

Fair value accounting

A consultation document on the use of
fair value accounting for certain financial
instruments by building societies

September 2003



HM TREASURY



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1. SUMMARY AND QUESTIONS

1.1 Directive 2001/65/EC of the European Parliament and of the Council 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 institutions¹ (the “**Fair Value Directive**”) was adopted on 27 September 2001. Building societies are also brought within the ambit of the Directive, but do not exist in other Member States, apart from the Republic of Ireland. The Fair Value Directive is attached at Annex A.

1.2 The Fair Value Directive is designed to enable companies and other institutions such as building societies to account for some of their financial instruments at fair value, in line with accounting practices in International Accounting Standard (IAS) 39 (*Financial Instruments: Recognition and Measurement*). Where financial instruments are valued at fair value, changes in value are recorded in the income and expenditure account, other than in certain limited circumstances.

1.3 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”². “Financial instrument” is defined by IAS 39 as “any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise” and includes cash, receivables, payables, equity and debt securities as well as financial derivatives such as futures, options and swaps, but only a limited range of financial instruments may be accounted for at fair value under the Fair Value Directive.

¹ OJ L283/28 of 27 October 2001.

² “International Accounting Standards 2003”, published by the International Accounting Standards Board.

1.4 The Fair Value Directive also enables 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.

1.5 The Fair Value Directive gives Member States the option to permit or require the valuation of financial instruments at fair values. It also gives Member States options to extend the permission or requirement to all building societies (as well as all other companies) and to restrict it to consolidated accounts. The Government is proposing to permit, but not require, all building societies to use fair value accounting for both their individual and consolidated accounts. This is in line with the approach³ proposed for company accounts³.

1.6 In addition, the Directive requires Member States to require building societies and other companies to set out in relevant documentation their financial risk management objectives and their exposure to risk. The Government proposes to apply this new disclosure requirement to all building societies.

1.7 Directives are not directly applicable in Member States and must be implemented through national law. The Fair Value Directive must be implemented by 1 January 2004. For building societies in the United Kingdom, this means making amendments to the Building Societies (Accounts and Related Provisions) Regulations 1998 (S.I. 1998/504 – “the 1998 Regulations”), by way of secondary legislation. Draft regulations are attached at Annex B.

³ “Fair Value Accounting: A Consultation Document” Department of Trade and Industry, 12 June 2003 (<http://www.dti.gov.uk/cld/fairvalueaccount.pdf>).

Questions for consideration

1.8 In the light of the discussion in the main text of this document, consultees are asked, in particular, to respond to the following questions, **giving reasons for their views**:

1. Do you agree with the Government's overall approach to implementation of the Fair Value Directive for building societies? This is to:

- ☞ permit rather than require fair value accounting;
- ☞ extend the permission to all building societies;
- ☞ extend the permission to individual accounts (as well as consolidated accounts); and
- ☞ permit valuation under a fair value hedge accounting system.
- ☞ require building societies to set out in the director's report their financial risk management objectives and their exposure to risk.

Contrary to the position for companies, the Fair Value Directive does not require building societies that do not account for their financial instruments at fair value to disclose in notes to the accounts the fair value of any derivative financial instruments they hold. We do not propose to introduce such a requirement in the Regulations, although building societies complying with the UK accounting standard FRS13 (*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. Do you have any comments or suggestions on the drafting of the Regulations at Annex B?

3. Can you:

- (a) identify any costs or benefits for your society or more generally resulting from the proposal?
- (b) quantify those costs or benefits?

See Annex C for details on costs and benefits.

Finally, please tell us what your particular interest is, eg are you writing in a personal capacity, or on behalf of a small building society, large building society, accountancy firm, representative body, etc.

2. HOW TO REPLY

2.1 We invite comments by **31 October 2003** at the latest. Earlier responses would be very welcome.

2.2 Responses should be sent - by email if possible – to the address below. Copies sent by post should be marked “Fair Value Consultation” on the envelope.

**Building Societies – Fair Value Consultation
Banking and General Insurance Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ**

Fax: 020 7270 4694

E-mail: mark.baldwin@hm-treasury.gov.uk

2.3 All responses will be acknowledged. In accordance with the code of practice on open government, comments will be made publicly available unless respondents specifically request otherwise. Any e-mail response sent from a corporate system may carry an automatically generated notice stating that the content of the message should be treated as confidential. If you are replying by e-mail, please make it clear in the body of your response whether or not you wish your comments to be treated as confidential.

Additional copies

2.4 This document is available electronically at www.hm-treasury.gov.uk. You may also photocopy it if you wish.

3. BACKGROUND

Fair Value Directive

3.1 European Union (EU) accounting requirements are based primarily on the four Accounting Directives: that is to say, the Fourth⁴ and Seventh⁵ Directives on the annual and consolidated accounts of companies; the Directive on the annual and consolidated accounts of banks and other financial institutions⁶ (the “Bank Accounts Directive”); and the Directive on the annual and consolidated accounts of insurance undertakings⁷ (the “Insurance Accounts Directive”). Building societies are not subject to the Fourth and Seventh Directive but the Bank Accounts Directive applies certain provisions of the Fourth Directive to credit institutions including building societies. For this reason the Government is required to implement the Fair Value Directive for building societies.

3.2 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. Member States are required to implement the Fair Value Directive by 1 January 2004.

3.3 The Fair Value Directive was the first major amendment to the Accounting Directives. It is part of the EU’s objective of enabling

⁴ 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.

⁵ 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.

⁶ 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.

⁷ 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.

companies to use modern accounting practices that are consistent with IAS issued by the International Accounting Standards Board (IASB). The Directive requires Member States to permit or require companies and building societies to implement more transparent accounting practices that are consistent with IAS 39. The Department of Trade and Industry are implementing the Directive in relation to companies, limited liability partnerships and credit institutions which are not mutual societies⁸.

3.4 The Directive requires Member States to permit or require building societies to account for some of their financial instruments at fair value. Where financial instruments are valued at fair value, changes in value are recorded in the income and expenditure account, other than in certain limited circumstances. Building societies that account for their financial instruments at fair value must comply with certain disclosure requirements. However, contrary to the position for companies, the Directive does not require building societies that do not account for their financial instruments at fair value to disclose in notes to the accounts the fair value of each class of derivative financial instruments they hold. Accordingly, we do not propose to extend this requirement to building societies. That said, building societies complying with the UK accounting standard FRS13 (*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.

