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**Item 5 of the Agenda**

# EPSAS issue paper on the notion of control

*Paper by PwC on behalf of Eurostat*
*- for discussion*

# The notion of control and its implications for financial reporting requirements under the future European Public Sector Reporting Standards (EPSAS)

September 2018

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# 1 Objectives of the issue paper

The aim of this issue paper is to analyse the function/purpose of the notions of control used in IPSAS; compare them with the notions of control or their equivalents in ESA 2010 and, where relevant and applicable, also MGDD (reference to IFRS is added if it is deemed relevant to the analysis). It is also to analyse and explain why the particular definitions of notions of control are used under IPSAS and, as a result, develop an approach for organising the future discussion on the notion of control with EPSAS stakeholders. The analysis should serve as a basis for but is not limited to the preparation of a future analysis of consolidation issues of financial statements in more detail.[1]

Based on the request from Eurostat, the issue paper addresses the following questions:

- What are the different notions of control and how are they defined across IPSAS (e.g. in the definition of elements, for service concession arrangements and for control of entities etc.)?
- Why are the notions of control (including as applied in the case of service concession arrangements) defined as they are in IPSAS?
- What is the function/purpose of the notions of control in financial accounting, in particular in IPSAS?
- How have the notions of control or its equivalents been defined in ESA 2010 and, where relevant and applicable, also MGDD and how do those differ from the notions of control as defined in IPSAS?
- Are there differences in the notion of control across IPSAS that would need to be addressed with a view to the future standard setting under EPSAS?
- What are the main difficulties/ issues when applying the notion of control as defined in IPSAS in practice?
- Taking into account costs and benefits, what way forward in practice would PwC recommend for the notions of control in the context of the future EPSAS standard setting?

Based on the analysis performed, an approach for organising the future discussion on the notion of control with the EPSAS stakeholders is proposed.

[1] See PwC, issue paper 'Consolidation of financial statements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)', September 2018, 52 pages.

# 2 Background of the issue

The notion of control is one of the fundamental aspects of accounting and financial reporting. Under international financial reporting frameworks such as IPSAS, this notion is key in the definition of an asset and in the recognition criteria for various forms of assets in the balance sheet of the reporting entity. The period over which control is exercised may also influence the measurement of the assets controlled, as it provides an indication of the period over which service potential or economic benefits may be obtained.

As there are assets with different nature implying differences in the application of control, it is interesting to analyse the rationale for those differences in order to inform the EPSAS standard setting.

It should be noted that liabilities are not considered in the analysis when talking of control, as they cannot be controlled (note: it is the potential counterpart who has control).

The notion of control is also crucial for the preparation of consolidated financial statements in international financial reporting frameworks such as IPSAS as it determines the scope of consolidation, which includes the controlling entity and all entities that it controls.[2]

The report of the cell on FTI mentions that "consolidation is mainly an issue for later, even if it is useful to take note during the process of compiling the first accrual opening balance sheet (OBS) of what information would be needed for consolidation at a later point in time. Issues for the presentation and preparation of consolidated financial statements such as the scope of consolidation and the notion of control are to be dealt with in the future EPSAS standard-setting process"[3].

[2] In certain cases, consolidated financial statements may be prepared on a voluntary basis at the level of a reporting entity and include entities that have no control relationship between them. See also section 3.1.10.

[3] Report of the EPSAS cell on first-time implementation (5 April 2017), page 17, https://circabc.europa.eu/d/a/workspace/SpacesStore/d1b2b587-c4b8-4fdf-a2e2-5735ae362b15/First%20time%20implementation%20guidence.pdf

# 3 Description of accounting guidance available in international accounting frameworks and in statistical rules

Accounting guidance available is discussed below, successively for IPSAS and ESA 2010 (including references to the MGDD, if applicable).

IPSAS rules are explained more in-depth, because IPSAS has been viewed a reference framework for the future EPSAS. As IPSAS and IFRS rules are largely similar with respect to the notion of control, IFRS rules are not analysed in the present issue paper.

## *3.1 International Public Sector Accounting Standards (IPSAS)*

### *3.1.1 Applicable standards*

Particular attention is first devoted to the concept of control in the IPSASB Conceptual framework, then on how the concept of control is considered as one asset recognition criterion for various categories of assets taking into account the unique characteristics of governments.

The various categories of assets (and the related IPSAS rules) that are analysed are:

- Intangible assets (IPSAS 31 'Intangible assets').
- Property, plant and equipment (IPSAS 17 'Property, plant and equipment').
- Investment properties (IPSAS 16 'Investment property').
- Assets held under leases (ED 64 'Leases').
- Service concession assets (IPSAS 32 'Service concession arrangements: grantor').
- Inventories (IPSAS 12 'Inventories' and IPSASB CP on revenue and non-exchange expenses).
- Financial assets (IPSAS 41 'Financial instruments').

We have chosen to adopt a forward-looking approach in view of the future EPSAS standard setting. When new IPSAS rules (exposure drafts and conceptual papers) are proposed, these are analysed in more detail and a brief reference only is made to the current IPSAS standards.

In addition, the concept of control is also key in the determination of the consolidation scope. We briefly address the issue in the present issue paper and refer to the issue paper 'Consolidation of financial statements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)' for further details.

### *3.1.2 IPSASB Conceptual framework*

An asset is a resource presently controlled by the entity as a result of a past event (Conceptual framework (CF) 5.6).

Control is an essential element in the definition of an asset. However, control of an item alone does not result in an asset being recognised on the balance sheet. In order for an asset to exist, the item over which control is exercised should meet the definition of a resource and control should exist as a result of a past event.

Because they are interconnected with each other, the different elements included in the definition of an asset are explained below, with a greater focus placed on the concept of 'presently controlled by the entity'.

