

Accounting Principles for the Consolidated Accounts

Basic information

Wärtsilä Corporation is a Finnish listed company organized under the laws of Finland and domiciled in Helsinki.

Wärtsilä enhances the business of its customers by providing them with complete lifecycle power solutions. When creating better and environmentally compatible technologies, Wärtsilä focuses on the marine and energy markets with products and solutions as well as services. Through innovative products and services, Wärtsilä sets out to be the most valued business partner of all its customers. This is achieved by the dedication of more than 16,000 professionals manning over 150 Wärtsilä locations in 70 countries around the world.

Basis of preparation

The consolidated annual financial statements are prepared in accordance with the International Financial Reporting Standards (IFRS) applying the IAS and IFRS standards, and their SIC and IFRIC interpretations, in force at 31 December 2007. International Financial Reporting Standards refer to the standards, and their interpretations, approved for application in the EU in accordance with the procedure 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 Finnish accounting principles and corporate legislation.

Reporting is based on the historical cost convention. Exceptions are assets available for sale, financial assets and liabilities designated at fair value through profit or loss, derivative contracts, items hedged at fair value, and share-based transactions made with cash and measured at fair value. The figures are in millions of euros.

Since 1 January 2007 the Group has applied the following updated standards:

- IFRS 7 Financial Instruments: Disclosures – The change has an impact on the notes to the financial statements.
- Amendment to IAS 1 Presentation of Financial Statements – The change has an impact on the notes to the financial statements regarding the managing of capital.
- IFRIC 8 Scope of IFRS 2 – No impact on the financial statements.
- IFRIC 9 Reassessment of Embedded Derivatives – No impact on the financial statements.

- IFRIC 10 Interim Financial Reporting and Impairment – Does not require changes to the accounting principles of the financial statements.

Use of estimates

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

Sales revenue is normally recognized when the product or service has been delivered, its value has been determined and it is probable that the booked receivable will be collected. These estimates affect the amount of sales revenue recognized. Revenue from long-term projects and long-term operations and maintenance agreements is recognized according to their percentage of completion when the profit on the project or agreement can be reliably determined. The degree of completion and the profit are based on management's estimates as to the realization of the project or agreement. These estimates are reviewed regularly. Booked sales revenue and profit are adjusted during the project when assumptions concerning the outcome of the entire project are updated. Changes in assumptions relate primarily to changes in the project's or agreement's schedule, scope of supply, technology, costs and any other relevant factors.

Warranty provisions are recorded on the recognition of sales revenue. The provision is based on 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 such provisions are not always sufficient.

The Group is a defendant in several court cases arising from its business operations. A provision 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.

The recoverable amounts of tangible and intangible assets and

goodwill are determined for all cash-generating units annually or, if it is shown that the asset has lost value, 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 growth, operating margin, useful life, future investment needs, and the discount interest rate. Changes in these assumptions can significantly affect future estimates.

Estimates of pension obligations in the case of defined benefit plans are based on actuarial estimates of factors including future salary increases, discount interest rates and income from reserve funds. Changes in these assumptions can significantly affect the company's pension obligations and pension costs.

Principles of consolidation

The consolidated financial statements include the parent company Wärtsilä Corporation and all subsidiaries in which the parent company directly or indirectly holds more than 50 per cent of the voting rights or in which Wärtsilä is otherwise in control, as well as the Group's associated companies (20 to 50 per cent voting rights and significant influence over the company but not control over its financial and operating policies). Associated companies are included in the consolidated financial statements using the equity method. If the Group's share of the associated company's losses exceeds its interest in the associated company, the carrying amount is written down to zero. After this losses are only reported if the Group has incurred obligations from the associated company.

Acquired or established subsidiaries and associated companies are included in the consolidated financial statements from the day the company was acquired or established until ownership of the company legally terminates.

Acquired companies are accounted for using the purchase method of accounting according to which the acquired company's identifiable assets, liabilities and contingent liabilities are measured at fair value on the date of acquisition. The difference between the purchase price and the company's net identifiable assets, liabilities and contingent liabilities is reported as goodwill. In the acquisition

of minority interests, if the Group already has control before the minority acquisition, the acquired assets and liabilities are measured at book value on the date of acquisition, and the difference between the purchase price and the book value of the net assets is reported as goodwill. Goodwill is tested for impairment at least annually.