3.5 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”. “Financial instrument”

⁸ “Fair Value Accounting: A Consultation Document” Department of Trade and Industry, 12 June 2003 (<http://www.dti.gov.uk/cld/fairvalueaccount.pdf>).

includes cash, receivables, payables, equity and debt securities as well as financial derivatives such as futures, options and swaps.

3.6 The Directive requires Member States to:

- €# permit or require the valuation of financial instruments at fair values;

- €# extend the permission or requirement to all companies or restrict it to any class of company (including building societies).

and gives Member States options to:

- €# restrict it to consolidated accounts; and

- €# permit the valuation of assets and liabilities which qualify as hedged items under a fair value hedge accounting system at the specific amount required by that system.

It also requires Member States to require building societies and other companies to set out in relevant documentation their financial risk management objectives and their exposure to risk.

3.7 Currently, the valuation of financial instruments in most building societies' accounts is on a historical cost basis (ie original cost or purchase price) or alternatively at previous valuations or at current cost. This often results in derivative financial instruments having no book value in building societies' accounts because they do not always have a cost.

3.8 The amendments proposed by the Government will allow fair value to be used for certain financial instruments by all building societies in their balance sheets. The use of fair value will result in

regular changes in values, which will be dealt with in the income and expenditure 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 building societies being more volatile than at present.

3.9 EU Regulation 1606/2002 applies International Accounting Standards to the accounts of companies with securities that can be publicly traded on a regulated market. Building societies which issue Permanent Interest Bearing Shares (PIBS) may fall within the scope of this Regulation, and may therefore at some time in the future be required (rather than permitted) to use fair value in their accounts.

3.10 Fair value will be an additional accounting option for most companies. Banks and insurance companies are allowed under the 1985 Act to value certain financial instruments at market value (in the case of banks) or current value (in the case of insurance companies). There are equivalent alternative accounting rules for building societies in Parts IV and VI of Schedule 7 of the 1998 Building Societies Accounts Regulations.

3.10 The Fair Value Directive uses many technical accounting terms (eg financial instruments, hedge accounting) that are not defined in the Directive. The European Commission made clear in its Explanatory Memorandum to the Directive that this was deliberate, and entirely consistent with the principles that have underpinned the Accounting Directives since their adoption: “As framework rules, they have not contained generic definitions of accounting terms which are well defined elsewhere in accounting standards and the accounting literature. Any definitions of financial instruments that were included

would become outdated very quickly in the light of the constantly growing variations of complex derivative financial instruments.”⁹

3.11 Not all these terms are currently defined in UK generally accepted accounting principles (UK GAAP). The ASB in the UK is proposing to issue standards that will include definitions of such terms (in line with IAS definitions) and has published two Financial Reporting Exposure Drafts, FRED 30 (*Financial Instruments: Disclosure and Presentation & Recognition and Measurement*) and FRED 23 (*Financial instruments: Hedge Accounting*). These standards are also expected to set the framework for the application of fair value measurement for financial instruments.

3.12 The Fair Value Directive is not directly applicable in Member States, but must be implemented through national law. The draft Regulations amend the Building Societies (Accounts and Related Provisions) Regulations 1998 (S.I. 1998/504 – “the 1998 Regulations”). The proposed amendments are set out in detail in Section 4.

3.13 For further background on Fair Value Directive and context on International Accounting Standards, Modernisation of Accounting Directives and the ASB’s Convergence Programme please refer to the Department of Trade and Industry’s consultation document on the implementation of the Directive for companies¹⁰.

⁹ Proposal for a Directive of the European Parliament and of the Council amending Directives 78/660/EEC and 83/349/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies; 24.02.2000; COM(2000) 80 final; 2000/0043 (COD). Page 7.

¹⁰ “Fair Value Accounting: A Consultation Document” Department of Trade and Industry, 12 June 2003 (<http://www.dti.gov.uk/cld/fairvalueaccount.pdf>).

4. PROPOSALS

Fair Value Directive

4.1 The various Member State options conferred by the Fair Value Directive mean that there are numerous permutations of how the Directive could be implemented.

4.2 The Government's general approach to implementation is to allow maximum flexibility. In other words, to permit but not require all building societies to use fair value accounting for certain of their financial instruments in both their individual and consolidated annual accounts. Building societies will also be permitted to value assets and liabilities which qualify as hedged items under a fair valued hedge accounting system at the specific amount required by that system. In order to ensure fair competition, the Government's policy is to work for a level playing field between companies and societies, unless inappropriate. Therefore, this approach for building societies is in line with the Government's proposals for implementing the Directive for companies.

4.3 It is not thought appropriate at this stage to have a requirement in law for building societies to adopt fair value accounting for financial instruments. Rather, the Government's approach is that they should be enabled to do so. The requirements in IAS 39 in particular as to which types of financial instrument should be accounted for at fair value are complex and may change in the future. Under IAS 39, certain categories of financial instruments are always recorded at fair value, whereas others are recorded at fair value only in certain circumstances. A flexible approach in legislation is therefore appropriate. It is consistent with the current policy of allowing choice where possible (for example building societies have been able to use

current value or historical cost accounting for certain types of asset). For the same reasons, it is proposed that building societies will be permitted rather than required to use the provisions on hedge accounting.

4.4 The Government believes it is sensible to extend application of the Directive to individual as well as consolidated accounts. Being unable to use fair value accounting for individual accounts could hinder the efficient preparation of consolidated accounts and introduce unwelcome inconsistency.

4.5 In line with the Directive, the Government proposes to require building societies to set out in the director's report their financial risk management objectives and their exposure to risk.

1. Do you agree with the Government's overall approach to implementation of the Fair Value Directive for building societies?

