FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Rundskriv

Finanstilsynet's review of financial reporting in 2018

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

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

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

1 Prioritised areas in the review of financial statements for 2018

Finanstilsynet will prioritise the following areas in its review of financial statements for 2018[1].

- Issues relating to the application of IFRS 9 *Financial instruments*
- Issues relating to the application of IFRS 15 *Revenue from contracts with customers*
- Disclosures about the expected effects of the implementation of IFRS 16 *Leases*

Finanstilsynet will also monitor entities' compliance with the content requirements in their formal reporting. Finanstilsynet expects to see an improvement in this area and expects the entities to comply with the guidelines for alternative performance measures (APMs).

2 New accounting standards

The new accounting standards require that entities have the necessary skills and resources to operationalise the standards, comply with comprehensive disclosure requirements and develop good documentation.

Finanstilsynet has initiated a number of supervisory cases where issues relating to IFRS 15 have been raised. Moreover, Finanstilsynet will carry out a thematic inspection of selected banks in 2019 on how they apply IFRS 9. Additional reviews relating to compliance with the new standards are considered on an ongoing basis.

As part of its supervision, Finanstilsynet has seen some examples that entities' documentation is too general in nature. Finanstilsynet expects the entities to devote adequate resources to ensuring compliance with the standards and to provide detailed documentation.

2.1 IFRS 9 *Financial instruments*

Information in the annual financial statements for 2018 for other entities and financial institutions

The implementation of the new accounting standard for financial instruments, IFRS 9, has significant effects for many entities. Entity-specific information about how IFRS 9 affects financial statements must be provided. IFRS 7 *Financial instruments: Disclosures* has also been amended and includes a detailed set of requirements for disclosure to be provided by entities when applying IFRS 9 for the first time, cf. IFRS 7.42I-42S. Among other things, impairment losses according to IAS 39 and IAS 37 at year-end 2017 shall be reconciled with

[1] These are in accordance with the priorities of the European Securities and Markets Authority (ESMA) as regards financial reporting; see https://www.esma.europa.eu/sites/default/files/library/esma32-63-503_esma_european_common_enforcement_priorities_2018.pdf

impairment losses according to IFRS 9 in the opening balance sheet for 2018. In addition, an overview shall be provided of reclassifications of financial assets based on new measurement categories.

IFRS 9 generally has the greatest effect for financial institutions, though other entities also need to consider materiality and, based on this, provide sufficient and entity-specific information about the accounting effects of the transition to the new standard. The standard changes several of the disclosure requirements in IFRS 7 with respect to credit risk and impairment losses. If the figures for 2017 are not restated in the 2018 financial statements, entities are not required to restate disclosures for 2017. That means that disclosures must be provided in accordance with the requirements of the previous version of IFRS 7 for the comparative period.

The disclosure requirements in IFRS 7 regarding hedge accounting have been changed. The new disclosure requirements also apply to entities that have chosen to continue with hedging under the provisions of IAS 39, c.f. IFRS 7.21A-24H.

In the paragraphs below, Finanstilsynet will focus on certain issues that have been observed when implementing the model for expected credit losses under IFRS 9 and that apply in particular to financial institutions.

Expected credit loss model – general

IFRS 9 does not require the use of any specific method for calculating expected credit losses. The calculations shall reflect an unbiased and probability-weighted amount that is determined by evaluating possible outcomes, the time value of money, reasonable and supportable information about past events, and current and future conditions, cf. IFRS 9.5.5.17.

The availability of information will vary between financial institutions and also between different portfolios in the individual institutions. The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of the current situation and future prospects, cf. IFRS 9 5.5.4 and IFRS 9 B5.5.51. Methods, input data and assumptions for calculating credit losses must be entity-specific. Entities must therefore provide good quantitative and qualitative disclosures about how they handle credit risk and calculate credit losses. Moreover, entities must disclose changes in estimation techniques and significant assumptions during the period, and provide reasons for those changes, see IFRS 7.35G.

