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

Draft EPSAS Screening Report
IPSAS 35 – Consolidated financial statements

Paper by PwC in cooperation with Eurostat

- for discussion -

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

EPSAS screening report

IPSAS 35 - Consolidated financial statements

May 2021

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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 35

This International Public Sector Accounting Standard (IPSAS) deals with the consolidated financial statements in the public sector. This standard is drawn primarily from IFRS 10, "Consolidated financial statements", which was issued by the International Accounting Standards Board (IASB) in May 2011.

In developing IPSAS 35, the International Public Sector Accounting Standards Board (IPSASB) applied its 'Process for Reviewing and Modifying IASB Documents' that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

The topic of consolidation, especially the determination of the consolidation scope, is crucial for the EPSAS project because it determines those entities that should be included into the scope of the EPSAS financial statements, and directly affects those entities that potentially need to be part of an accounting reform to be undertaken by Member States.

According to the draft EPSAS conceptual framework (version April 2018[1]), the determination of which public sector reporting entities should provide GPFRs under the EPSAS basis of accounting (i.e. the EPSAS reporting boundary) should be based on decision-making and accountability considerations, and be specified at the level of EPSAS standards with due regard to the circumstances of smaller and less risky entities.

[1] The latest version of the proposed Reporting Entity definition, sent to the EPSAS Working Group members in June 2020, defines the EPSAS reporting boundary along the lines of the ESA 2010 based public sector by also allowing exceptions for commercial entities controlled by the general government entities.

The objective of IPSAS 35 is to establish principles for the preparation and presentation of consolidated financial statements when an entity controls one or more other entities.

The key concept in the standard is indeed the concept of control. IPSAS 35 requires controlling entities to prepare financial statements that consolidate controlled entities on a line-by-line basis. Intragroup transactions should be eliminated. IPSAS 35 also provides a detailed discussion of the concept of control as it applies in the public sector, and guidance on determining whether control exists for financial reporting purposes. Consistent with the requirements of IPSAS 35, entities that are not part of the general government sector as defined in statistical bases of financial reporting, but that are controlled entities of the government, should be consolidated in the government's financial statements.

IPSAS 35 requires that a controlling entity that is an investment entity account for its investments at fair value through surplus/deficit. According to the IPSASB, entities that might meet the definition of an investment entity include a relatively small number of public sector entities (for example, some sovereign wealth funds, some pension funds and some funds holding controlling interests in public-private partnership projects (PPP) or private finance initiatives (PFI)) (IPSAS 35 BC20). The consistent requirements to account for investments at fair value through surplus/deficit in IPSASs and IFRSs should reduce any opportunity for accounting arbitrage when determining which accounting standards an investment entity should be required to apply.

Scope of the report

The present screening report analyses the preparation and presentation of consolidated financial statements for the economic entity.

Reference to EFRAG assessment

IPSAS 35 deals with the consolidated financial statements of public sector entities while IFRS 10 is applicable to consolidated financial statements of profit-oriented entities.

EFRAG published its final endorsement advice on IFRS 10, IFRS 11 and IFRS 12 on 30 March 2012[2]. EFRAG's assessment is that it supports the adoption of the standards and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that they:

- are not contrary to the principle of 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

[2] Endorsement advice on IFRS 10, 11, 12 is available on: http://old.efrag.org/files/EFRAG%20public%20letters/Consolidation/Final_Endorsement_Advice/Final_Endorsement_Advice_-_IFRS_10_IFRS_11_IFRS_12_IAS_27_and_IAS_28.pdf

- meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt the standards.

Later on, EFRAG (in the final letter to the European Commission regarding endorsement of investment entities dated 22 July 2015) assessed positively the amendments to IFRS 10 clarifying the following aspects of the accounting requirements for entities that qualify as investment entities under IFRS 10:

Exemption from presenting consolidated financial statements under IFRS 10. This exemption is available to a subsidiary of an investment company which is an intermediate parent entity, the ultimate parent of such entity, being an investment entity, does not consolidate this subsidiary in its financial statements.

Accounting for a subsidiary that is an investment entity and provides investment-related services under IFRS 10. This amendment clarifies that an investment entity should consolidate a subsidiary that is not an investment entity itself, and its main purpose and activities are providing services that relate to the investment entity's investment activities.

In addition, according to the EFRAG assessment, the amendments provide relief in certain circumstances, and so reduce the costs to preparers of applying IFRS.

Reference to EPSAS issue papers[3]

The PwC study of 2014[4] analysed the suitability of the IPSAS standards as a basis for developing EPSAS. This included the analysis of IPSAS 6 "Consolidated financial statements", the standard preceding IPSAS 35.

Following this analysis, IPSAS 6 was classified among the category 'Standards that may need amendments or for which implementation guidance is needed'. The emphasis was placed on the following considerations.

As the primary purpose of the EPSAS project is to implement harmonised accrual accounting systems across all subsectors of general government in Europe, the important thing is to define the boundaries of the entities that will be required to report under the new EPSAS rules.

