of extension for option 2(v) is that it would not create a barrier to growth, in that small companies and building societies would not be faced with the need to change their accounting systems completely when they got above a certain size. If implemented on a mandatory basis, it would also provide full comparability of all accounts. There would be a single set of accounting standards, which would have the advantages of simplicity, certainty and transparency.

4.5. Extension on a permissive rather than mandatory basis for any of the options has the benefit of minimising burdens on business. There will be costs for a company and building society in switching to adopted IAS. A permissive approach would mean that companies and building societies can switch to adopted IAS when it best suits their own circumstances, and when they judge that the benefits outweigh the costs.

4.6. When consulting on the options[22] we requested that respondents consider the costing of benefits to using adopted IAS and provide estimates as to these benefits. Those respondents who commented on the benefits were not able to quantify them.

Business Sectors Affected

4.7. This proposal will potentially affect all companies and building societies in Great Britain. There are currently approximately 1.1 million active companies on the register at Companies House and 63 building societies on the register at the Financial Services Authority. It is not possible to say how many of these will choose to prepare their accounts in accordance with adopted IAS. Use of IAS is likely to be largely confined to larger listed companies and building societies initially but will spread to others as they and users of accounts become more familiar with IAS.

Issues of Equity and Fairness

4.8. The Government considers that the proposal will not bring disproportionate benefits or have disproportionate effects on particular groups.

5. Costs

[22] International Accounting Standards, a consultation document on the possible extension of the European Regulation on International Accounting Standards, 30 August 2002, DTI, URN 02/1158 and Modernisation of Accounting Directives/IAS Infrastructure, March 2004, DTI and HM Treasury URN 04/733

(i) Compliance costs

Option 1:

5.1. If the application of the IAS Regulation is not extended, there will be no cost to businesses other than that falling on those already covered by the IAS Regulation. Any cost on shareholders, analysts and other users of accounts (such as investors, creditors and enforcement bodies) of having to be familiar with two sets of accounting regimes for investment or compliance purposes arises from the IAS Regulation itself rather than any extension to it.

Options 2(i) & 2(ii) (Extension of the application of the IAS Regulation to the individual accounts of publicly traded companies and building societies with listed securities and to the individual accounts of their subsidiaries) – on a mandatory basis:

5.2. The additional cost of extending the application of the IAS Regulation to the individual accounts of publicly traded companies and building societies with listed securities and the individual accounts of subsidiary undertakings on a mandatory basis should be minimal. These companies would need to prepare underlying accounting data in accordance with adopted IAS in order for the parent company or building society to prepare the group accounts already covered by the IAS Regulation.

5.3. Our best estimate is that for these categories of company and building society, a decision to prepare accounts in accordance with adopted IAS could be broadly neutral in cost terms. Groups whose parent company is publicly traded or whose parent building society has listed securities would incur ongoing costs in maintaining capability in two different accounting frameworks if they were unable to use adopted IAS in their individual and subsidiary accounts. However, switching to adopted IAS for these accounts would also require a one-off investment to restate comparative figures, re-design systems and procedures and adapt to different disclosure requirements. Also, some ongoing costs might arise as a result of adopted IAS's different requirements for subsidiary companies (e.g. the requirement to prepare a cash flow statement for each subsidiary).

Options 2(iii), 2(iv), 2(v) & 2(vi) (Extension of the application of the IAS Regulation to all companies and building societies excepting Options 2(i) and 2(ii)) – on a mandatory basis:

5.4. There will be a one-off cost for companies and building societies switching to IAS. Companies and building societies will have to change the basis on which they prepare their accounts, entailing changes to accounting systems. Changes to IT systems will be minimal as much of the work is already carried out by companies for internal purposes.

5.5. There will be one-off training costs for staff in being instructed in the standards and in interrogating the information in order to compile accounts to a different accounting regime. Anecdotal evidence suggests that small companies and building societies may require 1 person to be trained for 2 days. Medium to large companies and building societies may require 2 staff to be trained for between 3 and 5 days. This gives the following estimates:

Cost of training course	£750 per day (cost of a one day training package on IAS)
Cost of staff time per day	£100 per day (assuming staff pay of £25,000 per annum approximately)

5.6. We estimate the training costs for small companies may be approximately £1,700 per business (or £1,950m ((£750 x 2 + £100 x 2) x 1.15m) for the sector as a whole). It is possible that as many as 60% of small businesses may not have in-house accountancy staff and therefore would not incur a training cost. This would reduce the one-off cost burden on this sector to £1,170m. However, in these cases there may be a need for additional external advice and support; the costs of this will vary depending on individual circumstances. It is estimated that the cost for medium to large companies and building societies may be between £5,100 and £8,500 per business (or between £181m (2 x £750 x 3 + 2 x £100 x 3) x 35,500) and £301m ((2 x £750 x 5 + 2 x £100 x 5) x 35,500) for the sector as a whole).

