FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Circular

Finanstilsynet's review of financial statements in 2014

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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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1 Introduction

Finanstilsynet supervises the financial reporting of issuers that are listed or are applying for listing on Oslo Børs and 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 over the course of the past year, including

- impairment of assets
- bargain purchases
- contingent consideration from discontinued operations
- large companies' disclosure of remuneration to senior employees
- corporate governance statements

Final letters to listed companies are published on Finanstilsynet's website [letters in Norwegian].

This circular also deals with areas prioritised in the review of financial statements for 2014 and submission of country-by-country reports.

2 Impairment of assets

2.1 Reliability interval

In 2014 Finanstilsynet examined the use of reliability intervals when determining value in use in impairment testing. Depending on the uncertainty associated with the asset in question, an interval of +/- 15 to 30 per cent was established around an initial value in use estimate. If the asset's carrying value was within the interval, no impairment was done, even if the mid-point of the interval was below the carrying value. The interval is illustrated by the following example, in which the asset's fair value is assumed to be below its value in use: the asset to be impairment tested has a carrying value of 130. The company first computes an initial value in use of 100 that reflects cash flow uncertainty. Since this value is subject to large estimate uncertainty, the company has set an interval of +/- 30 per cent, giving a reliability interval of 70 to 130. In as much as the asset's carrying value is 130, which is within the interval, the company does not recognise an impairment loss.

In Finanstilsynet's assessment the use of a reliability interval in impairment testing is not in accordance with IFRS. According to IAS 36 *Impairment of Assets*, value in use is a singular estimate (point estimate) and not an interval. Uncertainty must be reflected in the determination of value. This can be done either by adjusting future cash flows or by adjusting the discount rate. Additional estimates involving differing probabilities may also be calculated. The value in use will in that case be the weighted average of the estimates; see IAS 36.32.

2.2 Cash-generating units (CGUs)

Impairment assessments are sensitive to the level at which cash-generating assets are identified. Identification of a cash-generating unit at too high a level may lead to assets that generate high cash inflows being grouped with assets that do not generate positive cash flows. This may in turn result in failure to make necessary impairments.

A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets; see IAS 36.6. It is the cash inflows, not the cash outflows, whose independence is to be assessed. Identifying CGUs involves judgement. In Finanstilsynet's view it must be done as a bottom-up analysis, not as a top-down analysis. In other words, a company starts with individual assets and aggregates them until largely independent cash inflows are achieved. IAS 36.66-71 has provisions stating how CGUs shall be identified.

CGUs shall be identified consistently from period to period, unless a change is justified; see IAS 36.72. When considering whether a change is justified, the definition of a CGU must be kept in mind. If the dependence between cash inflows changes, this could alter the identification of CGUs.

Finanstilsynet is of the view that the threshold for aggregating or changing CGUs is on the high side. Companies cannot aggregate or change units in order to avoid write-downs. In order for a change to be justified, it must be based on genuine changes in the interdependence of cash inflows.

2.3 Cash flows' duration in assessments of value in use

According to IAS 36, the estimation of the duration of cash flows from an asset shall be based on the asset's expected economic life. Where a CGU's value in use is calculated, the assets included will often have different useful lives. In such cases a decision must be made as to which assets are essential to the ongoing operation of the unit. The time horizon of the cash flows must be calculated with a basis in the essential asset with the longest useful life; see IAS 36.49.

Where a CGU contains goodwill, an entity can in some cases take a basis in perpetual cash flows. However, it must in each case consider whether goodwill is to be regarded as one of the essential assets. If goodwill is not considered to be an essential asset, a basis may not be taken in perpetual cash flows, and the time horizon must be limited to the life of the essential asset with the longest life.

2.4 Value in use and fair value

It follows from IAS 36 that an asset's value in use may be higher than its fair value since the value of continuing use of the asset to the owner may exceed what a market participant is willing to pay for it; see BCZ17 – 23. However, in order to ensure that value in use is determined with a basis in reasonable estimates, requirements are imposed on the cash flow estimates that are used. According to IAS 36, estimated cash flows shall inter alia be based on reasonable and supportable assumptions and shall represent management's best estimate. External evidence must be given greatest weight.

In some segments of the shipping and rig sector it is normal to define individual assets (ships or rigs, alongside any contract) as CGUs. These segments often have well-functioning secondary markets for the above assets or, alternatively, prices available for new ships/rigs, which can give a good indication of what rates the market expects in the future. The segments generally feature a high degree of transparency, low entry barriers, strong competition, and small synergies between the above assets and standardised services. Against this background, continuing use of an asset is less likely to generate a significantly higher cash flow for the current owner than would be achieved by a general market participant. In such cases Finanstilsynet considers that management's forecasts in a value-in-use calculation must be reconciled with market expectations.

