Accounting principles for the consolidated financial statements

Basic information

Wärtsilä Corporation is a Finnish listed company organised under the laws of Finland and domiciled in Helsinki. The address of its registered office is Hiililaiturinkuja 2, 00180 Helsinki. Wärtsilä Corporation is the ultimate parent company in the Wärtsilä Group.

Wärtsilä is a global leader in smart technologies and complete lifecycle solutions for the marine and energy markets. By emphasising sustainable innovation, total efficiency and data analytics, Wärtsilä maximises the environmental and economic performance of the vessels and power plants of its customers.

In 2019, Wärtsilä’s net sales totalled EUR 5.2 billion with approximately 19,110 employees. The company has operations in over 200 locations in more than 80 countries around the world. Wärtsilä is listed on Nasdaq Helsinki.

These consolidated financial statements were authorised for release by the Board of Directors of Wärtsilä Corporation on 29 January 2020, after which, in accordance with the Finnish Corporate Act, the shareholders have a right to approve or reject the financial statements in the Annual General Meeting. The Annual General Meeting also has a possibility to decide upon changes in the financial statements.

Basis of preparation

The consolidated financial statements are prepared in accordance with the International Financial Reporting Standards (IFRS) by applying IAS and IFRS standards and their SIC and IFRIC interpretations, which were in force on 31 December 2019. International Financial Reporting Standards refer to the standards, and their interpretations, approved for application in the EU in accordance with the procedures stipulated in the EU’s regulation (EC) No. 1606/2002 and embodied in Finnish accounting legislation and the statutes enacted under it. The notes to the consolidated financial statements also comply with the Finnish accounting and corporate legislation.

Reporting is based on the historical cost convention. Exceptions are the financial assets and liabilities at fair value through the statement of income, the assets and liabilities arising from pension plans, hedged items under fair value hedging, and the cash- and share-settled share-based payment transactions which are measured at fair value. The figures are in millions of euros except notes 32. Related party disclosures and 34. Auditors’ fees and services, which are presented in thousands of euros.

IFRS amendments

In 2019, the Group has adopted the following new and amended standards and interpretation issued by the IASB.

IFRS 16 Leases (effective for financial periods beginning on or after 1 January 2019) addresses the definition, recognition and measurement of lease agreements and notes related to leases. The standard replaced IAS 17 Leases.

The financial leases identified and capitalised according to IAS 17 before the financial period 2019 are classified as right-of-use (ROU) assets and the corresponding lease liability has been recognised. The lessor accounting remains similar to IAS 17, lessors continue to classify leases as finance leases or operating leases.

IFRS 16 introduces a single, on-balance sheet lease accounting model for lessees. Under IFRS 16, the companies are required to recognise right-of-use assets (ROU) and lease liabilities in the statement of financial position. These are initially measured at the present value of unavoidable future lease payments. The right-of-use assets are
depreciated and interest on lease liabilities recognised in the statement of income over the lease term. Whether a contract contains a lease is determined based on whether the customer has the right to control the use of an identified asset for a period of time. Exemptions regarding recognition of leases apply to short-term leases with lease period less than 12 months and to assets of low value.

Wärtsilä Group’s capitalised lease agreements consist mainly of office premise and machinery and equipment lease agreements. Based on the applied accounting policy, the Group recognises the lease agreements as lease liabilities and as ROU assets in its statement of financial position. Lease payments are presented as repayments of liabilities and related interest expenses. The lease payments are presented in the cash flow from financing activities and the interest related to leases are presented in the cash flow from operating activities. Lease payments related to short-term leases, low-value assets and variable payments are presented in the cash flow from operating activities.

The Group applied the modified approach in the transition. The Group applies the two available exemptions, which relate to either short-term contracts, in which the lease term is less than 12 months, or low-value assets, which are expensed to other operating expenses. Based on the Group’s calculation, the net present value of the capitalised lease liability amounts to EUR 212 million according to the following bridge calculation:

<table>
<thead>
<tr>
<th>MEUR</th>
<th>Nominal amount of rents according to leasing contracts on 31 December 2018</th>
<th>284</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Variable lease payments</td>
<td>-23</td>
</tr>
<tr>
<td></td>
<td>Residual value</td>
<td>-3</td>
</tr>
<tr>
<td></td>
<td>Expenses relating to short-term leases and leases of low-value assets</td>
<td>-15</td>
</tr>
<tr>
<td></td>
<td>Leases not yet commenced to which Wärtsilä is committed</td>
<td>-3</td>
</tr>
<tr>
<td></td>
<td><strong>Nominal amount of lease liability on 1 January 2019</strong></td>
<td>240</td>
</tr>
<tr>
<td></td>
<td>Present value</td>
<td>212</td>
</tr>
</tbody>
</table>

The nominal lease liability is initially measured at the present value of the lease payments. The lease payments exclude variable elements. Variable lease payments not included in the initial measurement of the lease liability are recognised directly in the statement of income. The lease term is the non-cancellable period of the lease plus period covered by an option to extend or option to terminate if the lessee is reasonably certain to exercise the extension option. Management judgement based on realistic estimates is used when determining the lease term for artificially short-term and leasing agreements with non-fixed terms. At transition, the lease payments were discounted by using the Group’s incremental borrowing rate. The incremental borrowing rates used are the sum of relevant interbank rates and average margin of group loan portfolio and are currency specific.

