8 November 2011 | 16 pages

The Standards: November Update

Erste 'reclassifies' CDS portfolio

- Accounting
- Monthly

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- **Erste CDS surprise** — Erste Bank recently announced a €460m post-tax charge on a previously undisclosed CDS portfolio. Erste had kept CDS liabilities off balance sheet by classifying them as financial guarantees. These liabilities have now been brought on balance sheet, with Erste citing a July IASB staff paper as catalyst for the change. We reviewed the relevant sections of IAS 39, and note that application guidance specifies that CDS do not generally qualify for treatment as financial guarantees.

- **Ferrovial deconsolidates BAA debt** — Ferrovial has sold a minority stake of 5.88% in BAA for €325m, leaving its ownership at only 49.99%. As a result, Ferrovial has said that BAA will be deconsolidated, meaning that Ferrovial argues it no longer controls BAA in terms of IFRS accounting rules. This removes €14.9bn of debt from the consolidated balance sheet and reduces Ferrovial's net debt to EBITDA ratio from 9.1x to 6.5x. We discuss the relevant accounting rules.

- **Accounting for mine stripping costs** — The IASB has published a new interpretation intended to reduce inconsistency in miners' accounting for production phase stripping costs. Our review of European miners accounting policies suggested current practice varies, but the new treatment, effective 2013, will require capitalisation of some stripping costs as fixed assets. We expect that some miners may report increased EBITDA margins from application of the new rules.

- **US life insurers DAC accounting change** — We highlight a change to US GAAP, due to take effect in 2012, which is likely to result in reduced book values for a number of US life insurers, and have some impact on recurring earnings. Insurers may defer and amortise costs related to the acquisition of insurance contracts, such as broker commissions, but the new rules seek to eliminate inconsistency in the nature of costs deferred. US life insurers Q3 results to date suggests that book value reductions may range between 1% and 15%.

- **Banks gain from increased own credit risk** — Many US and European banks Q3 results have been impacted by significant P&L gains recorded as a result of declining values of banks' own debt. Both IFRS and US GAAP give companies a 'fair value option', allowing (but not requiring) debt liabilities to be held at fair value, thereby subjecting P&Ls to the volatility of banks' credit spreads. New IFRS 9 rules will change this accounting, but have not yet taken effect.

- **PCAOB publicises Deloitte shortcomings** — The US Public Company Accounting Oversight Board has published detailed findings from its 2007 review of US public company audits carried out by Deloitte. Significant weaknesses included lack of evidence that the firm had evaluated the reasonableness of management assumptions.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Erste 'reclassifies' CDS portfolio

Erste announced cumulative post- tax loss of €460m from CDS accounting change

Erste Bank announced a number of charges in a press release on 10 October[1], as discussed by the CIRA European Banks team in *Erste Bank - Surprising CDS Disclosure; Some Value Left* (11 October). Included within these charges was a cumulative post-tax loss of €460m relating to a change of accounting policy for its portfolio of written (sold) CDS, and a cumulative post-tax loss of €220m relating to an "alignment of effective interest rate models used across the group". Both of these changes were unexpected by the market, and Erste has since underperformed the sector considerably, with Erste shares down 27% since the 10 October release, compared to a fall of 1% for the Stoxx 600 European banks sector (SX7P)[2].

CDS portfolio accounting

CDS portfolio previously treated as financial guarantees

Erste stated that the CDS charge followed a "reclassification" of the CDS portfolio from financial guarantees to derivatives, citing an IASB staff paper from July as the trigger for this change in accounting[3]. This resulted in the recognition of a €460m cumulative post tax loss, of which €180m was recorded in the 2011 P&L, €132m in the restated 2010 P&L, and €149m booked against equity at the start of 2010.

Erste disclosed net nominal CDS exposure of €5.2bn as at 30 September, €2.8bn written on sovereigns, and €2.4bn written on financial institutions. Erste noted that these were written in the years up to 2008, and that 14% of the portfolio related to banks or sovereigns in EU periphery countries.