The use of macroeconomic information in the entities' models and the weighting of scenarios significantly impact the impairment level. Information about how forward-looking information has been incorporated in the calculation of expected credit losses should be transparent and easily accessible for users of the financial statements, cf. IFRS 7.35G(b).

Significant changes in credit risk

For loans where the credit risk has increased significantly since initial recognition, impairment losses equal to lifetime expected credit losses shall be recorded. Changes in the risk of default occurring over the entire expected life of the loan (lifetime PD)[2] shall be considered to determine whether there has been any significant increase in credit risk, cf. IFRS 9.5.5.9.

The standard gives entities the opportunity to use probability of default over the next twelve months (12-month PD) when considering significant changes in credit risk if default patterns are not concentrated at a specific point in time over the life of the loan, cf. IFRS 9 B5.5.13. 12-month PD is therefore not suitable, for example, when the loan only has significant payment obligations beyond the next 12 months. Furthermore, 12-month PD cannot be used if changes in relevant macroeconomic or other credit-related factors are not adequately reflected in the estimated 12-month PD, cf. IFRS 9 B5.5.14[3]. Entities must conduct adequate analyses before using such a simplified approach. Regardless of how the bank assesses a significant increase in credit risk, there is a presumption in IFRS 9 that credit risk has significantly increased if contractual payments are more than 30 days past due (30-day "back stop"). This presumption can only be rebutted if it can be documented that it is not correct.

Migration of loans from stage 1 and 12-month losses to stage 2 and lifetime losses increases impairment. Information about how entities operationalise this is important for the users of the financial statements. Entities must provide specific information on quantitative and qualitative thresholds and on whether they use the 30-day "back stop" referred to above. Furthermore, entities must provide information on the guidelines and threshold values used to transfer loans back from stage 2 to stage 1, and whether there is a cure period to ensure that the loan actually has lower risk. Entities that consider a change in the 12-month PD to be a reasonable approximation of changes in the lifetime PD, must disclose this.

Expected life of loans

The expected life of a loan affects the calculation of the expected credit loss. If other factors remain constant, a longer life will give a higher probability of default and higher credit losses than a shorter life, cf. IFRS 9.B 5.5.10.

The effective life of a loan is often shorter than stated in the loan agreement due to repayments, early redemption and refinancing. In general, the figures used to estimate expected losses must be sufficiently detailed and divided into homogeneous subgroups of borrowers. For example, the calculation of the expected life of a residential mortgage should be differentiated based on the need for refinancing and the ability to make early repayments (for example geographically and between generations).

It is not necessarily sufficient to have details on past behaviour among borrowers when assessing the expected life of loans in the period ahead. IFRS 9 requires that entities take forward-looking information into account when calculating credit losses. For example, it is reasonable to assume that there are fewer prepayments and early redemptions of loans during

[2] PD – Probability of Default

[3] See the discussion on the topic in Transition Resource Group for the Impairment of Financial Instruments (ITG), September 2015. ITG has pointed out that entities need to prepare a robust analysis in advance in order to use 12-month PD as an approximation of lifetime PD to assess whether there has been any significant change in credit risk.

a recession. Changes in the expected life of loans will therefore be one of the assumptions that usually needs to be adjusted when entities draw up scenarios.

2.2 IFRS 15 *Revenue from contracts with customers*

Information on the application of IFRS 15 must be entity-specific. The information should enable the user to understand how contracts are analysed and how the five-step[4] model has been applied to the various revenue streams and contract types.

It is important that entities comply with the standard with respect to both requirements for documentation, operationalisation of the selected accounting treatment and compliance with the disclosure requirements. In some cases reviewed by Finanstilsynet, the documentation is too general in nature. Some entities do not analyse the contracts in accordance with the criteria in IFRS 15. For example, key parts of the contracts have not been analysed, such as elements of variable consideration and terms of delivery (so-called incoterms), or contracts have not been analysed in a timely manner. If necessary, Finanstilsynet will ask the entity to prepare new documentation that meets the requirements in the standard.