5.7. There are no on-going costs for medium and large companies as adopted IAS simply replaces the existing accounting standards. There may be additional on-going costs for small companies and building societies in having to comply with adopted IAS. IASB standards are primarily focused on the reporting requirements of large publicly traded companies, which are involved in complex transactions. Some standards are arguably less relevant to small businesses or require them to account for certain transactions in overly complex ways. As yet, there is no equivalent IASB to the ASB's FRSSE, which brings together in one place, with some simplifications, the accounting requirements from each of the full domestic standards as they apply to small businesses.

5.8. We would estimate the extra staff time spent in applying adopted IAS to small companies or building societies to be in the region of 1 person for 2 days per annum. Assuming the cost of staff time to be approximately £100 per day (a salary of £25,000 per annum), the cost of this may be approximately £200 per business (or £230m (£100 x 2 x1.15m) for the sector as a whole). Again, if as many as 60% of small businesses do not prepare their own accounts, the on-going cost burden would be reduced to £138m for the sector as a whole. However, once again additional cost may be incurred in respect of external advice and support.

5.9. There will also be costs for accountancy firms in a mandatory change to IAS. There are some 64,000 accountancy businesses or firms in the UK. We estimate there will be one-off training costs for two days training for a partner and 2 others in the region of £5,700 (or £365m for the sector as a whole), broken down as follows:

Cost of training course	£750 per day (cost of a one day training package on IAS)
Cost of staff time per day	£100 per day (assuming staff pay of £25,000 per annum approximately)
Cost of partner time	£400 (assuming partner pay of £100,000 per annum approximately)

Option 2(v) (Extension of the application of the IAS Regulation to all companies and building societies) – on a permissive basis

5.10. If companies and building societies are required to adopt IAS in the preparation of their financial statements compliance costs will be incurred. Permitting companies and building societies to use adopted IAS will impose no compliance costs. However there may be some costs to some companies in deciding to chose IAS. The cost would be in management time spent considering the issue, and possibly the cost of attending seminars or purchasing information on IAS. It is very difficult to estimate how many companies would spend a significant amount of time deciding whether to use IAS. However, the costs given above may give some indication. Giving companies and building societies the ability to choose to use adopted IAS in the preparation of their accounts will allow them the flexibility to prepare accounts in accordance with the accounting framework that is best suited to their needs. They will choose to switch to adopted IAS when they judge that the benefits outweigh the costs.

5.11. There will be a cost to those accountancy firms dealing with publicly traded groups or building societies with listed securities, arising directly from the IAS Regulation. There will be a cost on other accountancy firms in permitting non-publicly traded companies and building societies without listed securities to use adopted IAS. Those firms will need to become familiar with IAS in order to advise their clients on whether to switch. However, the ASB's convergence programme will mean that IAS and UK GAAP are similar, thereby reducing the cost of becoming familiar with IAS.

5.12. When consulting on the options for companies, we requested that respondents consider the cost of using adopted IAS and provide estimates as to the costs. Those respondents who commented on costs said that it was difficult to quantify those costs. The estimates provided varied widely and are summarised below:

- Mandatory extension of IAS will cost small companies an estimated £150 pa.
- Implementation costs likely to exceed £0.5m for the group on whose behalf the respondent answered.
- Consultancy costs are over £1,000 per day and significant assistance will be required.
- Costs of installation and training could be between £200 and £500 per company.
- Costs of Finance function in a large limited company likely to rise by some 10% (£25,000) pa.
- Costs of audit in a large limited company likely to rise by some 10% (£5,000) pa.

(ii) Other costs

5.13. The DTI considers that there are no costs imposed on sectors other than business.

(iii) Costs for a typical business

5.14. The costs for a typical business are discussed in detail at paragraphs 5.4 to 5.12 above. These proposals will affect companies, LLPs and those in the banking insurance and accounting professions.

6. Consultation with small business:

The Small Firm's Impact Test

Stage 1

6.1. Our estimates at paragraphs 5.4 and 5.8 above show that there may be a one-off training cost of £1,700 for a small company should it choose to use adopted IAS in the preparation of its financial statements. It is possible that as many as 60% of small companies may not have in-house accountancy staff and therefore would not incur a training cost. There will be no cost to small companies if they choose not to use adopted IAS.