Financial guarantees are 'off balance sheet' - they are not marked to market

The IFRS accounting treatment for both derivatives and financial guarantees is set out in IAS 39. Derivatives must be marked to market at each reporting date, while financial guarantees remain 'off balance sheet', unless management determine that it is probable (>50% likelihood) that a payout will be required to the holder of the guarantee[4], at which point a provision is recorded.

The IASB staff paper was not a formal IFRS interpretation

The cited IASB staff paper formed part of a series of discussion papers prepared for the IASB meeting of 28 July 2011, on the topic of credit derivatives and hedge accounting. Staff papers document the results of staff research, and initiate debate amongst the Board as part of the standard setting process. As such, the paper was not an accounting interpretation or clarification by the IASB. We therefore find it somewhat confusing that this paper was referred to by Erste management as a specific interpretation on the issue[5].

The paper noted the definitions of financial guarantee contracts and derivatives under IFRS, which we have reproduced in Figure 1.

[1] See www.erstegroup.com, 10 October 2011.

[2] Prices as of 4 November 2011.

[3] See www.ifrs.org, 28 July 2011.

[4] Financial guarantee contracts are financial instruments, but recognition of further liability following initial recognition is governed by *IAS 37: Provisions, Contingent Liabilities and Contingent Assets*.

[5] Source: CallStreet Erste conference call transcript, 10 October 2011.

Figure 1. Definitions of financial guarantee contracts and derivatives under IAS 39

Classification	IAS 39 definition
Financial guarantee contract	A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
Derivative	A derivative is a financial instrument or other contract with all three of the following characteristics:
	(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
	(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
	(c) it is settled at a future date.

Source: IAS 39, paragraph 9

IAS 39 guidance clarifies that CDS contracts are not generally financial guarantees

The staff paper also made reference to application guidance on the subject of financial guarantees within IAS 39:

*"**Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due**. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. **Such guarantees are not financial guarantee contracts**, as defined in this Standard, and are not insurance contracts, as defined in IFRS 4. **Such guarantees are derivatives and the issuer applies this Standard to them**."* [6] [emphasis supplied]

This guidance makes it clear, in our view, that CDS contracts do not generally qualify for treatment as financial guarantees, primarily because an entity may hold a 'naked' CDS position. This is not a recent addition to IFRS rules; IAS 39 has been in effect in Europe since the EU-wide adoption of IFRS in 2005, and the application guidance on financial guarantees formed part of a revision to IAS 39 published in August 2005, which took effect from 1 January 2006.

Erste announced CDS portfolio now largely closed in Q3 results

Erste has since reported Q3 results, in which management noted that the CDS portfolio has been largely closed, at no further significant incremental expense from the 30 September 2011 mark to market. Management noted that their accounting treatment came from the intention to hold until maturity, but that the reclassification and subsequent income statement exposure to the volatility of this portfolio resulted in a change of intention[7].

Effective interest rate models alignment

Company disclosure unclear on why effective interest rate accounting change was necessary

Aside from the reclassification of the CDS portfolio, Erste also reported a cumulative post-tax charge of €220m resulting from the "alignment of effective interest rate (EIR) models used across the group". The 2011 income statement impact was €10m but a charge of €210m was made against shareholders' equity and a further €100m against minority interest. This will unwind through the income statement over the life of the loans.

Erste stated that the accounting change arose as it was undergoing a group-wide process of aligning these methodologies "in preparation of the implementation of IFRS 9" (applicable from 2015). Erste's quarterly report noted that the cause was the "harmonisation and improvement of the IT-Tools within Erste". We are not aware of any changes to calculations of EIRs in IFRS 9 compared to IAS 39.

[6] IAS 39, paragraph AG4 (b).

[7] Source: CallStreet Erste conference call transcripts, 10 October and 28 October.

The effective interest rate method is used to determine revenue (and expense) recognition patterns for loans and other assets (and liabilities) held at amortised cost. The EIR is calculated as the rate which exactly discounts the estimated future cash flows of the financial instrument through its expected life, which results in greater income recognition in the early period of a loan, where the principal is greatest, and a gradual reduction in income recognition as loan principal is repaid.