The Group recognised at transition ROU assets amounting to EUR 213 million, non-current lease liabilities amounting to EUR 169 million, and current lease liabilities amounting to EUR 43 million. The lease expense reduction during 2019 arising from the lease agreements amounted to EUR 54 million and the increase of interest expense to EUR 5 million. The total depreciation expense for the financial period 2019 in the statement of income increased by EUR 49 million due to the ROU asset depreciations. The comparison figures have not been restated.

Condensed statement of financial position

<table>
<thead>
<tr>
<th>MEUR</th>
<th>31.12.2018</th>
<th>IFRS 16 adjustment</th>
<th>1.1.2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intangible assets</td>
<td>1 747</td>
<td>1 747</td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>324</td>
<td>-2</td>
<td>321</td>
</tr>
<tr>
<td>Right-of-use assets</td>
<td>215</td>
<td>215</td>
<td></td>
</tr>
<tr>
<td>Investments in associates and joint ventures</td>
<td>66</td>
<td>66</td>
<td></td>
</tr>
<tr>
<td>Other investments</td>
<td>16</td>
<td>16</td>
<td></td>
</tr>
</tbody>
</table>
Amendments to **IAS 28** by **Long-term Interests in Associates and Joint Ventures** (effective for financial periods beginning on or after 1 January 2019). The amendments clarify that IFRS 9 Financial Instruments is applied to the accounting for long-term interest in an associate or joint venture to which the equity method is not applied. The amendments have no impact on the consolidated financial statements.

Amendment to **IAS 19** by **Plan Amendment, Curtailment or Settlement** (effective for financial periods beginning on or after 1 January 2019). This amendment clarifies the accounting when a plan amendment, curtailment or settlement occurs during a reporting period. The amendment specifies that when a plan amendment, curtailment or settlement occurs during the annual reporting period, an entity is required to use updated assumptions to determine the current service cost and net interest. The amendment does not have a material impact on the consolidated financial statements.

Amendments to **IFRS 9** by **Prepayment Features with Negative Compensation** (effective for financial periods beginning on or after 1 January 2019). Prepayment Features with Negative Compensation amends the existing requirements in IFRS 9 regarding termination rights in order to allow measurement at amortised cost (or, depending...
on the business model, at fair value through other comprehensive income) even in the case of negative compensation payments. Without the amendment these financial assets would have had to be measured at FVPL. The amendments have no impact on the consolidated financial statements.

**IFRIC 23 Uncertainty over Income Tax Treatments** (effective for financial periods beginning on or after 1 January 2019). This interpretation addresses the accounting for income taxes when tax treatments involve uncertainty that affects the application of IAS 12. The key matter is whether the tax authority will accept the chosen tax treatment. When considering this, the assumption is that tax authorities will have full knowledge of all relevant information in assessing the proposed tax treatment. The interpretation does not have any significant impact on the consolidated financial statements.

**Annual improvements to IFRS Standards 2015-2017 Cycle:** The improvements that include smaller amendments to four standards do not have an impact on the consolidated financial statements.

**Management judgement and use of estimates**

The preparation of the financial statements in accordance with the IFRS requires management to make judgements, estimates and assumptions that affect the valuation of the reported assets and liabilities and other information, such as contingent assets and liabilities and the recognition of income and expenses in the statement of income. Although these estimates and assumptions are based on management’s best knowledge of current events and actions, actual results may differ from the estimates.

For Wärtsilä, the most significant judgements, estimates, and assumptions made by the management relate to revenue recognition, especially to project estimates for long-term projects and agreements, assumptions used in impairment testing, the valuation of trade receivables and inventories, determining the length of lease terms, estimates and assumptions used in defined pension benefit obligations, recognition of warranty provisions and provisions for legal cases, and uncertain tax positions. In addition, accounting for business combinations may require significant management judgement.

Assessing whether or not it is probable that the consideration from contracts with customers will be collected requires judgement, and might impact the timing and amount of revenue recognition.

Revenue from certain projects and long-term agreements is recognised over time according to the input method when the profit on the project or agreement can be reliably determined. The progress and the profitability are based on the management's estimates, which require significant judgement concerning the stage of completion, cost to complete, and time of completion. These estimates are reviewed regularly. Recognised revenue and costs recorded are adjusted during the project when assumptions concerning the outcome of the entire project are updated. Changes in assumptions relate to changes in the project’s or agreement’s schedule, scope of supply, technology, costs, and any other relevant factors.

Establishing whether distinct goods or services are considered as being separate performance obligations requires judgement, and might impact the timing and amount of revenue recognition.

Project business contracts usually involve elements of variable consideration. At each reporting date, management reassesses the transaction price, which requires significant judgement as it affects the timing of the revenue recognition. The valuation of accounts receivables also includes estimates mainly concerning the recoverability of receivables.

Determining whether different contracts with the same customer are accounted for as one contract involves the use of judgement, as it requires assessment of whether the contracts are negotiated together or linked in any other way. The timing and amount of revenue recognition can vary depending on whether two contracts are accounted for separately, or as one single arrangement.

Warranty provisions are recorded on the recognition of revenue. The provision is based on the accumulated experience of the level of warranty needed to manage future and current cost claims. Products can contain new
and complex technology that can affect warranty estimates with the result that earlier recognised provisions are not always sufficient.

Accounting for the business combinations may require estimates of the fair value of acquired assets and the expected amount of realised contingent consideration. In addition, the recoverable amounts of goodwill are determined for all cash generating units annually, or more often if there is an indication of an impairment, where its value in use is determined. The value in use is determined using estimates of future market development, such as growth and profitability, as well as other significant factors. The most important factors underlying such estimates are the net sales growth in the market area, the operating margin, the useful life of the assets, future investment needs, and the discount rate. Changes in these assumptions can significantly affect the expected future cash flows.