In its review of financial statements for 2018, Finanstilsynet will consider how the entities have analysed contracts and implemented IFRS 15, and how this is presented in the financial statements through principles and disclosures. Entities' contract analyses must be precise and thorough, and they must describe how the principles in the standard have been operationalised and how judgement has been exercised.

Disclosures and accounting policies

IFRS 15 includes extensive disclosure requirements. The requirements are given in the form of a framework, which means that the individual entity must adapt the requirements to its operations. Entities must consider whether the disclosures meet the objective of the standard. The disclosure requirements listed in the standard are not exhaustive. The standard essentially relates to the specific contracts and performance of an entity, and users therefore need sufficient information to understand how the standard has been applied and the judgements made by the entity.

The standard specifically refers to judgements, and changes in judgements, that affect the determination of the amount and timing of revenue arising from contracts with customers. There are explicit requirements for some disclosures, such as IFRS 15.124-125 on disclosures relating to the timing of satisfaction of performance obligations and IFRS 15.126 on determining the transaction price and the allocation of the transaction price to performance obligations. Other information that entities normally have to provide includes judgements related to the identification of performance obligations, the treatment of non-refundable upfront fees and pre-production costs. Finanstilsynet also refers to the disclosure requirements in IFRS 15.120 and IFRS 15.122, which are extensive and challenging to meet. It is therefore important that entities provide adequate explanations of these disclosures.

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[4] The five-step model is an integral part of IFRS 15 and was presented in IFRS 15. IN7 when the standard was published.

Initial application

Upon initial application of a standard, entities' description of concrete and entity-specific accounting policies and disclosures is crucial to enable users to understand the application of the new standard. Entities must consider whether it is necessary to include principles and detailed disclosures for comparative periods if the modified retrospective method is used, i.e. when figures for 2018 and 2017 have been recognised according to different principles.

Information about the transition to IFRS 15, including the selected transition method, and significant effects should be clearly stated. Finanstilsynet reminds entities of the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* no. 28 and the requirements in IFRS 15 Appendix C. If the modified retrospective method is used, section C8 in IFRS 15 requires additional disclosures in the year of adoption. The amount by which each financial statement line item is affected by the implementation of IFRS 15 shall be provided, along with an explanation of the reasons for significant changes. Finanstilsynet also reminds entities of the disclosure requirements for the practical expedients that have been used. Even though the transition effects are not significant at the time of transition, IFRS 15 changes important principles and terms for revenue recognition. New principles and terms have to be incorporated in contract analyses, internal processes and disclosures.

2.3 IFRS 16 *Leases*

IFRS 16 *Leases* enters into is effective on 1 January 2019. Entities are required to disclose information about how the amendments will affect their annual financial statements upon implementation, in accordance with IAS 8.30-31. Both qualitative and quantitative disclosures must be provided. IFRS 16 requires lessees to recognise all leases on the balance sheet. This will affect a number of key figures. The standard entails minor changes for lessors. Both lessees and lessors will be subject to more extensive disclosure requirements.

Annual financial statements 2018

The financial statements for 2018 will be published after the standard has become effective, and entities are therefore expected to largely have completed their implementation of IFRS 16. Entities must thus be able to describe the effect on equity as at 1 January 2019, or 1 January 2018 if applying the full retrospective method. In addition, the accounting principles expected to be applied must be disclosed. If the entity is a lessee, it must also disclose the use of practical expedients. To enable the users of the financial statements to assess the impact of IFRS 16, the information provided should explain the steps taken to establish whether a contract contains a lease, how lease terms and discount rates are determined, and whether the service and lease components of a contract should be separated. The disclosures provided should be concise and entity-specific.

The users of the financial statements should understand the link between future minimum lease payments for operating leases disclosed based on the requirements of IAS 17 and IFRS 16. Entities are therefore encouraged to include such information in the financial statements for 2018.

