FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Circular

Certain accounting-related issues based on the review of financial statements in 2013

CIRCULAR:
11/2013

DATE:
02.12.2013

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

2 Impairment of assets

Finanstilsynet dealt in circular 5/2011 og circular 19/2012 with themes connected to IAS 36 *Impairment of Assets* and measurement of value in use. The present circular, summarising the experience gained in 2013, focuses on the provisions of IAS 36 dealing with estimating future cash inflows from the continuing use of an asset and with determining the cost of debt in the discount rate.

2.1 Estimating cash flows when measuring value in use

Value in use is the present value of future cash flows expected to be derived from an asset. IAS 36.30 describes elements to be reflected in the calculation of an asset's value in use. Expectations about possible variations in the amount or timing of the future cash flows shall be taken into account. Adjustments shall be made either to the future cash flows or to the discount rate. Whichever approach is adopted to reflect expectations about possible variations in amount or timing, the result shall be to reflect the expected present value of the future cash flows, i.e. the weighted average of all possible outcomes (IAS 36.32). The estimates shall accordingly reflect the range of possible outcomes rather than a single most likely, minimum or maximum possible amount (IAS 36 A3(c)).

An entity shall base its cash flows on its latest approved financial budgets and/or forecasts. Moreover, reasonable and supportable assumptions must be used. Finanstilsynet points out that the cash flows should not necessarily be identical to budgets and/or forecasts when measuring value in use. Budgets and forecasts may be more optimistic than indicated by a "best estimate" and the requirement of reasonable and supportable assumptions.

IAS 36 Appendix A shows two approaches to measuring present value (traditional approach and expected cash flow approach). In Finanstilsynet's experience a widespread practice is to use the traditional approach of determining a single cash flow and then to allow for uncertainty by adjusting the discount rate. Finanstilsynet points out that the expected cash flow approach may, for example when running scenario analyses, be a more effective measurement tool than adjusting for uncertainty in the discount rate. Adjusting the discount rate is likely to appear inaccurate and to pose a larger challenge in terms of the requirement of reasonable and supportable assumptions compared with a scenario analysis. Estimating several possible outcomes of cash flows will enable the effect of the various assumptions to emerge more clearly both in terms of stated values and the weighting of the various outcomes (IAS 36 A7). There may nonetheless be risks that are more appropriately taken into account in the discount rate than in the cash flows, for example political risk. Preparers of financial statements must have an awareness of the range of possible cash flow outcomes and what approach is most appropriate to apply to arrive at the weighted average of all possible outcomes. This is important in order to ensure that the entire range of possible outcomes is taken into account and that some outcomes are not assigned excessive weight.

2.2 Determining cost of debt in the discount rate

The discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flows have not been adjusted (IAS 36.55). Rates used to discount cash flows shall reflect assumptions that are consistent with those inherent in the estimated cash flows (IAS 36 A3). IAS 35.56 expands the definition of discount rate.

A rate used to discount free cash flow to total capital must reflect both cost of equity and cost of debt. In Finanstilsynet's experience, it is widespread practice to start out from a capital asset pricing model when determining the cost of equity. The cost of debt is often determined on the basis of the entity's incremental borrowing rate or other market borrowing rates (IAS 36.A17). Finanstilsynet emphasises that interest rates must be adjusted to reflect the market's assessment of the specific risk factors associated with the asset's estimated cash flows. Risks that are not relevant, and risks for which the estimated cash flows have already been adjusted, must not be adjusted for (IAS 36 A18). Further, the discount rate must be independent of the entity's capital structure. Future cash flows expected to arise from an asset do not depend on the way in which the entity financed the asset (IAS 36 A19). The debt to equity ratio used in determining the weighted average cost of capital should be in line with normal capital structure in the industry, based on the market value of equity capital and debt.

