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<u>Item 5 of the Agenda</u>

Draft EPSAS Screening Report
IPSAS 36 – Investment in associates and joint ventures

Paper by PwC in cooperation with Eurostat

- for discussion -

This document was commissioned by Eurostat. It analyses the consistency of the named IPSAS standard with the draft EPSAS framework, with a view to informing future EPSAS standard setting. This version was prepared taking into account comments received from the participants of the Cell on Principles related to EPSAS Standards.

EPSAS screening report

IPSAS 36 - Investments in associates and joint ventures

September 2020

Table of contents

Background

Objectives

We refer to the general introduction to the pilot EPSAS screening reports that covers the following elements:

- Key objectives of EPSAS.
- Standard setting process in the public sector.
- Purpose and scope of the screening reports.
- Approach of the screening reports.
- European public good.
- Common elements considered when preparing the reports.

General introduction to IPSAS 36

IPSAS 36 is drawn primarily from International Accounting Standard (IAS) 28 'Investments in associates and joint ventures', published by International Accounting Standards Board (IASB). In developing IPSAS 36, the International Public Sector Accounting Standards Board (IPSASB) applied its 'Process for Reviewing and Modifying IASB Documents' that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

The objective of the IPSAS 36 standard is to prescribe the accounting for investments in associates and joint ventures and to set out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

IPSAS 36 should be applied by all entities that are investors with significant influence over, or joint control of, an investee where the investment leads to the holding of a quantifiable ownership interest.

The standard defines an associate as an entity over which the investor has significant influence, and 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 arrangement. To better understand IPSAS 36's definitions, significant influence is specified as the power to participate in the financial and operating policy decisions of another entity but is not control or joint control of those policies. Furthermore, joint control is the agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Investments in associates or joint ventures are accounted for using the equity method in line with IPSAS 36. An investment in an associate or a joint venture held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities (including investment-linked insurance funds), can be measured at fair value in accordance with IPSAS 41.

Scope of the report

The standard addresses the accounting, by an investor, of its investments in associates and joint ventures.

Reference to EFRAG assessment

IASB issued IFRS 10 ‘Consolidated financial statements’, IFRS 11 ‘Joint arrangements’, IFRS 12 ‘Disclosure of Interests in other entities’, IAS 27 ‘Separate financial statements’ (2011) and IAS 28 ‘Investments in associates and joint ventures’ (2011) on 12 May 2011. On 30 March 2012, the EFRAG provided its opinion on those. Following the EFRAG’s assessment, EFRAG has considered whether IAS 28 (2011) met the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that IAS 28 (2011):

- is not contrary to the principle of ‘true and fair view’ set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and
- meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered whether it would be not conducive to the European public good to adopt IAS 28 (2011) and it concluded that it is in the European interest to do so.

On 24 April 2018, EFRAG submitted its Endorsement Advice relating to the ‘Long-term Interests in Associates and Joint Ventures (Amendments to IAS 28)’ for use in the European Union and European Economic Area. EFRAG assessed that the Amendments meet all technical endorsement criteria of the IAS Regulation and are conducive to the European public good. The endorsement was published in the Official Journal of the European Union on 11 February 2019.

Reference to EPSAS issue papers[1]

The PwC study of 2014[2] analysed the suitability of the IPSAS standards as a basis for developing EPSAS. This included the analysis of IPSAS 7’ Investments in associates’ and IPSAS 8 ‘Interests in joint ventures’ that were replaced by IPSAS 36.

Following this analysis, no major comment has been made by Member States on IPSAS 7 and IPSAS 8, but the requirements included in these standards may potentially be

[1] EPSAS Issues papers are available on https://ec.europa.eu/eurostat/web/epsas/key-documents/technical-developments

[2] Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards (Ref. 2013/S 107-182395)

impacted by the discussions on IPSAS 6 as some of the principles of these standards are linked to each other. The most important concern related to the definition of the scope of consolidation and the application of the control concept in IPSAS 6. IPSAS 7 and IPSAS 8 are classified under category 3 ‘Standards that might be implemented with minor or no adaption’.

In the course of developing the technical proposal on EPSAS, Eurostat commissioned a series of twenty technical issues papers (IPs), which analyse in particular key public sector specific accounting issues. The papers were discussed at the EPSAS Working Group meetings during 2016-2018. The papers are all publicly available on Eurostat’s website.

Each of the IPs seeks to identify conclusions and key issues for further discussion. Taking into consideration the analyses provided in the IPs and the initial views exchanged with Member States’ public sector accounting experts during the Working Group meetings, Eurostat drew tentative conclusions that may serve, together with the IPs themselves, as considerations for future standard setting.

One EPSAS IP is in some respects relevant for the assessment of investments in associates and joint ventures. It was produced in October 2018 and covered the consolidated financial statements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS).

Three main types of issues linked to the preparation of consolidated financial statements discussed in the EPSAS Issue paper on Consolidation of financial statements issued in November 2018 are:

- Determination of the level at which consolidated financial statements should be prepared.
- Determination of the consolidation scope.
- Cost and complexity linked to the preparation of consolidated financial statements.

