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THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

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OUR REFERENCE	YOUR REFERENCE		DATE
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Review of financial reporting

1. Introduction

Finanstilsynet has reviewed certain aspects of the 2014 consolidated financial statements of BW Offshore Limited ("BWO"), in accordance with the Securities Trading Act section 15-1 subsection (3). The review focuses primarily on the company's method for depreciating vessels classified as conversion candidates. Reference is made to previous correspondence in the matter, most recently BWO's response letter of 16 November 2015.

BWO is a leading global provider of floating production services to the oil and gas industry. BWO specialises in the building, operating and leasing of FPSO (Floating Production, Storage and Offloading) vessels. As of year-end 2014 the company owned 14 FPSOs and 1 FSO, and operated 2 FPSOs on behalf of third party owners.

In 2014 BWO revised the depreciation method used for certain categories of assets in vessels defined as conversion candidates. Conversion candidates are vessels that have been demobilised from prior fields, are warm stacked, and are being actively marketed for redeployment. BWO argued that the consumption of future economic benefits embodied in these assets during the redeployment period is negligible, and therefore temporarily stopped depreciating such assets.

Finanstilsynet's assessment is that the revised depreciation method is not in compliance with *IAS 16 Property, Plant and Equipment*. The usage method of depreciation chosen by BWO is not considered suitable for FPSOs with redeployment risk. The method is inappropriate because the total service capacity of the assets is unknown, the consumption pattern of future economic benefit from the assets is uncertain and the assets are being exposed to wear and obsolescence also during periods of inactivity. Finanstilsynet has requested the advice of the Advisory Expert Committee on Accounting Issues (the "Expert Committee"). The statement from the Expert Committee is attached in Appendix 1.

During the review process BWO acknowledged that there is some consumption of economic benefit also in periods of inactivity, and will adjust depreciations going forward to reflect this. Finanstilsynet has noted this for the record.

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A more detailed review of the depreciation issue is given in section 2 below, and other topics covered by the review are commented on in section 3. The review is hereby considered closed.

2. Depreciation method

2.1 Background

BWO is the world's largest FPSO lease company with its fleet of 14 FPSOs and an additional vessel under construction. The company offers services at all stages of an FPSO's life cycle, from engineering to construction, installation and operation. Historically BWO has entered into long-term contracts with its clients prior to the construction and operation of the FPSO. The company is typically engaged early in the planning process to ensure optimal solutions. BWO will normally be responsible for operating the unit on behalf of the client when the FPSO is installed on site. Typical clients are large international oil companies. The vessels are usually built to be able to operate on site for the duration of the contract without the need to go to a yard for repairs or upgrades.

BWO decomposes each significant item of an FPSO into the following 3 main categories:

1. Hull and marine system: typically a converted and upgraded oil tanker or a new built hull including relevant marine systems, e.g. propulsion, navigation, steering, life boats etc.

2. Process equipment and utility system: topside equipment e.g. power plant, gas treatment, gas compression, separation systems, water injection, turret, fluid swivel system etc.

3. Non-recoverable equipment: comprises equipment that is tailor made for the specific oil field, and would normally have no value if the FPSO were to be redeployed on a different field e.g. risers, umbilicals, mooring systems and anchors.

Up to and including 2013, the company depreciated all assets using the straight-line method with a useful life equal to the total contract period for each vessel, typically over 15 years. BWO observes that over the last few years it has been able to secure contract extensions on several FPSOs even after the initially estimated 15 years, which indicates that the economic benefit from the units extends beyond the previously estimated useful life. The company has also recently entered into several contracts with significantly shorter duration. These observed changes created a need for BWO to better separate the useful life of the different components of an FPSO, and the company changed its depreciation method for assets in category 1 and 2 in its 2014 financial statement. The depreciation method for assets in category 3 was left unchanged. In the following, when reference is made to depreciation or to an "FPSO", the reference refers to assets and depreciation of the assets in category 1 and 2.