The Group is a defendant in several legal cases arising from its business operations. A provision for a court case is recorded when an unfavourable result is probable, and the loss can be determined with reasonable certainty. The final result can differ from these estimates.

Estimates of tax liabilities and receivables relate mainly to the expected result of ongoing tax audits, and recognition of deferred tax receivables from tax losses. Deferred tax assets on unused tax losses and other temporary differences are recognised to the extent it is probable that taxable profit is available.

Estimates of pension obligations regarding defined benefit plans are based on actuarial estimates of factors including future salary increases, discount rates, and return on plan assets. Changes in these assumptions can significantly affect the Group’s pension obligations and pension costs.

Principles of consolidation

Subsidiaries

The consolidated financial statements include the parent company Wärtsilä Corporation and all subsidiaries over which the Group has control. The Group controls an entity when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power to direct the activities of the entity. When the Group has less than a majority of voting or similar rights in an entity, the Group considers all relevant facts and circumstances in assessing whether it has power over an entity, including the contractual arrangements, voting rights, and potential voting rights. The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to the elements of control.

Business combinations

Acquired and established companies are accounted for using the acquisition method. Accordingly, the purchase price and the acquired company's identifiable assets, liabilities and contingent liabilities are measured at fair value on the date of acquisition. In the acquisition of additional interest, where the Group already has control, the non-controlling interest is measured either at fair value or at the non-controlling interests' proportionate share of the identifiable net assets. The difference between the purchase price, possible equity belonging to the non-controlling interests and the acquired company's net identifiable assets, liabilities and contingent liabilities measured at fair value is goodwill. Goodwill is tested for impairment at least annually. The purchase price includes the consideration paid, measured at fair value. The consideration does not include transaction costs, which are recognised in the statement of income. The transaction costs are expensed in the same financial period in which they occur, except the costs resulting from issued debt or equity instruments.

The acquired subsidiaries are included in the consolidated financial statements from the day the Group has control and disposed subsidiaries until the control ends. All intragroup transactions, dividend distributions, receivables and liabilities, as well as unrealised margins, are eliminated in the consolidated financial statements. In the consolidated statements of income and comprehensive income, non-controlling interests have been separated from the profit and the total comprehensive income for the financial period. In the consolidated statement of financial position, non-controlling interests are shown as a separate item under equity.
Any contingent consideration (additional purchase price) related to the combination of businesses is measured at fair value on the date of acquisition. It is classified either as a liability or equity. Contingent consideration classified as a liability is measured at fair value on the last day of each financial period, and the resulting loss or gain is recognised through the statement of income. Contingent consideration classified as equity is not remeasured.

The financial information from subsidiaries in countries with hyperinflation are adjusted according to IAS 29, when the impact of the hyperinflation is considered material for the consolidated financial statements.

**Associated companies and joint ventures**

Associated companies are all entities over which the Group has significant influence but not control or joint control. This is generally the case where the Group holds between 20% and 50% of the voting rights.

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the joint venture. Joint control is established by contractual agreement.

Associated companies and joint ventures are included in the consolidated financial statements using the equity method from the date the Group's significant influence or joint control commences until the date it ceases. Investments in associates are initially recorded at cost, and the carrying amount is increased or decreased according to the Group’s share of changes in the net assets of the associate after the date of the acquisition. The Group’s share of the associated company’s or joint venture’s profit for the financial period are shown as a separate item before the Group’s operating result, on the line Share of result of associates and joint ventures. The Group’s share of the associated company’s or joint venture’s losses exceeds its interest in the company, the carrying amount is written down to zero. After this, losses are only recognised if the Group has incurred obligations from the associated company or joint venture.

The accumulated exchange rate differences arising from the consolidation of associated companies and joint ventures, which are recorded in equity, are recognised in the statement of income as part of the gain or loss when change in ownership occurs.

**Non-current assets held for sale and discontinued operations**

Non-current assets and assets and liabilities related to discontinued operations are classified as held for sale if their carrying amounts are expected to be recovered primarily through sale rather than through continuing use. Classification as held for sale requires that the following criteria are met; the sale is highly probable, the asset is available for immediate sale in its present condition subject to usual and customary terms, the management is committed to the sale, and the sale is expected to be completed within one year from the date of classification.

Prior to classification as held for sale, the assets or assets and liabilities related to a disposal group in question are measured according to the respective IFRS standards. From the date of classification, non-current assets held for sale are measured at the lower of the carrying amount and the fair value less costs to sell, and the recognition of depreciation and amortisation is discontinued. A discontinued operation is a component of an entity that either has been disposed of, or is classified as held for sale, and represents a separate major line of business or geographical area of operations, is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or is a subsidiary acquired exclusively with a view to resale.

The result from the discontinued operations is shown separately in the consolidated statement of income and the comparison figures are restated accordingly. Non-current assets held for sale are presented in the statement of financial position separately from other items. The comparison figures for the statement of financial position are not restated.
Translating the transactions in foreign currencies

The items included in the financial statements are initially recognised in the functional currency, which is defined for each Group company based on its primary economic environment. The presentation currency of the consolidated financial statements is the euro, which is also the functional and presentation currency of Wärtsilä Corporation.

