



FINANSTILSYNET

THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

Circular

Certain accounting-related issues based on the review of financial statements for 2011

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Introduction

Finanstilsynet supervises the periodical financial reporting of issuers of transferable securities which are quoted or for which admission to quotation has been requested, on a regulated market within the EEA, and whose home state is Norway. Further provisions on financial reporting supervision are set forth in Regulations to the Securities Trading Act.

The circular describes certain accounting issues arising from the review of financial reporting conducted in 2011.

Recognition and measurement

1 Business combinations under common control

A combination of businesses under common control is a business combination in which all of the combining entities or businesses are ultimately controlled by the same party or parties both before and after the combination, and that control is not transitory, (IFRS 3 *Business Combinations* par. B1). Such business combinations lie outside the scope of IFRS 3.

Accounting treatment is not regulated by a specific IFRS standard or interpretation from the IFRIC¹ or the SIC². Management shall use its judgement in developing accounting policies. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* par. 10-12 contains further requirements with regard to what factors shall and may be taken into account when determining accounting policies in the absence of a relevant IFRS standard. The accounting policies selected shall result in information that is relevant and reliable. In order to be reliable, the policies must represent faithfully the entity's financial position and performance, reflect the economic substance of transactions and be neutral, prudent and complete.

Pursuant to IAS 8.11(a), an entity shall refer to guidance in standards and interpretations dealing with similar and related issues. IFRS 3 may therefore be relevant to business combinations under common control. Entities may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework, other accounting literature and accepted industry practices (IAS 8.12). The pooling of interests method is referred to in other accounting languages and in accounting literature. Based on this, both the acquisition method and the pooling of interests method are normally considered to be acceptable principles for business combinations under common control.

In Finanstilsynet's view there may be constraints to the use of the acquisition method in situations where one of the entities is a recent start-up with no business activity. Where a new entity is established to take over an existing business, there will often be no economic substance in the transaction. Based on Finanstilsynet's assessment, IAS 8.10(b)(ii) indicates that there will be no basis for new measurement of assets and liabilities, and a pooling of interests method will have to be applied.

¹ International Financial Reporting Interpretations Committee

² Standing Interpretations Committee

The following is an example of a situation where use of the acquisition method may be subject to constraints. Entity M has two wholly-owned subsidiaries, A and B, engaged in different businesses, and M wishes to spin off the business in A. To accomplish this, M's first step is to establish a new entity, N, which acquires M's interests in A for compensation which may be in shares and/or cash. N's shares may for example then be distributed as dividend to M's shareholders. The combination of N and A is a business combination under common control, and N must choose an accounting policy in accordance with IAS 8. Although N formally acquires A from M, the business of the new N group is a continuation of A's business. Since N has no business, the combination bears little resemblance to a transaction. The combination is in substance a reorganisation. Moreover, since the proportion of cash to shares in the compensation can normally be set fairly freely in this type of intra-group transaction, the form of compensation is of lesser significance for assessing the economic substance. Hence according to IAS 8.10(b)(ii) there is no basis for a new valuation of A's assets and liabilities.

In the above example, use of the acquisition method with N as the acquiring party will not normally be a relevant method for accounting for the transaction in N's consolidated financial statements. It will also not be relevant to apply the acquisition method with A as the acquiring party (reverse acquisition), since N has no business. According to IFRS 3.B19, the acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition.

In its separate financial statements N shall measure acquisition cost at the carrying amount of its share of the equity items shown in the separate financial statements of the original parent (M), provided that (i) the acquisition cost is in shares, (ii) the assets and liabilities of the new group and the original group are the same immediately before and after the reorganisation, and (iii) that the owners of the original parent before the reorganisation have the same absolute and relative interests immediately before and after the reorganisation (IAS 27 *Consolidated and Separate Financial Statements* par. 38B). If this paragraph is applicable to the separate financial statements, Finanstilsynet is of the view that there is clearly no substance in the transaction and thus no basis for new measurement of assets and liabilities in the consolidated financial statements. Finanstilsynet is further of the view that there may be transactions where the economic substance indicates that there is no basis for new measurement of assets and liabilities in the consolidated financial statements under IAS 8.10(b)(ii), even though the transaction is not covered by IAS 27.38B in the separate financial statements.