Where the entity's borrowing rate differs significantly from that of other actors in the industry, it is an indication of entity-specific factors whose relevance to the entity's estimated cash flows must be assessed. For example, the entity may be significantly less creditworthy than its competitors and therefore have a higher risk premium in its incremental borrowing rate. This will not necessarily be relevant when measuring assets' value in use. Similarly, the cost of debt must be adjusted if an entity has a capital structure that differs significantly from that of other actors in the industry (IAS 36 A19). It may also be the case that the difference in borrowing rate reflects the fact that the entity's business is less diversified than that of companies with which it may be naturally compared. In such cases the entity's borrowing rate may reflect the risk attached to the particular asset to a greater degree than in the case of comparable companies' borrowing rates. It is, regardless, important to compare the cost of debt with that of other industry actors and to analyse the cause of any differences. The discount rate should reflect the market's assessment of the specific risk factors associated with the asset's estimated cash flows. Entities must consider possible adjustments to their incremental borrowing rate to meet this requirement.

3 Hedge accounting – documentation

Hedge accounting may only be used where all documentation requirements are met. Finanstilsynet emphasises that all relevant documentation must be in place at the inception of the hedge. In the absence of documentation, hedge accounting cannot be applied in the financial statements, and the hedging instrument – e.g. forward contracts – must figure in the financial statements as if the entity has not applied hedge accounting.

3.1 General

Many entities have transactions (sales and/or purchases) in one or more foreign currencies, and use hedging instruments, for example forward exchange contracts, to ensure a future expected cash flow from such sales and/or purchases. According to IAS 39 *Financial Instruments – Recognition and Measurement*, unrealised gains or losses on derivatives must as a rule be presented as part of the profit or loss for the year.

If the conditions for cash flow hedging are met and the entity opts to apply hedge accounting, unrealised gain or loss on the hedging instrument must be recognised in other comprehensive income and be assigned to a separate equity component[1]. When the expected transaction occurs, the value changes must be reclassified from equity through other comprehensive income to profit or loss at the same time as the hedged transaction affects the profit or loss[2]. Derivatives shall be recognised at fair value in the balance sheet regardless of whether hedge accounting is applied or not.

All requirements on hedging documentation must be met (IAS 39.88).

3.2 Designation and documentation of the hedging relationship

IAS 39.88 sets no formal requirements for hedging documentation. However, Finanstilsynet expects the hedging relationship to carry a unique designation from its inception to its termination. Where an entity hedges highly probable payments from customers by means of forward exchange contracts, there must be a reference linking the forward contract and the highly probable customer payment, for example to a specific budget item. Documentation must exist when the contract is entered into.

The entity's hedging documentation must make clear what risk is being hedged. Where future customer payments are hedged by forward exchange contracts the documentation must state that the risk being hedged is exchange rate risk, and specify whether this risk is represented by the forward price or the spot price. If the spot price is being hedged, the entity must extract the interest element when entering into the forward contract and recognise this as a derivative

[1] The numerical value of the accumulated amount carried against equity cannot exceed the numerical value of the accumulated value change of cash flow on the hedged risk. Any value change on th**e** hedging instrument over and above this variable must be presented in profit or loss in the period in which it arises.
[2] If the hedged transaction is the purchase of a non-financial asset it will be possible, as an accounting policy choice, to reclassify the overall amount recognised in equity from equity through other comprehensive income to the cost of the asset at the same time as the hedged asset is recognised in the balance sheet.

in accordance with the general rule. If the forward price is hedged, ineffectiveness could result if the hedged object and the hedging instrument fall due at different times – even though the hedging instrument and the hedged transaction have the same volume. Ineffectiveness must be recognised in profit or loss on an ongoing basis.

In Finanstilsynet's view hedge accounting can at the outset only be used for customer payments that are expected to occur on or after the maturity date of the hedging instrument. This is because a hedging instrument cannot be designated for hedging for only a portion of the period during which the hedging instrument remains outstanding (IAS 39.75). Where the payment occurs earlier than originally expected, the hedge may nonetheless be carried through, but presupposes certainty that the expected transaction has occurred (IG F.5.4). This could affect the effectiveness testing.