Foreign subsidiaries

The income and expenses for statements of income and statements of comprehensive income of foreign subsidiaries are translated into euros at the quarterly average exchange rates. Statements of financial position are translated into euros at the exchange rates prevailing at the end of the financial period. The translation of the profit for the financial period and other comprehensive income using different exchange rates in the statement of comprehensive income and the statement of financial position causes translation differences, which are recognised in equity and in other comprehensive income as change. Translation differences of foreign subsidiaries’ acquisition cost eliminations and post-acquisition profits and losses are recognised in other comprehensive income and are presented as a separate item in equity. The goodwill generated in the acquisition of foreign entities and their fair value adjustments of assets and liabilities are considered as assets and liabilities of foreign entities, which are translated into euros using the exchange rates prevailing at the end of the financial period. When a foreign subsidiary is sold, the accumulated exchange rate differences recorded in the equity related to the subsidiary are recognised in the statement of income as a part of the gain or loss on sale.

Transactions and balances in foreign currencies

Transactions denominated in a foreign currency are translated into the functional currency using the exchange rate prevailing at the dates of the transactions. Receivables and liabilities are translated at the exchange rate prevailing at the end of the financial period. Exchange rate gains and losses related to trade receivables and liabilities are reported on the applicable line in the statement of income and are included in the operating result. Exchange rate differences related to financial assets and financial liabilities are reported as financial items in the statement of income, except exchange rate differences related to non-current debt that is part of the Group’s net investment in a subsidiary. Those are recognised in other comprehensive income and reported as translation differences in equity.

Net sales and revenue recognition

Revenue is presented net of indirect sales taxes, penalties and discounts. Revenue is recognised when control of the goods or services is transferred to the customer at an amount that reflects the consideration to which the Group expects to be entitled in exchange for those goods and services. The transaction price may include variable considerations, such as penalties, performance bonuses and discounts. Revenue recognised by the reporting date corresponds to the benefit of the service provided by Wärtsilä to the customer.

Revenue from contracts with customers is derived from four main revenue types. All revenue types are represented within both reportable segments, Wärtsilä Marine Business and Wärtsilä Energy Business.

Product sales consist of sales of spare parts and standard equipment, for which the revenue is recognised at a point in time when the control of the product has transferred to the customer, in general upon delivery of the goods. Product sale contracts generally include one performance obligation.

Goods and services -type of revenue involves short-term field service jobs, which include the delivery of a combination of service and equipment. The revenue is recognised at a point in time when the service is rendered. Goods and service -type contracts generally include one performance obligation.

Projects contain short- and long-term projects. Depending on the contract terms and the duration of the project, the revenue is recognised at a point in time or over time. Revenue related to Marine long-term projects, such as gas solutions construction contracts, integrated solutions projects, ship design, and Energy solutions turnkey contracts, is recognised over time. Revenue for tailor-made equipment delivery projects is recognised at a point in time both in Marine and Energy Business. Project contracts generally represent one performance obligation but can under
certain circumstances contain multiple performance obligations in the Marine business, when a contract contains multiple units of delivery.

Long-term agreements contain long-term operating and maintenance agreements for which the revenue is recognised over time. The contracts included in this revenue type generally contain one performance obligation per installation.

Contracts with customers often include warranties in line with Wärtsilä’s General terms and conditions, which are regarded as part of the promise to the customer. Extended warranties or warranties purchased as an option are identified as separate performance obligations.

Revenue recognised over time is measured in accordance with the input method (progress measured based on costs incurred) when the outcome of the contract can be estimated reliably. When the outcome cannot be reliably determined, the costs arising are expensed in the same financial period in which they occur, but the revenue is recorded only to the extent that the company will receive an amount corresponding to actual costs. Any losses are expensed immediately. If revenue for goods and services is recognised at a point in time, it is when control is transferred to the customer. The transfer of control is based mainly on transferring risks and rewards according to the delivery terms.

In case there are multiple contracts entered into with the same client at near the same time, the combination of the contracts is evaluated.

The Group applies the practical expedient according to IFRS 15.63 concerning significant financing components arising from contracts with customers. In case the lead time between the payments specified in the contract and the corresponding transfer of the promised good or service to the customer is one year or less, no adjustment is made for the effect of a possible significant financing component.

The Group also applies the practical expedient stated in IFRS 15.94 according to which an entity can recognise the incremental costs of obtaining a contract as an expense when incurred if the amortisation period of the asset that the entity would have recognised is one year or less. Wärtsilä has not incurred any costs of obtaining a contract to be recognised as an asset.

**Employee benefits**

**Pension and other long-term employee benefits**

**Pension plans**

Group companies in different countries have various pension plans in accordance with local conditions and practices. These pension plans are classified either as defined contribution or defined benefit plans. The fixed contributions to the defined contribution plans are expensed in the year to which they relate. The Group has no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay employee benefits. All other plans are defined benefit plans.

Defined benefit plans are funded through contributions to pension funds or pension insurance companies. Defined benefit plans may be unfunded or wholly or partly funded. The present value of the obligation arising from the defined benefit plans is determined per each plan using actuarial techniques, the projected unit credit method. The Group recognises the defined benefit obligation net of fair value of the plan assets at the end of the financial period.

Actuarial gains and losses and other remeasurements of the net defined benefit obligation are recognised immediately in the statement of other comprehensive income. Current service cost is the present value of the postemployment benefit, which is earned by the employees during the year. The Group determines the net interest expense on the net defined benefit plan by applying the discount rate used to measure the defined benefit obligation. Service cost is recognised in employee benefit expenses and the net interest in financial expenses. The defined benefit plans are calculated by qualified actuaries.
Other long-term employee benefits

In addition to defined benefit plans, Wärtsilä has other long-term employee benefits. They are presented separately from the defined benefit plans. Similarly, to the accounting for a defined benefit plan, for any other long-term benefit the Group recognises a liability for the obligation net of the fair value of plan assets, if any. Changes in other long-term employee benefits are recognised in the consolidated statement of income.