When the standard is applied for the first time, entities must, in accordance with IFRS 16.C12(b), reconcile the differences between operating lease commitments disclosed when applying IAS 17 and lease liabilities recognised at the date of application of IFRS 16. Entities should provide such information in the financial statements for 2018. The information must be provided in the financial statements for 2019 at the latest. Entities should also disclose assumptions and judgements used in estimating the discount rate used in determining the present value of the remaining lease payments and in recognising the right-of-use assets upon transition in accordance with IFRS 16.C8.

Other parts of the 2018 annual report

It would appear reasonable to describe the effect of IFRS 16 elsewhere in the annual report than in the annual financial statements, for example in the directors' report, the corporate governance report or in the definition of APMs. The directors' report's analysis of the entity's annual financial performance must also discuss how its performance for the year and financial position will change under the new accounting rules. The corporate governance report should include information on changes in internal control and risk management resulting from the new accounting rules, and the impact on the financial reporting.

Interim financial statements 2019

Interim financial reports in 2019 shall be prepared in accordance with IFRS 16, which will be effective from 1 January 2019. This applies to both recognition and measurement, in addition to presentation, classification and disclosures. In order for the interim financial reporting in 2019 to provide an update of the latest complete set of annual financial statements in accordance with IAS 34.6, entities must disclose sufficient information in the 2018 annual financial statements. If this is not possible, the interim financial statements must contain information on the effects of transition.

If an entity opts to implement IFRS 16 without restating comparatives, the information in the interim reports must be presented to enable the users to acquire the necessary insight into the information presented for both years.

3 Content requirements for annual and half-year reports

Both the annual and half-year reports must contain a directors' report, financial statements and a responsibility statement[5]. It must be clearly shown in both the annual and half-year reports which parts of the report represent the directors' report, the financial statements and the responsibility statement, respectively. The responsibility statement cannot be merged with the annual or half-year directors' report.

[5] Cf. Securities Trading Act Section 5-5 subsection (2), item 3.

Listed companies must make sure that they prepare annual and half-year reports in line with the content requirements and that the above-mentioned documents are presented in separate parts of the reports.

Finanstilsynet has noted that it is unclear in several half-year reports for 2018 which parts of the published report represent the directors' report and the financial statements, respectively. Several entities also include the responsibility statement in the half-year directors' report, while other entities fail to include one or more of the above-mentioned documents in their reports.

Some entities include non-financial information in their annual financial statements. For example, they include part of the sustainability reporting in the notes to the financial statements. In Finanstilsynet's opinion, such reporting should not be part of the financial statements, but be provided in other parts of the annual report.

4 Alternative performance measures

In 2017, Finanstilsynet completed a thematic inspection designed to determine entities' use of and compliance with guidelines for alternative performance measures. The results were published in the report "Thematic inspection of alternative performance measures 2017".[6] Non-compliance with the guidelines has also been an issue in several enforcement cases.

In 2018, Finanstilsynet has reviewed the financial reporting of 25 listed companies.
The reviews completed in 2018 have revealed that a number of entities are still not compliant with the requirements in a number of areas. Finanstilsynet has found significant instances of non-compliance in entities' explanations of their use of alternative performance measures and reconciliation. Moreover, Finanstilsynet has observed cases where greater prominence is given to alternative performance measures than to measures directly stemming from the financial statements, and where entities have not given a balanced description. Finanstilsynet will follow up entities' compliance with the guidelines in its review of future financial reports.

Key observations from the 2018 review are included in the report "Alternative performance measures 2018", which is published on Finanstilsynet's website.[7]

5 European Single Electronic Format (ESEF)

Following the amendments to the Transparency Directive, and as a part of the goal to harmonise financial reporting in Europe, the European Securities and Markets Authority (ESMA) has prepared a regulatory technical standard ("RTS") on ESEF which introduces a

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[6] https://www.finanstilsynet.no/contentassets/feba848927be4ee0ac7789a7e14d0c73/tematilsyn-om-alternative-resultatmal-2017.pdf [This report is available in Norwegian only.]
[7] https://www.finanstilsynet.no/contentassets/1836713aa7d44e76805ebbef21decd35/alternative-resultatmal-2018.pdf [This report is available in Norwegian only.]

requirement for a new single electronic reporting format for issuers in the European Economic Area.

