

Equities

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IFRS 2011

An Investor's Guide to IFRS Accounting

■ Industry Overview

- **Major accounting changes this year** — The IASB is expected to publish new standards on lease accounting, revenue recognition, pensions, financial instruments and insurance, all scheduled for H1 2011. If completed, this will be the biggest change to European accounting since 2005, when IFRS was adopted. We highlight the main expected changes, and affected sectors and companies.
- **IFRS as global GAAP?** — IFRS is spreading around the globe, with countries such as Canada, Korea, Argentina, and India adopting IFRS over 2011-14. Over 90 countries already require IFRSs for listed companies.
- **But not all IFRSs are equal** — Some countries use local standards based on, but not the same as, IFRS (eg China), some use “endorsed” versions of IFRS (eg EU). Lack of international accounting enforcement leads to local flavours of IFRS and sub-standard IFRS accounts. The IFRS label is no guarantee of quality.
- **US decision in 2011** — The SEC will decide this year whether, when and how the US should adopt IFRS. Earliest possible adoption year would be 2015. Japan may decide in 2012 if and when IFRS will become mandatory.
- **Standard by standard guide** — This report provides an overview of each IFRS for investors, highlighting valuation implications and potential problem areas.

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

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Accounting Issues for 2011

Decisions made during 2011 may affect fundamentally the way that companies globally report their results for many years to come.

Several major new standards by June

Firstly, the International Accounting Standards Board (IASB) has committed to publish, by June 2011, major new IFRSs on topics such as revenue recognition, leases, financial instruments, and insurance accounting, while also making significant changes to pension accounting, joint ventures and other topics. Many of these are driven by convergence with US GAAP and will be published jointly with the US standard setter, the Financial Accounting Standards Board (FASB). It will be a considerable challenge to produce high-quality, comprehensive standards on these important topics in the next few months.

US decision on adopting IFRS

Secondly, the US Securities and Exchange Commission (SEC) will decide during 2011 whether to commit to a timeframe for US adoption of IFRS. Clearly this decision is important for investors in US equities, due to the potential impact of switching from US GAAP to IFRS. But it is also significant for investors elsewhere, as the SEC's decision may affect the adoption of IFRS by other countries, the IASB and its governance, and the development of future standards. We summarise the current status of global adoption of IFRS on page 8.

New IASB and FASB Chairs

All this must take place during a year which will see substantial personnel changes at both IASB and FASB. The FASB has a new Chairman, Leslie Seidman, replacing Bob Herz who resigned unexpectedly in 2010, while David Tweedie retires after 10 years as IASB Chairman in June, to be replaced by Hans Hoogervorst¹. New board members will also be appointed to both Boards this year.

From page 10, we provide a summary guide to each IFRS and IAS in issue at January 2011.

Key New Standards in 2011

The IASB expects to issue several major new standards by the end of June:

- Revenue – replacing existing rules on when revenue is reported
- Leases – bringing all leases on balance sheet
- Financial Instruments – complete replacement of IAS 39 (note parts of this standard have already been issued as IFRS 9)
- Insurance – first comprehensive IFRS for insurance
- Pensions – amendments to IAS 19 may increase P&L pension costs
- Joint Ventures – abolishing proportionate consolidation in some cases (see page 47)
- Consolidation – new guidance on what should be consolidated (see page 43)

We discuss the first five projects, which we consider most significant for investors, below.

New rules on revenue recognition, leases, financial instruments, insurance, pensions, JV and consolidation

¹ Chairman of the Netherlands Authority for the Financial Markets, but not an accountant.

Will the IASB meet the June 2011 deadline?

We are often asked by investors if these projects are likely to be completed on schedule. We agree the work plan looks extremely ambitious. The IASB also has a history of missing targeted dates, deferring planned projects, or reducing project scopes. Nevertheless, the IASB is motivated to produce the new standards ahead of the SEC's IFRS adoption decision. The IASB would also like to complete the standards before some board members, including Chairman David Tweedie, leave the Board at the end of June.

The other key question is the likely effective date for the major new standards. The IASB has indicated they will not be mandatory before 2013 at the earliest, and we think delay beyond 2013 is likely.

Revenue Recognition

New revenue standard

The IASB plans to issue a new standard on revenue recognition by June, which is a joint project with FASB. This standard will replace the existing IAS 11 and IAS 18 (see pages 30 and 36).

What will change?

Current rules can be inconsistent

Current rules have two different approaches to revenue recognition – revenue for some contracts is reported on a “percentage of completion basis”, while in other cases no revenue is recorded until the customer has taken control of the goods and all significant risks and rewards have been transferred. This can result in very different revenue and profit profiles (though this is a timing issue – eventually the same revenue is reported whichever accounting method is used).

The IASB aims to develop a consistent standard for recognising revenue. It published an Exposure Draft (ED) in June 2010 which makes several proposed changes to existing requirements:

1. Revenue only at transfer to customer. Revenue should be recognised as the “performance obligation” to the customer is satisfied, which would correspond to the customer obtaining control of the good or service. Although various indicators of such customer control are provided (eg obligation to pay, legal title obtained, physical possession, etc), the guidance in the ED is fairly vague, and so it is difficult to assess the potential impact on companies.
2. Separating “performance obligations”. This means a contract might have to be broken into several components with different margins. This could apply to bundled goods and services, and could lead to revenue being deferred for related services such warranty or service commitments.
3. New guidance on treatment of contract related costs. Some costs which may currently be capitalised would have to be expensed (eg costs of obtaining a contract such as bid and proposal costs), potentially increasing initial losses.

Could affect some construction, engineering, oil services, aerospace & defence, and technology stocks

Which companies will be affected?

Some companies which currently use percentage of completion accounting, eg for long term construction contracts, may have to report revenues and profits later. Some percentage of completion based service contracts may also be affected. Affected companies could include construction, engineering, oil services, aerospace and defence, and technology stocks. Percentage of completion would only be allowed if it corresponded to the customer's control of the good or service.

We expect that this will receive considerable focus when the IFRS is issued and the implications for specific sectors or companies should become clearer. Interestingly, two European companies² already recently changed revenue recognition policies, citing the IASB's revenue project. The new Revenue standard may also have much greater impact in the US, as it will replace numerous sources of industry-specific guidance.

Leases

A Lease Exposure Draft was issued in August 2010, and an IFRS is scheduled for June. We have already published a detailed report on the implications of these proposals³.

What will change?

Lessees using operating leases will be affected as follows:

- Higher reported leverage, as operating lease commitments would be capitalised on balance sheet and included as financial obligations
- Lower interest coverage, on average
- Potentially lower EPS (and higher P/E) initially, based on the transitional rules proposed in the ED. However, the IASB may reconsider this
- Ongoing differences between P&L expense and cash lease payments
- Changes to metrics such as EV/EBITDA, although case-by-case impact
- Higher reported operating cash flow, as lease payments will be classified as financing cash flows

Which companies will be affected?

Most exposed sectors include retail, transport and leisure. For a list of exposed stocks, please see Appendix 1.

Lease changes will increase gearing and many other key metrics

Affects retail, transport and leisure

² Nestle and Vestas Wind Systems (see our report *Vestas Wind Systems: Brought to Account ...*, dated 30 November 2010).

³ *Bringing Leases on Balance Sheet: Proposed Elimination of Operating Lease Accounting*, dated 18 August 2010.

Financial Instruments

Replacement of IAS 39

The IASB has already issued parts of IFRS 9, on the classification and measurement of financial assets and liabilities. Sections on impairment rules (particularly relevant for banks' loan books) and hedge accounting (relevant for the large number of non-financial companies which hedge future cash flows for currency or commodity price exposures) are expected by June. The whole standard will become mandatory in 2013. Clearly this standard is particularly significant for banks and insurers.

We see some issues with both the current and proposed IFRS 9 rules:

Greater use of amortised cost?

- Amortised cost vs fair value: We think that when IFRS 9 is adopted, it could, on average, result in a higher proportion of banks' and insurance companies' balance sheets being measured at amortised cost rather than fair value. This may mean more stable, but potentially less relevant, balance sheets.
- New accounting for some equity investments: this may cause some confusion as gains/losses are never reported in the P&L.
- One-off restatements: When banks and insurers adopt IFRS 9 for the first time, it may result in a significant restatement of balance sheets (some assets being reclassified from fair value to amortised cost and vice versa).

Forward-looking impairment rules

- More forward-looking loan impairment rules: This may address one of the criticisms of IAS 39 during the credit crisis, that loans were effectively overstated due to the "incurred loss" impairment rule, but we do not yet have final details on how this will work.
- More flexible hedge accounting: more companies may apply hedge accounting, reducing P&L volatility and non-GAAP earnings adjustments.
- Need for consistency with US GAAP: It is important that differences between US GAAP and IFRS are reduced or removed to improve comparability of banks' balance sheets.

Insurance

A comprehensive standard for Insurance

The IASB issued an Exposure Draft on Insurance Contracts in July 2010. At present there is no comprehensive IFRS for insurance (see page 17 for a summary of IFRS 4), so there is inconsistency in reporting amongst insurance companies applying IFRS. This reduces comparability of results and arguably may lead to insurance companies suffering a valuation discount.

A full review of the insurance project is outside the scope of this report, but the Insurance ED proposed a building blocks approach to measuring insurance liabilities, taking into account:

- the expected cash flows (probability weighted) of the contract
- the time value of money, eg risk-free rate plus an illiquidity adjustment
- a risk adjustment
- a residual margin

This means insurance liabilities will be measured at a present value which will vary as market conditions such as interest rates vary, with movements reported in the P&L. The P&L presentation will also change to a margin-based approach, rather than reporting premiums and claims.

Risks from current timetable

While investors would benefit from a comprehensive Insurance IFRS, we believe there is significant risk if the standard is finalised too hastily. The June 2011 deadline seems aggressive given the lack of detailed guidance in some aspects of the ED (such as how to determine the discount rate, in particular calculating any illiquidity adjustment). Discussions around convergence with FASB are ongoing and while some issues have been resolved, agreement has yet to be reached on key areas eg presentation of an explicit risk adjustment margin. Insurance companies are also concerned about the interaction with the new Financial Instruments standard, which will affect the asset side of the balance sheet significantly.

Pensions (Post-Employment Benefits)

An amended pension IFRS will address two key issues:

Abolishing “corridor” affects airlines and banks

1. Abolition of the “corridor” rule. As discussed on page 37, IAS 19 currently permits a choice of pension accounting. Pension deficits may be fully marked-to-market on the balance sheet, or the “corridor” rule allows for smoothing by leaving some pension gains/losses off-balance sheet. The IASB plans to abolish the corridor alternative, so that all companies will report any pension deficit on balance sheet. This will affect a significant minority of European companies by reducing book value materially, particularly in the airlines sector (eg British Airways, Air France-KLM, Lufthansa, and SAS) and some banks (eg Banco Comercial Portugues, Banco Espirito Santo, UBS, Lloyds, Barclays). This should simplify analysis as the pension deficit will be on the balance sheet rather than hidden in the notes to the accounts.

P&L change lowers earnings

2. The pension cost reported in the P&L will change. At present the pension cost includes the expected return on pension assets, less the interest cost on pension liabilities. The IASB is expected to replace this with a notional interest charge on any pension deficit or surplus. This will generally reduce earnings, because companies normally assume the expected return on pension assets is higher than the pension discount rate. Companies most affected will be those with the largest funded pension schemes relative to company market cap, and those with the riskiest asset allocation, typically mainly in the UK (such as British Airways, BT, Taylor Wimpey, Premier Foods, Qinetiq).

For more detail of affected companies see our reports *UK Pension Problems Haven't Gone Away*, dated 27 July 2010, and *European Pension Exposure*, dated 5 August 2010.

More than 90 countries require IFRSs for listed companies

Global Adoption of IFRS

Figure 1 shows the current status of IFRS adoption for listed companies in various markets globally. IFRS adoption makes it easier for investors to compare companies in different countries, and provides a common accounting language. The IASB has been very successful at promoting the adoption of its standards, but the US has not yet signed up. The SEC will decide this year whether to set a date for US adoption of IFRS.

Figure 1. Status of IFRS Adoption in Various Countries

Country	IFRS Status for Listed Companies
All EU + EEA countries (1)	Mandatory to use IFRSs as adopted by EU
Argentina	From 2012
Australia	Mandatory (IFRS equivalent standards)
Brazil	Mandatory (since 2010)
Canada	Mandatory from 2011, early adoption permitted since 2008
Chile	Mandatory
China	China standards based on IFRS
Egypt	Mandatory
Hong Kong	HK standards almost identical to IFRS
India	Phased adoption over 2012-14 (2)
Indonesia	Not permitted
Israel	Mandatory except for banks/dual registrants
Japan	Permitted for some but not mandatory (3)
Korea	From 2011
Mexico	From 2012
Morocco	Mandatory for banks, permitted for others
New Zealand	Mandatory (IFRS equivalent standards)
Nigeria	From 2012
Russia	Not required
Singapore	Singapore GAAP to converge by 2012
South Africa	Mandatory
Switzerland	Multinationals must use IFRS or US GAAP
Taiwan	From 2013
Thailand	Not permitted
Turkey	Mandatory
USA	Not permitted except for foreign filers (4)

Source: Deloitte, IASB, CIRA

Notes: 1. EU: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, UK. EEA: Iceland, Liechtenstein, Norway. 2. Financial Times reported on 16/1/11 that India may delay IFRS adoption. 3. Japan may decide in 2012 whether to make IFRS mandatory, possibly from 2015 or 2016. 4. SEC to decide in 2011 whether to set timeframe for US adoption of IFRS, with earliest mandatory option in 2015 or 2016.

