

Quarterly Quiz

Winter 2009 / 2010

Question 1

In January 2010 the FRC reported on a study of 20 acquisitions following the introduction of IFRS3. The recent revision of this standard came into effect from 1st July 2009. The main features of the standard were the recognition of all “business combinations” as acquisitions and the more detailed allocation of intangible assets.

All of the acquisitions covered by the study involved a material proportion of intangible assets. The study investigated the way in which the acquisitions had been reported to investors.

For how many of the 20 studied transactions could the FRC find a ‘coherent and consistent link between the information in the business review and the intangible assets recorded’?

- (a) all 20 transactions
- (b) 16 of the 20 transactions
- (c) 11 of the 20 transactions
- (d) 4 of the 20 transactions
- (e) Don't know

Answer

The right answer is (d) 4 of the 20 transactions

This result was described as “disappointing” by the FRC, resulting in a promise to re-investigate compliance soon. The investigation was undertaken in response to companies suggesting that the new requirements were complex and difficult to perform, while investors suggested that the new disclosures were not useful.

A direct quote from the summary of the FRC’s report is as follows:

Nearly all the companies included in the study gave a logical and seemingly comprehensive account of the reasons and expected benefits of the acquisitions in their business reviews. However, we were able to find a coherent and consistent link between the information in the business review and the intangible assets recorded for only four transactions. Furthermore, we concluded that none of the descriptions of the factors giving rise to goodwill in the audited accounts was informative. This was because more than half the companies either failed to provide any description of goodwill or provided an analysis that was non descript, i.e. it merely repeated generic terms quoted from IFRS 3 2004 that were not specific to the transaction.

FRC Website: <http://www.frc.org.uk/images/uploaded/documents/FRC%20Study%20-%20Accounting%20for%20acquisitions1.pdf>

FT 6th January: Accounting rules over M&A spread confusion by Rachel Sanderson

Question 2

The Association of Private Client Investment Managers has reported huge retail interest in corporate bonds. It has been suggested that the potential market for these bonds issued by UK

corporates is in the region of £20bn. This market was thought to be constrained by the restrictions imposed by the Prospectus Directive, but those concerns have been largely removed by CESR's (Committee of European Securities Regulators) guidance over the past year.

What recent announcement is expected to give a major boost to the development of this market?

- (a) the LSE's announcement that is creating a new trading platform for investors in retail bonds
- (b) the FSA's announcement that it is taking responsibility for regulating the new market
- (c) NYSE Euronext's announcement that it is starting to trade a derivative based on retail bonds
- (d) The Bank of England's announcement that it is taking responsibility for regulating the new market
- (e) Don't know

Answer

The right answer is (a) the LSE's announcement that is creating a new trading platform for investors in retail bonds.

The LSE's retail trading platform will initially cover sterling corporate bonds and gilts. The system is already in use on the Borsa Italiana. The FSA, NYSE Euronext and the Bank of England have made no such announcements!

The Treasurer, December/January 2010, Technical Update by Martin O'Donovan, page 10

Question 3

IFRS 9: Financial Instruments is the standard that will ultimately replace IAS 39. The replacement project has been split into three phases with phase 1 and 2 already resulting in Exposure Drafts and phase 3 expected to produce its Exposure Draft in March 2010.

What are the themes of the three phases?

- (a) Phase 1: Recognition; Phase 2: Hedge Accounting; Phase 3: Impairment Methodology
- (b) Phase 1: Classification & measurement; Phase 2: Impairment Methodology; Phase 3: Hedge Accounting
- (c) Phase 1: Recognition; Phase 2: Fair value determination; Phase 3: Hedge Accounting
- (d) Phase 1: Classification; Phase 2: Measurement of Fair Value; Phase 3: Hedge Accounting
- (e) Don't know

Answer

The right answer is (b) Phase 1: Classification & measurement; Phase 2: Impairment Methodology; Phase 3: Hedge Accounting

The first phase, Classification and Measurement resulted in an Exposure Draft published in July 2009. The second phase, Impairment Methodology resulted in an Exposure Draft published in November 2009 while the Exposure Draft for the final phase, Hedge Accounting, is expected in March 2010.