Stage 2

6.2. The consultation document and its small firms summary was made widely available. The Society of Professional Accountants (SPA), who represent an independent group of small professional practices serving a total of some 90,000 incorporated businesses (the vast majority of which are small) were not in favour of compulsory extension to small companies. The SPA felt there would be little impact on small companies, as few would choose to move to adopt IAS.

6.3. The London Society of Chartered Accountants (with a membership of 30,000) commented that the application of adopted IAS should be extended to all companies. However, the IAS regulation should not be applied to the accounts of small companies (as defined) in the short term until a FRSSE has been developed that is consistent with IAS.

6.4. The Government encouraged several other small business organisations to respond to the consultation but did not receive comments.

7. Competition Assessment

7.1. The proposal has the potential to affect all companies and building societies that choose to prepare their financial statements in accordance with adopted IAS. 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.

7.2. 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 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 contain a number of 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 Financial Services Authority. 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 Government proposes to review the adoption of the IAS Regulation around 2008 and re-evaluate the extension options having regard to developments in the ASB's convergence programme and the IASB's development of an International FRSSE.

10. Consultation

(i) Within Government

10.1. The Department of Trade and Industry and HM Treasury have consulted with the Inland Revenue, The Financial Services Authority, the Small Business Service, Companies House and the Department for Enterprise, Trade and Industry in Northern Ireland.

(ii) Public consultation

10.2. On 2 September 2002, the Department published a consultation document on the possible extension of the IAS Regulation.
The consultation was sent to approximately 1,000 businesses, professional bodies, and representative organisations and individuals, and was also made available on the internet. The consultation closed on 26 November 2002. 69 responses were received, with the majority of respondents in favour of extension of the IAS Regulation. A number of respondents commented on the costs and benefits of extension of the IAS Regulation. Those comments have been incorporated into this regulatory impact assessment.

10.3. In March 2004, the Department of Trade and Industry and HM Treasury published a consultation document on the Modernisation Directive/IAS Infrastructure. Approximately 800 businesses, professional bodies, representative organisations and individuals were notified of the consultation. The consultation document was available on the DTI's Internet site, and printed copies were available on request. The deadline for comments was 2 July 2004.

10.4. A total of 38 organisations, businesses and individuals responded to the consultation. A number of respondents commented on the costs and benefits of the impact of IAS but were unable to further quantify those costs or benefits. Summaries of responses to both consultations are available at www.dti.gov.uk/cld/index.htm.

11. Summary and Recommendation

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

	Approximate number of companies and building societies affected	**Cost of mandatory extension of the IAS Regulation (£)**	**Cost of voluntary extension of the IAS Regulation (£)**	**Benefit (£)**
Option 1	N/A	N/A	N/A	N/A
Option 2(i)	1,350	Minimal	NIL	Not having to prepare group accounts using different sets of accounting systems.
Option 2(ii)	27,000	Minimal	NIL	Not having to prepare group accounts using different sets of accounting systems.
Option 2(iii)	250	£2.1m approx in one-off training costs. There will be minimal one-off system costs.	NIL	Easier comparison across sectors and markets.
Option 2(iv)	35,500	Between £181m and £301m approx in one-off training costs. There will be	NIL	Easier to seek admission to trading on a regulated market. Easier comparison

		minimal one-off IT system costs.		across sectors and markets.
Option 2(v)	1.2m	Cost to the accountancy sector £365m. Between £1,351m and £2,251m in one-off training costs. Between 138m and £230m in additional on-going compliance costs for small companies in interpreting adopted IAS in place of the FRSSE.	NIL	Easier comparison across sectors and markets.
Option 2(vi)	This option has not been costed because of the difficulty in identifying the number of companies covered			

11.2. The Government recommends option 2(v) on a voluntary basis. The benefits of this option are:

- Parent companies and building societies and subsidiaries in groups will be able to prepare their accounts to one framework of accounting standards.
- Companies and building societies that do business or seek capital across borders would be able to prepare their accounts to adopted IAS for ease of comparison.
- Comparability of accounts will assist, shareholders, analysts and other users of accounts.

- Comparability of accounts will help maintain the attractiveness of British companies and building societies to international investors.
- Costs savings in not having to prepare accounts to different national standards.
- Companies and building societies of different sizes will be able to choose which standard is best suited for their needs.

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.

