The thorny issue of capitalising leases

Accounting

ASB's discussion paper on accounting for leases

This paper floats the idea of removing the distinction between finance and operating leases, proposing that all leases be capitalised on the lessee's balance sheet. As I have mentioned in previous Hotlines, the implications for gearing ratios of retail companies and airlines could be dramatic.

However the paper includes proposals for the treatment of leases with renewal options in which only the value of the rentals for the initial fixed period would be capitalised. This means that leases would almost certainly be structured so as to minimise balance sheet impact and we could find that finance leases could be partly shifted off-balance sheet.

The technical committee has decided not to comment on the proposals because they are too vague to tell whether there will be any negative impact either on the availability of leasing as a funding option, or on financial covenants in existing loan agreements.

The critical issue of tax is, of course, not covered in this paper but it is assumed in many quarters that a change in accounting would give an opportunity to the authorities to remove tax incentives for leasing if they have not already done so. An article on this issue is planned for a future edition of *The Treasurer*. ■

FRED 20 – Accounting for pensions

The Association response to this exposure draft is posted on the website. The other responses we have seen put more emphasis than we did on the legal issue of who owns the pension fund, making the point that putting the assets in the sponsor's balance sheet would mislead investors by mixing up the company's assets with those that are legally separate.

Most respondents seem to agree with us that a more acceptable approach would need to produce a stable charge to the P&L supported by full disclosure of the fund assets and liabilities but not in the balance sheet. ■

Financial covenants – rolling or frozen GAAP

A number of current proposals for changes to accounting standards, including the two mentioned above, could result in volatile P&L and balance sheet figures. Borrowers negotiating loan agreements now should be thinking carefully whether to go for frozen or rolling GAAP for the calculation of financial ratios for covenant purposes.

Rolling GAAP has the advantage of allowing figures to be taken directly from the accounts but the disadvantage that it will be impossible to predict what these figures will be in years to come. Frozen GAAP requires a borrower to prepare two sets of figures, one on 'old' GAAP and one according to current standards. In the past this has been seen as a major disadvantage but the changes in accounting practice have not been as severe as we are now anticipating.

At the very least, borrowers choosing to go for rolling GAAP must ensure that they have provisions in the document that requires lenders, in the event of major changes in accounting standards, to negotiate in good faith to amend the covenants accordingly. ■

Regulation

Financial Services and Markets Bill

There is currently much activity on this issue. The FSA has now published its consultation paper on the categorisation of investors.

The consultation paper (CP43) is on the FSA website which can be accessed via a link from ours. CP43 is a development of a previous consultation paper on inter-professional dealing to which we responded several months ago. We came out strongly in favour of a three-tier rather than two-tier classification of investors and this is reflected in the FSA's latest proposals.

At the same time rapid progress is being made on the codes of conduct relating to non-investment and investment products.

One of our concerns has been that the split between investment and non-investment products will cause confusion in corporate treasuries as to which rules are applicable to any particular transaction.

Readers are urged to keep abreast of developments on this issue. Updates will be provided both in the Hotline and in the Technical Update on the Association website. For further information, please email me on cbradley@treasurers.co.uk ■

Response to Basel Committee proposal for capital adequacy for banks

Richard Boulton from the FSA came to the March technical committee meeting and gave us an up-date on developments. Our response to the Basel proposals is posted on the website. We are arguing for a much more sophisticated approach to applying capital to credit risk than the one originally proposed. We are also sending a copy of our response to IGTA members in an attempt to gain support for our position. ■

Risk management

FOA guidelines for market users of the London Metal Exchange

In 1996, following the losses announced by Sumitomo Corporation, the SIB (now FSA) published a review of the London Metal Exchange recommending, among other things, that the practices and procedures in the metals market should be properly understood by customers.

The development of the LME to meet the needs of its industrial users has resulted in its practices and procedures differing from those found in other derivative exchanges.

The Futures and Options Association (FOA) has now published 'Guidelines for market users of the London Metal Exchange', which is designed to improve awareness of the differences and of the special characteristics of this market.

It also contains some useful general guidelines on the management of risk (including the role of directors, setting policy and the organisation of risk management) which have much wider application.

Copies can be obtained from the FOA (email info@foa.co.uk., website at www.foa.co.uk). ■

Derivatives

Settlement of legacy transactions over the Easter period

TARGET is now to be closed for business on Good Friday and Easter Monday. As a result EURIBOR rates will not be quoted on these days although they may not be national holidays in all jurisdictions. ISDA is working with the Federation Bancaire de l'Union Europeenne (FBE) to agree a common approach on this matter.

If you have price fixings on instruments domiciled in offices elsewhere in the EU, please check the arrangements with your counterparty or with ISDA. ■

CAROLINE BRADLEY
The Association's technical officer

BUDGET 2000

Tax changes

Double Taxation Relief

As readers will have seen and heard, Budget proposals to limit double taxation relief have caused a furore with huge numbers being quoted as the increased tax burden on multinationals.

Until now companies have used so-called mixer companies to shelter low taxed foreign profits. The Revenue's discussion document on the subject, published last year, acknowledged that mixing provides capital export neutrality, which is not offered by the basic UK system.

The proposals mean that the UK now has the least attractive tax environment for the parent company of a multinational group of any of the G7 countries.

The net result of these changes is likely to be that existing UK multinationals will not remit profits to this country from overseas subsidiaries or will even be tempted to move outside the UK to a more attractive tax regime, perhaps on mainland Europe.

It is certain that foreign multinationals from outside the EU who would previously have looked to the UK as a natural base for their EU headquarters operations will now look elsewhere. We believe that having multinational companies based in the UK is essential for a robust UK economy and enables us to retain a high quality, well educated workforce in this country.

We must have a tax system which does not drive them away and the Association will be working with other bodies to lobby for a change in these damaging proposals. ■

Interest rate ratchets

On a more positive note, we have been surprised to see that the long-running discussions with the Revenue over interest rate ratchets has been resolved. Up to now, interest paid on a "ratchet loan" i.e. any loan that contains one of these provisions (typically when the margin increases with reductions in interest cover), has not been tax deductible.

The Revenue had taken the view that any loan interest which was in some way related to the performance of the company was in fact a dividend, even though it was an inverse relationship in these cases. From 21 March, companies are able to claim relief for interest paid on ratchet loans.

This is a bit of a mixed blessing since borrowers and bond issuers can now expect to come under pressure to include such provisions in documentation. ■

Please see comment by Philip Gillett on page 30.

Annual update for treasury professionals, Wokefield Park, Reading

This year's Annual Update on 12-13 May concentrates on major strategic issues. Plenary sessions include:

- an economic overview by Roger Bootle, author of 'The Death of Inflation';
- a case study of a corporate implementation of 'managing for value';
- the role of the Competition Commission; and
- the challenges of an Anglo-Dutch merger.

Workshops follow three streams: risk, corporate finance and the euro.

We will be joined by guests representing the International Group of Treasury Associations, giving delegates an opportunity to meet treasury professionals from around the world.

Cost – £475 (net of VAT) for the whole conference. A discount of £50 (net of VAT) is offered for delegates who cannot stay for the dinner and night. Please contact Kate Frere on 020 7213 0737.