A resource

A resource is an item with service potential or the ability to generate economic benefits. Physical form is not a necessary condition of a resource. The service potential or ability to generate economic benefits can arise directly from the resource itself or from the rights to use the resource. Some resources embody an entity's rights to a variety of benefits, including, for example, the right to:

(a) Use the resource to provide services;
(b) Use an external party's resources to provide services (for example leases);
(c) Convert the resource into cash through its disposal;
(d) Benefit from the resource's appreciation in value;
(e) Receive a stream of cash flows (CF 5.7).

Service potential is the capacity to provide services that contribute to achieving the entity's objectives. Service potential enables an entity to achieve its objective without necessarily generating net cash inflows. This is inherent in many public sector assets (CF 5.8).

Economic benefits are cash inflows or a reduction of cash outflows. These may be derived from, for example, an asset's use in the production or sale of services, or the direct exchange of an asset for cash or other resources (CF 5.10).

Presently controlled by the entity

An entity must have control of the resource. Control of the resource entails the ability of the entity to use the resource (or direct other parties on its use) so as to derive the benefit of the service potential or economic benefits embodied in the resource in the achievement of its service delivery or other objectives (CF 5.11).

In assessing whether it presently controls a resource, an entity assesses whether the following indicators of control exist:

(a) Legal ownership;
(b) Access to the resource, or the ability to deny or restrict access to the resource;
(c) The means to ensure that the resource is used to achieve its objectives;
(d) The existence of an enforceable right to service potential or the ability to generate economic benefits arising from a resource (CF 5.12).

The IPSASB acknowledges the views of those who argue that control may be difficult to apply in some cases because it requires judgment to assess whether control exists. In addition, control can be erroneously applied to a resource in its entirety and not to the individual benefits that accrue from the resource. However, notwithstanding such difficulties, the IPSASB concluded that control is an essential characteristic of an asset because the presence of control facilitates the association of an asset with a specific entity (Conceptual framework, Basis for conclusion 5.9 - CF BC 5.9).

Legal ownership of a resource, such as a property or an item of equipment, is one method of accessing the service potential or the economic benefits of an asset. However, rights to service potential or the ability to generate economic benefits may exist without legal ownership of the underlying resource. For example, the rights to service potential or the ability to generate economic benefits through the holding and use of leased property are accessed without the legal ownership of the leased asset itself. Therefore, legal ownership is not an essential characteristic of an asset. Legal ownership is however an indicator of control (CF BC 5.10).

The right to access a resource may give an entity the ability to determine whether:

- To directly use the resource's service potential to provide services to beneficiaries;
- Exchange the resource for another asset, such as cash; or
- Use the asset in any of the other ways that may provide services or generate future economic benefits (CF BC 5.11).

While access to a resource is crucial, there are resources to which the entity has access which do not give rise to assets, such as air. Therefore, the ability to access a resource must be complemented by the ability to deny or restrict the access of others to that resource, for example: (a) an entity might decide whether to set an entrance fee to a museum and restrict access to those who do not pay the fee, and (b) government may control a natural resource under its land to which it can restrict the access to others. Legally enforceable claims to specific resources, such as a right of access to a road or a right to explore land for mineral deposits, could represent an asset to the holder. However, an entity may be able to access the service potential or the ability to generate economic benefits associated with resources in ways that do not require legal rights. The IPSASB took the view that the factors identified in paragraph BC 5.9 are likely to be indicators of the existence of control rather than essential characteristics of the definition of an asset (CF BC 5.12).

The IPSASB also considered whether the economic ownership approach is a viable alternative to the control approach. The economic ownership approach focuses on an entity's exposure to the underlying economic attributes that contribute to an asset's value to the entity. Some respondents to the exposure draft 'Elements and recognition in financial statements', in supporting the control approach, commented on the complexity of the economic ownership approach. The IPSAS concluded that the economic ownership approach is subjective and difficult to operate, and therefore rejected this approach (CF BC 5.13).

The IPSASB considered whether an analysis of exposure to the risks and rewards incidental to ownership is a useful indicator of control. The control approach focuses on the power of the entity to direct how the resource is used to benefit from the service potential and/or the ability to generate economic benefits embodied in the resource. The risks and rewards approach focuses on an entity's exposure to the underlying economic attributes that contribute to an asset's value to the entity and the related risks. Consideration of the risks and rewards associated with particular transactions and events, and which party to any transaction or event bears the majority of those risks and rewards may be relevant and useful in identifying the nature of the asset controlled by the parties to the transaction or event. It may also be useful in determining how to quantify and associate the economic rights and obligations with particular parties. However, it is not of itself an indicator of the party that controls an asset. The IPSASB therefore decided not to include the risks and rewards of ownership as an indicator of control (CF BC 5.14).

As a result of a past event

The definition of an asset requires that a resource that an entity presently controls must have arisen from a past transaction or other past event. Entities can obtain assets by purchasing them in an exchange transaction or developing them. Assets may also arise through non-exchange transactions, including through the exercising of sovereign powers, and governments are unique in the way that they have a number of these sovereign powers.

The power to tax and issue licenses, and other powers to access, deny or restrict access to the benefits embodied in intangible resources like the electromagnetic spectrum, are examples of sovereign powers and rights that may give rise to assets. In assessing when an entity's control of rights to resources arise, the following should be considered:

(a) A general ability to establish a power;

(b) Establishment of a power through a statute;

(c) Exercising the power to create a right;

(d) The event that gives rise to the right to receive resources from an external party.

An asset arises when the power is exercised and the rights exist to receive resources (CF 5.13).

*Specifically in relation to sovereign powers*

The powers and rights of government are particularly significant for the identification of assets. The power to tax and issue licenses, and other powers to access, to deny or restrict access to the benefits embodied in intangible resources like the electromagnetic spectrum, are examples of sovereign powers. It is often difficult to determine whether such powers give rise to a right that is a resource and asset of the entity (CF BC 5.17).

