



FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Circular

Finanstilsynet's review of financial statements in 2017

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THIS CIRCULAR IS APPLICABLE TO:

Issuers listed on Oslo Børs and Oslo Axess
with Norway as their home state

FINANSTILSYNET

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The Circular's main content

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

The 2017 circular covers (in the following sequence):

1. Prioritised areas in Finanstilsynet's review of financial statements for 2017
2. Finanstilsynet's expectations with regard to entities' implementation of and compliance with new accounting standards, where
 - Finanstilsynet emphasises the importance of relevant information disclosures in the annual report for 2017. Information must also be disclosed on other consequences of the new standards, including for example clear information on the accounting treatment of onerous contracts.
3. Finanstilsynet's expectations with regard to entities' compliance with guidelines on alternative performance measures, where
 - the thematic report published by Finanstilsynet in October 2017 shows that many entities have room for improvement.
4. The International Accounting Standards Board's (IASB) "IFRS Practice Statement 2: *Making Materiality Judgements*", where
 - the IASB clarifies what it considers to be material information.

This circular also covers some accounting matters considered by Finanstilsynet in 2017 in its supervision of listed entities, including:

5. Sources of estimation uncertainty, where
 - Finanstilsynet emphasises that entities must, under the disclosure requirements of IAS 1, disclose information about key assumptions.
6. Identification of intangible assets and assessment of useful life, where
 - Finanstilsynet points to the importance of identifying all intangible assets acquired in a business combination.
7. Country risk, where
 - Finanstilsynet points out that this risk must be taken into account and that it should reflect current market assessments.

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

Finanstilsynet expects institutions to read, and to comply with, the assessments set out in this circular.

1 Prioritised areas in the review of financial statements for 2017

Finanstilsynet will prioritise the following areas in its review of financial statements for 2017¹.

- **Note disclosures on the expected effects of the implementation of new standards (IFRS 9 *Financial Instruments*, IFRS 15 *Revenue from Contracts with Customers* and IFRS *Leases*).** Finanstilsynet stresses the need for high quality implementation of IFRS 9 and IFRS 15 and the need for better communication of the expected impacts.

Finanstilsynet expects entity-specific quantitative and qualitative disclosures on the implementation and application of the new standards in the 2017 annual report. Finanstilsynet will monitor entities' implementation of the new standards over the course of 2018.

- **Specific issues as regards recognition, measurement and disclosure in IFRS 3 *Business Combinations*.** Finanstilsynet expects institutions to specifically consider:
 - o intangible assets
 - o adjustment of fair values in the course of the measurement period
 - o bargain purchases (negative goodwill) and
 - o business combinations under common control
- **Specific issues in IAS 7 *Statement of cash flows*.** Finanstilsynet draws attention to the amendments to IAS 7, effective from 2017 onwards. Disclosures are required that enable users to evaluate changes in liabilities arising from financing activities.

2 New accounting standards

Several amendments to IFRS will have come into effect by the time entities make their annual financial statements for 2017 publicly available. Entities are required to disclose information about how the amendments will affect the annual financial statements upon implementation, in accordance with IAS 8.30-31. Finanstilsynet comments on three of the amendments in particular but points out that the same comments may also apply to other amendments.

IFRS 9 and IFRS 15 must be implemented from 1 January 2018 at the latest, and IFRS 16 from 1 January 2019 at the latest.

¹ These are in accordance with the priorities from the European Securities and Markets Authority (ESMA) as regards financial reporting; see https://www.esma.europa.eu/sites/default/files/library/esma32-63-340_esma_european_common_enforcement_priorities_2017.pdf

Annual financial statements 2017

For new standards taken into use on 1 January 2018 Finanstilsynet expects entities to give an account of the implementation method used, of the effect on equity as at 1 January 2018 (1 January 2017 if the full retrospective method is used), of the practical expedients employed and of the accounting policies chosen. The account must be concrete and entity-specific.

Finanstilsynet urges entities to consider how the 2017 annual report can be a reference document for interim reporting in 2018. In this regard Finanstilsynet highlights IAS 34 *Interim Financial Reporting* paragraph 6: "*The interim financial report is intended to provide an update on the latest complete set of annual financial statements. Accordingly, it focuses on new activities, events, and new circumstances and does not duplicate information previously reported.*"

Finanstilsynet reiterates that any prior-period errors brought to light during the process of implementing the new accounting standards shall be presented separately from implementation effects.

For new standards or interpretations that are not taken into use on 1 January 2018, IAS 8.30-31 requires the entity to disclose information relevant to assessing the impact of the new standard or interpretation on the entity's financial statements. Disclosing, for example, information on the estimated effect of IFRS 16 may be of key importance. The account must be entity-specific.

