FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Circular

Finanstilsynet's review of financial statements in 2016

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

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1 Introduction

Finanstilsynet supervises the financial reporting of issuers whose financial instruments are admitted to trading on Oslo Børs or Oslo Axess.

This circular describes certain accounting matters which Finanstilsynet has noted in 2016, including:

- impairment of property, plant and equipment
- embedded derivatives in long-term power supply contracts
- application of the usage method of depreciation
- conversion of loans to shares
- guarantee fund levy for banks

Final letters in matters relating to financial reporting supervision are published on Finanstilsynet's website and on Newsweb.no.

Section 7 describes the guidelines published by the European Securities and Markets Authority (ESMA) on alternative performance measures. Section 8 describes the areas prioritised in the review of financial statements for 2016.

2 Impairment of property, plant and equipment

In light of the steep oil price fall in autumn 2014 Finanstilsynet carried out a thematic review to identify entities in oil-related industries where the risk of impairments was considered to be high. The thematic review initiated five specific reviews focusing on impairments.

Use of broker estimates
In periods of impaired markets and few transactions, increased diligence is required of entities that utilise broker estimates. A number of brokers have warned that poor liquidity in the market for supply ships creates substantial uncertainty as regards ship value estimates. Finanstilsynet expects entities to conduct their own calculations to assess the robustness of estimated values. Entities must have an independent perception of the assumptions underlying the estimates, and perform sensitivity analyses. Entities must test the assumptions against other available market information, and they should obtain supplementary documentation of the valuation methodology and assumptions underlying brokers' estimates. A check should also be made of whether the valuations have been prepared in compliance with the requirements of IFRS 13 *Fair Value Measurement*.

Assessment of possible outcomes
Finanstilsynet has in several instances called for entities to make use of scenario analyses when calculating value in use. Estimating a number of possible cash flow outcomes will bring out the effect of the various assumptions more clearly. This applies both to the values arrived at and the weighting of the various outcomes. Entities must have a deliberate awareness of the

cash flows' range of outcomes and of what method is best suited to arriving at the weighted average of all possible outcomes. The risk of an overly optimistic view of the future will be remedied if the entity supports its estimates with external evidence.

Reasonableness of the sum of assumptions
Although the individual assumptions used in calculating the cash flows, and the discount rate, may lie within a reasonable range, the sum of the assumptions may result in a valuation of the asset that is not reasonable from an overall perspective. If consistent use is made of revenue estimates in the uppermost part of the range and of cost and investment estimates in the lowest part of the range, the estimated usage value may prove to be too high.

Information about assumptions
Disclosures about impairment, impairment testing and the uncertainty of significant assumptions are crucial to assessing the reliability of an entity's estimates. This is particularly important in situations of large market uncertainty. Changes in assumptions used may have a significant impact on value estimates. ESMA singled this out as an area that listed entities should be attentive to when preparing and presenting their financial statements for 2015.[1] IAS 1.125 requires entities to disclose information about assumptions used by management when measuring assets and liabilities that have a substantial bearing on the amounts that are recognised in the financial statements.

Report on impairment
The thematic review of impairment will also result in a report on impairment. The report is based on the reviews of impairments conducted by Finanstilsynet. The report also describes the process that underlies Finanstilsynet's review of impairment testing and the factors to which importance is attached in the decisions taken. The report will be published on Finanstilsynet's website in December 2016.

3 Embedded derivatives in long-term power contracts

Electricity companies supply power-intensive industries through long-term contracts. The contracts are bilateral and specify volume, duration, delivery location, price and settlement currency. Virtually all contracts after 2010 are denominated in euro.

A contract to deliver electricity that is settled in a currency other than the entity's functional currency is considered to be a hybrid instrument consisting of a contract for physical delivery of electricity (host contract) with power price exposure and an embedded derivative with euro exposure.

Under the accounting rules, the host contract should not be recognised when entered into where the object is to deliver electricity in accordance with the entity's expected sale or usage requirements. The contract will only be taken to income upon delivery of the power. Exposure

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[1] "European common enforcement priorities for 2015 financial statements": https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1608_esma_public_statement_-_ecep_2015.pdf

to future power prices will accordingly not be reflected in the accounts upon entry into the contract. An embedded derivative should as a general rule be detached from its host contract and accounted for as a derivative at fair value with changes recognised through profit or loss. However, an embedded derivative should not be detached if its economic characteristics and risks are closely related to those of the host contract; see IAS 39 *Financial Instruments: Recognition and Measurement* para. 11.