The basis and quality of external market data must be assessed in each case. However, disregarding any surplus or shortfall in value of an associated contract, the difference between value in use and fair value can in general be expected to be substantially smaller for this type of asset than for other assets. If value in use over time remains significantly higher than fair value less costs to sell, this is a clear indication that management's expectations are overly optimistic.

3 Bargain purchases

3.1 Fair value measurement

In a business combination an acquirer may occasionally make a bargain purchase in which the value of net assets exceeds the compensation. According to IFRS 3 *Business Combinations* paragraph 18, the acquirer of a business shall measure identifiable acquired assets and liabilities assumed at their acquisition-date fair values. Fair value measurement is regulated by IFRS 13 *Fair Value Measurement.* Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. An orderly transaction is defined as a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary. Bargain purchases are to be regarded as anomalous transactions since business entities and their owners generally do not knowingly and willingly sell assets or businesses at prices below their fair values; see IFRS 3 BC 371.

Bargain purchases appear to happen more frequently than the IASB (International Accounting Standards Board) initially anticipated; see 3.5 below. Finanstilsynet would stress the need to take the following factors (3.2 – 3.4) into consideration when assessing whether a bargain purchase has been made.

3.2 Observable transaction price and estimated value

The transaction price achieved in an orderly transaction is the best evidence of fair value. Observable transaction prices are presumed to have priority over valuations carried out in connection with a transaction. This understanding is confirmed in IFRS 13 through the 'fair value hierarchy'.

The acquirer of a business shall measure an asset at fair value determined in accordance with its use by other market participants; see IFRS 3 B43. Hence the acquirer's own intended use of the asset and the acquirer's own assessment of future positive effects cannot serve as justification for a bargain purchase.

Even if an acquirer considers the price paid to be advantageous and lower than expected, this does not necessarily mean that the transaction price does not represent fair value. In the absence of duress it is unlikely that a seller would willingly sell a business for an amount below fair value; see IFRS 3 BC 381.

Nor is market inactivity an indicator that the transaction price may not represent fair value. However, the acquirer should in such situations do further work to determine whether the transaction price represents fair value; see IFRS 13 BC 134. Strategic and financial acquirers alike must be considered when potential market participants are to be identified.

3.3 Future investment needs

In a business combination the price of an asset may be reduced because the acquirer needs to make investments in order to sustain the asset's current level of performance. Expectations of future expenditures will reduce the price an acquirer is willing to pay and consequently also reduce the fair value of the asset; see IFRS 13 BC 39.

In Finanstilsynet's assessment, future expenditures which any market participant would take into account, and which are required in order to sustain operations and capacity, do not call for recognition as a liability. They are merely factors which must be taken into account when measuring the fair value of assets acquired in a business combination.

3.4 Economic obsolescence and reasonableness test

The cost approach is one of three valuation techniques dealt with in IFRS 13 and is often used to estimate an asset's fair value; see IFRS 13.62. According to IFRS 13 B8, the cost approach reflects the amount that would be required currently to replace an asset's service capacity, in other words the current replacement cost.

The current replacement cost must be adjusted for obsolescence – physical impairment and functional (technological) and economic obsolescence – to arrive at fair value to a market participant. Economic obsolescence is value loss caused by external influences, including governmental regulatory measures that require investments yielding little or no return. An acquirer would normally not pay more for an asset than the current value of the cash flows that the assets can generate, and the current replacement cost must be adjusted to reflect this; see IFRS 13 B9.

Sound internal control systems and the use of independent valuation experts will minimise the risk of measurement errors; see IFRS 3 BC 375. However, the use of independent valuation experts does not relieve management of their responsibility for ensuring that valuation techniques and assumptions applied are appropriate. Any reassessment of a bargain purchase should include a reasonableness test of the entire transaction.

3.5 ESMA report on bargain purchases

The European Securities and Markets Authority (ESMA) has conducted a survey of business combinations as presented in the 2012 annual financial statements of 56 companies across Europe[1]. The survey shows that bargain purchases were recognised in 11 per cent of the business combinations. Bargain purchases therefore appear to happen more often than the IASB first anticipated. One-third of the companies provided no information on or explanation why the transaction resulted in a gain. ESMA has urged the IASB to improve the note disclosure requirements in IFRS 3 in connection with the ongoing note disclosure project.

4 Contingent consideration from discontinued operations

The consideration in a sale transaction could depend on the financial result of the sold business in a given period ("earn-out"). Discontinued operations shall be presented under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. According to IFRS 5.35, adjustments in the current period to amounts previously presented in discontinued operations that are directly related to the disposal of a discontinued operation in a prior period shall be classified separately in discontinued operations. The nature and amount of such adjustments shall be disclosed.

IFRS 5.35(a) refers to the resolution of purchase price adjustments as an example in which such adjustments may arise. Finanstilsynet is of the view that IFRS 5.35 is applicable to earn-outs received following a sale transaction. These are adjustments to the original price and shall be classified as discontinued operations.

