FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Circular

Finanstilsynet's review of financial statements in 2015

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1 Introduction

Finanstilsynet supervises the financial reporting of issuers that are listed or are applying for listing on Oslo Børs or Oslo Axess. Provisions on financial reporting supervision are laid down in the Securities Trading Act with regulations.

This circular describes certain accounting matters which Finanstilsynet has noted in 2015, including

- Fair value measurement of fixed rate loans
- Deposit guarantee schemes for banks
- Going concern disclosure
- De facto control
- Carrying amount of a cash-generating unit
- Discontinued operations and intra-group transactions
- Thematic survey of fish farming entities

Final letters in matters such as the above relating to financial reporting supervision are published on Finanstilsynet's website.

This circular also deals with areas prioritised in the review of financial statements for 2015.

2 Fair value measurement of fixed rate loans

Financial institutions frequently enter into interest rate swaps agreements when issuing fixed interest loans. Under IFRS an interest rate swap is a derivative to be recognised at fair value. In order to avoid accounting mismatches, Norwegian financial institutions often select the fair value option.

According to IFRS 13 *Fair Value Measurement*, fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date (exit price). Fixed rate lending (retail market) in Norway features a large number of providers, considerable competition and publicly available information on market participants' lending rates; see the website finansportalen.no and the banks' price lists. There is however no secondary market (dealer market) for fixed rate loans.

Hence where already contracted fixed rate loans are to be recognised at fair value, no directly observable prices are available. In the absence of an observable exit price for fixed rate loans, their value must be estimated by means of a valuation technique that is appropriate in the circumstances and that maximises the use of relevant observable inputs; see IFRS 13.61. According to IFRS 13.22, when measuring fair value, an entity must use the assumptions that market participants would use when pricing the asset. Potential purchasers of already contracted fixed rate loans in Norway would be other financial institutions that are licensed to engage in lending activity under the Financial Institutions Act and that are themselves fixed rate lenders in the retail market. These institutions have the option of purchasing an existing loan or establishing a new loan directly with the borrower.

The unit of account, and what is being measured, is the individual loan; see IFRS 13.14 and IAS 39.43. Fair value is usually determined by discounting the loan's future contractual cash flows using a discount rate. The amount and timing of interest and principal payments appear in the contract, whereas the discount rate must be determined based on market participants' assumptions.

For market participants a fixed rate loan in the retail market and a fixed rate loan in a simulated secondary market will be regarded as identical products since the cash flows are identical, the risk is the same and the participants will be the same in both markets. Since potential purchasers of loans will also be providers of loans, the same funding requirements will underlie the pricing of new loans and the valuation of existing loans. Situations may arise where – due to certain transaction-related costs, for example marketing activities – the required rate of return of the purchaser and issuer of a loan are not identical. However, in Finanstilsynet's assessment the established discount rate cannot diverge significantly from the observed market lending rate for new loans with the same term and equivalent collateral.

According to IAS 39 AG 76 the best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price. If the estimated discount rate differs from the entity's own and the market's lending rate, so called day one gains or losses will arise because fair value at the recognition date differs from the transaction value. The discount rate used in a valuation model must be reconciled with observed lending rates offered by market participants. In the event of divergences, the cause must be assessed, and in the event necessary changes have to be made in the discount rate.

3 Deposit guarantee schemes for banks

Banks and credit institutions that are members of the Norwegian Banks’ Guarantee Fund have to pay an annual levy to that Fund. Under Regulations of 6 May 1997 no. 429 on payment of a levy to the Norwegian Banks' Guarantee Fund, the levy is calculated with reference to the average of aggregate guaranteed deposits and risk weighted assets for capital adequacy at the end of the third and fourth quarter of the calendar year two years prior to the year of payment and at the end of the first and second quarter of the calendar year prior to the year of payment. The levy is imposed on 1 January and is payable at a time determined by the Fund's board of directors. The regulations contain provisions governing payment of the levy upon admission to the scheme but no rules regarding withdrawal from the scheme.