This is to:

- ⊘ permit rather than require fair value accounting;**
- ⊘ extend the permission to all building societies;**
- ⊘ extend the permission to individual accounts (as well as consolidated accounts); and**
- ⊘ permit valuation under a fair value hedge accounting system.**
- ⊘ require building societies to set out in the director's report their financial risk management objectives and their exposure to risk.**

Contrary to the position for companies, the Fair Value Directive does not require building societies that do not account for their financial instruments at fair value to disclose in notes to the accounts the fair value of any derivative financial instruments they hold. We do not propose to introduce such a requirement in the Regulations, although building societies complying with the UK accounting standard *FRS13 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.

The Draft Regulations

4.6 This section explains in further detail what effect the draft Regulations (if made in their current form) would have.

4.7 The draft Regulations amend the Building Societies (Accounts and Related Provisions) Regulations 1998 (S.I. 1998/504 – “the 1998 Regulations”). The 1998 Regulations prescribe the form and content of

the annual accounts which must be prepared in respect of building societies, including group accounts where applicable.

Regulation 1 of the draft Regulations provide that the Regulations come into force on 31st December 2003. The draft Regulations will only apply to annual accounts and directors' reports which relate to a financial year beginning on or after 1st January 2004.

Regulation 2 of the draft Regulations amends Schedule 7 to the 1998 Regulations (accounting principles and rules – "Schedule 7") so as to permit building societies to include certain financial instruments (including derivative financial instruments) in their accounts at fair value (see the new paragraph 31A of Schedule 7). The amendments specify the type of financial instruments which may be valued at fair value. For example, non-derivative financial instruments which are held to maturity and loans and receivables originated by the society and not held for trading purposes may not be included at fair value. Liabilities may only be included at fair value if they are held as part of a trading portfolio or are derivative financial instruments. This is consistent with IAS 39.

The amendments also specify the methods for determining fair value (see the new paragraph 31B of Schedule 7). Where a reliable market can readily be found for a financial instrument, the fair value should be determined by reference to its market value. But where this is not possible, two alternative methods are specified: for fair value to be determined by reference to the market value of its components, or where this does not apply, the value resulting from generally accepted valuation models and techniques. Where the fair value of an instrument cannot be determined by reference to any of the three methods specified by the amendments, the instrument cannot be included at fair value.

The amendments made by regulation 2 also permit societies to include hedged items at fair value (see the new paragraph 31C of Schedule 7). This is a Member State option under which societies may be permitted to include any assets and liabilities which qualify as hedged items under a fair value hedge accounting system, or identified portions of such assets or liabilities, at the amount required under the system. It is intended to allow the use of fair value hedging in accordance with IAS 39.

The new paragraph 31D of Schedule 7 specifies how changes in the value of a financial instrument which has been included at fair value are to be accounted for.

The new paragraph 31E of Schedule 7 makes provision for the fair value reserve. Amounts may be transferred from the fair value reserve only when they are realised, relate to taxation, are no longer necessary for the purposes of paragraph 31D(3) or (4) of Schedule 7 or are otherwise unnecessary for the purposes of the valuation method used.

Regulation 3 amends Schedule 5 to the 1998 Regulations (notes to the accounts) so as to require information about fair valuation to be given in the notes to a society's accounts where fair value accounting has been used.

Regulation 4 amends Schedule 8 to the 1998 Regulations (directors' report) so as to require certain disclosures in the directors' report. In particular, the report must indicate the financial risk management objectives and policies of the society (or, where relevant, the group) and the exposure of the society (or, where relevant, the group) to price risk, credit risk, liquidity risk and cash flow risk. Such disclosures are only

required in relation to the use of financial instruments where the information is material for the assessment of the society's (or, where relevant, the group's) assets, liabilities, financial position and income and expenditure.

Regulation 5 inserts relevant definitions into the 1998 Regulations. Certain terms are to have the same meaning as in Directive 78/660/EEC (the Accounting Directive). Many of these terms are not, in fact, defined by that Directive but rely on accounting standards for their interpretation.

Do you have any comments or suggestions on the drafting of the Regulations at Annex B?

Finally, the attached partial Regulatory Impact Assessment (Annex C) seeks comments on the likely costs and benefits of the proposals. It indicates where costs and benefits may occur and offer initial estimates for these. It would be helpful if consultees could comment on the potential costs and benefits for their building society (or more generally) of the proposals.

Can you;

(a) identify any costs or benefits for your society or more generally resulting from these proposals?

(b) quantify those costs or benefits?

See Annex C for details on costs and benefits.

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**

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 44(2)(g),

Having regard to the proposal from the Commission ⁽¹⁾,

Having regard to the opinion of the Economic and Social Committee ⁽²⁾,

Acting in accordance with the procedure laid down in Article 251 of the Treaty ⁽³⁾,

Whereas:

(1) Article 32 of the Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies ⁽⁴⁾ requires the items shown in the annual accounts to be valued on the basis of the principle of purchase price or production cost.

(2) Article 33 of Directive 78/660/EEC authorises Member States to permit or require companies to revalue certain assets, to value certain assets at replacement cost or to apply other methods that take into account the effects of inflation on the items shown in the annual accounts.

(3) Article 29 of the Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts ⁽⁵⁾ requires assets and liabilities to be included in consolidated accounts to be valued in accordance with Articles 31 to 42 and Article 60 of Directive 78/660/EEC.

(4) Article 1 of Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions ⁽⁶⁾ requires assets and liabilities to be valued in accordance with Articles 31 to 42 of Directive 78/660/EEC, except when Directive 86/635/EEC provides otherwise.

(5) The annual and consolidated accounts of insurance undertakings are prepared in accordance with Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings ⁽⁷⁾. The amendments to Directives 78/660/EEC and 83/349/EEC do not concern the provisions of Directive 91/674/EEC, but the Commission may bring forward similar proposals to amend that Directive after having consulted the relevant advisory committee.

(6) The dynamic nature of international financial markets has resulted in the widespread use of not only traditional primary financial instruments such as shares and bonds, but also various forms of derivative financial instruments such as futures, options, forward contracts and swaps.

(7) Leading accounting standard setters in the world are moving away from the historical cost model for the valuation of these financial instruments towards a model of fair value accounting.

