

Accounting treatment of loans and borrowings

*Issue paper presented at the EPSAS
Working Group meeting
Luxembourg, 19-20 November 2018*



Contents

Introduction	3
Accounting and reporting guidance	5
Government practices in the EU	19
Matters for discussion	21

Introduction

Objectives of the issue paper

- Prepare the future discussion on accounting for loans and borrowings with the EPSAS stakeholders.
- Topics currently addressed in the paper:
 - Main categories of loans and borrowings.
 - Accounting and reporting guidance available.
 - Country analysis.
 - Main difficulties in practice.
 - Matters for discussion to achieve sound, efficient and harmonised accounting for loans and borrowings by Member States.

Introduction

Background of the issue

- Governments at all levels often incur large amounts of borrowings to fund their activities. These represent a very significant portion of liabilities in the balance sheet.
- They may also provide loans as financial support to certain categories of economic operators, including in times of financial distress, and not always at normal market conditions (concessionary loans).
- 2013 Staff Working Document from the Commission to the Council and the European Parliament and 2014 PwC study.
 - Diversity in accounting practices by Member States: use of nominal amounts vs amortised cost method, etc.
 - Difficulties to determine fair value in the public sector context.
 - Complexity and extent of disclosures.

Accounting and reporting guidance

IPSAS (loans) (current guidance) (1/3)

- Financial instruments standards IPSAS 28 (presentation), IPSAS 29 (recognition and measurement) and IPSAS 30 (disclosures).
- Loans are financial assets (may be included in categories **in red** below).

Categories of financial assets	Description, examples	Measurement
At fair value through profit or loss (FVTPL)	Derivatives or designated at inception	Fair value (FV) with changes in FV through P/L
Loans and receivables	Fixed or determinable amounts	Amortised cost
Held to maturity (HTM) debt instruments	If intention and ability to hold to maturity (e.g. bonds)	Amortised cost
Available for sale (AFS) debt instruments	Residual category	Fair value with changes in FV in equity. Impact P/L upon impairment or sale

Accounting and reporting guidance

IPSAS (loans) (current guidance) (2/3)

- Special guidance on concessionary loans (at below market rates).

At inception

Dr Loan (at fair value - NPV using the prevailing market interest rate)

Dr Financial expense (day one loss)

To Cr Cash

Over the period of the loan

Dr Loan (gradually reconstitute nominal amount at maturity date)

To Cr Financial income (unwinding of the discount - financial income reflecting normal market conditions)

Accounting and reporting guidance

IPSAS (loans) (current guidance) (3/3)

- Impairment test (incurred credit loss model) if objective evidence of impairment (e.g. decline in expected cash flows)

- Financial assets measured at amortised cost

Impairment loss: difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate.

- Financial assets measured at fair value

The cumulative loss that had been recognised directly in equity should be removed from equity and recognised in profit and loss for the period.

Impairment loss: difference between the acquisition cost (net of any principal amount and amortisation) and current fair value, i.e. recoverable amount calculated as the present value of expected future cash flows discounted at the current market rate of interest for a similar financial asset.

Accounting and reporting guidance

IPSAS (borrowings) (current guidance)

- Borrowings are financial liabilities (included in categories **in red** below).

Categories of financial liabilities	Description, examples	Measurement
At fair value through profit or loss (FVTPL)	Derivatives or designated at inception	Fair value with changes in FV through P/L
Other financial liabilities	Not entered into for trading purposes	Amortised cost

Accounting and reporting guidance

IPSAS (loans and borrowings) (current guidance) (1/3)

- Amortised cost.

$$\text{Amortised cost} = \text{Cash paid} - \text{Principal repayments} +/\text{- Unamortised premiums or discounts} - \text{Impairment}$$

- The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument (excluding credit losses) to the net carrying amount of the financial asset or financial liability.
- The calculation includes all fees and points paid or received that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts.
- The effective interest rate is the interest prevailing at the inception of the loan and does not change subsequently.