A government's power to establish a right to levy a tax or fee, for example, often begins a sequence of events that ultimately results in the flow of economic benefits to the government. The IPSASB considered two opposite views as to when an asset arises from the powers and rights of government to levy a tax or fee. Under the first view, the government has an inherent power to tax at every reporting date and, therefore, the general ability to levy taxes or fees is an asset. Proponents of this view accept that such an asset is unlikely to be capable of faithfully representative measurement, but this should not deflect from an acknowledgement that government has a perpetual asset. The contrary view is that the power to levy taxes and fees must be converted into a right by legal means, and that such a right must be exercised or exercisable in order for an asset to come into existence. Many respondents to the IPSASB Consultation paper and Exposure draft supported this latter view. The IPSASB concluded that a government's inherent powers do not give rise to assets until these powers are exercised and the rights exist to receive service potential or economic benefits (CF BC 5.18).

### *3.1.3 Intangible assets*

An intangible asset is an identifiable non-monetary asset without physical substance (IPSAS 31.16).

Intangible assets can either be acquired from third parties or generated internally.

Notwithstanding their specific nature, intangible items can generate future economic benefits or contribute to the future service potential of an organisation. As such they can be recognised as an asset and amortised, provided that they meet certain recognition criteria. Given the inherent nature of intangible assets, such recognition criteria are typically much stricter than for physical assets.

Under IPSAS 31, an intangible item should be recognised as an intangible asset if, and only if, all of the following criteria are met:

- It is identifiable, i.e. either it is separable (i.e. it can be sold, transferred, rented, licensed or exchanged) or it arises from legal or contractual rights.
- The public sector entity has present control over it, i.e. it has the power to obtain the future economic benefits or service potential flowing from the underlying asset and to restrict access of others to such benefits or service potential.
- It is probable that the future economic benefits or service potential will flow to the entity.
- The cost of the asset can be measured reliably.

How an entity applies the concept of control as one of the recognition criteria for an intangible asset is explained in paragraphs 21 to 24 of IPSAS 31.

An entity controls an asset if the entity has the power to obtain the future economic benefits or Service potential flowing from the underlying resource and to restrict the access of others to those benefits or that service potential. The capacity of an entity to control the future economic benefits or service potential from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits or service potential in some other way (IPSAS 31.21).

Scientific or technical knowledge may give rise to future economic benefits or service potential. An entity controls those benefits or that service potential if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted), or by a legal duty on employees to maintain confidentiality (IPSAS 31.22).

An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits or service potential from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits or service potential arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits or service potential expected from it, and it also meets the other parts of the definition (IPSAS 31.23).

An entity may have a portfolio of users for its services and may expect that, because of its efforts in building relationships with them, those users will continue to use its services. However, in the absence of legal rights to protect, or other ways to control the relationships with users of a service or the loyalty of those users, the entity usually has insufficient control over the resource to meet the definition of an intangible asset. In the absence of legal rights to protect such relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of an acquisition) provide evidence that the entity is nonetheless able to control the expected future economic benefits or service potential flowing from the relationships with the users of a service. In such a case, the relationships with users of a service are separable and meet the definition of an intangible asset (IPSAS 31.24).

In addition, the existence of control may have an impact on measurement too. For example, IPSAS 31.93 stipulates that the useful life of an intangible asset arising from binding arrangements (including rights from contracts and other legal rights) should not exceed the period of the binding arrangement (including rights from contracts and other legal rights), i.e. the period over which the entity has control over the resources arising from the binding arrangements. Examples include licences (which provide the right to use certain resources over a certain period of time) and patents (which provide the right to deny or restrict the access of others to the patented resources). The impact is both on the acquisition cost of the asset (which will be higher if the period over which cash flows or service potential can be generated by the asset is high) and its carrying amount (the shorter the useful life of an asset, the faster its carrying amount decreases through amortisation/depreciation).

#### *3.1.4 Property, plant and equipment*

Property, plant and equipment (PP&E) are tangible items that are:

(a) held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) expected to be used during more than one reporting period (IPSAS 17.13).

PP&E can either be acquired from third parties or constructed by an entity.

In the case of items of PP&E, control is often evidenced by the ownership and the physical possession of the asset.

Paragraph 84 of IPSAS 17 stipulates that in determining the date of disposal of an item of PP&E (and therefore - reasoning by analogy - in determining the date of acquisition by the acquirer), an entity applies the criteria included in IPSAS 9 for recognising revenue from the sale of goods. To improve the accounting for revenue and non-exchange expenses, the IPSASB issued a consultation paper (CP) in August 2017 on 'Accounting for revenue and non-exchange expenses'. The current rules relating to revenue from exchange transactions will be replaced by new rules aligned on the IFRS equivalent, i.e. IFRS 15 'Revenue from contracts with customers'. Under the new proposals, revenue is recognised to depict the transfer of goods and services based on a 'control' approach (versus a risks and rewards approach under the current rules).

IPSAS 17.84 also states that the disposal of an item of PP&E may occur in a variety of ways (e.g. by sale, by entering into a lease or by donation).

### *3.1.5 Investment properties*

Investment property is land or building (including part of a building) or both, held to earn rentals or for capital appreciation, or both (IPSAS 16.7). The key distinctive feature of an investment property is that it generates cash flows largely independently of the other assets of the entity.

Similar rules apply for the disposal (and therefore by analogy to the acquisition) of an investment property as for the disposal of an item of PPE.

### *3.1.6 Assets held under leases*

Under ED 64 Leases, a lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration (ED 64.5).

The new IPSASB proposals align lease accounting rules applicable to lessees to those of IFRS 16, the new IFRS equivalent standard. All lessees should recognise a righ-of-use asset and a corresponding liability in the amount of the net present value of the future lease payments in the balance sheet.

To assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

(a) The right to obtain substantially all of the economic benefits from use of the identified asset; and

(b) The right to direct the use of the identified asset (ED 64 AG4).

Further guidance on (a) and (b) above are given in paragraphs AG 16 to AG 18 and paragraphs AG 19 to AG 25 respectively.

If the customer has the right to control the use of an identified asset for only a portion of the term of the contract, the contract contains a lease for that portion of the term (ED 64 AG 5).