(8) The Communication of the Commission on Accounting harmonisation: a new strategy vis-à-vis international harmonisation called for the European Union to work to maintain consistency between Community accounting directives and developments in international accounting standard setting, in particular within the International Accounting Standards Committee (IASC).

(9) In order to maintain such consistency between internationally recognised accounting standards and Directives 78/660/EEC, 83/349/EEC and 86/635/EEC, it is necessary to amend these Directives in order to allow for certain financial assets and liabilities to be valued at fair value. This will enable European companies to report in conformity with current international developments.

(10) This amendment to Directives 78/660/EEC, 83/349/EEC and 86/635/EEC is in line with the Commission's communication to the European Parliament and the Council of 13 June 2000 on the EU financial reporting strategy which proposes the use of recognised international accounting standards for the preparation of consolidated financial statements by listed companies. The purpose of this amendment is to allow the application of the international accounting standard dealing with the recognition and measurement of financial instruments.

⁽¹⁾ OJ C 311, 31.10.2000, p. 1.

⁽²⁾ OJ C 268, 19.9.2000, p. 1.

⁽³⁾ Opinion of the European Parliament of 15 May 2001 (not yet published in the Official Journal) and Council Decision of 30 May 2001

⁽⁴⁾ OJ L 222, 14.8.1978, p. 11. Directive as last amended by Directive 1999/60/EC (OJ L 162, 26.6.1999, p. 65).

⁽⁵⁾ OJ L 193, 18.7.1983, p. 1. Directive as last amended by the 1994 Act of Accession.

⁽⁶⁾ OJ L 372, 31.12.1986, p. 1.

⁽⁷⁾ OJ L 372, 31.12.1986, p. 1. (7) OJ L 374, 31.12.1991, p. 7.

EN Official Journal of the European Communities 27.10.2001 L 283/29

- (11) Comparability of financial information throughout the Community makes it necessary to require Member States to introduce a system of fair value accounting for certain financial instruments. Member States should permit the adoption of that system by all companies or any classes of companies subject to the Directives 78/660/EEC, 83/349/EEC and 86/635/EEC in respect of both the annual and consolidated accounts or in respect of consolidated accounts only. Further, Member States should be permitted to require the adoption of that system in respect of all companies or any classes of companies for both the annual and consolidated accounts or for the consolidated accounts only.
- (12) Fair value accounting should only be possible for those items where there is a well-developed international consensus that fair value accounting is appropriate. The current consensus is that fair value accounting should not be applied to all financial assets and liabilities, for instance not to most of those relating to the banking book.
- (13) The notes on the accounts should include certain information concerning financial instruments in the balance sheet, which have been measured at fair value. The annual report should give an indication of the company's risk management objectives and policies in relation to its use of financial instruments.
- (14) Derivative financial instruments can have a significant impact on the financial position of companies. Disclosures on derivative financial instruments and their fair value are considered appropriate even if the company does not use fair value accounting. In order to limit the administrative burden for small companies, Member States should be allowed to exempt small companies from this disclosure requirement.
- (15) Accounting for financial instruments is a fast evolving area of financial reporting which necessitates a review by the Commission based on the experiences of Member States with fair value accounting in practice,

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Directive 78/660/EEC is hereby amended as follows:

1. the following section shall be inserted:

'SECTION 7a

Valuation at fair value

Article 42a

1. By way of derogation from Article 32 and subject to the conditions set out in paragraphs 2 to 4 of this Article, Member States shall permit or require in respect of all companies or any classes of companies valuation at fair value of financial instruments, including derivatives.

Such permission or requirement may be restricted to consolidated accounts as defined in Directive 83/349/EEC.

2. For the purpose of this Directive commodity-based contracts that give either contracting party the right to settle in cash or some other financial instrument shall be considered to be derivative financial instruments, except when:

- (a) they were entered into and continue to meet the company's expected purchase, sale or usage requirements;
- (b) they were designated for such purpose at their inception; and
- (c) they are expected to be settled by delivery of the commodity.

3. Paragraph 1 shall apply only to liabilities that are:

- (a) held as part of a trading portfolio; or
- (b) derivative financial instruments.

4. Valuation according to paragraph 1 shall not apply to:

- (a) to non-derivative financial instruments held to maturity;
- (b) to loans and receivables originated by the company and not held for trading purposes; and
- (c) to interests in subsidiaries, associated undertakings and joint ventures, equity instruments issued by the company, contracts for contingent consideration in a business combination as well as other financial instruments with such special characteristics that the instruments, according to what is generally accepted, should be accounted for differently from other financial instruments.

5. By way of derogation from Article 32, Member States may in respect of any assets and liabilities which qualify as hedged items under a fair value hedge accounting system, or identified portions of such assets or liabilities, permit valuation at the specific amount required under that system.

Article 42b

1. The fair value referred to in Article 42a shall be determined by reference to:

- (a) a market value, for those financial instruments for which a reliable market can readily be identified. Where a market value is not readily identifiable for an instrument but can be identified for its components or for a similar instrument, the market value may be derived from that of its components or of the similar instrument; or
- (b) a value resulting from generally accepted valuation models and techniques, for those instruments for which a reliable market cannot be readily identified. Such valuation models and techniques shall ensure a reasonable approximation of the market value.

2. Those financial instruments that cannot be measured reliably by any of the methods described in paragraph 1, shall be measured in accordance with Articles 34 to 42.

Article 42c

1. Notwithstanding Article 31(1)(c), where a financial instrument is valued in accordance with Article 42b, a change in the value shall be included in the profit and loss account. However, such a change shall be included directly in equity, in a fair value reserve, where:

- (a) the instrument accounted for is a hedging instrument under a system of hedge accounting that allows some or all of the change in value not to be shown in the profit and loss account; or
- (b) the change in value relates to an exchange difference arising on a monetary item that forms part of a company's net investment in a foreign entity.

2. Member States may permit or require a change in the value on an available for sale financial asset, other than a derivative financial instrument, to be included directly in equity, in the fair value reserve.

3. The fair value reserve shall be adjusted when amounts shown therein are no longer necessary for the implementation of paragraphs 1 and 2.