All intra-group transactions, dividend distributions, receivables and liabilities and unrealized margins are eliminated in the consolidated financial statements. In the income statement, minority interests have been separated from the income for the reporting period. In the Group's balance sheet minority interests are shown as a separate item under equity.

Measurement of fair value of assets acquired in business combinations

In major business combinations, the Group has employed an external advisor when measuring the fair values of the tangible and intangible assets acquired. In the case of tangible assets, comparisons have been made with the market prices of corresponding assets, and the decrease in value resulting from the assets' age, degree of wear and other similar factors has been estimated. Measurement of the fair value of intangible assets is based on estimates of cash flows related to these assets.

Joint ventures

Joint ventures are companies in which the Group shares control with another party. The Group's holdings in joint ventures are consolidated proportionately line by line. The consolidated financial statements include the Group's share of its joint ventures' assets, liabilities, income and expenses.

Foreign subsidiaries

In the consolidated financial statements, the income statements and cash flows of foreign subsidiaries are translated into euros at the quarterly average exchange rates. Balance sheets are translated into euros at the exchange rates prevailing at the balance sheet date and translation differences are recognized in equity.

Transactions in foreign currencies

Transactions denominated in a foreign currency are translated into euros using the exchange rate prevailing at the dates of the transactions. Receivables and liabilities are translated into euros at the exchange rate prevailing at the balance sheet date. Exchange rate gains and losses related to non-financial receivables and liabilities are reported on the applicable line in the income statement and are included in operating income. Exchange rate differences related to financial receivables and financial liabilities are reported as financial items in the income statement.

Net sales and revenue recognition

Sales are presented net of indirect sales taxes and discounts. Sales are recognized when the significant risks and rewards connected with ownership have been transferred to the buyer. This usually means that revenue recognition occurs when a product or service is delivered to the customer in accordance with the terms of delivery. Revenue from long-term contracts and long-term operating and maintenance agreements is recognized in accordance with the percentage of completion method when the outcome of the contract can be estimated reliably. The percentage of completion is based on the ratio of costs incurred to total estimated costs to date for long-term construction contracts, whereas for long-term operating and maintenance agreements it is calculated on the basis of the proportion of the contracted services performed. When the final outcome of a long-term project cannot be reliably determined, the costs arising from the project are expensed in the same reporting period in which they occur, but revenue from the project is recorded only to the extent that the company will receive an amount corresponding to actual costs. Losses due to projects are expensed immediately.

Research and development costs

Research and development costs are expensed in the reporting period during which they occur except for development costs, which are capitalized when it is probable that the development project will generate future economic benefits for the Group, and when the criteria of IAS 38 (Intangible assets), including commercial

and technological feasibility, have been met. These projects involve the development of new or significantly improved products or production processes. Capitalized development costs are amortized and the cost of buildings, machinery and facilities for development depreciated on a systematic basis over their expected useful lives. Grants received are reported as other income.

Pension benefits

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 contributions to defined contribution plans are charged to the income statement in the year to which they relate. The present value of the obligation arising from defined benefit plans is determined using the projected unit credit method and the plan assets are measured at fair value at the measurement date. The Group's obligation with respect to a plan is calculated by identifying the extent to which the cumulative unrecognized actuarial gain or loss exceeds by more than 10 per cent the greater of the present value of the defined benefit obligation and the fair value of the plan assets. The excess is recognized in the income statement over the expected average remaining working lives of employees participating in the plan. Defined benefit plans are calculated by qualified actuaries.

Share-based payments

Under IFRS 2 the fair value of employee options is reported as an expense and an increase in shareholders' equity. This does not apply to any existing option plans of the Group, as these were granted before IFRS 2 came into force.

The company's bonus programme, which is fixed to share value, is valued at the fair value of the share on the reporting date and reported in the income statement for the term-to-maturity of the bonus programme.

Goodwill and other intangible assets

The difference between the purchase price and the fair value of a company's net assets and contingent liabilities at the date of acquisition is reported as goodwill. Goodwill consists of the

future economic benefit of those assets whose value the Group is unable to calculate either separately or individually at the date of acquisition. Under IFRS goodwill is not amortized but tested for impairment at least annually, and more often if there are indications of impairment.

