

Technical Update Test (Q3 2004) Worked Solutions

Question 1

The ASB is seeking views on an Exposure Draft regarding amendments to IAS19.

Which of the following best reflects the amendments suggested?

- (a) IAS 17 Retirement Benefits and IAS 19 Employee Benefits are complementary and require similar treatment for similar situations. The amendment is therefore a minor tidying up process.
- (b) IAS 17 and IAS 19 are in conflict. The amendment proposes that IAS 19 be amended to follow the same treatment for actuarial gains and losses as IAS 17, i.e. recognition in the Profit and Loss Account.
- (c) IAS 17 and IAS 19 are in conflict. The amendment proposes that IAS 19 be amended to follow the same treatment for actuarial gains and losses as IAS 17, i.e. recognition outside the Profit and Loss Account in the Statement of recognised Gains and Losses.
- (d) IAS 17 and IAS 19 are in conflict. The amendment proposes that IAS 19 be amended to permit an option to follow the same treatment for actuarial gains and losses as IAS 17, i.e. recognition outside the Profit and Loss Account in the Statement of Recognised Gains and Losses.
- (e) don't know.

Answer

The right answer is (d) IAS 17 and IAS 19 are in conflict. The amendment proposes that IAS 19 be amended to permit an option to follow the same treatment for actuarial gains and losses as IAS 17, i.e. recognition outside the Profit and Loss Account in the Statement of Recognised Gains and Losses.

The Treasurer, July/August 2004, Technical Update, p 40.

Question 2

The Association of British Insurers (ABI) has published a document to initiate an improvement in standards in the bond markets. One of the recommendations contained in the document concerns the situation of a change of control of the issuer.

Which of the following most closely resembles the ABI proposal covering change of control?

- (a) in the interests of simplicity there should be no reference to change of control; it is a normal investment risk.
- (b) change of control has a direct impact on investment risk and so investors should have the right to increase the spread over the reference rate.
- (c) change of control has a direct impact on investment risk and so investors should have the right to redeem the debt on terms that reflect the original agreement.
- (d) change of control has a direct impact on investment risk and so investors should have the right to renegotiate the entire loan agreement.
- (e) don't know.

Answer

The right answer is (c) change of control has a direct impact on investment risk and so investors should have the right to redeem the debt on terms that reflect the original agreement.

The ABI maintains that bond investors can suffer a significant fall in the value of their investments through a change in control. Unlike credit risk, this adverse event risk potential is rarely priced into the return of the bond at issue. Whilst equity investors can exercise voting rights bond investors are typically caught without any protection.

However issuers will need to think through the implications of giving such a change of control covenant and decide whether this is ultimately in their own company's best interests.

The Treasurer, September 2004, Technical Update "ABI stirs up bond terms debate" p62

Question 3

A report recently published by the British Institute for International and Comparative Law, based on a joint initiative from the ASB and the Company Law Centre, recommends that the ability to pay dividends should no longer depend on the currently defined 'profits available for the purpose'.

Which of the following reflects the recommended basis upon which the ability to pay dividends should depend?

- (a) shareholder approval; a majority of those voting on a motion to approve the dividend.
- (b) shareholder and bondholder approval; both having to approve a dividend in separate votes.
- (c) a solvency test based on the prospectus-style working capital statement.
- (d) a solvency test based on an ongoing ability to meet obligations, given resources likely to be available, over the next year.
- (e) don't know.

Answer

The right answer is (d) a solvency test based on an ongoing ability to meet obligations, given resources likely to be available, over the next year.

The solvency test recommended will be based on the directors' opinion that the company remains able to repay its debts and has sufficient resources as a going concern to be able to meet its liabilities as they fall due. Notably, the recommendation adds that the going concern should include 'the resources in [the directors'] view likely to be available' rather than the narrower prospectus-style definition which requires loans to be replaced or refinanced months ahead of maturity.

The Treasurer, September 2004, Technical Update, p61

Question 4

IAS 39 was fully revised in December 2003. Since then there have been amendments and an Exposure Draft was issued in April 2004. The ACT responded to the ED during the third quarter.

Which of the following most closely describes the substance of the ED and the ACT's response?

