INTRODUCTION

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In this month's *Technical Update* we catch up with the latest news on IAS 39 and present the Association of Corporate Treasurer's (ACT) argument as to why the European Commission's proposal for partial adoption will be disadvantageous to corporates and their treasurers. Then, in *Technical Update Extra* (see page 49) we begin a series of articles which examine International Swaps and Derivatives Association (ISDA) agreements, starting with a wake-up call by legal experts who warn that treasurers have a duty to negotiate ISDA agreements and not passively accept what they are first given. We hope this series, which will see us discuss the Schedules and Confirmation of ISDA documentation, credit support, innovations and other ancillary documentation, will be useful. ■

Examining the impact of IFRS

The Loan Market Association (LMA) and the ACT have issued a joint statement to their members highlighting the possible impact of International Financial Reporting Standards (IFRS) on existing loan documentation.

From January 2005, the consolidated financial statements of most publicly-traded companies, governed by the law of an EU member state, must conform to IFRS. The associations recommend that borrowers and lenders examine the formulation of existing financial covenants and clauses in facility agreements which rely on calculations derived from the obligor's financial statements. They should then address any necessary changes.

Suggested wording has been prepared for inclusion in loan agreements so when there is a change in Generally Accepted Accounting Principles (GAAP), the parties "enter into negotiations in good faith" with a view to agreeing practical amendments. This should be done "to ensure that the change does not result in any material alteration in the commercial effect of the obligations" in the agreement.

The associations also stress that the option for inclusion of "frozen GAAP" provisions in the LMA recommended primary documents, and other forms of facility agreements may not be practical. ■

EC proposals for cut-down IAS 39

Extensive lobbying from European banks over the International Financial Reporting Standard – IAS 39 – has led the European Commission (EC) to propose its own cut-down version of the standard (see *Editorial*, page 1, *The Treasurer*, September). The proposal was made at an Accounting Regulatory Committee (ARC) meeting in early September, which discussed three options:

- Partial endorsement – carving out provisions relating to the fair value option for liabilities and aspects of hedge accounting;
- full endorsement but with the banks allowed exclusion from the entire standard; and
- postponement to endorsement.

It now looks likely that partial adoption will be favoured by the EC next month. Concerns have been recognised by the International Accounting Standards Board (IASB) and a working group has been set up to discuss amendments, but these will not be ready in time to meet the European timetables for IFRS adoption in January 2005.

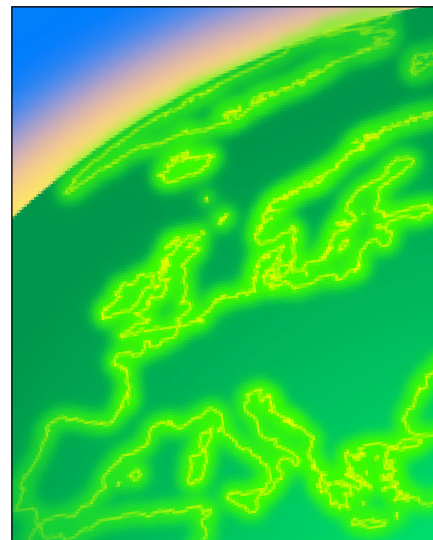
One of the key changes in the proposed partial solution, which will affect corporate treasurers, is that the EC is striking out the option to fair value any financial liability through the company's profit and loss accounts (P&L). Financial assets can still be fair-valued.

In considering the legal implications of this, the EC found that if the fair value option is omitted, reporting companies in Europe will not be allowed to apply the full standard.

A small group of member states, including the UK, have continued to support full endorsement of IAS 39, but right now it is partial adoption that commands the most support. A formal vote is expected at the next ARC meeting on 1 October, with the EC making a financial decision by November.

For corporates, the bulk of the requirements of IAS 39 will probably come into force on time. The last-minute changes will be beneficial for banks but the ACT believes that limitations relating to the fair value option will prove disadvantageous to corporates.

The ACT has expressed its concerns at the highest level to the EC and the ARC and has deprecated any tampering with the standard by the EC. If Europe goes its own way on this standard, one of the major benefits of IAS 39 –



namely recognition as an acceptable alternative to US Generally Accepted Accounting Principles (GAAP) (see *News*, page 7) by the US authorities – will be lost.

The contention from the bank lobby was that the IAS 39 rules on hedge accounting did not sufficiently take into account the way in which many European banks operate their asset/liability management, particularly in a fixed interest rate environment. The strict requirements concerning what qualifies for hedging would have made it impossible for banks to hedge their core deposits on a portfolio basis. This would have forced them to carry out major and costly changes both to their asset/liability management and to their accounting systems.

The EC has produced a marked-up version of the standard which strikes out those provisions which prevent portfolio hedging of core deposits on a fair value measurement basis. Specifically, deletions were made to:

- Paragraph 83 to allow hedging of a portfolio of core deposits;
- AG99A to allow hedging of the interest rate component of core deposits, remunerated at 0% or below market interest rates;
- AG124 to relax the effectiveness test for fair value hedging of a portfolio of financial instruments including core deposits; and
- paragraph 81A to relax effectiveness testing criteria. ■

ACT responds to DTI consultation

The ACT has submitted a full response to the Department of Trade and Industry's (DTI's) consultation on the Operating and Financial Review (OFR). It supports the DTI's direction and its requirements which are expected to lead to better standards of reporting on a company's performance and future developments, its strategies and risks. There are, however, numerous details where the ACT believes changes can be made.

