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Response to the Accounting Standards Board's consultation: The future of UK GAAP

The Building Societies Association

The Building Societies Association represents mutual lenders and deposit takers in the UK including all 52 UK building societies. Mutual lenders and deposit takers have total assets of over £390 billion and, together with their subsidiaries, hold residential mortgages of almost £260 billion, 21% of the total outstanding in the UK. They hold over £250 billion of retail deposits, accounting for just under 23% of all such deposits in the UK. Building societies alone account for about 32% of all cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

This response focuses on the potential impact of international financial reporting standards (as adopted for use in the EU) for small and medium-sized enterprises on building societies, specifically those currently using UK GAAP. Societies that have issued permanent interest bearing shares - generally speaking, the larger ones - have been required to use IFRS since 1 January 2005.

The majority of building societies operate straightforward businesses with limited product ranges. They are also small. They operate in the UK only, many on a regional or local basis.

Summary

We are pleased to be invited to comment on the Accounting Standards Board's consultation:

www.frc.org.uk/images/uploaded/documents/CP%20Policy%20Proposal%20the%20future%20of%20UK%20GAAP.pdf

We are also grateful for the time ASB officials gave up in December to talk to a group of building societies on their proposals.

In short, we welcome the revised standard but reject the proposal to apply full IFRS to all building societies.

We believe that "public accountability" alone is not a suitable criterion; instead size should be addressed. It seems anomalous that very large privately-owned entities will be allowed to adopt IFRS for SMEs when small regional and local mutuals will not, merely because they are "publicly accountable". Instead they will have to adopt full IFRS. We are concerned that as IFRS are designed for the capital markets, they are an unsuitable vehicle for small and medium-sized building societies, or indeed other similar sized mutuals. They certainly impede understanding of a mutual's financial position by its members. Their application to small and medium-sized building societies lacks justification on cost/ benefit grounds .

The ASB has, however, recognised that full IFRS are inappropriate for entities such as charities and housing associations – also surely "publicly accountable" - and has proposed a tailored standard for them. We do not seek special treatment; we propose that mutuals that have not issued permanent interest bearing shares be allowed the option of adopting the SME standard. By proposing to require that all societies adopt full IFRS and therefore incur disproportionate costs, the ASB is in danger of placing them at a competitive disadvantage to much larger entities such as high street banks. This goes against the spirit of the government's recent white paper on reforming financial markets. Our response to the white paper may be found here:

www.bsa.org.uk/policy/response/white_paper_bsaresponse.htm

Finally, we suggest that the timing of the transition from UK GAAP is inappropriate given the current economic climate, the resulting raft of new prudential requirements and the uncertainty surrounding the final format of IAS 39 (to become IFRS 9).

Background – IFRS for SMEs

In July, the International Accounting Standards Board published its long-awaited simplified version of international financial reporting standards for small and medium sized enterprises (IFRS for SMEs). The advent of the new standard has prompted the Accounting Standards Board to an important debate affecting UK companies and not-for-profit entities: the future of UK GAAP in an IFRS world.

We welcome this revised standard. It is considerably shorter than full IFRS, written in a more accessible style, with many significant relaxations in the accounting requirements and reduced disclosure provisions. For example on goodwill, SMEs will be able to continue with the UK GAAP approach and amortise it over its useful life - no need for detailed annual impairment reviews (unless circumstances indicate one is required).

But we note that there will still be significant changes to the format of the financial statements and the disclosures required, and most importantly there will be changes to the numbers as well. It removes some policy options allowed under full IFRS such as accounting for property, plant and equipment, investment properties and employee benefits.

For those on UK GAAP IFRS for SMEs will change the recognition criteria for various assets and liabilities, the basis on which many items are measured and the treatment of certain gains and losses.

The consultation, however, proposes that building societies, regardless of size, go straight to full IFRS as they fit the ASB's proposed criterion of "public accountability". But we reject the proposal that the full version, designed for the capital markets, is suitable for small and medium-sized building societies, or indeed other similar sized mutuals.

We are therefore disappointed that the Accounting Standards Board is currently minded to refuse smaller mutuals access to this standard (but will allow very large private companies access). The exclusion of size in the definition is, in our opinion, a grave mistake.

Finally, the introduction to the consultation says "the intention is to work under the IASB framework and to converge to the fullest extent possible consistent with the needs of UK entities". As we will argue later, we feel this intention is disingenuous; not all UK entities' needs will be served by a wholesale move of "publicly accountable" entities to full IFRS without reference to size.