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

5th October 2004

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Annex B2

FINAL REGULATORY IMPACT ASSESSMENT
ON
THE MODERNISATION DIRECTIVE FOR COMPANIES AND BUILDING SOCIETIES

1. Proposal

1.1. The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004, the Building Societies Act 1986 (International Accounting Standards and Other Accounting Amendments) Order 2004 and the Building Societies (Accounts and Related Provisions) (Amendment) Regulations 2004, as they implement the Modernisation Directive[23].

1.2. For companies the implementation of the Fair Value Directive[24], options in the IAS Regulation[25], and other changes necessary to ensure 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 Modernisation Directive. The costs and benefits of the Fair Value Directive and the options in the IAS Regulation are discussed in separate regulatory impact assessments[26].

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

[23] 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.

[24] 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.

[25] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, OJ L243/1 of 11 September 2002.

[26] Final Regulatory Impact Assessment on the use of Fair Value accounting for certain financial instruments for companies and building societies, URN 04/1668 and the Final Regulatory Impact Assessment on the exercise of Member State options in the international accounting standards (IAS) Regulation, URN 04/1669

2.1. The Modernisation Directive is designed to bring European accounting requirements into line with modern accounting practices. It requires Member States to make certain changes to national law concerning the form and content of company and building society accounts. It also gives Member States options on whether and how they implement certain aspects of it. This will enable companies and building societies to follow modern, more transparent accounting practices that are consistent with International Accounting Standards (IAS).

2.2. The Regulations will apply to financial years starting on or after 1 January 2005.

(ii) Devolution

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 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 matter 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.

(iii) Background

The Accounting Directives

2.4. EU accounting requirements are based primarily on the four Accounting Directives: the Fourth Directive on the annual accounts of certain companies[27], the Seventh Directive on the consolidated accounts of certain companies[28], the Directive on the annual and consolidated accounts of banks and other financial institutions[29] (the Bank Accounts Directive), and the Directive on the annual and consolidated accounts of insurance undertakings[30] (the Insurance Accounts Directive).

The Modernisation Directive

2.5. On 6 May 2003 the Council of Ministers adopted the Modernisation Directive. This amends the Fourth and Seventh Directives, the Bank Accounts Directive and the Insurance Accounts Directive.

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[27] 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.

[28] 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.

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

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

2.6. The Modernisation Directive is designed to: -

- remove conflicts between the Accounting Directives and IASB standards in existence at the time it was drawn up; and
- ensure that optional accounting treatments currently available under IASB standards in existence at 1 May 2002 are available to EU companies and building societies which continue to have the Accounting Directives as the basis of their accounts (i.e. those companies and building societies which will not prepare their accounts in accordance with the IAS Regulation).

2.7. The Directive must be implemented by 1 January 2005. It is not directly applicable and must be implemented through amendments to the Companies Act 1985, the Building Societies Act 1986 and the Building Societies (Accounts and Related Provisions) Regulations 1998.

2.8. In a number of places, the Modernisation Directive gives Member States options on how to implement it. The Government's general approach to implementing the Directive is to facilitate greater convergence between UK accounting standards and IAS, without imposing unnecessary burdens.

The Fair Value Directive

2.9. The Fair Value Directive amended the Accounting Directives to permit certain financial instruments to be recorded at fair value in accordance with IAS 39 *(Financial Instruments: Recognition and Measurement)*. For companies and building societies, the implementation of the Fair Value Directive is being taken forward through the same Statutory Instruments that implement these accounting amendments for companies and building societies.

The IAS Regulation

2.10. The IAS Regulation introduces important changes, which will directly affect the way in which certain undertakings across the EU prepare their financial statements. Companies and building societies governed by the law of a Member State, whose securities are admitted to trading on a regulated market in any Member State in the EU ("publicly traded companies and building societies with listed securities"), will be required to prepare their consolidated accounts on the basis of accounting standards issued by the IASB that are adopted by the European Commission. It will apply to financial years commencing on or after 1 January 2005. The Government also proposes that such undertakings should be permitted to prepare their individual accounts, and all other companies and building societies should be permitted to prepare their individual and consolidated accounts, in accordance with adopted IAS.

Dividends

2.11. As part of the DTI consultation on implementing the Fair Value Directive[31] for companies, the Government proposed to amend the provisions in the Companies Act 1985 on the information to be disclosed regarding dividends and the location of those disclosures. The proposed amendment attracted considerable comment. Many consultees did not support the amendment as proposed, and there were a number of alternative suggestions.

2.12. A revised proposal was included in the consultation on implementing the Modernisation Directive. Following comments from consultees, the description of the information to be disclosed has been modified. Most significantly, the disclosures will now have to be made only in the notes to the accounts rather than in the profit and loss account. This is consistent with the requirements of IAS.