This regulation[8] will require all entities covered by the Transparency Directive to use the new format for electronic reporting of the annual reports for financial years beginning on or after 1 January 2020. This will apply to issuers having Norway as their home state whose transferable securities are admitted to trading on a regulated market. This requirement does not apply to entities whose issuance of debt instruments is confined to denominations of at least EUR 100 000 or to mutual funds, cf. the Securities Trading Act Section 5-4.

The new electronic reporting format requires the entire annual report to be prepared in XHTML ("Extensible Hypertext Markup Language"). In order to make the financial statements machine-readable, consolidated financial statements prepared in accordance with IFRS must be labelled with XBRL tags ("eXtensible Business Reporting Language"). A taxonomy is used to mark up the financial statements with XBRL tags. The taxonomy is a hierarchical structure for classifying financial information. Entities may create extensions to the taxonomy, as long as these elements are anchored to the taxonomy. The mark-up requirement initially applies to the primary financial statements. For financial years beginning on or after 1 January 2022, notes to the financial statements must also be marked up. There is no requirement for the notes to the financial statements to be marked up in detail, but these need to be marked up by applying mark-ups for whole sections of the notes (block tagging).

The regulation is currently pending endorsement by the European Commission and is likely to be published in the second quarter of 2019. Even though the amendments to the Transparency Directive have not yet been incorporated into the EEA Agreement or implemented in Norwegian law, Finanstilsynet urges Norwegian entities encompassed by the Transparency Directive to prepare for the introduction of the new electronic reporting format.

6 Financial information in prospectuses

In connection with the scrutiny of prospectuses, it may be necessary to consider certain accounting issues. For some time, Finanstilsynet has noted that entities' assessments and documentation of such accounting issues are inadequate. Entities have an obligation to ensure that relevant accounting issues have been adequately reviewed and documented before the draft prospectus is sent to Finanstilsynet. Finanstilsynet has also noted instances where the transaction information provided in the submitted drafts is inadequate. This is especially true where part of a business is admitted for trading on a stock exchange following a reorganisation and in prospectuses related to the acquisition of businesses in financial distress.

Finanstilsynet's scrutiny of prospectuses does not represent a complete review of the financial reporting. When preparing preliminary guidance and in the scrutiny of prospectuses, Finanstilsynet will nevertheless still ask for documentation that substantiates entities' accounting treatment. Finanstilsynet will also continue to require entities to present comprehensive information on transactions and accounting assessments in prospectuses and

[8] Cf. the Transparency Directive Art. 4 para. 7

on the choices made. In 2018, Finanstilsynet has on several occasions requested documentation that describes accounting solutions, and has also required entities to include far more information in the final prospectus than in the draft prospectus.

Finanstilsynet reminds entities that accounting solutions should be adequately documented before they request preliminary guidance and before they submit the draft prospectus to Finanstilsynet. Entities must also include information about these issues in the draft prospectus sent to Finanstilsynet.

7 Changes in estimates

Entities use estimates that affect the carrying amount of assets and liabilities, income and expenses when preparing financial statements. The estimates shall be based on the most recent reliable information available. If there are any changes in the factors underlying the estimates, or new information arises, the entity must change the estimates. Changes in accounting estimates are accounted for on a prospective basis, as opposed to changes in accounting policies or corrections of prior period errors, which are retrospectively accounted for by restating comparatives. Entities must therefore distinguish between changes in accounting estimates on the one hand and changes in accounting policies or prior period errors on the other hand.

If an entity changes an accounting estimate that has a material effect in the current or future periods, it shall disclose the nature and amount of the change in accordance with IAS 8.39. The disclosure requirement also applies to interim financial statements, cf. IAS 34.16A (d). Such information shall be clearly stated in the annual and interim financial statements. The information shall be included in the notes to the annual or interim financial statements, with a clear reference from the accounting line item or items that are affected. If the estimate change has a material impact on important key figures or performance measures, the amount of the effect on such figures should be specified.

