Note 3 - Critical estimates and assessments concerning the use of accounting principles

In the preparation of the Group accounts the management makes accounting estimates, discretionary assessments and assumptions that influence the effect of the application of the accounting principles and hence the amounts booked for assets, liabilities, income and expenses. Estimates and discretionary assessments are evaluated continuously and are based on empirical experience and expectations of events which, as of the balance sheet date, are deemed likely to occur in the future.

Losses on loans and guarantees

The Bank rescores its loan portfolio monthly. Customers in a poor risk class, payment defaults, negative migration or other objective criteria are assessed for individual write-down. Should the Bank's calculations show that the present value of the discounted cash flow based on the effective interest rate at the time of estimation is below the book value of the loan, an individual write-down will be carried out. Impaired loans are reviewed quarterly.

Write-down is considered in the case of exposures larger than NOK 250,000 that are in default, or where the Bank has other relevant objective information. Collective write-downs are calculated for groups of commitments subject to rising credit risk but where it is not possible to identify which commitment will entail loss. Calculation is based on increase in expected loss on portfolios which have migrated negatively since the date of approval.

Assessment of individual and group write-downs will invariably be a matter of discretionary judgement. The Bank uses historical data as a basis for estimating the need for write-downs.

In cases where collateral values are tied to specific objects or industries that are in crisis, collateral will have to be realised in illiquid markets, and in such cases assessment of collateral values may be encumbered with considerable uncertainty.

In the case of events that have taken place, but have yet to be reflected in the Bank's portfolio monitoring systems, the need for write-downs is estimated on a group basis using stress test models.

See also note 2 on accounting principles and note 6 on risk factors.

Fair value of equity capital interests

Assets recognised at fair value through profit and loss will mainly be securities traded in an active market. An active market is defined as a market for trading of similar products where willing buyers and sellers are present at all times, and where prices are accessible to the general public. Shares quoted in a regulated market place fit in with the definition of an active market. A market with a large spread between bid and asked prices and where trading is quiet may pose a challenge. Some key shares will be based on in-house valuations, transaction prices or external analyses of the company. Such shares are valued using acknowledged valuation techniques. These include the use of discounted cash flows or comparative pricing where similar, listed, companies are used (multiple pricing) to determined the value of the unlisted company. Such valuations could be encumbered with uncertainty. Assets classified as available for sale will also be recognised at fair value through other comprehensive income. Market values will generally be based on valuations or the latest known trade of the share. Shares which cannot be reliably valued will be carried at cost.

Fair value of derivatives

Fair value of derivatives is usually determined using valuation models where the price of the underlying, for example interest rates or exchange rates, is obtained in the market. When measuring financial instruments for which observable market data are not available, the Group makes assumptions regarding what market participants would use as the basis for valuing similar financial instruments. The valuations require application of significant judgment when calculating liquidity risk, credit risk and volatility among others. Changes in these factors would affect the estimated fair value of the Group's financial instruments.

For options, volatilities will either be observed implicit volatilities or estimated volatilities based on historical movements in the price of the underlying instrument. In those cases where the Bank's risk position is approximately neutral, middle rates will be used. "Neutral risk position" is understood to mean for example that interest rate risk within a maturity band is virtually zero. Where market prices that are obtained are based on transactions with lower credit risk, this will be taken into account by amortising the original price difference measured against such transactions over the period to maturity.

Pensions

Net pension liability and the pension cost for the year are based on a number of estimates, including: return on pension assets, future interest and inflation rates, wage trend, turnover, the basic state pension entitlement and the general trend in the number of disability pensioners, all of which are of major significance. Estimate changes resulting from changes in the parameters mentioned will in large measure be accrued over average remaining earning period and not be immediately charged to profit in the same way as other estimate changes. The Group follows the updated guidance on pension assumptions from the Norwegian Accounting Standards Board, adjusted for company-specific factors. Parameters employed are shown in the note 24 on pensions.

Goodwill

The Group conducts tests to assess possible impairment of goodwill annually or in the event of indications of impairment. Assessment is based on the Group's value in use. The recoverable amount from cash flow generating units is established by calculating discounted future cash flows. The cash flows are based on historical earnings and expectations of future factors and include suppositions and estimates of uncertain factors. The outcome of the impairment tests depends on estimates of discount rates which are set on a discretionary basis based on information available on the balance sheet date.

Regarding goodwill related to Romsdals Fellesbank, the portfolio is regarded as integrated in the Bank's other lending and deposit operations, and, as from 2009, the lowest level for the cash generating unit is the Parent Bank level. A net cash flow is estimated based on earnings in the Bank's loan and deposit portfolio. Earnings are estimated based on average portfolio and margin, and average commission income. Allocated costs are calculated with reference to the Bank's cost ratio in relation to total assets. A five-year average is employed in the calculation since this is considered to provide the best estimate of future cash flows. Expected loss on the loan portfolio is also calculated (0.3 per cent).