Article 42d

Where valuation at fair value of financial instruments has been applied, the notes on the accounts shall disclose:

- (a) the significant assumptions underlying the valuation models and techniques where fair values have been determined in accordance with Article 42b(1)(b);

- (b) per category of financial instruments, the fair value, the changes in value included directly in the profit and loss account as well as changes included in the fair value reserve;

- (c) for each class of derivative financial instruments, information about the extent and the nature of the instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and

- (d) a table showing movements in the fair value reserve during the financial year.;

2. in Article 43(1):

- (a) the reference in point 10 to 'Articles 31 and 34 to 42' shall be replaced by a reference to 'Articles 31 and 34 to 42c', and

- (b) the following point shall be added:

'14. Where valuation at fair value of financial instruments has not been applied in accordance with Section 7a:

- (a) for each class of derivative financial instruments:

- (i) the fair value of the instruments, if such a value can be determined by any of the methods prescribed in Article 42b(1);

- (ii) information about the extent and the nature of the instruments; and

- (b) for financial fixed assets covered by Article 42a, carried at an amount in excess of their fair value and without use being made of the option to make a value adjustment in accordance with Article 35(1)(c)(aa):

- (i) the book value and the fair value of either the individual assets or appropriate groupings of those individual assets;

- (ii) the reasons for not reducing the book value, including the nature of the evidence that provides the basis for the belief that the book value will be recovered.;

3. the text of Article 44(1) shall be replaced by the following text:

'1. Member States may permit the companies referred to in Article 11 to draw up abridged notes on their accounts without the information required in Article 43(1)(5) to (12) and (14)(a). However, the notes must disclose the information specified in Article 43(1)(6) in total for all the items concerned.;

4. in Article 46(2) the following point shall be added:

'(f) in relation to the company's use of financial instruments and where material for the assessment of its assets, liabilities, financial position and profit or loss,

∞ # the company's financial risk management objectives and policies, including its policy for hedging each major type of forecasted transaction for which hedge accounting is used, and

∞ # the company's exposure to price risk, credit risk, liquidity risk and cash flow risk.';

5. in Article 59(2)(a) and (b) the reference to 'Articles 31 to 42' shall be replaced by a reference to 'Section 7 or 7a';

6. the following Article shall be inserted:

'Article 61a

Not later than 1 January 2007, the Commission shall review the provisions in Article 42a to 42d, Article 43(1)(10) and (14), Article 44(1), Article 46(2)(f) and Article 59(2)(a) and (b) in the light of the experience acquired in applying provisions on fair value accounting and taking account of international developments in the field of accounting and, if appropriate, submit a proposal to the European Parliament and the Council with a view to amending the abovementioned Articles.'

Article 2

Directive 83/349/EEC is amended as follows:

1. the text of Article 29(1) shall be replaced by the following text:

'1. Assets and liabilities to be included in consolidated accounts shall be valued according to uniform methods and in accordance with Sections 7 and 7a and Article 60 of Directive 78/660/EEC.';

2. in Article 34:

(a) the reference in point 10 to 'Articles 31 and 34 to 42' shall be replaced by a reference to 'Articles 31 and 34 to Article 42c', and

(b) the following points shall be added:

'14. Where valuation at fair value of financial instruments has been applied in accordance with Section 7a of Directive 78/660/EEC:

(a) the significant assumptions underlying the valuation models and techniques where fair values have been determined in accordance with Article 42b(1)(b) of that Directive;

(b) per category of financial instruments, the fair value, the changes in value included directly in the profit and loss account as well as, in accordance with Article 42c of that Directive, changes included in the fair value reserve;

(c) for each class of derivative financial instruments, information about the extent and the nature of the instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and

(d) a table showing movements in the fair value reserve during the financial year.

15. Where valuation at fair value of financial instruments has not been applied in accordance with Section 7a of Directive 78/660/EEC:

(a) for each class of derivative instruments:

(i) the fair value of the instruments, if such a value can be determined by any of the methods prescribed in Article 42b(1) of that Directive;

(ii) information about the extent and the nature of the instruments; and

(b) for financial fixed assets covered by Article 42a of that Directive, carried at an amount in excess of their fair value and without use being made of the option to make a value adjustment in accordance with Article 35(1)(c)(aa) of that Directive:

(i) the book value and the fair value of either the individual assets or appropriate groupings of those individual assets;

(ii) the reasons for not reducing the book value, including the nature of the evidence that provides the basis for the belief that the book value will be recovered.';

3. in Article 36(2) the following point shall be added:

'(e) in relation to the use by the undertakings of financial instruments and, where material for the assessment of assets, liabilities, financial position and profit or loss,

∞ # the financial risk management objectives and policies of the undertakings, including their policies for hedging each major type of forecasted transaction for which hedge accounting is used, and

∞ # the exposure to price risk, credit risk, liquidity risk and cash flow risk.';

4. the following Article shall be inserted:

'Article 50a

Not later than 1 January 2007, the Commission shall review the provisions in Article 29(1), Article 34(10), (14) and (15) and Article 36(2)(e) in the light of the experience acquired in applying provisions on fair value accounting and taking account of international developments in the field of accounting and, if appropriate, submit a proposal to the European Parliament and the Council with a view to amending the abovementioned Articles.'

Article 3

The text of Article 1(1) of Directive 86/635/EEC shall be replaced by the following text:

'1. Articles 2, 3, 4(1), (3) to (5), Articles 6, 7, 13, 14, 15(3) and (4), Articles 16 to 21, 29 to 35, 37 to 41, 42 first sentence, 42a to 42d, 45(1), 46(1) and (2), Articles 48 to 50, 50a, 51(1), 56 to 59, 61 and 61a of Directive 78/660/EEC shall apply to the institutions mentioned in Article 2 of this Directive, except where this Directive provides otherwise. However, Articles 35(3), 36, 37 and 39(1) to (4) of this Directive shall not apply with respect to assets and liabilities that are valued in accordance with Section 7a of Directive 78/660/EEC.'

Article 4

1. Member States shall bring into force the laws, regulations and administrative provisions necessary for them to comply with this Directive before 1 January 2004. They shall forthwith inform the Commission thereof.

When Member States adopt these provisions, they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods for making such reference shall be laid down by Member States.