Accounting and reporting guidance

IPSAS (loans and borrowings) (current guidance) (2/3)

- Amortised cost (illustrative example). Bond issued with a face value of EUR 100,000 bearing interest at 10% and redeemable in 5 years. Issued with a 3% discount. Transactions costs of 2,000.

Effective interest rate	11.37%			
Number of years	Carrying amount at 1/1/N	Interest expense	Cash flow	Carrying amount at 31/12/N
0	-		95,000	95,000
1	95,000	10,797	(10,000)	95,797
2	95,797	10,888	(10,000)	96,685
3	96,685	10,988	(10,000)	97,673
4	97,673	11,101	(10,000)	98,774
5	98,774	11,226	(110,000)	-

Accounting and reporting guidance

IPSAS (loans and borrowings) (current guidance) (3/3)

- Fair value
- Fair value hierarchy:
 - First, quoted prices in an active market (level 1).
 - Then valuation techniques (market comparables, discounted cash flows) making maximum use of market inputs (level 2 if inputs are based on market data, level 3 if not).
- The best evidence of fair value is the transaction price unless fair value is based on market comparables or on a valuation technique whose variables only include data from observable markets.

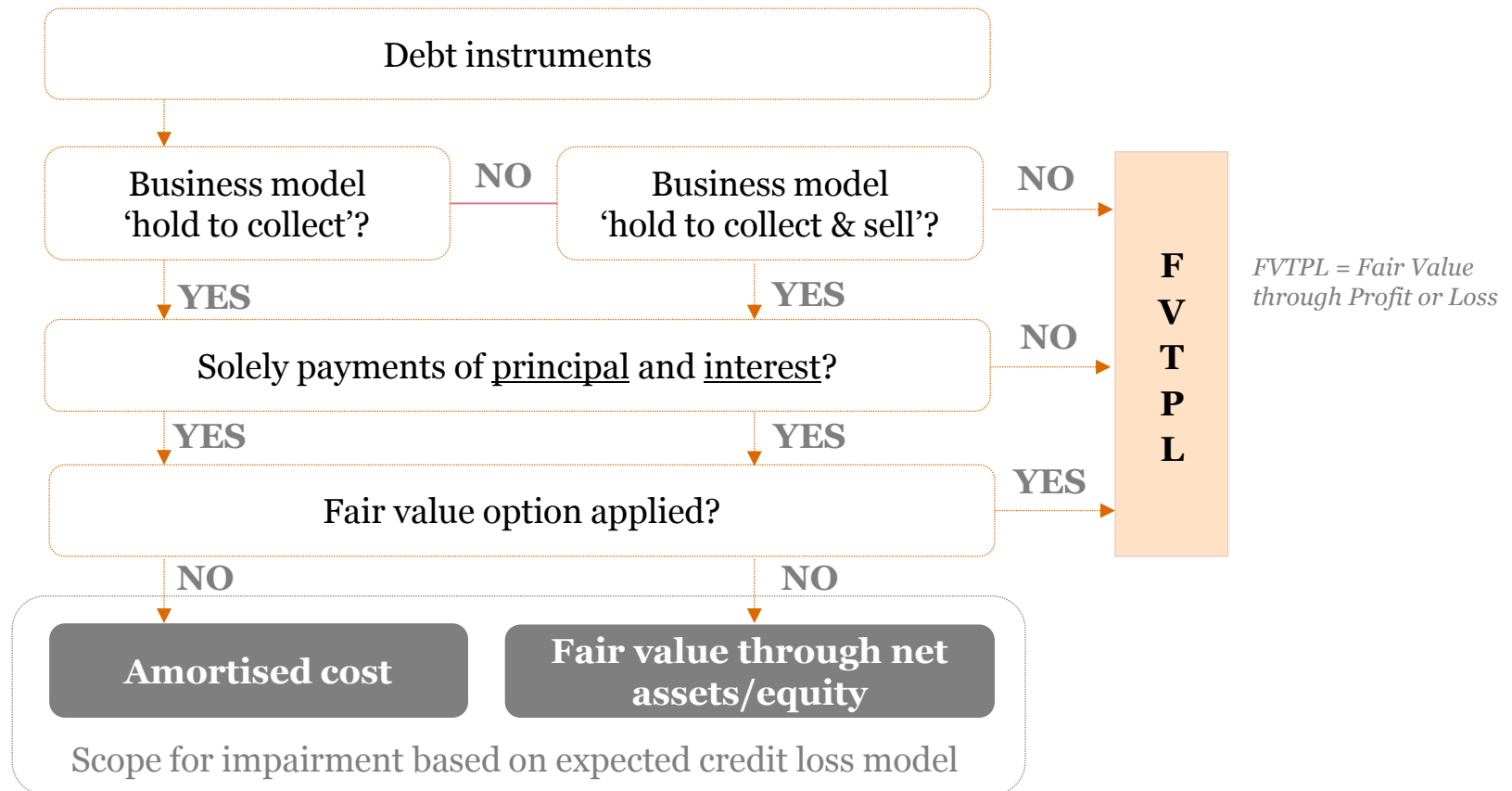
Accounting and reporting guidance

IPSAS (loans) (new rules)

- IPSAS 41 ‘Financial instruments’ inspired by IFRS 9 ‘Financial instruments’.
- Main changes compared to the current IPSAS rules:
 - New simplified classification and measurement rules for financial assets which are aligned on the business model of the public sector entity and the characteristics of the assets.
 - New expected credit loss (ECL) model under IPSAS 41 (versus incurred loss model under IPSAS 29).

Accounting and reporting guidance

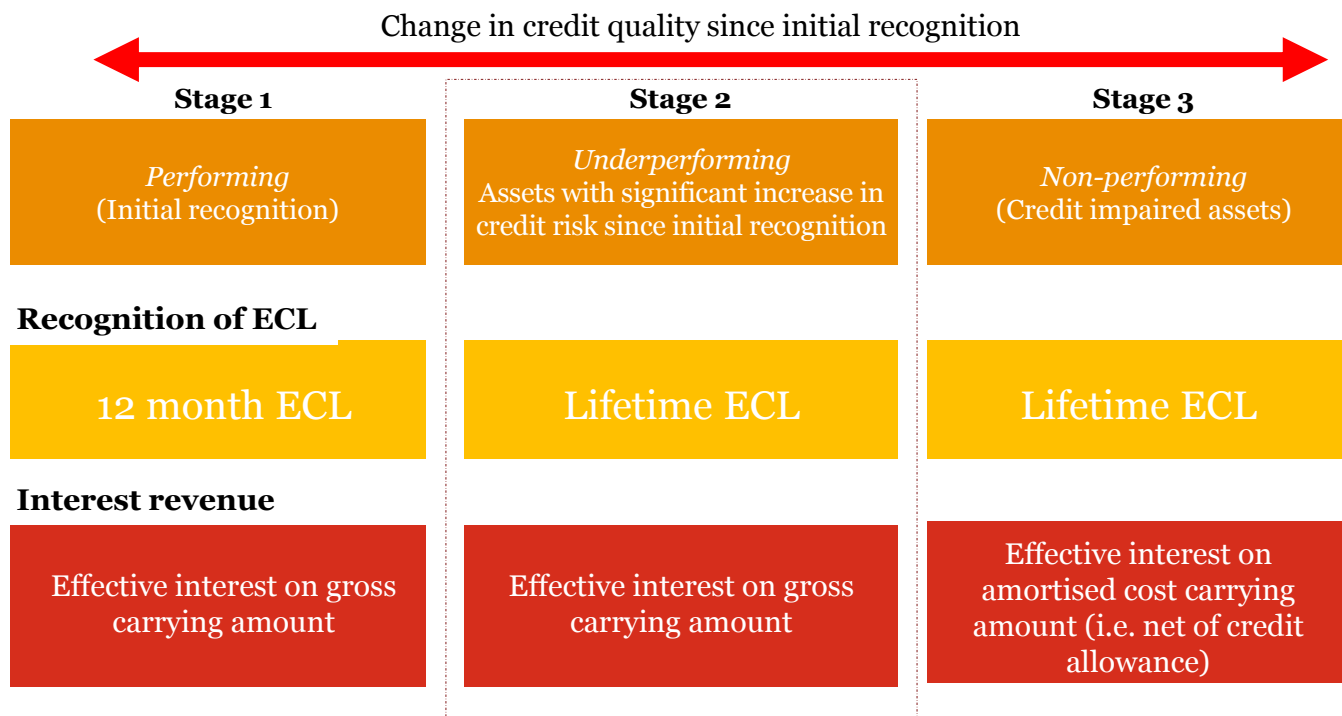
IPSAS (loans) (new classification and measurement rules)