The new proposed approach to lease accounting by lessees implies having control over the resource during the lease term, moving away from the current approach under IPSAS 13 'Leases'. IPSAS 13 requires recognition of a leased asset and a lease liability by the lessee based on a risks and rewards approach, i.e. a lease is recognised in the balance sheet of the lessee if substantially all risks and rewards incidental to ownership of the leased asset are transferred from the lessor to the lessee.

*Illustrative example*

A property lease with a non-cancellable lease term of 9 years would not usually have transferred substantially all risks and rewards incidental to ownership of the property from the lessor to the lessee under current IPSAS 13. Indeed, the useful life of a lease property is much longer and the indicators for finance lease classification would in most cases not be met. Such leases would be accounted for as operating leases by the lessee under current IPSAS rules, with no balance sheet impact on initial recognition and lease payments recognised as operating expenses. Under the new proposed rules (ED 64), a right-of-use asset would be recognised, representing the right that the lessee has to use the property during 9 years, together with a corresponding lease liability.

In developing its new rules on lease accounting, the IPSASB noted that the right-of-use model of IFRS 16 is based on the foundational principle that leases are financings of the right to use an underlying asset, and results in the following accounting:

(a) The lessee recognises a 'right-of-use asset'; and

(b) The lessee recognises lease liabilities related to the future lease payments (ED64 BC6).

The IPSASB considered whether there were any public sector issues that warranted a departure from the right-of-use model for lessee accounting in IFRS 16. In so doing, the IPSASB came to the following conclusions:

(a) The right-of-use asset satisfies the definition of, and recognition criteria for, an asset in the IPSASB's Conceptual framework.

(b) The right-of-use asset is recognised when the lessee controls the asset, which is consistent with the Conceptual framework. The IPSASB noted that the 'risks and rewards incidental to ownership' model in IPSAS 13 is not based on control, and is therefore not consistent with the Conceptual framework.

(c) The information reported under the single lessee accounting model specified in IFRS 16 would provide the most useful information to the broadest range of users of financial statements.

(d) The right-of-use model prevents arbitrage, gaming and information asymmetry, and improves comparability between public sector entities that lease assets and public sector entities that purchase assets.

(e) The IPSASB acknowledged that there would be costs associated with adopting the right-of-use model in the public sector. However, the IPSASB did not consider that these would outweigh the benefits of so doing, particularly if the IPSASB also adopted the exemptions in IFRS 16 (ED64 BC7).

Under the new lease accounting model, the lessee, who has physical possession of the asset and uses it, depreciates the right-of-use asset over the period of use.

Concerning lessor accounting, the IPSASB proposes in ED 64 not to adopt the IFRS 16 risks and rewards incidental to ownership model. Instead, the IPSASB is also proposing the right-of-use model for lessors. It found that convergence with IFRS 16 for lessor accounting and the lack of consistency between lessor and lessee accounting would give rise to a number of public sector specific issues:

- Consolidation issues where the lessor and lessee are part of the same economic entity and separate records needs to be maintained for the underlying asset and lease receivable.

- Understandability issues because of different accounting models for the same transaction.

- Asymmetrical information in the public sector - different recognition criteria for the same transaction distorts the analysis of the financial position of public sector entities.

An alternative approach advocated by some, but however not proposed by the IPSASB, could have been to the following: the measurement of the underlying asset in the lessor's books would be

reduced proportionately for the portion corresponding to the right-of-use granted. A receivable would be recognised (counterpart to the lessee's liability) and possibly a gain or loss recorded as the difference between the reduction in the carrying amount of the underlying asset and the lease receivable.

### *3.1.7 Service concession assets*

Under IPSAS 32, a service concession arrangement is a binding arrangement between a grantor and an operator in which the operator (a) uses the service concession asset to provide a public service on behalf of the grantor for a specified period of time and (b) is compensated for its services over the period of the service concession arrangement.

Recognition of service concession assets by the grantor under IPSAS 32 mirrors the IFRS treatment by the operator (IFRIC 12 'Service concession arrangements').

IPSAS 32 addresses only arrangements in which the grantor:

(a) controls or regulates the services provided by the operator; and
(b) controls any significant residual interest in the service concession asset at the end of the term of the arrangement.

In the case of whole-of-life assets, only condition (a) must be met for recognition of a service concession asset by the grantor.

The main accounting issue in service concession arrangements is whether the grantor should recognise a service concession asset (IPSAS 32 BC11).

The IPSASB considered the merits of the risks and rewards and the control-based approach to assess whether the grantor should recognise the asset. The risks and rewards approach focuses on the economic aspects of the terms and conditions in the arrangement. The IPSASB did not believe this focus to be appropriate for service concession arrangements because the primary purpose of a service concession asset, from the grantor's point of view, is to provide specified public services on behalf of the grantor using a service concession asset, and not to provide economic benefits such as revenue generated by such assets (e.g. from user fees). Thus, the service potential of the asset accrues to the grantor. Economic benefits are only likely to arise from a service concession arrangement in circumstances where the operator is granted the right to earn revenue from third-party users, of either the service concession asset or another revenue-generating asset. A control-based approach focuses on control over the economic benefits and the service potential of the service concession asset (IPSAS 32 BC12).

As it is often the case that service concession arrangements are entered into for the sharing of risks between the grantor and the operator, the IPSASB also questioned whether sufficiently objective criteria could be established for assessing risks and rewards to enable consistent results to be determined. In addition, weighting of various risks and rewards was seen to be problematic. The IPSASB concluded, therefore, that the risks and rewards approach is inappropriate (IPSAS 32 BC13).

The IPSASB also considered whether a rights and obligations approach was appropriate. Although such an approach could have conceptual merit, the IPSASB believes that it would represent a

significant change in the accounting and financial reporting of assets and liabilities for public sector entities that could have implications beyond service concession arrangements. Given the IPSASB's decision to complement IFRIC 12, which uses a control-based approach, the IPSASB agreed that a rights and obligations approach was not appropriate for this standard (IPSAS 32 BC14).

