FINAL REGULATORY IMPACT ASSESSMENT ON THE MODERNISATION DIRECTIVE AND FRIENDLY SOCIETIES

1. PROPOSAL

1.1 The Friendly Societies Act 1992 (International Accounting Standards and Other Accounting Amendments) Order 2005 and the Friendly Societies (Accounts and Related Provisions) (Amendment) Regulations 2005, insofar as they implement Directive 2003/51/EC of the European Parliament and of the Council of 18 June 2003 ("the Modernisation Directive").

2. PURPOSE AND INTENDED EFFECT

Objective

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 friendly society accounts. It also gives Member States options on whether and how they implement certain aspects of it. Adopting a policy of a level playing field with companies in terms of take-up of the Member State options will enable friendly societies to follow modern, more transparent accounting practices that are consistent with International Accounting Standards (IAS) and ensure that they are not disadvantaged relative to companies.

Devolution

2.2. Responsibility for friendly society law matters lies with the Chancellor of the Exchequer. Friendly society law is an area which is reserved to Westminster under the Scottish, Welsh and Northern Irish devolution legislation and therefore any resulting changes to legislation will also apply in Scotland, Wales and Northern Ireland.

Background

2.3 Friendly societies are mutual organisations, run for and by the benefit of members, providing a wide range of savings, assurance, insurance and healthcare products. As of April 2004, there were 211 friendly societies in total on the register at the Financial Services Authority (FSA). 25 of these societies are what are known as directive friendly societies, meaning they are subject to the 1991 Life Insurance Accounts Directive.

2.4 EU accounting requirements are based primarily on the four Accounting Directives:

- 1978 Fourth Directive on Company Accounts[1]
- 1983 Seventh Directive on Consolidated Accounts[2]
- 1986 Directive on Accounts for Banks and other Financial Institutions[3]
- 1991 Insurance Accounts Directive[4]

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[1] 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.

[2] 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.

[3] 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.

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

2.5 The Modernisation Directive is designed to:

- remove conflicts between the Accounting Directives and International Accounting Standard Board (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 undertakings which continue to have the Accounting Directives as the basis of their accounts.

2.6 The Modernisation Directive is required to be implemented only insofar as the existing Accounting Directives it is amending already apply to friendly societies. The 1991 Insurance Accounts Directive applies to directive friendly societies (that are insurance undertakings and that are authorised to carry on insurance business). The 1991 Insurance Accounts Directive also applies certain provisions of the 1978 Fourth Directive on Company Accounts to insurance undertakings (including directive friendly societies). The 1978 Fourth Directive on Company Accounts therefore indirectly impacts on directive friendly societies. Friendly societies fall outside of the scope of the other two existing Accounting Directives amended by the Modernisation Directive and it is not proposed to make any changes to friendly society legislation as a result of amendments to these accounting directives.

2.7 The Directive is not directly applicable and must be implemented through amendments to the Friendly Societies Act 1992 (“the 1992 Act”) and regulations made under this Act.

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. In addition, level playing field issues arise unless there is consistency between companies and friendly societies.

Risk Assessment

2.9 The Government is required to implement the Modernisation Directive. Failure to implement the changes required by the Directive would result in infraction proceedings being brought against the UK and would prevent friendly societies from following up-to-date accounting requirements. Failure to implement those proposals not required by the Modernisation Directive but presented as options or as possible extensions would prevent friendly societies from following up-to-date accounting practices.

3. Options

3.1 There are numerous permutations for implementing the provisions of the Modernisation Directive. For simplicity, only three main overarching options of “do nothing”, “full implementation” and “full implementation plus two extensions” are discussed.

Option 1: 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. Doing nothing on the options presented by the Modernisation Directive risks preventing directive friendly societies from being able to follow up-to-date accounting practices.

Option 2: Implementation of the accounting amendments for directive friendly societies

3.3 This option focuses on implementation of requirements and options contained within the Modernisation Directive for directive friendly societies. As a whole, it would result in compliance with the requirements to implement the Modernisation Directive, reflection of best practice in audit reporting and allowing directive friendly societies to follow up-to-date accounting practices in line with those followed by companies. This option is broken into 5 subsections a – e which are discussed in detail below.

a) Audit Reports

3.4 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 already conform very closely to the requirements of the Modernisation Directive.

3.5 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).

