

Equities

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The Standards: October Update

EU draft proposals threat to Big 4 audit firms

■ Accounting
■ Monthly

- **Big trouble for Big 4?** — Draft EU proposals suggest a major overhaul of the European audit market. Proposals include possible restrictions on audit firms performing non-audit services, mandatory rotation of auditors, and requirements for joint audits of large companies.
- **Recalculating depreciation on a replacement cost basis in mining sector** — The Citi Metals & Mining team recently highlighted the impact of depreciation accounting on the sector. The team calculates that 2010 sector EPS would have been 16% lower if a measure of replacement cost was used instead of historical cost depreciation. Differences in the average age of plant and machinery across the sector mean that the P&L impact varies significantly by company, which distorts P/E analysis.
- **Comparing Aggreko and APR accounting** — A report by the Citi Business Services team highlights the significance of accounting differences when comparing Aggreko's international power projects business with newly listed APR Energy. The team reports that the policy on capitalisation of mobilisation costs reduces comparability of EBITDA.
- **UK proposals on annual reports** — The UK Department for Business Innovation and Skills recently published proposals to overhaul the narrative reporting sections of annual reports. Annual reports have been criticised for their increasing length and complexity, and the proposals aim to focus on the link between business strategy, financial results, and director remuneration.

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EU draft proposals threat to Big 4 auditors

Proposed changes to EU audit market

The European Commission is proposing major changes to the regulation of audit firms. A draft of a regulation, expected to be published in November, has been widely leaked to the press¹. This follows a Green Paper on the subject published in October 2010. The proposals are aimed at encouraging greater competition for the audit of public companies across Europe, and increasing auditor independence. This reflects concerns about the auditors' role in the financial crisis, the lack of competition due to the dominance of the Big 4 firms in the EU audit market², and the potentially huge problems if one of the four largest audit firms ceased to operate.

Key proposals include:

- Requiring audit firms to give up providing non-audit services
- Mandatory rotation of auditors
- Joint audits for very large companies

Potential block on audit firms providing non-audit services

The most extreme proposal is to prohibit firms from providing both audit and non-audit services, ie creating audit-only firms, to address potential conflicts of interest. This proposal will be strongly opposed by the major audit firms, and we think it is unlikely to take effect. It is possible that the EU may compromise with an alternative solution, such as further restricting the provision of non-audit services by auditors. Although the proposal would reduce potential for conflicts of interest, disadvantages could include a negative impact on audit quality (eg as jobs in audit would be less attractive to graduates).

Mandatory rotation could improve auditor independence

The mandatory rotation of auditors could restrict the length of relationships between audit firms and companies, perhaps to nine years. Current rules require audit partner rotation, but there are no limits to company relationships with audit firms. We believe this could improve auditor independence and audit quality by avoiding overly close relationships between auditor and company, and by requiring a fresh approach after a period of time.

Joint audits already required in France

The European Commission is also considering requiring joint audits for listed companies. This is already a requirement in France (and was a requirement in Denmark until 2005). Advocates of this policy believe it would help audit market competition by increasing opportunities for audit firms outside the Big 4. It could also reduce disruption if one of the Big 4 firms failed. However, the use of joint auditors could be detrimental to audit quality, for example if (as suggested by the UK Financial Reporting Council) company management engaged in "opinion shopping" between the two firms. We note that some of the most controversial accounting decisions in recent years have occurred at companies with joint auditors³.

¹ Eg Financial Times, "Big audit firms face Brussels onslaught", 26 September 2011.

² According to the Green Paper, the "Big 4" firms (PwC, KPMG, Deloitte and Ernst & Young) have market share for listed company audits over 90% in the vast majority of EU countries.

³ For example, see our recent work on the approach taken by European banks and insurers on the impairment of Greek sovereign debt in *The Standards: Sovereign Debt Update*, 8 September 2011.

Citi Metals & Mining team report on impact of historical cost depreciation accounting

Using replacement cost accounting reduces EPS by 16%

Citi Business Services team highlights accounting differences between Aggreko and APR

Mobilisation costs treated differently

EBITDA margins not comparable

Mining sector 'stale' depreciation charges

The Citi Metals & Mining team recently published a report entitled [The True Historical P/E](#) (3 October), which assessed the impact of 'stale' depreciation charges on EPS. The team notes that reported depreciation charges reflect the historical cost of capital expenditure rather than the replacement cost of property, plant, and equipment (PPE). This can distort P/E comparisons in capital intensive industries, particularly at times of significant fixed asset inflation. They argue that all else being equal, companies that have older capital bases should trade on lower P/Es.

The report compared gross PPE with accumulated depreciation and the annual depreciation charge in order to derive the average age of assets, and their average expected useful life. Applying a capex inflation factor of 10%, the historical cost of PPE was inflated in order to estimate replacement cost. The reported depreciation charge was then replaced with the inflation adjusted replacement cost estimate in each company's 2010 P&L. The impact on reported EPS was significant, with a sector average decrease in 2010 EPS of 16%.

Aggreko and APR comparability reduced by accounting policy choice

A recent report by the Citi EMEA Business Services team, [Aggreko PLC \(AGGK.L\) - Compare and Contrast](#) (19 September), highlighted the newly listed APR Energy as a comparative for Aggreko's international power projects (IPP) business. The two companies have operational similarities, but the analysts have identified an accounting inconsistency which reduces comparability of EBITDA.

The report highlighted a difference between the two companies in their treatment of mobilisation costs (costs incurred to mobilise and install power generating equipment). IPP involves the international provision of temporary power solutions, meaning that significant costs are incurred in transporting and installing electrical generators to locations agreed with customers. APR's mobilisation costs represented 6% of sales in 2010 and 19% in 2009.