Individual questions

Question 1 – *Which definition of public accountability do you prefer: the Board's proposal (paragraph 2.3) or the current legal definitions (paragraph 2.5)? Please state the reasons for your preference. If you do not agree with either definition, please explain why not and what your proposed alternative would be?*

Question 2 – *Do you agree that all entities that are publicly accountable should be included in Tier 1? If not, why not?*

Under IFRS there is no definition of what constitutes "small-medium". Currently the UK has size limits that determine whether a company is small or medium sized (turnover test, balance sheet total test and number of employees test). IFRS does not have such determinations but the International Accounting Standards Board instead states that IFRS for SMEs is intended for those companies that are not “publicly accountable”. It is up to the regulatory bodies in the UK to specify eligibility criteria.

The definition the ASB has proposed means that all building societies, regardless of size, are “publicly accountable”. It says in chapter 2.3 of the consultation that an entity is “publicly accountable” if:

> a. its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);
>
> b. it is a deposit-taking entity and/or holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities broker/ dealer, mutual funds or investment banks.

The consultation suggests, as a possible alternative, the Companies Act 2006 definition of what constitutes an SME. Section 384 of that act precludes “banking companies” from the small companies regime and section 467 similarly precludes FSA authorised firms from the medium-sized firm definition.

We agree that building societies are accountable to the public but they are so in a very different way to shareholder-driven entities, such as banks. It is the individual savings and mortgage customers of building societies who are societies’ members, to whom they are accountable. Unless they have issued securities known as permanent interest bearing shares (and are therefore already subject to full IFRS), societies are not of interest, or accountable to, institutional investors or credit analysts. Neither are they of interest, or accountable in the same way, to the government.

How building societies discharge their responsibilities towards their members is set down by legislation. Included in the legislation is the provision of summary financial information in an accessible format – something banks are unable to match. This annual summary financial statement is provided to every member along with the right to attend the annual general meeting. Many members become involved in the running of their society.

Building societies have not had to be rescued by government in the way some large international banks have been. This is in part due to the restrictions placed on them by legislation. The Building Societies Act 1986 requires all societies to derive at least 50% of their funding from their members. Building societies are also subject to certain statutory restrictions on, for example, acting as a market maker in securities, commodities and currencies (and trading in the last two) and entering into transactions involving derivative investments. These are the very activities that led banks to the brink of ruin (and to state ownership).

We therefore believe that neither the preferred ASB definition nor the Companies Act definition is adequate. They do not take size into consideration. It seems incongruous that very large privately-owned organisations will be able to apply the requirements of the IFRS for SMEs but a local building society with a handful of staff may not. Indeed the ASB accepts in chapter 2.11 that small entities will be caught by its proposed definition but regrettably suggests no remedy. We believe the ASB is wrong to disregard such a crucial indicator.

The ASB has, however, acknowledged that its three tier structure will not fit all entities and has proposed a public benefit entity standard. This is designed for entities such as housing bodies. Building societies exist, not to generate profit for the City, but to accept savings from and provide loans to individuals to help them buy their own home. Societies should therefore be seen in the same way as housing bodies.

Chapter 3.15 says that public benefit entities face a number of accounting issues that profit-oriented entities rarely encounter and goes on to list ten such issues. Top of the list is the presentation of primary financial statements; societies face the same issue (but deal with it through the legally-mandated provision of summary financial statements).

There is a small minority of ordinary savings and/ or mortgage members who wish to read the full accounts of a society – they generally find it difficult to understand the implications of some of the figures when they are prepared under IFRS. In addition, the accounts of at least one society have mushroomed since it adopted the international standards *(see question 15)*.

Our proposal is that the unique nature of mutually-owned entities such as building societies and their existing legally-mandated accountability to members should be recognised by allowing them to opt for IFRS for SMEs. **It follows that we do not agree that all entities that are publicly accountable should be included in Tier 1.**

We understand why standard setters have tried to develop standards that are straightforward, accessible and in line with the needs of their stakeholders reading the accounts and the costs to the entity to produce the numbers. We understand also the drive for a common language of accounting. But we believe that IFRS are not a suitable reporting vehicle for mutuals such as smaller building societies. These entities are focused solely on the UK – often on just one region - and will remain so. As we said in an earlier response on the issue: "The drive for global comparability and global standards while being of benefit for multinational companies is completely unnecessary for SMEs who do not have overseas interests/ overseas." Our response to the ASB's 2007 consultation on IFRS for SMEs may be found here:

http://www.bsa.org.uk/policy/response/ASB_IFRS_for_SMEs.htm

Question 3 – *Do you agree with the Board's proposal that wholly-owned subsidiaries that are publicly accountable should apply EU adopted IFRS? If not, why not?*