Ferrovial deconsolidates BAA debt

Ferrovial sold minority stake in BAA for €325m

Ferrovial recently announced the completion of the sale of 5.88% of FGP Topco (the BAA holding company) for €325m (£280m)[8]. The disposal brings Ferrovial's stake in BAA down to 49.99%, and the Ferrovial CFO noted in the Q3 earnings conference call[9] that BAA would be accounted for under the equity method from Q4. This means that Ferrovial is arguing it no longer controls BAA and therefore BAA is no longer consolidated in the group accounts.

Ferrovial will deconsolidate BAA and apply equity accounting from Q4

Ferrovial will derecognise all of BAA's assets and liabilities, including debt, from its balance sheet. A one-off P&L gain or loss will be recognised as the difference between the value of assets and liabilities derecognised, and the proceeds of sale combined with the fair value of the remaining 49.99% stake.

The equity method means that the opening value of the 49.99% BAA stake will be adjusted for Ferrovial's share of the change in the net asset value of BAA each period, with the share of income recorded in one line of the P&L, generally below operating profit.

Ferrovial's planned use of the equity method is predicated on Ferrovial no longer having control over BAA. The current rules on consolidation (in IAS 27) state that control is presumed to exist when the parent owns more than half the voting power (ie >50% ownership) but control can exist with 50% or less, eg due to agreement with other shareholders, power to appoint or remove the majority of board members, etc. As none of these conditions are met, it seems reasonable for Ferrovial to argue it no longer has control in accordance with IAS 27.

New rules on consolidation from 2013

The IASB published new rules on consolidation in May[10], which will replace existing rules from 2013. However, we think the new rules are also relevant in this case, as we expect that Ferrovial management would have considered the future accounting change when entering into this transaction.

The new standard (*IFRS 10: Consolidated Financial Statements*) defines control as having rights to variable returns from involvement in the investee entity and the ability to affect those returns through the company's power over the investee. IFRS 10 explicitly states that a shareholding of less than 50% may not always represent a non-controlling stake. IFRS 10 includes application guidance to assess this:

"When assessing whether an investor's voting rights are sufficient to give it power, an investor considers all facts and circumstances, including the size of the investor's holding of voting rights relative to the size and dispersion of holdings of the other vote holders…When the direction of relevant activities is determined by

[8] Ferrovial announced the disposal had been agreed on 10 October. Ferrovial confirmed that the transaction had been completed in Q3 results announced on 26 October. For further details see *Ferrovial - Valuation Validation* (11 October) by the CIRA European Infrastructure team.

[9] Source: CallStreet Ferrovial Q3 results call, 27 October 2011.

[10] See the June edition of *The Standards* (3 June)

majority vote and an investor holds significantly more voting rights than any other vote holder or organised group of vote holders, and the other shareholdings are widely dispersed, it may be clear, after considering the factors listed… that the investor has power over the investee." [11]

Although Ferrovial has a large stake at 49.99% of BAA, as the other shareholders are large and concentrated (three shareholders hold the other 50.01%) we think that under IFRS 10 it is also reasonable to argue that Ferrovial does not have control, assuming that no other shareholder has a voting agreement with Ferrovial.

Net debt to EBITDA ratio decreases from 9.1x to 6.5x as result of disposal

The deconsolidation is likely to have significant impact on Ferrovial's consolidated net debt position. Ferrovial reported net debt of €20.4bn at 30 September (including BAA), representing a net debt to EBITDA ratio of 9.1 times, based on annualised Q3 YTD results. At Q3, €14.9bn of this debt was attributed to BAA, meaning that the net debt position ex-BAA was €5.5bn. While BAA made up 65% of group EBITDA in 2011 YTD results, the Ferrovial ex-BAA net debt to EBITDA ratio falls to 6.5 times, based on annualised Q3 YTD EBITDA, and deducting the disposal proceeds of €325m from the net debt position.