Other intangible assets include patents, licences, capitalized development costs, software, customer relations and other intellectual property rights. These are valued at cost except for intangible assets identified in connection with acquisitions, which are valued at the fair value at the acquisition date. Intangible assets are amortized 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 amortized over the life of the contract.

The general guidelines for scheduled amortization are:

Development costs	5–10 years
Software	3–7 years
Other intangible assets	5–20 years

Property, plant and equipment and depreciation

Fixed assets acquired by the Group are recorded in the balance sheet at cost less accumulated depreciation and impairment losses. Grants received are reported as a reduction in acquisition costs. The fixed assets of acquired subsidiaries are valued at their fair value at the acquisition date. 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

Investment properties

Properties that are not used in the Group's operating activities, or that are held to earn rental income or for capital appreciation or both, are classified as investment properties. Investment properties are treated as long-term investments and are valued at cost less accumulated depreciation and impairments.

Leases

Lease agreements where all material rewards and risks of ownership have been transferred to the Group are classified as finance leases. Assets acquired under finance lease are recognized as fixed assets at the lower of the fair value of the leased asset or the estimated present value of the underlying lease payments. The corresponding rental obligation, net of finance charge, is included in interest-bearing liabilities with the interest element of the finance charge being recognized in the income statement over the lease period. Assets acquired under a finance lease are depreciated over their estimated useful lives in accordance with the same principles that apply to other similar fixed assets.

Lease agreements where the risks and benefits of ownership have not been transferred to the Group are classified as operating leases. Operating lease payments are reported as rental expenses.

Inventory valuation

Inventories are carried at the lower of cost or net realizable value. Cost includes allocated purchasing and manufacturing overhead costs in addition to direct manufacturing costs. Inventory valuation is primarily based on the weighted average cost.

Financial assets and financial liabilities

Financial assets are classified into the following categories: financial assets designated at fair value through profit or loss, investments held to maturity, loans and other receivables, and financial assets available for sale. Financial assets are classified on the basis of their purpose upon initial recognition.

Cash and cash equivalents comprise cash in hand, deposits held at call with banks and similar investments. Other liquid funds comprise short-term highly liquid investments that are subject to only minor fluctuations in value.

Trade receivables are recognized at their anticipated realizable value, which is the original invoiced amount less an estimated valuation allowance for impairment on these receivables. Receivables are valued individually. Credit losses are expensed in the income statement.

Investments held to maturity are valued at cost. Investments held to maturity are assets with fixed or determinable payments, that

mature on a fixed date, and which the Group intends and is able to hold until maturity.

Loans receivable as well as financial liabilities are recognized at the settlement date and measured at amortized cost using the effective interest rate method. Transaction costs are included in the initially recognized amount.

Derivatives are initially reported at cost in the balance sheet and are thereafter valued at their fair value at each balance sheet date.

Certain foreign exchange derivatives are eligible for hedge accounting in accordance with IAS 39. Changes in the fair value of derivative contracts that have been signed to hedge future cash flows are reported under shareholders' equity, provided that they meet the requirements for hedge accounting. Changes in fair value due to interest rate differences are reported in the income statement. Any accrued profit or loss in the hedge reserve under shareholders' equity is reported as an adjustment to selling proceeds or transaction costs in the same period as any transactions relating to the hedged obligations or estimates.

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.

Equity in foreign subsidiaries situated outside the euro zone is hedged against exchange rate fluctuations mainly through foreign exchange derivatives and foreign currency borrowings using the equity hedging method to reduce the effect of exchange rates on the Group's equity. When a foreign subsidiary is sold, these translation differences are included in the gain or loss on disposal reported in the income statement.

For derivatives that do not satisfy the conditions for hedge accounting in accordance with IAS 39, changes in fair value are reported directly in the income statement.

The fair value of interest rate swaps is calculated by discounting the underlying future cash flows. Currency forwards are valued at

existing forward rates at the balance sheet date. Currency options are valued at their market value at the balance sheet date.