[1] ESMA Report 16 June 2014 No. 643 "Review on the application of accounting requirements for business combinations in IFRS financial statements": http://www.esma.europa.eu/system/files/2014-643_esma_report_on_the_ifrs_3.pdf

5 Large companies' disclosure of remuneration to senior employees

Finanstilsynet conducted in 2014 a survey of senior management remuneration disclosure in a selection of annual reports for 2013 to identify the period for which data on remuneration to senior employees was disclosed. The companies concerned were included in the OBX index on Oslo Børs. The survey showed that the reporting of variable remuneration (bonuses) varies. Some companies disclosed such remuneration earned in 2012 and disbursed in 2013. These companies did not disclose in their annual report for 2013 remuneration earned in 2013. Other companies reported remuneration earned and disbursed (but not solely disbursed) in 2013.

Finanstilsynet presumes that the varying practice may be due to differing interpretations of the Annual Accounts Act section 7-31(b). This provision requires large companies to report overall remuneration and other benefits to senior employees, board members et al.[2] Disclosures of senior management remuneration shall at least include: *"… The overall remuneration the person concerned has received or earned for services rendered over the course of the financial year"*.

In Finanstilsynet's assessment this naturally implies a requirement to disclose both received and earned remuneration for services performed over the course of the period. An annual report shall accordingly contain information about total remuneration for the particular financial year, irrespective of whether disbursement takes place the following year. Equally, information about remuneration earned in the previous year and disbursed in the particular financial year shall not be disclosed. Where the size of the variable remuneration is not known when reporting, companies must on a best effort basis estimate the liability concerned and report that liability. Comparative figures shall be provided to permit collation of overall remuneration for one year with equivalent figures for the preceding year; see IAS 1.38. In Finanstilsynet's view it is not natural to interpret the provision to mean that two alternatives are offered such that either remuneration received or remuneration earned can be disclosed.[3]

6 Corporate governance statements

Listed companies with Norway as their home state are required under the Annual Accounts Act section 3-3(b) to prepare an annual statement on their corporate governance principles and practices. This statement shall be included, or referred to, in the management report.

Finanstilsynet conducted in 2014 a survey of a selection of listed companies' corporate government statements. The survey focused on the companies' compliance with the requirements of the Annual Accounts Act, inter alia on whether the statements included:

[2] Large companies are public limited companies, listed companies etc.; see section 1-5.
[3] See EY's "IFRS in Norway" page 577 where disclosure of the accounting cost is recommended.

- reasons for any departure from the NUES[4] standard
- a description of the main elements of the company's and/or group's internal control and risk management systems related to the financial reporting process
- the composition of the board of directors and other corporate bodies, including a description of the main elements of current instructions and policies
- any provisions of the articles of association that (i) deviate from chapter 5 of the Public Limited Companies Act, (ii) regulate the composition of the board of directors and (iii) permit repurchase of Treasury shares or increases of capital

Most of the companies surveyed provided satisfactory corporate governance statements and met the requirements of the Annual Accounts Act. Some statements covered only parts of the content required by section 3-3(b), specifically internal control and risk management systems for reporting purposes, the main elements of instructions to the board of directors, and provisions of the articles of Association that deviate from chapter 5 of the Public Limited Companies Act. However, no material reporting anomalies were identified. Finanstilsynet would like to make it clear that the requirements of the Annual Accounts Act must be met by all listed companies with Norway as their home state. Incomplete corporate governance statements may also constitute a breach of Oslo Børs' rules on listed companies.

7 Prioritised areas in the review of annual financial statements for 2014

ESMA published "European common enforcement priorities for 2014 financial statements"[5] on 28 October 2014. This document describes topics of which ESMA considers that listed companies should be particularly aware when preparing and presenting their financial statements for 2014. The following topics are involved:

- preparation and presentation of consolidated financial statements and related disclosures
- financial reporting by entities which have joint arrangements and related disclosures
- recognition and measurement of deferred tax assets

Finanstilsynet will have these topics in focus when reviewing financial statements for 2014, alongside prioritised topics from previous years that remain relevant. Finanstilsynet also keeps track of sectors of importance to Oslo Børs, i.e. in the oil and energy, shipping and seafood sectors.

[4] NUES = The Norwegian Code of Practice for Corporate Governance.
[5] http://www.esma.Europa.eu/system/files/2014_1309_esma_public_statement_-_2014_european_common_enforcement_priorities.pdf

8 Submission of country-by-country reports

The requirement to submit annual reports and interim reports to Finanstilsynet pursuant to the Securities Trading Act section 5-12(2) is deemed to be met by storage in the officially appointed mechanism of Oslo Børs; see section 5-12(1). The same applies to country-by-country reporting. Companies shall accordingly not file reports or notifications separately with Finanstilsynet.

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