The SEC must determine in 2011 whether, when and how the US should adopt IFRS for listed company reporting. The SEC will be influenced by factors such as whether IFRS is a sufficiently developed set of standards for US reporting, and if the independence of the IASB standard setting process is satisfactory.

We do not know yet if the SEC will set a firm date for US adoption of IFRS. The SEC's decision may influence other countries too. Japan is expected to make a decision about mandatory adoption of IFRS (perhaps by 2016) in 2012.

Different versions of IFRS

Unfortunately many countries have not adopted an identical set of IFRS standards but have made local adjustments. For example, companies listed in the European Union have to use IFRS “as adopted by the EU”. In practice the EU-endorsed IFRSs are almost the same as full IFRS, with the exception of a specific element of IAS 39 applicable to some banks. In addition the EU endorsement process takes some time, so companies are sometimes not allowed to use issued IFRSs even though the IASB allows early adoption (eg IFRS 9).

China standards based on IFRS but not the same

Some countries have adopted accounting standards which are based on IFRS but which are not the same. For example, China’s accounting standards, though similar to IFRS, have some differences such as not permitting the fair value model for property, plant and equipment (IAS 16) or intangibles (IAS 38), and not permitting the reversal of impairment charges (IAS 36). India is also considering requiring listed companies to use Indian standards with some differences from IFRSs (eg investment companies required to use the cost model and not permitted to use the fair value model in IAS 40).

Further, even where countries require “full IFRS”, the standards are not necessarily appropriately applied by all companies, or they may be interpreted inconsistently in different countries. There is no international enforcement of accounting requirements.

This may limit the benefits of IFRS adoption and reduce comparability. There is a possible brand risk to IFRS standards if some companies claim to apply IFRS fully but in practice do not. Some academic evidence suggests that the possible benefits of IFRS adoption (improved liquidity, valuation ratios, lower cost of equity) arise only in countries with stronger accounting enforcement⁴.

IFRS label is no guarantee of quality

In other words, investors should not assume that all IFRS reporting companies apply the same standards consistently or that the IFRS “label” guarantees high reporting quality.

⁴ Eg see review of academic evidence in “*The European IFRS Experiment: Objectives, Research Challenges and some Early Evidence*” by P. Pope, S. McLeay.

IFRS: Standard by Standard

Guide to IASs and IFRSs

In this report we provide a short guide to each standard issued by January 2011, listed in Figure 2. International Financial Reporting Standards (IFRSs) have been issued since 2001 by the IASB. International Accounting Standards (IASs) were issued by its predecessor body the IASC.

Figure 2. List of International Financial Reporting Standards at January 2011

IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26*	Accounting and Reporting by Retirement Benefit Plans*
IAS 27	Consolidated and Separate Financial Statements
IAS 28	Investments in Associates
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 31	Interests in Joint Ventures
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

Source: International Accounting Standards Board. *Note: we have not included IAS 26 in this report because it only relates to reporting by pension schemes, ie it does not affect company accounts.

We include a brief overview of each standard and its implications for investors, such as how the information may be incorporated into valuation or any weaknesses in the standard (such as flexibility or choices which may reduce comparability across companies). Obviously this is not intended as a substitute for reading the full standard. For more details or if you have any specific questions, please contact us.

**Interpretations (IFRICs) = guidance on
detailed technical points**

The IASB's International Financial Reporting Interpretations Committee (IFRIC) issues interpretations of specific technical issues which supplement the guidance in the standards. We have not described each IFRIC (called SICs for interpretations pre 2001), but have mentioned them if we think they may be significant for an investor's understanding of a particular standard.

Throughout this report for convenience we use the terms "profit and loss account" (P&L) for the income statement (often now combined with other comprehensive income in one statement of comprehensive income) and "balance sheet" for what the IASB now refers to as the statement of financial position. Similarly we refer to minority interests for what are now called non-controlling interests. Finally, we use the terms "company", "group" or "entity" to refer to the reporting entity being analysed.

**How to adopt IFRS and minimum
required disclosures**

IFRS 1: First-time Adoption of IFRSs

This standard sets out the rules for a company adopting IFRS for the first time, ie the extent to which IFRSs should be applied retrospectively or prospectively. Whilst this standard is no longer relevant to EU companies, it will be important in countries which are adopting IFRS from 2011 onwards (such as Canada).

Main Points of the Standard

When a company applies IFRS for the first time, it prepares an opening IFRS balance sheet for the start of the first comparative year; for example companies adopting IFRS in (calendar) 2005 had an opening IFRS balance sheet as of 1 January 2004.

The opening IFRS balance sheet is prepared in accordance with IFRS, ie as if IFRS had always been applied, except for certain simplifying exemptions. These include:

- Previous acquisitions do not have to be restated as if IFRS 3 had applied (eg goodwill previously written off to reserves is not restated)
- Fair value may be used as “deemed cost” for property, plant and equipment on transition
- Pension deficits can be fully recognised on the opening IFRS balance sheet even if the company subsequently applies the corridor rule

In addition IFRS 1 sets out the minimum information which companies have to provide when adopting IFRS, such as reconciliations of equity and comprehensive income between the previous GAAP and IFRS. IFRS 1 only requires one year of comparative figures in the financial statements (although national regulations may require more).

Issues for Investors

**First-time adoption choices may flatter
balance sheet or earnings**

Investors should be aware that IFRS 1 permits various choices (such as revaluing fixed assets which do not have to be revalued in future) which may allow companies to flatter the opening balance sheet or future earnings. Over time these effects should fade.

In addition, IFRS 1 only requires relatively limited reconciliation between old GAAP and IFRS. In practice many companies provided more than the permitted minimum information when they adopted IFRS.

IFRS 2: Share-Based Payment

Shares and options paid to employees have to be expensed through P&L

IFRS 2 covers the expensing of shares and options granted to employees (as well as other share-based payments). Prior to 2005, when this standard was introduced, employee share options were normally expensed at intrinsic value (ie zero expense if the option strike price was set to the current share price).

Main Points of the Standard

Costs spread over the vesting period

The fair value of shares or options granted to employees should be expensed through the P&L. If the share-based payment has a vesting period, the expense is charged to the P&L evenly over the vesting period.

Options measured at fair value using any reasonable valuation model

The fair value of employee options may be estimated using any reasonable model, if no market price is available (typically employee options are granted subject to conditions so there are no equivalent traded options). The model must take into account specified factors: exercise price, current share price, expected volatility, life of option, expected dividends, and the appropriate risk-free interest rate, and any other factors which a knowledgeable market participant would consider. Companies typically use a Black-Scholes model or a binomial model.

Fair value is measured at date of grant and not re-measured subsequently

The fair value is estimated at the date of grant and in most cases the fair value is not re-measured. However, in the case of cash-settled share-based payments, the expense is re-measured at each reporting date.

Many employee options schemes have vesting conditions, typically that the employee has to work for the company for the vesting period or the options/shares are forfeited. The expense is calculated by reducing the fair value of the options/shares granted by the amount which is not expected to vest⁵. Once estimated, this expense is then spread over the vesting period. Although the fair value is not re-measured, the vesting assumptions are re-assessed at each reporting period.

Example: A company grants options with a fair value of £5m and a vesting period of 4 years. It is anticipated initially that 20% of the options will not vest, due to the employee leaving before the end of the vesting period. The annual P&L expense will be $80\% \times £5m / 4 \text{ years}$, ie £1m per annum, assuming the original assumption on vesting proportion does not change.

Issues for Investors

Do not strip this expense out of “adjusted” EPS

Impact on EPS: Share-based payments are typically significant for technology companies, some media companies, and some younger/growth companies. Many companies in the technology sector (and a few others) exclude share-based payments from adjusted earnings metrics. We disagree with this exclusion as the options or shares distributed are a form of employee pay, and so a normal business expense. Further, it is a recurring adjustment which is dilutive to existing shareholders, as discussed in recent research⁶.

⁵ This applies for most vesting conditions. Certain types of vesting conditions (market conditions, eg a share price target) are taken into account when estimating the fair value of the options.

⁶ *Adjusted Earnings: A Review of Non-GAAP EPS in Europe*, dated 8 November 2010.

DCF valuation should incorporate future option grants and options currently outstanding

Impact on DCFs: Investors also ask us how these options should be captured in Discounted Cash Flow (DCF) valuations. In our view, future estimated cash flows being discounted should take into account the total expected employee cost, even if some of the remuneration may be paid in the form of options. In addition the fair value of already outstanding options, if material, should be estimated and deducted (like debt) from the calculated enterprise value when estimating the equity value of the business. Of course in the actual reported cash flow statement, options expense is a non-cash figure, although cash inflows may arise from the exercise of options (employees paying the strike price to the company).

Review key assumptions if expense is highly material

Sensitivity to assumptions: The calculation of options expense depends on various significant assumptions (such as future dividend payments, share price volatility, proportion of options which will not vest due to employees resigning, etc) and so if the expense is material these assumptions should be reviewed. Changes in the assumed proportion of options which will vest can affect the P&L charge materially (eg if a catch-up adjustment is made) but unfortunately these assumptions are usually not disclosed.

Tax treatment is complicated

Tax: The tax treatment of options expense can be complicated. Some tax authorities (eg in the UK) give a corporate tax deduction for the value of the options when they vest rather than at the date of grant. If the share price has increased, the tax deductible options cost may be larger than the P&L options cost. This tax effect is shown in the statement of other changes in equity rather than in the P&L. As a result the P&L tax and the cash tax may diverge.

IFRS 3: Business Combinations

New standard on M&A effective in 2010

IFRS 3 was revised recently as part of convergence with US GAAP (although the resulting standards are not fully converged). This version of IFRS 3 was mandatory for annual periods beginning on or after 1 July 2009, ie 2010 for calendar year-ends. The new standard changes the treatment of contingent consideration (earn-outs), step acquisitions, and acquisition related costs.

Main Points of the Standard

Acquired assets and liabilities measured at fair value; difference between price paid and net assets is goodwill

The **acquisition method** is applied to all business combinations. Pooling of interest/merger accounting is not permitted. An acquirer must be identified. The assets and liabilities of the acquired business are measured at fair value (with certain exceptions), including certain intangible assets (such as value of customer relationships, etc) which were not previously recognised on the acquiree's balance sheet. Goodwill is the difference between the price paid for the acquisition and the fair value of the net assets acquired.

Assets and liabilities which are not measured at fair value on acquisition include deferred tax assets and liabilities (measured in accordance with IAS 12) and pension deficits/surpluses (measured in accordance with IAS 19). Minority interests can be measured either at fair value or at the share of the acquiree's net identifiable assets (ie excluding the minority interest goodwill). In practice we expect few companies will opt for fair value measurement of the minority interest⁷.

Earn-outs now subsequently marked-to-market

The price paid for the acquisition is determined on the acquisition date - this is important if payment is in shares rather than cash. The acquisition date is the date the acquirer obtains control. The price paid includes the estimated fair value of contingent consideration ("earn-outs"). Subsequent changes in the value of the contingent consideration are usually marked-to-market through the P&L. This is a change to the previous version of IFRS 3 when such costs were treated as goodwill adjustments.

Negative goodwill booked as gain in P&L

If the price paid is less than value of the net assets acquired, known as a bargain purchase, the resulting gain is recognised in the P&L. This is sometimes called "negative goodwill".

Sometimes an acquisition is achieved in stages (a step acquisition). For example, a company may own 20% of an associate company and then buy the remaining 80%. When control is obtained, typically on obtaining the majority of the voting power, the previously held stake is revalued and a gain or loss is recognised in P&L. Many investors find it counterintuitive that a gain or loss is recognised on the associate stake when it has not been sold and the gain or loss only reflects the new transaction price for buying a further stake.

Final figures can take up to a year

Sometimes the acquirer cannot complete all the acquisition accounting by the next reporting date. Estimates may be used and adjustments can be made for up to one year from the acquisition date as the full information becomes available.

Acquisition related costs such as lawyers' fees must be expensed in the P&L. Prior to the IFRS 3 revision, these costs were capitalised in goodwill.

⁷ The previous IFRS 3 did not permit fair value measurement of minority interests. US GAAP now requires minority interests in new acquisitions to be measured at fair value.

If a minority interest is bought out by the group, the difference between the price paid and the book value of the minority interest is adjusted in equity, ie written off to reserves.

Issues for Investors

Acquisition accounting can be opaque and cloud the underlying performance of businesses. We suspect the amendments to IFRS 3, mandatory from 2010, will have made this problem worse.

Fair value write-downs can increase
future reported profits

Fair Value Write-downs: The acquirer re-states the acquiree's balance sheet to fair value. If the value of acquired assets is lowered, or liabilities increased, as part of this fair value exercise, future profits are increased (for example, writing down fixed assets will lower future depreciation charges). The other side of such adjustments is an increase to goodwill, but since goodwill is no longer amortised this has no P&L impact, unless goodwill becomes impaired.

The previous version of IFRS 3 required companies to present both the book value and the fair value of the acquiree's balance sheet at the acquisition date, so investors could see any write-downs. The new version of IFRS 3 only requires disclosure of the fair values, so it may be harder or impossible to identify fair value write-downs on acquisition which may flatter future earnings. In our view this removes an important market discipline. Of course companies can still choose to provide the book value information in the interests of transparency.

