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**EPSAS WG 19/09.3**

**Luxembourg, 08 November 2019**

## **EPSAS Working Group meeting**

To be held in Luxembourg  
on 18-19 November 2019, starting at 09:30

### **Item 4 of the Agenda**

#### **Pilot EPSAS Screening Report**

#### **IPSAS 41 – Financial instruments**

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

*This document pilots an approach to screening the consistency of individual IPSAS standards with the draft EPSAS Conceptual Framework, with a view to informing future EPSAS standard setting. The WG is invited to discuss the approach taken, and to comment on the analysis provided and on the conclusions reached.*

# Pilot EPSAS screening report

IPSAS 41 - Financial instruments  
Draft

2019



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# 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 41

IPSAS 41 is based on International Financial Reporting Standard IFRS 9 'Financial instruments', issued by the International Accounting Standards Board (IASB) in July 2014. In developing IPSAS 41, the 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.

Main public sector differences between IFRS 9 and IPSAS 41 are summarised below<sup>1</sup>.

- IPSAS 41 contains additional application guidance to deal with concessionary loans, financial guarantee contracts entered into at nil or nominal consideration, equity instruments arising from non-exchange transactions and fair value measurement.
- In certain instances, IPSAS 41 uses different terminology from IFRS 9.
- IPSAS 41 does not distinguish between 'revenue' and 'income'. IFRS 9 distinguishes between 'revenue' and 'income', with 'income' having a broader meaning than the term 'revenue'.

Principles from IFRIC 16 'Hedges of a net investment in a foreign operation' and IFRIC 18 'Extinguishing financial liabilities with equity instruments' have been included as authoritative appendices to IPSAS 41. The IASB issues IFRICs as separate documents.

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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](https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf)<sup>1</sup>

Governments at all levels often incur large amounts of borrowings to fund their activities, including their social programs or the construction of infrastructure assets. These represent a very significant portion of liabilities in the balance sheet. They may also provide loans as financial support to government entities or to other categories of economic operators, including in times of financial distress. The financial crisis has led some governments to intervene in various ways, including by taking an investment in financial institutions that needed a capital injection or by purchasing ‘toxic’ financial assets. Sometimes, governments can provide loans at below market conditions (concessionary loans). Issuing of financial guarantees by governments on borrowing of nongovernment entities is also a significant activity in many EU Member States. Governments may issue financial guarantees for a variety of reasons, for example to support infrastructure projects, boost the economy or stabilise the financial market in times of distress, putting them at risk if the debtor defaults. Governments that have significant levels of borrowings or other financial instruments in their statement of financial position may be at risk in the case of fluctuations of exchange rates, interest rates or other variables.

The objective of IPSAS 41 is to establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity’s future cash flows.

### **Scope of the report**

The present screening report analyses the recognition, classification, measurement and (some of the) presentation requirements applicable to the financial assets and liabilities in the scope of IPSAS 41. The assessment covers authoritative pronouncements of the standard as well as non-authoritative material to support entities in applying the principles in the standard. For example, the useful application guidance on concessionary loans and financial guarantees issued through a non-exchange transaction is an integral part of IPSAS 41.

Presentation of fair value gains/losses in either “surplus or deficit” or “net assets/equity” is subject to the assessment. However, the disclosure requirements for financial assets and liabilities are covered in IPSAS 30 ‘Financial instruments: disclosures’ and are therefore not considered in this report.

### **Reference to EFRAG assessment**

Based on the requirements of Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG provided an opinion on IFRS 9 ‘Financial instruments’. EFRAG summarised its conclusions and its endorsement advice to the European Commission as follows:

*“As explained above we have concluded that IFRS 9 meets the qualitative characteristics of relevance, reliability, comparability and understandability required*

*to support economic decisions and the assessment of stewardship, leads to prudent accounting, and therefore is not contrary to the true and fair view principle. We have also concluded that IFRS 9 is conducive to the European public good. Although our conclusions have been reached on the basis of very limited quantitative assessments, we recommend IFRS 9 for endorsement without further delay, as we have learnt that data would not be available on a broad basis before 2017 when IFRS 9 implementation efforts are advanced. We therefore also recommend that the implementation of IFRS 9 is closely monitored to identify any unforeseen or unanticipated consequences that would need to be remedied. EFRAG stands ready to assist in this effort”.*

EFRAG submitted its endorsement advice on IFRS 9 ‘Financial instruments’ to the EC on 14 September 2015<sup>2</sup>.