2. Member States shall communicate to the Commission the main provisions of domestic law, which they adopt in the field governed by this Directive.

Article 5

This Directive is addressed to the Member States.

Done at Brussels, 27 September 2001.

For the European Parliament
The President
N. FONTAINE

For the Council
The President
C. PICQUÉ

1st September 2003

 STATUTORY INSTRUMENTS

2003 No.**BUILDING SOCIETIES**
**The Building Societies (Accounts and Related Provisions)
 (Amendment) Regulations 2003**

<i>Made</i> - - - -	2003
<i>Laid before Parliament</i>	2003
<i>Coming into force</i> - -	2003

The Treasury, in exercise of the powers conferred upon them by sections 73(6) to (8)(a) and 75(1) of the Building Societies Act 1986(b) hereby make the following Regulations:

Citation, commencement and interpretation

1.—(1) These Regulations may be cited as the Building Societies (Accounts and Related Provisions) (Amendment) Regulations 2003 and come into force on 31st December 2003.

(2) [These Regulations apply in relation to –

- (a) the annual accounts of any society, and
- (b) any report which the directors of a society are obliged to prepare by virtue of section 75 of the Building Societies Act 1986,

which relates to a financial year beginning on or after [1st January 2004].

(3) In these Regulations –

- (a) “the principal Regulations” means the Building Societies (Accounts and Related Provisions) Regulations 1998(c); and
- (b) references to numbered schedules are to Schedules to the principal Regulations.

Valuation at fair value

2.—(1) In Part 3 of Schedule 7 –

- (a) in paragraph 8(1) (general rules for inclusion of fixed assets), for “paragraph 28”, substitute “paragraph [13], 28, 31A or 31C”;
- (b) in paragraph 13(1) (fixed financial assets), at the end, insert “and to paragraphs 31A and 31C”;
- (c) in paragraph 14 (current assets), for “paragraphs 15 and 16”, substitute “paragraphs 15, 16, 31A and 31C”.

(a) See section 73(12) for definition of “prescribed”.

(b) 1986 c.53.

(c) S.I. 1998/504; amended by S.I. 1999/248 and S.I. 2001/3649 and modified by 2003/1633.

(2) After paragraph 31 of Schedule 7, insert –

“Part 6A

VALUATION AT FAIR VALUE

Inclusion of financial instruments at fair value

31A.- (1) Subject to sub-paragraphs (2) to (4), financial instruments, including derivative financial instruments, may be included at fair value.

(2) Sub-paragraph (1) only applies to financial instruments which constitute liabilities if-

- (a) they are held as part of a trading portfolio; or
- (b) they are derivative financial instruments.

(3) Sub-paragraph (1) does not apply to-

- (a) non-derivative financial instruments held to maturity;
- (b) loans and receivables originated by the society and not held for trading purposes;
- (c) interests in connected undertakings or joint ventures;
- (d) equity instruments issued by the society;
- (e) contracts for contingent consideration in a business combination; and
- (f) other financial instruments with such special characteristics that the instruments, according to generally accepted accounting principles or practice, should be accounted for differently from other financial instruments.

(4) If the fair value of a financial instrument cannot be determined reliably in accordance with paragraph 31B, sub-paragraph (1) does not apply to that financial instrument.

(5) In this paragraph, “joint venture” means an undertaking, other than a connected undertaking, which a society manages jointly with one or more undertakings.

Methods for determining “fair value”

31B.- (1) The fair value of a financial instrument is its value determined in accordance with this paragraph.

(2) If a reliable market can readily be identified for the financial instrument, its fair value is to be determined by reference to its market value.

(3) If a reliable market cannot readily be identified for the financial instrument but can be identified for its components or for a similar instrument, its fair value is to be determined by reference to the market value of its components or of the similar instrument.

(4) If neither sub-paragraph (2) nor (3) apply, the fair value of the financial instrument is to be a value resulting from generally accepted valuation models and techniques.

(5) Any valuation models and techniques used for the purposes of sub-paragraph (4) must ensure a reasonable approximation of the market value.

Hedged items

31C. A society may include any assets and liabilities, or identified portions of such assets or liabilities, which qualify as hedged items under a fair value hedge accounting system at the amount required under that system.

Accounting for changes in value of financial instruments

31D.- (1) This paragraph applies where the fair value at which a financial instrument is included in accordance with paragraph 31A or 31C is different from the fair value at which it was last included in accordance with that paragraph.

(2) Notwithstanding paragraph 4 in Part 1 of this Schedule, and subject to sub-paragraphs (3) and (4) below, the amount of the difference in value shall be included in the income and expenditure account.

(3) Where-

(a) the financial instrument accounted for is a hedging instrument under a hedge accounting system that allows some or all of the amount of the difference in value not to be shown in the income and expenditure account, or

(b) the difference in value relates to an exchange difference arising on a monetary item that forms part of a society's net investment in a foreign entity,

the amount of the difference in value shall be credited to or (as the case may be) debited from a separate reserve ("the fair value reserve").

(4) Where the instrument accounted for –

(a) is an available for sale financial asset, and

(b) is not a derivative financial instrument,

the difference in value may be credited to or (as the case may be) debited from the fair value reserve.

The fair value reserve

31E.-(1) An amount may be transferred –

(a) from the fair value reserve to the income and expenditure account if the amount represents realised profit,

(b) to or from the fair value reserve in respect of the taxation relating to any amount credited or debited to the reserve.

(2) The fair value reserve shall be adjusted to the extent that the amounts shown in it are no longer necessary for the purposes of paragraph 31D(3) or (4), or otherwise for the purposes of the valuation method used.

(3) The fair value reserve shall not be reduced except as mentioned in this paragraph.

(4) The treatment for taxation purposes of amounts credited or debited to the fair value reserve shall be disclosed in a note to the accounts.”.

Information about fair value in notes to the accounts

3. After paragraph 35 of Schedule 5 (notes to annual accounts) insert –

“Information about fair value of assets and liabilities

36.-(1) This paragraph applies where financial instruments have been included at fair value by virtue of paragraph 31A or 31C of Schedule 7.