IASB website:

<http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+A+Replacement+of+IAS+39+Financial+Instruments+Recognitio/Financial+Instruments+Replacement+of+IAS+39.htm#ias>

The Treasurer November 2009 and December /January 2010 Technical Update by Martin O'Donovan pages 9 and 11 respectively.

Question 4

What is a WOCU?

- (a) a weighted Oceania currency unit
- (b) a western operationally controlled unit
- (c) a world currency unit
- (d) a wi-fi operable computer unit
- (e) don't know

Answer

The right answer is (c) a world currency unit

The WOCU is a synthetic currency unit created from a basket of the 20 top world economies. The WDX Organisation was formed to realise the project and WOCU prices can now be seen. The intention is to provide a low-volatility hedging alternative for corporates, rather than hedging against individual currencies. By reducing volatility the risk, and therefore cost, of hedging should be capable of being reduced. The currency was launched on January 1st 2010.

Treasurer Cash Management Supplement Winter 2009, Gaining Currency by Ian Hillier-Brook and Ken Lillie, page 14.

Wocu website www.wocu.com

Question 5

Phase 2 of the project to replace IAS39 with a new standard, IFRS 9: Financial Instruments, concerns impairment methodology for financial assets carried at amortised cost.

The proposal is to switch the methodology for determining how and when income and losses are recognised.

Which of the following is true regarding the Phase 2 recommendations?

- (a) The existing model determines expected losses at the outset and recognises interest income less expected losses over the life of the instrument. The proposed model recognises a loss in value only when there is evidence that repayment will be less than complete.
- (b) The existing model recognises a loss in value only when there is evidence that repayment will be less than complete. The proposed model determines expected losses at the outset and recognises interest income less expected losses over the life of the instrument.
- (c) The existing model allows a high initial loss expectation, but any reduced loss must be incorporated at termination. The proposed model requires a consistent loss in value; an initial yearly estimate is used that is then restated at maturity to show actual annual values.
- (d) The existing model requires a consistent loss in value; an initial yearly estimate is used that is then restated at maturity to show actual annual values. The proposed model allows a high initial loss expectation, but any reduced loss must be incorporated at termination.
- (e) Don't know

Answer

The right answer is (b) The existing model recognises a loss in value only when there is evidence that repayment will be less than complete. The proposed model determines expected losses at the outset and recognises interest income less expected losses over the life of the instrument.

The existing model is called the 'incurred loss' model. Objective evidence of a trigger event is required such as a lender conceding concessions or major financial difficulty. The proposed model is based on expected losses. The expected loss is reassessed for each period and the initial effective interest rate is then applied as the discount rate to the probability-weighted cashflows.

IASB website: (general on the replacement project)

<http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+A+Replacement+of+IAS+39+Financial+Instruments+Recognitio/Financial+Instruments+Replacement+of+IAS+39.htm#ias>

IASB website (specific Phase 2 summary)

<http://www.iasb.org/NR/rdonlyres/296E9F47-8A0D-4914-9809-DB308C531058/0/SnapshotFIImpairmentweb.pdf>

The Treasurer December /January 2010 Technical Update by Martin O'Donovan page 11.

Question 6

Liquidity risk has become much more prominent since the credit crunch began. In the current environment companies can no longer assume that a lender can always be found so using internal liquidity becomes ever more important. In managing liquidity risk, which are the most important of the following attributes?

- (a) access to the credit default swap market
- (b) investment in state-of-the-art IT systems
- (c) effective financial systems, procedures and controls
- (d) effective accounting and reporting
- (e) don't know

Answer

The right answer is (c) effective financial systems, procedures and controls

Clearly access to the CDS market is largely irrelevant when trying to manage your own liquidity. Investment in state-of-the-art IT systems might be part of a risk management strategy, but without effective systems, procedures and controls the IT cannot function. Effective accounting and reporting, again, might be a part of the ideal risk management solution but on its own it is essentially backward looking, whereas any form of risk management must be forward-looking to deal with problems as they arise rather than after they have impacted.

Cash Management Supplement, Winter 2009, The Lifeblood of the Business by Will Spinney.