In June 2018, the European Commission requested EFRAG to consider the accounting for equity instruments from a long-term investment perspective. The objective is to identify possible accounting treatments that would properly portray the performance and risk of long-term investment business models. On 6 May 2019, EFRAG launched a public consultation to gather constituents' views on whether alternative accounting treatments to those in IFRS 9 are needed to portray the performance and risks of equity and equity-type instruments held in long-term investment business models. The project is active at the date of this report. Currently it is not possible to assess its potential impact on the IFRS 9 accounting model.

### **Reference to EPSAS issue papers and other EPSAS preparatory work**

The PwC study of 2014<sup>3</sup> analysed the suitability of the IPSAS standards as a basis for developing EPSAS. This included the analysis of IPSAS 29 ‘Financial instruments: recognition and measurement’. Following this analysis, IPSAS 29 was classified among the category ‘Standards that (may) need (some) amendments or for which implementation guidance is (may be) needed’.

The study included the following extract that summarises the comments received from the Member States on IPSAS 29 and the analysis of these comments by PwC:

‘Concerns relating to this standard are mostly expressed in general terms, including the appropriateness to apply fair value measurement for public sector entities. While we do not believe that there is an urgent need to change much in the standard, except as part of the normal maintenance plan of the standards (and the need to follow up the latest developments in IFRS), it is probably sound to confirm the basic principles and objectives underlying financial instruments accounting. This mainly concerns the need to reflect in a transparent way in the financial statements the substance of the (sometimes complex) financing arrangements, the financial risks

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<sup>2</sup> <https://www.efrag.org/Activities/328/IFRS-9---Financial-Instruments?AspxAutoDetectCookieSupport=1>

<sup>3</sup> See PwC, 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, 2013/S 107-182395, 1 August 2014

that are taken by governments when they enter into significant and risky transactions, including financial guarantees, use of derivatives, investments in financial institutions or other private entities. Governments at all levels also often incur large amounts of borrowings to fund their activities, including their social programs or the construction of infrastructure assets. These transactions should be properly reflected in the financial statements. It should finally be reminded that the IPSASB plans to publish a standard dealing with financial instruments issues that are specific to the public sector in 2016.'

The study also notes that most complex financial instruments transactions are often managed centrally, involving a limited number of specialists (treasurers, etc.), therefore mitigating the comments on the cost and complexity of IPSAS 29.

The IPSASB issued IPSAS 41 as a replacement of IPSAS 29 in August 2018. The new standard brings significant improvements to the existing recognition and measurement rules relating to financial instruments in three main areas:

- a new single classification and measurement model for financial assets that considers the characteristics of the asset's cash flows and the objective for which the asset is held;
- a single forward-looking impairment model, the expected credit loss (ECL) model, that is applicable to all financial instruments subject to impairment testing;
- an improved hedge accounting model that broadens the hedging relationships in scope of the guidance. The model develops a strong link between an entity's risk management strategies and the accounting treatment for instruments held as part of the risk management strategy.

During 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 during 2016-2018. The papers are all publically available on Eurostat's website. Two EPSAS IPs addressing financial instrument topics were produced in 2018. The topics covered were the accounting treatment of loans and borrowings on the one hand, and the accounting treatment of financial guarantees on the other hand.

Each of the IPs seek 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.