Under the revised depreciation policy BWO has employed a usage method of depreciation whereby the depreciation charge was measured based on the number of production days. This results in a straight-line depreciation over the useful life of the asset in periods of operation, and no depreciation if the vessel is laid up and reclassified to a conversion candidate. BWO has defined a set of additional restrictions for classifying a vessel as a conversion candidate:

- The vessel has to be warm stacked, e.g. maintained and kept ready for use.
- There must be a high probability of utilising the current production topside when redeployed to a new field.

- There must be a high probability of redeployment, where the company is working on specific leads/tenders.
- The expected layup is for shorter periods of time (0-2 years).

If not all the conditions for classification as a conversion candidate are fulfilled, the FPSO will continue to be depreciated also during lay-up.

In the 2014 financial report BWO had classified one vessel, the FPSO Azurite, as a conversion candidate, and stopped depreciating assets in category 1 and 2 on this vessel.

In the financial report for 2014, the usage method of depreciation was applied to one vessel and thus did not have a material effect on the numbers reported by the entity. In Finanstilsynet's view it was nevertheless important to address the issue, since the revised depreciation practice could result in material errors in future reporting.

2.2 BWO's assessment
BWO's rationale for revising the depreciation method was to bring into play a method that better reflected the consumption of future economic benefit from the assets as required by IAS 16.60.

BWO reasoned that assets within category 1 and 2 are not field/contract specific, and that only minor modifications are needed for redeployment to a new field. Based on market developments and experience from assets that have obtained life extensions, BWO determined that the equipment normally will have a useful life that extends beyond the initial contract period.

Several factors in addition to the expected usage of an asset have to be considered when determining the useful life of an asset. IAS 16.56 specifies that factors such as maintenance, technical and commercial obsolescence and legal or similar limits also have to be assessed. Vessels in lay-up that are classified as conversion candidates are kept in warm stack, with ongoing daily maintenance to keep the vessel fully functional and to avoid wear and tear. Hence the consumption of future economic benefits during this redeployment period is not comparable with consumption under normal operations. BWO is of the opinion that wear and tear in the redeployment period is negligible. BWO also argues that previous contract extensions have demonstrated that technical obsolescence for non-field specific items is less relevant in the FPSO business.

IAS 16.61 calls for an issuer to consider whether there has been a significant change in the expected pattern of consumption of future economic benefits embodied in an asset and, if so, to adjust the depreciation method accordingly. BWO considers the reclassification of an FPSO from a producing asset to a conversion candidate to encompass such a shift.

BWO was of the opinion that the unit measure that best reflects the useful life of an FPSO is the number of estimated production days expected to be obtained from the asset. This is consistent with the definition of useful life set forth in IAS 16.6.

IAS 16.62 states that a variety of depreciation methods can be used, and that an entity shall select the method that most closely reflects the expected pattern of consumption of economic benefits. BWO concluded that a usage method of depreciation is the method that most closely reflects this pattern. BWO also referred to IAS 16.55, which states that under a usage method of depreciation the depreciation charge can be zero while there

is no production. The company was of the opinion that applying a usage method of depreciation would result in a more systematic allocation of the depreciable amount over the useful life of the FPSO as required by IAS 16.50.

BWO also referred to accounting literature and industry practice claiming that it supports the use of the usage method of depreciation for FPSO assets:

- *EY International GAAP 2015, chapter 18*: 'By relating depreciation to the proportion of productive capacity utilised to date, it reflects the fact that the useful economic life of certain assets, principally machinery, is more closely linked to its usage and output than to time. This method is normally used in extractive industries, for example, to amortise the costs of development of productive oil and gas facilities.'