Deconsolidation of debt should not impact valuation

The deconsolidation of BAA debt should not affect the valuation of Ferrovial, as the economics of the 49.99% stake are unaffected by whether debt is consolidated in the IFRS balance sheet. However, it may have an effect on the perception of the company. The FT reported that the Ferrovial CEO admitted the impact of deconsolidating BAA debt was 'cosmetic', but the impact of the transaction on BAA's headline financial leverage ratios is considerable. The partial disposal of the BAA stake is the latest in a series of divestments by Ferrovial; Ferrovial sold a 10% stake in the Canadian 407 express toll road in October 2010, reducing its holding from 53% to 43%, and resulting in the deconsolidation of €3,150m[12] of debt.

IFRS interpretation on stripping costs

New accounting rules on accounting for mine stripping costs

The IFRS Interpretations Committee (IFRIC) recently published *IFRIC 20: Stripping Costs in the Production Phase of a Surface Mine*[13], intended to counter current inconsistencies in this area of accounting. Stripping costs are costs incurred in the removal of mine waste materials to gain access to mineral ore deposits.

The IFRIC noted that while stripping costs incurred in the development phase of the mine (before production starts) are generally capitalised and depreciated/amortised over the life of the mine, there is no consensus on how to treat stripping costs incurred during the production phase of mining.

Some stripping costs capitalised as fixed assets

The new rules require capitalisation of stripping costs incurred during the production phase, as either an addition to inventory or to fixed assets, if certain criteria are met (eg costs can be measured reliably). To the extent that stripping costs benefit current period production in the form of inventory produced, then they will be capitalised as inventory. If the benefit is in the form of improved access to ore, then the costs will be added to the value of the fixed assets associated with the mine, so long as future economic benefit is expected and the component of ore body to which has access has been improved can be identified. If costs meet neither of these definitions, they will be expensed as incurred.

[11] IFRS 10, paragraphs B42 - B43.

[12] Source: Ferrovial Q3 2010 results; last reported debt position of 407 express toll road prior to 10% disposal.

[13] See www.ifrs.org, 19 October 2011.

In practice it is likely that the costs associated with inventory produced and improved access may not be separately identifiable. In this case, stripping costs will be allocated between inventory and fixed assets. The allocation will be based on a relevant production measure; one of the examples included in the IFRIC is by comparison of the actual stripping ratio[14] with the average expected ratio for the mine. Using this method, any excess stripping costs over the amount expected during a period would be capitalised as fixed assets, with the balance included within inventory.

We have reviewed the accounting policies of European mining stocks under Citi coverage to assess the disparity in the current treatment of production phase stripping costs. The accounting policies, where disclosed in annual reports, are summarised in Figure 2.

Figure 2. Summary of European miners' accounting policy for production phase stripping costs

RIC	Name	Production phase stripping costs accounting policy
AAL.L	Anglo American	Stripping costs are deferred to the extent that the actual stripping ratio exceeds the expected average stripping ratio of the mine
ABGL.L	African Barrick	Consistent with IFRIC 20
ANTO.L	Antofagasta	Once a mine reaches production stage, only costs which give rise to a future benefit are capitalised as development costs
BLT.L	BHP Billiton	Stripping costs are deferred to the extent that the actual stripping ratio exceeds the expected average stripping ratio of the mine
FQM.L	First Quantum Minerals	Waste rock stripping costs related to production are inventoried as incurred
FRES.L	Fresnillo	Stripping costs are charged to the income statement as operating costs unless they are associated with the development of a mine in which case they will be capitalised as development costs
FXPO.L	Ferrexpo	Stripping costs are charged to the income statement as operating costs unless they are associated with the development of a mine in which case they will be capitalised as development costs
GEMD.L	Gem Diamonds	Stripping costs incurred during the production phase are deferred when they give access to future economic benefits and are charged to operating costs using the expected average stripping ratio over the average life of the area being mined
GLEN.L	Glencore	Stripping costs are deferred to the extent that the actual stripping ratio exceeds the expected average stripping ratio of the mine
POG.L	Petropavlovsk	Stripping costs incurred during the production phase of a mine are deferred where this is the most appropriate basis for matching the costs against the related economic benefits, and either capitalised as inventory or deferred as fixed assets and amortised based on a comparison of the actual stripping ratio to the expected average stripping ratio of the mine
RIO.L	Rio Tinto	Stripping costs are deferred to the extent that the actual stripping ratio exceeds the expected average stripping ratio of the mine
RRS.L	Randgold Resources	All stripping costs incurred during the production phase of a mine are treated as variable production costs and are capitalised as inventory
VED.L	Vedanta	Stripping costs and secondary development expenditure, mainly comprising of costs on blasting, haulage, excavation, etc incurred during the production stage of an ore body are charged to the income statement immediately
XTA.L	Xstrata	Stripping costs are deferred to the extent that the actual stripping ratio exceeds the expected average stripping ratio of the mine

Source: Company annual reports, CIRA.