The IPSASB concluded that a control-based approach was the most effective means to determine whether the grantor should recognise the asset. The IPSASB concluded that if a control-based approach is used, it should be consistent with IFRIC 12, for the same reasons cited in paragraph BC2. Accordingly, this standard addresses only arrangements in which the grantor (a) controls or regulates the services provided by the operator, and (b) controls any significant residual interest in the service concession asset at the end of the term of the arrangement. Consistent with IFRIC 12, in the case of whole-of-life assets, only condition (a) must be met for recognition of a service concession asset. The IPSASB concluded that it was important to stress that a service concession arrangement is a binging arrangement. Accordingly, the assessment of whether a service concession asset should be recognised is made on the basis of all of the facts and circumstances of the arrangement (IPSAS 32 BC15).

If the public sector entity controls the service concession asset (following IPSAS 32 criteria), it presents it in its balance sheet and depreciates it over its useful life; this applies even if the operator has access to the asset during the concession period in order to be able to provide the services foreseen in the service concession arrangement.

Accounting for service concession arragements is addressed in a separate issue paper. We refer to this paper for further details on the topic.[4]

#### *3.1.8 Inventories*

Under IPSAS 12 'Inventories', inventories are assets:

(a) in the form of materials or supplies that are either to be consumed in the production process;
(b) to be consumed or distributed in the rendering of services;
(c) held for sale or distribution in the ordinary course of operations; or
(d) in the process of production for sale or distribution (IPSAS 12.9).

Similar to items of PPE, control of items of inventory is often evidenced by the ownership and the physical possession of the asset.

Where the government controls the rights to create and issue various assets, including postal stamps and currency, these items of inventory are recognised as inventories (IPSAS 12.13).

Derecognition rules (and reasoning by analogy recognition rules) relating to inventories follow the criteria included in IPSAS 9 for recognising revenue from the sale of goods. As already mentioned, the current IPSAS rules will be replaced by new rules aligned on IFRS, requiring revenue recognition to depict the transfer of goods and services based on a 'control' approach (versus a risks and rewards approach under the current rules).

[4] See PwC, issue paper 'Accounting treatment of service concession arrangements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)', October 2018, 37 pages.

### *3.1.9 Financial assets*

The concept of financial asset is very broad. It includes cash, loans, receivables, investments in notes, commercial papers, bonds and shares as well as other more complex instruments such as derivatives and structured debt instruments.

Basically, a financial asset is any asset that is:

(a) cash,

(b) an equity instrument of another entity, or

(c) a contractual right to receive cash or another financial asset or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.

An equity instrument is any contract that evidences a residual interest in the assets of an entity after having deducted all of its liabilities (IPSAS 28.9).

Recognition of a financial asset in the balance sheet implies the existence of a contractual right and therefore the existence of control over a resource.

### *3.1.10 Control over an entity and consolidation*

In many cases, several entities work together for a common purpose, under one organisation (the economic entity). Consolidation is the process of presenting financial statements of all entities that make up the economic entity on a consolidated basis, i.e. as if they were the financial statements of a single economic entity. In effect, consolidation brings together several related sets of accounts into one overall version. Determining which accounts are included in the consolidated financial statements is based on the concept of 'control'.

Under IPSAS 35 'Consolidated financial statements', the consolidation scope includes the controlling entity and all controlled entities (IPSAS 35).

An entity controls another entity when the entity is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature and amounts of those benefits through its power over the other entity.

*Control in consolidation versus control over an individual asset*

When assessing whether control exists for the purpose of determining the consolidation scope under IPSAS, three conditions should be fulfilled: the power condition, the variable returns/benefits condition and the link between the two.

This differs from the assesment of control for an individual asset. An asset is a resource presently controlled by an entity as a result of a past event. The term 'controlled' here refers to a notion which is close to the power condition when assessing control in consolidation, and this notion is used in addition to the notion of 'benefits' which is embedded in the definition of a resource (i.e. an item with service potential or the ability to generate economic benefits), the two being necessary elements to meet the definition of an asset.

Similar concepts are thus used to assess whether an entity should be consolidated or not and whether an individual asset exists. However, the term 'control' is used in isolation and includes all concepts that are necessary to assess the consolidation scope, while it covers a narrower concept and is used together the the notion of benefits when it relates to the determination of whether an asset exists.

To be complete, it should also be noted that consolidated financial statements can be prepared in order to include entities with no control relationship between them in the scope of the same reporting entity if this is useful for accountability or decision making. A typical example is the preparation of whole-of-governments accounts (WGA) including all tiers of government in a country in order to present the full picture of the country, whithout however any control relationship between e.g. central and local governments.

For further information on the consolidation topic, we refer to the separate issue paper 'Consolidation of financial statements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)'.

## *3.2 Draft EPSAS Conceptual framework*

The draft EPSAS Conceptual framework (version dated May 2018) contains similar definitions for assets and the different elements included in the definition of an asset as the IPSAS Conceptual framework.

An asset is a resource presently controlled by the entity as a result of past events or transactions.

A resource is an item with service potential or the ability to generate economic benefits. Service potential is the capacity to provide services that contribute to achieving the entity's objectives. Economic benefits are cash inflows or a reduction in cash outflows.

## *3.3 International Financial Reporting Standards (IFRS)*

IFRS principles are not analysed in this paper because IPSAS are based on them and have been analysed in detail in the previous section.

Moreover, recent developments in IPSAS (and before that in IFRS) introduce more consistency in the recognition criteria for assets, all based on the concept of control, moving away in several cases from a risks and rewards approach. Examples include the recent changes to the revenue recognition and leases standards in IFRS[5] and the recent proposals regarding those topics in IPSAS.

## *3.4 ESA 2010*

### *3.4.1 Rules relating to individual assets*

The assets recorded in the balance sheets are economic assets (ESA 2010 7.14).

An economic asset is a store of value representing the benefits accruing to the economic owner by holding or using the entity over a period of time. It is a means of carrying forward value from one accounting period to another (ESA 2010 7.15).