Screening of IPSAS 36 ‘Investments in associates and joint ventures’ against criteria set in the draft EPSAS framework

Introduction

The EPSAS criteria listed in the draft EPSAS framework have been used to perform an assessment of IPSAS 36 ‘Investments in associates and joint Ventures’, published in 2015 by the IPSASB.

In order to develop recommendations, one should first consider whether IPSAS 36 would meet the qualitative characteristics of the draft EPSAS CF, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

This report considers recognition, measurement as well as presentation and disclosure requirements applicable to investments in associates and joint ventures for each of the qualitative characteristics of the draft EPSAS CF.

Further, this paper includes a high-level comparison between the requirements of IPSAS 36 and other international accounting and financial reporting frameworks applied by the public sector entities in various jurisdictions, such as IFRS, ESA 2010 and EU Accounting Rules, bearing in mind the objective of alignment, reduction of cost of implementation and compliance cost.

Finally, it is assessed whether IPSAS 36 would be conducive to the European public good.

The findings are presented below, and the conclusion is included in the next section of this report.

Conformity with Qualitative Characteristics

Relevance

Financial and non-financial information is relevant if it is capable of making a difference in achieving the objectives of GPFRs. Financial and non-financial information can make a difference when it has confirmatory value, predictive value, or both.

The objective of the IPSAS 36 is to prescribe the accounting treatment for investments in associates and joint ventures so that users of financial statements can discern information about an entity's investments and changes in such investments.

The principal issues in accounting for investments in associates and joint ventures are:

- The recognition of investments; and
- The initial and subsequent measurement of investments by applying the equity method.

The disclosure requirements to be fulfilled in relation to qualifying investments are within the scope of IPSAS 38 ‘Disclosure of Interests in Other Entities’.

Application of the equity method

An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition of the investment, any difference between the cost of the investment and the entity’s share of the net fair value of the investee’s identifiable assets and liabilities is accounted for as follows:

(a) When an entity has included goodwill relating to an associate or a joint venture in the carrying amount of the investment, amortisation of that goodwill is not permitted.

(b) Any excess of the entity’s share of the net fair value of the investee’s identifiable assets and liabilities over the cost of the investment is included as revenue in the determination of the entity’s share of the associate or joint venture’s surplus or deficit in the period in which the investment is acquired.

Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost and the carrying amount is increased or decreased to recognise the investor’s share of the surplus or deficit of the investee after the date of acquisition. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor’s proportionate interest in the investee arising from changes in the investee’s equity that have not been recognised in the investee’s surplus or deficit (i.e. resulting from the revaluation of property, plant and equipment and foreign exchange translation differences) (IPSAS 35 para 16).

The recognition of revenue on the basis of distributions received would not be an adequate measure of the revenue earned by an investor on an investment in an associate or a joint venture because the distributions received may bear little relation to the performance of the associate or joint venture. As a result of joint control of, or significant influence over, the investee, the investor has an interest in the associate's or joint venture's performance and, as a result, the return on its investment. The investor accounts for this interest by extending the scope of its financial statements to include its share of the surplus or deficit of such an investee. The application of the equity method provides more relevant information about the investor's net assets/equity and surplus or deficit.

The equity method specified by IPSAS 36 is relevant because it helps the users estimate the future economic benefits or service potential of the investment over which public sector entity has significant influence or joint control. In addition, initial recognition at cost has a confirmatory value because it shows the level of investment made in the past.

Fair value measurement

When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through surplus or deficit in accordance with IPSAS 41 (IPSAS 36 para 24).

Fair value has both confirmatory and predictive values, with some potential constraints. For instance, the reliability of the assumptions used in the fair value measurement (such as internal assumptions not confirmed by the observable market data) could affect the reliability of financial information. For investments measured at fair value, the benefits of the forward-looking information used to determine the fair value however outweigh the complexity of the valuation techniques and uncertainty of the underlying assumptions. This is especially valid if measurement at cost is not capable to properly reflect the actual value of an investment due its underlying nature (e.g. when it is closely interrelated with and defined by market trends). When the fair value measurement is based upon unobservable inputs, appropriate disclosures provide essential information about how fair value has been determined.

If an entity has an interest in an associate or a joint venture that is an investment entity, it should, when applying the equity method, retain the fair value measurement applied by that investment entity associate or joint venture to its interest in controlled entities. The fair value measurement reflects, at the level of the investor, the business model of its (investment entity) associate or a joint venture, regardless of whether the investor is itself an investment entity. Consequently, it results in the provision of relevant information without having to perform a restatement of the investment entity's own EPSAS accounts.

When the investment ceases to be an associate or a joint venture and the retained interest in the former associate and joint venture is a financial asset, the entity should measure the retained interest at fair value. The fair value of the retained interest should be regarded as its fair value on initial recognition as a financial asset in accordance with IPSAS 41.

If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not re-measure the retained interest. The retained interest should be measured using the equity method ‘before’ and ‘after’ the change. It follows that there is neither a change in the ‘group boundaries’ nor a change in the measurement requirements, and therefore information is relevant to the users without remeasurement. For the reasons stated above, this requirement meets the relevance criterion. Also, this requirement does not involve significant judgement and would therefore not raise any significant issues with regards to reliability of information.