The ASB's Convergence Programme

2.13. 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 paper[32] shortly setting out proposals for achieving this.

(iv) Risk Assessment

2.14. The Government is required to implement the Modernisation Directive by 1 January 2005. Failure to implement the changes required by the Directive would result in infraction proceedings being brought against the UK and would prevent companies and building societies from following up-to-date accounting requirements. Failure to implement those proposals not required by the Modernisation Directive would prevent companies and building societies from following up-to-date accounting practices.

2.15. Not implementing the Modernisation Directive to remove conflicts between the Accounting Directive and IAS would prevent those companies not complying with the IAS Regulation from following IAS as closely as possible. This could create an artificial barrier to growth. For example, non-publicly traded companies and building societies without listed securities to which the IAS Regulation did not apply are more likely to be deterred from obtaining admission to trading on a regulated market the greater the difference there is between their existing accounts and IAS accounts.

3. Options

[31] Fair Value Accounting, URN 03/960, June 2003.
[32] A Strategy for Convergence with IFRS, 183/173.

3.1. There are numerous permutations for implementing the provisions of the Modernisation Directive and other accounting amendments. The Government is proposing to take up five Member State options as discussed below. Each option is separate and stands alone. Within each option there is little choice of how it can be implemented. Although for simplicity, only the two main overarching options of "do nothing" and full implementation were discussed in the draft partial regulatory impact assessment that accompanied the consultation respondents were asked, amongst other things, if they agreed with the Government's proposals to implement (or not implement as the case may be) the Member State options in the Modernisation Directive. 23 of the 24 respondents who commented on that question agreed with the Governments policy on implementation and provided comments on the drafting of the regulations.

<u>Option 1:</u>

Do nothing.

3.2. It is not feasible to "do nothing" for many of the accounting amendments, as that option would lead to infraction proceedings being brought against the UK for failure to implement the Modernisation Directive. To "do nothing" would also deny companies the opportunity to use up to date accounting practices. The risks of doing nothing are discussed at paragraphs 2.14 and 2.15 above.

<u>Option 2:</u>

Implementation of the accounting amendments: to comply with the requirements to implement the Modernisation Directive; to reflect best practice in audit reporting; and to enable companies and building societies to follow up-to-date accounting practices.

3.3. Option 2 is broken in to 5 subsections a to e, which are discussed in detail below.

a. Amendments to consolidation provisions to facilitate alignment with IAS 27.

3.4. Under the existing provisions of the 1985 Act a parent company which is itself a wholly-owned subsidiary of a non-EU parent company (an intermediate parent company) would be required to prepare consolidated accounts, even if electing to follow IAS and meeting the exemption criteria of IAS 27 *(Consolidated Financial Statements and Accounting for Investments in Subsidiaries)*. New Section 228A of the Companies Act 1985 aligns the exemptions from preparation of consolidated accounts more closely with those in IAS 27 by implementing a previously unexercised Member State option in the Seventh Directive. Article 11 of the Seventh Directive gives Member States an option to exempt intermediate parent companies from the requirement to prepare consolidated accounts, if that company is a subsidiary of another undertaking not governed by the law of an EEA State, providing certain conditions are fulfilled.

3.5. Article 14 of the Seventh Directive (enacted in section 229(4) of the 1985 Act) provides for the exclusion of an undertaking from the consolidated accounts of the parent if its activities are so incompatible with those of the parent that inclusion would fail to meet the requirement to give a true and fair view of the undertakings included therein, taken as a whole. In practice this exclusion is rarely used. This provision is in conflict with IAS 27, which does not permit any exclusion on the grounds of incompatible activities.

3.6. Under IAS 27, an undertaking is a subsidiary undertaking if it is controlled by a parent, irrespective of the existence of an interest in the capital of the undertaking. Article 2.1 of the Modernisation Directive is implemented by repealing the provision in section 258(4) of the 1985 Act that requires a participating interest to exist in order for an undertaking to be a subsidiary undertaking. Section 258(4) is also amended to extend the circumstances in which a parent-subsidiary undertaking relationship exists. This extension will apply to building societies.

b. Amendments to the audit report of individual companies, building societies and groups.

3.7. Audit reports currently differ across Member States. Articles 1.15 and 1.18 of the Modernisation Directive seek to achieve greater harmonisation and reflect best practice in the format and content of audit reports. Audit reports prepared in accordance with UK Statement of Auditing Standards 600 are already very similar to the requirements of the Modernisation Directive.

3.8. One of the changes is that, in future, the auditors will need to identify the financial reporting framework applied in the preparation of accounts (i.e. whether by IAS or UK GAAP).