(2) There shall be stated-

(a) the significant assumptions underlying the valuation models and techniques used where the fair value of the instruments has been determined in accordance with paragraph 31B(4) of that Schedule;

(b) for each category of financial instrument, the fair value of the instruments in that category and the amounts-

(i) included in the income and expenditure account, and

(ii) credited to or (as the case may be) debited from the fair value reserve,

in respect of instruments in that category; and

(c) for each class of derivative financial instruments, the extent and nature of the instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows.

(3) Where any amount is transferred to or from the fair value reserve during the financial year, there shall be stated in tabular form –

- (a) the amount of the reserve as at the date of the beginning of the financial year and as at the balance sheet date respectively;
- (b) the amount transferred to or from the reserve during that year; and
- (c) the source and application respectively of the amounts so transferred”.

Disclosures in relation to financial instruments

4. In Schedule 8 (directors’ report), after paragraph 10 (new activities) insert --

“Financial risk management objectives etc.

11. The directors’ report shall contain, in relation to the use of financial instruments by the society and by any subsidiary undertaking, and where material for the assessment of the society’s or (as the case may be) group’s assets, liabilities, financial position and profit or loss -

- (a) the financial risk management objectives and policies of the society or (where applicable) the group, including the policy for hedging each major type of forecasted transaction for which hedge accounting is used, and
- (b) the exposure of the society or (where applicable) of the group to price risk, credit risk, liquidity risk and cash flow risk”.

Interpretation

5. In Schedule 11 (interpretation) –

- (a) after paragraph 12 (amounts repayable), insert -

“Financial instruments

12A. References to “derivative financial instruments” are deemed to include commodity-based contracts that give either contracting party the right to settle in cash or some other financial instrument, except when such contracts -

- (a) were entered into and continue to meet the society’s expected purchase, sale or usage requirements;
- (b) were designated for such purpose at their inception; and
- (c) are expected to be settled by delivery of the commodity.”;
- (b) in paragraph 13 (other definitions), after the definition of “EEA State”, insert –
““fair value reserve” has the meaning given by paragraph 31D of Schedule 7;”;
- (c) after paragraph 13, insert -

“14.-(1) The expressions listed in sub-paragraph (2) have the same meaning as they have in Council Directive 78/660/EEC(a) (as last amended by Council Directive 2001/65/EEC(b)); and for the purposes of those expressions, it shall be assumed that a society is subject to the provisions of that Directive.

(a) OJ L 222, 14.8.1978, p.11; as amended by Council Directive 83/349/EEC, Council Directive 84/569/EEC, Council Directive 89/666/EEC, Council Directive 90/604/EEC, Council Directive 90/605/EEC, Council Directive 94/8/EC, Council Directive 1999/60/EC and European Parliament and Council Directive 2001/65/EC.
(b) OJ L 283, 27.10.2001, p.28.

(2) “Available for sale financial asset”, “business combination”, “cash flow risk”, “commodity-based contracts”, “credit risk”, “equity instrument”, “exchange difference”, “fair value hedge accounting system”, “financial fixed asset”, “financial instrument”, “foreign entity”, “hedge accounting”, “hedge accounting system”, “hedged items”, “hedging instrument”, “held to maturity”, “held for trading purposes”, “liquidity risk”, “monetary item”, “price risk”, “receivables”, “reliable market” and “trading portfolio”.”

Two of the Lords Commissioners of Her Majesty’s Treasury

EXPLANATORY NOTE

(This note is not part of the Regulations)

These Regulations implement in part Directive 2001/65/EC of the European Parliament and of the Council 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 L 283 27.10.2001 p.28 to 32). A Transposition Note showing how the main provisions of this Directive (in so far as it applies to building societies) will be transposed into UK law is available from the Banking and General Insurance Team, HM Treasury, 1 Horseguards Road, London SW1A 2HQ. The Transposition Note is also on HM Treasury’s website (www.hm-treasury.gov.uk).

These Regulations amend the Building Societies (Accounts and Related Provisions) Regulations 1998 (S.I. 1998/504 – “the 1998 Regulations”). Regulation 2 amends the 1998 Regulations so as to permit building societies to include certain financial instruments (including derivative financial instruments) in its accounts at fair value. The amendments specify the type of financial instruments which may be valued at fair value, the methods for determining fair value, how assets and liabilities that qualify as hedged items under a fair value hedge accounting system are to be accounted for and how changes in the value of financial instruments are to be accounted for.

Regulation 3 amends the 1998 Regulations so as to require information about fair valuation to be given in the notes to a society’s accounts.

Regulation 4 amends the 1998 Regulations so as to require disclosures in relation to the use of financial instruments by a building society.

Regulation 5 inserts relevant definitions into the 1998 Regulations.

**PARTIAL REGULATORY IMPACT ASSESSMENT
ON
THE USE OF FAIR VALUE ACCOUNTING BY BUILDING SOCIETIES**

1. Proposal

1. The Building Societies (Accounts and Related Provisions) (Amendment) Regulations 2003 implement Directive 2001/65/EC of the European Parliament and of the Council (27 September 2001)¹ (“the Fair Value Directive”) for building societies.

2. Purpose and intended effect

(i) Objective

2. The Fair Value Directive requires Member States to enable companies and other institutions such as building societies, to follow modern, more transparent accounting practices in the area of financial instruments that are consistent with International Accounting Standards (IAS).

3. The intention of this proposal is to permit all building societies 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 income and expenditure 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.

(ii) Background

4. EU accounting requirements are based primarily on the four Accounting Directives: the Fourth Directive on the annual accounts of certain companies², Seventh Directive on the consolidated accounts of certain companies³, the Directive on the annual and consolidated

¹ L283/28 of 27 October 2001.

² 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.

³ 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.

accounts of banks and other financial institutions⁴ (the Bank Accounts Directive), and the Directive on the annual and consolidated accounts of insurance undertakings⁵ (the Insurance Accounts Directive). The Fair Value Directive amends the Fourth Directive, the Seventh Directives and the Bank Accounts Directive. Building societies are not subject to the Fourth and Seventh Directive but the Bank Accounts Directive applies certain provisions of the Fourth Directive to credit institutions, including building societies. Therefore, the Government is required to implement the Fair Value Directive for building societies.