Application of impairment requirements on long-term interests

When instruments containing potential voting rights in substance currently give access to the benefits associated with an ownership interest in an associate or a joint venture, the instruments are not subject to IPSAS 41 ‘Financial instruments’ but are accounted for under IPSAS 36. In all other cases, instruments containing potential voting rights in an associate or a joint venture are accounted for in accordance with IPSAS 41 ‘Financial instruments’.

An entity also applies IPSAS 41, rather than IPSAS 36, to other financial instruments in an associate or joint venture to which the equity method is not applied. These include long-term interests that, in substance, form part of the entity’s net investment in an associate or joint venture (the so-called ‘quasi-equity’ loans).

IPSAS 41’s classification and measurement apply to financial assets that are other long-term interests in accordance with IPSAS 36. IPSAS 41 requires financial assets to be classified based on the business model within which they are held and their contractual cash flow characteristics. The classification of financial assets in accordance with these models provides relevant information. Applying IPSAS 41 impairment requirements to any long-term interest carried at amortised cost provides an appropriate basis for users to understand the extent of expected credit losses resulting from credit risk of such long-term interests. As a result, it brings relevant information for assessing the likelihood of collecting future contractual cash flows.

Disclosures

IPSAS 36 requires that entities provide the related disclosures in accordance with IPSAS 38 ‘Disclosure of interests in other entities’ for all investments in associates or joint ventures, including those that are held by venture capital organisations or similar entities and measured at fair value.

Although IPSAS 38 requires more extensive and voluminous disclosure about interest in other entities, it requires entities to aggregate or disaggregate the disclosure such that useful information is not obscured. IPSAS 38 specifies additional disclosure about an entity's interests in joint arrangements (particularly joint ventures) and associates. The requirements focus mainly on joint ventures and associates that are material to the reporting entity and require less detailed information for individually immaterial investments. This addresses any issues that could result from the non-disclosure of information regarding the nature and extent of risks associated with associates and joint ventures as well as the potential loss of information due to the elimination of proportionate consolidation for joint arrangements classified as joint ventures. The summarised financial information required for each joint venture and associate that is material to the reporting entity enhances the relevance of information provided to users. The aggregation of information provided for individually immaterial associates and joint ventures that are accounted for under the equity method alleviates concerns about excessive and too granular information.

Faithful representation / Reliability

To be reliable, financial and non-financial information must provide a faithful representation of the substance of economic and other phenomena that it purports to represent. The notion of faithful representation and reliability in the draft EPSAS CF is linked to the qualitative characteristics of completeness, prudence, neutrality, verifiability, substance over form and being free from material error. These characteristics are separately discussed below.

Harmonised accounting policies and reporting periods

The entity's financial statements should be prepared using uniform accounting policies for like transactions and events in similar circumstances. (IPSAS 36 para 37) Therefore, if an associate or a joint venture uses accounting policies other than those of the entity for like transactions and events in similar circumstances, adjustments should be made to make the associate's or joint venture's accounting policies conform to those of the entity when the associate's or joint venture's financial statements are used by the entity in applying the equity method. This requirement supports the objective of faithful representation of financial information.

The most recent available financial statements of the associate or joint venture are used by the entity in applying the equity method. When the end of the reporting period of the entity is different from that of an associate or a joint venture the entity either:

(a) Obtains, for the purpose of applying the equity method, additional financial information as of the same date as the financial statements of the entity; or

(b) Uses the most recent financial statements of the associate or joint venture adjusted for the effects of significant transactions or events that occur between the date of those financial statements and the date of the entity's financial statements. (IPSAS 36 para 36)

In addition, proper ownership percentages should be applied, especially in those scenarios when there have been changes in the equity interest of an associate or joint venture over the year. Conclusively, the above requirement enhances the reliability of financial information used for the purpose of subsequent measurement of investments.

Equity method vs fair value model

IPSAS 36 requires public sector entities to use the equity method for their investments in associates and joint ventures, even though it has some constraints: for example, it does not reflect changes in the price level since the initial acquisition date. On the other hand, equity method could provide relevant and reliable information for investments as it reflects changes in the investor's share of the surplus or deficit of the investee after the date of acquisition and also other adjustments to the carrying amount that have not been recognised in the investee's surplus or deficit (i.e. resulting from the revaluation of property, plant and equipment and foreign exchange translation differences).

When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through surplus or deficit in accordance with IPSAS 41. The robustness of the assumptions used in the fair value measurement of investments could also affect the reliability of the information. Proponents of the fair value measurement believe that fair value is the most relevant and faithful representation of the underlying economics of a transaction. However, there might be uncertainties surrounding the amount to be recognised as fair value, as in many cases there might be no directly observable market price for these investments. In such events, the fair value method could result in less reliable financial information (refer to the section of QC 'Prudence').

The overall conclusion of the screening is that IPSAS 36 satisfies the reliability criterion.