- *Deloitte iGAAP 2015, chapter 7*:'Another useful basis is the unit of production method, which apportions the cost of the asset over its productive life measured in terms of the units produced or machine hours utilized in relation to the total of such units or hours estimated to comprise the productive life of the asset. The method is theoretically superior to the straight-line and reducing balance methods in that it more accurately matches costs with the consumption of economic benefits, if the life of the asset can be measured with some precision in terms of its ultimate total output. This method is commonly used in the oil, gas and other extractive industries…'

The company also referred to the annual reports of Statoil, Total and Petrobras, and that these companies use the unit of production method (a usage method) when depreciating oil and gas assets. BWO concluded that based on this, the usage method of depreciation is commonly used in the industry, and that accounting literature indicates that the usage method is theoretically superior to the straight-line method.

2.2.1 Summary

In conclusion, BWO argues that the consumption of future economic benefits during a redeployment period for a vessel classified as a conversion candidate is at a minimum, and not comparable to normal operations. The economic benefits from the asset are consumed in a pattern that is linked to the number of operating days on a field; hence a usage method of depreciation would be the method that most closely reflects this pattern. Accounting literature and industry practice support the use of the method.

2.3 Finanstilsynet's assessment

The starting point for IAS 16 is that all assets should be depreciated. The depreciation begins when the asset is available for use as intended, and ends when the asset is held for sale or is derecognized, ref. IAS 16.55. The depreciation does not stop when the asset is idle or is retired from active use. Although the depreciation charge can be zero under the usage method of depreciation while there is no production, the fundamental principle that all assets should be depreciated continuously also applies to assets being depreciated under this method.

The objective of a depreciation method is to approximate the pattern in which the bundles of economic benefits inherent in the asset are consumed by the entity over time. For the usage method of depreciation to best reflect the pattern of consumption, there is an inherent assumption that there needs to be a strong correlation between the degree of use of the asset and the amount of consumption of future economic benefits from the asset. This again requires a certain degree of precision in estimating the total service capacity (inherent benefits) of the asset.

For FPSOs that have a risk of becoming conversion candidates, the total service capacity would be unknown, and it would most likely fluctuate over the lifetime of the asset. For example, provided that the FPSO is not able to secure a new contract, the service capacity would be zero, as there is no alternative use. Likewise, if the vessel is redeployed, it is highly probable that the service capacity of the asset would be reduced, due to the high degree of tailor made solutions in the FPSO industry. Hence, a usage method of depreciation would

not be suitable to allocate the consumption of future economic benefit to reflect the consumption pattern as required by IAS 16.60.

The customization of FPSOs is highlighted as one of BWO's main activities. Careful consideration of the weather conditions, oil quality, gas solutions, environmental concerns, regulatory measures etc. is needed to find the optimal solution for each specific field. The necessity for customization supports the claim that a conversion candidate would have a lower service capacity after redeployment or would need modifications, causing existing equipment to be obsolete.

Although the usage method of depreciation is commonly used by extractive industries, it is not commonly used by FPSO leasing companies. The decisive difference between an oil company owning an FPSO, and an FPSO leasing company, is that the oil company is able to estimate how the FPSO is expected to be utilized at recognition. Depreciation of the FPSO in an oil company is based on volume produced relative to total estimated production volume, and since the oil company is in control of both the producing asset and the associated oil field it can estimate the future pattern of consumption of the FPSO with a sufficient degree of precision at recognition. An FPSO leasing company will not be able to measure the consumption pattern with sufficient precision for an FPSO with a risk of becoming a conversion candidate, since the total service capacity is unknown.

An example often used in accounting literature of an asset that is frequently depreciated using the usage method of depreciation with time as a measure for useful life is the airline engine. These assets are depreciated based on hours and cycle times used relative to a total estimated hours and cycle times. For airline engines, the number of cycle times and hours used between each overhaul is strictly regulated, and different parts of the engine often have a pre-determined lifetime. An airline engine is a standardized asset with an extensive and well documented maintenance schedule. Information is systematically gathered from users of the engine by the manufacturers to ensure safety and to optimize the operation of the engine and the maintenance schedule. The total engine capacity does not change significantly over time, and so the expected benefit of one engine hour is constant throughout the useful life, indicating a strong relationship between use and consumption of economic benefit, hence making the method appropriate to use.