Eurostat tentatively concluded the following in respect of the papers covering financial instruments topics:

- the “symmetric” recognition of claims and liabilities in the creditors and debtors accounts, a key condition in national accounts, is not necessarily transferrable where it leads to a breach of financial accounting principles and in particular that of “prudence”;
- overly-simple solutions would not help in the case of complex financial instruments. Where entities enter in the complex financial instruments, they should also be prepared to comply with recognition and measurement principles. Appropriate information should also be reported to users about the risks relating to those instruments;
- the new IPSAS 41 had drawn conclusions from the recent financial crisis. Prudence was a key driver behind the approach of the new standard;
- so-called “day one” losses should be recognised, in particular for concessionary loans;
- guidance is necessary for the consistent application of the new standard and in particular the new approach to measurement following the Expected Credit Loss (ECL) model.



# Screening of IPSAS 41 Financial instruments against EPSAS endorsement criteria

## Introduction

The EPSAS criteria listed in the EPSAS CF have been used to perform an assessment of IPSAS 41 “Financial Instruments”, published in 2014 by the IPSAS board and effective for the annual periods commencing after 1 January 2022.

Financial instruments can represent a significant proportion of an entity’s assets and liabilities and play an important role in managing the risks and generating cash flows for the investors. They have different forms and different levels of complexity. Therefore, it is important to maintain a principle based set of standards, able to provide consistent accounting treatment for a broad range of transactions in the scope of IPSAS 41. Creating unnecessary guidance for specific/standard contracts would not meet the objectives of the EPSAS CF to provide relevant information to the users in the complex area of financial instruments.

When governments enter into major risky transactions using financial instruments, the accounting treatment of such transactions should reflect these risks and the substance of the arrangements, in the same way as for private companies. Examples include complex financing arrangements, financial guarantees, use of derivatives, investments in financial institutions or other private entities. This is the reason why IPSAS 41 has no major revisions compared to the IFRS equivalent standard IFRS 9, effective since 2018 and already "tested" in the private sector environment. No conceptual issues were identified that could have an impact on the assessment of the qualitative characteristics of the EPSAS CF.

In order to develop recommendations, one should first considered whether IPSAS 41 would meet the qualitative characteristics of the 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, classification and measurement (as well as some presentation) requirements applicable to financial instruments, as well as other items in the scope of IPSAS 41 for each of the qualitative characteristics of the EPSAS framework.

Further, this paper includes a high-level comparison between the requirements of IPSAS 41 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.

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

## **Relevance**

### *Recognition and de-recognition of financial assets and financial liabilities*

Accounting complexity around de-recognition rules of financial assets and financial liabilities requires public sector entities to apply the assessment criteria carefully to the individual material transactions. Professional judgment is needed to determine whether de-recognition criteria are met or not.

IPSAS 41 requires no symmetrical approach to de-recognition of financial assets and liabilities in cases where the contractual cash flows are modified. A modification in contractual cash flows does not necessarily result in the derecognition of the financial asset. For financial liabilities, the legal extinguishment test is generally well understood by preparers and reflects the transfer of legal rights and obligations relating to the financial liabilities. In order to help entities in more complex situations, a quantitative test is helpful in determining whether the significant change in the cash flows requires an extinguishment accounting. Governments could apply different interpretations with different accounting impacts for gains and losses upon modification and subsequent measurement.

In order to enhance the relevance and comparability of the information, appropriate disclosures help understand the practical consequences of the derecognition rules for financial assets and liabilities, especially as a result of modifications in contractual cash flows.

### *Classification and measurement*

The classification of financial assets is the foundation for the requirements relating to the measurement of financial assets on an ongoing basis, and the requirements for impairment and hedge accounting.

IPSAS 41 provides one single approach for the classification of all financial assets. The two criteria used to determine how financial assets should be classified and measured are:

- The entity's management model for managing the financial assets; and
- The contractual cash flow characteristics of the financial assets.

IPSAS 41 also allows an entity to elect to account for financial assets at fair value through surplus/deficit in some cases, to eliminate an accounting mismatch between financial assets and liabilities. In addition, there is an irrevocable option to present in net assets/equity subsequent changes in the fair value of an investment in an equity instrument that is neither held for trading nor contingent consideration in a public sector combination.