Completeness

The information which fulfils the recognition criteria should be complete within the bounds of materiality and cost-benefit considerations.

Scope

IPSAS 36 provides the basis for accounting for ownership interests in associates and joint ventures. That is, the investment in the other entity confers on the entity the risks and rewards incidental to an ownership interest. IPSAS 36 applies only to quantifiable ownership interests including ownership interests arising from investments in the formal equity structure of another entity (i.e. share capital or an equivalent form of capital, such as units in a property trust). Quantifiable ownership interests may also include ownership interests arising from other investments in which the entity's ownership interest can be measured reliably (for example, interests in a partnership). Where the equity structure of the other entity is poorly defined, it may be difficult to obtain a reliable measure of the ownership interest.

Some contributions made by public sector entities may be referred to as an ‘investment’ but may not give rise to an ownership interest. Accordingly, the public sector entity is not exposed to the risks, nor does it enjoy the rewards, that are incidental to an ownership interest. As a result, those transactions are not included within the scope of IPSAS 36. The completeness QC is however positively affected by the requirement in IPSAS 38 ‘Disclosure of interests in other entities’ to disclose information about an entity’s non-quantifiable ownership interests in other entities.

An entity does not need to apply the equity method to its investment in an associate or a joint venture if the entity is a controlling entity that is exempt from preparing consolidated financial statements or if other specific circumstances apply. This requirement does not contradict with the QC of completeness of EPSAS CF. The individual financial statements could serve a different purpose and have different users compared to the consolidated financial statements and therefore application of the equity method would not be justified with reference to the QC of relevance and the cost-benefit constraint.

In case of certain investments, the entity may elect to measure that investment at fair value through surplus or deficit in accordance with IPSAS 41. This election is available for each investment associate or joint venture that meets the criteria in IPSAS 36 para 24, at initial recognition of the investment. An investment entity will, by definition, have made this election for its investments. This election for each individual investment makes information less verifiable and adds complexity to the financial statements. Consistent application of a particular measurement model to investments that share common characteristics is important to achieve both complete and neutral presentation of investments in the financial statements. For certain entities however, this election could provide a substantial relief in terms of cost of preparation of the financial statements and demonstrate positive “cost-benefit” outcome.

Presentation

An investment in an associate or a joint venture accounted for using the equity method should be classified as a non-current asset. This classification reflects the nature of these investments.

The overall conclusion of the screening is that IPSAS 36 satisfies the completeness criterion.

Prudence

Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or revenue are not overstated while liabilities or expenses are not understated.

Existence of significant influence

The assessment of whether an entity jointly controls or significantly influences another entity requires a degree of judgement that generally depends on factors such as complexity of the transaction and ownership structure of the underlying investee. Whether an investor has significant influence over the investee is a matter of judgment based on the nature of the relationship between the investor and the investee, and on the definition of significant influence in IPSAS 36.

The main objective of IPSAS 38 is to require disclosure of information about all significant judgements and assumptions made in determining the nature of an entity's interest in another entity. More specifically, whether an entity has joint control of an arrangement (and the type of joint arrangement when it has been structured through a separate vehicle) or significant influence over another entity. Therefore, providing information about assumptions and judgement exercised that supports an entity's assessment is relevant to users.

Application of the equity method

Appropriate adjustments to the entity's share of an associate's or joint venture's surplus or deficit after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date. Similarly, appropriate adjustments to the entity's share of the associate's or joint venture's surplus or deficit after acquisition are made for impairment losses such as for property, plant and equipment or, where relevant, goodwill.

Information provided by measuring an investment using equity method is prudent, because the initial measurement at cost uses information derived from the price of the transaction that gave rise to the asset. After the date of acquisition, the carrying amount is increased or decreased to recognise the investor's share of the surplus or deficit of the investee; therefore, this approach normally provides a relevant and prudent ongoing measurement basis for the investment.

Fair value measurement

The fair value model provides the monetary value of an investment using information updated to reflect conditions at the measurement date. Because of the updates, fair values reflect changes, since the previous measurement date, in estimates of cash flows and other factors reflected in those fair values. Unlike using the initial cost with the equity method, the fair value of an investment is not derived, even in part, from the price of the transaction that gave rise to the investment. Although, updating the fair values with sufficient regularity inevitably creates additional volatility in the statement of financial position compared to the equity method.

Fair values reflect the perspective of market participants and may not exceed the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. However, if no active market exists for an asset, the current value is determined indirectly using measurement techniques and the degree of prudence may be difficult to assess, when it comes to the non-observable assumptions.

Impairment losses

Whenever application of IPSAS 36 indicates that the investment in an associate or a joint venture may be impaired, an entity applies IPSAS 26 ‘Impairment of cash-generating assets’, and possibly IPSAS 21 ‘Impairment of non-cash-generating assets’.

IPSAS 26 directs an entity to determine the ‘value in use’ of the cash-generating investment. In determining the ‘value in use’ of the cash-generating investment in accordance with IPSAS 26, an entity should use appropriate assumptions and methods to reach the expected results.