Entities that hedge expected transactions that are considered highly probable must provide evidence that this is so. When hedging customer payments, such evidence could for example be a portion of budgeted revenues. The entity must render it highly probable that the hedged portion of the budget will be realised. This can be done for example by pointing out that the hedged portion has been achieved in all previous periods.

Evidence must be available that the hedging documentation was in place at the inception of the hedging relationship. One way to ensure this is by dating and signing the documentation. Not only the hedging instrument must be signed and dated, but also the reference linking the hedged object and the hedging instrument along with other documentation.

3.3 Further notes on measuring effectiveness

Effectiveness must be measured both prospectively and retrospectively (IAS 39.88(a) and (e) and AG 105-106). IAS 39 does not specify a specific approach for measuring prospective effectiveness. However, Finanstilsynet considers that entities cannot simply assume that customer payments will at least match outstanding forward contracts in respective currencies. This is because payment could occur before the hedging instrument matures, possibly resulting in imperfect hedge effectiveness. The entity must also document how it intends to assess the hedging instrument's effectiveness. Where retrospective effectiveness is concerned, the actual results of the hedge must be within a range of 80-125 per cent in order to be considered highly effective (AG 105(b)). Effectiveness must also be measured in order to meet the note disclosure requirements set out in IFRS 7 *Financial Instruments – Disclosures* 24(b) with regard to ineffectiveness. Finanstilsynet points out that ineffectiveness shall not be recognised in profit or loss together with the hedged object, but as a gain/loss on financial instruments in the income statement in the period in which it arises.

4 Segment reporting and geographical areas

IFRS 8 *Operating Segments* paragraph 33 requires an entity to report on the geographical distribution of revenues in its home state, and on material operating revenues attributed to one individual foreign country. Information on groups of states may be disclosed.

A number of entities in certain industries, including shipping, do not report geographical distribution of revenues since their operations are of such a nature that the entire world is defined as their home market. Finanstilsynet nonetheless notes that some shipping companies provide this information.

Information on geographical distribution of revenues is mandatory for all entities, including those with just one operating segment. IFRS 8 gives no directions on how revenue distribution should be presented. This is left to the entities. Entities are however required to explain the way in which revenues are distributed and to report the amounts on the basis of the financial information used to prepare the financial statements. In shipping it may for example be the case that revenues are distributed geographically by loading port. The entity must also disclose which state it defines as its home state.

5 Defined benefit pension plans and discount rate

According to IAS 19 *Employee Benefits*, pension obligations are to be discounted using the interest rate on high quality corporate bonds. In countries where no deep market for such bonds exists, the government bond rate shall be used. Up to 2012 the understanding was that no deep market for high quality corporate bonds existed in Norway. The interest rate on government bonds was therefore used as a basis for the discount rate.

For the accounting year 2012 many entities had changed the discount rate used when calculating pension obligations from 2011 to 2012. These entities used the interest rate on covered bonds to estimate the discount rate.

Switching from the government bond rate to the corporate bond rate to calculate the discount rate involves a change in accounting estimate. According to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 39, entities must disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect on future periods.

IAS 1 *Presentation of Financial Statements* paragraph 122 requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Entities that have significant pension obligations and whose assessment of the discount rate has a large effect on the amounts recognised in the financial statements must accordingly disclose such information.

In its review of annual financial statements for 2012 Finanstilsynet has noted many entities' failure to disclose satisfactory information on the change in their discount rate. Finanstilsynet expects sufficient information to be disclosed on changes in estimates related to the discount rate used in financial statements ahead.

Finanstilsynet further expects entities to provide information on the assessments which management considers important when determining the discount rate where this is important for the financial statements. Reference is also made to ESMA's public statement *European common enforcement priorities for 2013 financial statements*. See point 8 of this circular.