Accounting and reporting guidance

IPSAS (loans) (new impairment rules)

- The new ECL consists in a 'three-stage' model for impairment based on changes in credit quality since initial recognition, distinguishing credit losses on performing loans, underperforming loans and non-performing loans.



Accounting and reporting guidance

IPSAS (loans and borrowings) (disclosures)

- Key disclosures include:
 - Classes of financial assets and liabilities.
 - Summary of significant accounting policies.
 - Fair value and fair value hierarchy: on level 1, 2 and 3 fair values.
 - Risk management policies.
 - Nature and extent of risks: credit risk (credit quality, concentration of credit risk, collaterals, qualitative and quantitative information on ECL and how risks evolve), liquidity risk (maturity analysis for financial liabilities) and market risk (sensitivity analysis on movements in exchange rates and interest rates).

Accounting and reporting guidance

EAR

- EAR 11 'Financial instruments' is based on IAS 39 (pending IPSAS 29 at the time EAR 11 was issued) and considering public sector guidance (e.g. on concessionary loans).
- Specific guidance for financial support loans granted by EU entities from borrowed funds (e.g. European Financial Stability Mechanism and Balance of Payments loans): these are measured at nominal value. The effective interest rate is the nominal interest rate.

Accounting and reporting guidance

IFRS

- IFRS 9 ‘Financial instruments’ (IPSAS 41 is based on this standard).
- To be noted:
 - Concept of OCI (other comprehensive income) under IFRS (to reflect changes in fair value).

