FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Circular

# Certain accounting-related issues based on the review of financial statements for 2012

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**THIS CIRCULAR IS APPLICABLE TO:**
Issuers listed on Oslo Børs and Oslo Axess with Norway as their home state

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# 1 Introduction

Finanstilsynet supervises the periodical financial reporting of issuers of transferable securities which are quoted, or for which admission to quotation has been requested, on a regulated market within the EEA, and whose home state is Norway. Further provisions on financial reporting supervision are set forth in Regulations to the Securities Trading Act.

This circular describes certain accounting and supervisory matters which Finanstilsynet has noted over the course of the past year. See also Finanstilsynet's website for an overview of all final letters to listed entities [letters in Norwegian].

# 2 Transactions – business combination or acquisition of assets

Acquisition of business is regulated in IFRS 3 *Business Combinations*. The standard provides the definition of a business. If the assets acquired are not a business, the transaction has to be accounted for as an acquisition of assets; see IFRS 3.3. It may in some cases be difficult to draw the distinction between business acquisition and acquisition of individual assets.

Appendix A to IFRS 3 defines business as "An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants." According to Appendix B paragraph B7, a business consists of inputs and processes applied to those inputs that have the ability to create outputs.

According to IFRS 3.B11, determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, the fact that the seller operated the set as a business or that the acquirer intends to operate the set as a business is not relevant. What matters is the presence of inputs, processes and outputs that are capable of being managed as a business by a market participant.

In some cases the processes carried out may require little labour. Moreover, activities can be outsourced, and little labour may be needed to monitor them. The fact that a process requires little labour is in Finanstilsynet's view not an argument for the non-existence of processes. Equally, the fact that certain activities or functions are outsourced to other parties has no relevance to the assessment. What matters is the presence of processes that are applied to the inputs, not who carries them out.

# 3 Depreciation and calculation of residual value

Property, plant and equipment are recognised at cost less any accumulated depreciation and any accumulated impairment losses. According to IAS 16 *Property, Plant and Equipment* paragraph 6, depreciable amount is the cost of an asset less its residual value. Residual value is the estimated amount that an entity would currently obtain from disposal of the asset if the asset were already of the age and in the condition expected at the end of its useful life. According to IAS 16.BC.29, an increase in the expected residual value of an asset because of a past event must affect the depreciable amount; expectations of future changes in residual value (other than the effects of the expected wear and tear) must not. Residual value must according to IAS 16.51 be reviewed at least at each financial year-end.

Where an entity intends to own an asset for a period shorter than its expected useful life, the residual value may be substantial. This may be the case, for example, for vessels. When estimating the residual value of a vessel it is relevant to consider the value of an equivalent vessel in the current market. In the absence of equivalent vessels of relevant age in the current market, the residual value must be estimated by other means. Such estimates must take into account current market conditions, and future price increases must not be taken into account.

Finanstilsynet has noted instances where entities have calculated residual value as a percentage of acquisition cost and retained this unchanged throughout the asset's useful life. In Finanstilsynet's view this is not in conformity with IAS 16 because the calculation fails to take account of current market conditions and because the residual value is not reviewed on an annual basis.

# 4 Impairment loss for property, plant and equipment

## 4.1 Reasonable and supportable assumptions

According to IAS 36 *Impairment of Assets* paragraph 8, an entity is required to make a formal estimate of recoverable amount if there are indications that an impairment loss has occurred. The recoverable amount is the higher of its fair value less costs to sell and its value in use; see IAS 36.18. In the measurement of value in use, IAS 36.33(a) requires cash flow projections to be based on reasonable and supportable assumptions. External evidence must be given greater weight than internal evidence.

It may be difficult to provide documentary evidence of internal assumptions. This will be the case in situations where no history is available and the assumptions are not supported by market data. For example, assumptions underlying the calculation of a vessel's value in use may be difficult to support if the entity has not previously owned a vessel, has not entered into contracts for the vessel ahead, and it is not known in the market what terms apply to contracts corresponding to those which the entity expects to enter into. In a situation where the assumptions underlying the calculation of value in use are difficult to substantiate and support, Finanstilsynet is of the view that external evidence, for example brokers' estimates, must be given greater weight than the entity's internal assumptions.

## 4.2 Disclosures concerning impairment loss for property, plant and equipment

IAS 36.130 requires disclosure when an impairment loss is recognised in the accounting period. This rule applies to impairment of individual assets, including goodwill, and cash-generating units. Information must be disclosed on the events and circumstances that led to the recognition of the impairment loss, the amount of the impairment loss and a description of the asset. If the recoverable amount is its fair value less costs to sell, the basis used to determine fair value less costs to sell – such as whether fair value was determined by reference to an active market, see IAS 36.130(f) – must be disclosed. If the recoverable amount is value in use, the discount rate(s) and any previous estimate of value in use must be disclosed; see IAS 36.130(g).

Where a cash-generating unit has goodwill or an intangible asset with an indefinite useful life included in the carrying amount of that unit, IAS 36.134 requires disclosure of the estimates used to measure the recoverable amount. This applies regardless of whether or not an impairment loss has been recognised. Where measurement of the recoverable amount for other assets is concerned, entities are encouraged to disclose information about the estimates used; see IAS 36.132. In Finanstilsynet's view this is often useful information, particularly in cases where an entity is close to having to recognise an impairment loss, and Finanstilsynet encourages entities to consider disclosing this information regardless of whether or not measurement resulted in an impairment loss. Finanstilsynet emphasises that an obligation to disclose information may also be present where no impairment loss is recognised. This follows from the provisions of IAS 1, including IAS 1.125 concerning estimation uncertainty.