Potential for increased EBITDA margins for companies not currently deferring stripping costs

The most common practice appears to be to defer stripping costs to the extent the costs exceed the expected average stripping ratio of the mine. This has the effect of spreading stripping costs evenly over the expected life of the mine. Randgold Resources capitalises all production phase stripping costs as inventory (which is the required treatment under US GAAP), while Vedanta charges all such costs to the income statement immediately. African Barrick's accounting policy appears consistent with the IFRIC 20 rules, and a number of miners did not provide specific detail on their policy in this area. We note that none of the current accounting policies are inappropriate under IFRS, but that a lack of specific guidance has resulted in a degree of accounting flexibility in this area.

We expect that the IFRIC may increase EBITDA margins in some cases; particularly those miners who are expensing these costs as incurred, or capitalising all production phase costs as inventory. Prospective application may also result in a transitional boost to earnings, as some costs are deferred to a later period.
The IFRIC is unlikely to have significant margin implications for those miners whose policy effectively spreads the stripping costs over the life of the mine.

[14] The stripping ratio is the ratio of waste material removed per unit of ore extracted.

New rules effective 2013

The new rules, subject to endorsement by the EU, will apply from 2013 and may only be applied prospectively. We are not aware of any comment on the impact of these new rules to date from the European mining companies but we expect miners may comment in 2011 annual reports.

US Life Insurers: DAC accounting change

Deferred Acquisition Costs (DAC) accounting change to reduce book value

Several US life insurers gave guidance in Q3 results on the impact of a forthcoming US GAAP accounting change. Accounting Standard Update (ASU) 2010-26 is likely to have a significant effect on US life insurers' book value, and some impact on earnings, from 2012. The change was discussed in detail by the CIRA US Life Insurance team in *Beware the ASU 2010-26 DAC Attack - Change Will Hit Insurers' Balance Sheet and Earnings in 2012* (22 September).

The change affects the recognition of Deferred Acquisition Costs (DAC) assets. Insurers are permitted to capitalise costs related to gaining new business or renewing existing policies, and the costs are then amortised over a period which depends on the nature and duration of the policy. Acquisition costs were previously defined in US GAAP as costs that **vary with** and **are primarily related** to the acquisition of insurance contracts. This is a relatively wide definition, and costs deferred often included advertising, training, as well as some general overheads such as rent. Costs could be deferred irrespective of whether they related to the 'successful acquisition' of new contracts.

Costs must relate to successful acquisition of new insurance contracts to be deferred

The ASU noted differences in the types of costs deferred by insurers, and therefore the definition of acquisition costs has been amended so that only costs that are **directly related** to the **successful acquisition** of new or renewal insurance contracts may be deferred. This means that incremental direct costs attributable may be deferred, while all other costs must be expensed as incurred.

A number of US life insurers have reported Q3 results in recent weeks, and a summary of the guidance on the impact of the accounting change is included in Figure 3. All companies surveyed have decided to apply the changes retrospectively (prospective application is allowed but would have penalised current earnings to a greater extent). The actual impact of the change will be reported Q1 2012.

Range of potential hit to book values between 1% and 15% on results to date

The potential impact on opening equity ranged from 1% of Q3 reported book value (StanCorp Financial) to up to 13% - 15% (Ameriprise Financial, Torchmark). The potential impact on 2012 earnings was also varied, with Reinsurance Group of America guiding to a reduction of 6% to 10% of operating income, while Ameriprise estimate a marginal benefit to operating earnings. MetLife did not provide guidance on the impact of the change in Q3 results, and will provide guidance at an investor day in December.