- (a) the ED recommended that the availability of the option to 'fair value through the P&L' should be restricted; the ACT opposed the proposal arguing that it negated the original intention of allowing natural offsets that do not meet formal hedge criteria.
- (b) the ED recommended that the availability of the option to 'fair value through the P&L' should be restricted; the ACT supported the proposal arguing that it negated the original intention of allowing natural offsets that do not meet natural hedge criteria.
- (c) the ED recommended that there should be an option to 'fair value through the P&L'; the ACT supported the proposal arguing that profit volatility would be reduced.
- (d) the ED recommended that embedded derivatives should be valued separately from their host instrument and that any changes in value should be taken to reserves; the ACT opposed the proposal arguing that the practical complexity was too great.
- (e) don't know.

Answer

The right answer is (a) the ED recommended that the availability of the option to 'fair value through the P&L' should be restricted; the ACT opposed the proposal arguing that it negated the original intention of allowing natural offsets that do not meet formal hedge criteria.

The Treasurer, September 2004, Technical Update p 60; ACT website, www.treasurers.org

Question 5

The Bank of England has published proposals to modify its operations in the sterling money markets.

What are the objectives of the changes?

- (a) lower volatility in the money markets with improved banking system liquidity management.
- (b) management of short term market rates in line with government policy.
- (c) removal of the need for intervention in the markets by managing demand for liquidity.
- (d) allowing banks to make payments via the Bank of England RTGS payment system.
- (e) don't know.

Answer

The right answer is (a) lower volatility in the money markets with improved banking system liquidity management.

It is an objective to achieve lower volatility and therefore flatten the yield curve in line with official policy. But since 1997 interest rates have been determined by the Monetary Policy Committee, so the rate can not be government policy. Banks already make wholesale payments using the Bank's RTGS system.

The Treasurer, July/August 2004 Technical Update p 39, The Bank of England website www.bankofengland.co.uk/markets/money/smmreform040507.pdf

Question 6

You are treasurer of a BBB-rated company. In negotiating a new borrowing facility you have been told by the lender that their package of documentation is "LMA compliant" and therefore no changes are permissible.

Which of the following is likely to be your informed reaction?

- (a) inform the lender that use of the LMA Agreement is not mandatory; if the lender is unwilling to negotiate then you will seek another lender.
- (b) inform the lender that the LMA agreement is intended to be a start point for negotiations, not a final prescription.
- (c) the term 'LMA compliant' might mean merely that the general thrust is similar to the LMA Agreement and that therefore changes cannot be ruled out.
- (d) although the term 'LMA compliant' might mean very little, in principle you would accept the LMA Agreement; it is designed to reflect a A-rated borrower.
- (e) don't know.

Answer

The right answer is (d) although the term 'LMA compliant' might mean very little, in principle you would accept the LMA Agreement for investment grade borrowers; it is designed to reflect a A-rated borrower.

Answers (a), (b) and (c) are all based on factually correct statements about the LMA loan documentation. However as a BBB-rated borrower you would normally expect to be unable to negotiate similar terms to those of an A-rated borrower. Hence starting with the LMA primary documentation will tactically be a good base from which to negotiate.

The Treasurer July/August 2004, Technical Update p38, Technical Update Extra LMA Loan Agreement pp41-42, ACT website www.treasurers.org

Interpretation of Scores

- 0-2** This score indicates that your knowledge of current events is below that required of a professional treasurer. Use the “Technical Update” section in *The Treasurer* to keep yourself informed on recent developments. Alternatively visit the CPD resources database to gain a more rounded understanding of the wider issues.
- 3** Although you have a good grasp of the new developments, the score indicates there is still room for improvement. Re-read your recent copies of *The Treasurer* (in particular the “Technical Update” section) to keep yourself informed. Alternatively the CPD resources database contains a wide range of articles on recent best practice.
- 4-5** Well done! Your score indicates that you have obviously been keeping yourself up-to-date with recent developments. If there is anything that you are unsure of, the “Technical Update” section in *The Treasurer* may prove useful, as will the CPD resources database for more in-depth analysis.
- 6** If the Association gave out gold stars you would be in line for one, well done! You have obviously kept yourself up-to-date and read *The Treasurer* regularly. Why don't you try one of the diagnostic tests now? These examine an issue in more depth, and enable you to measure your development through entry and exit questions.