3.9. Article 1.16 of the Modernisation Directive requires disclosure, whenever non-statutory accounts (eg: interim accounts) are published, of whether the auditors have drawn attention in their report to any matter by way of emphasis, without qualifying the audit report, as well as of whether the audit report was qualified or unqualified.

c. Presentation of items within the format of accounts.

3.10. Paragraph 3(7) of Schedule 4 to the 1985 Act is repealed and replaced by a requirement for companies to show in the profit and loss account paid and proposed dividends as separate items, with a requirement to show dividend movements from reserves plus dividends paid, liable to be paid and proposed; the information is to be disclosed in the notes to the accounts rather than the profit and loss account.

3.11. Article 1.2 of the Modernisation Directive gives Member States the option to permit or require the presentation of amounts within items in the profit and loss account and balance sheet to have regard to the substance of the reported transaction. Paragraph 3 of Schedule 2 (and corresponding provisions in Schedules 3, 5 and 6) of the companies regulations and regulation 6 of the building societies regulations amend the existing requirements of the 1985 Act and the 1998 Regulations by requiring that the presentation of items within the accounting formats have regard to their economic substance.

d. Fair value of investment property, living animals and plants.

3.12. The Fair Value Directive amended the Accounting Directives to permit certain financial instruments to be recorded at fair value in accordance with IAS 39 *Financial Instruments Recognition and Measurement*. Article 1.12 of the Modernisation Directive gives Member States the option to extend the use of fair value accounting to other asset categories. Following adoption of IAS 40 *Investment Property* and IAS 41 *Agriculture on investment property and living animals and plants,* the Government has decided to permit these categories of assets to be fair valued in both individual and consolidated accounts.

e. Amendments to the Directors' Report of individual building societies and groups.

3.13. Articles 1.14, 1.17 and 2.10(a) of the Modernisation Directive require directors' reports to contain a fair review of the building society's position, including an analysis of the risks and uncertainties faced, in order to give greater transparency and precision of reporting on performance on financial and non-financial matters. Articles 3 and 4 of the building societies Order implement these provisions.

3.15. The requirements relating to the directors' report in relation to companies are being taken forward with proposals for the Operating and Financial Review, which have been the subject of a separate consultation and Regulatory Impact Assessment[33].

4. Benefits

Option 1:

4.1. There are no benefits in choosing Option 1. To do nothing would prevent companies from following the most up-to-date accounting practices.

Option 2a. Amendments to consolidation provisions to facilitate alignment with IAS 27.

4.2. Option 2a implements a Member State option in the Seventh Directive that has not previously been implemented (see paragraph 3.4 above). This will allow the requirement to prepare consolidated accounts to be more closely aligned with IAS 27. The Government estimates that there may be some 500 companies who will benefit from these changes, with savings in accountancy staff time in not having to prepare consolidated accounts. It is estimated that the saving could be between £1,000 and £5,000 per company giving a cost saving totalling between £0.5m and £2.5m per annum. Aligning accounting practices with IAS will increase comparability, consistency and transparency of accounts.

Option 2b. Amendments to the audit report of individual companies, building societies and groups.

4.3. Option 2b makes amendments to the audit report of individual companies, building societies and groups. This will more closely align the requirements of the 1985 Act and the 1986 Act with current practice in audit reporting.

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[33] Draft Regulations on the Operating and Financial Review and Directors' Report, DTI, May 2004, URN 04/1003.

Option 2c. Presentation of items within the format of accounts.

4.4. Option 2c makes amendments to the presentation of items within the format of accounts. These amendments facilitate the convergence of UK accounting standards with IAS, bringing the benefits of alignment with IAS previously described, and ensure that items can be presented in the most meaningful way.

Option 2d. Fair value of investment property, living animals and plants.

4.5. Option 2d will facilitate convergence with IAS and use of up-to-date accounting practices by allowing companies and building societies to use fair value accounting for investment property and biological assets.

Option 2e. Amendments to the Directors' Report of individual building societies and groups.

4.6. Option 2e will facilitate greater transparency and reporting on performance on financial and non-financial matters. The directors' report will provide additional information encouraging members to exercise effective and responsible control.

4.7. The overall benefits of Options 2a to e are that they will allow company and building society law to reflect the requirements of the Modernisation Directive, reflect current best practice in audit reporting, and allow companies and building societies to follow up-to-date accounting practices. A benefit generally in implementing the Modernisation Directive is that for companies and building societies that do business or seek capital across borders, It would make their accounts more comparable with those of competitors using IAS. This comparability would assist shareholders, analysts and other users of accounts. We have requested quantified information from companies in order to assist in assessing this benefit but they have been unable to provide the information.