Question 4 – *Do you still consider that wholly-owned subsidiaries that are publicly accountable should be allowed reduced disclosures? If so, it would be helpful if you could highlight such disclosure reductions as well as explaining the rationale for these reductions.*

Full IFRS for wholly-owned publicly accountable subsidiaries will give consistency of recognition and measurement at the expense of long accounts. IFRS for SMEs means shorter accounts but potentially leads to recognition and measurement differences that need to be adjusted on consolidation into full IFRS group accounts. It could also mean different versions of disclosures could be required, for example, on leasing.

On balance, we agree that that wholly-owned subsidiaries that are publicly accountable should apply EU adopted IFRS and that other subsidiaries that are not publicly accountable should have the option to use the IFRS for SMEs. That will still be onerous for such subsidiaries particularly the requirement to produce a cash flow statement.

But as we point out in our response to questions 1 and 2, we believe that full IFRS for those mainly smaller building societies that do not have listed securities are inappropriate and an unsuitable reporting vehicle for their members.

Chapter 2.18 states that the board was unable to identify reduced disclosures. We are unclear, however, of the benefit to all stakeholders in wholly-owned subsidiaries, even if they are "publicly accountable", producing some of the disclosures. Reduced disclosures will simplify accounting arrangements within groups as all entities will be able to use the same measurement criteria while recognising that key information is available at the consolidated level and need not be provided by the subsidiary.

Question 5 – *Do you agree with the Board's proposal that the IFRS for SMEs should be used by 'Tier 2' entities?*

We do not agree. As we have said elsewhere, Tier 2 needs to reflect size. It seems incongruous that a privately held business with, for example, tens of thousands of employees and creditors of hundreds of millions of pounds will be able to use IFRS for SMEs but a mutual such as a local building society with a turnover of a few million and a handful of staff may not, merely because it meets a theoretical definition of "publicly accountable". While we appreciate that the ASB wants to apply uniform accounting requirements where possible, it must do so in a proportionate, accountable, consistent, transparent and targeted way and not raise costs or distort competition. Large, privately held businesses should be subject to the same accounting regime as large "publicly accountable" entities.

Chapter 3.6 says that entities that take deposits or hold assets in a fiduciary capacity should apply full IFRS. Charities, housing associations, HE and FE colleges and some co-operatives are, however, allowed to use a public benefit standard but not other mutually-owned entities such as building societies. Those targeted for public benefit standard have just as much public accountability as building societies, perhaps more so in the public's eyes. Some of these public benefit entities are large commercially-operated entities.

Chapter 3.8 notes that IFRS does not contemplate their application by public benefit entities and this raises the risk of there being uncertainty and ambiguity in the sector as to how they should be applied. The same may be said for mutually-owned entities. We are not seeking a similar standard, or any kind of special treatment; instead we propose that building societies that have not issued permanent interest bearing shares be allowed the option of adopting the SME standard.

Question 6 – *Do you agree with the Board's proposal that the IFRS for SMEs should be adopted wholesale and not amended? If not, why not? It would be helpful if you could provide specific examples of any amendments that should be made, as well as the reason for recommending these amendments.*

We disagree. We suggest that the ASB should be able to amend IFRS for SMEs for domestic application as and when necessary. We believe that if the standard is no longer appropriate in an area – for example, tax - the ASB should consider amending the standard for domestic application. The ASB argues it should not be able to make amendments (other than any that might be required to meet legislative requirements), as it would then have to apply its own care and maintenance regime. It feels that such an ability opens the board to lobbying for further changes. Subject to appropriate checks and balances, we urge the board to be open to change – else it risks UK businesses preparing accounts that do not reflect accurately their position.

Question 7 – *Do you agree with the Board's proposal that large Non-Publicly Accountable Entities should be permitted to adopt the IFRS for SMEs? Or do you agree that large entities should be required to use EU adopted IFRS? Please give reasons for your view.*

Please see our answer to question 5.

Question 8 – *Do you agree with the Board that the FRSSE should remain in force for the foreseeable future?*

No comment.

Question 9 – *Do you agree that the FRSSE could be replaced by the IFRS for SMEs after an appropriate transition period, following the issuance of the IFRS for SMEs?*

No comment.