The ACT has noted that it is not possible to give a definitive and final view on the OFR regulations since the reporting standards have yet to be developed by the Accounting Standards Board (ASB).

The suggested start date of 1 January 2005 is hence wildly premature. Furthermore:

- Much depends on the reporting standards yet to be issued. However, requirements on content and director liability which are too strict could reduce OFR content to being defensive, pointless and bland.
- 'Safe harbours' for statements honestly made in good faith should be provided.
- The OFR should be subject to the same standards as the rest of the annual report. Requirements for 'due and careful enquiry' seem to set new and higher levels.
- Auditors' roles should be confined to process – not second guessing directors' judgements.
- There is a risk that excessive expectations will be raised about the work of the Financial Reporting Review Panel (FRRP). A phased approach to enforcement by FRRP is essential.
- The burden of introducing the OFR at the same time as International Accounting Standards for listed companies is too great. Deferment of mandatory OFR requirements is urged.
- Support was expressed for the government's approach to corporate social responsibility and environmental issues.
- Confidentiality provisions similar to those under the Listing Rules should be incorporated. This is subject to the Listing Rules' provision that the resultant disclosure is not misleading.
- Excessive requirements for detail could make the OFR confusing and unclear as to the really important points.
- The requirements to produce an OFR should be extended to the largest non-listed companies and in due course to all significant public interest bodies.

The ACT's full response is available online at **www.treasurers.org/technical/papers/orffinalpr.cfm**. A summary of the DTI proposals was provided on page 11 of the June issue of *The Treasurer*.

New focus on director liability

Following an earlier consultation, the DTI has now put out proposals for changes in relation to directors' liabilities. In its submission on this, the ACT had said that Section 310 of the Companies Act should be relaxed so that a company may indemnify its directors against the costs of defending themselves in proceedings alleging negligence (see *News*, page 10, *The Treasurer,* May) .

The DTI is recommending that this should be the case whether proceedings are brought by the company he/she works for or by a third party. If the director loses the case, he/she would have to repay the company. For action brought by a third party, the indemnification can be extended to the legal and financial costs of an adverse judgement, but excluding fines and penalties.

The DTI has decided not to allow a contractual limitation on auditors' liability, as suggested by the ACT. The accounting profession's desire for a cap on potential liabilities was effectively thwarted by an Office of Fair Trading report published in August which found that a liability cap would not result in increased competition.

However, Patricia Hewitt, Secretary of State for Trade and Industry, has opened the door to a possible alternative approach. In a written statement to Parliament, she said: "The government… actively calls upon auditors, business and investors to work together to examine whether proposals for a system of proportionate liability via contract are practical and/or desirable."

The government has decided not to bring forward any proposals to extend an auditor's duty of care. The government will also remove the loophole allowing the provision of indemnity to a director by a company in the same group in which he is employed, where it would be unlawful for his/her own company to provide that indemnification.

Any director indemnities will also need to be disclosed in the directors' report. ■

Patricia Hewitt called for an alternative approach to director liability.

Rating agencies investigated

The Committee of European Securities Regulators (CESR) has been asked by the European Commission (EC) to provide technical advice on credit rating agencies, as part of an assessment of the need for legislation to deal with them.

The CESR will look at potential conflicts of interest within the agencies; the transparency of their methodologies; their access to inside information; and concerns about possible lack of competition in the market for the provision of credit ratings.

In their call for evidence the CESR has summarised the various initiatives underway regarding the possible need for regulation of agencies. These include:

- The International Organisation of Securities Commissions statement of principles from September 2003 and its imminent code of conduct;
- The US SEC reports and their use of the designation Nationally Recognised Statistical Rating Organisation (NRSRO) for certain regulatory purposes;
- Certain G8 and Organisation for Economic Co-operation and Development reports; and the ACT's code of standard practices for participants in the credit rating process, issued jointly with the AFTE and AFP (the French and US treasurers associations). The last item is an initiative from the ACT (see pages 18-19, *The Treasurer*, May).

The ACT has worked with the AFTE, which responded to the call for evidence, with a submission that cross-referred to the ACT's earlier code.

The ACT has also provided briefings on practical experiences that companies can have when dealing with agencies and the potential complications and concerns that can arise.

The briefings cover:

- payment for solicited ratings by issuers and agency access to inside information;
- the need to provide a level playing field between credit rating agencies;
- conflicts of interest arising from advisory service;
- the need for any eventual regulation or codes of practice to distinguish between purely statistical ratings and those based on access to confidential information.

Although not directly within the scope of the CESR investigation, the *de facto* oligopoly within the ratings industry was noted as raising strong feelings among issuers.

The full submission to the CESR is available at **www.treasurers.org/technical/papers/resources/ACTAFTEresponseCESR.pdf** ■

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