Finanstilsynet has reviewed an interim financial report where the entity had made a change in an accounting estimate that resulted in a significant increase in profits. Without the estimate change, the entity would have recorded a loss, whereas it reported a profit. The improved performance was commented on in several places in the interim report, in the stock exchange statement and in the presentation of the financial statements, although there was no information about the change in the accounting estimate. The company had briefly commented on the change in estimates under group performance in the interim report, which was presented prior to the interim financial statements. There was no reference to the notes from the affected accounting line item. The information appeared to be difficult to access for the users of the financial statements. Finanstilsynet’s conclusion was that the change in the accounting estimate was not adequately explained in the interim financial statements.

8 Significant influence

An entity with significant influence over an investee shall normally account for its investment in the associate using the equity method, in accordance with IAS 28 *Investments in Associates and Joint Ventures.*

According to IAS 28, when an entity holds 20 per cent or more of the voting power of an investee, it is presumed that the entity has significant influence. If the entity holds less than 20 per cent, it is presumed that the entity does not have significant influence. If these presumptions are not to be applied, the existence or non-existence of significant influence must be clearly demonstrated if the entity holds less than 20 per cent of the voting power.

In Finanstilsynet's view, the 20 per cent limit should not automatically classify the investment based solely on the quantitative share of the voting power. The assessment of whether significant influence exists must also be a qualitative assessment of the factors that affect the entity's influence over its investee. When an entity holds close to 20 per cent of an investee, or when called for by other circumstances, the entity must make a thorough review of whether or not significant influence exists. Significant influence may also exist if an entity holds far less than 20 per cent of the voting power if significant influence can be clearly demonstrated in other ways.

Significant influence is normally evidenced by the existence of one or more of the circumstances stated in IAS 28.6. The list is, however, not exhaustive. If other relevant circumstances than those specified in IAS 28.6 have been identified and affect an entity's influence over its investee, these circumstances must be included in the assessment of significant influence. An example is where the entity is the largest shareholder and the remaining holdings are distributed among a large number of shareholders.

According to IAS 28.6(a), representation on the board of directors or equivalent governing body of the investee may evidence significant influence. IAS 28.6(a) is not limited to situations where individual shareholders nominate their own board representatives. It may also include other forms of representation, based on a specific assessment of the circumstances relating to the person represented on the board of directors. The person's relationship to the investee, shareholders and the various roles held by this person may be relevant to consider in this context.

IAS 28.6(c) indicates that significant influence can normally be evidenced where there are material transactions between the entity and its investee. In Finanstilsynet's opinion, it will be most relevant to consider this from the investee's perspective. A transaction of substantial financial value to the investee creates a power disparity, potentially putting the investor in a position of influence.

The assessment of whether circumstances specified in IAS 28.6(c) exist must be based on an analysis of all aspects of transactions and business cooperation between the entities. New modes of cooperation are constantly observed, especially where the ownership extends beyond traditional purchase and sale of goods and services, and where various forms of cooperation can create significant financial value for one or both of the entities. Such cooperation must also be considered in the assessment of significant influence.

Finanstilsynet has reviewed the accounting treatment of an investment of 16.4 per cent in an investee. The entity and the investee had the same chair of the board. The chair of the board was not formally appointed to represent the entity on the board of the investee, but had close connections to the entity. The chair of the board was also a shareholder in the entity. In addition, he was an important long-term business partner of the managing director and the largest shareholder in the entity. Furthermore, he had an important role in building up and managing the entity from the very start. In Finanstilsynet’s opinion, the close links between the chair of the board and the entity in fact made him a representative of the entity.

The entity and the investee also had cooperation agreements that were of great significance to the investee. In addition, the entity was the investee’s largest shareholder, and the remaining holdings were distributed among a large number of shareholders. After an overall assessment, Finanstilsynet concluded that it could be clearly demonstrated that the entity had significant influence over the investee in spite of holding less than 20 per cent.