3.6 Furthermore, article 1.16 of the Modernisation Directive requires disclosure, whenever non-statutory accounts (e.g. 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.

b) Presentation of items

3.7 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. The Government has adopted this option as a requirement, as has already been done for companies and building societies.

c) Fair Value of financial instruments

3.8 Article 4.5 of the Modernisation Directive applies Articles 42a to 42d of the Fourth Accounts Directive to insurance undertakings. This requires Member States to permit or require insurance undertakings to account for their financial instruments at fair value. The Government has adopted a permissive approach, as has already been done for companies and building societies.

d) Fair Value of investment property and biological assets

3.9 Article 1.12 of the Modernisation Directive gives Member States the option to extend the use of fair value accounting to asset categories other than financial instruments. Following adoption of IAS 40 Investment Property and IAS 41 Agriculture, the Government has decided to permit the relevant categories of assets (investment property and biological assets) to be fair valued in both individual and consolidated accounts of directive friendly societies.

e) Directors' Report

3.10 Articles 1.14, 1.17 and 2.10(a) of the Modernisation Directive require directors' reports to contain a fair review of the friendly 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.

Option 3: Implementation of the accounting amendments plus extension of two requirements to all friendly societies

3.12 Although the Modernisation Directive is only required to be implemented for directive societies, the Government proposed to extend two of the mandatory aspects of the Directive to non-directive friendly societies. This option realises the same benefits as described in option 2 and would ensure the benefits associated with legislative simplicity are realised for all friendly societies. The two extensions relate to the audit report and the directors' report as outlined in the previous section (2a and 2e respectively).

3.13 In terms of the audit reports, there would be no increase in the accounts which the auditor is required to report on nor on the true and fair opinions which they are required to give. The increased requirements are for the auditors to identify the accounting framework used and describe the scope of the audit. The extension also provides for increased flexibility in the opinions that the auditor can give. As well as being qualified or unqualified, the auditor may also draw special attention to a matter by way of emphasis.

3.14 In terms of the directors' report, all societies are already required to produce a directors' report containing a fair review of the development and performance of the business of the society. The increased requirement is for that review to analyse the development and performance of the business comprehensively and to include a description of the principal risks facing the society.

4. BENEFITS

Option 1: Do nothing

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

Option 2: Implementation of accounting amendments for directive friendly societies

4.2 In addition to the benefits of implementation more widely - ensuring compliance with the requirements to implement the Modernisation Directive, reflecting best practice in audit reporting and allowing directive friendly societies to follow up-to-date accounting practices in line with those followed by companies – there are individual benefits in the various requirements and options of the Directive as outlined below.

4.3 Option 2a makes amendments to the audit report of individual friendly societies and groups. This will more closely align the requirements of the 1992 Act with current practice in audit reporting.

4.4 Option 2b 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. It is also important that formats do not create excessive rigidity and become an obstacle to presenting items in the most meaningful way.

4.5 Option 2c and d will facilitate use of up-to-date accounting practices by allowing directive friendly societies to use fair value accounting for their financial instruments, investment property and biological assets, facilitating convergence with IAS.

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 directive friendly society law to reflect the requirements of the Modernisation Directive, reflect current best practice in audit reporting, and allow friendly societies to follow up-to-date accounting practices. The changes will also ensure that there is consistency between companies and friendly societies for the purpose of these accounting changes.

Option 3: Implementation of the accounting amendments plus extension of two requirements to all friendly societies

4.8 Extension of option 2a (audit report) to all friendly societies will have the benefit of aligning the requirements of the 1992 Act more closely with current accounting practice in audit reporting.

4.9 Extension of option 2e (directors' report) to all friendly societies will ensure that members of all friendly societies will benefit from 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.

4.10 In general terms, these two extensions will reflect current best practice in audit reporting, and allow friendly societies to follow up-to-date accounting practices. As not extending these requirements would result in greater legislative complexity, friendly societies will also benefit from the resulting legislative simplicity that these extensions introduce.

Business sectors affected

4.11 As of April 2004, there were 211 friendly societies in total on the register at the Financial Services Authority, of which 25 were directive friendly societies. In other words, 25 societies are subject to the 1991 Life Insurance Directive and hence, the changes made to it by the Modernisation Directive. Option 2a will affect all directive and non-directive friendly societies that require an auditors' report. However, in practice, auditors already carry this out although not required under the 1992 Act. These changes simply reflect best practice. Option 2b will affect all directive friendly societies by changing the presentation of items in the format of accounts. Option 2c and d are optional; a directive friendly society may choose to use fair value accounting for financial instruments, investment property and biological assets, but none will be required to do so. Option 2e will affect all directive and non-directive friendly societies by introducing new requirements for the directors' report.