Share-based payments

The company's bonus scheme, which is tied to the price development of the company's share during a predetermined timeframe, is measured at the fair value of the share on the reporting date and reported in the statement of income for the term-to-maturity of the bonus scheme. An upper limit is set for the bonus. When a bonus scheme ends, and the employment requirement is fulfilled, the bonus is settled in cash and/or shares.

Goodwill and other intangible assets

Goodwill

Goodwill is the difference between the aggregate of the acquisition-date fair value of the consideration transferred, and the acquirer's share of the company's net identifiable assets and liabilities measured at fair value on the acquisition date. The consideration transferred is measured at fair value, including also the acquirer's previously held equity interest.

Research and development costs

Research costs are expensed in the financial period during which they occur. Development costs are capitalised when it is probable that the development project will generate future economic benefits for the Group and when the related criteria, including commercial and technological feasibility, have been met. These projects involve the development of new or significantly improved products or production processes. Earlier expensed development costs are not capitalised.

Capitalised development costs are measured at cost less accumulated amortisations and impairment. Capitalised development costs are amortised and the cost of buildings, machinery, and facilities for development depreciated on a straight-line basis over their expected useful lives, 5-10 years. Amortisations are started when the asset is finished and can be taken into use. Before that, the asset is tested for impairment annually. Grants received for research and development are reported as other operating income. Grants related to capitalised development costs are netted with the costs occurred before the capitalisation.

Other intangible assets

Other intangible assets are recorded at cost if the cost is reliably measurable and the future economic benefits for the Group are probable. Wärtsilä's other intangible assets include patents, licenses, software, customer relations and other intellectual property rights that can be transferred to a third party. These are measured at cost, except for intangible assets identified in connection with acquisitions, which are measured at the fair value at the acquisition date. The cost of intangible assets comprises the purchase price and all costs that can be directly attributed to preparing an asset for its intended use.

Other intangible assets are amortised on a straight-line basis over their estimated useful lives. Intangible assets, for which the time limit for the right of use is agreed, are amortised over the life of the contract. Intangible assets identified in connection with acquisitions are amortised over their delivery times or estimated useful lives.

The general guidelines for scheduled amortisation are:

- Software 3-7 years
- Development expenses 5-10 years
- Other intangible assets 5-20 years
The estimated useful lives and the residual values are reviewed at least at the end of each financial period, and if they differ significantly from previous estimates, amortisation periods are adjusted accordingly. Amortisation of intangible assets is stopped when an item is classified as held for sale.

A gain or loss arising from the sale of intangible assets is recognised in other operating income or other operating expenses in the statement of income.

**Property, plant and equipment**

Property, plant and equipment acquired by the Group are measured in the statement of financial position at cost less accumulated depreciation and impairment losses. The cost of an asset includes costs directly attributed to preparing an asset for its intended use. Grants received are reported as a reduction in costs. The property, plant and equipment of acquired subsidiaries are measured at their fair value at the acquisition date. The borrowing costs that are directly attributable to the asset acquisition, construction or production, and to completion of the asset for its intended use or sale requiring necessarily a considerable length of time, will be capitalised in the statement of financial position as part of the cost of the asset. Other than directly attributable borrowing, costs are expensed in the period in which they are incurred.

Subsequent expenditure is included in the cost of an asset only if the future economic benefits for the Group are probable and the costs are reliably measurable. Expenditure related to regular, extensive inspections and maintenance is treated as an investment, capitalised and depreciated during the useful life. All other expenditure, such as ordinary maintenance and repairs, is recognised in the statement of income as an expense as incurred.

Depreciation is based on the following estimated useful lives:

- Buildings 10-40 years
- Machinery and equipment 5-20 years
- Other tangible assets 3-10 years

Depreciation is expensed on a straight-line basis over the estimated useful lives of the assets. Land is not depreciated, as its useful life is considered as infinite. The estimated useful lives and the residual values are reviewed at least at the end of each financial period, and if they differ significantly from previous estimates, depreciation periods are adjusted accordingly. Depreciation of property, plant and equipment is stopped when an item is classified as held for sale.

A gain or loss arising from the sale of property, plant and equipment is recognised in other operating income or other operating expenses in the statement of income.

**Leases**

The Group’s capitalised lease agreements consist mainly of office premises, vehicles and production machinery and equipment lease agreements. The average lease period for buildings is approximately eight years, and for machinery and equipment approximately four years. The Group recognises a right-of-use (ROU) asset and a lease liability at the commencement of the lease. Whether a contract contains a lease is determined based on whether Wärtsilä has the right to control the use of an identified asset for a period of time.

At the commencement date, a right-of-use asset as defined by IFRS 16 is measured at cost. The cost of the right-of-use asset shall comprise the amount of the initial measurement of the lease liability, any lease payments made at or before the commencement date (less any lease incentives received), any initial direct costs incurred by the lessee and an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories.
The nominal lease liability is initially measured at the present value of the lease payments over the lease term. The lease payments include fixed payments, amounts to be expected to be paid under residual value guarantees, the exercise price of reasonably certain extension options, and payments of penalties for terminating a lease in case this reflects the lease term. The lease payments are discounted using the interest rate implicit in the lease, if this rate can be readily determined. Otherwise the lessee’s incremental borrowing rate is used. The incremental borrowing rates used are the sum of relevant interbank rates and average margin of group loan portfolio and are currency specific.