5. 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 IAS issued by the International Accounting Standards Board ("IASB").

6. IAS 39 (*Financial Instruments: Recognition and Measurement*) and the related standard IAS 32 (*Financial Instruments: Disclosure and Presentation*) 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"⁶. "Financial instrument" includes cash, receivables, payables, equity and debt securities as well as financial derivatives such as futures, options and swaps.

7. Building societies that account for their financial instruments at fair value must comply with certain disclosure requirements. For example, disclosure of the significant assumptions underlying the valuation models and techniques used in applying fair value. Such disclosure requirements could make it easier for prospective members/investors to analyse society accounts.

8. Directives are not directly applicable in Member States but must be implemented through national law. Member States are required to implement the Fair Value Directive by 1 January 2004. To do this for building societies, amendments will be made to the Building Societies (Accounts and Related Provisions) Regulations 1998 (S.I. 1998/504 – "the 1998 Regulations").

⁴ 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.

⁵ 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.

⁶ "International Accounting Standards 2003", published by the International Accounting Standards Board. Page 39-15.

(iii) Risk Assessment

9. The Government is required to implement the Fair Value Directive for building societies. Failure to implement the Directive would result in infraction proceedings being brought against the UK. It would also hinder the Accounting Standards Board in its programme of converging UK accounting standards with IAS, thereby preventing building societies from following up-to-date accounting practices consistent with IAS. All building societies would potentially be affected by the proposal.

3. Proposal

10. The Fair Value Directive requires Member States to:

- ~~€#~~ permit or require the valuation of financial instruments at fair value;
- ~~€#~~ extend the permission or requirement to all building societies;

and gives Member States options to:

- ~~€#~~ restrict the permission or requirement to consolidated accounts only;
- ~~€#~~ permit the valuation of assets and liabilities that qualify as hedged items under a fair value hedge accounting system at the specific amount required by that system.

It also requires Member States to require building societies and other companies to set out in relevant documentation their financial risk management objectives and their exposure to risk.

11. The Government proposes to extend fair value and hedge accounting to all building societies and all accounts on a permissive basis rather than as a requirement⁷. The Government proposes to apply the new disclosure requirement outlined above to all building societies.

12. Contrary to the position for companies, the Fair Value Directive does not require building societies that do not account for their financial instruments at fair value to disclose in notes to the accounts the fair value of any derivative financial instruments they hold. The Government does not propose to introduce such a requirement in the Regulations, although building societies applying FRS13 (*Derivatives and other Financial Instruments: Disclosures*) already have to make more

⁷ However, under EU Regulation 1606 on the application of International Accounting Standards, building societies which issue **Permanent Interest Bearing Shares** (PIBS) may at some point in the future be required (rather than permitted) to use fair value in their accounts.

extensive disclosures than those required by the Directive in the notes to their accounts.

13. Fair value accounting will make financial statements more transparent, but it may also lead to the balance sheets and results of some building societies 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 income and expenditure account in most cases. The permissive nature of this proposal may result in societies using different accounting methods, making it harder to compare the different performance of different societies. However, since fair value brings accounting practices for building societies into line with International Accounting Standards, it could make it easier for foreign investors to analyse the accounts.

4. Benefits

14. The proposal has the benefit of allowing choice and flexibility in the use of fair value accounting. Building societies 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 societies at this stage. Allowing societies 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 building societies should have the opportunity to follow modern accounting practice and account for them at fair value.

15. The Government welcomes comments from respondents on the benefits of the proposal, and any quantification of these benefits.

Business Sectors Affected

16. This amendment will potentially affect all building societies in the United Kingdom. There are currently 65 building societies registered with the Financial Services Authority. It is not possible to say how many of these will account for their financial instruments at fair values.

17. 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. However, they will also need to do this as a result of the implementation of the Fair Value Directive for companies⁸. In addition, firms should be aware that building societies 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

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

5. Costs

(i) Compliance costs

19. The Government considers that the proposal does not impose compliance costs on building societies in general as they will be permitted rather than required to use fair value accounting for their financial instruments. However, any society wanting to use fair value may incur training and systems development costs, and ongoing costs.

20. There will however be some cost to some societies 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 societies would spend a significant amount of time deciding whether to use fair value accounting, or quantify how much this would cost.

21. The main cost of the proposal will be the cost to accounting firms in training on the new requirements. See Department of Trade and Industry's (DTI) Partial Regulatory Impact Assessment (on the Use of Fair Value Accounting for Certain Financial Instruments)⁹. The costs DTI has calculated are the accountancy costs as a result of companies taking up Fair Value. However, these costs are likely to be incurred as a result of the application of the Fair Value Directive to companies. In addition, all building societies which do not already do so will incur some compliance cost in meeting the new disclosure requirements set out in

⁸ "Fair Value Accounting: A Consultation Document" Department of Trade and Industry, 12 June 2003 (<http://www.dti.gov.uk/cld/fairvalueaccount.pdf>).

⁹ <http://www.dti.gov.uk/cld/fairvalueaccount.pdf> Annex E.

paragraph 10 above. The Government considers that there are no costs imposed on sectors other than business.

22. The Government welcomes comments on the possible costs of the proposal.

6. Competition Assessment

23. It is not anticipated that the proposal will: affect some building societies more than others; affect market structure; change the number or size of those societies; lead to significantly higher set-up costs for those societies; or lead to significantly higher on-going costs, than at present.

24. The Government welcomes comments from respondents on this assessment.

7. Enforcement and Sanctions

25. In the United Kingdom building societies are registered and regulated by the Financial Services Authority (FSA). FSA regulation includes an enforcement regime for ensuring that financial returns meet the requirements of existing legislation.

8. Monitoring and Review

26. 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.

9. Consultation

(i) Within Government

27. The Department has consulted with the Department for Trade and Industry and the Financial Services Authority.

(ii) Public consultation

28. A consultation document on the proposed changes was published on 5 September. The deadline for responses to this is 31 October.

10. Summary and Recommendation

29. The Government proposes to permit but not require all building societies to use fair value accounting for certain of 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 societies at this time.