The economic benefits consist of primary incomes such as operating surplus, where the economic owner uses the asset, or property income, where the economic owner lets others use it. The benefits are derived from the use of the asset and the value, including holding gains and losses, that is realised by disposing of the asset or terminating it (ESA 2010 7.16).

The economic owner of an asset is not necessarily the legal owner. The economic owner is the institutional unit entitled to claim the benefits associated with the use of the asset by virtue of accepting the associated risks (ESA 2010 7.17). The criterion for recording the transfer of goods from one unit to another is that the economic ownership passes from one to the other (ESA 2010 1.90). As a general principle, an asset can thus not be split between institutional units, i.e. the full amount of the asset has to be allocated to a particular institutional unit.

The definitions of several types of assets refer to resources under direct control, responsibility and management of institutional units. Institutional units constitute the level at which assets and liabilities are recorded in the ESA 2010 reporting methodology.[6]

An asset is recorded for an institutional unit if it has the benefits from the use of the asset and the associated risks.

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[5] It should however be noted that IFRS 16 continues applying a risks and rewards model to lessor accounting while applying a control model to lessee accounting.

[6] Institutional units are economic entities that are capable of owning goods and assets, of incurring liabilities and of engaging in economic activities and transactions with other units in their own right. For the purposes of the ESA 2010 system, the institutional units are grouped together into five mutually exclusive domestic institutional sectors: (a) non-financial corporations; (b) financial corporations; (c) general government; (d) households; (e) non-profit institutions serving households. The five sectors together make up the total domestic economy. Each sector is also divided into subsectors (ESA 2010 1.57).

For leases and in particular public-to private partnerships (PPPs), more detailed guidance exists on how to assess economic ownership of the asset based on a risks and rewards approach (considering several criteria or types of risks).

### *3.4.2 Leases*

A financial lease is a contract under which the lessor as legal owner of an asset conveys the risks and benefits of ownership of the asset to the lessee. Under a financial lease, the lessor is deemed to make, to the lessee, a loan with which the lessee acquires the asset. Thereafter the leased asset is shown on the balance sheet of the lessee and not the lessor; the corresponding loan is shown as an asset of the lessor and a liability of the lessee (ESA 2010 5.134).

Financial leases may be distinguished from other kinds of leases because the risks and rewards of ownership are transferred from the legal owner of the good to the user of the good. Other kinds of leases are (i) operating lease; and (ii) resource lease. Contracts, leases and licenses, as defined in chapter 15, can be considered as leases as well (ESA 2010 5.135).

### *3.4.3 PPPs*

In a PPP or service concession contract, the operator (usually a private partner) both receives a right and incurs an obligation to provide public services on behalf of a public sector entity and is compensated for it, as well as, when applicable, for the design, construction and maintenance of the asset.

If the operator bears the majority of the risks and rewards related to the asset, no asset and liability is recorded in the government entity balance sheet, and the PPP or service concession contract is reported as an off balance sheet item. Where on the contrary the public sector grantor bears the majority of the risks and rewards related to the asset, the transaction should be reported on the balance sheet of the government entity.

The ESA Manual on Government Deficit and Debt further distinguishes between a service concession contract (which is typically a long-term contract where users predominantly compensate the operator) and a PPP (where the government directly pays the compensation).

Detailed rules on the accounting of PPPs can be found in chapter 20 'The government accounts' of the ESA 2010 manual paragraphs 276 to 290.

Public-private partnerships (PPPs) are long-term contracts between two units, whereby one unit acquires or builds an asset or set of assets, operates it for a period and then hands the asset over to a second unit. In the contract period the PPP contractor has the legal ownership. Once the contract period is over, the government has both economic and legal ownership (ESA 2010 15.41).

As with leases, the economic owner of the assets in a PPP is determined by assessing which unit bears the majority of the risks and which unit is expected to receive a majority of the rewards of the assets. The asset will be allocated to this unit. The main risk and reward elements to be assessed are:

(a) construction risk, which includes costs overruns, the possibility of additional costs resulting from late delivery, not meeting specifications or building codes, and environmental and other risks requiring payments to third parties;

(b) availability risk, which includes the possibility of additional costs such as maintenance and financing, and the incurrence of penalties because the volume or quality of the services do not meet the standards specified in the contract;
(c) demand risk, which includes the possibility that demand for the services is higher or lower than expected;
(d) residual value and obsolescence risk, which include the risk that the asset will be less than its expected value at the end of the contract and the degree to which the government has an option to acquire the assets;
(e) the existence of grantor financing or granting guarantees, or of advantageous termination clauses notably on termination events at the initiative of the operator (ESA 2010 20.283).

The risks and rewards are with the operator if:

1) the construction risk; and
2) either the demand or the availability risks

have been effectively transferred.

Other factors such as financing arrangements, guarantees, the degree to which the government determines the design, quality, size, and maintenance of the assets as well as the services produced, the units to which the services are provided, and the prices of the services produced are also included in the risks and rewards assessment. Due to the complexity and variety of PPPs, all facts and circumstances surrounding the transaction should be considered in determining the accounting treatment (ESA 2010 20.284 to 286).

For further details, we refer to the separate issue paper on service concession arrangements.[7]

### *3.4.4 Consolidation*

ESA 2010 reporting includes the accounts of all entities included in the general government sector (GGS) (S.13). The GGS consists of all government units and all non-market NPIs controlled by government units. It also includes other non-market producers.

Information that is more detailed is included in the separate issue paper 'Consolidation of financial statements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)'.

[7] See PwC, issue paper 'Accounting treatment of service concession arrangements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)', October 2018, 37 pages.

## *3.5 Comparison between IPSAS and ESA 2010 rules*

The table below provides an overview of the main rules addressing the notion of control included in IPSAS and ESA 2010 rules.