The presence of economic reality in this type of transaction, and justified use of IFRS 3, cannot be entirely ruled out. In that regard it may be noted that IFRS 3 contains no general prohibition against a new start-up being the acquirer in a business combination. According to IFRS 3 B18, a new entity that transfers cash or other assets or incurs liabilities as compensation can be the acquiring party. All facts and circumstances must be thoroughly assessed in order to decide whether a transaction has substance.

2 Fair value of biological assets

According to IAS 41 *Agriculture* par. 12, biological assets should be measured at fair value less estimated costs to sell. This does not apply if fair value cannot be reliably measured. Fair

value is the amount for which the biological asset could be exchanged in an arm's length transaction between knowledgeable and willing parties. IAS 41 describes several valuation techniques and in what situations the respective techniques are to be used.

When IFRS was introduced in 2005 it was common practice in the salmon farming industry to value biological assets weighing less than 4 kg at cost except where the entity expected to sell at a loss. In 2006 Finanstilsynet adopted a decision that requires immature farmed salmon to be recognised at fair value based on observed slaughter prices. Finanstilsynet's decision was appealed, but its main elements were retained. The appeal ruling clarified that the fair value of immature salmon should be based on the slaughter price of mature salmon adjusted for the difference in value between mature and immature farmed salmon. How the adjustment was to be carried out was not specified. Regardless, for mature farmed salmon, market prices less relevant costs constitute fair value.

Finanstilsynet is aware that it is not uncommon in the aquaculture industry to measure biological assets' fair value using growth models, possibly supplemented with an assessment based on the lowest value principle in cases where it is considered that a loss may be realised. Growth models are typically based on current costs with an additional amount for a portion of future earnings. Future earnings are calculated as future net sales revenues less accrued and expected future costs. The addition is based on the relationship between weight on the balance sheet date and expected weight on the slaughter date. Growth models vary in complexity.

A feature common to growth models is that costs accrued in bringing the biological asset to its condition on the balance sheet date are included in the calculations. Finanstilsynet is aware that costs related to the realised mortality (dead fish) are sometimes included in the growth model's calculation of the fair value of live fish. Finanstilsynet notes that historical costs are not relevant in a fair value model.

The use of growth models incorporating historical costs may produce skewed results since the calculated value per kilo of immature fish may be higher at locations with relatively high costs. In an industry comparison, the most cost-effective entities will accordingly be those with the lowest fair value per kilo, despite the expectation of being the most profitable. In periods of high prices, measuring fair value using growth models may result in low valuation of biological assets of a cost-effective fish farmer. The models also have a systematic "levelling" effect in relation to price changes. This is due to another feature common to growth models, i.e. that only a fraction of the change in the kilo price of mature fish is taken into account in measuring the value of immature fish.

In Finanstilsynet's view, using growth models to measure fair value may, depending on the model's complexity and other circumstances such as market conditions etc., produce a value that diverges materially from fair value.

Finanstilsynet expects entities to establish a sound methodology for measuring the fair value of farmed fish and to be able to adequately describe the underlying assumptions. Several factors cause biological assets' fair value to be dependent on their location and condition, and this shall, according to IAS 41.9, be reflected in the measurement of fair value. In order to measure fair value based on concrete, verifiable assumptions, entities need to apply a natural classification by location. Location influences many factors in the calculation of fair value of biological assets. For example, the cost of transport will vary with the distance the well boat is expected to cover, and the FCR (Feed Conversion Ratio) will vary with natural conditions

such as sea temperature.

Finanstilsynet emphasises that the elements in the valuation must be based on reasonable and documented assumptions. The assumptions must be viewed in conjunction and be consistent with information given elsewhere in the financial reporting, management report etc. For example, any information provided about disease problems at a particular location must be reflected in the assumptions employed to measure the fair value of biological assets at that location. Disease will often affect a number of assumptions such as FCR, future medicine expenses, mortality rate per unit of time, expected slaughter date and expected distribution of quality. Actual biological status and location will therefore be central elements in the valuation.