Step acquisitions can result in P&L profit

Gain/Loss on Buying More Shares: Under the new IFRS, buying more shares so that an associate becomes a subsidiary can result in a gain or loss in the P&L. This gain or loss may not be clearly disclosed at the time (and may even be included within revenues) and so may distort underlying profit trends.

Earn-out mark-to-market may be
unhelpful

Earn-outs Marked-to-Market: We also have concerns about the new treatment of contingent consideration, which may result in counterintuitive results. This can be significant for technology and media companies, particularly advertising agencies. For example, if an acquired subsidiary is performing well, the change in value of the earn-outs may result in a large cost, which could far outweigh the reported better performance. In other words, good performance of an acquired business may result in lower profits. In practice we expect that many companies and investors will remove the earn-out mark-to-market from "adjusted earnings". In some cases the earn-outs may be effectively paying for the services of the former owners who continue to work in the business, so the underlying cost should not be ignored.

Watch out for goodwill write-off to
reserves on purchase of minority interest

Write-off Minority Goodwill to Reserves: Finally, the accounting treatment for the purchase of minority interests may reduce shareholders' equity significantly (if the fair value of the minority interest is more than book value), which could distort Return on Equity calculations.

IFRS 4: Insurance Contracts

Insurance industry lacks a proper IFRS

IFRS 4 does not provide a comprehensive framework for accounting for insurance business. Introduced in 2005, it was intended as an interim standard to reduce the diversity of insurance accounting practices. The IASB is working on a new standard: an Exposure Draft was published in July 2010 and a final Standard is expected by June 2011 – with effective date yet to be determined.

Main Points of the Standard

IFRS 4 permits numerous inconsistent accounting practices

IFRS 4 exempts insurance contracts from other IFRSs. Companies are permitted to continue to use the accounting policies which they used prior to adoption of IFRS 4 (eg local GAAP or US GAAP) with certain exceptions. IFRS 4 therefore permits many inconsistent accounting practices, eg:

- Insurance liabilities may be measured on a discounted or undiscounted basis
- Discount rates for insurance liabilities may reflect expected investment returns or a more prudent rate may be used
- Insurance liabilities may be remeasured to reflect changes in market interest rates, but they do not have to be
- Companies may choose to apply “shadow accounting”⁸
- Companies may use non-uniform accounting policies for insurance contracts of subsidiaries

IFRS 4 imposes a “liability adequacy test” ie companies must check at each reporting date that the recognised insurance liability is adequate, using current estimates of cash flows expected under the insurance contracts. IFRS 4 requires certain minimum disclosures about insurance contracts.

Issues for Investors

Lack of comparability may cause share price discount

It is plainly unsatisfactory that there is no comprehensive accounting standard for insurance contracts. As a result accounting practices vary considerably amongst European insurers and therefore key investment metrics, whether based on earnings or book value, are not comparable across companies. Many companies apply some aspects of US GAAP in the absence of detailed IFRS guidance. It is possible that European insurance companies' shares trade at a discount due to the perceived lack of transparency.

Possible solution in 2011 but we are not very hopeful

If the IASB manages to publish a comprehensive and sensible standard on insurance accounting as planned in 2011, this should be helpful for investors in insurance companies. However this is a difficult task with which the IASB has struggled for many years. In addition the possibility of continuing differences between IFRS and US GAAP (if they are unable to agree a fully converged standard or the US does not issue an updated standard) suggests that challenges over comparability may remain.

⁸ Shadow accounting: In some accounting models, realised gains/losses on an insurer's assets have a direct effect on measurement of the insurance liabilities. Shadow accounting permits all recognised gains/losses on assets to affect the measurement of insurance liabilities in the same way, regardless of whether (a) the gains/losses are realised or unrealised and (b) unrealised gains/losses are recognised in profit or loss or in other comprehensive income.

IFRS 5: Non-current assets held for sale and discontinued operations

Discontinued operations are stripped out of P&L

This standard determines when parts of businesses can be treated as discontinued operations. This is important because discontinued operations are stripped out of the main P&L and presented separately.

Main Points of the Standard

Non-current assets (or a “disposal group” of assets, including subsidiaries) are classified as **held for sale** if the carrying amount is expected to be recovered principally through sale rather than continuing use in the business. The sale must be “highly probable”, ie management must be committed to a plan to sell, actively marketing the asset/group, and the sale should be expected within one year.

Such assets are measured at the lower of the carrying amount and fair value less costs to sell. They are not depreciated. Assets and liabilities of a disposal group are shown separately from other assets and liabilities in the balance sheet.

Discontinued operation must be major line of business or region

A **discontinued operation** is part of the business which either has been disposed of or is classified as held for sale, and which meets one of the following criteria:

- Major line of business or geographical area of operations
- Part of a co-ordinated plan to dispose a major line/geographical area of business, or
- Subsidiary acquired exclusively with a view to resale

The results of a discontinued operation are presented as a single amount in the P&L, which is a combination of the post-tax profit or loss of the operation and any post-tax gain or loss on disposal or on measurement to fair value less costs to sell. This amount is analysed into the revenue, expenses, pre-tax profit, tax, any pre-tax gain/loss and the associated tax, but this analysis may be presented in the notes. The net cash flows attributable to the operating, investing and financial activities of the discontinued operation must also be disclosed.

Issues for Investors

Classifying businesses as discontinued may flatter headline EPS figure

Investors may have some concerns that companies can use the re-classification of a business as a discontinued operation as a way of excluding losses or poor performance from the main part of the P&L and from a “continuing EPS” figure. In some cases businesses may continue to be classified as discontinued even if they are not sold within a year.

Although stripping discontinued businesses out of the main part of the P&L may help investors forecast the results of the continuing business, the performance of the discontinued business should not be forgotten as this affects total cash flows and returns to shareholders. In addition stripping out poorer performing businesses as discontinued may give a flattering impression of the group's overall performance.

Measuring businesses held for sale at fair value less costs to sell may be helpful for sum-of-the-parts valuations.

IFRS 6: Exploration for and Evaluation of Mineral Resources

Limited accounting guidance for extractive industries

This is a limited standard and as a result investors may see divergence in accounting practices amongst companies in the extractive industries.

Main Points of the Standard

Standard only covers exploration and evaluation costs

The standard only applies to exploration and evaluation expenditures but not to other aspects of accounting by companies in this sector. Exploration and evaluation assets are measured initially at cost. The standard gives examples of costs which might be included in calculating these assets, such as acquisition of rights to explore, geological studies, exploratory drilling, and other activities relating to evaluating the technical feasibility and commercial viability of mineral extraction.

After initial recognition, exploration and evaluation assets are measured using either the cost model (ie cost less depreciation/amortisation and any impairment) or the revaluation model (ie regularly revalued to fair value).

Issues for Investors

No IFRS guidance on reserves

Current IFRS does not contain any guidance on calculating reserves and resources, although various jurisdictions provide specific codes. These estimates are used in the calculation of various figures in the accounts, such as depreciation, amortisation, impairment, provisions for site rehabilitation, and stripping costs. Reserves and resources figures depend on important assumptions such as commodity prices.

Inconsistent capitalisation

Different companies may not capitalise the same costs within exploration and evaluation assets, and they may not use the same accounting policy for stripping costs. Since some companies in extractive industries capitalise a higher proportion of their costs than others, return on capital comparisons may be distorted.

Comprehensive standard many years away

In April 2010 the IASB published a Discussion Paper, *Extractive Activities*. The IASB will decide whether to add this project to its active agenda in 2011. In practice this means that a comprehensive accounting standard is several years away. However, the IASB's Interpretation Committee, IFRIC, recently issued proposed guidance on the accounting for stripping costs⁹ to address the current diversity in practice in this specific area.

⁹ Draft IFRIC Interpretation: *Stripping Costs in the Production Phase of a Surface Mine*, issued 26 August 2010. Stripping is the removal of mine waste materials to access mineral deposits.

Mandatory disclosures about financial instruments

IFRS 7: Financial Instruments: Disclosures

This is a disclosure-only standard: it does not affect actual accounting, only what information must be provided about financial instruments. It was issued in 2005 (replacing IAS 30 and parts of IAS 32) and became mandatory in 2007. It has been amended subsequently in response to the credit crisis. The IFRS 7 disclosures are intended to inform investors about both the importance of financial instruments to a company and the potential risks arising from them.

Main Points of the Standard

IFRS 7 applies to all financial instruments, apart from exceptions such as investments in subsidiaries, associates and joint ventures (covered by IAS 27, IAS 28 and IAS 31); instruments arising from pension plans (IAS 19), insurance contracts (IFRS 4) and share-based payments covered by IFRS 2. It applies to all companies not just banks.

Disclosures required by IFRS 7 include:

- Financial assets and liabilities by accounting category (eg fair value through P&L, available for sale, amortised cost)
- Disaggregated information about financial income, expense and impairment
- Details of any reclassifications between accounting categories
- The fair value of each class of financial asset and liability so this can be compared with the carrying amount
- Fair values categorised as level 1 (quoted prices), level 2 (fair value based on observable inputs) or level 3 (based on unobservable inputs)
- Information about assets pledged or held as collateral
- Qualitative and quantitative information about cash flow hedges and fair value hedges
- Credit risk information, including analysis of assets past due or impaired
- Liquidity risk information, including maturity analysis of financial liabilities
- Market risk information, including sensitivity analysis for each type of market risk, or that reflects interdependencies (eg value-at-risk)

Issues for Investors

Information such as the fair value hierarchy (instruments categorised into levels 1, 2, and 3) received considerable attention during the credit crisis¹⁰. The quality of information provided varies between banks, but generally compliance has been improving, probably partly due to greater attention from regulators. IFRS 7 disclosures are only required annually so the infrequency and delay in reporting may reduce the value of the information to investors.

Importance of fair value disclosures highlighted in credit crisis

¹⁰ In fact the level 1/2/3 fair value hierarchy was a US requirement but not an IFRS requirement during 2007/08 – IFRS 7 was amended to include this disclosure in 2009.

New segment reporting standard in 2009, taking “through eyes of management” approach

IFRS 8: Operating Segments

This standard became mandatory in 2009. It largely adopted the segment disclosure requirements of US GAAP (SFAS 131) into IFRS. It is a disclosure-only standard. While the previous segment reporting standard IAS 14 was more prescriptive, IFRS 8 emphasises presenting information as seen “through the eyes of management”.

Main Points of the Standard

An operating segment is a component of the business which engages in business activities to earn revenues and whose operating results are regularly reviewed by the **chief operating decision maker** (eg CEO or board) to make decisions about resource allocation and to assess performance. Operating segments may be combined if they have similar economic characteristics and the segments are similar in respect of products and services, types of customer, production process and distribution.

Segment information must be provided if the resulting operating segment or combination of segments meets a 10% threshold for revenue, profit or loss or assets. Segments not meeting the thresholds can be combined in an “other segments” category, but this category cannot exceed 25% of total revenues.

Segment profit does not have to be an IFRS figure

Companies must report a measure of profit or loss for each reportable segment¹¹. Other items are required if regularly reported to the chief operating decision maker or if included in the measure of segment profit or loss, including

- Revenues (internal and external)
- Total assets and liabilities
- Depreciation and amortisation
- Material items disclosed in accordance with IAS 1 (ie exceptional items)

Geographic disclosure is only required for revenues and for non-current assets (at least for home country and other material countries). The company must also disclose whether any customers represent more than 10% of revenues, though it does not have to disclose their identity.

Issues for Investors

IFRS 8 has the advantage of being consistent with internal management information, but may reduce comparability between companies.

What does segment information say about company management?

Investors should consider if it is reasonable for the company to manage the business on the basis of the disclosed segmentation and the chosen profit measure. Some companies still only disclose one segment, which may be reasonable for a smaller or simple business but probably not for a complex international group.

Overall the switch from IAS 14 to IFRS 8 has had less impact than expected.

¹¹ This can be a non-GAAP measure of profit. However reconciliation of total segment profit to an IFRS profit measure such as profit before tax is required.

IFRS 9: Financial Instruments

Successor to IAS 39 not yet in use in Europe

*IFRS 9 will replace IAS 39, but is being published in phases. Classification and measurement of financial assets and liabilities rules have been finalised, but sections on impairment rules and hedge accounting are still in progress¹². The effective date of IFRS 9 is 1 January 2013, but early adoption is permitted. However, the EU has not yet endorsed IFRS 9, so **no EU listed companies can use it yet**. We do not expect EU endorsement until late 2011 or 2012.*

Main Points of the Standard

IFRS 9 will allow financial assets to be categories in one of three ways as shown in Figure 3.

Figure 3. IFRS 9 Classification of Financial Assets

Category	Includes	Accounting
FV through P&L	Default category, including all derivatives	Marked to market through P&L
Fair value through OCI	Equities (only if companies make election)	FV on balance sheet. Dividends through P&L.
Amortised cost	Debt instruments meeting business model and cash flow criteria	Amortised cost

Source: IASB, CIRA

All debt instruments at amortised cost or fair value through P&L

Debt instruments will be measured at amortised cost if

- The business model is to hold them for collection of contractual cash flows
- The contractual terms give rise to cash flows on specified dates that are solely payments on principal and interest

New category for equities

All other instruments will be measured at fair value through P&L, with one limited exception for some equities. Equities may be held at fair value through Other Comprehensive Income (OCI) if an irrevocable election is made to this effect when the equity asset is first recognised, and it is not held for trading. Equities held at fair value through OCI are shown at fair value on the balance sheet; dividends are reported in the P&L but all other gains or losses are recognised in OCI, whether or not they are realised. For details of the current accounting for amortised cost instruments or those at fair value through P&L, see IAS 39 (page 54).