Aggreko expenses mobilisation costs through the P&L as incurred, while APR capitalises the costs as fixed assets before depreciating these over the contract life (a period of between one and three years).

The inconsistent treatment affects the comparability of EBITDA margins – Aggreko's EBITDA is after deducting mobilisation costs while APR's does not include mobilisation depreciation. Comparing the two companies further down the P&L is less problematic, but there is still the potential for inconsistency if the depreciation charge is significantly different from the mobilisation costs incurred. Overall, APR's method is likely to result in smoother recognition of these expenses (APR's 2009 and 2010 results highlight the potential volatility of mobilisation costs), but will result in later recognition of expenses in the case of rising costs.

UK consultation on narrative reporting

Proposed UK overhaul of 'front half' of annual reports

The UK Department for Business Innovation and Skills (BIS) recently published a consultation paper on narrative reporting (ie the "front half" of annual reports)⁴. The paper argues that current reports are too long and complex, contain outdated disclosure requirements, and are not read by investors. BIS proposes replacing the current Business Review and Director's Report with a Strategic Report and an Annual Directors' Statement.

BIS suggests that the current scope of statutory audit should remain unchanged, with the paper noting a lack of "compelling evidence to change the law" in this area. This contrasts with the UK Financial Reporting Council's recent proposal⁵ of an extension of the scope of audit opinions to provide more assurance on the annual report as a whole. Current rules require a positive opinion on the financial statements only, with further reporting by exception of any inconsistencies between the financial statements and the rest of the annual report.

More succinct Strategic Report

BIS proposes requiring a Strategic Report which would include high level financial and remuneration information, as well as forward looking analysis. BIS notes that this Report should be shorter than current narrative reports, and would refer to the more detailed Director's Statement where necessary. BIS proposes that there will be few detailed rules covering the content of the Strategic Report, in order to let companies "tell their story". This would also allow companies to include information on the environmental and social impact of their business model and strategy in the Strategic Report.

The Annual Directors' Statement would contain more detailed disclosures required under company law and applicable regulation, eg the UK Corporate Governance Code. This would have standardised headings and a prescribed layout for ease of access and to increase comparability among companies.

Remuneration report to focus on how compensation will vary with performance

The paper also outlines proposals to reduce the complexity of remuneration reports while increasing their usefulness to investors. BIS suggests that the disclosure should focus on the total remuneration of directors (rather than focusing on detailed but separate information on each strand of remuneration), and provide investors with a clear link of how compensation plans are linked to business strategy. The proposals also suggest that reports should include a scenario analysis, estimating how total executive compensation varies with company performance.

The proposals include a number of potential new statistics on remuneration, such as comparison of executive pay to that throughout the organisation, total executive pay as a percentage of total profits, and disclosure of the highest paid executives below board level, or details of those paid above a certain level.

Following the consultation exercise, the UK Government intends to publish draft proposals with any regulatory requirements taking effect for years beginning 1 October 2012.

⁴ See www.bis.gov.uk/publications, 19 September 2011.

⁵ See September edition of *The Standards*, 12 September 2011.

Appendix 1: Recent Publications

Figure 1. Recent Publications

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

Source: Citi Investment Research and Analysis

Appendix 2: IASB Work Plan Overview

Figure 2. Key IASB expected standard publication dates 2011/2012

Standard Name	Key expected changes	Companies / Sectors Most Impacted	Joint project with FASB	Expected Re-exposure Date	Expected Publication Date	Expected Effective Date
Leases	<ul style="list-style-type: none"> Abolition of operating/finance lease distinction All leases on balance sheet Potential changes to lessor accounting and P&L treatment not yet agreed 	Companies with significant operating lease exposure (eg retail, transport, leisure)	Yes	Q1 2012	H2 2012	TBC, not earlier than 1-Jan-13 ³
Insurance	<ul style="list-style-type: none"> First comprehensive IFRS for Insurance Building blocks approach to measuring insurance liabilities Closer to fair value measurement of liabilities, potentially more volatility 	Insurers	Yes ¹	H1 2012 ⁴	TBC ²	TBC, not earlier than 1-Jan-13 ³
Revenue recognition	<ul style="list-style-type: none"> Convergence of IAS 11 Construction Contracts and IAS 18 Revenue Move away from "percentage of completion" basis of accounting used for construction and service contracts. Focus on completion of performance obligations as criteria for revenue recognition 	Construction, engineering, oil services, aerospace & defence, technology	Yes	Q4 2011	H2 2012	TBC, not earlier than 1-Jan-13 ³
IFRS 9 - Impairment	<ul style="list-style-type: none"> Splitting loan books into "good book/bad book" Forward looking impairment estimation model - consideration of expected losses 	Banks	Yes	H1 2012 ⁴	TBC ²	TBC, not earlier than 1-Jan-13 ³
IFRS 9 - Hedge Accounting	<ul style="list-style-type: none"> Removing quantitative hurdles to hedge accounting Enhanced risk management disclosure 	Corporates undertaking hedging	Yes	Nov 2011 ⁵	2012	TBC, not earlier than 1-Jan-13 ³
IFRS 9 - Offsetting financial assets & liabilities	<ul style="list-style-type: none"> Boards unable to agree on convergence of IFRS and US GAAP offsetting rules Likely enhanced disclosure to aid reconciliation between IFRS and US GAAP 	Banks (mainly US)	Yes	n/a	Dec 2011	TBC, not earlier than 1-Jan-13 ³

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

Appendix A-1

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