Fair value is not entity-specific. Market prices of all relevant inputs shall be applied as far as possible. Any price premiums applied must relate to the condition or location of the fish, for example geographic differences in quality which objectively speaking are not reflected in the ordinary quality classification. A premium due to higher prices realised with a basis in developed customer relationships cannot be employed. In the case of immature fish, Finanstilsynet states that forward prices are more relevant than spot prices where such markets exist. If the entity has entered into fixed price contracts on fish feed, this does not affect the amount for which farmed fish in isolation can be sold, and estimated feed costs shall be based on the expected market price of feed. The fair value of the biological assets shall also not be affected by location-specific factors related to fallowing or the like, and the estimated future costs should therefore reflect allocation formulas based on normal capacity. Since a licence is required in most localities in order to farm fish, and these licences may have substantial value, capital costs or hypothetical rent should be taken into account in determining fair value.

The provision of IAS 41 to the effect that any value increases resulting from further biological transformation should not be taken into account, was removed with effect from 2009. Finanstilsynet is of the view that entities should develop and apply current value models of future cash flows in determining the fair value of biological assets in the future. This also applies under IFRS 13.³

IAS 41.47 requires an entity to disclose the methods and significant assumptions applied in determining the fair value of each group of biological assets. Finanstilsynet expects aquaculture entities to be specific in their descriptions of accounting policies and determination of assumptions related to biological assets. To Finanstilsynet's knowledge there are differences, some substantial, between aquaculture entities in terms of their determination of fair value, and these differences are not clearly evident from the entities' accounting policy descriptions and note disclosures in general. Entities must identify factors specific to their accounting and provide an adequate description of the method/valuation technique used, as well as concrete information on how central assumptions are determined.

³ The IASB published in May 2011 IFRS 13 which provides a common framework for the determination of fair value, including determination of the fair value of biological assets. The standard enters into force for the financial year starting 1 January 2013 or later. The standard is expected to be approved for use by EEA issuers in the third quarter of 2012.

Presentation

3 Statement of cash flows

Finanstilsynet has noted fundamental errors in the cash flow statements of several entities. The presentations of cash flow statements have in a number of cases included items which clearly have no cash flow effects. Entities should undertake better quality insurance when preparing the cash flow statement.

General information

The statement of cash flows shall provide information on how the entity has generated and spent cash and cash equivalents. Information on the entity's historical cash flows is useful for the users of financial accounts since it provides a basis to assess the entity's ability to generate cash and cash equivalents. Cash includes cash holdings and demand deposits (IAS 7 *Statement of Cash Flows* Definitions par. 6). Cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities (IAS 7.10). Operating activities are defined as the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents, while financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

As a general rule, an entity shall report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities (IAS 7.21). Exceptions from presenting on a gross basis are mentioned in 22 to 24. Cash flows which may be reported on a net basis are receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity, and receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short. Consequently receipts and payments related to long-term debt shall be presented on a gross basis. Re-purchase and sale of treasury shares shall also be reported on a gross basis.

The aggregate cash flows arising from obtaining and losing control of subsidiaries shall be presented separately and classified as investing activities (IAS 7.39). According to IAS 7.42, the aggregate amount of the cash paid or received as consideration for obtaining or losing control of subsidiaries shall be reported. When the transaction involves no cash payment or receipt, only the subsidiary's bank holding shall be presented separately and classified as investing activity. An entity shall disclose in respect of both obtaining and losing control of subsidiaries, the total aggregate consideration paid or received, the portion of the consideration consisting of cash and cash equivalents, the amount of cash and cash equivalents in the subsidiary and the amount of assets and liabilities other than cash or cash equivalents in the subsidiary (IAS 7.40). Cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control shall be classified as cash flows from financing activities (IAS 7.42A).