6 Use of external valuations to determine fair value

IFRS 13 *Fair Value Measurement* became effective on 1 January 2013. This standard contains guidelines on how fair value is to be determined. Where the preparation of financial statements is based on external valuations it is the entities' responsibility to ensure that such valuations are prepared in accordance with the requirements of the standard. Entities must demand that external valuations contain information on the application of the principles of the standard, on the valuation technique(s) used, and on the key assumptions underlying the application of the techniques. This is important in order for entities to fulfil the disclosure requirements in IFRS 13.91-99.

Where fair value less cost to sell is used as the recoverable amount for impairment purposes, the principles of IFRS 13 shall be applied when measuring fair value. Note disclosure requirements are however set out in IAS 36.

7 Change in accounting policy, retrospective restatement or reclassification

Financial statements shall as a general rule be presented consistently from one period to the next. Where an entity changes the presentation or classification of items in its financial statements, it shall reclassify comparative amounts unless reclassification is impracticable. Comparative amounts shall also be restated if the entity changes an accounting policy or identifies material errors in prior periods. Here too there are exceptions where reclassification is impracticable.

Finanstilsynet points out that disclosures are required in relation to retrospective reclassification of items in the financial statements carried out in accordance with IAS 1.41 and 42. The nature of the reclassification, the amount of each item reclassified and the reason for the reclassification must be disclosed. Where accounting policy is changed, information shall be disclosed in accordance with IAS 8.28 and 29 where an IFRS is applied for the first time and where accounting policy is changed voluntarily. Where errors are identified in prior periods, information shall be disclosed in accordance with IAS 8.49.Where restatement of comparative amounts is impracticable, information about this shall be disclosed.

An entity shall also present a third statement of financial position as at the beginning of the preceding period if the above-mentioned restatements have a material effect on the information in the statement of financial position as at the beginning of the preceding period (IAS 1.10f). The requirement for a third statement of financial position is elaborated on in IAS 1.40A-D.[3]

Finanstilsynet is aware that some entities neither make the note disclosures required in connection with the reclassification of comparative amounts nor present a third statement of financial position when required.

8 Enforcement priorities for 2013 financial statements

Finanstilsynet recalls ESMA's statement of "European common enforcement priorities for 2013 financial statements". This statement describes topics of which ESMA considers listed entities should be particularly aware when preparing 2013 financial statements. The following items are involved:

- Impairment of non-financial assets
- Measurement and disclosure of post-employment benefit obligations
- Fair value measurement and disclosure
- Disclosures related to significant accounting policies, judgements and estimates
- Measurement of financial instruments and disclosure of risk, particularly relevant for financial institutions

Finanstilsynet will have attention on these topics in its review of the 2013 financial statements. Finanstilsynet will also focus on industries of importance to Oslo Børs, viz. oil and energy, shipping and seafood.

9 Half-yearly financial report for 2013 – failure to present a responsibility statement and/or half-yearly report

The half-yearly financial report shall contain the half-yearly financial statements, the half-yearly management report and statements made by the persons responsible within the issuer (Securities Trading Act section 5-6, subsection (2)). The statements shall affirm that the half-yearly financial statements have been prepared in accordance with applicable accounting standards and give a true and fair view of the assets, liabilities, financial position and profit or

[3] These provisions are added through the Annual Improvements to IFRSs 2009–2011 Cycle and apply to periods starting on 1 January 2013 or later.

loss of the entity and the group taken as a whole, and that the half-yearly management report includes a fair review of important events in the first half-year with a bearing on the half-yearly financial statements and of principal risks and uncertainties in the second half-year.

Finanstilsynet has examined all half-yearly reports for 2013 and found that 20 entities have failed to publish responsibility statements and/or the half-yearly management report which are mandatory parts of the half-yearly report. The entities concerned have been given a short deadline to publish the missing responsibility statements and/or half-yearly management reports.

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