Onerous contracts

Accounting for onerous contracts is a central theme for many entities. Since IFRS 15 does not include specific rules for onerous contracts, the IASB's interpretations committee, IFRS IC, has discussed the accounting treatment of onerous contracts at several meetings in 2017. The discussions have centred on how onerous contracts should be accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Finanstilsynet expects entities to disclose relevant and precise information on their accounting for onerous contracts in the 2017 annual report under the rules in effect for 2017. Entities are also required to disclose information about any changes under new rules, as well as information about transitional effects arising from the implementation of new standards.

Other parts of the 2017 annual report

Finanstilsynet considers it natural to describe the effect of new standards elsewhere in the annual report than in the annual financial statements, for example in the management report, the corporate governance report or the definition of APMs. The management report's analysis of the result for the year² must also show how the results for the year and the financial position will change under the new accounting rules. Similarly, Finanstilsynet expects the corporate governance report to give an account of changes in the systems for internal control and risk management brought about by new accounting rules, and their bearing on the financial reporting process.

Interim financial statements 2018

Interim financial reporting in 2018 shall be prepared in accordance with the new standards taken into use on 1 January 2018. This applies both to recognition and measurement, along with presentation, classification and disclosures. In order for the interim financial reporting in

² Accounting Act section 3-3a, second and third subsections

2018 to provide an update of the latest complete set of annual financial statements under IAS 34.6, entities must, as mentioned above, disclose necessary information in the 2017 annual financial statements. If this is not possible, the interim financial statements must contain all information on transitional effects.

Where an entity opts to implement new standards without restating comparatives, it must present the information in the interim reports in such a way that the users of the reports acquire the necessary insight into the information that is presented for both years.

Disclosures

The new accounting standards set extensive requirements for disclosures. Entities must ensure that work on procuring the data needed to comply with the requirements starts in time, and that disclosures are properly presented. The information must be entity-specific.

3 Alternative performance measures

Finanstilsynet has reviewed listed entities' use of alternative performance measures (APMs) and their compliance with the relevant guidelines. The results from the survey, along with an account of the principles enshrined in the guidelines and Finanstilsynet's views in certain areas, are presented in a thematic supervisory report³ published on 17 October 2017.

Use of APMs is discretionary, and many entities choose to present such measures in the belief that they represent useful information for the market and put analysts and investors in a better position to assess an entity's financial over time. Finanstilsynet expects entities to carefully consider their choice of APMs, and to ensure that the ones presented are of high relevance for the entity. Entities must see to the establishment of adequate procedures for quality assuring and reporting of APMs. Accordingly, sufficient focus to be given to the choice of APMs and to the amount of information to be disclosed. It is important to involve the management board and audit committee in this work.

Finanstilsynet expects entities to comply with the guidelines. Entities whose 2016 annual report inadequately explained their use of, or inadequately defined, their APMs, or failed to reconcile APMs to the financial statements, are expected to improve their practices to ensure compliance with the guidelines.

Finanstilsynet makes reference to the clarifications published by ESMA in an updated Q&A on 30 October 2017⁴. Finanstilsynet will base its supervision on ESMA's clarifications.

³ <https://www.finanstilsynet.no/contentassets/feba848927be4ee0ac7789a7e14d0c73/tematilsyn-om-alternative-resultatmal-2017.pdf> [This report is available in Norwegian only.]

⁴ ESMA32-51-370: https://www.esma.europa.eu/sites/default/files/library/esma32-51-370_gas_on_esma_guidelines_on_apms.pdf

4 Materiality judgements

The IASB published in autumn 2017 "IFRS Practice Statement 2: *Making Materiality Judgements*"⁵, which is a practical guide to assessing materiality when preparing financial statements under IFRS. The practice statement does not change or introduce new requirements in IFRS standards, but brings together all materiality requirements laid down in current standards.

The need for materiality judgements is pervasive in the preparation of financial statements. Materiality judgements need to be made in decisions about recognition, measurement, presentation and disclosure. The object of the practice statement is to improve the information communicated in financial accounts by highlighting the importance of material information and of reducing immaterial and superfluous information.

The practice statement contains a model for making materiality judgements, based on primary users' need for information. The IASB urges less use of checklists and more exercise of judgement when considering what information is expected to be of material significance for users. Information in annual financial statements must be entity-specific and tailored to the users' information needs. The practice statement also gives guidance on how to make materiality judgements about prior-period information, errors, warrants and for interim reporting.

The practice statement is now in effect, and Finanstilsynet urges all entities to familiarise themselves with the statement when preparing the annual financial statements for 2017 and subsequent financial reporting.

5 Sources of estimation uncertainty

The IFRS require entities to disclose information about assumptions that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year; see IAS 1 *Presentation of Financial Statements*, paragraph 125.