The issue regarding preparation of consolidated financial statements is related to the efforts and costs of preparation. The PwC report of 2014 indicates a relatively low accounting maturity across the EU (54%) and mentions the practical challenges: "One

[3] EPSAS Issues papers are available on https://ec.europa.eu/eurostat/web/epsas/key-documents/technical-developments
[4] Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards (Ref. 2013/S 107-182395)

of the biggest challenges of the consolidation process is to make sure that all entities that should be included in the scope are effectively consolidated...The practical challenge of gathering information across a series of entities with different financial systems should not be underestimated...".

The preparation of the consolidated financial statements should be driven by the users' needs. Chapter 9 of the PwC study of 2014 identifies groups of users for the future EPSAS reporting. The users identified in the document were the following: preparers (Ministry of Finance and operational finance and accounting departments), auditors, internal users (public administration, Parliament and other policy makers), external users (taxpayers and service recipients, media, financial markets, EU institutions and national statistical offices as well as other users such as other international organisations, academics and private sector service providers). The draft EPSAS CF stresses that it is in the public interest to have comprehensive and complete financial statements providing a true and fair view of the financial position, financial performance and cash flows of the public sector reporting entity for accountability and decision-making purposes. To achieve this, it is very important that all transactions and events of a public sector reporting entity be properly reported in the consolidated financial statements of that entity.

Each entity should develop a good understanding of the users of its GPFSs and their needs. For example, the public administration can use financial information to demonstrate accountability, evaluate performance and inform decision-making. Policy makers are held accountable for the results achieved and rely on financial information to assess past performance in the civil service and inform future resource allocation decisions. Citizens are interested in assessing government performance and hold them accountable for the good use of public money, while fund providers are primarily interested in the financial capacity of the reporting entity. They may use the information included in the financial statements when making voting and investment decisions.

Finally, users may also be interested by financial information that is combined for a group of entities, irrespective of whether a control relationship exists between these entities (for example whole-of-government accounts may provide useful information on the financial position and performance of a country, even if no control relationship exists between the various governments whose financial statements are combined).

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

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

The first two topics are of a conceptual nature and are closely related to the objective of accountability and decision-making needs. The third topic is more of an organisational nature.

As discussed in the EPSAS Issue Paper on Consolidation of financial statements, the requirements to produce consolidated financial statements within one country are very much dependent on how reporting entities have been defined within that country, which in turn may be linked to the institutional landscape of the country. Consolidated financial statements must for example generally be prepared for the central government reporting entity and at the level of each local government.

A question that arises in the context of the EPSAS project is also whether, in addition to the above, whole-of-government accounts (WGA), i.e. consolidated accounts giving the full picture of the public sector of one nation, should be prepared.

The scope of the EPSAS financial statements should include those entities or transactions that significantly impact or could potentially significantly impact government public finances and government key metrics, such as government debt and surplus or deficit. Material and complex transactions that are structured through separate legal entities (securitisations, PPPs, sale and leaseback transactions etc.) should be properly reflected in the government's consolidated financial statements.

Eurostat tentatively concluded:

- It is important to have a clear understanding of the notion of control in IPSAS as used in the context of assets and for consolidation. Despite some differences both concepts are consistent in their philosophy.

- It is also important to outline the differences between the control-based approach in IPSAS and the risks and rewards approach in ESA 2010. EPSAS as a financial accounting project should stay as close as possible to the concept of IPSAS, which is the control approach.

- EPSAS should enable consistent and comprehensive public accounting systems delivering information for ESA 2010 purposes. The definition of the scope of EPSAS provided in the draft EPSAS Conceptual Framework provided the basis for that purpose, at least from the point of view of the source data for national accounts.

- Differences between primary private and public sector accruals-based accounting bases are not necessarily a major obstacle for consolidation as in most cases the differences between IPSASs and national financial accounting standards could be overcome in a similar manner as those between IFRS and national standards.

- “True and fair view”, in combination with the notion of “public interest”, provides the necessary conceptual basis for compiling whole of government accounts.

- When consolidating whole-of-government accounts with a view to delivering financial information for decision-making and accountability, the focus should be placed on the public sector (rather than general government sector).

- There is also a need to reconcile the financial accounting and the ESA 2010 reporting frameworks. IPSAS 22 and/ or IPSAS 18, or modified versions thereof, could be highly helpful in achieving this objective, in particular for reconciliation between the whole of government accounts and the ESA 2010 aggregates. Examples from several countries show the feasibility of reconciling between whole of government accounts and ESA 2010 aggregates.

- Working towards consistency between EPSAS and ESA, and reconciling figures between them, does not mean that one framework would substitute the other. The objective is rather to eliminate unnecessary differences and to be in the position to explain the remaining differences to the users.

- Finally, ESA is not an entity-level reporting framework serving decision-making and accountability. However, the compilation of data for ESA purposes needs comprehensive, consistent and comparable entity-level information which is subject to internal control and external audit.

Screening of IPSAS 35 ‘Consolidated financial statements’ against criteria set in the draft EPSAS framework

Introduction

The EPSAS criteria listed in the draft EPSAS framework have been used to perform an assessment of IPSAS 35 ‘Consolidated financial statements’, issued in January 2015 by the IPSASB.