The classification criteria provide relevant information because the contractual cash flows and the management model of the financial assets are important for making decisions and assessing performance of the financial instruments portfolios. Besides, the classification and measurement approach in IPSAS 41 has no complex bifurcation requirements for financial assets. This approach should achieve the right balance between relevance and reliability of the information available to the users about the complex financial assets with variable cash flows.

Taking into account the management model in determining the accounting for financial assets provides a basis for increased relevance for some but not all financial assets. Indeed, only assets having cash flows which are 'solely payments of principal and interest' ('SPPI') can subsequently result in amortised cost or fair value measurement based on the management model. Assets not meeting the SPPI test are measured at fair value.

Considering the balance between the objectives of relevance and understandability, the use of the management model test for financial assets (both originated and acquired) with basic loan features provides an adequate basis for classification and measurement. Consequently, such financial assets can be categorised based upon the criteria that faithfully represent the instruments' characteristics and the objectives of various investment strategies.

IPSAS 41 provides a single forward-looking impairment model for the assets not measured at fair value through surplus/deficit that eliminates the threshold for impairment recognition.

The forward-looking model requires an entity to recognise expected credit losses at all times, applying a dual measurement approach based on 12-months expected losses or life-time expected losses. The complexity of this dual approach is partially mitigated by useful practical expedients for certain groups of financial assets (such as assets that result from exchange transactions that are within the scope of IPSAS 9 and non-exchange transactions in the scope of IPSAS 23). For smaller public sector entities, these practical expedients help reduce the cost of implementation and compliance with the forward-looking impairment model requirements.

The requirement to use amortised cost measurement in certain cases and fair value measurement in other cases leads to relevant information. For example, amortised cost provides the most relevant information for measuring many financial liabilities as it reflects the issuer's legal obligation to pay the contractual amounts. The same applies to financial assets that are basic loans in the hold to collect business model. The fair value information is less relevant in these cases because it does not reflect the expected cash flows. However, when financial liabilities are held for trading, the entity's short-term objective is not to repay the contractual amount due but rather to achieve a trading result from repurchasing it. In such cases, fair value provides more relevant information compared to amortised cost.

The fact that IPSAS 41 requires changes in fair value due to changes in the entity's own credit risk to be presented in net assets/equity further contributes to the relevance of the information.

### *Hedge accounting*

IPSAS 41 significantly improves the requirements for applying hedge accounting, giving new possibilities in applying this accounting technique (e.g. hedging risk components of non-financial items, net positions, aggregate exposures, layers, etc.) Some other requirements regarding hedge accounting are simplified, (e.g. the hedge effectiveness range of 80-125% in which entities had to fall under the previous standard does not exist any more. Instead, entities set themselves the threshold in line with their own hedging objectives). Applying hedge accounting in cases where it was not possible before brings the financial statements closer to risk management practice of public sector entities, thus contributing to the relevance of information provided to the users of financial statements.

### **Faithful representation / Reliability**

#### *SPPI test*

The implementation of the cash flow characteristics criterion requires judgment to ensure that financial assets are classified into the appropriate category. To mitigate the potential risk on inappropriate accounting treatment, IPSAS 41 includes substantial guidance on specific contractual features and terms that indicate in which cases the cash flow characteristics test is expected to be met.

The assessment of the business model criterion increases the complexity, at the risk of affecting the reliability of the information because preparers have to separate similar SPPI compliant financial assets between the amortised cost category and the fair value through net assets/equity category, requiring judgement to evaluate the distinguishing factors for each portfolio.

#### *Fair value option*

An irrevocable designation at inception of a financial asset as at fair value through surplus/deficit if it eliminates or significantly reduces an accounting mismatch may bring some limitation to the relevance of the information. Indeed, if the reason for choosing the fair value option disappears, the ongoing fair value measurement may give rise to an accounting mismatch. However, strict reclassification restrictions in IPSAS 41 are justified by the increased reliability of the information.