Question 10 – *Do you agree with the Board's current views on the future role of SORPs. If not, why not?*

We agree with the board's view on a limited future role for SORPs. Furthermore, we agree that a transitional role for the majority of SORPs is appropriate until the IASB has completed its work.

Question 11 – *Do you agree with the Board's proposal to develop a public benefit entity standard as part of its plans for the future of UK GAAP? If not, how should (converged) UK GAAP address public benefit entity issues?*

We agree broadly with the board's proposal. Chapter 3.5 defines a public benefit entity as "an entity whose principal objective is not the generation of profit". The consultation goes on to say: "An entity that is organised and operated primarily for community or social benefit whose funders and other resource providers do not receive any financial return from the organisation and any surpluses are applied to support the objectives of the entity." Both quotations apply equally to a building society, where statute makes clear that its principal purpose must be to "make loans which are secured on residential property and are funded substantially by its members".

A building society's members are its savers and borrowers; its mutual status means that any surplus is directed at raising savings rates and lowering mortgage rates, not distributed to external City interests.

And chapter 3.7 says that "…IFRS are not framed with public benefit entities in mind raises the issue of whether the standards are appropriate for this particular sector". We agree but add that the same could be said for mutuals that have no listed securities. In addition, chapter 3.4 notes that the public sector will converge its standard with IFRS *where appropriate* and UK government adopts its own standards.

We are not suggesting that mutuals, however, have their own standard but merely seeking to highlight apparent inconsistencies in the board's thinking towards non-plc entities. Our smaller members would be content to be allowed to use IFRS for SMEs.

Question 12 – *If you do agree with the proposal to develop a public benefit entity standard, should the standard cover all the requirements for preparing true and fair view accounts or should it cover only those issues where IFRS or the IFRS for SMEs needs to be supplemented for the public benefit entity sector?*

No comment.

Question 13 – *Do you agree the issues listed in the above table are distinctive for the public benefit entity sector and should therefore be covered in a public benefit entity standard? What other issues might the proposed standard include?*

No comment.

Question 14 – *The Board accepts there may be a continuing need for guidance to supplement a public benefit entity standard in sectors such as charities, housing and education.*

Where this is the case, do you think the Board should provide a Statement confirming the guidance is consistent with UK GAAP, including the public benefit entity standard?

No comment.

Question 15 – *If you are an entity whose basis of preparing financial statements will change under these proposals, what are the likely effects of applying those new requirements? Please indicate both benefits and costs and other effects as appropriate. If you are a user of financial statements (such as an investor or creditor) what positive and negative effects do you anticipate from the implementation of the proposals set out in this paper?*

We acknowledge that the IASB has tried to develop standards that are straightforward, accessible and in line with the needs of their stakeholders reading the accounts and the costs to the firm to produce the numbers. We applaud the drive for a common language of accounting *although we note in chapter 2.38 that France and Germany are minded to keep their own arrangements.*

But smaller societies are concerned at the costs of implementing IFRS, in whatever form. They acknowledge that higher one-off and ongoing costs are inevitable but consider the overall costs for full IFRS to be higher than those for the SME standard. Societies expect costs to be very high, both financially through training, consultancy and systems changes, and also through time commitments. They will be ongoing and not just incurred at implementation. This is certainly the case for building societies that are already required to use full IFRS.

Example of the costs of full IFRS implementation in the building society sector

For one society that has adopted IFRS, the process began 18 months before implementation. This society is one of the smaller ones that has issued permanent interest bearing shares and therefore required to use full IFRS – a useful comparator for those facing the costs and upheaval of conversion from UK GAAP. Its process started by working out the key changes from UK GAAP and their effect on, and costs for, the society. These included:

- revenue recognition
- hedge accounting
- classification of financial instruments
- impairment provisions
- intangible assets
- disclosures
- subsidiaries.

It has not been possible to quantify the indirect costs, but it is clear they are likely to be far higher than the direct costs. As an indicator of the latter, audit fees rose for this society on implementation of IFRS: from £53,000 in 2004 to £72,500 in 2008 with a high point of £113,000 in 2005. These figures are not insignificant to smaller mutual institutions.