The cash flow is calculated over 20 years and is discounted by the risk-free interest rate + risk premium for similar businesses (pre-tax interest rate 10 per cent). Calculations show that the value of discounted cash flows exceeds recognised goodwill by a good margin.

Other goodwill in the Group is calculated based on average earnings in the market area and is discounted at the risk-free interest rate + the risk premium for similar businesses (12-14 per cent).

Acquisitions

Acquisition of another company is accounted for by the acquisition method. This method requires a full purchase price allocation (PPA) in which the purchase price is allocated to identified assets and liabilities in the acquired company. Excess values beyond those allocated to identified assets and liabilities are booked as goodwill. Any deficit values are, after careful assessment, recognised as income through profit/loss in the year of the acquisition (badwill). The analyses contain both concrete calculations and use of best judgement in arriving at the fairest possible value of the acquired companies at time of acquisition. Although some uncertainty invariably attends estimation items, they are supported by determinations of expected cash flows, comparable transactions in previous periods etc. See also note 40 on business acquisitions/business combinations.

Non-current assets held for sale (IFRS 5)

SpareBank 1 SMN's strategy is that ownership resulting from defaulted exposures should at the outset be of brief duration, normally not longer than one year. Work on selling such companies is continuously in progress, and for accounting purposes they are classified as held for sale. See also note 39 on investments in owner interests.

Sale of loan portfolios

In the transfer of loan portfolios to Eksportfinans, SpareBank 1 Boligkreditt and SpareBank 1 Næringskreditt, the Group considers whether the criteria for derecognition under IAS 39 are met. At the end of the accounting year all transferred portfolios were derecognised from the Parent Bank’s balance sheet. See also note 9 on derecognition of financial assets.

Unrealised gain at Visa Norge FLI as a result of sale of Visa Europa to Visa Inc

On 2 November 2015 an agreement was announced between Visa Europe Ltd. and Visa Inc. whereby Visa Inc. acquires all shares of Visa Europa. The transaction comprises a cash consideration of EUR 11.5 billion, convertible preference shares estimated as of the announcement date at EUR 5.0 billion, and a conditional cash consideration of up to EUR 4.7 billion, to be disbursed four years after completion of the transaction. Actual completion is subject to approval by the competition authorities of the EU and Jersey and will take place in the second quarter of 2016.

SpareBank 1 SMN is a member of the association Visa Norge FLI (“Visa Norge”), which is a shareholder of Visa Europe Ltd. If completed, the transaction will increase the book value of Visa Norge’s equity capital by a substantial margin. SpareBank 1 SMN has received information from Visa Norge giving a preliminary estimate of expected proceeds of the sale accruing to Visa Norge. The estimate is uncertain and is based on various assumptions. The principle for allocating proceeds between members of Visa Norge has yet to be finally clarified, but Visa Norge has clarified its intention to allocate the proceeds to its members, and indicated that the members’ proportion of voting rights in Visa Norge can be employed for estimation purposes.

Following completion of the transaction, Visa Norge will receive its part of the compensation for the sale of the share. Only after a resolution from the board of Visa Norge will it be possible to distribute assets to the members of the association. Such distribution can accordingly take place in the second quarter of 2016 at the earliest.

SpareBank 1 SMN has thoroughly reviewed the accounting treatment of the transaction, including assessments regarding the liquidity of the preference shares expected to be awarded, share price risk, foreign exchange risk, tax risk and implementation risk inherent in the transaction. The calculation includes no estimation of value of the conditional cash consideration which may be disbursed four years after completion of the transaction since the conditions underlying any such future disbursement are thus far not known. The owner interest in Visa Norge FLI is deemed to be a financial asset and classified in the category ‘available for sale’.

According to IAS 39.46, assets classified as available for sale shall be measured at fair value – but only if fair value can be reliably measured. SpareBank 1 SMN has recognised its share of the expected consideration as an unrealised value change. The estimate of the consideration which will be received in the second quarter of 2016 is subject to great uncertainty and may change in the period to disbursement.

SpareBank 1 SMN has recognised NOK 74.7 million as unrealised value change of Visa Norge FLI against other comprehensive income (OCI) in the fourth quarter of 2015. It is assumed that a distribution from Visa Norge to the participating banks will come under the exemption method such that the net effect on other comprehensive income net of tax in the fourth quarter of 2015 will be NOK 74.1 million.