Investments in other companies are classified as available-for-sale investments and are recognized at fair value. Listed shares are valued at their market value. Unlisted shares for which the fair value cannot be reliably measured are valued at cost less impairment. Changes in fair value are reported directly in shareholders' equity until the shares are disposed of, at which point the accumulated fair value changes are released from equity to the income statement. If the fair value of shares becomes permanently impaired or there is objective evidence that it is impaired, impairment is recognized in the income statement.

Gains and losses on disposal and impairments of shares that are attributable to operating activities are included in operating income, while gains and losses on disposal and impairments of other shares are included in financial income and expenses.

Impairments

The carrying amounts of assets are reviewed at each balance sheet date to determine whether there is any indication of impairment. The assets are divided into the smallest possible cash-generating units that are effectively independent of any other assets of the Group. An impairment loss is recognized whenever the carrying value of the assets or cash-generating unit exceeds their value in use. An asset's value in use is the higher of its net realizable value or the recoverable amount from the asset. The recoverable amount is based on discounted future cash flows. Previously reported impairment losses of tangible assets are reversed if the assumptions for calculating the recoverable amount have changed.

Provisions

Provisions are recognized in the balance sheet 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, forecast losses on projects, onerous contracts and restructuring costs.

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

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

Income taxes

The income statement includes taxes on the Group's consolidated taxable income for the reporting period in accordance with local tax regulations, tax adjustments for previous reporting periods and changes in deferred taxes. Deferred tax liabilities and assets are calculated on all 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 balance sheet date. The balance sheet includes deferred tax liabilities in their entirety and deferred tax assets at their estimated probable amount.

Dividends

The dividend proposed by the Board of Directors is not deducted from distributable equity until approved by the company's annual general meeting.

Adoption of new and updated IFRS standards

The standards, their interpretations and amendments described below have been released but are not yet in force and the Group will not adopt them until the mandatory adoption date. In 2008 the Group will adopt the following new and updated standards and interpretations issued by the IASB:

- IFRIC 11 IFRS 2 – Group and Treasury Share Transactions (effective for periods beginning on or after 1 March 2007). The new interpretation clarifies the area of application of share-based payment involving an entity's own equity instruments. The new interpretation will have no impact on future financial statements.
- IFRIC 12 Service Concession Arrangements (effective for periods beginning on or after 1 January 2008). The Group does not have agreements with the public sector as intended by the interpretation, as a result of which the interpretation will have no impact on future financial statements. The interpretation has not yet been approved for application in the EU.

- IFRIC 13 Customer Loyalty Programmes (effective for periods beginning on or after 1 July 2008). The Group does not have customer loyalty programmes as intended by the interpretation, as a result of which the interpretation will have no impact on future financial statements. The interpretation has not yet been approved for application in the EU.
- FRIC 14 IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction (effective for periods beginning on or after 1 January 2008). This interpretation is applied for defined retirement benefit plans and other long-term defined employment benefits when these plans involve minimum funding payments. The Group is currently assessing the impacts of this interpretation. According to initial assessments, the new interpretation will have no significant impact on future financial statements.

In 2009 the Group will adopt the following new and updated standards and interpretations issued by the IASB:

- IFRS 8 Operating Segments (effective for periods beginning on or after 1 January 2009). IFRS 8 replaces IAS 14 Segment Reporting. According to the new standard, segment reporting is based on the internal reports of management and the measurement principles used therein. The Group will assess the possible impacts of segment reporting in the notes to future financial statements.
- Amendment to IAS 23 Borrowing Costs (effective for periods beginning on or after 1 January 2009). The main change from the previous version is the removal of the option of immediately recognising an expense borrowing costs that relate to assets that take a substantial period of time to get ready for use or sale. An entity is, therefore, required to capitalise borrowing costs as part of the cost of such assets. The Group has thus far expensed capital expenditure in the reporting period during which they occurred. The Group considers that the change to this standard will not have a significant impact on future financial statements. The revised standard has not yet been approved for application in the EU.
- Amendment to IAS 1 Presentation of Financial Statements (effective for periods beginning on or after 1 January 2009). The revised standard changes the way in which financial statements are presented. The Group considers that the change will impact primarily the presentation of the income statement and the statement of changes in shareholders' equity. The revised standard has not yet been approved for application in the EU.