Addressing “own credit” gains and losses

The accounting for financial liabilities is largely unchanged from IAS 39, apart from an exception relating to financial instruments measured at fair value through P&L due to a fair value option. The change in fair value in these liabilities which arises from own credit risk will be recognised in other comprehensive income (in IAS 39 the whole movement in fair value is recognised in P&L).

Issues for Investors

At present this standard is generally not in use and we do not expect many companies to apply IFRS 9 until it becomes mandatory in 2013. However, we see several important issues for investors:

¹² For more details on IFRS 9, see our report *Financial Instruments Accounting: Current State of Play*, dated 14 September 2010.

More bonds at amortised cost

Amortised cost vs fair value: We think that when IFRS 9 is adopted, it may on average result in a higher proportion of banks' and insurance companies' balance sheets being measured at amortised cost rather than fair value. Under IAS 39, bonds quoted in an active market can only be measured at amortised cost if they are held to maturity, which is highly restrictive, whereas IFRS 9 will allow bonds to be measured at amortised cost if the business model and contractual cash flow tests are met. In our view this will typically result in less useful information for investors because for quoted bonds we believe the market price is the most value-relevant information.

Some realised gains/losses excluded from P&L

New accounting for equities: The new Fair Value through OCI category for equities is in our opinion likely to cause some confusion for investors because some realised gains or losses (on the sale of equities) will never be recognised in the P&L.

One-off restatements: When companies adopt IFRS 9 for the first time, it may result in a significant restatement of balance sheets (some assets being reclassified from fair value to amortised cost and vice versa).

Timetable: We expect the rest of IFRS 9 to be finalised in 2011. New rules on loan impairments will be particularly important for banks. A revised impairment proposal is expected to be published jointly with FASB during January 2011. New rules on hedge accounting may affect a broad range of companies which undertake hedging activity.

Can IASB/FASB converge?

Convergence: The IASB and FASB had been asked to converge their accounting standards for financial instruments. However at the time of writing, IFRS 9 is significantly different from the FASB's financial instrument Exposure Draft and it is unclear whether the Boards will be able to achieve convergence¹³. It would be helpful if the two Boards could converge standards to enable easier comparisons of (for example) European and US banks.

¹³ However, the recent appointment of Leslie Seidman as FASB Chairman may indicate that the FASB will make significant changes to its financial instrument proposals, removing some differences with IFRS 9.

IAS 1: Presentation of Financial Statements

Basic framework for financial statements

This standard sets a framework for what constitutes a complete set of financial statements in IFRS. For example it specifies what (minimum) line items should be included in each financial statement. It also describes the general features of financial statements: ie fair presentation and compliance with IFRSs, prepared on an accrual basis, etc. The IASB is currently working on a project on financial statement presentation to replace IAS 1 and IAS 7.

Main Points of the Standard

IFRS financial statements must contain:

- Statement of financial position (balance sheet)
- Statement of comprehensive income either as two statements (income statement and statement of comprehensive income) or one statement
- Statement of changes in equity
- Statement of cash flows
- Notes, including disclosure of accounting policies, the most significant accounting judgements and major sources of estimation uncertainty

Operating profit not required or defined

The P&L must include line items for revenue, finance costs, associates/JVs using the equity method, tax, discontinued operations, profit or loss. Operating profit is not a required line item, because operating profit is not defined in IFRS. Expenses may be analysed (in the P&L or in the notes) either by nature of expense (eg raw materials, employee costs, depreciation, etc) or by function of expense ("cost of sales" method).

Exceptional items not defined

The term "exceptional items" is not used in IFRSs, but material items such as write-downs, restructuring charges, and property gains/losses should be disclosed separately.

The balance sheet must contain certain specified line items and must present current and non-current assets and liabilities separately. Requirements for the cash flow statement are set out in IAS 7.

"True and fair override" exists, but extremely rare

IAS 1 also states that if in "extremely rare circumstances" management concludes that compliance with an IFRS would be so misleading that it would conflict with the objective of financial statements, it may depart from the requirement. This is sometimes known as a "true and fair override". We are aware of only a few instances of this amongst listed European companies.

Issues for Investors

Lack of prescription causes problems in practice

The IAS 1 requirements are not very prescriptive which means reduced comparability of key metrics such as operating margin. For example, pension costs may be classified within operating costs or split between operating and financial costs. The failure to define exceptional items also leads to wide variation in practice.

The IASB and FASB are working on a project on Financial Statement Presentation to converge and improve presentation requirements but this has been delayed (further Board discussions deferred until after June 2011), so we do not expect the resulting standard to take effect for several years.

IAS 2: Inventories

This standard sets out how to value inventories (often called stock in the UK).

Main Points of the Standard

Inventories at lower of cost and NRV

Inventories are measured at the lower of cost and net realisable value (NRV). NRV is the estimated selling price less costs of completion and sale. Cost may be determined on a first-in, first-out (FIFO) basis or at weighted average cost. Last-in, first-out (LIFO) is not permitted in IFRS though it is permitted in US GAAP.

Costs of inventories include an allocation of fixed (eg depreciation) and variable (indirect materials and indirect labour) production overheads. In times of high production, the amount of fixed overhead allocated to each unit of production is reduced so that inventories are not measured above cost. At low production, the fixed overhead allocation is not increased. Any unallocated overheads are charged to the P&L.

Inventory write-downs may be reversed subsequently.

Issues for Investors

LIFO not permitted

The use of FIFO accounting means that balance sheet figures are current, but in some circumstances LIFO (which is not permitted in IFRS) may give a better indication of current profitability. Differences between LIFO and FIFO will be greater in times of inflation.

Overhead absorption effects may affect profitability at times of high or low production. Inventory write-downs are sometimes classified as “exceptional charges” but this can flatter the underlying profit record.

IAS 7: Statement of Cash Flows

IAS 7 sets out requirements for the cash flow statement, which reconciles the opening and closing cash position, and categorises cash flows into operating, investing and financing.

Main Points of the Standard

Cash flows classified
operating/investing/financing; can be
direct or indirect presentation

The cash flow statement reports cash flows classified into operating, investing and financing activities. Operating cash flows may be presented directly (eg cash in from customers, cash out to suppliers) or indirectly (profit or loss adjusted for non-cash items).

Lack of standardisation

IAS 7 is relatively un-prescriptive about cash flow classifications. For example, interest and dividends paid may be classified as operating or financing and interest and dividends received may be classified as operating or investing.

If a joint venture is proportionately consolidated, then the cash flow statement includes the proportionate share of the JV's cash flows. If a JV is accounted for using the equity method, only dividends received are recognised.

The cash flow statement reconciles the opening and closing total of cash and cash equivalents. Cash equivalents are "short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value".

IAS 7 requires disclosure of any cash or cash equivalents that are not available for use by the group eg due to legal restrictions, exchange controls, etc.

Issues for Investors

Inconsistent starting point

In Europe, almost all cash flow statements are presented using the indirect method, ie reconciling profit to cash flow from operating activities. Some companies start from net income while others start from operating profit (or another profit measure), which can be confusing and reduce comparability.

The IASB is likely to replace the current cash flow format as part of its Financial Statement Presentation project, but we do not expect a new standard to be effective for several years. The IASB is considering making direct cash flow statements mandatory.

No net debt reconciliation

One major frustration for investors is the **lack of reconciliation to net debt**. Although the cash flow statement reconciles the movement in cash, other changes (such as currency translation and the effect of acquisitions on debt) can affect the net debt movement. Some companies provide a reconciliation of net debt but this is not mandatory. Note that net debt is not a defined term in IFRS so net debt figures are not necessarily comparable (eg whether to include derivative assets/liabilities, whether to include investments other than cash equivalents, etc).

Adjust for restricted cash in valuation
metrics

Investors should note any **restricted cash** and exclude this from net debt or enterprise value calculations, in our view.

Accounting policies such as capitalisation of costs can affect the cash flow presentation. For example, development spending which is capitalised on the balance sheet will be classified as investing cash flows, while development costs which are expensed will be classified as operating cash flows.

**Operating profit and cash flow from
operating activities not comparable**

Finally, analysts sometimes compare operating profit and cash flow from operating activities, but the two figures are not comparable, for example:

- Cash flow from operating activities is after tax and may include interest paid and received, and dividends paid or received, while operating profit is before tax and financial income/expense
- Cash flow from operating activities is before cash flows on capitalised development while operating profit is after the associated amortisation charges
- Cash flow from operating activities is before capex but operating profit is after depreciation costs.

IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors

IAS 8 describes how accounting policies can be changed and what information has to be provided, and how errors should be corrected and disclosed.

Main Points of the Standard

Accounting policies should be determined by applying the relevant IFRS. If there is no relevant IFRS, management shall use judgement in developing a policy that results in relevant and reliable information for investors. Management should consider the requirements of IFRSs dealing with similar issues, and then consider the guidance in the IASB Framework. Accounting guidance from other standard-setters (eg FASB) may be considered if it does not conflict with IFRSs or the Framework.

Accounting policy changes and corrections of errors usually applied retrospectively; change in estimates applied prospectively

Accounting policies should be applied consistently and only changed if required by an IFRS or if the change will result in reliable and more relevant information. Accounting policy changes are normally applied retrospectively unless the IFRS requires otherwise. Various disclosures are required when an accounting policy is changed, including the nature of the change and the impact on each line item for the current period and each prior period presented.

When a new IFRS has been issued but has not yet been applied by the company, it should disclose this together with information to assess the possible impact will have on the financial statements when applied or a statement that the impact is not known or reasonably estimable.

Changes in accounting estimates, such as a reassessment of the useful life of a depreciable asset, are applied prospectively. Material errors are corrected by retrospective restatement unless impracticable.

Issues for Investors

Watch out for restatement red flags

Accounting restatements should be considered carefully by investors. Many investors consider restatements, whether due to errors or a change in accounting policy, to be a possible “red flag”. Does the restatement give a new impression of previous years’ results, and will future years’ profits be higher as a result of the restatement?

Accounting errors are relatively rare. Errors may suggest weaknesses in financial reporting and controls.

If a company will be affected in future by a new IFRS, it is worth checking the notes for the company’s view on the potential impact, although unfortunately these are usually unhelpful “boilerplate” disclosures.

Treatment of events after balance sheet date but before accounts issued

IAS 10: Events after the Reporting Period

IAS 10 covers the treatment of events which occur after the balance sheet date but before the financial statements are signed.

Main Points of the Standard

Events after the reporting period are those that occur after the balance sheet date and the date when the financial statements are authorised for issue. These events are either **adjusting events**, which affect the amounts in the financial statements, or **non-adjusting events**, which do not affect the amounts in the financial statements but which should be disclosed.

Adjusting events are those that provide new information about the assets or liabilities at the balance sheet date. Examples include:

- Bankruptcy of a customer (indicating a trade receivable impairment existed at year end)
- Determination of profit-sharing or bonus amounts
- Settlement of a court case
- Sale of inventories indicating impairment at year end.

Non-adjusting events must be disclosed, together with an estimate of the financial effect (or a statement that an estimate cannot be made). Examples include:

- Acquisitions
- Major restructurings
- Plans to discontinue a business
- Significant changes in tax laws
- Entering into significant commitments.

Issues for Investors

In practice most major non-adjusting post-balance sheet events (such as acquisitions) will already have been announced in accordance with listing rules, or will already be known to the market (eg tax law changes).

Acquisitions, restructuring, disposals, etc, must be disclosed

IAS 11: Construction Contracts

This is one of two standards covering revenue recognition (the other is IAS 18). IAS 11 describes “percentage of completion” accounting for construction contracts.

Main Points of the Standard

Stage of completion accounting for construction contracts

A construction contract is one “specifically negotiated” for the construction of an asset. When the outcome of the contract can be estimated reliably, revenues and costs are recognised by reference to the stage of completion. If a contract is expected to be loss-making, the expected loss must be recognised immediately.

Stage of completion may be assessed by:

- Proportion of costs incurred (most common method in our experience)
- Physical proportion of work completed

Contract revenue is the initial amount agreed in the contract, together with any probable variations or incentive payments. Contract costs include costs that relate directly to the contract or are chargeable to the customer, and allocated general contract related costs (eg insurance, overheads).

Example: A contract is expected to incur total costs of 80 and revenues of 100. In the first year, costs of 32 (ie 40% of total contract costs) have been incurred. It also received a payment of 50 from the customer. The company reports revenues of 40, costs of 32 and profit of 8 on the contract. The balance sheet shows a contract liability of 10.

IFRIC 15 (*Agreements for the Construction of Real Estate*), effective in the EU from 2010, provides guidance about when IAS 11 or IAS 18 applies. IFRIC 15 specifies that IAS 11 applies if the customer is able to specify major structural elements or the design or make major structural changes (whereas most “off plan” purchases involve buying a standard product). IFRIC 15 applies to real estate construction but may be applied in other industries by analogy.¹⁴

Issues for Investors

Greater reliance on accounting estimates = higher risk for investors

Percentage of completion accounting means that companies can report significant revenues and profits on contracts before the final outcome is known. This can sometimes lead to large profit warnings occurring towards the end of contracts. IAS 11 accounting is particularly dependent on management estimates so investors should look at a company’s track record in estimating the outcome of contracts accurately. The timing of cash flows may also differ markedly from reported revenues.

Watch out for abolition of percentage of completion accounting

The IASB is working on a new IFRS on revenue recognition which will replace IAS 11 and IAS 18 (see page 4). We expect that percentage of completion accounting will be abolished and revenue recognition will be based on the transfer of control to the customer, although in some cases the pattern of revenue and profit recognition will be similar to current outcomes. However in other cases companies will have to delay revenue recognition to contract completion.