It follows from IAS 7.16(b) that cash receipts from sales of property, plant and equipment, intangibles and other long-term assets shall be classified as investing activities.

Cash receipts and payments of long-term assets and interest received on such assets cannot be classified as financing activities. These cash flows shall be classified either as operating or investing activity, depending on the nature of the item (IAS 7.33).

Unrealised gains and losses arising from exchange rate changes are not cash flows (IAS 7.28). This means for example that changes in a loan during the period resulting from currency effects must be identified and separated from net receipts and payments on the loan. According to IAS 7.28, the effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency shall be reported in the statement of cash flows as a reconciling item between cash and cash equivalents at the beginning and the end of the period. The amount shall be presented on a separate line from cash flows from operating, investing and financing activities.

Interim financial statements

Pursuant to IAS 34 *Interim Financial Reporting* par. 10, an entity may present a condensed statement of cash flows in its interim financial report. The condensed statement of cash flows must include, at a minimum, each of the headings and subtotals included in its most recent annual financial statements. The information must be presented in a manner that provides relevant, reliable, comparable and understandable information (IAS 1 *Presentation of Financial Statements* par. 17(b)). In Finanstilsynet's view a three-line statement of cash flows will not normally meet this requirement or the requirement of IAS 1.29 that each material class of similar items shall be presented separately. Items of a dissimilar nature or function shall be presented separately unless they are immaterial. IAS 1.17 and IAS 1.29 also apply to interim financial statements (IAS 1.4).

A single line termed 'statement of cash flows from investing activities' with no further information on the investments made is, in Finanstilsynet's assessment, insufficient in relation to the requirements of IAS 1.17(b). If cash flows from investing activities arise, for example, from investments in a particular class of fixed assets, this must be stated explicitly. The same observations may be made regarding cash flows from financing activities. A single line termed 'cash flows from financing activities' provides no information as to whether this refers to issuance of a loan, loan repayment, dividends or other financial or equity transactions.

According to IAS 7.21, issuance of new debt and repayment of existing debt shall be presented on a gross basis. In Finanstilsynet's view, it will normally be necessary to report issuance and repayment of debt on a gross basis in the interim financial statements in order for the information to be relevant, reliable, comparable and comprehensible.

Where cash flows are reported using the indirect method, a reconciliation between profit or loss and cash flows from operating activities shall be presented. Profit or loss shall be adjusted for non-cash items such as depreciation, provisions etc., and changes in the period in holdings and assets and liabilities related to operations (working capital), (IAS 7.18(b) and 7.20). In Finanstilsynet's view IAS 1.17(b) also requires a reconciliation in interim financial statements. The items may be condensed in the interim financial statement, but material non-cash transactions and change in working capital should be specified.

4 Classification of loans

Classification of loans is regulated in IAS 1 *Presentation of Financial Accounts*. According to IAS 1.69(c) and (d) a liability shall be classified as current when it is due to be settled within 12 months or the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period.

According to IAS 1.74, an entity that breaches a provision of a long-term loan arrangement on or before the balance sheet date with the effect that the liability becomes payable on demand shall classify the liability as current, even if the lender agreed, after the balance sheet date and before the issuance of the financial statements, not to demand payment as a consequence of the breach. The loan is classified as current because the entity, on the balance sheet date, does not have an unconditional right to defer its settlement for at least 12 months. Only where the lender has issued a waiver that expires at least 12 months after the balance sheet date may the entity classify the loan as current (IAS 1.75).

IAS 1.76 also states that the following events, if they occur between the balance sheet date and the date the financial statements are authorised for issue, shall be disclosed as non-adjusting events:

- refinancing on a long-term basis,
- rectification of a breach of a long-term arrangement, and
- the lender issues a waiver to rectify a breach of a long-term loan arrangement.

In Finanstilsynet's view, the provisions of IAS 1.74 and 1.76 give clear guidelines on how a loan should be classified when an entity is in breach of a provision of a loan arrangement on the balance sheet date. In Finanstilsynet's view, an entity cannot, for example, argue that the loan is actually long-term and cite that the lender has provided a period of grace immediately after the balance sheet date but before issuance of the financial statements.