In order to develop recommendations, one should first consider whether IPSAS 35 would meet the qualitative characteristics of the draft EPSAS CF, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

Consolidation is the process of presenting financial statements of all entities that make up the reporting entity on a consolidated basis, i.e. as if they were the financial statements of a single economic entity. Consolidation of financial statements provides useful financial information and delivers benefits both for accountability and decision-making purposes. This is in addition to the benefits brought by the production of the financial statements at the level of each individual entity.

This report analyses the consolidation requirements in IPSAS 35 against each of the qualitative characteristics of the draft EPSAS CF.

Further, this paper includes a high-level comparison between the requirements of IPSAS 35 and other international accounting and financial reporting frameworks applied by the public sector entities in various jurisdictions, such as IFRS, ESA 2010 and EU Accounting Rules, bearing in mind the objective of alignment, reduction of cost of implementation and compliance cost.

Finally, the paper assesses whether IPSAS 35 would be conducive to the European public good.

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

Conformity with Qualitative Characteristics

Relevance

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

The standard addresses two main issues related to the preparation of consolidated financial statements:

- The determination of the consolidation scope, which aims at defining which entities are included in the consolidated financial statements.
- The technique and procedure that are applied in the preparation of the consolidated financial statements.

Determining the consolidation scope

Determining which entities are included in the consolidation scope is based on the concept of control. Consolidated financial statements should include the accounts of the controlling entity and those of all controlled entities.

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.

In order to have control, the entity's ability to use its power to generate benefits from its involvement in the other entity is key. An entity that acts as an agent on behalf or for the benefit of another entity does not control that entity, as its decision-making power benefits the other entity.

Additional considerations:

- The existence of potential voting rights (e.g. purchased call options) that are presently exercisable should be considered in assessing the ability to control.
- The power to establish the regulatory framework within which entities operate and to impose conditions or sanctions on their operations does not constitute control.

The assessment of control can involve a significant degree of judgment, particularly when an entity is involved with structured entities or in cases in which several investors separately have the ability to direct different relevant activities. Challenging areas in the assessment of control are further discussed below.

<u>Ability to direct the controlled entity's relevant activities</u>

Under IPSAS 35, the relevant activities are those activities that significantly affect the nature or amount of the benefits that an entity receives from its involvement with other entities.

The assessment of the relevance of the activities requires a comprehensive analysis of an entity's relationship with another entity and understanding of the way it engages with other parties in the activities of the entity being assessed for control. In some situations, identifying the relevant activities of the entity assessed for control will be challenging. For example, when an entity is set up with predetermined activities (e.g. a "structured entity"), the purpose and design of the entity is an important factor to evaluate power rather than the degree of managerial involvement in its operating activities.

It is not always obvious to determine which activities could significantly affect the returns of the controlled entity; judgement may be required which, if applied incorrectly, might have a negative impact on the relevance of information provided. The level of judgement and the requirement to focus on relevant activities when assessing control represents one of key challenges of IPSAS 35. However, the guidance in IPSAS 35 (which includes a range of factors to assess control - such as voting rights and potential voting rights held by the entity, along with other facts and circumstances), should provide sufficient information and a conceptually solid basis for an entity to assess and consequently draw a conclusion about whether it controls another entity.

While determination of whether control exists over an entity is in most cases straightforward, it might be more judgemental in a number of other cases as explained above. In such circumstances, governments may find useful to develop specific resources to guide the analysis and document the areas where assessment of control is judgmental, for example a targeted questionnaire.

Where the evaluation is subjective, the disclosure required by IPSAS 38 "Disclosure of interests in other entities" about assumptions and judgement used to determine "relevant activities" should be helpful to explain decisions reached in those more challenging scenarios and thereby either enhances relevance of information or limits the loss of relevance that might result from applying inappropriate judgement.

In those situations where voting rights are limited in scope, para AG8 of IPSAS 35 refers to the relevant activities of the entity being assessed for control that may be directed by means of binding arrangements or provisions in founding documents such as articles of association or a constitution. In such cases, an entity's consideration of the purpose and design of the entity being assessed for control should also include consideration of the risks to which the other entity was designed to be exposed, the risks it was designed to pass on to the parties involved and whether the entity is exposed to some or all of those risks.

In general, operational difficulties may arise to assess whether the rights are substantive or not, which may affect the relevance of information. In some cases, this assessment might be complex, particularly when differentiating between substantive and protective rights of the investors.

Protective rights relate to fundamental changes to the activities of another entity or apply in exceptional circumstances. Because protective rights are designed to protect the interests of their holder without giving that party power over the entity to which those rights relate, an entity that holds only protective rights cannot have power or prevent another party from having power over the entity to which those rights relate. Consequently, according to para 29 of the standard, an entity holding only protective rights does not control the other entity.

Agent/principal relationships

IPSAS 35 provides criteria and guidance for an entity to evaluate whether a decision maker is using its power as a principal or as an agent. These criteria would affect the assessment of whether an entity is a principal and, if so, whether the entity should consolidate another entity subject to the assessment.