Most entities employ assumptions about the future in their estimates. Such assumptions may be uncertain in varying degrees. Estimates supported by market data, or where market participants share a relatively similar view of the underlying assumptions, are less uncertain than estimates where market participants' views of the assumptions differ. In situations where market participants' views of the assumptions vary widely, and where a reasonable change in the assumptions prompts a significant adjustment to the carrying value, Finanstilsynet considers that information about the assumptions should be disclosed. In order to understand the effect of changed assumptions on assets and liabilities, users of financial statements need both qualitative information about how the assumptions are determined and quantitative information about the assumptions employed.

⁵ Practice Statement: <http://www.ifrs.org/issued-standards/materiality-practice-statement/>. Access to the Practice Statement requires a subscription.

A pertinent example is oil companies' oil price assumptions. Assumptions about oil prices up to three years ahead in time are supported by forward prices in a liquid market. Where an oil company uses forward prices, disclosing that fact will suffice. The market for long-term forward prices is less liquid, and market participants' views regarding long-term prices in this market will differ. The long-term oil price assumption is often the most sensitive assumption in an oil company's assessment of the recoverable amount for an oilfield. Where a change made to an assumption drawn from a reasonable range of possible assumptions will entail a material adjustment to the carrying amounts, either as write-downs or reversals of write-downs, Finanstilsynet is of the view that oil companies should disclose quantitative information about the long-term oil prices employed. The information should be disclosed for several future points in time to enable the user of the financial statements to understand the price curve employed. Information must also be disclosed about the sensitivity of the carrying amounts to the assumptions underlying their calculation; see IAS 1.129(b).

Oil companies' estimation of the long-term oil price is merely one example of assumptions that need to be specified under IAS 1.125. Other industries also employ assumptions about the future where a wide range of reasonable assumptions exists, and where a change within this range of possible outcomes could have a material effect on the carrying amount of assets and liabilities.

6 Identification of intangible assets and assessment of useful life

In a business combination the acquirer shall recognise, separately from goodwill, the identifiable procured tangible and intangible assets in the acquiree. To qualify for recognition, assets must meet the definition of assets given in the IASB's framework and standards.

Where groups of individual assets are purchased, the purchase sum must be apportioned on the individual identifiable tangible and intangible assets based on the assets' relative fair value.

Intangible assets shall be identified and recognised separately from other assets and goodwill, provided the asset concerned meets the definition given in IAS 38 *Intangible Assets*. This requires the intangible asset to be identifiable, which is the case when it is separable or when it arises from contractual or other legal rights.

The examples given in IFRS 3 "*Illustrative Examples*", which is not an exhaustive list, show that a relatively large number of intangible assets need to be identified and recognised separately from other assets and, in the event, goodwill.

All procured intangible assets that are identifiable shall be recognised separately. A thorough analysis has to be made of each recognised intangible asset's useful life in order to achieve amortisation over the assets' useful life that are reasonable.

Many intangible assets arise from investments related to technological innovation. In view of the rapid shifts and changes in technology, the IFRS provisions require useful lives to be

analysed on a cautious basis, and on the assumption that useful lives will likely be short; see IAS 38.92-93.

IAS 38.90 lists several factors that may limit an intangible asset's useful life. Technical, technological, and commercial obsolescence must be considered. A high degree of innovation entails a short useful life for relatively new assets based on older technology. Another factor that must be considered is the stability in the industry in which the asset is employed, and changes in the market's demand for products and services related to that asset. Moreover, changes in consumers' consumption patterns are frequent and may well entail a shorter useful life than previously observed.

The standard also states that it is important to take into account the effect of expected actions of existing competitors and potential new competitors. Estimated useful life must reflect the possible market entry of new participants and new substitutes.

Finanstilsynet emphasises that it is only when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity, that an asset shall be considered to have an indefinite life; see IAS 38.88.

7 Country risk

Country risk is a measure of the risk facing an entity that invests in certain countries and areas. Country risk reflects a number of factors such as economic, financial, legal, political or institutional factors, and is associated with events with low probability but with a potentially large effect.

There are several approaches to, and views on, how country risk is best reflected in valuations. This risk must be taken into account and it must reflect current market assessments of the risks specific to the asset concerned; see IAS 36 *Impairment of Assets* paragraph 55 and IAS 36 A18. In a value-in-use calculation where the current value of future cash flows is estimated, country risk can be taken into account either by adjusting expected cash flows for the effect of engaging in activities in high-risk areas, or as an add-on to the discount rate.

If account is taken of country risk as an add-on to the discount rate, external sources should be given weight when considering the size of the add-on (country risk premium), and a reasonableness assessment of the discount rate employed should be carried out.

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