Technical Update Test (Q1-Q4 2003) Worked Solutions

Question 1

The Financial Reporting Council has issued a new Combined Code to come into effect for reporting years starting after 1st November 2003. Which of the following is recommended by the new Code?

(a) the same person should not hold the roles of chairman and chief executive at the same time.
(b) that at least 50% of members of the boards of smaller companies should be independent non-executive directors.
(c) clarification of the roles of the chairman and the senior independent director, emphasising the chairman's role in providing leadership to the non-executive directors and in the communication of shareholders' views to the board.
(d) the board should report on the quality and effectiveness of internal control and on any failures of control, e.g. in treasury.
(e) don't know.

Answer

The right answer is (c) clarification of the roles of the chairman and the senior independent director, emphasising the chairman's role in providing leadership to the non-executive directors and in the communication of shareholders' views to the board

All other answers were included in earlier versions of the code. The revised version of the code specifically changed the recommendation for the composition of smaller company boards from answer (b) to' at least 2 directors' rather than 50%.

The Treasurer February 2003 Hotline, June 2003 Hotline, September 2003 Hotline, www.frc.org.uk/combined.cfm

Question 2

During the first half of 2003 ISDA introduced a new 2002 Master Agreement. This replaced the 1992 Master and the 1987 Master before that. Which of the following is true for the new 2002 Master Agreement?

(a) it is merely a tidying-up operation.
(b) it introduces a new concept of the 'close-out amount' and a contractual set-off provision for early termination.
(c) it extends grace periods but imposes more severe penalties for actual default after the grace period.
(d) the new agreement must be accepted 'in totality' by all parties to the agreement.
(e) don't know.

Answer

The right answer is (b) it introduces a new concept of the 'close-out amount' and a contractual set off provision for early termination.

In fact grace periods are reduced in the new agreement and Gary Walker, in his May 2003 article, argues that all users of swaps should tailor the agreement to fit their individual circumstances.

The Treasurer February 2003 Hotline, May 2003 'Master Class in ISDA' Gary Walker, September 2003 'Fixing the Plumbing' Kimberly Summe, Jeffrey Golden and John Berry, www.isda.org

Question 3

The Urgent Issues Task Force of the ASB reported on the purchase and sale of its own shares by a listed company. Which of the following fairly describes the accounting methodology required?

(a) holdings in a listed company's own shares should be accounted for as a deduction from shareholders' funds.
(b) purchases and sales of a company's own shares should be reflected through the Profit and Loss Account.
(c) holdings in a listed company's own shares should be accounted for as assets.
(d) any purchase of its own shares by a listed company must be followed by the cancellation of those shares.
(e) don't know

Answer

The right answer is (a) holdings in a listed company's own shares should be accounted for as a deduction from shareholders' funds.

Specifically such share dealings should not be recognised by the Profit and loss Account.

The Treasurer April 2003 Treasury Essentials pp27-28, June 2003 Hotline, September 2003 Hotline, www.asb.org.uk

Question 4

During 2003 the SEC issued a consultation paper on the role and function of ratings agencies, including whether ratings should be used for regulatory purposes and, if so, which agencies ratings should be used. Which of the following best describes the ACT's response to the consultation?

(a) all rating agencies whose ratings were approved for regulatory purposes should follow a prescribed methodology to determine their rating.
(b) rating agencies should be given joint access to company presentations, with opportunities for questions, so that all agencies had equal access to company management.

(c) for regulatory purposes, the rating used should reflect the weighted average of published ratings from all major agencies.
(d) ratings can be based on public data alone; on public data with minimal reviews by the issuer or on confidential information plus extensive management discussion. Ratings only in the last two classes should be used for regulatory capital assessments.
(e) don't know

Answer

The right answer is (d) additionally, the ACT stressed that the basis on which the rating had been prepared should be clearly available when ever a rating is published or quoted. This would help prevent unacceptable pressure being brought to bear on issuers to cooperate on a rating, following the publishing on an unsolicited rating

The Treasurer April 2003 Hotline, September 2003 Hotline
http://www.treasurers.org/technical/papers , http://www.sec.gov/rules/concept/33-8236.htm

Question 5

For a company with a reporting date of 31 December 2005, the date of its transition to IFRS will be 1 January 2004. This means such a company will be required to prepare comparative IFRS accounts for 2004. So began a letter from the FSA to all listed companies after publication of a survey by ICAEW. The survey showed which of the following?

(a) half of all respondents were "not very aware" or "not at all aware" that they needed to comply with International Accounting Standards and three quarters were unaware of the impact this would have on their accounts.
(b) one third of all respondents were "not very aware" or "not at all aware" that they needed to comply with International Accounting Standards and less than half were aware of the impact this might have on their accounts.
(c) one in ten of all respondents were "not very aware" or "not at all aware" that they needed to comply with International Accounting Standards and nine out of ten were aware of the impact this might have on their accounts.
(d) over one quarter were unaware of any International Accounting Standards.
(e) don't know.

Answer

The right answer is (b) one third of all respondents were "not very aware" or "not at all aware" that they needed to comply with International Accounting Standards and less than half were aware of the impact this might have on their accounts.