As a general principle, when assessing control under IPSAS 35, only substantive rights held by the entity and other shareholders are considered. Similar to the control assessment regarding de facto control under the QC “Substance over form”, if an entity holds less than the majority of the voting rights, it is required to consider both substantive rights that it holds, and substantive rights held by other parties.

The standard requires an entity to consider a range of factors when assessing whether a decision maker is acting as an agent or a principal, including the situation when any single party holds substantive rights to remove the decision maker without cause. The existence of a single party with substantive rights to remove the decision maker alone would be sufficient to conclude that the decision maker is an agent. In the absence of unilateral removal rights involving various parties, an entity must consider a range of other factors including:

(a) the scope of authority over to the decision maker;

(b) the rights held by other parties;

(c) remuneration; and

(d) its exposure to variability of benefits from the interests.

Consolidation procedures

Once the scope of consolidation is agreed, consolidation procedures apply to bring together separate financial statements into one set of accounts.

The financial reporting of the entities within the economic entity should be prepared at the same reporting date using uniform accounting policies for like transactions and other events in similar circumstances. Any balances and transactions between entities within the economic entity are eliminated in full, including revenues, expenses and dividends or similar distributions. Intra-group surpluses or deficits that are recognised in assets (e.g. in inventory or fixed assets), are eliminated in full except where a deficit indicates an impairment loss that must be recognised.

The consolidation method in IPSAS 35 is consistent with the other EU and global generally accepted accounting principles and provides relevant information about the performance of the economic entity as a single reporting unit.

Based on the assessment of the IPSAS 35 requirements, relevant information is presented in the financial statements of an economic entity in which the assets, liabilities, net assets/equity, revenue, expenses and cash flows of the controlling entity and its controlled entities are presented as those of a single economic entity.

Faithful representation / Reliability

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

The reliability of the consolidated information prepared in accordance with IPSAS 35 requirements is analysed below under separate subsections.

Ability to direct the controlled entity's relevant activities

There are various cases when more than one party has decision-making authority over different activities of another entity and each activity may significantly affect the benefits. As discussed above, identifying the relevant activities requires judgement and might affect the reliability of information.

De facto control

The assessment of 'de facto control' requires consideration of all facts and circumstances. In some cases, it can be challenging for some entities to determine the date when they obtain de facto control. However, in order to faithfully represent the activities of a group of entities, the consolidated information needs to be based on the substance of the arrangements and the careful exercise of judgement is inherent in such a principles-based approach.

In addition, IPSAS 38 requires disclosure in respect to the judgement exercised and assumptions used to determine control, when an entity owns less than half of the voting rights. This qualitative information reduces the degree of uncertainty introduced by the use of judgement in the assessment of de facto control and contributes to the reliability of the financial statements.

Agent/principal relationships

As noted earlier under the QC of relevance, entities need to consider a range of factors when making the evaluation of agent/principal relationships. In some cases, obtaining the information needed for the assessment of control might be challenging and may raise concerns about reliability. Moreover, the weighting of factors listed in IPSAS 35 depends on the relevant facts and circumstances that are appropriate to the entity conducting the assessment.

Completeness

The financial information in consolidated financial statements prepared under IPSAS 35 should be complete taking into account materiality and cost-benefit considerations.

Preparation of the consolidated financial statements under IPSAS is based on the concept of control. Preparing a set of financial statements which covers in a comprehensive way the assets, liabilities, items of income and expenses and cash flows of the entities over which the reporting entity has control seems to best serve the accountability and decision-making objectives of financial statements. Recognition of assets and liabilities on the balance sheet makes them apparent to the users and triggers questions on how governments manage these.

A controlled entity is not excluded from consolidation because its activities are dissimilar to those of the other entities within the economic entity, for example, the consolidation of commercial public sector entities with entities belonging to the general government sector. Relevant information is provided by consolidating such controlled entities and disclosing additional information in the consolidated financial statements about the different activities of controlled entities. For example, the disclosures required by IPSAS 18, ‘Segment reporting’ help to explain the significance of different activities within the economic entity.

Due consideration may be given to smaller and less risky entities; for pragmatic reasons, these can be left out of the consolidation scope if the aggregated impact of the non-inclusion of such entities in the consolidated financial statements is not material.

Commercial public sector entities

The accountability and decision-making objectives of EPSAS financial statements are addressed when the IPSAS scope of consolidation is used, that is by preparing a set of financial statements which covers in a comprehensive way the assets, liabilities, items of income and expenses and cash flows of the entities over which the reporting entity has control. Recognition of assets and liabilities on the balance sheet makes them apparent to the users and should trigger questions on how governments manage these.

The possibility to account for investments in controlled public sector corporations involved in commercial activities using the equity method, rather than the full consolidation method, has been discussed between EPSAS stakeholders. Presenting the investments in those entities using the equity method would show the same impact on the equity and results of the reporting entity as including them fully in the consolidation scope. However, it would not reflect comprehensively the reporting entity’s assets, liabilities, items of income and expenses and cash flows. Such a treatment could only be envisaged on the grounds of practicability and cost-benefit considerations, together with the disclosure of separate information on the financial position, financial, performance and cash flows of those controlled commercial public sector entities in the notes to the accounts in order to mitigate the impact of the absence of full consolidation. Furthermore, any final position on this topic would also need to consider the negative impact of such a departure from IPSAS-compliant consolidation rules on other important QCs such as relevance for accountability and decision-making, faithful presentation and comparability. On the latter QC, comparability could indeed be impaired if certain government-controlled activities are carried out within the general government sector by some governments and through commercial public sector entities by other governments.