¹⁴ For example, see our report *Vestas Wind Systems: Brought to Account ...*, dated 30 November 2010, for discussion of the application of IFRIC 15.

IAS 12: Income Taxes

IAS 12 covers accounting for both current and deferred taxes.

Main Points of the Standard

IAS 12 covers current and deferred taxes on income

IAS 12 covers income taxes payable on taxable profits and taxes on distributions to the reporting entity (eg withholding taxes on dividends). This means it does not cover other taxes such as sales taxes, employer taxes on employee salaries or bonus pool taxes.

Current tax is the amount of income taxes payable or recoverable on the taxable profit or loss for a period. Deferred tax is the tax payable or recoverable in future periods in respect of temporary differences, tax losses or tax credits.

Temporary differences are differences between the balance sheet amount of an asset or liability and its tax base (the value attributed to it for tax purposes). Temporary differences can be taxable (implying higher current tax in future) or deductible (implying lower current tax in future).

Example: Suppose a machine was purchased for 1000 with an accelerated tax allowance available, so it would be depreciated for tax purposes over 2 years, but for accounting purposes it is depreciated over 5 years (both straight line). After one year, the tax base would be 500 but the net book value would be 800. This results in a taxable temporary difference of 300. Assuming a tax rate of 30%, the deferred tax liability on the temporary difference would be 90 (300x30%).

Deferred tax liabilities are recognised for all taxable temporary differences. Deferred tax assets are only recognised on deductible temporary differences, tax losses and tax credits, if it is probable that taxable profits will be available against which they can be offset. Note that the existence of unused tax losses is “strong evidence” that future taxable profits may not be available. Companies are required to disclose information about tax losses, temporary differences and tax credits for which no deferred asset has been recognised.

Deferred tax assets and liabilities are measured at the tax rates expected to apply when they are realised/settled, based on tax laws “enacted or substantively enacted” by the balance sheet date.

IAS 12 prescribes disclosures intended to help investors understand the tax position, such as a numerical reconciliation between the tax expense and the profit before tax multiplied by the tax rate.

Issues for Investors

Deferred tax can be considered an application of the matching principle

Deferred tax is a poorly understood subject amongst investors. Simplistically, it can be considered as an application of the matching principle – current tax can vary substantially from normal tax rates due to use of tax losses, investments, etc, but deferred tax smoothes out many of these timing differences.

We recommend reviewing the major categories of deferred tax assets and liabilities and considering the implications for future cash flows. For example:

- Deferred tax liabilities relating to fixed assets may crystallise if tax rules change or the company invests less in future

- Tax losses may imply low cash tax rates in future as losses are utilised, but the impact may depend on jurisdictions and expiry of loss carry-forwards
- Pension deficits should be included in valuations net of any associated deferred tax assets (in many jurisdictions corporate pension contributions are tax deductible when paid)

In addition companies may have “off balance sheet deferred tax assets”, eg if it is uncertain whether tax losses can be utilised. These unrecognised potential deferred tax assets may have some value.

It is important to distinguish between tax losses or temporary differences and the resulting deferred tax assets. For example a tax loss of 100 gives rise to a deferred tax asset of 30 (at a 30% tax rate).

IAS 16: Property, Plant and Equipment

IAS 16 covers accounting for fixed assets, such as depreciation methods.

Main Points of the Standard

Cost model or revaluation model

Tangible fixed assets are measured initially at cost. Subsequently they can be measured using a cost model (cost less depreciation and any impairment) or a revaluation model.

Revaluation gains in OCI, losses in P&L

If the revaluation model is applied, revaluations must be carried out “with sufficient regularity to ensure that the carrying amount does not differ materially” from fair value. If one item of property plant and equipment (PP&E) is revalued, the whole class of such assets must be revalued. Decreases in valuation are recognised in P&L (unless they reverse a previous increase recognised in OCI) while increases in valuation are recorded in Other Comprehensive Income (unless they reverse a previous decrease recognised in P&L).

Cost, less residual value, should be depreciated on a systematic basis over the useful life. The depreciation method, which can be straight line, diminishing balance, or another method, should reflect the pattern in which the asset’s economic benefits are expected to be consumed.

Issues for Investors

In practice, the revaluation model is fairly rare for property, plant and equipment. Most companies use the cost model. There is no requirement to disclose fair values of fixed assets, although this would be useful.

Straight line depreciation is far more common than other depreciation methods. Unfortunately it can be difficult to check if companies within a sector are using comparable depreciation periods, because the useful lives are often disclosed as broad ranges.

IAS 17: Leases

IAS 17 covers the accounting for both lessees and lessors. Leases are classified into finance leases (on the lessee's balance sheet) and operating leases (off balance sheet). The IASB is planning to issue a new IFRS on Leases in 2011.

Main Points of the Standard

A lease is "an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time". Some arrangements may not take the legal form of a lease but still fall within the scope of IAS 17¹⁵.

Finance lease transfers risks and rewards of ownership

A **finance lease** is a lease that transfers "substantially all" the risks and rewards of ownership. Likely indicators include:

- Ownership transferring at the end of the lease, or an option to buy the asset for much less than market price at the end of the lease
- Lease term being the major part (typically interpreted as 75%+) of the economic life of the asset
- Present value of minimum lease payments being substantially all (eg 90%+) of the fair value of the asset

At the start of the lease, the lessee reports an equal asset and liability, which are measured as the lower of the fair value of the asset and the present value of the minimum lease payments. The asset is depreciated over the shorter of the lease term and the life of the asset (if the asset will not be acquired at the end of the lease). The lessee also reports an interest charge on the lease liability.

Operating leases are off-balance sheet and cost is spread evenly over lease term

An **operating lease** is any lease which is not a finance lease. The lease payments are charged as an expense over the lease term, usually on a straight line basis.

IAS 17 also covers the accounting for lessors, which is largely symmetric with the lessee accounting. If the lessor grants an operating lease, the asset remains on the lessor's balance sheet. The income from the operating lease is usually recorded on a straight line basis.

Lessors that have granted finance leases have transferred the risks and rewards of ownership. Therefore the asset is no longer on the lessor's balance sheet, but it reports a receivable equal to the net investment in the lease. The financial income from the lease is allocated on a systematic basis reflecting a constant periodic return on the net investment in the lease.

¹⁵ Guidance is provided in IFRIC 4, *Determining whether an arrangement contains a lease*.

Issues for Investors

IAS 17 has been criticised because two similar leases may be treated very differently depending on the operating/finance lease classification. This affects key metrics such as net debt, gearing, operating profit and enterprise value multiples. In addition comparisons between companies which buy assets and those which lease them can be distorted. In some sectors (eg retail) analysts routinely produce “lease-adjusted” metrics such as EV/EBITDAR, with leases capitalised in the enterprise value. However, current estimates of operating lease liabilities may be imprecise due to the limited information currently available.

Forthcoming IFRS to bring all leases on balance sheet

The IASB’s Exposure Draft on Leases proposes abolishing the distinction between operating and finance leases (at least for lessee accounting) and bringing all leases on lessees’ balance sheets. This should improve comparability and also provide more detailed information about lease exposures. Although the IFRS is likely to be issued in June 2011, we do not expect the new standard to be mandatory until 2013 at the earliest.

For more information, see *Bringing Leases on Balance Sheet: Proposed Elimination of Operating Lease Accounting*, dated 18 August 2010. For lists of exposed stocks, please see Appendix 1.

IAS 18: Revenue

IAS 18 covers revenue accounting, except for construction contracts covered by IAS 11. The IASB plans to replace IAS 18 and IAS 11 in a comprehensive new standard on revenue.

Main Points of the Standard

Guidance on revenue from sale of goods

Revenue is recognised from the sale of goods when:

- The significant risks and rewards of ownership have been transferred
- The seller no longer has effective control over or involvement with the goods
- Revenue can be measured reliably
- The economic benefits are probable, and
- Costs can be measured reliably

In many cases this is straightforward, eg when the customer takes delivery of the goods, but some situations can be more complicated (eg goods delivered but still subject to conditions).

Revenue for services can be on “stage of completion”

Revenue is recognised for services provided on a “stage of completion” basis (as in IAS 11 for construction contracts) if the revenue, costs and stage of completion can be measured reliably, and if the economic benefits are probable.

IAS 18 contains some illustrative examples for more difficult situations (eg whether revenue should be recognised for goods shipped subject to conditions). However it contains relatively little detailed guidance.

Issues for Investors

No detailed industry-specific guidance (unlike US GAAP)

IAS 18 is a general principles-based standard and, unlike US GAAP, does not contain detailed industry-specific revenue recognition rules. The lack of detailed guidance means more reliance on management judgment, and so companies may account for similar transactions in dissimilar ways. Some companies apply more specific US GAAP guidance to the extent it is consistent with IAS 18 principles.

Unfortunately for investors, it is very hard to assess if companies are applying reasonable revenue policies or what the impact would be if they changed policy, from the information published in annual reports.

More focus on revenue recognition as new standard gets closer

The IASB is expected to publish a new Revenue IFRS in June 2011 and although this will not be mandatory until 2013 at the earliest (probably later), it may increase investor scrutiny of industries with less transparent revenue recognition (eg long-term contract accounting, bundled sales of goods and services, etc).

Key standard for investors due to valuation impact, complexity, and sensitivity to assumptions

IAS 19: Employee Benefits

For investors, IAS 19 is important for specifying the accounting for defined benefit pensions and other post-employment benefits. We receive many questions about IAS 19 due to its complexity, the relevance of pensions to many companies' valuations, and the sensitivity of deficits to key assumptions.

Main Points of the Standard

Pension liabilities are measured as the estimated future cash flows discounted at a high quality (AA) corporate bond discount rate of appropriate currency and duration. Pension assets are measured at fair value.

Mark-to-market or corridor method

IAS 19 offers two possible methods for accounting for pensions. Using the more common method (which could be described as the mark-to-market method), the difference between the pension assets and liabilities (the deficit or surplus) is reported on balance sheet¹⁶.

The alternative method (corridor method) allows some deficit or surplus to remain off-balance sheet. The corridor method specifies that actuarial gains or losses each period can remain off-balance sheet if they are less than the "corridor" of 10% of the greater of pension assets and liabilities. Any gains or losses in excess of the corridor are recognised on the balance sheet, through the P&L, over many years. As a result, the corridor method results in meaningless pension assets or liabilities on the balance sheet.

P&L charge components

The main components of the P&L charge are:

- Service cost (ie the value of the pension benefits earned in the year)
- Expected return on pension assets
- Interest on pension liabilities
- Amortisation of actuarial gains/losses (if using the corridor method)

In some cases other charges may arise from changes to the pension such as settlements or curtailments.

If the mark-to-market method is used, actuarial gains and losses (the difference between the P&L charge and the full mark-to-market movement in the balance sheet) are booked in Other Comprehensive Income.

Issues for Investors

IAS 19 gives several potential problems for investors:

Pensions can flatter earnings

1. **Earnings flattered.** Companies' earnings may be flattered if they have a large pension scheme, because the % expected return on pension assets usually exceeds the interest rate charged on the liabilities. This means that even a company with a deficit may report a net pension financial income.

¹⁶ Note that a pension surplus is only reported on balance sheet if the company will derive an economic benefit from it eg due to refunds or lower future contributions. Additional guidance is provided in IFRIC 14.

2. **Off balance sheet liabilities.** Companies which use the corridor method may have off-balance sheet assets or (more commonly) liabilities. Investors wishing to include the pension deficit/surplus in valuations have to check the notes to the accounts.
3. **Inconsistent classification of pension costs.** IAS 19 does not specify where pension costs are reported in the P&L. Some companies report all pension costs within operating profit while others report service cost within operating costs and expected return on asset/interest on liabilities within financial income/expense.
4. **After-tax deficit unclear.** Although many investors wish to include after-tax deficits in company valuations, IAS 19 does not require disclosure of the net-of-tax pension deficit. IAS 12 requires disclosure of deferred tax assets by major category but nevertheless the tax associated with a pension deficit is not always disclosed. In some cases, there will not be any associated tax asset, so it would not always be appropriate to apply (1-tax rate) to the deficit.
5. **Lack of information about other measures of pension deficit.** The estimate of pension liabilities is highly sensitive to many assumptions (mortality, discount rate, inflation, salary increases, etc). Some investors/analysts may prefer to use or at least consider other measures of the pension liability such as the funding deficit (which determines cash contributions) or buy-out deficit (the valuation which an insurer would apply if considering acquiring the liability). However these are not required to be disclosed.

Include net of tax deficit like debt in EV
and deduct from DCFs

We recommend including the net-of-tax pension deficit within company valuations, ie including in the enterprise value for EV multiples and deducting from DCF valuations as a debt-like liability. While the IAS 19 measure is certainly not perfect, it is the only consistently disclosed measure of the pension deficit.

If the pension scheme is material to the company's valuation we recommend checking the IAS 19 disclosures in the annual report, such as:

- Disclosure of pension asset mix – this shows the risk in the asset portfolio and any hedging of the liabilities
- Key assumptions such as discount rate, inflation and mortality assumptions which affect the liability (discount rate and inflation assumptions should be close to standard benchmarks; mortality assumptions are harder to assess)
- The expected return on assets – a high expected return can flatter earnings
- Sensitivity of the liability to changes in discount rate, inflation and mortality assumptions – this allows us to estimate updated deficits during the year

Forthcoming changes

The IASB is planning to issue an amended pension standard in Q1 2011, which we do not expect to be mandatory until 2013. The new standard is likely to make two main changes:

- Abolish the corridor rule – this should simplify pension accounting
- Replace the expected return on assets and interest on liabilities with a notional interest charge on the deficit or surplus – this will reduce earnings on average, make the earnings figure somewhat more meaningful and should improve comparability between companies somewhat.

IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

This standard permits some government grants to be shown as income in the P&L, whereas others are offset against assets (thus reducing depreciation).

Main Points of the Standard

Government grants are assistance from the government (transfer of cash or other assets) in return for the company complying with certain conditions, such as the company investing in a particular area.

Grants relating to assets may be accounted for in one of two ways:

1. Deducting the grant from the carrying amount of the asset (thus reducing future depreciation)
2. Reporting the grant as deferred income (a liability) and then recognising the income over the useful life of the asset

Other grants should be recognised in P&L systematically to correspond to the related costs (ie those which the grant is intended to compensate). They may be presented in one of two ways:

1. Showing the grant as "other income"
2. Deducting the grant from the related expense

Issues for Investors

We do not receive many questions on this standard. However, it is worth noting the extent to which a company has received government support, particularly if it may not be available in future. Grants may also create significant timing differences between profit and cash flow, and it may not be clear where they have been reported in the cash flow statement.

Grant can be liability or reduction in asset on balance sheet

Grant may be presented as income or reduction of expense in P&L

IAS 21: The Effects of Changes in Foreign Exchange Rates

This standard describes how to incorporate foreign currency transactions and foreign operations into the financial statements.

Main Points of the Standard

IAS 21 applies to accounting for both foreign currency transactions and for translating the results of foreign subsidiaries included in the group accounts.

Reporting foreign currency transactions

Foreign currency transactions are translated into the functional currency as follows:

- Transactions are initially translated at the spot rate (in practice monthly averages may be applied)
- Monetary balance sheet items (eg cash, receivables, debt) are translated at the closing rate
- Other balance sheet items (eg tangible or intangible fixed assets) are translated at the exchange rate applying at the transaction date, ie they are not retranslated
- Exchange gains/losses arising from settlement or translation of monetary items (at different rate from initial recognition) are reported in P&L

Translating foreign subsidiaries

When a subsidiary is translated into the parent's currency for the group accounts, the following steps are applied:

- Assets and liabilities are translated at the balance sheet date closing rate
- The P&L is translated at the exchange rate at the transaction dates (may be approximated by average rate)
- Resulting exchange differences are reported in Other Comprehensive Income

There is additional guidance for translating a subsidiary in a hyperinflationary economy to which IAS 29 applies.

Issues for Investors

Major item in OCI

Exchange differences are often a large item in Other Comprehensive Income, ie balance sheet movements which bypass the P&L. Balance sheets may be volatile due to year-end retranslation of subsidiaries.

Some exposures are hedged

Transactional risk is often hedged (see also IAS 39 for hedge accounting rules) while translational risk may be reduced by matching foreign currency investments and borrowings.

IAS 23: Borrowing Costs

Some interest costs must be capitalised

Borrowing costs associated with the creation of certain assets which take a long time to construct or get ready must be capitalised (prior to 2009, companies had a choice of capitalisation or expensing these costs). This affects interest coverage ratios.

Interest costs included in cost of assets which take a long time for the company to construct

Main Points of the Standard

Borrowing costs (ie interest) associated with constructing or producing any asset that “takes a substantial period of time to get ready for its intended use or sale” must be capitalised.

The costs to be capitalised are either the actual costs on borrowing directly attributable to the asset, or the company’s average borrowing cost rate multiplied by the expenditure on the asset (not to exceed the actual borrowing cost incurred).

Borrowing costs start to be capitalised when the company has started activities relating to the asset, has incurred costs related to the asset, and has incurred borrowing costs. Borrowing costs are no longer capitalised once the asset is ready for intended use or sale. Capitalisation should also be suspended if active development of the asset is suspended for extended periods.

Issues for Investors

The intention of this standard is to make internally produced or constructed asset values more comparable with that of purchased assets. For example, if a newly constructed asset is purchased, the purchase price will implicitly reflect the financing costs of the developer. Capitalised interest costs are eventually charged to the P&L (usually in the form of higher depreciation) and this can be seen as matching the income arising from use of the asset.

Need to adjust interest coverage ratios

However, the disadvantage for investors is that the P&L interest costs understate the cash interest costs. This affects interest coverage ratios; P&L interest charges should be adjusted to reflect capitalised interest costs. This is particularly important if a company is financially stretched.

In addition some judgement may be required about when (or how much) borrowing costs should be capitalised, and so companies’ accounting practices on capitalisation may differ.

IAS 24: Related Party Disclosures

IAS 24 requires related party transactions to be disclosed. It is a disclosure-only standard, ie it does not affect the accounting for these transactions.

Main Points of the Standard

Dealings with related parties should be disclosed

Related parties may be people (eg shareholders with control, joint control or significant influence over the company, or key management personnel, or close family members of a related party), or companies/other entities (eg other members of the group, associates, joint ventures, pension plans of the group, entities controlled by a related party).

Companies must disclose:

- The entity's parent and the ultimate controlling party
- All related party transactions, including purchases/sales, provisions of guarantees or collateral, leases, transfers, etc
- Key management personnel compensation, in total and by type (salary/bonus, pension, termination benefits, share-based payments)

Issues for Investors

Related party transactions may not be on an arm's-length basis and some transactions could even be detrimental to other shareholders. A company's business may also be affected if a relationship with a related party changes. Related party disclosures should therefore be reviewed for anything unusual or significant. Investors should be particularly careful to scrutinise related party disclosures if there are significant corporate governance concerns.

Other requirements may go further

National legislation or guidelines may go further than the requirements of IAS 24, for example annual report disclosures about management remuneration are typically more extensive.

IAS 27 Consolidated and Separate Financial Statements

When a group invests in another business, it may be treated as a subsidiary, an associate (IAS 28), a joint venture (IAS 31), or an investment (IAS 39/IFRS 9), depending on the level of investment and the nature of the relationship. IAS 27 addresses the first of these. The IASB is planning to replace IAS 27 in H1 2011.

Main Points of the Standard

Subsidiary if “control”, typically >50% of votes

Consolidated accounts should include all subsidiaries, ie entities which are controlled by the parent. Control is presumed if the parent owns more than half of the voting power (ie 50% plus 1 vote) unless clearly demonstrated otherwise. Control may exist if half or less of the voting power is owned due to:

- Agreements with other investors
- Power over majority of board votes (can be indirect, due to ability to replace board members)
- Power over financial and operating policies eg due to an agreement

Potential voting rights (eg from options or convertible instruments) are also considered relevant if they are currently exercisable/convertible.

Separate guidance on when special purpose entities (SPEs) should be consolidated is provided in Interpretation SIC 12.

Subsidiaries should be included with the same period end as the parent accounts, but at most no more than 3 months different.

If the group sells a stake in a subsidiary while retaining control, or buys out a minority interest, no gain or loss is reported in the P&L (ie the adjustment is within shareholders equity). However if control is lost, a gain or loss is reported.

The standard also covers reporting of subsidiaries in the separate (legal entity) accounts, but equity investors typically focus on group (consolidated) accounts.

Issues for Investors

Grey area

Determining whether another business is controlled and should be consolidated can be a grey area in IFRS, and is not consistently applied in practice. When a company is consolidated, its revenues, profits, assets, liabilities and cash flows are fully included in the group accounts, whereas only the net profit, net assets, and dividends from associates are included. Companies may therefore have incentives to consolidate businesses which are high margin or with strong balance sheets or good cash flow, and to exclude from consolidation businesses with poor profitability, high debt or poor cash flow.

We recommend reviewing why material businesses are consolidated if ownership is less than 50% or not consolidated if ownership is over 50%.

Minority interests can be significant to valuation, but unfortunately disclosures are typically minimal (eg no information about fair value or about the minority share of cash flows). We do not recommend valuing minority interests at the balance sheet amount as this is often a significant underestimate of the value.

New standard, but do not expect major changes

Some investors also find it counterintuitive that when a group sells a stake in a subsidiary, it does not report a gain or loss, whereas when it purchases a newly controlling stake in an associate, a gain or loss on the associate investment is reported (although the stake has not been sold).

The IASB is expected to publish a new standard on consolidation in H1 2011 and to improve associated disclosures. We do not expect this to be mandatory until 2013 or later. The new guidance may affect some consolidation decisions but we do not expect major changes overall. We expect the new standard will reiterate that control does not necessarily depend on 50% voting control, and will provide additional guidance. For example, a group may have control with a voting rights of less than 50% when other shareholders are small and dispersed, making it unlikely they would act together to outvote the large shareholder.

The new standard would replace both IAS 27 and the guidance on consolidation of special purpose vehicles in SIC 12.

IAS 28: Investments in Associates

This standard describes when an investment should be treated as an associate and hence the equity method should be applied.

Main Points of the Standard

Associates if “significant influence”, usually 20% of votes

An investment is treated as an associate if the group has significant influence but not control; any investment which is controlled is a subsidiary within the scope of IAS 27. Significant influence is assumed if the holding (voting power) is 20% or more, unless demonstrated otherwise. However significant influence can exist with less than 20% holding, eg due to board representation. Potential voting rights (options, converts, etc) which are currently exercisable should also be considered. This is similar to the guidance for control in IAS 27 (ie there is a presumption at a certain shareholding but it can be overcome by other factors).

Use equity method ie one-line treatment in P&L and balance sheet

Associates are presented in the group accounts using the equity method. This means that:

- Associates are initially measured at cost, but this is subsequently adjusted for the group's share of comprehensive income (including profit/loss)
- The share of associate profit/loss is reported as a line in the P&L (eg if the shareholding is 25% and the profit after tax of the associate is 100, associate income of 25 will be reported)
- Dividends from the associate are included in the cash flow statement, and reduce the carrying value of the investment

Associate investments may become impaired. Determining *if* the investment is impaired uses the impairment test for equity investments in IAS 39, but the *size* of the impairment is determined in accordance with IAS 36 (ie higher of value in use and fair value less costs to sell).

Issues for Investors

Another grey area

Like IAS 27, determining whether an investment is an associate can be a grey area in IFRS and in practice the guidelines may not be consistently applied. In our experience, associate treatment is quite common at shareholdings well below 20% (sometimes as low as 6%).

Inconsistent with treatment of other equity investments

Associate treatment is different from the accounting for normal equity investments in the scope of IAS 39/IFRS 9. Other equity investments must be measured at fair value on the balance sheet. Companies may prefer to treat an investment as an associate, because of the more stable balance sheet valuation. Also, impairment charges are typically much smaller for associates, because a DCF calculation can be used (whereas IAS 39 requires a write down to market value if impaired, although IFRS 9 will not).

Lack of information

IAS 28 requires minimal information about associates (eg fair value disclosed only if there are published prices, no information required about associate cash generation, no information about gross asset/liabilities or debt).

Apparent P&L tax rates distorted

Associate income is presented above the tax line of the P&L¹⁷, but is an after-tax figure. This can distort apparent tax rates.

¹⁷ Occasionally we have seen it presented below the tax line, but this is inconsistent with IAS 1 guidance.

IAS 29: Financial Reporting in Hyperinflationary Economies

Historical cost accounting may become somewhat meaningless in hyperinflationary economies unless an adjustment is made for inflation.

Main Points of the Standard

Hyperinflation indicated if inflation of
100%+ over 3 years

Indicators for determining when an economy is in hyperinflation include the population preferring to keep wealth in other assets or currencies, or a cumulative inflation rate over three years of 100% or more (eg 26% pa or more). IAS 29 applies to companies whose functional currency is that of the hyperinflationary economy. IAS 29 is applied from the start of the reporting period in which hyperinflation is identified.

Monetary items on the balance sheet are not restated, but non-monetary items are restated by increasing by the inflation rate (ie change in the price index) from the date the item was acquired. P&L items are restated by applying the inflation rate from the date the income/expense was recorded. Companies suffer a loss on a net monetary asset and a gain if they have a net monetary liability (if these assets/liabilities are not linked to a price level). This gain/loss is reported in the P&L.

Once the economy is no longer hyperinflationary, the restated amounts at the end of the previous reporting period are used as the new carrying amounts for assets/liabilities.

Issues for Investors

Companies may have subsidiaries in hyperinflationary economies. When the decision is made that IAS 29 applies, a significant restatement of balance sheet and earnings may occur.

Venezuela is a recent example of a hyperinflationary economy¹⁸.

¹⁸ For example, Telefonica applied IAS 29 to its Venezuelan business in its 2009 financial statements.

IAS 31: Interests in Joint Ventures

IAS 31 currently provides two possible ways of accounting for many joint ventures, but this standard will be replaced soon.

Main Points of the Standard

A joint venture is an arrangement (often but not necessarily a company or other legal entity) subject to joint control between the reporting group and another party. Joint control means that key strategic decisions require the consent of both controlling parties.

Choice of JV accounting

Companies may use the equity method or proportionate consolidation to report their share in joint venture (JV) entities. The equity method is also used for associates and is described in IAS 28.

Proportionate consolidation means that the group's share of the JV's revenues, costs, profits are included in the P&L, its share of assets and liabilities in the balance sheet, and the relevant proportion of the JV cash flows is included in the cash flow statement.

Issues for Investors

Affects cash flow reporting as well as P&L, balance sheet

The current choice of accounting reduces comparability. A group will report higher revenues and a "grossed-up" balance sheet with proportionate consolidation, while equity accounting may be preferable for JVs with low profitability, poor/negative cash flow and/or significant debt.