The initial measurement of the lease payments does not include possible variable elements. Variable lease payments not included in the initial measurement of the lease liability are recognised directly in the statement of income.

The lease term is the non-cancellable period of the lease plus period covered by an option to extend or option to terminate if the lessee is reasonably certain to exercise the extension option. Management judgment based on realistic estimates is used when determining the lease term, especially concerning lease agreements containing termination and purchase options and lease agreements with indefinite lease terms.

Subsequently, the right-of-use assets are measured at initial measurement less accumulated depreciation and impairment losses. The right-of-use assets are depreciated and interest on lease liabilities recognised in the statement of income over the lease term. The lease liabilities are subsequently measured at initial recognition less occurring lease payments that are allocated to the principal.

Lease payments are presented as repayments of liabilities and related interest expenses. The lease payments are presented in the cash flow from financing activities and the interest related to leases are presented in the cash flow from operating activities. Lease payments related to short-term leases, low-value assets and variable payments are presented in the cash flow from operating activities.

Contracts may combine different kinds of obligations to the supplier, which might be a combination of lease components or a combination of lease and non-lease components. These lease and non-lease components are accounted for separately and the consideration is allocated between the components based on relative stand-alone selling prices.

The lease and non-lease components are separated. In the case that separating the components is not possible judgement is used to allocate the non-lease component in the accounting. The selection of separating or not the non-lease component from lease is applied to the whole asset class.

Modifications to lease agreements may result in adjustments to existing right-of-use assets and lease liabilities. A gain or loss arising from a modification and a termination of a lease agreement is recognised in other operating income or other operating expenses in the statement of income.

The Group applies the two available exemptions, which relate to either short-term contracts, in which the lease term is less than 12 months, or low-value assets, which are expensed to other operating expenses.

**Impairment of assets**

**Goodwill**

The carrying amount of goodwill allocated to cash generating units is reviewed annually for signs of possible impairment or more frequently should any indication of impairment arise. If any such indication exists, the recoverable amount of the goodwill is estimated. In order to define a possible impairment, the Group’s assets are divided up into the smallest possible cash generating units, which are mainly independent of other units and the cash flows of which are separately identifiable and to a large extent independent of the cash flows of other similar units.

An impairment loss is recorded when the carrying amount of an asset is greater than its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and its value in use. The value in use is for goodwill is based on the expected discounted future net cash flows resulting from the asset or cash generating unit.
A pre-tax rate which reflects the markets’ position on the time value of money and asset-specific risks is used as the discount rate.

An impairment loss is recognised immediately in other operating expenses in the statement of income. An impairment loss recognised for goodwill is not reversed under any circumstances.

Other intangible assets and property, plant and equipment

The carrying amounts of assets are reviewed annually for signs of possible impairment or more frequently should any indication of impairment arise. If any such indication exists, the recoverable amount of the asset is estimated and compared to the carrying amount of the asset. An impairment loss is recorded when the carrying amount of an asset is greater than its recoverable amount. The recoverable amount is the higher of an asset’s fair value less costs to sell and its value in use.

An impairment loss is recognised immediately in other operating expenses in the statement of income. In connection with the recognition of the impairment loss, the useful life of the amortisable/depreciable asset is reassessed. An earlier impairment loss recognised for an asset is reversed if the estimates used to determine the recoverable amount change. However, reversal of impairment shall not exceed the asset’s carrying amount less impairment loss.

Determination of the fair value of assets acquired through business combinations

In significant business combinations, the Group has used external advisors when estimating the fair values of property, plant and equipment and intangible assets. For property, plant and equipment, comparisons have been made of the market prices of similar assets, and the depreciation of the acquired assets due to ageing, wear, and other similar factors has been estimated. The fair value measurement of intangible assets is based on estimates of the future cash flows associated with the assets. The acquired identifiable intangible assets include typically technology, customer relationships, and trademarks.

Inventories

Inventories are carried at the lower of cost and net realisable value. Materials and consumables are valued weighted average cost. Finished products are valued at direct purchasing and manufacturing costs and allocated purchasing and manufacturing overhead costs. Work in progress includes costs for direct labour and material costs and allocated overhead costs related to manufacturing and purchasing when control has not yet transferred to the customer.

The devaluation of inventory due to obsolete and excess stock, is performed based on the management's best estimate on the balance sheet date. Analysis of inventory aging, turn over and composition compared to anticipated future use is the basis for the estimates.

Financial assets and liabilities

Financial assets

Financial assets are classified, at initial recognition, as subsequently measured according to the following categories: financial assets measured at amortised cost, financial assets at fair value through the statement of income and financial assets at fair value through other comprehensive income. Financial assets are classified according to their cash flow characteristics and the business model they are managed in and accounted for at settlement date.
Financial assets at amortised cost

The Group’s financial assets at amortised cost includes interest-bearing investments, other receivables and trade receivables that are recognised at their anticipated realisable value, which is the original invoiced amount less an estimated valuation allowance for impairment. The Group assesses the possible increase in the credit risk for financial assets measured at amortised cost at the end of each reporting period individually. The methodology applied depends on whether there has been a significant increase in credit risk. The loss allowance is estimated at an amount equal to 12-month expected credit losses at the current reporting date, if there has not been a significant increase in credit risk.