IFRIC Interpretation 21 – Levies covers the accounting for liabilities to pay a levy. The deposit guarantee scheme is an example of such a liability to pay a levy, and the interpretation identifies the obligating event for the recognition of a levy. The obligating event is the activity that triggers the payment of the levy as defined in the legislation. The liability to pay a levy shall be recognised on the date that the obligating event takes place. IFRIC Interpretation 21 does not regulate accounting for the contra entry to the liability; other standards will determine whether this is an expense or an asset.

A bank that is a member of the scheme on 1 January must pay a guarantee fund levy for the entire year. So long as there are no provisions regarding reduction of the levy where a bank withdraws from the scheme in the course of the year, banks will have to recognise the entire liability on 1 January. The contra entry to the liability cannot be recognised as an asset under other standards. Attention is drawn to an Opinion issued by European Securities and Markets Authority's (ESMA) dated 25 September 2015[1]. The depost guarantee scheme levy must accordingly be expensed in its entirety in the first quarter of each year.

Finanstilsynet notes that several banks, also subsequent to the effective date of IFRIC Interpretation 21, have accounted for the levy on an accruals basis over the year. Finanstilsynet expects these banks to adjust their practice as from the first quarter of 2016 at the latest.

4 Going concern disclosure

IAS 1 Presentation of Financial Statements paragraph 25 requires management, when preparing financial statements, to assess the entity's ability to continue as a going concern. Where management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. This applies both when preparing annual and interim financial statements; see IAS 1.4.

IAS 1.26 provides supplementary guidance on how management should assess whether the going concern assumption is appropriate. Management should take into account all available information about the future, and the scope of the analyses required will depend on entity-specific factors relating to current and expected profitability. An entity whose ability to continue as a going concern is in doubt will be expected to have conducted extensive analyses of those factors.

An entity must disclose the judgements that management has made in assessing the entity's ability to continue as a going concern, see IAS 1.122 and the agenda decision of the IFRS Interpretations Committee from July 2014.[2] Note disclosures must be entity-specific and detailed, so that any user of the financial statements is able to understand clearly the assumptions on which the going concern assumption rests.

Going concern and liquidity risk

Going concern assumptions are closely linked to an entity's liquidity risk. IFRS 7 Financial Instruments – Disclosures paragraph 39(a) and (c) requires an entity to provide a maturity analysis for financial liabilities, and to describe how it manages the inherent liquidity risk. IFRS 7 B10A, B11 and B11C-F provide further guidance on information to be disclosed.

For an entity whose ability to continue as a going concern is uncertain, obtaining an overview of future maturities broken down into sufficiently short periods will be imperative. Please

[1] See https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1462_esma_opinion_on_accounting_for_deposit_guarantee_scheme.pdf

[2] http://media.ifrs.org/2014/IFRIC/July/IFRIC-Update-July-2014.pdf

note that the intervals stated in IFRS 7 B11 are merely examples, and that appropriate periods must be considered in each case. In most cases where the ability to continue as a going concern is uncertain, it will be natural to split the period from three months to one year and from one year to five years into further time intervals than stated in the example.

Finanstilsynet has commented on liquidity risk and information on loan terms in circular 5/2011[3] and in circular 31/2011[4]. See 2.2.2 "Liquidity risk" and 2.2.4 "Information on loan agreement terms" in circular 5/2011, and 7 "Liquidity risk – management of inherent risk" in circular 31/2011.

Interim financial report disclosures

An entity shall include in its interim financial reporting an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period; see IAS 34 Interim Financial Reporting paragraph 15. Where the ability to continue as a going concern is highly uncertain, it is in Finanstilsynet's assessment imperative that the information provided in interim financial reports on such matters is precise and adequate.

It is not sufficient for supplementary information to be provided in stock exchange notices or in presentation material accompanying the presentation of interim financial reports.