IPSAS 21 requires that, if the recoverable service amount of an asset is less than its carrying amount, the carrying amount should be reduced to its recoverable service amount. Recoverable service amount is the higher of an asset’s fair value, less costs to sell and its ‘value in use’. ‘Value in use’ of a non cash- generating asset is defined as the present value of the asset’s remaining service potential. The present value of the remaining service potential may be assessed using the depreciated replacement cost approach, the restoration cost approach or the service units approach, as appropriate.

The internal assumptions used in the fair value measurement to determine the ‘value in use’ of an investment often require a significant level of judgement in case those are not confirmed by the observable market data. In making the estimates required under conditions of uncertainty, the risk is that the value of investments could be overstated and that could affect the faithful representation of financial information.

Neutrality

Information is neutral if it is free from bias. GPFSs are not neutral if the information they contain has been selected or presented in a manner designed to influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

The principles included in IPSAS 36 have been tested for many years in the private sector. Users perceived no negative impact of IAS 28 on the neutrality of the IFRS financial statements. The requirements to apply accounting policies consistently year on year and to disclose such policies in the notes to the accounts reinforce the QC ‘Neutrality’.

Verifiability

Verifiability is the quality of information that helps assure users that GPFSs is based on supporting evidence in a way that it faithfully represents the substance of economic and other phenomena that it purports to represent.

Existence of significant influence

For the purposes of IPSAS 36, a binding arrangement is an arrangement that confers enforceable rights and obligations on the parties to it as if it were in the form of a contract. Binding arrangements can be evidenced in several ways, as prepared in writing, in the form of a contract or documented discussions between the parties. Statutory mechanisms such as legislative or executive authority can also create enforceable arrangements, similar to contractual arrangements, either on their own, or in conjunction with contracts between the parties.

The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

(a) Representation on the board of directors or equivalent governing body of the investee;

(b) Participation in policy-making processes, including participation in decisions about dividends or similar distributions;

(c) Material transactions between the entity and its investee;

(d) Interchange of managerial personnel; or

(e) Provision of essential technical information (IPSAS 36 para 12).

The existence of significant influence by an entity is in some cases verifiable as it can be supported by specific binding arrangement provisions and/or it can be traced back to other reliable evidence or information. In other cases, the exercise of judgment may be required.

Fair value measurement

Fair value information is less verifiable compared to cost, and it involves certain assumptions that are not always observable on the market. Although it would have an impact on the assessment of verifiability, it can improve relevance of the information provided in view of the accountability and decision-making objectives of financial statements. Public sector entities using the fair value model are required to disclose information about the methods and significant assumptions applied in estimating the fair value. The objective of the disclosure it to make the fair value information verifiable against other sources of observable evidence available to the market participants.

Upstream and downstream transactions

Gains and losses resulting from ‘upstream’ and ‘downstream’ transactions involving assets that do not constitute an operation, as defined in IPSAS 40, between an entity (including its consolidated controlled entities) and its associate or joint venture are recognised in the entity’s financial statements only to the extent of unrelated investors’ interests in the associate or joint venture. “Upstream” transactions are, for example, sales of assets from an associate or a joint venture to the investor. The entity’s share in the associate's or the joint venture's gains or losses resulting from these transactions is eliminated. "Downstream" transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture.

When downstream transactions provide evidence of a reduction in the net realisable value of the assets to be sold or contributed, or of an impairment loss of those assets, those losses should be recognised in full by the investor. When upstream transactions provide evidence of a reduction in the net realisable value of the assets to be purchased or of an impairment loss of those assets, the investor should recognise its share in those losses.

These provisions are in line with the verifiability principles of the EPSAS CF, and faithfully represent the substance of economic and other phenomena of the underlying transactions.

Impairment losses

The net investment in an associate or joint venture is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the net investment (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows from the net investment that can be reliably estimated. Objective evidence that the net investment is impaired includes observable data that comes to the attention of the entity about the specified loss events. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment. Whenever application of these paragraphs of IPSAS 36 indicates that the investment in an associate or a joint venture may be impaired, an entity applies IPSAS 26 'Impairment of cash-generating assets', and possibly, IPSAS 21 'Impairment of non-cash-generating assets'.

Share of deficit of an associate or a joint venture

After the entity's interest is reduced to zero, additional deficits are provided for, and a liability is recognised, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. If the associate or joint venture subsequently reports surpluses, the entity resumes recognising its share of those surpluses only after its share of the surpluses equals the share of deficits not recognised.

The recognition principles in the standard are consistent with the definition of a liability in the draft EPSAS CF. As a reminder, a liability is a present obligation of the entity for an outflow of resources that results from past events or transactions. A present obligation is a legally binding obligation (legal obligation) or non-legally binding obligation, which an entity has little or no realistic alternative to avoid. A legal obligation is enforceable in law. Non-legally binding obligations differ from legal obligations in that the party to whom the obligation exists cannot take legal (or equivalent) action to enforce settlement.

A cohesiveness between various disclosure notes required by IPSAS 38 provides evidence of verifiable and reliable information.