Business Sectors Affected

4.8. There are currently approximately 1.2 million active companies on the register at Companies House and 63 building societies on the register at the Financial Services Authority. The Government estimates that Option 2a will only affect some 500 of the companies that prepare consolidated accounts. Option 2b will affect all companies and building societies that require an auditors' report. However, in practice, auditors already carry this out although not required under the 1985 Act. These changes simply reflect best practice. Option 2c will affect all companies and, where applicable, building societies, by changing the presentation of items in the format of accounts. Option 2d is optional; a company or building society in any business sector may choose to use fair value accounting for investment property and biological assets, but none will be required to do so. Option 2e will affect all building societies by introducing new requirements for the directors' report.

4.9. The proposal will particularly affect accounting firms in that they will need to take account of the change in accounting practice and train staff accordingly. There are over 64,000 UK businesses or firms operating primarily in the accounting area.

Issues of Equity and Fairness

4.10. The Department considers that the proposals will be neutral in their effect and the changes will not bring disproportionate benefits or have disproportionate effects on particular groups. The impact on small businesses is discussed at paragraphs 6.1 and 6.2 below.

5. Costs

(i) Compliance costs

Option 1:

5.1. There would be no compliance costs on companies and building societies in the "do nothing" option.

Option 2a. Amendments to consolidation provisions to facilitate alignment with IAS 27.

5.2. For Option 2a there will be a small training cost for accountants and accountancy staff in making themselves aware of changes and there will be minimal IT costs. However, any costs should be outweighed overall by the benefits of time and costs saved by those companies who are able to take advantage of the exemption from having to prepare consolidated accounts.

Option 2b. Amendments to the audit report of individual companies, building societies and groups.

5.3. Option 2b has minimal cost, as those requirements are a reflection of current best practice.

Option 2c. Presentation of items within the format of accounts.

5.4. There will be a minimal training and IT cost to Option 2c. The amendments are not intended to make any generic changes in the presentation of specific items in the accounts. The changes will clarify the balance sheet and profit and loss formats specified by the 1985 Act and the 1986 Act by requiring that the presentation of items within the accounting formats have regard to their economic substance.

Option 2d. Fair value of investment property, living animals and plants.

5.5. Option 2d will have a cost in the training of staff and updating of IT systems for those companies that decide to take up the fair value option. We estimate that cost to be in the region of £600 per company or building society. (1 day's training at £500 plus cost of staff time at £100).

Option 2e. Amendments to the Directors' Report of individual building societies and groups.

5.6. Building societies are already required to prepare a directors' report. Option 2e will increase the costs associated with this. Costs relating to business risk assessments and identifying key performance indicators will be greater for those building societies that need to introduce systems in order to meet the new requirements. It is difficult to get a hard idea of what impact the revised audit requirement would have and what additional work auditors would carry out in order to arrive at an opinion on the consistency of the directors' report with the annual accounts. We estimate the cost of preparing a directors' report to increase by an average of between £500 and £1,000, although this would vary according to the size of the building society (the cost for the sector can therefore e estimate at between £31,500 and £63,000 per annum across the sector).

(ii) Other costs

5.8. The Government considers that there are no costs imposed on sectors other than business. These proposals will affect companies, LLPs and those in the banking, insurance and accounting sectors.

(iii) Costs for a typical business

5.9. For Options 2a to c there would be a minimal cost in training staff in the accountancy sector and in-house accountants, and in updating IT. Option 2d is not a requirement on businesses, but for those that choose to take it up, there will be a larger training and IT cost. However, for many businesses, it will be difficult to separate these costs from costs resulting from other accounting developments: the Fair Value Directive; increased use of IAS; and the ASB's convergence programme.

6. Consultation with small business:

The Small Firm's Impact Test

6.1. The Government considers that the proposals to implement the Modernisation Directive will have little or no cost implications for small businesses.

6.2. Small businesses have no requirements to prepare group accounts. Where they choose to prepare group accounts, it is expected that no material cost will be imposed by the proposed amendments. They are not required by the 1985 Act to have their accounts audited. Where they do so, it is expected that no material cost will be imposed by the proposed amendments. Small businesses are likely to be affected by the proposed amendments on the presentation of items within the format of accounts, but any additional cost should be minor.

7. Competition Assessment

7.1. The proposals have the potential to affect all public and private companies, building societies and LLPs in all markets. 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 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 1986 Act and subsequent Regulations contain a number of 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 Financial Services Authority. 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 Accounting Directives under review and consider the need for further changes.

