

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, incomes 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.

Continued turbulence in the capital markets has led to increased uncertainty about some of the assumptions and expectations underlying the preparation of the various accounting estimates. It is expected that 2013 will also be marked by some uncertainty with regard to the trend in the Norwegian and international economies.

Losses on loans and guarantees

The Bank rescors its loan portfolio monthly. Customers in a poor risk class, payment defaults, negative migration or other objective criteria are assessed for individual write-down. Individual write-down is calculated as the difference between the loan's book value and the present value of discounted cash flow based on the effective interest rate at the time specified losses were initially determined.

Individual write-down of retail market commitments is calculated based on the same principles. 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. Write-down needs are estimated with a basis in estimated future cash flows. Uncertainty attends these estimates.

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 determine the value of the unlisted company. Such assets 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 price.

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.

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. If this is not the case, the relevant bid or offer price is used to determine the net position.

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.

Intangible assets

Write-down tests of intangible assets are largely based on discounting of expected future cash flows. Cash flow estimates will invariably be subject to substantial uncertainty, and in some cases the methods used to assign cash flows to different assets will also be encumbered with uncertainty.

Pensions

Net pension commitments 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. Uncertainty largely relates to the gross commitment and not to the net commitment shown in the balance sheet. 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. As from 1 January 2008 the defined contribution pension scheme is closed to new members. As from the same date the Group is offering its employees a defined contribution scheme, thereby reducing the extent of uncertainty attending the Group's pension scheme. 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 on pensions.

Goodwill

The Group conducts tests to assess possible impairments of goodwill values annually or in the event of indications of value 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 hurdle rates which are set on a discretionary basis based on information available on the balance sheet date.

As regards the impairment test of 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 11 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 (14-15 per cent).

Significant acquisitions

Acquisition of another company must be 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). Under IFRS 3 point 62 the PPA may be considered provisional or final.

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 as fully as possible by determinations of expected cash flows, comparable transactions in previous periods etc. See also note 39.

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 by one line consolidation. See also note 38.

Transfer of loan portfolios

In the transfer of loan portfolios to Eksportfinans and 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.