In cases where the evaluation of control requires judgement, the disclosures about assumptions and judgement used to determine the controlling entity should be helpful to explain decisions reached in those more challenging scenarios and thereby either enhance relevance of information or limit the loss of relevance that might result from applying inappropriate judgement.

Based on the screening exercise, proper application of the principles included in IPSAS 35 leads to meeting the QC of completeness. We refer to further comments provided under the QC of prudence.

Prudence

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

IPSAS 35 applies a uniform control model for all investees including situations of de facto control, agent/principal relationships and structured entities. To have power over another entity, an entity must have existing rights that give the entity the current ability to direct the relevant activities of the other entity. The rights that may give an entity power can differ (IPSAS 35 para AG 16).

Public sector entities often obtain power over another entity from rights other than voting rights. They may also obtain power over another entity without having an equity instrument providing evidence of a financial investment. An entity may have rights conferred by binding arrangements. These rights may give an entity power to require the other entity to deploy assets or incur liabilities in a way that affects the nature or amount of benefits received by the first-mentioned entity. The assessment of whether such rights give rise to power over another entity may be complex and require more than one factor to be considered.

Consistently with the QC of prudence, the consolidation principles should not leave out of the scope of the consolidated financial statements significant liabilities whose cash out should ultimately be paid by the governments. Structuring of transactions that aim to achieve off balance sheet treatment of government debts should not be possible when applying the principle-based requirements of IPSAS 35.

In addition, IPSAS 38 requires disclosure in respect to the judgement exercised and assumptions used to determine control, when an entity owns less than half of the voting rights. These disclosures provide information that reduces the degree of uncertainty introduced by the use of judgement in the assessment of control in the situations where the controlling entity holds less than majority of the voting rights.

The screening of IPSAS 35 has not revealed any conceptual issues that could be linked to the QC of Prudence.

Neutrality

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

In some cases, the guidance and examples provided in IPSAS 35 might be interpreted in different ways and this could lead to inconsistency and diverse application in practice. In particular, when determining substantive rights, rights of other parties and in other challenging assessments, IPSAS 35 might not provide detailed answers in the form of specific guidance and examples for all possible arrangements in various jurisdictions.

This is inherent to a principles-based control model, the use of judgement is required. On the other hand, the disadvantage of applying principles instead of rules, is that there might be divergence in practice. As noted earlier in the discussion about relevance and reliability QCs, the level of judgment required by IPSAS 35 is not so exceptional in nature that it would be impracticable to apply the standard in a consistent manner and achieve neutral presentation of the reporting entity.

Verifiability

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

In some cases, in determining whether potential voting rights are substantive or not might be challenging. In particular, the assessment of control requires an analysis of various factors including the purpose and design of the instruments that provide potential voting rights and any other involvement that an entity has with the investee. This includes an assessment of the terms and conditions of such rights as well as an entity´s motives and reasons for agreeing to them.

Some difficulty in performing the analysis of potential voting rights might arise in cases of deadlock clauses between the investors and rights to buy or sell equity instruments at a future date. In such cases, there may be a negative impact on availability of reliable information to appropriately perform evaluation of control. For example, the entity might not have access to the information about the rights of other shareholders and the agreements entered into by other parties. Further, even though an entity might have the ability to control an investee, it might not have legal rights to gather the financial information to meet its consolidation obligations.

The use of judgment that is needed to apply IPSAS 35 principles in certain circumstances may make verifiability of the appropriateness of the judgments used more difficult. As already mentioned, appropriate disclosure about assumptions used and judgments made should however be given to mitigate this.

Substance over form

The ‘Substance over form’ QC is achieved when the underlying transactions, other events, activities or circumstances are accounted for and presented in accordance with their substance and economic reality, and not merely their legal form.

Investment entities

An investment entity is defined in IPSAS 35 as an entity that:

(a) Obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

(b) Has the purpose of investing funds solely for returns from capital appreciation, investment revenue, or both; and

(c) Measures and evaluates the performance of substantially all of its investments on a fair value basis.

Under IPSAS 35 an entity considers all facts and circumstances when assessing whether it is an investment entity, including its purpose and design. IPSAS 35 para AG89–AG106 describes aspects of the definition of an investment entity and discusses the typical characteristics of the investment entities in the public sector context.

The guidance focuses on the substance of each of the three elements that make up the definition of the investment entity. The absence of any of these elements does not necessarily disqualify an entity from being classified as an investment entity. However, the absence of any of these characteristics means that an entity is required to disclose information about the significant judgments and assumptions made in determining that it is an investment entity. Disclosure of these judgments and assumptions is important for transparency and encourages appropriate use of the investment entity accounting requirements in the public sector, consistent with the QC of “Substance over form”.