Proportionate consolidation may mean reported cash flows are not readily accessible to the group (eg distributions will need to be agreed with the joint venture partner).

IAS 31 is expected to be replaced in H1 2011, although the new standard will not be mandatory straight away. This is likely to require associate accounting for most JV entities, although this will not apply to all types of joint arrangement. We expect many listed companies currently using proportionate consolidation in their group accounts to switch to equity accounting.

IAS 32: Financial Instruments: Presentation

IAS 32 and IAS 39 both cover financial instruments

This standard should be read together with IAS 39, also covering financial instruments.

Main Points of the Standard

Debt/equity definition and treatment of converts

IAS 32 defines when a company's own financing should be classified as debt or equity (eg preference shares, hybrid debt, etc). Equity financing must not contain any contractual obligation to deliver cash or other financial asset, for example equity instruments must be perpetual and dividends must be discretionary rather than fixed. Instruments which do not meet the definition of equity are classified as liabilities.

Convertible debt accounting

Convertible debt is treated as a compound financial instrument and split into debt and equity components (reported as debt and equity on the balance sheet). The debt component is valued by measuring fair value of equivalent debt without the conversion feature and the equity component is the residual (ie value of convertible debt less estimated fair value of debt component).

IAS 32 requires that treasury shares are deducted from equity.

Rules on netting off

IAS 32 also provides guidance on when financial assets and liabilities may be netted off (for example a derivative asset and liability with the same counterparty). They should only be offset when the company has both a legal right to net off, and intends to settle on a net basis.

Issues for Investors

Interest on hybrid debt may not go through P&L

Hybrid debt may qualify for equity classification. This will mean that the interest on the hybrid debt will be classified as dividend payments and so not reported in the P&L (and also classified as dividends rather than interest in the cash flow statement). Investors may wish to adjust interest cover calculations and after-interest free cash flow figures. (Note however that EPS calculations will already take hybrid interest payments into account).

Since convertible bonds are split into debt and equity components, P&L interest charges do not reflect the actual cash interest costs but the appropriate interest rate for a similar non-convertible debt, applied to the debt component. P&L interest charges will be higher than cash interest charges.

US/IFRS bank balance sheets not comparable

Offsetting rules differ between US GAAP and IFRS and this reduces the comparability of IFRS and US GAAP bank balance sheets (more netting in US GAAP). IASB and FASB are currently working to converge this guidance as part of the IFRS 9 project.

IAS 33: Earnings per Share

Basic and diluted earnings per share (EPS) must be disclosed, and IAS 33 provides guidance on how to calculate the denominator (number of shares).

Main Points of the Standard

IAS 33 requires companies to calculate two earnings measures, basic EPS and diluted EPS. Diluted EPS takes into account the effect of dilutive potential ordinary shares, eg convertible debt and options.

Basic EPS only reflects shares outstanding

Basic EPS is calculated by dividing the net income attributable to the ordinary shareholders of the parent company (ie after minority interest's share of net income, preference dividends, interest payments on hybrid debt classified as equity, etc) by the time-weighted average number of ordinary shares outstanding in the period. For example, if 100 shares were outstanding at the start of the year and a further 20 shares were issued half way through the year, the basic number of shares is 110.

Diluted EPS reflects potential shares from options or converts

Diluted EPS takes into account the possible effect of potential ordinary shares, such as convertible debt or options. Options are only deemed dilutive when they are "in the money" (market price exceeds exercise price). Options are treated as a combination of shares issued at market price (due to value from the exercise price) which are not dilutive, and shares issued for no consideration. For example, if 10 options exist to buy a share currently trading at £2 for an exercise price of £1, the dilution would be 5 shares.

For convertible debt, the EPS should be calculated as if the convertible converted into shares at the start of the period, with the net of tax interest charge on the convertible added back to net income. If this EPS is lower than EPS without conversion, then the convertible is dilutive and diluted EPS should be calculated assuming its conversion.

Issues for Investors

EPS and Price/Earnings multiples are widely used by investors so it is important that there is guidance on calculating the number of shares used in EPS calculations. Both basic and diluted EPS should be displayed though some companies emphasise basic EPS and some diluted EPS.

Diluted EPS calculation flawed but preferable to basic EPS

Diluted EPS only includes options to the extent they are "in the money" (intrinsic value) so it understates the full economic impact. Although we think the diluted EPS calculation is flawed, we believe it is a better measure than basic EPS. We favour diluted EPS as we believe it is appropriate to include the potential dilution to ordinary shareholders of other equity claims from option holders and convertible debt holders. We do not agree with the argument that diluted EPS double counts the impact of employee options expensed through the P&L; rather the dual effect on EPS correctly reflects the economic impact of the options.

IAS 33 focuses on the calculation of the denominator not the numerator for earnings per share. EPS figures may not be fully comparable due to different accounting choices in calculating net income. In addition many companies provide adjusted versions of EPS which are not consistent with IFRS requirements. For further discussion of EPS measures, see *Adjusted Earnings: A Review of Non-GAAP EPS in Europe*, dated 8 November 2010.

Limited requirements for interim
accounts

IAS 34: Interim Financial Reporting

This standard explains how quarterly and half-year reports should be prepared and states minimum information which must be provided. The requirements for interim reports are less extensive than for annual reports.

Main Points of the Standard

Interim accounts should include:

- P&L/Statement of Comprehensive Income (may be one or two statements)
- Balance sheet
- Cash flow statement
- Statement of changes in equity
- Certain note disclosures, such as some segment information, unusual items (often called exceptionals), information about M&A, dividends paid, etc.
Companies must also disclose any events/transactions which are material to understanding the results.

The statements may be condensed compared to full year accounts, but must contain at least the headings and subtotals. Accounting policies used should be the same as those in the previous annual report, unless there is an accounting policy change to be reflected in the next annual statements (eg due to a new accounting standard taking effect).

Issues for Investors

EU listed companies must apply IAS 34
to half year accounts

EU listed companies have been required to apply IAS 34 when issuing interim results since 2008, although this requirement does not apply to “interim management statements” (IMs) which are not full results. EU companies must publish half-year results, but IMs are permitted instead of full quarterly results (some countries go further in requiring quarterly results). The EU considered making quarterly results mandatory but decided against this in the face of considerable opposition from some companies, particularly in the UK, which argued this would encourage “short termism” and would be a considerable administrative burden. A small number of companies have actually stopped issuing quarterly results, perhaps due to the need to apply IAS 34.

The IAS 34 requirements are less onerous than for full year results and this can be frustrating for investors. For example, some companies update pension valuations while others do not, even if pension risks are highly material.

IAS 36: Impairment of Assets

This standard sets out how and when to test assets for impairment. IAS 36 applies to all assets unless covered by the valuation methodology in another standard such as inventory (IAS 2), financial assets (IAS 39/IFRS 9), deferred tax assets (IAS 12), pensions (IAS 19).

Main Points of the Standard

Compare book value with higher of fair value and DCF

An asset is impaired if the book value is higher than the recoverable amount. Recoverable amount is the higher of fair value less selling costs and a DCF valuation (known as value in use).

A company must calculate the recoverable amount of an asset if at the end of the reporting period there is any indication of impairment (such as significant decline in asset's market value, adverse changes in the business environment, higher interest rates, or company-specific issues such as restructuring plans). Intangible assets which are not amortised, such as goodwill, must be tested for impairment annually.

Guidance on DCFs

The DCF valuation used to calculate value in use must reflect the expected cash flows from the asset, the time value of money (ie risk-free interest rates), and other factors such as uncertainty of cash flows, the price of risk, and illiquidity (the latter factors may be incorporated by adjusting expected cash flows or the discount rate). Cash flow projections should be based on current budgets/forecasts (normally for a maximum of 5 years). Long run growth rates assumed should normally be steady or declining.

Impairments and reversals usually through P&L; goodwill impairment cannot be reversed

Impairment losses are normally reported in the P&L, unless they reverse a previous revaluation increase not reported in the P&L. After the impairment, any depreciation or amortisation is revised to reflect the lower carrying amount. Impairment charges can be reversed through the P&L, except for goodwill.

Goodwill is allocated to "cash-generating units" (CGUs) which must be no larger than an operating segment, while the standard does allow for significant flexibility in selecting CGUs. Goodwill is tested for impairment at the level of these units. Goodwill impairments cannot be reversed.

Issues for Investors

DCF's subjective

Many investors are somewhat sceptical about the value and rigour of impairment testing, in particular as DCF valuations are so subjective.

Goodwill impairment charges may not occur even if an acquisition is clearly not worth the price originally paid, because the decline in value of the acquired goodwill may be offset by internally generated goodwill in another part of the unit. The size of CGU chosen and later re-allocations of goodwill amongst units (eg due to changes in reporting structure) may also reduce the likelihood of goodwill impairment. Occasionally companies only report one segment/CGU.

Possible incentive to maximise goodwill

Since goodwill (and other intangibles with indefinite life) is no longer amortised, there may be a greater incentive for acquisitive companies to maximise goodwill, eg through fair-value write-downs of acquired assets or recognising additional liabilities such as provisions on acquisition.

May flatter "underlying" earnings

Impairment charges are often treated as exceptional items, but may reduce future expenses such as depreciation or amortisation, so "underlying" earnings may be flattered by impairment charges. Similarly impairment charges reduce net book value, so increase apparent return on equity figures.

IAS 37: Provisions, Contingent Liabilities and Contingent Assets

This standard describes how provisions should be calculated, and requires disclosure of contingent liabilities. Pensions are an important type of provision but are covered separately in IAS 19.

Main Points of the Standard

Uncertain liabilities

A provision is a “liability of uncertain timing or amount”. Provisions should be recognised if the liability (for cash or other outflow) is probable (ie >50% probability).

Provisions are measured at the best estimate of the cost of settling the obligation, which may be a probability-weighted figure (expected value) in some cases, or the most likely outcome in others (although other outcomes must be considered).

The provision should be a present value if discounting has a material effect. The expense as the discounting unwinds over time (increasing the liability) is reported as an interest cost.

Provisions permitted for restructuring if conditions met

Provisions must not be recognised for future operating losses, but they are recognised for onerous contracts (a contract is onerous if the unavoidable costs associated with it are more than its economic benefits). A provision may be made for restructuring, but only if certain criteria are met, including a detailed formal plan for restructuring and announcement of the plan to affected parties or starting to implement it.

Contingent liabilities are disclosed

A contingent liability is a possible but unconfirmed liability, or a present obligation which is not probable to result in cash outflow or other loss, or a present obligation which cannot be measured reliably enough to recognise. Contingent liabilities are not reported as a liability on the balance sheet but must be disclosed. (Contingent assets are disclosed if probable).

Issues for Investors

Can be used to manage earnings

Provisions create differences between cash flow and earnings, and may allow companies to manage earnings. For example, the use of “cookie jar” provisions is a well-known creative accounting technique, although rules on provisions are stricter than in the past. As uncertain liabilities, provisions involve more accounting judgement than many other balance sheet items. Provisions may also be used to “kitchen sink” bad results and improve subsequent earnings.

For this reason investors are often sceptical of companies which record large provisions. IAS 37 requires the disclosure of a reconciliation of opening and closing provisions, and so any provision releases (creating earnings without cash inflow) or utilisation of provisions (cash outflow with no P&L impact) can be identified. We recommend checking the provision note. Provisions created at acquisition which increase goodwill are not charged to the P&L but may flatter subsequent earnings relative to cash flow.

Should be reflected in DCFs

Provisions for long-term liabilities, such as some environmental liabilities, for which the cash outflows are not captured in a DCF model, should be treated like debt in valuations.

Contingent liabilities can be highly material, eg potential legal liabilities, so this note should be scrutinised, although disclosure is often limited or “boilerplate”.

IAS 38: Intangible Assets

Some intangible assets are recognised in the accounts, but many internally generated intangible assets are not. In particular IAS 38 explains when development costs should be capitalised and when expensed, which we are frequently asked by investors.

Main Points of the Standard

Intangible assets are non-monetary assets without physical substance. They may be acquired through M&A, separate purchase, or may be internally generated.

Criteria for capitalisation

To capitalise an intangible asset on balance sheet it must meet these criteria:

1. Identifiable – either separable (eg capable of being separately sold) or arising from contractual/legal rights
2. Probable benefit from asset
3. Measurable cost

Intangible assets which are separately purchased or internally generated are recognised initially at cost. Assets acquired by M&A are measured initially at fair value. Most intangible assets are subsequently measured at amortised cost, although IAS 38 permits revaluation if there is an active market for the asset. If the asset has an indefinite life (eg goodwill) it is not amortised.

Internal research costs are expensed. Development costs are capitalised if they meet criteria such as technical feasibility of project, probable economic benefits, intention to complete the asset, and reliable measurement of costs.

Issues for Investors

Amortisation charges often added back in adjusted earnings

As a result of IAS 38, many more acquired intangible assets (value of customer relationships, customer lists, etc) are recognised separately from goodwill, and are amortised. There is some controversy as to whether these amortisation charges are meaningful, and many companies, analysts and investors add back amortisation charges in adjusted earnings measures. In our view some amortisation charges should not be added back¹⁹.

May need to adjust for R&D capitalisation policy

The rules on capitalising internal development costs are perceived by many investors as rather vague and inconsistently applied. In practice the extent of capitalisation varies greatly between sectors, eg pharmaceutical companies do not capitalise development costs due to the uncertainty of regulatory approval. Company results within sectors may also be less comparable because of differing capitalisation policies. This can affect several key metrics such as EV/EBITDA, P/E, Price/book, and ROE.