Substance over form

Accounting policies are determined by classes of assets having similar economic characteristics. This allows the substance of transactions to be reflected in the accounting treatment for each class.

In general, investments that are held in the activities of a government for the long term, can be accounted for either using the equity method of IPSAS 36, or subject to certain conditions as indicated above, the fair value model of IPSAS 41. Both may be of relevance with regards to the accountability and decision-making objectives of financial statements.

The relevance of the requirement of substance over form is analysed below under separate subsections.

Quantifiable ownership interests

Recognition and measurement principles used by IPSAS 36 requirements reflect the economic substance of quantifiable ownership interests. If an entity holds a quantifiable ownership interest and it holds, directly or indirectly (e.g., through controlled entities), 20 per cent or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence. This principle supports the QC ‘Substance over form’ and allows the real economic phenomena to be reflected when recognising ownership interests.

Potential voting rights

An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or to reduce another party’s voting power over the financial and operating policies of another entity (i.e., potential voting rights). In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other binding arrangements whether considered individually or in combination) that affect potential rights, except the intentions of management and the financial ability to exercise or convert those potential rights. This requirement supports the QC ‘Substance over form’ by taking into account all and less obvious decisive factors in determining the existence of significant influence.

Contribution of monetary non-monetary assets

The gain or loss resulting from the contribution of non-monetary assets that do not constitute an operation, as defined in IPSAS 40, to an associate or a joint venture in exchange for an equity interest in that associate or joint venture should be accounted for in accordance with paragraph 31, except when the contribution lacks commercial substance, as that term is described in IPSAS 17 'Property, plant and equipment'. If such a contribution lacks commercial substance, the gain or loss is regarded as unrealized and is not recognised unless paragraph 34 also applies. Such unrealised gains and losses should be eliminated against the investment accounted for using the equity method and should not be presented as deferred gains or losses in the entity's consolidated statement of financial position or in the entity's statement of financial position in which investments are accounted for using the equity method. (IPSAS 36 para 33) Considering that the substance of transaction has to be properly reflected in the accounting treatment (i.e. if a contribution of non-monetary assets lacks commercial substance or not) definitely supports QC 'Substance over form' of EPSAS CF.

Share of deficit of an associate or a joint venture

If an entity's share of the deficit of an associate or a joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognising its share of further deficits. The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture. For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture (e.g. preference shares and long-term receivables or loans).

QC 'Substance over form' is achieved when the underlying transactions, other events, activities or circumstances are accounted for and presented in accordance with their economic reality, and not merely their legal form which is the case in as a result of this requirement.

Understandability

'Understandability' QC is achieved when information is presented in a manner that facilitates expert and non-expert users to comprehend its meaning.

The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence. Although there are a number of aspects to the notion of 'understandability', most of the aspects are covered by the discussion above about relevance, reliability and comparability.

In our view, the principles of IPSAS 36 are straightforward, do not raise any significant concerns and introduce any complexities that may impair understandability. The accounting treatment of investments under IPSAS 36 provides understandable information to the users of the financial statements, especially under the equity method.

Comparability

Comparability is the quality of information that enables users to identify similarities in, and differences between, two sets of phenomena in different reporting entities or in one reporting entity at different points in time. A key objective of EPSAS is to achieve the necessary level of financial transparency and comparability of financial reporting, between and within EU Member States.

Interconnection with other IPSAS standards

Many of the procedures that are appropriate for the application of the equity method are similar to the consolidation procedures described in IPSAS 35. Furthermore, the concepts underlying the procedures used in accounting for the acquisition of a controlled entity are also adopted in accounting for the acquisition of an investment in an associate or a joint venture which provides consistent application of principles throughout different IPSAS standards.

Fair value measurement election for investments in associates or joint ventures held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities

Overall, cost-benefit considerations should taken into account when a particular measurement method versus another is selected. In addition, different users of financial statements may have different views of what these costs or benefits are.

Continuing the use of the equity method

If an investment in an associate becomes an investment in a joint venture or an investment in a joint venture becomes an investment in an associate, the entity continues to apply the equity method and does not remeasure the retained interest. This requirement applies to situations that involve an entity losing joint control of a joint venture and retaining significant influence in the underlying investment (an associate) and vice versa and requires no remeasurement in such cases.

The purpose of this requirement is to address the accounting when an entity changes its interest in an associate to a joint venture or vice versa. It should be acknowledged that, in such cases, the investor-investee relationship and the nature of the interest changes. However, in both cases the underlying interests will continue to be accounted for using the equity method. In such cases the information would be more comparable from year to year as nothing has changed as it would not be necessary to remeasure the investment.

The use of judgment and estimates (e.g. whether an investor has significant influence over the investee, fair value measurement of certain investments in line with IPSAS 41, etc.) may to some extent impair the comparability of financial statements.

However, except for the described election for certain types of investments, application of the requirements of IPSAS 36 combined with appropriate disclosures provided in the notes about the accounting estimates used are likely to result in comparable application of the standard across the EU and by entities over time.