#### *Expected credit loss model*

An assessment of the significant increase in credit risk takes into consideration only the changes in the risk of a default occurring rather than changes in the amount of expected credit losses. This aligns the assessment of changes in credit risk with the way probabilities of default are generally tracked in practice and provides reliable information about the practices of the holders of the financial assets. The level of judgement required for recognition of expected credit losses is substantial as the financial information is being prepared taking into account high levels of uncertainty (and is difficult to track back to the source information/assumptions included in the financial models). On the other hand, extensive information related to the inputs, assumptions and estimation techniques used should be disclosed. This contributes

to the reliability of the information, yet might not achieve an absolute level of comparability between the public sector entities.

### *Investments in unquoted equity securities*

IPSAS 41 requires all investments in equity instruments, and derivatives over them, to be measured at fair value. This includes investments in and derivatives over, unquoted equity instruments that cannot be measured with sufficient degree of reliability. In cases where the fair value measurement is based upon unobservable inputs, disclosures are able to provide the essential information to users. Despite this limitation, the rare cases where fair value cannot be determined are covered by the exception to fair value measurement provided in the standard.

The notion of faithful representation and reliability in the EPSAS CF is supported by the qualitative characteristics of completeness, prudence, neutrality, verifiability and substance over form. These are separately discussed below.

### **Completeness**

The completeness of the information requirements of the standard should be assessed together with additional extensive disclosure requirements of IPSAS 30. For example, to make expected credit loss information reliable, additional disclosures of inputs, assumptions and estimation techniques must be presented. The analysis of the suitability of the disclosure requirements of IPSAS 30 is not covered in this report.

### **Prudence**

#### *Initial recognition of financial instruments measured at fair value*

The transaction price is generally considered the best evidence of the financial instrument's initial fair value. However, it is possible for an entity to determine that the instrument's fair value is not the transaction price. In this case, the surplus or deficit on initial recognition is only recognised if fair value is evidenced by a quoted price in an active market for an identical asset or liability (that is, a level 1 input) or based on a valuation technique that uses only data from observable markets. This way the recognition of day one surpluses and deficits is only applied in a limited number of cases and prudence considerations prevail over fair value considerations.

#### *Classification and measurement*

With some exceptions (justified by other QCs such as relevance and reliability), fair value measurement is required for all financial assets and for some financial liabilities.

For example, the contractual cash flow test excludes financial instruments with contractual features that give rise to exposure to risks or changes in value unrelated to a basic lending instrument from the amortised cost measurement basis. Financial instruments with such contractual features would be measured at fair value through surplus/deficit, even though the entity might hold such instruments to collect contractual cash flows. The cash flows of such instruments are generally less

predictable and thus amortised cost is a less relevant representation of the future cash flows. Therefore, a fair value measurement basis for this type of financial assets is not contrary to the principle of prudence.

### *ECL model*

Due to its forward-looking nature, the IPSAS 41 ECL model broadens the information that an entity is required to consider when it determines its expectation of credit losses. Consequently, more timely information is required about expected credit losses and it provides financial statement users the ability to make better decisions.

The forward-looking impairment model of IPSAS 41, inspired by its IFRS equivalent, responds to the objective of G20 'to strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information'. ECL model considers all relevant credit information, including macroeconomic factors, and provides more timely recognition of economic losses upon significant credit deterioration when full lifetime expected losses have to be recognised. This approach ensures that the losses will react to deteriorating economic conditions in a timely manner, resulting in prudent measurement of financial assets subject to credit risk, such as loans granted by governments to various public and private entities.

The forward-looking ECL impairment model anticipates recognition of impairment losses in case of financial crisis when the risks relating to financial assets increase. The IPSAS 41 approach produces relevant information, under the assumption that the expected credit loss valuation techniques and assumptions are disclosed with sufficient details.

### *Investments in equity instruments - optional presentation of fair value changes outside surplus/deficit*

The option to present changes in the fair value of equity instruments in net assets/equity ensures that entities do not have to recognise fair value movements in surplus/deficit. This is a prudent approach, especially relevant if investments are held as part of a long-term investment business model. In this presentation approach, no unrealised gains/losses are presented in the surplus/deficit.

## **Neutrality**

IPSAS 41 requires recognition of all financial assets and liabilities and provides consistent measurement principles for all classification categories, achieving neutral presentation of the inflows and outflows of economic benefits and thus the economic reality.