5 De facto control

Finanstilsynet stated in circular 5/2011 that de facto control was viewed as a part of the concept of control employed in IAS 27 Consolidated Financial Statements and Accounting for Investments in Subsidiaries. Because no guidance was provided by the International Accounting Standards Board (IASB) it was unclear how this concept should be interpreted.

By virtue of IFRS 10 Consolidated Financial Statements it is clear that de facto control is part of the control concept.

An important element in assessing whether an investor has de facto control is the extent to which the investor has power over the investee. An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities, ie the activities that significantly affect the investee's returns. According to IFRS 10 B41 an investor with less than a majority of the voting rights has rights that are sufficient to give it power when the investor has the practical ability to direct the relevant activities unilaterally. The standard also provides guidance on the content of the concept of power in IFRS 10 B42 – B46.

This entails that an entity with owner interests of 50 per cent or less in another entity must make an assessment of the power it possesses. The more voting rights the entity has, and the

[3] 3 http://www.finanstilsynet.no/no/Artikkelarkiv/Rundskriv/2011/1_kvartal/Enkelte-regnskapsmessige-forholdbasert-pa-regnskapskontrollen-2010--/

[4] 4 http://www.finanstilsynet.no/no/Artikkelarkiv/Rundskriv/2011/4_kvartal/Enkelte-regnskapsmessige-forholdbasert-pa-regnskapskontrollen-2011/

more dispersed the voting rights are among the other investors, the more likely it is that the entity has rights giving it the possibility to direct the relevant activities. After considering existing rights both in isolation and relative to other investors, it may be clear to the entity that it has power, or does not have power. If this is not clear, additional factors must be considered; see IFRS 10 B45. This provision refers to IFRS 10 B18 – B20, stating that B18 shall be given greatest weight.

An assessment of whether actual control exists will often be a matter of judgement. Finanstilsynet points out that IFRS 12 Disclosure of Interests in Other Entities paragraph 7(a) requires an entity to disclose information about significant judgements and assumptions it has made in determining whether it has control of another entity. This includes cases where an entity has owner interests of less than 50 per cent and has concluded that it does not have power to direct relevant activities, but where certain factors indicate that the entity has control.

6 Carrying amount of a cash-generating unit

According to IAS 36 Impairment of Assets the carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount is determined. IAS 36.77 makes clear that all assets that generate or are used to generate the relevant streams of cash inflows shall be included in the cash-generating unit. Corporate assets are assets that do not themselves generate cash inflows and that relate to several cash-generating units. All corporate assets that relate to relevant cash-generating units shall be allocated to those units; see IAS 36.102.

An intangible asset that does not itself generate cash inflows must therefore be grouped together with other assets in a cash-generating unit. All relevant assets that contribute to generating the cash inflows shall be grouped with cash-generating units. This may include fixed assets and working capital in addition to intangible assets.

7 Discontinued operations and intra-group transactions

Finanstilsynet has considered how discontinued operations should be presented in consolidated financial statements in cases where there are substantial intra-group transactions between discontinued and continued operations.

The consolidated financial statement shall present all units included in the group as a single economic unit. Operations in a discontinued unit are a part of the group up to the date of disposal. Transactions between continued and discontinued operations shall accordingly be fully eliminated up to that date; see IFRS 10 B86.

Results from discontinued operations shall be presented separately from continued operations; see IFRS 5 Non-current Assets Held for Sale and Discontinued Operations paragraph 1(b). IFRS 5.30 requires an entity to present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations. The financial statements must moreover give a faithful representation of financial income in accordance with IAS 1.15. This requires the presentation of information in a manner that is relevant, reliable, comparable and understandable; see IAS 1.17(b).

IFRS provides no specific guidelines for the presentation of transactions between continued and discontinued operations. Hence different views exist on how this can and should be done, and practices are also dissimilar.

Finanstilsynet's assessment is that a number of approaches are acceptable under IFRS. What is crucial is that eliminations are done in accordance with the rules governing consolidation, but in such a manner that the financial statements promote the general considerations of IAS 1 and enable the user to evaluate the financial effects of discontinued operations. Choice of mode of presentation and disclosures must in Finanstilsynet's view be based on the group's specific situation. The need for additional information will vary. The issue is particularly relevant for sales of goods between the two entities in the group that the group has resold in the period.