Accounting and reporting guidance

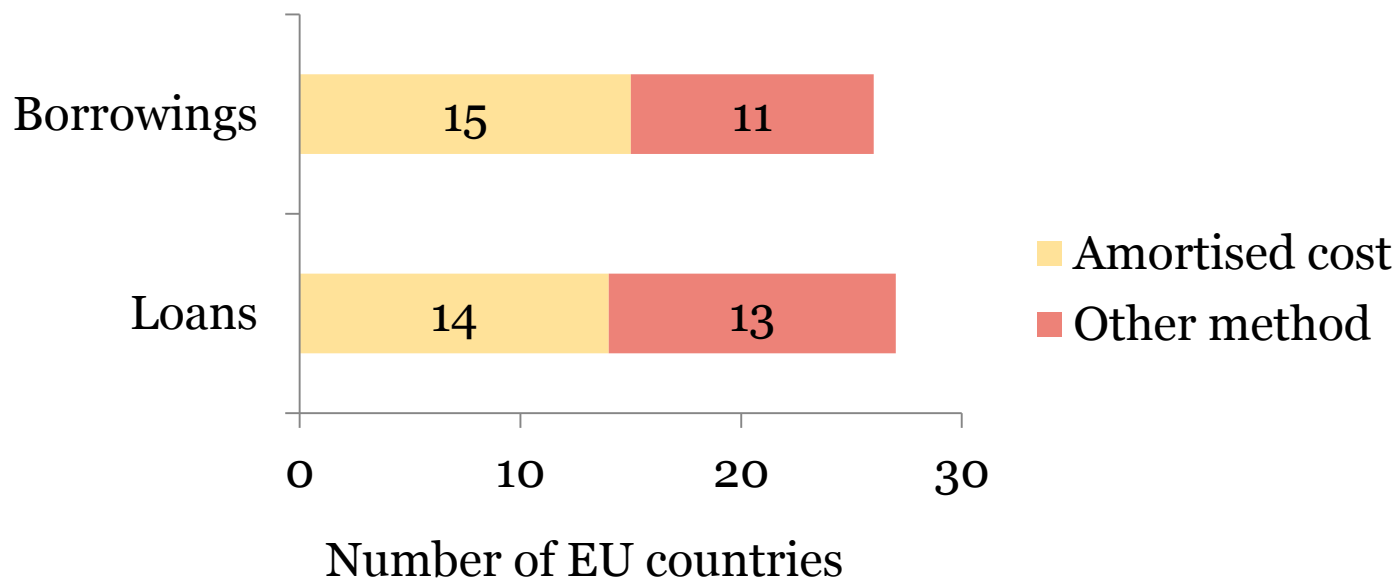
ESA 2010

- A financial claim is the right of a creditor to receive a payment or series of payments from a debtor. In order to maintain symmetry at the macroeconomic level, financial claims and corresponding liabilities are recorded at the same value. These values exclude commissions, fees and taxes.
- Loans, trade credits and deposits are valued at nominal value.
- Non-performing loans (i.e. that have not been serviced for some time) are included as a memorandum item to the balance sheet of the creditor but no impairment loss is recorded.
 - Nominal value and market equivalent value should be disclosed.
- Debt securities are recorded at market value.
- Loans classified by original maturity, currency and purpose of lending.

Government practices in the EU

2014 PwC study report

The PwC study of 2014 shows diversity in accounting for loans and borrowings.



Government practices in the EU

Country analysis

- Findings from country analysis (central governments of FR, LT and SE).

	France	Lithuania	Sweden
Applicable rules	National rules based on international standards (standards 7 and 11).	LPSAS (Lithuanian Public Sector Accounting Standards) based on IPSAS.	National rules for the private sector (based on IFRS and IPSAS).
Main categories of loans and borrowings	Loans: loans to foreign governments (e.g. Greek loan). Borrowings: bonds issued .	Loans: domestic loans to social security funds. Borrowings: bonds issued , loans from international institutions.	Loans: loans to the Swedish National Bank and student loans. Borrowings: bonds issued .
Measurement	Loans: initially at nominal value and subsequently at their present value. Borrowings: amortised cost.	Loans: amortised cost. Available-for-sale financial assets at fair value. Borrowings: amortised cost.	Loans: amortised cost. Students loans at their present value. Borrowings: amortised cost.

Matters for discussion

Difficulties encountered in practice

- Complexity of the subject-matter.
 - Need to develop strong expertise to deal with the most complex issues.
- Inherently difficult measurement.
 - Tailored (and sometimes complex) models to capture the risks inherent to the recoverability of the loans (ECL model under the new IPSAS rules) and assess fair value for debts instruments measured at fair value.
 - Management judgment to estimate cash outflows (including uncertainties surrounding these estimates) and other measurement assumptions.
- Presentation and disclosures.
 - Judgment in assessing categories to present on the balance sheet and nature and extent of disclosures.

Matters for discussion

Possible way forward

- Need for guidance or sharing of best practices relating to fair value measurement and impairment models?
 - Sharing of best practices regarding complex measurement of assets (at fair value or using impairment models such as ECL models)?
 - Need for consistency between Member States when assessing similar risks (e.g. impairment of loans to specific countries)?
- Presentation and disclosures.
 - Need for consistency in presentation and disclosures? Determine guidance in respect of the categories of loans and borrowings (which might be adapted to best suit particular Member States situations)?

Thank you!