There are three specific exceptions to the main rule that an embedded currency derivative has to be detached from its host contract. One exception applies where there is a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place; see IAS 39 A33(d)(iii). The other two exceptions are not relevant in the present context.

In Finanstilsynet's assessment the "economic environment" in the accounting standard is to be understood as a geographical area where non-financial items in general are traded and where there are one or more currencies that are commonly used. The standard refers to items in the plural. Hence the market for one concrete commodity cannot be regarded as an economic environment under the provision of IAS 39. An integrated Nordic energy market can accordingly not be viewed as an economic environment as described in the standard because only one commodity is traded in this market. In Norway domestic transactions constitute an economic environment. Mainly Norwegian kroner are used in domestic transactions. Contracts between Norwegian entities with settlement in euro therefore contain a currency derivative that is not closely related to the host contract. The currency derivative must be detached and accounted for at fair value at each reporting period.

4 Application of usage-based depreciation

Finanstilsynet has considered the application of usage-based depreciation for laid-up vessels. The basic rule under IAS 16 *Property, Plant and Equipment* is that all assets are to be depreciated from the time that the asset is available for use up to the time it is classified as held for sale or is derecognised; see IAS 16.55. The standard provides examples of various depreciation methods – including the usage-based/unit-of-production method of depreciation – which may be appropriate for certain assets. In order for a usage-based method to best reflect the consumption of economic benefits, there must be a strong link between usage of the asset and the consumption of future economic benefits from the asset. It must also be possible, with some degree of certainty, to calculate the residual total future economic benefits from the asset. Further, the asset cannot become obsolete – economically, technologically, legally or physically – when not in use. If the asset is leased to a third party, the lessor must have control of how much the asset is used or produces.

Where usage-based depreciation is used, zero depreciation is charged when the asset is idle for the whole period. There is nonetheless a basic expectation of relatively continuous impairment over time. Very few assets have no form of reduction of future economic benefits over time even where the asset is not in active use. Repair and maintenance of an asset do not negate the need to depreciate it; see IAS 16.52.

Finanstilsynet does not consider the usage-based method to be a suitable method for depreciating laid-up vessels.

5 Conversion of loans to shares

Banks with loans to entities that have financial problems and/or are unable to service debt will in some cases convert the entire loan or parts of it to shares in the entity. The actual conversion is itself objective evidence that the loan is impaired; see IAS 39.59. Any residual portion of the loan must be tested for impairment.

IAS 39.26 requires the carrying amount of a loan that is converted to be compared with the fair value of the shares received, and the difference to be recognised in profit or loss as a loan loss. The shares received should in the first instance be recognised at fair value; see IAS 39.25. This entails presenting the loss as a loan loss (at the latest) in the period in which the conversion is carried out, and not as a change in the value of the shares in subsequent periods.

IFRS 13 defines fair value as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Simultaneous cash issues directed at other shareholders are an example of transactions that are well suited as a basis for calculating shares' fair value. A conversion price that is significantly higher than the subscription price offered to other shareholders is a clear indication that the fair value of the new shares received is lower than the nominal value of the loan that was converted. The same applies to unsuccessful attempts to induce new investors to participate in issues at the same price as that used for conversion purposes.

6 Banks' Guarantee Fund levy for banks

Reference is made to Finanstilsynet's circular 12/2015 containing a description of the guarantee fund levy for banks. According to the circular, banks are required to expense the entire guarantee fund levy on 1 January each year. The Ministry of Finance has amended Regulations of 6 May 1997 no. 429 on payment of a levy to the Norwegian Banks' Guarantee Fund. The amendment regulates withdrawal from the Guarantee Fund in the course of the calendar year such that a pro rata deduction of the levy is granted for that part of the year that the bank concerned has not been a member of the Guarantee Fund. The amendment enters into force on 1 January 2017 and entails that the guarantee fund levy has to be accounted for on an accrual basis through the year.

7 Alternative performance measures

ESMA published in autumn 2015 "Guidelines on Alternative Performance Measures" (APMs). The guidelines apply to listed entities' reporting of alternative performance measures in annual and interim reports outside the financial statements. The guidelines also apply to entities that are subject to a prospectus requirement that disclose such information in their prospectus. The guidelines entered into force on 3 July 2016. Finanstilsynet will survey entities' compliance with the guidelines, and will publish a thematic report in the course of 2017.

An APM is defined in the guidelines as a financial measure of historical or future financial performance, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework. An APM is generally based on the entity's financial information (presented under relevant accounting legislation, for example IFRS) and adjusted for certain items. Examples of APMs are operating earnings, earnings before one-time charges and earnings before interest, taxes, depreciation, and amortisation (EBITDA).