The guidance in IPSAS 36 should help with consistent interpretation and application of the accounting requirements. There are no areas identified where the lack of guidance would lead to divergence in practice and inconsistencies in the information provided in the notes to the financial statements in relation to risks associated with those entities. In our view, the provisions of IPSAS 36 have been developed as a package, which should promote consistency and coherence of the requirements thereby comparability of financial reporting.

Alignment with other frameworks

ESA 2010

Consolidation is a method of presenting the accounts for a set of units as if they constituted one single entity (unit, sector, or subsector). It involves eliminating transactions and reciprocal stock positions and associated other economic flows among the units being consolidated (ESA 2010 20.152).

Consolidation does not affect balancing items because the consolidated items appear symmetrically within each account. For example, a grant from a central government to a local government unit is consolidated by eliminating the expenditure from central government and the revenue from the local government, thus leaving unchanged the net lending/net borrowing of general government (ESA 2010 20.154).

The determination of joint ventures and a notion of joint control can be found in ESA 2010 rules. In line with the respective provisions, public and private sector units can enter into a joint venture whereby an institutional unit is established. That unit may enter into contracts in its own name and raise finance for its own purposes. The unit is allocated to the public or private sectors depending on which party controls it. ESA 2010 states that foreign direct investment enterprises comprise those entities that are identified as subsidiaries, associates and branches. A subsidiary is where the investor owns more than 50%, an associate is where the investor owns 50% or less, and a branch is a wholly or jointly owned unincorporated enterprise.

The case of joint ventures where government units are involved is covered in ESA 2010, chapter 20 Government accounts. ESA 2010 paragraph 20.49 mentions that ‘many public units enter into arrangements with private entities or other public units to undertake a variety of activities jointly, on market or non-market basis’. Three types of arrangements are foreseen: jointly controlled units ('joint ventures'), jointly controlled operations and jointly controlled assets.

In the case of joint ventures, a unit is set up (as corporation, partnership or any other legal form) which is clearly an institutional unit, i.e. meeting the criteria as defined in ESA 2010 paragraph 2.12, i.e. entering into contracts in its own name and possibly raising finance for its own purpose.

The ESA 2010 asset category relevant for IPSAS 36 is "AF.5 Equity and investment fund shares". ESA 2010 does not make a distinction between investments in associates and investments in "non-associates". The valuation (measurement) depends mainly on whether the shares are listed or unlisted (see ESA 2010 7.71 onwards). However, ESA 2010 7.73 (b), which allows valuation based on the value of own funds, corresponds to the equity method.

IFRS[3]

IPSAS 36, 'Investments in associates and joint ventures' is drawn primarily from IAS 28, 'Investments in associates and joint ventures' (amended in 2011, including amendments up to December 31, 2014). The main differences between IPSAS 36 and IAS 28 (amended in 2011) are as follows:

- IPSAS 36 uses different terminology, in certain instances, from IAS 28 (amended in 2011);
- IPSAS 36 applies to all investments where the investor has a quantifiable ownership interest. IAS 28 (amended in 2011) does not contain a similar requirement. However, it is unlikely that equity accounting could be applied unless there was a quantifiable ownership interest.
- Where an entity is precluded by IPSAS 29 from measuring the retained interest in a former associate or joint venture at fair value, IPSAS 36 permits an entity to use carrying amount as the cost on initial recognition of the financial asset. IAS 28 (amended in 2011) requires that the retained interest be measured at fair value.
- IPSAS 36 requires that an entity with an interest in an associate or a joint venture that is an investment entity, should, when applying the equity method, retain the fair value measurement applied by that investment entity associate or joint venture to its interest in controlled entities. IAS 28 (amended in 2011) permits an entity with an interest in an associate or a joint venture that is an investment entity to retain the fair value measurement applied by that investment entity associate or joint venture.

[3] Refer to the IPSAS-IFRS Alignment Dashboard regularly updated by the IPSASB available on https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf

EU accounting rules

The objective of EU Accounting Rule 2 ’Consolidation and accounting for joint arrangements and associates’ is to define the economic entity in the European Union (EU) context, controlled entities, jointly controlled entities and associates, to identify the circumstances in which they should be consolidated and how they should be included in the consolidated accounts. This accounting rule also requires certain information to be disclosed about interests in controlled entities, joint arrangements, associates and structured entities in the notes to the financial statements.

This accounting rule is based on the following IPSAS standards:

- IPSAS 35 'Consolidated financial statements',
- IPSAS 36 'Investments in associates and joint ventures',
- IPSAS 37 'Joint arrangements', and
- IPSAS 38 'Disclosure of interests in other entities',

- as well as articles 141, 147, 148, 152 and 208 of the Financial Regulation (Regulation (EU, Euratom) 2018/1046 of 18 July 2018).

The principles applied are included in EU AR 2 are similar to IPSAS.

This accounting rule applies to accounting for controlled entities, jointly controlled entities, associates and joint ventures in the financial statements of the EU and those EU entities which prepare and publish separately their financial statements and have interests in other entities. It establishes requirements for the preparation and presentation of consolidated financial statements by EU entities having interests in other entities.

The decision regarding the most appropriate method of accounting for interests in other entities depends on the type of control that the entity has over the other entity, i.e. exclusive control, joint control, significant influence.