In addition, this society recruited a specialist accountant specifically for IFRS implementation with the increased staffing levels maintained today. It also invested – and continues to invest – considerable resources in educating board members about IFRS and their application to the society. These board members are highly skilled professionals, some of whom are financially qualified, yet some still struggle to see the relevance of IFRS to the business. There are continued concerns with full IFRS which include the costs of:

1. Maintenance of the effective interest rate models;

   - review of expected life profiles and assumptions used
   - reconciling data extracts to underlying systems
   - capture of new products and fees
   - modelling impacts of changes to the life profiles.

2. Monitoring of hedge accounting

3. Maintenance of separate UK GAAP and IFRS figures for regulatory reporting.

4. Explanation of model workings during internal and external audits

Problems with member understanding of IFRS

As signalled above, an area of concern reported by this society *(and others that have been required to move away from UK GAAP)* is communicating the meaning of the IFRS figures. The annual accounts of the highlighted society have increased from 43 pages in 2004, to 64 in 2005 (first time adoption of IFRS) and 74 in 2008 (implementation of IFRS 7). In addition, the society reports ongoing issues with IFRS use, which include:

- communicating impacts to the board and audit committee. Events such as the credit crunch have a major impact on fair values and hedge accounting.
- external reporting – reported v underlying profit
- explaining impacts to members – many find concepts such as derivatives and fair value volatility hard to grasp. Quite feasibly, some could be alarmed at what is essentially a timing difference.

As we mention earlier, building societies already discharge their public accountability obligations through the summary financial statement. **Imposing full IFRS on smaller, mainly regional societies, will cause unnecessary costs and disruption which will be borne by the individual members thus leading to the possibility of lower savings and higher mortgage rates.**

The current crisis has prompted a regulatory response that is absorbing much of building societies' resources. On top of everyday business activities, societies are currently having to:

- pay for the reckless behaviour of failed banks now under government control through FSCS levies. The system of funding the FSCS is under review but in the meantime, building societies are acknowledged to be paying a disproportionate amount.
- prepare for a much more stringent liquidity regime that will require them to hold a buffer of high quality/ low yield assets. This comes on stream in 2010.
- manage the impact of a new FSA sourcebook for building societies which will restrict how much they can lend, putting them at a competitive disadvantage.
- implement provisions of the Capital Requirements Directive which include losing the exemption of inter bank exposures of less than 12 months.
- face further restrictions on lending following implementation of the FSA's mortgage review.
- put systems in place to enable faster payout under the FSCS by the end 2010.
- consider the implications of the code of practice on taxation.
- prepare for new XBRL tax reporting requirements.

For a large international institution, these are costly and disruptive activities; for a smaller, domestic mutual, these new requirements have a huge impact on the bottom line. This situation would be problematic enough in business-as-usual times but is more so in times of stress. If larger societies with larger staffs are badly affected, smaller ones are even more so. Many report that they have engaged extra staff and/or paid for external consultants to help them cope with the added regulation. These not inconsiderable costs come at times when there is huge pressure on margins with what profits there are having been eroded by contributions to the FSCS to bail out failed banks. This leads to less competition and choice in financial services.

To add a move to IFRS – full or for SMEs - when there is no immediate commercial imperative risks damaging the building society sector further.

Chapter 2.38 acknowledges that there is a cost involved in the transition to new reporting arrangements but that "those costs are outweighed, at least in the medium to long-term, by overall benefits of strengthened and less complex financial reporting requirements." This appears to suggest that the benefits of conversion to IFRS take time to become apparent. In the current climate, such delays in reaping "benefits" are debatable.

In summary, we are not convinced that for building societies – or for their members - there will be any benefits to a forced move to full IFRS. The evidence points to the opposite.

Question 16 – *What are your views on the proposed adoption dates?*

We recognise the ASB has to provide such dates but we consider 2012 is simply not practical. Not just because mutuals such as building societies are already under severe regulatory pressure but also because the international standards are themselves under review. For example, the replacement for the highly contentious IAS 39 "Financial instruments: recognition and measurement", IFRS 9 which is still to be endorsed by the EU. That means societies, and other firms currently on UK GAAP, will have to cope with a standard that changes almost as soon as they adopt it.

Given the current economic climate, the regulatory burden already facing mutuals and the question mark over the final form of some standards, we propose that implementation date be moved to 2016 at the earliest. It goes without saying that by implementation for mutuals we mean from UK GAAP to IFRS for SMEs. Not only will a delay mean that societies will have time to adapt to their new prudential regulatory obligations and the new economic landscape but it may also reduce implementation costs as the teething problems associated with changing to any new system such as IFRS for SMEs will be ironed out by then.

29 January 2010