In one case Finanstilsynet expressed the view that a presentation in which the income from an internal sale of goods was eliminated from discontinued operations, and the cost of the goods was eliminated from the continued operations, is not in conformity with IFRS. The result from discontinued operations was in this specific case underestimated, and the result from continuing operations was overestimated. The financial statements for the group thus did not provide a fair presentation of actual earnings, either for continued or for discontinued operations.

The IFRS IC considered a similar example and in IFRIC Update from September 2015 explained their tentative agenda decision.5 The IFRIC IC states that intra-group transactions must be eliminated, and this shall be understood such that an entity must in its consolidated financial statements eliminate intra-group sales against the internal selling party and intra-group purchases against the internal purchasing party. The committee's preliminary decision sets the stage for the main principle of IFRS 5.32 to be met through additional information in the notes.

In the absence of further adjustments, elimination according to the IFRS IC's tentative decision leads to overestimation of the result from the purchasing unit and underestimation of result from the selling unit in the group. Finanstilsynet agrees that intra-group transactions must be eliminated so that the consolidated financial statements only present transactions with the outside world. Finanstilsynet is nonetheless of the view that costs in the group must be allocated to the unit where the incomes are generated and presented. In the specific matter dealt with by Finanstilsynet, this was the continued operations.

If the tentative agenda decision remains unchanged, Finanstilsynet will take due note and will in future not require restatements where the income statement is presented as required by IFRS IC. However, in Finanstilsynet's view other presentations are available that give better financial information and that could be in accordance with IFRS.

[5] http://media.ifrs.org/2015/IFRIC/September/IFRIC-Update-September-2015-updated.pdf

8 Thematic survey of fish farming entities

In autumn 2014 Finanstilsynet initiated a thematic inspection to survey certain aspects of the financial reporting of listed fish farming entities. The findings were published in November 2015 in a report available on Finanstilsynet's website.[6] The entities' practice as regards fair valuation of biological assets turned out to be disparate both in terms of models and assumptions employed.

Models for the valuation of biological assets employ a number of unobservable inputs, and the fair value measurement is consequently in Level 3 in the IFRS 13 fair value hierarchy. Despite the availability of publicly observable market data, both in the form of spot and forward prices, for several of the markets concerned, the survey identified wide differences in prices employed. This was because the entities had instead used their own internal, unobservable prices.

Regardless of valuation technique and level in the fair value hierarchy, a general principle is that fair value measurement must to the greatest possible extent be based on relevant observable inputs and to the least possible extent on unobservable inputs, such as the entity's own price expectations (see IFRS 13.67).

9 Prioritised areas in the 2015 financial reporting supervision

Finanstilsynet draws attention to ESMA's Public Statement of "European Common enforcement priorities for 2015 financial statements.[7] This describes areas to which ESMA considers listed entities should give particular attention when presenting their 2015 annual financial statements.

The prioritised areas are:

1. Impact of the financial markets conditions on the financial statements.
   ESMA urges listed entities to give particular attention to the current interest rate environment and exposure to country risk, foreign exchange risk and price risk for commodities.

2. Statement of cash flows and related disclosures. Listed entities must ensure that their cash flow statement and related disclosures are consistent with the other primary financial statements.

3. Fair value measurement and related disclosures.

[6] http://www.finanstilsynet.no/no/Artikkelarkiv/Aktuelt/2015/4_kvartal/Rapport-fra-tematilsyn--oppdrettsforetak/

[7] See https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1608_esma_public_statement_-_ecep_2015.pdf

> ESMA is of the view that there is considerable room for improvement as regards fair value measurement of non-financial assets and liabilities, and related disclosures.

Finanstilsynet will, as in previous years, focus attention on these areas in its financial reporting supervision for 2015.

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