10. Consultation

(i) Within Government

10.1. The Department of Trade and Industry and HM Treasury have consulted with the Small Business Service, the Inland Revenue, Companies House, the Department for Enterprise, Trade and Industry in Northern Ireland and the Financial Services Authority.

(ii) Public consultation

10.2. In March 2004, the Department of Trade and Industry and HM Treasury published a consultation document on the Modernisation Directive/IAS Infrastructure. Approximately 800 businesses, professional bodies, representative organisations and individuals were notified of the consultation. The consultation document is available on the DTI's Internet site, and printed copies are available on request. The deadline for comments was 2 July 2004.

10.3. The Government consulted on proposals to change the requirements for companies on how dividends are shown in the accounts as part of the consultation on Fair Value in June 2003. Responses to the consultation have informed the Governments decision and are reflected in the proposals for dividends detailed at paragraphs 2.12, 2.13, 3.11 and 3.12 above.

10.4. A total of 38 organisations, businesses and individuals responded to the consultation. The majority of respondents who commented, were in agreement with the Governments proposals. A number of respondents provided useful comments on the drafting of the Regulations which have been taken into account in the final version of the Regulations. Where respondents commented on costs and benefits it was in relation to the impact of IAS. These comments have been taken into account in the final RIA on the exercise of Member state options. A summary of responses to the consultation is available on the internet at www.dti.gov.uk/cld/index.htm.

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
2a. Amendments to the consolidated accounts to facilitate alignment with IAS.	Minimal training and IT cost.	Removes conflict between the Companies Act 1985/Building Societies (Accounts and Related Provisions) Regulation 1998 and IAS. Saving accountancy staff time of between £.05m and £2.5m per annum
2b. Amendments to the audit report of individual companies, building societies and groups.	Insignificant costs as changes reflect best practice currently in use.	Company and building society law will reflect best practice.
2c. Presentation of items within the format of accounts.	Small training and IT cost.	Changes will clarify the balance sheet and profit and loss formats in the Companies Act 1985/Building Societies (Accounts and Related Provisions) Regulation 1998.
2d. Fair value of investment property, living animals and plants.	£600 per company or building society (that chooses to use fair value accounting)in the training of staff, plus updating of IT systems.	Will facilitate use of up-to-date practices.
2e. Amendments to the directors' report of individual building societies and groups	£500 - £1,000 per building society on average in preparing additional information for the directors' report - £31,500 to £63,000 per annum for the sector.	Greater transparency and reporting on performance on financial and non-financial matters.

11.2. The Government recommends Options 2a to e. These Options will allow company and building society law to reflect the requirements of the Modernisation Directive, reflect current best practice in audit reporting, and enable companies and building societies to follow up-to-date accounting practices.

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.

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

5th October 2004

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Annex B3

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 Directive[34].

[34] 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

1.2 For companies, the implementation of the Modernisation Directive[35], options in the IAS Regulation[36], 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 assessments[37].

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).

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

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[35] 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")

[36] 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")

[37] 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

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 companies[38], Seventh Directive on the consolidated accounts of certain companies[39], the Directive on the annual and consolidated accounts of banks and other financial institutions[40] (the Bank Accounts Directive), and the Directive on the annual and consolidated accounts of insurance undertakings[41] (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.

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 options[42] 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 consultation[43], 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

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[38] 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.
[39] Seventh Council Directive of 13 June 1983 (83/349/EEC) based on Article 54(3)(g) of the Treaty on consolidated accounts. OJ L193/1of 18 July 1983.
[40] 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.
[41] 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.
[42] International Accounting Standards, A consultation on the possible extension of the European Regulation on International Accounting Standards, DTI, URN 02/1158
[43] Modernisation of Accounting Directives/IAS infrastructure, A Consultation Document. DTI, URN04/733.

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 risks[44].

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 exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction[45]. "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.

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[44] Source: The Explanatory Memorandum prepared by the European Commission that accompanied the proposed Fair Value Directive.
[45] "International Accounting Standards 2003", published by the International Accounting Standards Board. Page 39-15.

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 paper[46] setting out proposals for achieving this.

(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;

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

- 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 consultation[47] 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.

[47] 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 companies[48] the Government estimates that 50% of large companies (5,700 approx), 20% of medium-sized companies (4,800 approx) 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.

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

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 chose 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 contains 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 all 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 each company – Total cost £18.7m (£850 X 22,000 companies) Ongoing costs £11m to £22m (22,000 companies X £500 and X £1,000)	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

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.

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

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