As for measurement, the value at initial recognition is only different from the transaction price if it relies on a quoted price in an active market for an identical asset or liability or based on a valuation technique that uses only the observable market data. This way the possible manipulation is minimised by referencing to the market price that is supposed to be neutral and free from bias.

## **Verifiability**

Fair value information is less verifiable compared to amortised cost, and involves certain assumptions that are not always observable on the market. Although it would have an impact on the assessment of verifiability, it improves relevance of the information required for the decision-making.

Governments have to make certain assumptions in applying the principle based classification and measurement requirements. In such cases, the standard requires the use of verifiable data rather than management intentions to serve as a basis for the accounting records. When determining the fair value, the standard requires the use of observable data and valuation techniques that maximise the use of observable market data as inputs.

Another example is the business model test. The business model is assessed at a level that reflects the way groups of basic lending instruments are managed together to achieve a particular business objective and is observable through the particular activities that the entity undertakes to achieve the particular business objective. As such, a business model is a matter of fact rather than an assertion, which helps produce information that is verifiable. Again, any reclassifications are possible only following the change in the business model of an entity.

## **Substance over form**

IPSAS 41 (as a principle-based standard) is designed to reflect the substance of an economic phenomenon instead of merely providing information about its legal form. In case the legal form differs from the substance of an economic phenomenon, relevant information is provided in order for the users to understand the difference.

In some accounting frameworks, classification and measurement of financial instruments is driven by legal form rather than by economic substance. An approach based on economic substance is superior to one based on the legal form; therefore IPSAS 41 is more appropriate in this regard. The requirements of the standard properly address the need to reflect in a transparent way the substance of the (sometimes complex) financing arrangements, the financial risks that are taken by governments when they enter into significant and risky transactions, including financial guarantees, derivatives, investments in financial institutions or other private entities.

Governments at all levels often incur large amounts of borrowings to fund their activities, including their social programs or the construction of infrastructure assets. The substance of these transactions should be reflected in the financial statements as either financial liabilities or equity instruments.

Based on our assessment, the principle-based classification and measurement requirements of IPSAS 41 achieve an adequate reflection of risks and the expected cash flows of a broad range of financial instruments of governments. The standard requires an assessment of the substance of contractual arrangements and (in some cases) the purpose of entering into the contractual arrangements.

## **Understandability**

The assessment of this QC depends on the level of complexity of the existing processes and models currently in place in the public sector entity. For example, the expected credit loss model is based on principles and, except for a few practical expedients, avoids bright lines and thresholds. It can be aligned to the existing internal policies and practices to the maximum possible extent, to reflect management's assessment of the economic phenomena.

The hedge accounting model in IPSAS 41 significantly reduces the arbitrary rule-based requirements, enabling the alignment of hedge accounting more closely with the risk management practices adopted when hedging financial and non-financial risks. This enables entities to better reflect their risk management practices in their financial statements, with additional disclosures to allow the users to understand the risks the entity faces, the risk management strategies in place and assess the effectiveness of these strategies.

Based on our assessment, complexity of some of the requirements of IPSAS 41 does not impair understandability, provided appropriate disclosures be provided as required by IPSAS and assuming users have a reasonable knowledge of financial markets. Therefore, the standard satisfies the understandability criterion.

## **Timeliness**

As mentioned above under QC 'prudence', the new ECL model takes a forward-looking view to the recognition of credit losses and therefore provides timely information about such losses.

## **Comparability**

### *Classification and measurement of financial assets (investments in debt securities)*

IPSAS 41 contains an option to designate a financial asset as at fair value through surplus/deficit if it eliminates or significantly reduces accounting mismatches that would otherwise result from measuring economically matched assets or liabilities on different bases. Without the use of the option, economically matched assets and liabilities could generate gains or losses in surplus/deficit that would not be a proper reflection of economic reality. This option results in relevant information and does not affect comparability assessment.

### *ECL model*

Significant levels of complexity in the models that entities must develop could be considered as obstacles to comparability and will require a significant implementation effort. However, the existence of various practical expedients in the ECL model will be very helpful in achieving the right balance between the cost and benefits of implementing the requirements.