Issues of equality and fairness

4.12 We do not consider that the proposal will bring any disproportionate benefits or have disproportionate effects on particular groups.

5. Costs

Compliance costs

Option 1: Do nothing

5.1 There would be no compliance costs on friendly societies in the "do nothing" option. However, friendly societies would not be able to follow up-to-date accounting practices and may be disadvantaged relative to companies (for whom these changes have already been made).

Option 2: Implementation of accounting amendments for directive friendly societies.

5.2 Option 2a (audit reports) has minimal cost and no significant additional resources would appear to be necessary, as those requirements are a reflection of best practice already in use.

5.3 There will be a small training and IT cost to Option 2b (presentation of items). 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 1992 Act by requiring that the presentation of items within the accounting formats have regard to their economic substance.

5.4 Option 2c and d (fair value) will have a cost in the training of staff and updating of IT systems for those friendly societies that decide to take up the fair value option. The DTI estimated the cost for companies to be in the region of £600 per company. (1 day's training at £500 plus cost of staff time at £100).

5.5 Friendly 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 friendly 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. It appears that many friendly societies already comply with these changes as current best practice. For those that do not, the Government estimates the cost of preparing a directors' report could increase by an average of between £500 and £1,000, although this would vary according to the size of the friendly society.

Option 3: Implementation of accounting amendments plus extension of two requirements to all friendly societies

5.6 In addition to the costs of implementation for directive friendly societies at detailed in paragraphs 5.2 and 5.5, take up of this option and the extension of these two requirements would result in greater costs for non-directive friendly societies. Extension of option 2a (audit reports) would have minimal cost as those requirements are a reflection of best practice already in use but we estimate that extension of option 2e (directors' report) could result in greater costs of up to £1,000 (as outlined in paragraph 5.5) for non-directive friendly societies.

Other costs

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

6. Consultation with small business: the small firm's impact test

6.1 The DTI have already conducted a Small Firm Impact Test on the impact of the Modernisation Directive on small firms where it was concluded that the proposals to implement the Modernisation Directive would have little or no cost implications for small businesses.

7. Competition assessment

7.1 The proposal has the potential to affect all friendly societies. 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.

8. Compensatory simplication measures

8.1 In the report of the Better Regulation Taskforce (published 16 May 2005), one of the two principal conclusions was that the Government should apply a "One in One out" approach to new regulation, with Ministers and departments giving a high priority to simplifying or removing over-complex and burdensome regulation as they do to the introduction of new. These draft Statutory Instruments pre-date this report, but are largely permissive in nature. The instruments codify best practice and have a limited cost impact.

9. Enforcement and sanctions

9.1 The Friendly Societies Act 1992 and subsequent Regulations made under this Act contain a number of requirements on accounting and auditing. Breaches of the most important of these requirements are criminal offences for which both the friendly society and any of its officers in default can be prosecuted and fined. Friendly societies are also subject to supervision and regulation by the Financial Services Authority. The Authority 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.

10. Monitoring and review

10.1 The EU Contact Committee on the Accounting Directives will keep the Accounting Directives under review and consider the need for further changes.

11. Consultation

Within Government

11.1 HM Treasury have consulted with the Department for Trade and Industry, the Financial Services Authority and the Department for Enterprise, Trade and Industry in Northern Ireland. As part of the consultation published in March 2004 on the same accounting changes for companies and building societies, the DTI and HM Treasury consulted the Inland Revenue, the Financial Services Authority, the Small Business Service, Companies House and the Department for Enterprise, Trade and Industry in Northern Ireland.

Public consultation

11.2 In July 2004, HM Treasury published a consultation document on the Modernisation Directive and IAS infrastructure for friendly societies. The consultation document is available on HM Treasury's website, and printed copies are available on request. A total of three organisations responded, including the representative body, the Association of Friendly Societies. All respondents were in broad agreement with the Government's proposals. Consultation respondents agreed that the same Member State options implemented for companies should be implemented for friendly societies to ensure a level playing field. Consultation respondents also agreed that the proposal to extend two of the requirements to non-directive friendly societies already reflected best practice currently in place and that the proposal was unlikely to introduce significant costs. Respondents noted that it was difficult to quantify the costs and benefits of this proposal but did not disagree with the estimates put forward in the partial Regulatory Impact Assessment. A full summary of responses is available on the HM Treasury website.

12. Summary and recommendations

12.1 The Government recommends Option 3. This option will allow friendly society law to reflect the requirements of the Modernisation Directive, reflect current best practice in audit reporting, and enable friendly societies to follow up-to-date accounting practices.

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

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