In case of exclusive control, in order to determine the scope of consolidation in the EU consolidated financial statements, this accounting rule applies the ‘control concept’. The definition and indicators of control are provided further in the section 4.2 of this accounting rule. It is noted that Art. 241 FR foresees that (i) Union institutions (as listed in Art. 2 FR) and (ii) Union bodies set up under the TFEU and the Euratom Treaty having legal personality and receiving contributions charged to the budget (see Article 70 FR) are included in the scope of consolidation by virtue of their legal status alone (although it is understood that the consolidation of these entities is also in compliance with the control concept).

In case it is assessed that the EU entity does not have an exclusive control over another entity, it should further consider whether it has joint control of and significant influence over an entity following guidance provided in sections 4.3 and 4.4 of EU AR 2.

In its consolidated financial statements, the EU entity should report its interest in an associate or joint venture using the equity method. If the EU entity participates in a joint venture but has no control of the joint venture nor significant influence, it should account for its interests in the joint venture in accordance with the EU accounting rule 11 ‘Financial Instruments’.

After application of the equity method, including recognising the investments losses in accordance with chapter 5.4.2, the EU entity applies the provisions in the EU accounting rule 11 to determine whether it is necessary to recognise any additional impairment loss with respect to the EU entity's net investment and the amount of the impairment loss.

The EU entity should discontinue the use of the equity method from the date that it ceases to have significant influence in an associate or joint control in a joint venture but retain, either in whole or in part, their investment.

An EU entity should consider the level of detail necessary to satisfy the disclosure objective. It should aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or aggregation of items that have different characteristics.

European Public Good

Assessing whether IPSAS 36 is conducive to the European public good

The assessment of whether IPSAS 36 would be conducive to the European public good addresses the following items:

a) Whether the standard will improve financial reporting;
b) The costs and benefits associated with the standard; and
c) Whether the standard could have an adverse effect to the European economy, including financial stability and economic growth.

These assessments will allow the EU authorities to draw a conclusion as to whether the standard is likely to be conducive to the European public good.

The analysis revealed no reasons why IPSAS 36 would not be conducive to the European public good:

- Recognition and measurement in accordance with IPSAS 36 and respectively, the presentation and disclosure requirements of IPSAS 38 will provide useful information to the users of the GPFSs and will improve the overall quality of financial reporting in the public sector. The requirements on the accounting of equity interest will enhance the quality of the financial information reflected in the financial reporting information of investors. However, the question of whether a choice of measurement model should be imposed or permitted, or not, in case of certain investments, where the entity may elect to measure that investment at fair value through surplus or deficit in accordance with IPSAS 41 or by using the equity method, may be discussed.

- Implementation of the standard should result in a moderate one-off cost and should be relatively cost-neutral on an ongoing basis for preparers. These practical challenges do not overweight the conceptual merits of the standard.

- Technical and/or practical difficulties may arise during the application of IPSAS 36. These can happen in relation to the scope determination, including applying judgement in determining whether joint control or significant influence exists and applying the equity method, including gathering of information from all entities in scope, intra-group eliminations and harmonisation of accounting policies.

- Considering its conceptual merits, the standard will bring improved financial reporting when compared to heterogeneous reporting requirements currently applied in the EU. As such, its content is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship. The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

Conclusion

Assessing IPSAS 36 against the criteria formulated in the draft EPSAS framework

The analysis has not revealed major conceptual issues with IPSAS 36 'Investments in associates and joint ventures' and has not identified any inconsistency between IPSAS 36 and the draft EPSAS framework.

Following the screening analysis summarised in the present report, the future standard setter could consider the following conclusions. The information resulting from the application of IPSAS 36:

- would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information needed for making economic decisions and achieving the necessary level of financial transparency and comparability of financial reporting in the European Union;
- would not be contrary to the true and fair view principle; and
- would be conducive to European public good.

However, in order to achieve consistent application of the new standard within the EU context and therefore better address the comparability objective of EPSAS financial statements, additional guidance and improvements in certain areas might be desirable.

- *Election to measure investments at fair value through surplus or deficit in accordance with IPSAS 41.* When an investment in an associate or a joint venture is held by, or is held indirectly through, an entity that is a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect to measure that investment at fair value through surplus or deficit in accordance with IPSAS 41. The choice of using either the equity method or the fair value model for each investment in an associate or joint venture creates a potential risk of a lack of comparability between governments that may use different measurement bases for similar types of assets. In addition, application of the fair value model is more costly than application of the equity method. Cost-benefit considerations may influence the choice of a particular treatment versus another. Different users of financial statements may have different views of what these costs or benefits are.

- *Judgment and comparability*. The use of judgment and estimates is inherent in the preparation of financial statements and may to some extent affect the comparability of financial statements.

The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

The future standard setter could consider the conclusions of this assessment and likely net benefit of using the requirements of IPSAS 36 as a starting point in implementing the equivalent EPSAS, considering the need for additional guidance in certain areas and resolution of the matters identified in the present EPSAS screening report.