A uniform ECL approach brings a uniform calculation basis for impairment applicable to all financial instruments in its scope. This leads to comparable information despite



complexity of the requirements and implementation challenges identified by the public sector preparers.

In order to achieve consistent application of the new standard within the EU context and therefore even better address the comparability objective of EPSAS financial statements, additional appropriate guidance may need to be provided.

#### *Investments in equity instruments*

The option to present changes in the fair value of equity instruments in net assets/equity unless the equity instrument is held for trading ensures that entities do not have to recognise short-term changes in fair value in surplus/deficit. However, gains and losses on investments in equity instruments re-measured through net assets/equity will never affect surplus/deficit even when the investment is sold. Further, no impairment loss will ever be recognised in surplus/deficit; this potentially limits the relevance and comparability of the information, especially in case of long-term equity investors.

The “neutral depiction” objective is met despite less comparable information presented in surplus/deficit because this presentation option is available only upon initial recognition and cannot be reconsidered at a future date. An alternative fair value model (with recycling of the gain and losses upon disposal) to the investments in equity instruments would require a conceptually sound impairment model for equity instruments - a challenging area, resulting in additional complexity/implementation cost and creating even more potential for diverse practices. The benefits of the proposed option comprise simplicity (no recycling, no impairment testing) and consistency with measurement of other financial instruments at fair value (as opposed to the lower of cost and market approach).

#### *Hedge accounting*

Hedge accounting is not mandatory. Hence, because entities are able to choose whether to use hedge accounting or not, this option limits comparability of the financial statements.

### **Alignment with ESA 2010 rules**

Alignment with ESA reporting is desirable, to avoid the burden of a dual reporting in the public sector. Differences with ESA reporting requirements should be avoided where possible, both regarding the scope of entities to be included in the IPSAS scope of reporting and the IPSAS requirements in terms of measurement and disclosures.

In the area of recognition and de-recognition, alignment with ESA is considerable. Financial assets and liabilities (with some limited exceptions) generally qualify for recognition in the statement of financial position under both frameworks, although there are significant differences in the classification and measurement. De-recognition of financial assets is based on the transfer of risks and rewards of ownership under both ESA 2010 and IPSAS 41. Nevertheless, practical application

of derecognition criteria could lead to different conclusions under both frameworks, since the wording used to describe the derecognition criteria is not identical.

For classification and measurement of financial assets, differences exist. Under ESA 2010 rules, loans, as non-negotiable financial instruments, are recorded at nominal value. Debt securities, as negotiable financial instruments such as bonds, are valued at market value. To keep symmetry between loans financial assets and financial liabilities, the value non-performing loans is kept at nominal value but both the nominal value and the fair value of such loans are disclosed as memorandum items.

Fundamental differences in the measurement of financial assets therefore exist between IPSAS 41 and ESA 2010 requirements.

For some financial assets the amortised cost measurement basis would not be materially different from the nominal value (the amount of principal due, including the interest accrued). For many other financial assets (concessionary loans and other instruments, including the investments in the listed bonds that meet the conditions for the amortised cost classification under IPSAS 41), classification and measurement will be different compared to the ESA 2010 requirements.

### **Alignment with IFRS<sup>4</sup>**

IFRS 9 was used as a basis to develop IPSAS 41. Additional guidance and illustrative material are included in IPSAS 41 to address public sector specificities. This includes for example:

- additional illustrative examples related to concessionary loans;
- fair value measurement guidance specific to the valuation of unquoted equity instruments;
- equity transactions with a non-exchange component.

The above guidance is helpful in achieving the objective of comparability between public sector entities without creating unnecessary differences between IFRS and IPSAS.