The guidelines are aimed at promoting the usefulness and transparency of APMs. Adherence to the guidelines will improve the comparability, reliability and/or comprehensibility of APMs. Issuers that provide APMs should do so in a way that is appropriate and useful for users' decision-making. The guidelines aim to ensure uniform practices across Europe. Paragraphs 20-48 of the guidelines deal with presented financial information and what information is to be disclosed when using APMs. A summary follows below.

Information: Definitions and the basis for calculation adopted, including any hypotheses or assumptions used, should be included for all APMs and their components. It should also be indicated whether the APM or any of its components are related to the (expected) performance of the presented or future reporting period.

Presentation: APMs disclosed should be given meaningful labels reflecting their content and basis of calculation in order to avoid, and not be liable to, misunderstanding or confusion with other labels such as "one-time effects", "unusual" or "rare".

Reconciliations: Each APM should be reconciled with historical financial information. This also applies to performance measures based on figures that are not yet, or are not going to be, published. An APM that cannot be reconciled with financial information should be explained in terms of the consistency of that APM with the accounting policies employed by the issuer.

Explanation on the use of APMs: It should be made clear why an APM is considered to provide relevant and reliable information.

Prominence: An APM should not be displayed in a way that is liable to create the impression that it provides more important or more correct information than that presented in the financial statements proper, or that is liable to distract from such information.

Comparatives: Comparative figures from previous periods should be presented; this also applies in the case of APMs for future periods. If it is impracticable to provide comparatives, reasons for this should be given. The reconciliation principles apply equally to comparatives.

Consistency: The definition and calculation of an APM should be consistent over the period covered by the historical financial information. Any changes should be explained, and reasons why these changes result in reliable and more relevant information should be given. Restated comparative figures should also be provided.

See ESMA Guidelines on Alternative Performance Measures.[2]

8 Prioritised areas in the review of 2016 financial statements

Reference is made to ESMA's public statement "European common enforcement priorities for 2016 financial statements".[3] This defines areas which ESMA considers listed entities should particularly consider when preparing and presenting their financial statements for 2016. Finanstilsynet will be attentive to these areas in its review of financial statements for 2016.

The prioritised areas are:

Presentation of financial performance: ESMA stresses the importance of providing investors with high quality disclosures about financial performance. ESMA urges listed entities to ensure transparency and consistency in the statement of profit or loss, notes and in the documents accompanying financial statements.

Financial instruments – distinction between equity instruments and financial liabilities: ESMA is aware of situations where the distinction between equity instruments and financial liabilities requires significant judgement. ESMA reminds issuers that the general principle for distinguishing liabilities from equity is whether the entity has an unconditional right to avoid delivering cash or other financial asset for the purpose of settlement.

Disclosure of the impact of new accounting standards on IFRS financial statements: ESMA highlights that some aspects of the new IFRS standards which come into force in 2018 and 2019 represent a significant change compared to the current standards. The standards concerned are Financial Instruments (IFRS 9), Revenue from Contracts with Customers (IFRS 15) and Leases (IFRS 16). These new standards may affect the recognition, measurement and presentation of assets, liabilities, income, expenses and cash flows. Entities must accordingly prepare for the introduction of the new standards without delay. Attention is drawn to ESMA's following public statements: "Issues for consideration in implementing IFRS 9: *Financial Instruments*"[4] and "Issues for consideration in implementing IFRS 15: Revenue from Contracts with Customers"[5].

Finanstilsynet emphasises that it is important for entities to disclose possible impacts of the switch to IFRS 9 and IFRS 15 in their financial statements for 2016 rather than later. Possible impacts of changes in the regulatory regime should be quantified. Reference is also made to the provision of IAS 8.30 which states that where an entity has not applied a new IFRS that has been published but has yet to enter into force, the entity should disclose this fact.

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[2] https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1057_final_report_on_guidelines_on_alternative_performance_measures.pdf
[3] https://www.esma.europa.eu/sites/default/files/library/esma-2016-1528_european_common_enforcement_priorities_for_2016.pdf
[4] https://www.esma.europa.eu/sites/default/files/library/2016-1563_public_statement-issues_on_implementation_of_ifrs_9.pdf
[5] https://www.esma.europa.eu/sites/default/files/library/2016-1148_public_statement_ifrs_15.pdf

Information of relevance for assessing the impact of the new IFRS on the entity's financial statements in the period that the IFRS is applied for the first time should also be disclosed.

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