Finanstilsynet is of the opinion that the extract from Deloitte referred to by BWO supports Finanstilsynet's view, as Deloitte writes that a prerequisite for using the method is that the life of the asset can be measured with some precision in terms of its ultimate output. In Finanstilsynet's view the ultimate output from an FPSO with redeployment risk is highly uncertain.

For a usage method of depreciation to best reflect the consumption of future economic benefit from the asset, there is also a presumption that the asset in question experiences no obsolescence or wear during periods of inactivity. BWO initially claimed this to be the case, but Finanstilsynet was not convinced that this was correct. Finanstilsynet questioned the rationale from BWO for the following reasons:

- The likelihood of obsolescence and wear would be expected to increase with time. BWO estimated initially that a redeployment period would normally last for 2-5 years (ignoring the time used to convert/adapt the vessel to a new contract, which can take up to an additional 3 years) depending on the market situation. The prerequisite for being classified as a conversion candidate was later in the review process restricted by BWO to a maximum of 2 years. Other market sources estimates that the redeployment period can be even longer, possibly between 4 and 7 years. Without further extensive evidence, Finanstilsynet found it difficult to accept that an FPSO has no reduction in future estimated economic benefit for up to as long as 7 years. This increases the probability that conversion candidates could experience commercial obsolescence.

- There is a consensus in the accounting literature that the useful life of an asset cannot be extended indefinitely by maintenance. Eventually it will be uneconomic to maintain the asset, so while maintenance can extend the useful life of an asset, it is unlikely to make it indefinite. Although it is possible to have periods of no depreciation under the usage method of depreciation, the expected

length of the redeployment period for FPSOs contradicts the common conception that very few assets have qualities that justify not to be depreciated over extended periods of time. In Finanstilsynet's view it is highly unlikely that an FPSO has these qualities.

- Cost escalation in the industry has been very high over the last decade. Increasingly more complicated regulations have been highlighted by BWO and other industry players as one of the driving factors behind these significant cost increases. Key technical challenges when redeploying FPSOs are environmental and other regulatory changes that require modifications to the asset. This contradicts the claim that an FPSO is not exposed to both technological and regulatory obsolescence over time.

- BWO has stated that the technological development has been more or less non-existent since the 1990s. This view is not shared by some of the company's competitors. SBM Offshore in fact separates FPSO's into 3 different generations, where technology is a differentiating factor[1]. This indicates that FPSOs can be exposed to technological obsolescence over time.

Conclusion

Finanstilsynet's assessment is that the usage method of depreciation is not appropriate for BWO's FPSO conversion candidates. The total service capacity of the assets cannot be estimated with sufficient accuracy, and the correlation between the degree of use and the amount of consumption of economic benefit is uncertain. The fundamental assumption taken when applying the usage method of depreciation of no obsolescence or wear during periods of inactivity is not convincingly established.

Based on this assessment, Finanstilsynet concludes that the depreciation of assets categorized in asset category 1 and 2 was not considered to be in accordance with IAS 16 in BWO's financial statements for 2014. BWO is required to change the depreciation method for these assets going forward.

2.4 Subsequent amendments to BWOs depreciation method

After receiving Finanstilsynet's preliminary assessment, BWO acknowledged that although the consumption of economic benefits during a redeployment period is considered by the company to be negligible, it is probably not zero, and therefor accepts that the depreciation cannot be zero. BWO has decided to change the depreciation so that conversion candidates will be depreciated also during redeployment periods, but BWO will adjust the depreciation ratio in these periods. This will be done by revising the useful life of the asset to take into account the change in the expected pattern of consumption of future economic benefits during these periods. The result will be a lower depreciation charge during redeployment periods compared to production periods.