Since many estimates in an impairment loss assessment are subject to uncertainty, there is a significant risk of material adjustment of carrying amounts. IAS 1.125 requires entities to disclose information about the assumptions they make about the future and about other major sources of estimation uncertainty. IAS 1.126 lists examples of pertinent assumptions. Assumptions disclosed in accordance with IAS 1.125 relate to the estimates that require management's most difficult, subjective or complex judgements; see IAS 1.127. In Finanstilsynet's view the assumptions used in the calculation of value in use are often of this nature.

Information referred to in IAS 1.125 must be disclosed in a way that helps the user to understand the management's assessments. In Finanstilsynet's view, information about the sensitivity of carrying amounts to methods and assumptions, see IAS 1.129(b), is also relevant. It may also be necessary to view a number of factors collectively and to analyse sensitivity to various combinations of assumptions. While a reasonably possible change in a single assumption need not entail an impairment loss, a combination of reasonably possible changes in a number of assumptions may do so.

# 5 Operating Segments

## 5.1 Chief operating decision maker

IFRS 8 *Operating Segments* paragraph 5 mentions three criteria that must be met in order for a component of an entity to be an operating segment. One criterion is that the component's operating results are regularly reviewed by the entity's chief operating decision maker in order (a) to decide which resources are to be allocated to the segment, and (b) to assess its performance; see IFRS 8.5(b). This provision is elaborated on in IFRS 8.7. The term "chief operating decision maker" identifies a function, not necessarily a manager with a specific title. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer, but it may also be a group of directors or others.

In Norwegian entities the chief operating decision maker is normally the administrative management and not the board of directors. This follows from the board of directors' role as defined in the company legislation and the Norwegian Code of Practice for Corporate Governance. The administrative management will normally be the party that allocates resources to operating segments and assesses performance; see IFRS 8.7. However, the possibility that the board of directors in some cases allocates resources to operating segments and assesses performance cannot be ruled out. The identification of the chief operating decision maker must in all cases be based on a concrete assessment of facts.

## 5.2 Aggregation of operating segments

IFRS 8 permits two or more operating segments to be aggregated into a single operating segment if aggregation is consistent with the core principle of this IFRS, and the segments have similar economic characteristics; see IFRS 8.12. The segments must also be similar in the following respects: the nature of their products and services; the nature of their production processes; the type or class of customer for their products and services; the methods used to distribute their products or provide their services; and, if applicable, the nature of the regulatory environment. Finanstilsynet notes that very few entities disclose that operating segments have been aggregated, and points out that this is mandatory under IFRS 8.22(a).[1]

[1] *Annual Improvements to IFRSs 2010-2012 Cycle*, proposes increased disclosure requirements when operating segments have been aggregated, including disclosure of management's judgements and of the economic indicators that have been assessed. It is proposed that entities apply the amendments for annual periods beginning on or after 1 January 2014.

# 6 Expenditure on research and development and maintenance of existing intangible assets

Expenditure on research and development is regulated in IAS 38 *Intangible Assets*. If accounting policies in respect of expenditure on research and development are relevant to an understanding of the financial statements, the policies applied and assessments made by management must be disclosed in notes; see IAS 1 *Presentation of financial statements* paragraphs 117 and 122. In Finanstilsynet's view the entity must disclose how it separates expenditure on research and development from expenditure on maintenance of existing intangible assets. Accounting and disclosures depend on how expenditures are classified. Expenditure on maintenance and research must be recognised as expenses as and when they arise, whereas the entity must consider whether expenditure on development meets the criteria for recognition as an intangible asset in accordance with IAS 38. Moreover, IAS 38 requires specific disclosures about expenditure on research and development activities. No such disclosure requirements apply to expenditure on the maintenance of existing intangible assets.

Separating expenditure on research and development from expenditure on maintenance of existing intangible assets must in large measure be based on judgement. However, IFRSs provide little guidance on the exercise of such judgement, and defining boundaries may be difficult in practice. Finanstilsynet is nonetheless of the view that entities are under obligation to draw up such boundaries when this is of importance for their financial reporting. It requires an entity to maintain a conscious awareness of expenditure separation and to have in place policies to assure such separation on an ongoing basis. Separation must be based on sensible definitions, and Finanstilsynet considers it natural to base them on the definitions of research and development in IAS 38.8; see IAS 38.56 and 59. It is also relevant to have an eye to other sources of guidance; see IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraphs 10-12. Further sources may be germane. What matters is that the guidance leads to relevant and reliable information.

# 7 Information to Finanstilsynet

An entity's officers, employees and auditor are obliged to provide Finanstilsynet with such information about the entity's circumstances as Finanstilsynet requires for supervisory purposes; see the Securities Trading Act section 15-2 subsection (7). Finanstilsynet may require such information to be given within a set period and in different formats. Anyone who wilfully or through negligence violates the information requirement is punishable by fines or imprisonment of up to one year; see the Securities Trading Act section 17-3 subsection (2).

A long period may elapse from the point when Finanstilsynet informs an entity that questions have arisen regarding the entity's financial reporting to the point when the entity receives a letter stating that a review has been completed. This allows time for the two sides to exchange views on the facts of the matter and to consider each other's assessments. Such reviews are utterly dependent on entities' maintaining good communication with Finanstilsynet with regard to the matters under review. Information given made must be sufficient and appropriate to illuminating the facts of the matter in question. If there are significant changes in facts or assessments previously submitted, and the changes are key in an ongoing case, Finanstilsynet expects the entities concerned to disclose such changes on their own initiative.

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