### **Alignment with EU Accounting Rules**

EU Accounting Rule (AR) 11 prescribes the accounting treatment of financial instruments and applies to the classification, presentation, recognition and measurement of financial instruments as well as to disclosures on financial instruments and the risk management in the context of financial instruments. EU AR 11 is derived from IPSAS 28-30, IPSAS 29 has been superseded by IPSAS 41 that is effective for annual periods beginning on or after 1 January 2022. A detailed comparison of the requirements of AR 11 and IPSAS 41 would therefore include differences for all the new requirements of IPSAS 41, as compared to the previous accounting standard IPSAS 29.

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<sup>4</sup> 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](https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf)

# Conclusion

## Assessing IPSAS 41 against the criteria formulated in the EPSAS CF

The analysis has not revealed major conceptual issues with IPSAS 41 'Financial instruments' and has not identified any inconsistency between IPSAS 41 and the EPSAS CF.

Following the screening analysis summarised in the present report, it can be concluded that:

- IPSAS 41 provides 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;
- the information resulting from the application of IPSAS 41 would not be contrary to the true and fair view principle.

This conclusion is drawn even considering the following areas that have been identified as the most challenging because of judgmental aspects involved in assessing various qualitative characteristics:

- *Consistent measurement approach.* According to IPSAS 41, excepted for basic lending instruments (potentially eligible for measurement at amortised cost), all other financial assets are measured at fair value. Moreover, the consistent measurement approach is reflected in a single model based on the principle of expected, rather than incurred, credit losses resulting in earlier recognition of credit losses. These features of the standard are improvements to the diverse current accounting practices since they combine both confirmatory and predictive values to the users of the GPFs and address some of the issues of other accounting frameworks. In particular, IPSAS 41 will improve timeliness of recognition of credit losses, reduce diversity/complexity of impairment models and eliminate reporting of changes in own creditworthiness in surplus/deficit.
- *Option to recognise gains and losses on investments in equity instruments in the net assets/equity.* For the investments in equity instruments (optionally re-measured through net assets/equity), no impairment loss will ever be recognised in surplus/deficit. This option potentially limits the relevance and comparability of the information, especially in case of long-term equity investors. On the other hand, an alternative fair value model (with recycling of the gain and losses upon disposal) to the investments in equity instruments would require a conceptually sound impairment model for equity instruments -

a challenging area, resulting in additional complexity/implementation cost and creating even more potential for diverse practices.

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, guidance is desirable, in particular concerning the new approach to determining impairment losses under the Expected Credit Loss (ECL) model of IPSAS 41.

### **Assessing whether IPSAS 41 is conducive to the European public good**

The assessment of whether IPSAS 41 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. If the assessment concludes there is a net benefit, the standard will be conducive to the objectives of the European public good.

The analysis revealed no reasons why IPSAS 41 would not be conducive to the European public good:

- IPSAS 41 will contribute to improving financial reporting when compared to heterogeneous reporting requirements currently applied in the EU. It will bring a distinct improvement in the impairment of financial assets and hedge accounting, whilst bringing relevant accounting for basic lending and other financial instruments. Further, the improvements in accounting for the impairment of financial assets meet the objective of having a forward-looking impairment model that leads to more timely recognition of expected credit losses. In doing so, the impairment requirements are expected to contribute to financial stability. Furthermore, users will be able to distinguish between instruments for which the credit risk has increased significantly and those for which it has not.
- Implementation of the standard may result in one-off costs and should be relatively cost neutral on an ongoing basis for preparers. The benefits derived from the improvements should however outweigh the costs. A proportionate pragmatic approach to implementation contributes to this objective.
- Some lenders may face fluctuations in surplus/deficit because of the requirement to measure financial assets that do not meet the cash flow characteristics test at fair value through surplus or deficit. This requirement may have an impact on the decisions about the financial instruments offered to borrowers. Besides, accounting for equity instruments at fair value could have

an impact on the long-term investors, because prohibition on recycling gains and losses in the optional model may not properly reflect their performance. The above does not lead to conclude that implementation of IPSAS 41 would not be conducive to the objectives of the European public good.

The assessment concludes that there will be a net benefit of using the requirements of IPSAS 41 as a starting point in implementing the equivalent EPSAS (considering the need for additional guidance in applying the ECL model and possibly in other areas). The standard will be conducive to the objectives of the European public good.