Although the differences between typical characteristics of investment entities in public and private sector have been identified by the IPSASB, the consistent requirements in IPSASs and IFRSs in this area reduce opportunities for accounting arbitrage when determining which accounting standards an investment entity should be required to apply.

De facto control

The standard focuses on the ‘ability to control’ and provides application guidance on factors to be considered to determine de facto control (not arising from holding a majority of the voting rights). Explicitly extending the ‘ability to control’ approach to situations where an entity controls another entity with less than the majority of voting rights, requires a degree of judgement because it requires an entity to consider all relevant facts and circumstances that can lead to control.

In some cases, particularly situations involving more conventional controlled entities without complex transactions and simple shareholder structures, the assessment is likely to be a straightforward one. In other cases, it could be challenging to make the assessment, in particular:

- Determining whether other shareholders are widely dispersed and whether there is a possibility of agreements between them.
- Access to information and gathering evidence on whether rights held by other entities are substantive and assessing what are substantive rights.
- Assessing whether rights held by others are only protective in nature and whether or not they impact the assessment of control.

There might be situations where agreements between other potential controlling entities are concluded without the involvement of the entity, making it challenging to obtain the information about those agreements and the rights they convey to others. IPSAS 35 requires an entity to consider additional facts and circumstances, making the decision about whether control exists.

The assessment of de facto control requires consideration of all facts and circumstances, for example, determining the exact point in time and about when other investors are sufficiently dispersed. Other shareholdings are widely dispersed when the direction of relevant activities is determined by majority vote and an entity holds significantly more voting rights than any other vote holder or organised group of vote holders. It can in some cases be challenging for some investors to determine the date when they obtain de facto control. Nevertheless, in order to faithfully represent the activities of a group of entities, the consolidated information would need to be based on the substance of the arrangements and the careful exercise of judgement is inherent in such a principles-based approach.

In case inappropriate judgements are made when conducting the assessment and considering the facts and circumstances, the information obtained might be incomplete and lose its usefulness for decision-making and accountability. This will have a negative effect on the QC of substance over form.

Understandability

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

Although there are a number of aspects linked to the notion of ‘understandability’, most of the aspects are covered in the above discussions about relevance, reliability and comparability. One additional issue that needs to be considered in assessing whether the information resulting from the application of IPSAS 35 is understandable, is whether that information is unduly complex.

De facto control

The current application guidance and clarifications provided in the standard are useful to allow entities to assess the cases in which de facto control exists, and IPSAS 38 also enhances understandability of information by requiring an entity to disclose the assumptions and judgement used in determining de facto control. Therefore, the guidance and disclosure would make the financial information understandable by users.

Finally, IPSAS 35 does not alter the fundamental purpose and underlying principles of the consolidated financial information. Therefore, no new issues about understandability are expected to arise. The overall assessment is therefore that the standard satisfies the understandability QC.

Comparability

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

Uniform control model including situations of de facto control, agent/principal relationships, potential voting rights and structured entities

When determining control of an entity being assessed for control under IPSAS 35, entities should apply a uniform ability to control model to all entities. Under IPSAS 35, an entity considers a wide range of sources of rights when assessing control and applies a uniform set of principles in a similar way to assess control when other parties hold potential voting rights, deadlock rights or similar rights. This principle-based approach enhances the QC of comparability.

Broad range of facts and circumstances

IPSAS 35 requires entities to consider a broad range of facts and circumstances in determining control. It provides application guidance and examples on how to apply the new requirements that articulate the principles in a simple way without making the fact patterns overly complex. This is helpful to ensure that entities apply the control model and the requirements in a similar way, leading to comparable information.

A degree of judgment in some complex areas

The concern regarding comparability arises from the degree of judgement required in some areas, particularly when the evaluation requires various factors to be considered and those factors might contain uncertainty or the information to support them might be difficult to obtain. In some cases, the guidance and examples provided in IPSAS 35 might be interpreted in different ways. In particular, when assessment of control involves evaluation of the purpose and design, determination of substantive rights and other challenging areas, consistent application of the standard cannot be guaranteed.

Judgment is required under IPSAS 35 to assess control in complex arrangements. This is an inherent to the application of a principles-based framework. The use of the concept of control (which is also used in IFRS and many other national accounting standards) is however less likely to lead to differences in application than an approach that would primarily be based on the assessment of risks and rewards. Appropriate disclosure about assumptions used and judgments made in the notes to the financial statements also helps users to compare financial statements.

The overall conclusion is therefore that IPSAS 35 meets the QC of comparability.

Timeliness

Timeliness means having information available for users before it loses its capacity to be useful for accountability and decision-making purposes. Having relevant information available sooner can enhance its usefulness as input to assessments of accountability and its capacity to inform and influence decisions that need to be made.

The inherent nature of consolidation may make it a time-consuming process, especially if robust and efficient consolidation procedures are not implemented. The extent to which the QC of timeliness may be affected is not due to the requirements of the standard but is rather linked to the organisation of the consolidation process within the reporting entity.

Particular attention must be paid to the need to keep a good balance between the various QCs to optimally contribute to the usefulness of the financial information. For example, the publication of consolidated financial statements should not be unnecessarily delayed to achieve a degree of precision which does not add a lot of value to the users of the consolidated financial statements.