For trade receivables and receivables from over time revenue recognition in accordance with the input method, a simplified approach is used and the loss allowance is measured at the estimate of the lifetime expected credit losses. Receivables from over time revenue recognition in accordance with the input method should be covered with advance payments collected from customers, so recognising credit losses based on the lifetime expected loss amounts mainly concerns trade receivables. Examples of events giving rise to impairment include a debtor's serious financial problems, and a debtor's probable bankruptcy or other financial arrangement.

The Group may sell undivided interests in trade receivables on an ongoing and one-time basis to lending institutions. Financial assets sold under these arrangements are excluded from trade receivables in the Group’s consolidated statement of financial position at the time of payment from the acquirer, considering that substantially all risks and rewards have been transferred. If the acquirer has not settled the payment to the extent that the ownership, risk and control over the receivable have been substantially transferred, then such financial assets sold are re-recognised in the consolidated statement of financial position at the end of the reporting period.

Interest-bearing investments are measured at amortised cost and they include loans and receivables, which are non-derivative financial assets that have fixed or determinable payments and that are not quoted on active markets. They arise when the Group provides a loan or delivers products and services directly to a debtor. They are included in non-current receivables, unless they have a maturity of less than 12 months from the reporting date. Such items are classified as current receivables.

Cash and cash equivalents comprise cash in hand, deposits held at call with banks, and other short-term cash investments. Other short-term cash investments are highly liquid investments that are subject to only minor fluctuations in value and have a maturity of up to three months on the date of acquisition. Cash in hand and deposits held at call are presented at amortised cost. Other cash investments are mainly measured at fair value, except for commercial paper investments that are presented at amortised cost. Credit accounts related to Group cash pool accounts are included in current financial liabilities.

Financial assets at fair value through the statement of income

Financial assets at fair value through profit or loss include derivatives not included in hedge accounting and other financial investments.

Other financial investments include Wärtsilä’s investments in other companies (both listed and unlisted shares) and they are classified as financial assets at fair value through the statement of income. The fair value for listed shares is based on their market value. Gains and losses from fair valuation and disposal and impairments of shares that are attributable to operating activities are included in operating income, while gains and losses from fair valuation and disposal and impairments of other shares are included in financial income and expenses.

The category includes also derivatives that do not qualify for hedge accounting and are not financial guarantee agreements and other financial assets recognised at fair value through the statement of income, which are financial assets held for trading.

Derivatives held for trading, as well as financial assets maturing within 12 months after the end of financial period, are included in current assets. Non-derivative financial assets are included in non-current assets unless the Group intends to dispose of the investment within 12 months from the reporting date.
Except for commercial paper investments that are presented at amortised cost, other short-term cash investments are recognised at fair value.

**Financial assets at fair value through other comprehensive income**
Financial assets recognised at fair value through other comprehensive income include derivatives eligible for hedge accounting.

**Financial liabilities**
The Group’s financial liabilities are initially recognised and subsequently classified either into financial liabilities recognised at amortised cost or financial liabilities recognised at fair value through the statement of income.
Financial liabilities are classified as current unless the Group has the unconditional right to defer the payment of the debt to at least 12 months from the end of the financial period. Financial liabilities (or parts thereof) are only derecognised once the debt has extinguished, i.e. once the contractually specified obligation is discharged, cancelled or expires.

**Financial liabilities recognised at amortised cost**
Financial liabilities recognised at amortised cost include trade and other payables, loans and borrowings.

The loans raised by the Group are included in financial liabilities recognised at amortised cost. They are measured at their initial recognition at fair value using the effective interest rate method. After the initial recognition, loans are measured at amortised cost. Interests on loans are expensed through the statement of income over the maturity of the debt using the effective interest rate method.

**Financial liabilities recognised at fair value through the statement of income**
In the Wärtsilä Group, financial liabilities recognised at fair value through the statement of income include derivatives that are not eligible for hedge accounting.

**Derivatives**
Derivatives are initially recognised at fair value in the statement of financial position and are thereafter measured at their fair value at the end of each reporting period.

Gains and losses from the fair value measurement are recognised in the statement of income as determined by the purpose of the derivatives.

Wärtsilä hedges its sales and purchases in foreign currencies with foreign exchange derivatives or currency options. Certain foreign exchange derivatives are eligible for hedge accounting. The ineffective portion is immediately recognised in the financial items in the statement of income for the financial period. Currency forwards are measured at forward rates at the end of the financial period and currency options at their market value at the end of the financial period.

In addition, Wärtsilä hedges its interest rate risk with derivatives.

**Derivatives measured at fair value through statement of income**
Realised and unrealised gains and losses from changes in fair values of derivatives that are not included in hedge accounting are recognised in the statement of income in the period in which they have arisen.

Interest rate hedges against Wärtsilä Group’s loan portfolio belong to this group. Changes in the fair value of these interest rate hedges are immediately recognised in financial income or expenses in the statement of income. The fair value of interest rate swaps is calculated by discounting the future cash flows.

**Derivatives measured at fair value through other comprehensive income**
The effective portion of derivatives eligible for hedge accounting is recognised at fair value through other comprehensive income.
For derivatives included in hedge accounting, the Group documents the relationship between each hedging instrument and the hedged asset upon entering into a hedging arrangement, along with the risk management objective and the strategy applied. Through this process, the hedging instrument is linked to the relevant assets and liabilities, projected business transactions or binding contracts. The Group also documents its ongoing assessment of the effectiveness of the hedge as regards the relationship between a change in the derivative's fair value and a change in the value of the hedged cash flows or transactions.