*Figure 1: Outline of IPSAS and ESA 2010 rules addressing the notion of control*

| Application domains | IPSAS | ESA 2010 |
|---|---|---|
| **Individual assets** | An asset is defined in the IPSASB Conceptual framework as a resource that an entity presently controls. Other criteria should be considered in order to recognise an asset, such as the ability to generate future economic benefits or service potential.<br><br>The concept is applied consistently to various types of assets, taking into account the different nature of these assets: intangible assets, items of PP&E, investment properties, leased assets, service concession assets, inventories and revenue recognition, financial assets. | An asset is defined under ESA 2010 as an economic asset. Definitions of several types of assets refer to resources under direct control, responsibility and management of institutional units.<br><br>As a general principle, an institutional unit books an asset if it has the benefits from the use of the asset and the associated risks. For leases and in particular for PPPs, the guidance to assess economic ownership of the asset based on a risks and rewards approach (considering several criteria or types of risks) is developed in more detail. |
| **Consolidation** | The consolidation scope includes all entities over which the reporting entity has control. Three conditions should be met in order to have control: (1) power to direct the relevant activities, (2) exposure to the variable returns of the entity and (3) link between the two. | ESA 2010 reporting includes the accounts of all entities included in the GGS (S.13). The GGS consists of all government units and all non-market NPIs controlled by government units. It also includes other non-market producers. |

IPSAS adopts an approach based on control for the recognition of assets in the balance sheet and recent IPSASB developments aim to bring more consistency in that domain. Assets under ESA 2010 rules are economic assets and the economic owner (not necessarily the legal owner) is the institutional unit entitled to claim the benefits associated with the use of the asset by virtue of accepting the associated risks. Differences may therefore arise between the two sets of rules in certain cases (e.g. for leased assets or service concession assets).

# 4 Difficulties/issues in applying the notion of control

Based on our practical experience in applying IPSAS and similar standards and on the analysis performed in the context of this issue paper, the following are identified as the main difficulties/issues that arise in applying the notion of control:

- Practical implementation issues.
- Technical complexity.

## *4.1 Practical implementation issues*

Practical implementation issues may arise when determining whether the public sector entity has control or not over some resources, mainly upon first-time adoption of accrual accounting standards.

It may for example be difficult to establish a comprehensive inventory of all assets over which the reporting entity has control. Historical information may be missing, for example about who is the owner of certain pieces of land located in certain regions, therefore making it difficult to build up a comprehensive and reliable inventory of such assets upon first-time adoption.

If such difficulties do arise in practice, determination of who has control over a resource is however relatively easy in the vast majority of the cases.

## *4.2 Technical complexity*

Application of the notion of control may also give rise to technical difficulties in some cases. Judgment may be required in applying certain accounting rules that refer to the notion of control.

Examples of such technical difficulties and cases where judgment needs to be exercised, include (a) determination of the moment in time or period when control is transferred in order to establish when revenue should be recognised, or (b) determination of whether control exists over certain entities in order to decide whether they should be consolidated (the latter example is dealt with in more detail in the issue paper 'Consolidation of financial statements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)').

The exercise of judgment is however an integral part of the process of preparing (consolidated) financial statements and does not involve a degree of complexity that is much greater when applying the notion of control than in many other situations where judgment also needs to be exercised. Other approaches to asset recognition such as a risks and rewards approach would often involve a higher degree of judgment.

# 5 Discussion of matters relevant for a European harmonisation

As identified under chapter 4 'Difficulties/issues in applying the notion of control', practical implementation issues may arise and a certain degree of complexity and judgment may be needed in applying the notion of control under international accounting standards.

These issues either are of an organisational matter or are part of the normal process of preparing accrual-based (consolidated) financial statements.

In our opinion, the most important topics that are worth being discussed at a European level in the context of the EPSAS standard setting and that are relevant for a European harmonisation relate to:

- The conceptual approach to asset recognition.
- The conceptual approach to determine the consolidation scope.

## *5.1 Conceptual approach to asset recognition*

IPSAS adopts a control-based approach to asset recognition and both recent IPSAS and IFRS developments tend to align the rules in that domain. Under ESA 2010 rules, assets are recorded by the economic owner leading in certain cases (e.g. when accounting for leases and service concession assets) to a risks and rewards approach to asset recognition, thus creating a difference with the approach based on control prescribed by international accounting standards.

The key conceptual question that may be discussed between Member States is whether the asset recognition rules under EPSAS should be based on the concept of control, or whether a model based on economic ownership allowing a risks and rewards assessment would in certain cases represent a better model.

It should be noted that all recent developments in international accounting standards go in the direction of a control-based approach to asset recognition, including for example:

- The new IFRS 16 'Leases' and the recent IPSASB proposals under ED 64 'Leases' which require all lessees to recognise a right-of-use asset[8] on their balance sheet for the right they have during the lease term, without the need to assess whether substantially all of the risks and rewards incidental to ownership of the asset leased have been transferred by the lessor to the lessee.
- The new IFRS 15 'Revenue from contracts with customers' standard and the recent IPSASB proposals for revenue and expense recognition (IPSASB CP 'Revenue and non-exchange expenses') which require revenue recognition based on a model that depicts the transfer of goods and services from the seller to the purchaser.
- IPSAS 32 'Service concession assets: grantor' which mirrors the treatment of IFRIC 12 'Service concession arrangements' which addresses the accounting treatment by the

[8] Not the same as the physical asset.

operator. Under these rules, the service concession asset is recognised on the balance of the entity that has control over it. A risks and rewards approach is not followed.

*Rationale for approach to asset recognition in view of the objectives of IPSAS financial statements and ESA 2010 reporting*

Objectives of financial statements versus objectives of statistical reporting

Accounting and statistical reports provide complementary financial information that enables users to evaluate the performance of government and the economy as a whole. Accounting and statistical standards are both primarily accrual-based but important differences arise due to differences in their underlying reporting objectives.

The objective of fnancial statements prepared in accordance with IPSAS is to provide information useful for decision making at entity level and to demonstrate the entity's accountability for the resources entrusted to it and which it controls.

The objective of ESA 2010 reporting is to provide information suitable for analysing and evaluating fiscal policy options and outcomes at macro-economic level.

Rationale for control-based approach under IPSAS versus economic ownership approach under ESA 2010

The rationale developed to justify a control-based approach to asset recognition under IPSAS and an economic ownership approach under ESA 2010 is explained below.