¹⁹ See *Adjusted Earnings* report previously mentioned for detailed discussion.

IAS 39: Financial Instruments: Recognition and Measurement

Much criticised in the credit crisis, IAS 39 will be replaced by IFRS 9 (see pages 6 and 22). It should also be considered together with IAS 32 (financial instrument presentation) and IFRS 7 (financial instrument disclosures).

Main Points of the Standard

We summarise below four main aspects of IAS 39: the treatment of financial assets, financial liabilities, specific rules for derivatives, and the calculation of impairments of financial assets.

4 categories of assets

Financial assets (investments) are classified into four categories as shown in Figure 4. Note that IAS 39 does not apply to associates, JVs or subsidiaries.

Figure 4. IAS 39 Classification of Financial Assets

Category	Includes	Accounting
FV through P&L	All derivatives, trading book assets	Marked to market through P&L
Available for Sale	Default category eg equities not held for short term trading, most quoted debt	FV on balance sheet. Dividends/interest, realised gains/losses in P&L
Loans & receivables	Debt instruments not quoted in active market	Amortised cost
Held to maturity	Debt instruments held to maturity	Amortised cost

Source: IASB, CIRA

This means that a quoted bond, for example, may be measured in one of three ways depending on the company's intentions: either at fair value through P&L (if the bond is held for trading in the short term), Available for Sale (in most other cases), or amortised cost (if the bond will be held to maturity). Available for Sale (AFS) is a hybrid of fair value and amortised cost accounting: these assets are measured at fair value on the balance sheet, but the P&L accounting is similar to amortised cost assets, except for the impairment calculation. Equities may be classified either at fair value through P&L or AFS.

Assets may be reclassified between categories in certain circumstances²⁰.

Liabilities at amortised cost or FV through P&L

Financial liabilities are measured at amortised cost or fair value through P&L. Fair value applies if the liabilities are held for trading, derivatives, or if the company elects fair value treatment. All other liabilities are at amortised cost.

Derivatives at FV on balance sheet; hedge accounting may apply

All **derivatives** are measured at fair value on the balance sheet, and in most cases the change in value is reported in the P&L. However, specific rules apply to derivatives held for **hedging** purposes. Gains/losses on derivatives qualifying as cash flow hedges are usually not recognised in the P&L until the underlying cash flow is realised. Derivatives held as fair value hedges are marked-to-market through the P&L, but so is the hedged instrument. Quite onerous rules apply before hedge accounting can be applied, eg the hedge must be shown to be effective.

²⁰ The IASB amended IAS 39 in October 2008 to allow certain reclassifications; many European banks took advantage of this amendment and reclassified assets out of the fair value and AFS categories.

Impairment tests for AFS and amortised cost

Financial assets which are not measured at fair value through P&L are tested for **impairment**. Assets are impaired if there is objective evidence that a “loss event” has occurred which has an impact on the future cash flows. Such evidence includes significant financial difficulty of the issuer and breach of contract (eg default/delinquency in payments) but may also include economic factors which correlate with defaults (eg higher unemployment rates). Additional guidance is provided to determine when AFS equities are impaired (for example an equity is impaired if there is a “significant” or “prolonged” decline in the market price).

If amortised cost instruments are impaired, they are written down to the present value of the estimated cash flows, discounted at the original effective interest rate (with the impairment charged to P&L). If AFS assets are impaired, they are written down to fair value through the P&L.

Issues for Investors

The choice of accounting methods for financial instruments reduces comparability of banks’ (and to some extent insurers’) balance sheets and P&Ls.

Controversial amendment in 2008

The IASB’s amendment of IAS 39 in October 2008 to allow reclassifications between asset categories was widely criticised by investors. The amendment, made as a result of political pressure at the height of the credit crisis, allowed banks to transfer assets out of fair value and AFS categories, and thus increase book values or avoid P&L write-downs. A majority of large EU listed banks made such reclassifications at the time.

The fair value treatment of some financial liabilities has been controversial, as it may result in counterintuitive P&L gains when the credit standing of a company’s own debt deteriorates.

Impairment rules criticised as backward looking

Impairment rules are open to interpretation and are not consistently applied. In addition, the “incurred loss” impairment rule in IAS 39 has been criticised as too backward-looking and therefore not providing timely information about loan impairments.

Hedge accounting rules are complicated and therefore some companies do not apply hedge accounting to their hedging. The resulting P&L volatility is sometimes excluded from “underlying” earnings calculations.

The IASB’s replacement of IAS 39 is discussed under IFRS 9 on page 22.

IAS 40: Investment Property

There are different accounting rules for investment properties compared to other properties (which are covered by IAS 16). Investment properties may be measured at fair value or at (depreciated) cost.

Main Points of the Standard

Investment properties are those held to earn rentals or for capital appreciation. Owner-occupied properties do not qualify as investment properties.

Choice of valuation, but must be applied consistently

Investment properties may be measured at fair value or at (depreciated) cost. The same policy must be applied for all investment properties. If measured at fair value, changes in value are reported in P&L. If measured using the cost model, IAS 16 requirements apply. If measured at cost, the fair value should be disclosed unless (in exceptional cases) it cannot be determined.

Fair value can be based on DCF if market price not available

The best evidence for fair value is current prices in an active market for similar properties, but other indicators of fair value can be considered such as current prices of different properties, recent prices of properties in less active markets, and DCF valuations based on expected cash flows. Companies are not required to use an independent or professionally qualified valuer, however they should disclose if the valuation has been made by an independent professional valuer with relevant experience or not. They should also disclose the methods and assumptions used in valuation.

Issues for Investors

Balance sheet should be reasonable guide to market value

The fair value model is used by most European property companies. The use of fair values means that the balance sheet is a reasonable guide to valuation and price/net asset value is a widely used valuation metric in the property sector.

IAS 41: Agriculture

This is a niche standard covering the treatment of biological assets (eg trees in a plantation forest, vines, cattle, etc). We have never yet received a question on IAS 41!

Main Points of the Standard

Biological assets measured at fair value
less costs to sell

Biological assets (living animals or plants) and agricultural produce at the point of harvest are covered by this standard. After harvest, IAS 2 (Inventories) will apply.

These assets should be measured at fair value less costs to sell. If fair value cannot be measured reliably, they are measured at cost, but there is a presumption that fair value can be measured reliably. IAS 41 also covers the treatment of related government grants.

Issues for Investors

This is only relevant to the small number of listed companies which produce biological assets as part of their business.

However, IAS 41 illustrates the trend towards measuring assets at fair value rather than cost in IFRS, which is controversial. Fair value measurement generally results in more relevant asset values on the balance sheet but is criticised by some for creating more volatile and/or less meaningful earnings.

Appendix 1: Operating Lease Exposure

Using reported data, the screen below shows the implied present value of lease payments assuming inclusion of 100% of the year one lease commitments, 80% of years 2-5, and 60% of lease commitments beyond 5 years. This will overstate the impact for companies with very long-term lease commitments, but may understate the liability for companies which pay significant contingent rentals. We then derive the implied increase in Enterprise Value from capitalising leases. This is our preferred approach for screening lease exposure. We highlight below the most affected companies in the STOXX Europe 600 Index, excluding financial services.

Company Name	Sector	Country	Sh price local curr	Mkt cap €m	Year 1	Lease commitment €m years 2-5	>5 years	EV now €m	EV plus lease €m	EV % Increase
DEBENHAMS	Retail	UK	68	1,037	222	886	4,918	1,655	5,536	235%
DIXONS RETAIL	Retail	UK	22	954	449	1,523	1,884	1,241	4,039	225%
HOME RETAIL GROUP*	Retail	UK	221	2,144	424	1,542	2,583	1,627	4,834	197%
IBERIA**	Travel & Leisure	SPAIN	3	3,323	256	647	606	1,900	3,846	102%
TUI TRAVEL	Travel & Leisure	UK	270	3,569	687	1,431	406	3,692	5,767	56%
HALFORDS GROUP	Retail	UK	408	1,024	104	372	444	1,196	1,864	56%
KESKO 'B'	Retail	FINLAND	34	3,398	353	1,072	935	3,186	4,958	56%
SAINSBURY (J)	Retail	UK	381	8,417	467	1,690	5,935	10,138	15,518	53%
KINGFISHER	Retail	UK	270	7,555	489	1,777	3,697	7,850	11,978	53%
FIRST GROUP	Travel & Leisure	UK	391	2,230	720	2,109	151	4,774	7,272	52%
JCDECAUX	Media	FRANCE	23	5,024	523	1,562	1,410	5,643	8,261	46%
ACCOR	Travel & Leisure	FRANCE	35	7,863	523	1,975	4,030	9,804	14,325	46%
AIR FRANCE-KLM	Travel & Leisure	FRANCE	14	4,173	1,051	3,037	2,477	11,182	16,149	44%
TRAVIS PERKINS	Ind. Goods & Services	UK	1,071	3,065	153	551	1,223	3,591	4,919	37%
AHOLD KON.	Retail	NETHERLANDS	10	11,608	600	2,042	3,108	11,813	15,911	35%
DEUTSCHE LUFTHANSA***	Travel & Leisure	GERMANY	16	7,421	537	1,528	2,630	9,698	13,035	34%
METRO	Retail	GERMANY	53	17,457	1,393	4,494	4,071	21,895	29,325	34%
NEXT	Retail	UK	2,134	4,609	255	887	1,168	5,083	6,747	33%
BRITISH AIRWAYS	Travel & Leisure	UK	288	3,929	202	733	2,275	6,635	8,788	32%
THOMAS COOK GROUP	Travel & Leisure	UK	202	2,053	263	610	180	2,666	3,524	32%
MARKS & SPENCER GROUP	Retail	UK	373	7,005	258	920	3,392	9,435	12,465	32%
WHITBREAD	Travel & Leisure	UK	1,784	3,741	103	345	1,354	4,310	5,502	28%
STAGECOACH GROUP	Travel & Leisure	UK	206	1,756	172	470	24	2,070	2,632	27%
DEUTSCHE POST	Ind. Goods & Services	GERMANY	13	16,261	1,357	2,901	1,935	18,755	23,594	26%
TESCO	Retail	UK	404	38,406	1,163	4,130	11,160	48,447	59,610	23%
CABLE & WIRELESS WWD.	Telecommunications	UK	70	2,182	136	222	295	2,204	2,694	22%
BT GROUP	Telecommunications	UK	179	16,484	554	1,868	6,196	28,068	33,833	21%
A P MOLLER - MAERSK 'B'	Ind. Goods & Services	DENMARK	53,500	31,051	1,692	4,593	6,014	45,781	54,756	20%
DEUTSCHE TELEKOM	Telecommunications	GERMANY	10	41,511	2,553	7,520	14,475	88,586	105,840	19%
LOGICA	Technology	UK	137	2,604	164	381	155	2,931	3,492	19%
NATIONAL EXPRESS	Travel & Leisure	UK	251	1,514	274	146	60	2,255	2,681	19%
ALCATEL-LUCENT	Technology	FRANCE	2	5,601	229	667	249	5,248	6,160	17%
DELHAIZE GROUP	Retail	BELGIUM	58	5,847	260	746	852	8,094	9,462	17%
LADBROKES	Travel & Leisure	UK	135	1,454	67	198	238	2,231	2,599	17%
CELESIO (XET)	Retail	GERMANY	19	3,189	212	418	508	5,240	6,091	16%
WILLIAM HILL	Travel & Leisure	UK	189	1,570	54	176	270	2,193	2,548	16%
CARREFOUR	Retail	FRANCE	32	22,041	1,002	2,183	3,014	28,475	33,032	16%
CAP GEMINI	Technology	FRANCE	37	5,747	230	498	137	4,479	5,190	16%
BALFOUR BEATTY	Construct. & Material	UK	325	2,643	115	254	63	2,282	2,638	16%
WOLSELEY	Ind. Goods & Services	UK	2,186	7,368	304	810	439	7,950	9,165	15%
HOCHTIEF	Construct. & Material	GERMANY	63	4,859	316	730	86	6,227	7,178	15%
ATOS ORIGIN	Technology	FRANCE	40	2,789	160	294	70	2,934	3,371	15%
PUBLICIS GROUPE	Media	FRANCE	38	7,283	209	589	598	7,720	8,759	13%
WPP	Media	UK	794	11,865	415	1,073	1,149	15,041	17,004	13%
THALES	Ind. Goods & Services	FRANCE	27	5,299	170	432	269	5,288	5,965	13%

Source: Datastream, company annual reports, CIRA

Market cap as of 19 January 2011. *HRG has disclosed a discounted lease liability of €3,683m (£3,148m), slightly higher than our calculation of €3,207m. **Iberia disclosed lease commitments for years 1-4 and >4 years. ***Lufthansa lease commitment for >5 years is a CIRA calculation based on an assumed 15-year lease life (per annum amount disclosed not total commitment).

Notes

Notes

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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To satisfy regulatory requirements, we correspond Under Review to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

Relative three-month ratings: CIRA may also assign a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the analyst's coverage universe over a 3 month period. The relative call may highlight a specific near-term catalyst or event impacting the company or the market that is anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) will indicate the most and least preferred stocks in his coverage universe, explaining the basis for this short-term view. This three-month view may be different from and does not affect a stock's fundamental equity rating, which reflects a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls correspond to a buy recommendation and least preferred calls correspond to a sell recommendation. Any stock not assigned to a most preferred or least preferred call is considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

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