Alignment with other frameworks

ESA 2010

Significant differences exist between ESA 2010 requirements and IPSAS 35, including some notable differences in the scope of consolidation and the consolidation techniques.

For example, the EU governments prepare statistical reports which present consolidated financial information in a sectoral approach, breaking down between the general government sectors and public corporation sectors (Non-Financial and Financial). This information is compiled in accordance with ESA 2010. IPSAS 35 requires the consolidation of all controlled entities, other than the exception from consolidation relating to investment entities.

The ESA 2010 framework defines various institutional sectors. One of them is the general government sector (GGS). The general government sector (S.13) consists of institutional units which are non-market producers whose output is intended for individual and collective consumption, and are financed by compulsory payments made by units belonging to other sectors, and institutional units principally engaged in the redistribution of national income and wealth (ESA 2010 2.111). Applicable rules for the government sector are explained in detail in chapter 20 “The government accounts” of the ESA 2010 manual.

Consolidation scope

ESA 2010 allows for all sectors to be presented as either consolidated or unconsolidated even if the general principle is not to consolidate (ESA 2010 paragraphs 1.107 and 1.108). The usual approach for general government is to present consolidated data. Statistical reporting serves an important role and provides information that is comparable across countries. While financial statements are issued for accountability and decision making at an entity level, ESA 2010 statistics on the general government sector (GGS) are produced by governments for the purpose of macroeconomic analysis and decision making. For example, paragraph 20.153 of the ESA 2010 manual stipulates that ’to relate government aggregates to the economy as a whole as in revenue or expenditure to GDP ratios, it is better to eliminate the internal churning of funds and include only those transactions that cross the boundaries with other domestic sectors and with the rest of the world sector’.

When it comes to IPSAS, the reporting unit for financial statements is the economic entity, defined as a group of entities that includes one or more controlled entities. Control is the main criterion that determines consolidation.

According to IPSAS 35, three conditions should be met in order to have control: (1) the power to direct the relevant activities, (2) the exposure to the variable returns of the entity and (3) the link between the two.

Consolidation techniques

Consolidation is a method of presenting the accounts for a set of units as if they constituted one single entity (unit, sector, or subsector). It involves eliminating transactions and reciprocal stock positions and associated other economic flows among the units being consolidated (ESA 2010 20.152). The decision about the level of detail employed in consolidation should be based on the policy usefulness of the consolidated data and the relative importance of the various types of transactions or stocks (ESA 2010 20.155). In practice, consolidation of data is thus done only when it is useful for the purpose of the ESA 2010 statistical reporting.

As far as consolidation techniques are concerned, ESA 2010 rules do not require consolidation of transactions in the production account, such as sales and purchases of goods and services. Consolidation is only required for some major types of transactions (current and capital transfers, interest arising on intergovernmental holdings of financial assets and liabilities, and transactions, other economic flows and stocks in financial assets and liabilities) where it is considered useful for the purpose of the ESA 2010 reporting.

Under IPSAS, all material intragroup transactions and balances should be eliminated.

Whole-of-government reporting entity (WGA)

In addition, whole-of-government accounts (WGA) comprising the accounts of all tiers of government within one country may also be prepared to serve accountability and decision-making objectives, without the need to have any control relationship existing between the various levels of government. The reporting entity is then defined at the level of the country's government/public sector as a whole. IPSAS financial statements prepared for the whole-of-government reporting entity, at the highest level of consolidation, may include, in addition to government departments, sub-national bodies such as state governments, and government owned businesses that primarily engage in market activities.

Reconciliation between IPSAS 35 and ESA 2010

Providing a reconciliation between the IPSAS 35 consolidated financial statements and the ESA 2010 would facilitate the understanding of the two types of reporting by users. Applying the principles of IPSAS 22 allows entities to present separately in the notes the information for the GGS.

IFRS[5]

IPSAS 35, is drawn primarily from IFRS 10, “Consolidated financial statements”. The main differences between IPSAS 35 and IFRS 10 are as follows:

- Commentary additional to that in IFRS 10 has been included in IPSAS 35 to clarify the applicability of the standard to accounting by public sector entities.
- IPSAS 35 uses different terminology, in certain instances, from IFRS 10.
- IPSAS 35 defines the term “binding arrangement”. This term is broader than the term “contractual arrangement”, which is used in IFRS 10.
- IFRS 10 identifies typical characteristics of an investment entity separately from the definition of an investment entity. IPSAS 35 does not identify such typical characteristics. However, it does discuss some of these characteristics in the context of the definition of an investment entity.
- IPSAS 35 contains more guidance on non-financial benefits.
- IPSAS 35 does not require that a controlling entity, that is not itself an investment entity, shall consolidate all controlled entities. Instead it requires that such a controlling entity shall present consolidated financial statements in which it (i) measures the investments of the controlled investment entity at fair value through surplus or deficit in accordance with IPSAS 29 and (ii) consolidates the other assets and liabilities and revenue and expenses of the controlled investment entity in accordance with IPSAS 35.
- IPSAS 35 contains additional illustrative examples that reflect the public sector context.