In recent years Finanstilsynet has seen several instances of loans erroneously classified as long term. Finanstilsynet emphasises that in the event of default or breach of other loan terms, the terms of the waiver must be examined closely in order to determine whether the loan shall be classified as long term or current.

5 Results of operating activities

IFRS does not require a particular form for presentation of comprehensive income, but certain items must be disclosed (IAS 1 *Presentation of Financial Statements* par. 82). According to that provision the statement shall include the items profit or loss and comprehensive income. Further items, headings and subtotals in the statement of comprehensive income shall be presented when such presentation is relevant to an understanding of the entity's financial performance (IAS 1.85). Disclosure of the results of operating activities is permitted, but not mandatory. Users of the financial statements are often interested in the results of operating activities, and many entities have incorporated these results as a subtotal in the presentation of comprehensive income.

If the profit or loss is presented separately in the statement, all profit or loss related items shall be included. IAS 1 *Basis for Conclusions* par. 56 notes that it would be misleading if items of an operating nature were excluded from the results of operating activities. This also applies where exclusion has been industry practice. An example is that it would be inappropriate to exclude items clearly related to operations: inventory write-downs and restructuring and relocation expenses. Similarly, it would be inappropriate to exclude items on the grounds that they are non-cash transactions, such as depreciation and amortisation expenses.

Property companies may choose to account for investment property by using either the fair value model or the cost model (IAS 40 *Investment Property* par. 30). Changes in the fair value of investment properties are a normal aspect of the activity of a property company using the fair value model. It would be inappropriate for such property companies to present the total line 'results of operating activities' without including these value changes. The item showing value changes is an operations-related item which must be included in the total line 'results of operating activities' if such a total line is presented. A subtotal before value changes can be presented, but in that case it must be clear that this subtotal is before results of operating activities before value changes.

Notes

6 Errors

Pursuant to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, material prior period errors shall be corrected retrospectively in the first set of financial statements authorised for issue after their discovery (IAS 8.42). Material errors shall be corrected by restating the comparative amounts for the prior period(s) presented in which the error occurred. If the error occurred before the earliest prior period presented, the error shall be corrected by restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

Finanstilsynet emphasises that adequate note disclosures shall be provided when correcting errors. Pursuant to IAS 8.49, an entity shall disclose the nature of the prior period error for each prior period presented, and the amount of the correction for each financial statement line item affected, if practically possible. Further, disclosures shall be made of the size of the correction of the basic and diluted earnings per share. The amount of the correction at the beginning of the earliest prior period presented shall also be disclosed, and, if retrospective restatement is impracticable, the circumstances that led to this and a description of how and from when the error has been corrected.

Prior period errors in recognition and measurement shall be labelled as errors. An accounting error shall not be toned down by being described as a change of accounting policy or as a re-presentation of prior periods' financial statements.

7 Liquidity risk – management of inherent risk

Liquidity risk is described in circular 5/2011 section A par. 2.2.2. Below are Finanstilsynet's comments on the requirement to describe how entities manage inherent liquidity risk (IFRS 7 *Financial Instruments: Disclosures* par. 39(c)).

The above provision requires a description of how the entity manages the liquidity risk inherent in the various time intervals presented in the maturity analyses required pursuant to IFRS 7.39(a) and (b). Further guidance is provided in IFRS 7 B11E and B11F.

Concrete information must be disclosed with regard to how the entity intends to meet its liquidity requirements. In the short term, it may be a matter of holding sufficient liquid funds. An entity must state if the entity has financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities and are held in order to reduce liquidity risk. Any borrowing facilities or other lines of credit that it can access to meet liquidity needs must also be described. Where the entity has set liquidity reserve targets, such targets should be described and any breach of these targets must be disclosed. A description of internal control procedures and contingency plans for managing liquidity risk may also be relevant. If the entity has significant concentrations of liquidity risk in its assets or its funding sources, these should be disclosed.

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