Figure 3. Company guidance on impact of DAC accounting change

Name	RIC	3Q11 Reported BV	Book Value Reduction	2012 P&L Reduction
AFLAC	AFL	12,714	$500m - $700m (implied 4% - 6%)	Immaterial decrease
AIG	AIG	86,802	3%	Not disclosed
Ameriprise Financial	AMP	10,609	$1.3bn - $1.4bn (implied 12% - 13%)	Marginal benefit to operating earnings
Genworth Financial	GNW	17,368	$1.3bn - $1.6bn (implied 7% - 9%)	To guide in Q4
Lincoln National	LNC	14,919	$0.95bn - $1.15bn (implied 6% - 8%)	Not disclosed
Principal Financial Group	PFG	10,289	$550m - $750m (implied 5% - 7%)	$35m - $40m operating income (c. 3% of consensus 2012E operating income)
Protective Life	PL	4,082	13% - 15%	8% - 10% of operating income
Prudential Financial	PRU	36,306	$2.6bn - $3.1bn (implied 7% - 9%)	Not disclosed
Reinsurance Group of America	RGA	5,663	6% - 9% (BV excl OCI)	6% - 10% of operating income
StanCorp Financial	SFG	2,031	$20m - $25m (implied 1%)	$3m - $4m PBT (1% - 2% of consensus 2012E PBT)
Torchmark	TMK	4,183	9% - 15% (BV excl OCI)	1% - 2% of EPS
Unum Group	UNM	9,460	$400m - $600m (implied 4% - 6%)	Immaterial decrease in net income

Source: Company reports, dataCentral, CIRA.

According to the CIRA US Life Insurance team, write downs have varied from 15% to 50% of DAC, as per company disclosure, with 15% for Torchmark and 50% for Ameriprise. On average, at the end of 3Q11 DAC equalled around 54.0% of shareholders equity (ex. OCI) for the group of US life insurers studied. It ranged from a low of 21.0% for StanCorp, up to a high of 95.9% for AFLAC. The wide difference reflects the mix of different types of products sold, distribution systems used, level of advertising and general marketing expenditures. In general, DAC is less significant on shorter duration group insurance products and higher on longer duration policies such as individual life, variable annuities and long term care.

US insurers may appear more expensive on P/B multiples

A change in DAC accounting should not have significant implications for valuation. However, the change does represent a meaningful reduction of book value in some cases, as well as a reduction in reported earnings. This will make insurers appear more expensive on a price to book basis, as well as on P/E metrics. However, the accounting change will result in an increase in the return on equity measure, due to the reduction in book equity.

DAC accounting inconsistent under IFRS and US GAAP; divergence expected to continue

This accounting change highlights one of the areas of continuing divergence between the US standard setter FASB and the IASB with regards to insurance. Current IFRS does not include comprehensive rules for insurance accounting, and therefore does not prescribe which costs may be deferred, or the amortisation period. The IASB is currently working on a project to produce a comprehensive standard for insurance accounting, with a new draft version expected to be published in 2012.

Banks book gains on own credit deterioration

Reduction in own debt value = P&L gain if fair value option used

A number of US and European banks have recorded significant gains in Q3 results from a reduction in the value of the banks' own debt. Although financial liabilities (other than derivatives) are normally measured at amortised cost, both US GAAP and IFRS allow companies to elect to measure financial debt at fair value. This is known as the Fair Value Option (FVO).

Accounting treatment permitted under IFRS and US GAAP

All companies can make irrevocable elections to apply the FVO on an instrument by instrument basis. US GAAP includes no restrictions on a company's ability to apply the FVO, but under IFRS the option can only be applied in one of three circumstances:

- Reducing or eliminating a measurement inconsistency

- Instruments managed and performance evaluated on a fair value basis
- Instrument contains embedded derivatives

We believe these rules may offer significant flexibility in deciding whether to invoke the FVO for a company's own debt.