EU accounting rules

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

EU Accounting Rule 2 ’Consolidation and accounting for joint arrangements and associates’ is based on IPSAS 35, IPSAS 36, IPSAS 37 and IPSAS 38 as well as articles 141, 147, 148, 152 and 208 of the Financial Regulation (Regulation (EU, Euratom) 2018/1046 of 18 July 2018). This accounting rule applies to accounting for controlled entities, jointly controlled entities and associates in the consolidated financial statements of the EU and those EU entities which prepare and publish separately their financial statements and have interests in other entities. It establishes requirements for

[5] 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

the preparation and presentation of consolidated financial statements by EU entities having interests in other entities.

EU AR 2 therefore acknowledges that consolidated financial statements may need to be prepared and presented at different levels (with different reporting entities being defined) to meet the accountability and decision-making objectives at those levels.

The scope of consolidation is legally defined in Art. 241 of the Financial Regulation and comprises:

- the EU institutions (as listed in Art. 2 FR),
- the Union bodies set up under the TFEU and the Euratom Treaty having legal personality and receiving contributions charged to the budget (see Article 70 FR); and
- other bodies meeting the applicable accounting consolidation criteria (see Article 80 FR in conjunction with EAR 2 Consolidation and Accounting for Joint Arrangements and Associates).

It is understood that the EU institutions and the Union bodies set up under the TFEU and the Euratom Treaty (as defined above) are included in the scope of consolidation by virtue of Article 241 FR alone, i. e. without further consideration of the consolidation criteria applicable to other bodies. However, EAR 2 clarifies that the consolidation of these institutions and bodies is also in compliance with the consolidation criteria set up in this standard, i.e. the control concept. (cf. EAR 2, section 4.2.5.2). The definition and indicators of control as applicable under the control concept are provided further in the section 4.2 of EU AR 2. The Rule also stipulates that determination of the scope of consolidation should take into account the general principle of materiality. However, due to Art. 241 FR, applying the concept of materiality does not lead to an Union institution or an Union body as referred to above to be excluded from the scope of consolidation.

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

The principles included in EU AR 2 are similar to IPSAS 35.

European Public Good

Assessing whether IPSAS 35 is conducive to the European public good

The assessment of whether IPSAS 35 would be conducive to the European public good addresses the following items:

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

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

The analysis revealed no reasons why IPSAS 35 would not be conducive to the European public good:

- Requirements for the preparation and the presentation of consolidated financial statements in accordance with IPSAS 35 will provide useful information to the users of the GPFSs and will improve the overall quality of financial reporting in the public sector. The criterion in assessing the proposals is whether the consolidation requirements will be improved when compared to the information provided currently under the local accounting frameworks of the EU member states.

  The draft EPSAS CF stresses that it is in the public interest to have comprehensive and complete financial statements providing a true and fair view of the financial position, financial performance and cash flows of the public sector reporting entity for accountability and decision-making purposes. To achieve this, it is important that all transactions and events of a public sector reporting entity be properly reported in the consolidated financial statements of that entity.

- Implementation of the standard may result in a relatively significant one-off cost and moderate costs on an ongoing basis for preparers. These practical challenges do not outweigh the conceptual merits of the standard.

  Since the activities of public corporations that are trading on the market (e.g. state-owned utilities, public corporations active in the telecommunications industry or in the railway industry) often differ from the activities of the entities that are part of the GGS, specific accounting policies that address the specific characteristics of the activities of these entities should be developed to best reflects the economic substance of their transactions. This is in line with IPSAS requirements, in particular with the rules applicable regarding the selection of accounting policies that provide relevant and reliable information under IPSAS 3 ‘Accounting policies, changes in accounting estimates and errors’. In many cases, the IFRS accounting policies of commercial public sector entities can be carried forward with no or little change in the IPSAS consolidated financial statements.

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

Conclusion

Assessing IPSAS 35 against the criteria formulated in the draft EPSAS framework

The analysis has not revealed major conceptual issues with IPSAS 35 'Consolidated financial statements' and has not identified any major inconsistency between IPSAS 35 and the draft EPSAS framework.

The IPSAS 35 scope of consolidation, based on the notion of control rather than on the GGS boundaries, provides a comprehensive picture of the economic entity's financial position, financial performance and cash flows. Moreover, this control-based approach complies with internationally recognised principles for consolidation such as IPSAS and IFRS). The accountability and decision-making objectives of the EPSAS financial statements will be met by including in the set of financial statements the assets, liabilities, items of income and expenses and cash flows of the entities over which the reporting entity has control.

Following the screening analysis summarised in the present report, the future standard setter could consider the following conclusions. The information resulting from the application of IPSAS 35:

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

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

- *Judgment and comparability.* The use of judgment and estimates is inherent in the preparation of financial statements and may to some extent affect the comparability of financial statements. In the case of this particular standard, this can mainly relate to the assessment of whether control exists in particular, limited circumstances.

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

The future standard setter could consider the conclusions of this assessment and likely net benefit of using the requirements of IPSAS 35 as a starting point in implementing the equivalent EPSAS, considering the need for additional guidance in certain areas and resolution of the matters identified in the present EPSAS screening report.