2.5 Finanstilsynet's comment on the amended depreciation method

The amended depreciation method is considered to be in line with the requirements of IAS 16.51 and 61, which instruct entities to review the useful life and depreciation method at least at each financial year-end, and adjust if there has been a significant change in the expected pattern of consumption of the future economic benefits from the asset.

Finanstilsynet is of the opinion that any changes in depreciation ratio have to result in a reasonable change in the estimated useful life of the FPSO. E.g. a 50% reduction in the depreciation charge would imply a doubling of the expected useful life of the FPSO. To evaluate the reasonableness, BWO has to consider all factors listed in IAS 16.56.

[1] SBM Offshore Capital Markets Day 2014 – Technology
http://www.sbmoffshore.com/wp-content/uploads/2014/09/4.-Capital-Markets-Day_Technology_FINAL.pdf

Finanstilsynet is also of the opinion that if BWO expects an FPSO to become a conversion candidate at some future point in time, this has to be factored in at the initial estimation of useful life. E.g. if the expected useful life of a continuously producing FPSO is 25 years, and BWO expects the vessel to be a conversion candidate for two years, the initial useful life should be estimated to be 27 years, with a corresponding adjustment to depreciation charges. Consequently, only an unexpected redeployment period would justify a change to the depreciation charge, all else equal.

The financial statement for 2014 did not disclose sufficiently detailed information regarding the depreciation method used for conversion candidates. BWO is expected to improve the disclosures regarding the depreciation methods, so that the information given is in compliance with IAS 16.73-79 in future financial statements.

3. Other topics covered by the review

3.1 Revised depreciation schedule and disclosure of change in accounting estimate

BWO revised its estimate of useful life for a number of vessels in the first quarter of 2014. Such an adjustment is a change in accounting estimate according to *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors*, paragraph 5. BWO is accordingly required, under IAS 8.39, to disclose the effect this change has on depreciation in current and future periods.

BWO has in its reply letter informed Finanstilsynet that the change in depreciation resulting from the revised useful life estimate was indicated in the company's first quarter 2014 financial report, and in the Directors' report in the 2014 annual report. Due to large capital cost increases quarter to quarter, BWO stated that it is impracticable to estimate the effect on future periods.

Finanstilsynet recognizes that it would be impracticable for BWO to estimate the impact on future depreciations as a result of the change, and so disclosing only the impact for the current period is considered acceptable. The amount should have been stated explicitly in the 2014 financial statement. It is not sufficient to disclose this through other public information or in a form that requires the reader to do his own calculations.

BWO has confirmed that the information will be included in future reporting. Finanstilsynet notes this for the record.

3.2 Disclosure of liquidity risk

Finanstilsynet recommended BWO to reconsider the time bands used in the maturity analysis for financial liabilities disclosed in accordance with *IFRS 7 Financial Instruments: Disclosures* paragraph 39a) and B11. In Finanstilsynet's view it would give the reader of the financial report a better understanding of the liquidity risk if the 1-5 year time band was split into several shorter periods. The shortest time periods could be considered removed, since the information would be outdated before the report would be made public.

BWO agreed that splitting the time band of 1 – 5 years into shorter time periods could provide more useful information. BWO also stated that this information was already being disclosed on a regular basis in the company's quarterly presentations. The company will take this into consideration going forward, and include the information in the 2015 accounts. Finanstilsynet notes this for the record.

4. Closing

Finanstilsynet has not considered whether the above matters are subject to the securities legislation's provisions regarding the requirement to disclose inside information in accordance with the securities Trading Act section 5-2 subsection (1) and section 3-2. Finanstilsynet expects the undertaking to consider its requirement to disclose inside information on a continuous basis.

Finanstilsynet has forwarded a copy of this letter to the issuer's appointed auditor and to Oslo Børs.

Appendix:

1. Statement from the Advisory Expert Committee on Accounting Issues

On behalf of Finanstilsynet

Christian Falkenberg Kjøde
Head of section

Håkon Stensrud
Senior Adviser

This document is electronically approved, and does not need a signature.