Note that as regards IAS39 the requirement to provide prior year comparatives for the first year of implementation has been waived

The Treasurer October 2003 Hotline http://www.fsa.gov.uk/pubs/ceo/ceo_letter040903.pdf

Question 6

The thrust of IAS 39 and FAS 133 (amongst others) concerns the move towards 'fair value accounting'. Which of the following statements best reflects the impact on UK companies of these standards?

(a) minimal impact for corporates, gains on the underlying asset will be offset by losses on the hedge and vice versa.
(b) major impact for corporates, hedging instruments are always marked to market while the underlying assets are not. This gives rise to illusory gains and losses.
(c) manageable impact, if care is taken that all hedges undertaken qualify for treatment as hedges then the accounting follows only the net position.
(d) possibly manageable impact, if care is taken that all hedges undertaken qualify for treatment as hedges and no hedging is necessary against uncertain future currency revenues.
(e) don't know

Answer

The right answer is (d) possibly manageable impact, if care is taken that all hedges undertaken qualify for treatment as hedges and no hedging is necessary against uncertain future currency revenues. If the forecast revenues can be demonstrated to be highly probable they can qualify for hedging.

Unfortunately, underlying assets/liabilities and their hedges may not be treated identically unless the hedge qualifies under the guidelines. These hedge guidelines provide, under specific circumstances, for both asset and hedge to be treated similarly. Even in these circumstances, the full position must be accounted for, not just the net position. It is feared that the guidelines may exclude some economically effective hedging.

The Treasurer July/August 2003 Hotline, Jul/August 2003 'Learning to Live with IAS 39', December 2003 Hotline, www.asb.org.uk; www.fasb.org; www.fas133.com

Question 7

During 2003 the ASB received comments on FRED 31, its draft standard on share-based payment. In parallel the IASB discussed its ED2 on the same topic. The proposals are likely to apply from 1st January 2004.

According to the draft standards, which of the following describes the appropriate accounting for share options awarded to employees?

(a) all share options should be charged to the Profit and Loss Account at the fair value of the options granted at issue with no subsequent charge.
(b) all share options should be charged to the Profit and Loss Account at the fair value of the options at issue, and the option value should be re-measured and adjusted each year.
(c) equity-settled options will carry an initial P&L charge at issue but no subsequent P&L impact. Cash-settled options will carry an initial P&L charge with annual re-measurement.

(d) cash-settled options will carry an initial P&L charge but no subsequent charge. Equity-settled options will carry an initial charge to the P&L and subsequent annual re-measurement.
(e) don't know

Answer

The right answer is (c) equity-settled options will carry an initial P&L charge at issue but no subsequent P&L impact. Cash-settled options will carry an initial P&L charge with annual re-measurement.

The Treasurer March 2003 'Settling on Scheme Standards' Matthew Pearlman, April 2003 'Accounting for Value', David Creed

Question 8

What are 'eligible debt securities'?

(a) debt securities which are eligible for discount by the Bank of England.
(b) debt securities which are eligible for banks' Tier 1 Capital.
(c) debt securities which are issued by the Bank of England.
(d) debt securities which are uncertificated money market instruments.
(e) don't know.

Answer

The right answer is (d) debt securities which are uncertificated money market instruments.

Dematerialisation of the UK Money Markets was due to take place in September 2003. EDSs replace the equivalent money market instrument, but are held and registered in dematerialised, registered form by CREST.

The Treasurer September 2003 Hotline,
http://www.bankofengland.co.uk/markets/money/guidance.pdf

Question 9

In October 2003 a working group of major bond-market investors launched a major initiative to improve the current state of the sterling and euro fixed-income and credit markets.

Which of the following best describes the proposals put forward in this initiative?

(a) more flexible documentation coupled with a unified ratings approach.
(b) more rigorous documentation and issuer call options.
(c) minimum covenants for issuers and investor put options.
(d) more widespread use of ratings and less focus on secondary markets.
(e) don't know.

Answer

The right answer is (b) more rigorous documentation and issuer call options.

The major issues raised were:

- *Minimum covenants for corporate issuers*
- *Issuer call options*
- *More rigorous documentation standards*
- *Improved disclosure*
- *More widespread use of ratings*
- *A focus on secondary markets*

The Treasurer November 2003 Hotline, December 2003 Hotline, *http://www.treasurers.org/technical/papers/investorinitiative.cfm*

Question 10

The LMA published revised versions of its primary and secondary market documentation, for use as from 2 January 2003. Specifically the revisions concerned LMA confidentiality letters. Which of the following is true for lenders under these revised confidentiality letters?

(a) confidentiality undertakings cease if the potential lender is excluded from the facility concerned.
(b) confidentiality undertakings cease on signing the loan agreement or transfer document.
(c) confidentiality undertakings cease on the lender ending participation in the loan facility.
(d) confidentiality undertakings never cease.
(e) don't know.

Answer

The right answer is (b) confidentiality undertakings cease on signing the loan agreement or transfer document

This is the situation under the standard LMA confidentiality letters and is not ideal for borrowers. Borrowers are recommended to negotiate the terms to ensure that the confidentiality obligations persist for, say, 12 months after the date on which a lender sells its participation

The Treasurer February 2003 Hotline, *http://www.treasurers.org/technical/lmaguide.cfm*