Theoretical justification for fair value treatment

On a theoretical basis, there is logic in measuring the liability side of a banks' balance sheet at fair value. Aside from removing valuation mismatches with the asset side of the balance sheet, banks could potentially (in some cases) buy back debt in issue and therefore crystallise gains. Also, this method is consistent with the initial measurement of a bond (proceeds of a bond issue represent the fair value of the future payments and therefore reflect credit risk). Importantly, the FVO cannot be reversed, and therefore any narrowing of credit spreads during Q4 and beyond will result in banks reporting own debt losses.

IFRS 9 will remove volatility of own debt valuation from P&L

However, some investors have complained about the counterintuitive outcome of banks reporting gains when their credit standing deteriorates. The IASB has responded: IFRS 9, the eventual replacement for IAS 39, prohibits the recognition of FVO own credit gains and losses in the P&L[15], which will instead be recognised in Other Comprehensive Income (OCI), which does not affect net income.

Other elements of IFRS 9 have not yet been issued (including new rules on impairment and hedge accounting) and the standard is not expected to be mandatory until 2015. At present EU companies are not allowed to adopt IFRS 9 as it has not yet been endorsed by the EU. Refer to Appendix 2 for more detail on the progress of IASB projects, including IFRS 9. The FASB financial instruments exposure draft, published in May 2010, did not include a similar proposal, but did propose that the gain or loss on own credit (net of the change in the price of credit) be presented as a separate item on the face of the income statement.

Deloitte criticised by US regulator

PCAOB releases details of Deloitte 2007 audit shortcomings

Deloitte & Touche LLP, one of the 'Big 4' global accounting firms, has been criticised by the PCAOB[16] in a recent release[17]. The criticism follows the 2007 review of Deloitte's audits of US public companies, carried out annually by the PCAOB. Summary results were published in May 2008, and PCAOB rules give audit firms one year from publication of the initial report to improve on deficiencies found by the PCAOB inspectors. If firms fail to make sufficient improvements in this period, the PCAOB then publishes the full report, including more detail on the findings.

Criticism that Deloitte audit procedures over management estimates insufficient

The PCAOB report outlined a number of Deloitte shortcomings. Most prominent was criticism of Deloitte's quality control procedures over the audit of management estimates. The audit of management estimates is a critical part of audit procedures, as management judgment is often associated with balances critical to the overall results reported.

The PCAOB noted that in some cases Deloitte had failed to provide evidence that the firm had evaluated the reasonableness of management assumptions, or verified the data upon which management estimates had been made. Examples given by

[15] Source: IFRS 9, paragraph BCG.2 (a). Gains and losses will only be reflected in the P&L to the extent that OCI recognition would create or enlarge an accounting mismatch.

[16] The Public Company Audit Oversight Board is a US regulatory body which oversees public company audits.

[17] See www.pcaobus.org, 17 October 2011.

the PCAOB included the work performed over a change in revenue recognition policy, and valuation models used in asset impairment tests.

A PCAOB spokesperson noted that the disclosure is not a disciplinary action, and that a number of small audit firms have had similar criticisms aired previously[18]. However, the disclosure of specific audit failings is unusual for a Big 4 firm. The PCAOB did not comment on Deloitte's progress in remediating the areas of weakness found by the PCAOB after the one year period from May 2008 expired in May 2009.

[18] Source: Bloomberg, 17 October 2011.

Appendix 1: Recent Publications

Figure 4. Recent Publications

Please email neil.dawson@citi.com if you would like to be added to our distribution list, or to request hard copies. We also produce a monthly edition of The Standards which is published at the start of each month.