9 Distinguishing between equity and liabilities – issuers’ classification of additional Tier 1 instruments

IAS 32 *Financial Instruments – Presentation* establishes principles for the classification and presentation of financial instruments. An issuer of a financial instrument shall classify the instrument, or components of the instrument, as a liability or equity in accordance with the definitions of financial liabilities and equity instruments.

The distinction between equity instruments and financial liabilities was a priority area for Finanstilsynet in its review of annual financial statements for 2016. See description in circular 12/2017.

It is of great significance to issuers whether financial instruments are classified as equity or liabilities. The classification affects key figures such as the debt-to-income ratio, equity ratio and return on equity. Moreover, the classification also directly affects the income statement as interest and gains and losses on financial liabilities are recognised in the income statement, while equity transactions, such as dividends, are recorded directly in equity. This means, among other things, that net interest income will be affected by the classification of the instrument.

In recent years, Norwegian banks have issued additional Tier 1 instruments adapted to the EU’s Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR). The purpose of issuing additional Tier 1 instruments is to strengthen the bank's capital adequacy ratio as these instruments qualify as Tier 1 capital in capital adequacy calculations.

In order to qualify as Tier 1 capital, one of the terms of the agreement must be that the issuer has an unconditional right to stop interest payments.

CRD IV and CRR have not yet been incorporated into the EEA Agreement, but the relevant provisions were largely incorporated in the Norwegian Financial Institutions Act with effect from 30 September 2014. Even before this, the structure of the capital adequacy framework was completed, and agreements between the issuers of additional Tier 1 instruments and Nordic Trustee ASA as trustee on behalf of the bondholders, were adapted to the new regulations. The condition that the issuer has an unconditional right to stop interest payments on the perpetual additional Tier 1 instruments was included, whereby additional Tier 1 instruments issued prior to the amendments to the Act and regulations would meet the criteria for being classified as Tier 1 capital.

According to IAS 32.16 an entity may classify an instrument as equity only if both conditions in (a) and (b) have been met:

a) *The instrument includes no contractual obligation:*
    1) *to deliver cash or another financial asset to another entity, or*
    2) *to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.*
b) *If the instrument will or may be settled in the issuer's own equity instruments, it is:*
    1) *a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments, or*
    2) *a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.*

The loan agreements between the issuers and the trustee on behalf of the investors contain no provision permitting additional Tier 1 instruments to be settled by using the issuer's own equity instruments. Nor is there any contractual obligation to exchange financial assets with another entity under conditions that are potentially unfavourable to the issuer. The final condition that must be met in order to classify additional Tier 1 instruments as equity, is that there is no contractual obligation for the issuer to deliver cash, cf. IAS 32.16(a)(1).

The additional Tier 1 instruments that are issued according to the capital adequacy framework are perpetual, and bondholders cannot demand redemption of the bonds. According to the agreement, the issuer also has full flexibility with respect to interest payments. Thus, there is no contractual obligation to pay either the principal or interest.

In practice, issuers of additional Tier 1 instruments will pay interest to their investors. According to the loan agreement, issuers nevertheless have an unconditional right to avoid paying interest. In accordance with IAS 32, the contractual obligation in the agreement is the decisive factor. This is also pointed out by the International Accounting Standards Board (IASB), cf. IFRIC Update November 2006[9], which refers to discussions in June of the same year in the IASB:

[9] https://www.ifrs.org/-/media/feature/news/updates/ifrs-ic/2006/november-2006-ifric-update.pdf

> The Board discussed whether so-called economic compulsion should affect the classification of a financial instrument […].
>
> The Board confirmed that such a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability under IAS 32.
>
> The Board also stressed that IAS 32 requires an assessment of the substance of the contractual arrangement. It does not, however, require or permit factors not within the contractual arrangement to be taken into consideration in classifying a financial instrument.

Additional Tier 1 instruments qualifying as Tier 1 capital when calculating the bank's capital adequacy ratio must be subject to conditions whereby the issuer has an unconditional right to stop interest rate payments on the perpetual loan. Such additional Tier 1 instruments will be classified as equity under IAS 32.

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