

April 17, 2009

Shedding Some Accounting Light on Citigroup's Earnings Release

- Citigroup reported its 2009 first quarter earnings today, containing numerous special and new components. **Many of these items will likely impact the earnings of other financial companies.**
- Earnings and regulatory capital benefited from Citigroup's adoption of the brand-new FASB decision amending the **other-than-temporary impairment rules.**
- In addition, Citigroup stated that the **revised fair value rules** which the banking industry and Congress fought so hard for **"had no impact."**
- **The deterioration of Citigroup's creditworthiness contributed almost \$3 billion of pre-tax gains.** This was caused by Citigroup's decision to elect the use of fair value accounting for certain of its liabilities and fair value accounting for derivatives whose value was impacted by Citigroup's reduced creditworthiness.
- In addition, Citigroup broke out the **\$541 million pre-tax benefit from the accretion of discount on securities that were reclassified to held-to-maturity** in the fourth quarter of 2008.

Although Citigroup provided a schedule entitled "Summary of Press Release Disclosures", breaking out the gain from the sale of Redecard shares, the reversal of a litigation reserve and the tax benefit from an IRS audit resolution, there are still numerous other items discussed in the earnings release on which we thought we would provide our insights.

Other-Than-Temporary Impairments – A Little Less Impaired

As discussed in our note of April 3, 2009, *FASB Yields to Pressure and Approves Amendments to Fair Value and Other-Than-Temporary Impairment Rules*, The FASB recently issued three new FASB Staff Positions (FSPs) which amend the rules for other-than-temporary impairments, provide guidance on calculating fair values in inactive and distressed markets, and require quarterly fair value disclosures. Although not required to be adopted until the second quarter of 2009, Citigroup chose to adopt them early in the first quarter.

The first, FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, changes the timing of when an impairment is considered other-than-temporary. **It also allows only the credit portion of an other-than-temporary impairment to be charged to earnings when a company does not intend to sell the security and it is not more likely than not that it will be required to sell before a recovery in value.** Citigroup's adoption of this FSP allowed it to avoid a \$631 million pre-tax impairment charge against earnings, and instead charge it to other comprehensive income (OCI).

OCI does not appear on the income statement, but instead is recorded to accumulated other comprehensive income (AOCI) within shareholders' equity. **These OCI charges will not reduce bank's regulatory capital.**

In addition, FSP FAS 115-2 and FAS 124-2 requires companies to **reassess prior other-than-temporary impairment charges** when there is no intent to sell and it is viewed as not more likely than not that a sale would be required prior to recovery of value. In those cases, the non-credit portion of the impairment charge is reclassified out of retained earnings and into accumulated other comprehensive income. **Although this adjustment does not impact the current period's earnings, it did result in Citigroup reclassifying \$431 million of after-tax impairment losses out of retained earnings and into AOCI, resulting in a corresponding increase in regulatory capital.**

What About the Other Two Financial Crisis FSPs?

FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, provides guidance on when companies can ignore observable market inputs in valuing assets and liabilities because they arise from illiquid markets and distressed sale. It is generally believed that in the current market the rule change will benefit companies' valuations by allowing them to overlook distressed sale prices in calculating fair values. **Citigroup was required to adopt this FSP at the same time as the FSP on other-than-temporary impairments, but stated that it "had no impact on Citi's financial results."**

The third FSP in the FASB's financial crisis trio will require fair value disclosures in quarterly reports. Citigroup will not have to provide these disclosures until they file their first quarter Form 10-Q in May.

Gains on Deterioration of Citigroup's Credit:

Credit Value Adjustment on Citi Liabilities at Fair Value Option	\$ 180 million
Credit Value Adjustment on derivative positions, excluding monoline insurers	\$ 2,738 million

When Citigroup calculates that fair value of one of its liabilities accounted for at fair value, it must consider its own credit standing. If its credit worthiness deteriorates, the value of the liability declines (since it is more risky and buyers would pay less for it.) **When a company writes down its liabilities due to changes in fair value, the offset is a gain.**

Citigroup, like many other companies, has elected to account for certain financial assets and liabilities under FAS No. 159, *The Fair Value Option*. Changes in the fair value of those assets and liabilities will produce gains and losses which are recorded in Citigroup's earnings, including the gains from the deterioration of its own credit. **During the first quarter the impact of changes in Citigroup's creditworthiness produced a gain of \$180 million related to liabilities for which the fair value option was elected.**

In addition, Citigroup holds derivatives accounted for as both assets and liabilities. **For those derivatives whose value is linked to Citigroup's credit standing, the deterioration of Citigroup's credit produced \$2,738 million of gains that were reported in earnings.**

“Non-Credit Accretion” of \$541 million

Our November 5, 2008 note, *Accounting for Investment Securities – FAS No. 115*, details the accounting rules for investment securities, and the breakdown between trading, available-for-sale, and held-to-maturity. **In the fourth quarter of 2008 Citigroup took an unusual step and reclassified some of its securities previously designated as trading** (which must be marked to fair value each period with gains and losses recorded in earnings) **and available-for-sale** (which also must be marked to fair value each period, but with gains and losses recorded in AOCI until the security is disposed of or matures.) **The securities were reclassified to held-to-maturity, so are no longer accounted for at fair value, but instead are accounted for at amortized cost.** (Note that both available-for-sale and held-to-maturity securities are subject to other-than-temporary impairments, discussed in our April 3, 2009 note.)

Citigroup noted in its earnings presentation that the revenue marks in Securities and Banking included “non-credit accretion” of \$541 million. This appears to be the accretion of discount resulting from the reclassifications:

- For the securities previously classified as trading, **the amortization of the discount resulting from losses previously recognized in earnings**, and
- For the securities previously classified as available-for-sale, **the amortization of any previously recorded other-than-temporary impairment losses.**

Note that in both cases the income from the amortization of discount should only be based on the expected cash flows from the securities.

Notes

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