Title	Date	Region	Pages
Pension Perspectives: Q3 2011 - Higher deficits, possible impact on cashflow	06-Oct-11	Europe	19
The Standards: Sovereign Debt Update - Review of Greek Debt Impairments in Q2 Results	08-Sep-11	Europe	26
Pension Perspectives: Summer Sell-off - Pension Pain Returning	22-Aug-11	Europe	14
European Banks - Greek Sovereign Debt Impairments in 2Q11	27-Jul-11	Pan-Europe	12
Pension Perspectives: Q2 2011 - 2010 Annual Reports Show UK Deficit Improvement	19-Jul-11	Europe	21
The Standards: Sovereign Debt Update - French plan for Greek debt may not solve accounting problem	08-Jul-11	Europe	11
The Standards: New Pension Rules - Revisions likely to reduce earnings on average	17-Jun-11	Global	12
The Standards: Sovereign Debt Questions - Accounting for Government Debt Restructuring or Rescheduling	20-May-11	Europe	20
The Standards: New IFRS on JVs - Removing proportional consolidation option for many JV entities;	13-May-11	Global	10
Pension Perspectives: Q1 2011 - Deficit Pain Receding?	08-Apr-11	Europe	16
The Fundamentals: Equity Valuation - A Review of Valuation Methods from First Principles	17-Mar-11	Europe	40
IFRS 2011 - An Investor's Guide to IFRS Accounting	21-Jan-11	Global	64
Vestas Wind Systems (DEN) (VWS.CO): Brought to Account	30-Nov-10	Europe	28
Adjusted Earnings - A Review of Non-GAAP EPS in Europe	08-Nov-10	Europe	36
Financial Instruments Accounting - Current State of Play	14-Sep-10	Global	13
Bringing Leases on Balance Sheet - Proposed Elimination of Operating Lease Accounting	18-Aug-10	Europe	21
European Pension Exposure - Many Liabilities Still Off-Balance Sheet	05-Aug-10	Europe	11
UK Pension Problems Haven't Gone Away - Review of Company Exposure and Recent Developments	27-Jul-10	Europe	24

Source: Citi Investment Research and Analysis

Appendix 2: IASB Work Plan Overview

Figure 5. Key IASB expected standard publication dates 2011/2012

Standard Name	Key expected changes	Companies / Sectors Most Impacted	Joint project with FASB	Expected Re-exposure Date	Expected Publication Date	Expected Effective Date
Leases	■ Abolition of operating/finance lease distinction ■ All leases on balance sheet ■ Potential changes to lessor accounting and P&L treatment not yet agreed	Companies with significant operating lease exposure (eg retail, transport, leisure)	Yes	H1 2012	H2 2012	TBC, not earlier than 1-Jan-13[3]
Insurance	■ First comprehensive IFRS for Insurance ■ Building blocks approach to measuring insurance liabilities ■ Closer to fair value measurement of liabilities, potentially more volatility	Insurers	Yes[1]	H1 2012[4]	TBC[2]	TBC, not earlier than 1-Jan-13[3]
Revenue recognition	■ Convergence of IAS 11 Construction Contracts and IAS 18 Revenue ■ Move away from "percentage of completion" basis of accounting used for construction and service contracts. ■ Focus on completion of performance obligations as criteria for revenue recognition	Construction, engineering, oil services, aerospace & defence, technology	Yes	Q4 2011	H2 2012	TBC, not earlier than 1-Jan-13[3]
IFRS 9 - Impairment	■ Splitting loan books into "good book/bad book" ■ Forward looking impairment estimation model - consideration of expected losses	Banks	Yes	H1 2012[4]	TBC[2]	TBC, not earlier than 1-Jan-13[3]
IFRS 9 - Hedge Accounting	■ Removing quantitative hurdles to hedge accounting ■ Enhanced risk management disclosure	Corporates undertaking hedging	Yes	Q4 2011[5]	2012	TBC, not earlier than 1-Jan-13[3]
IFRS 9 - Offsetting financial assets & liabilities	■ Boards unable to agree on convergence of IFRS and US GAAP offsetting rules ■ Likely enhanced disclosure to aid reconciliation between IFRS and US GAAP	Banks (mainly US)	Yes	n/a	Q4 2011	TBC, not earlier than 1-Jan-13[3]

Source: IASB, CIRA. [1]Insurance is a joint project, but the timing of the final standards will differ. FASB will publish an exposure draft when the final IASB standard is published.[2] The IASB website does not currently display target dates for publication of final standards on Insurance or Impairment. [3]The IASB has not yet finalised the effective dates for these standards. The IASB has published an exposure draft proposing that IFRS 9 will not be effective until 2015. [4] Re-exposure or review draft. [5] Review draft to be published.

Appendix A-1

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