Changes in the fair value of derivative contracts designated to hedge future cash flows are recognised in other comprehensive income and presented in the fair value reserve in equity, provided that the hedging is effective. Any gain or loss in the fair value reserve related to derivatives accumulated through other comprehensive income is reported in the statement of income in the same period as any transactions relating to the hedged obligations or estimates, e.g. as an adjustment to net sales or material and services. The ineffective portion is immediately recognised in the financial items in the statement of income for the financial period. Changes in fair value of foreign exchange derivatives due to interest rate differences are recognised in the statement of income.

**Fair value hierarchy**

Financial instruments measured at fair value are classified according to the following fair value hierarchy: instruments measured using quoted prices in active markets (level 1), instruments measured using inputs other than quoted prices included in level 1 observable either directly or indirectly (level 2), and instruments measured using inputs that are not based on observable market data (level 3). Financial instruments measured at fair value include financial assets and liabilities at fair value through the statement of income.

**Contract balances**

Contract balances consist of customer-related assets and liabilities.

When control over goods or services is transferred to a customer before the customer pays the consideration, the receivable is recognised as a contract asset. The contract asset represents the right to future consideration.

When the customer pays consideration in advance, or the consideration is due before transferring the contractual performance obligation, the amount received in advance is presented as a contract liability. Contract liabilities are recognised as revenue when the Group performs under the contract.

**Provisions and contingent liabilities**

Provisions are recognised in the statement of financial position when the Group has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Provisions can arise, for example, from warranties, environmental risks, litigation, foreseeable losses on projects, and restructuring costs. The amount to be recognised as provisions corresponds to the management’s best estimate of the expenses that will be necessary to meet the existing obligation at the end of the financial period.

Estimated future warranty costs relating to products delivered are recorded as provisions. The amount of future warranty costs is based on accumulated experience.

Provisions for restructuring costs are made once the restructuring plan has been approved and the implementation started, or the personnel concerned have been informed of the terms. The plan must indicate which activities and personnel will be affected and the timing and cost of implementation.

Contingent liabilities are possible obligations resulting from previous events, the existence of which will only be ascertained once the uncertain event that is beyond the Group’s control materialises. Existing obligations that are not likely to require the fulfilment of a payment obligation or the amount of which cannot be reliably determined, are also considered contingent liabilities. Contingent liabilities are presented in the notes.
**Income taxes**

The statement of income includes taxes on the Group's consolidated taxable income for the financial period in accordance with local tax regulations, tax adjustments for previous financial periods, and changes in deferred taxes. Tax effects related to transactions recognised through the statement of income and other events are recognised in the statement of income. Tax effects related to transactions or other events to be presented as components of other comprehensive income or directly in equity are also recognised, respectively, in other comprehensive income or directly in equity.

Income tax positions are evaluated to identify situations when there might be uncertainty due to tax regulation being subject to interpretation. Provisions for these uncertain tax positions are recognised when it is considered more likely than not that the positions will be challenged by the tax authorities. The provision recognised is based on the estimation of the amount of the final taxes to be paid to the tax authorities.

Deferred tax liabilities and assets are calculated on temporary differences arising from the difference between the tax basis of assets and liabilities and the carrying values using the enacted tax rates at the end of the financial period. The statement of financial position includes deferred tax liabilities in their entirety and deferred tax assets at their estimated probable amount.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities, and when the deferred tax assets and liabilities relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities which intend to settle the balances on a net basis.

**Dividends**

The dividend proposed by the Board of Directors is deducted from distributable equity when approved by the company's Annual General Meeting. Unpaid dividends are presented as liability in the consolidated financial statements.

**Adoption of new and updated IFRS standards**

In 2020, the Group will adopt the following amended standards issued by the IASB.

Amendments to **IFRS 3 Business Combinations** (effective for financial periods beginning on or after 1 January 2020). The amendments are intended to assist entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition. The amendments clarify the minimum requirements for a business, remove the assessment of whether market participants are capable of replacing any missing elements, add guidance to help entities assess whether an acquired process is substantive, narrow the definitions of a business and of outputs, and introduce an optional fair value concentration test. The amendments are not expected to have an impact on the consolidated financial statements.

Amendments to **IAS 1 Presentation of Financial Statements** and **IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors** (effective for financial periods beginning on or after 1 January 2020). The purpose of the amendments is to align the definition of ‘material’ across the standards and to clarify certain aspects of the definition. The amendments clarify that materiality will depend on the nature or magnitude of information, or both. The amendments are not expected to have an impact on the consolidated financial statements.

Amendments to **IFRS 9 Financial Instruments, IAS 39 Financial Instruments: Recognition and Measurement** and **IFRS 7 Financial Instruments: Disclosures** (effective for financial periods beginning on or after 1 January 2020). These amendments provide certain reliefs in connection with interest rate benchmark reform. The reliefs
relate to hedge accounting and have the effect that IBOR reform should not generally cause hedge accounting to terminate. Any hedge ineffectiveness should continue to be recorded in the statement of income. The amendments are not expected to have significant impact on the consolidated financial statements.

The Group expects to adopt later than 2020 the following new standard issued by the IASB.

**IFRS 17 Insurance Contracts** (effective from financial periods beginning on or after 1 January 2021). IFRS 17 applies to all types of insurance contracts (direct insurance and re-insurance) regardless of the type of entities that issue them, as well as to certain guarantees and financial instruments with discretionary participation features. The overall objective is to provide a consistent accounting model for insurance contracts. The impact is under review within the Group.

* Not yet endorsed for use by the European Union as of 31 December 2019.