The IPSASB considered whether control is an essential characteristic of an asset. {...} The IPSASB acknowledges the views of those who argue that control may be difficult to apply in some cases because it requires judgment to assess whether control exists. In addition, control can be erroneously applied to a resource in its entirety and not to the individual benefits that accrue from the resource. However, notwithstanding such difficulties, the IPSASB concluded that control is an essential characteristic of an asset because the presence of control facilitates the association of an asset with a specific entity (Conceptual framework BC 5.9).

The IPSASB also considered whether the economic ownership approach is a viable alternative to the control approach. The economic ownership approach focuses on an entity's exposure to the underlying economic attributes that contribute to an asset's value to the entity. Some respondents to the Exposure Draft, Elements and Recognition in Financial Statements, in supporting the control approach, commented on the complexity of the economic ownership approach. The IPSASB concluded that the economic ownership approach is subjective and difficult to operate, and therefore rejected this approach (Conceptual framework BC 5.13).

ESA 2010 is a system for producing macro-economic statistics. As such, it records the economic reality of transactions rather than their legal form. This can involve looking through complex financial operations to understand who bears the financial risks and who has control over the rewards, irrespective of how the contracts have been constructed (MGDD, Introduction; scope and definitions, February 2016, p.4).

The notions of control and economic ownership interact with each other. For example, existence of control over a resource (e.g. an item of property, plant and equipment or a licence) facilitates the assessment that the benefits of the asset will flow to the entity that will also bear the related risks during the period of control over the asset. Conversely, for example, transfer of the risks and rewards relating to the ownership of an asset is one of the indicators to consider when assessing whether control has passed from the seller of a good to the buyer in an exchange transaction under the new proposed IPSAS revenue recognition rules (in line with IFRS 15).

However, application of the two approaches may lead to different conclusions as to asset recognition. For example, a situation that leads to a control over an asset without bearing substantially the risks and rewards related to that asset is a short-term non-cancellable lease of a building, let's say for three years. The lease would provide control over the use of the asset during three years but would typically not transfer substantially all risks and rewards incidental to ownership of the building from the lessor to the lessee. Indeed, the asset will continue to generate economic benefits and involve related risks thereafter for the rest of its useful life, which is much longer than three years.

In order to inform the debate, we present in the following table the pros and cons of the two approaches to asset recognition.

*Figure 2: Pros and cons of approaches to asset recognition*

| Approach to asset recognition | Pros | Cons |
|---|---|---|
| **Based on control** | - Complies with IPSAS and IFRS and the recent developments in these standards.<br>- Brings more consistency in the approach for the various types of assets (1).<br>- More neutral and free from bias as its application tends to require less judgment than an approach based on risks and rewards (2).<br>- More transparent as it tends to bring more assets in the balance sheet than an approach based on economic ownership (3). | - Does not comply with ESA 2010 rules and does not put the primary focus on the economic value of the asset to the entity (4). |

| | | |
|---|---|---|
| **Based on economic ownership** | - Aligns with ESA 2010 rules and focuses on the economic value of the asset to the entity (4). | - Does not comply with IPSAS and IFRS and the recent developments in these standards.<br>- Brings less consistency in the approach for the various types of assets (1).<br>- Less neutral and free from bias as application of a risks and rewards approach tends to require more judgment than an approach based on control (2).<br>- Less transparent as it tends not to report on the balance sheet assets that the entity controls (3). |

(1) Application of a control-based approach to asset recognition leads to more consistency in the way assets are recognised on the balance sheet. ED 64 'Leases' highlights for example that the previous leases standards (in IFRS and IPSAS) had two different accounting models for leases (finance leases leading to leased asset being recognised by the lessee, operating leases leading to leased asset staying on the balance sheet of the lessor) that allowed transactions that were economically similar to be accounted for very differently. Application of the control-based approach leads to recognition of assets which comply with the definition of assets in the Conceptual framework.

(2) Application of a control-based approach will make it more difficult to structure certain transactions in a way that allows assets used by the entity (and the related liabilities) to be presented off balance sheet (e.g. leased assets or service concession assets). Experience shows that off balance sheet treatment was often one key objective followed by the reporting entities when structuring a lease or service concession arrangement.

(3) Bringing assets on the balance sheet following application of a control-based approach seems to better serve the accountability and decision-making objectives of financial statements. It would provide a more comprehensive picture of the assets under the control of the government entity and therefore of the resources entrusted to that government entity, which is key information for a public sector entity. Recognition of assets on the balance sheet makes them apparent to the public and should force governments to make conscious decisions on how best to manage these assets.

(4) Adopting an economic ownership approach to asset recognition, which considers the risks and rewards associated with the asset, focuses on an entity's exposure to the underlying economic attributes that contribute to an asset's value to the entity and the related risks. From an operational viewpoint, alignment with ESA 2010 rules would allow to limit the burden of ongoing management of the differences between the two sets of rules.

## *5.2 Conceptual approach to determine the consolidation scope*

Whether or not the concept of control should prevail to determine the scope of consolidation is a very important topic for discussion in the context of the EPSAS project. This issue is dealt with in a separate issue paper 'Consolidation of financial statements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)'.

# 6 PwC's recommendations on the way forward

Based on the analysis of the pros and cons of both a control-based approach to asset recognition and an approach based on risks and rewards presented in the previous chapter, we believe there are both conceptual merits (e.g. consistency in the approach) and more compelling reasons with regards to the users' needs and accountability and decision-making objectives of financial statements (neutrality, transparency) to recommend the use of an approach built on control, as required in international accounting standards such as IPSAS and IFRS.

Member States might want to confirm or discuss whether these merits overweight the disadvantage of not being aligned with ESA 2010 rules.

Our view regarding the conceptual approach to be followed for the determination of the scope of consolidation is presented in a separate issue paper 'Consolidation of financial statements with a view to financial reporting requirements under the future European Public Sector Accounting Standards (EPSAS)'.