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Conseil de normalisation des comptes publics

# Opinion n° 2015-08 of 10 December 2015 relating to control restrictions or exclusions for Central Government equity investments

On 10 December 2015, the Public Sector Accounting Standards Council adopted this Opinion amending the requirements of Central Government Accounting Standard 7 "Financial Assets" in respect of control restrictions or exclusions for Central Government equity investments[1].

## 1. Background

These amendments were introduced in response to the matter jointly referred to the Council by the Director of the Budget, the Director-General of Public Finances and the Director of Social Security, namely "*the difficulties in applying the boundaries and control criteria for Central Government equity investments defined in the Central Government Accounting Standards Manual to social security organisations*". As signatories of the referral, the Directors note that the interpretation of these criteria continually raises issues during the audit of Central Government accounts, particularly with respect to their application to the National Social Security Funds or the organisation responsible for amortising France's social security debt (CADES) and henceforth to public health establishments. Of the five qualifications of the Central Government accounts for 2014 made by the Government Audit Office, one relating to financial assets is still valid; it relates both to the boundary of equity investments and to the measurement and reliability of the accounts provided by the entities concerned.

[1] The requirements in this Opinion and the proposed amendments are based on the Central Government Accounting Standards Manual approved by the Order of 23 September 2015 amending accrual accounting rules for Central Government.

## 2. Amendments to Standard 7 "Financial Assets"

In response to the referral, the Council is clarifying Standard 7 by:

- ✓ the addition of comments in the introduction explaining the situations in which Central Government's control as a reporting entity over other entities is subject to restrictions[2] or exclusions. These situations are the result of constitutional, organic law or legislative provisions defining specific governance scope separate from the reporting entity "Central Government" or effectively precluding Central Government from obtaining benefits from the activity of the entity concerned. This applies in particular to "social security" and "local" sectors.

- ✓ an amendment of the wording of a part of the paragraph on "Restrictions on control" and the identification in the requirements of situations where specific governance scope separate from the reporting entity "Central Government" precludes the latter from exercising control.

## 3. Qualification of the change

This Opinion clarifies the situations in which control exercised by Central Government is subject to restrictions or exclusions without changing the substance of the requirements applicable to Central Government equity investments. These clarifications are not therefore within the scope of Central Government Accounting Standard 14 "Changes in Accounting Policy, Changes in Accounting Estimates and the Correction of Errors".

## 4. Effective date

The Public Sector Accounting Standards Council proposes immediate application of this Opinion.

2 The requirements of the previous version of Standard 7 dealt with situations in which there are "Restrictions on control" but the latter were omitted from the introduction.

# STANDARD 7
# FINANCIAL ASSETS

# Contents

# STANDARD 7
# FINANCIAL ASSETS

## Introduction

This Standard deals with the Central Government's equity investments, the receivables related to these investments and loans and advances that the Central Government makes to other entities incorporated as separate entities from the Central Government.

### *Special case of entities without legal or corporate personality*

Entities without legal or corporate personality separate from that of the Central Government do not meet the definition of equity investments, even if their accounting system is to some extent separate from that of Central Government. The accounts of these entities are integrated directly in to the Central Government accounting system. This provision applies to subsidiary budgets in particular (in a departure from this general principle, the subsidiary budget of the Order of Liberation, which is incorporated as a separate entity, is included) and to the special accounts that are presented separately from the general budget in the Budget Act.

## I. LOANS AND ADVANCES

The specific nature of the Central Government's activities does not warrant a departure from business accounting recognition and measurement principles with regard to loans and advances.

## II. EQUITY INVESTMENTS

Equity investments are to be understood in the broad sense of the term, whereas the term is most commonly used to refer to holdings of equity securities.

Yet, many entities are linked to the Central Government, even though there are no equity securities issued to represent this link. In most cases, the entities concerned have no share capital per se to be partially or fully owned by the Central Government, since they are not incorporated as companies.

The definition of equity investment used in the Standard is based in particular on the concept of a long term relationship between the Central Government and the investee entities. This relationship does not exist where acquisition is followed rapidly by disposal. In the latter case, it appears appropriate to recognise the investments in a separate category (such as "other financial assets" for example). This remains exceptional.

### II.1. Categories of equity investment

#### II.1.1. The legal status of entities related to Central Government

The entities related to the Central Government take many different legal forms: companies, public establishments of all kinds (administrative, industrial and commercial, scientific and technological, cultural or professional), public interest groups, economic interest groups, non-profit associations.

### II.1.2. The classification of Central Government equity investments on a control basis

The control concept is used in the Standard as an approach to the classification of investee entities.

Indeed, even though this Standard, like all the other Standards in this manual, covers the "separate financial statements" of the Central Government, the proposed classification of equity investments lays the foundations for future consolidation of the Central Government's financial statements with those of the entities under its control.

The requirements identify situations in which control is subject to restrictions or exclusions as a result of constitutional, organic law or legislative provisions.

Thus, in certain cases, as a result of constitutional or organic law provisions entities fall within a specific scope of governance separate from Central Government. This is the case of "local sector entities" (to which the financial governance principles based on Article 72 of the Constitution apply) and "social security entities", defined as all those entities within the scope of the Social Security Finance Act provided for in Article 34 of the Constitution or subject to the financial equilibrium objectives it sets.

Social security entities include National Public Establishments and other entities in which Central Government holds an interest arising from a capital contribution that are classified as non-controlled entities. Other "social security entities" are not Central Government equity investments.

This distinction between controlled and non-controlled entities also provides a basis for proposing two different measurement approaches for the two types of investment.

## II.2. Measurement of equity investments

### II.2.1. Measurement on initial recognition

Measurement of equity investments on initial recognition is at acquisition cost, including directly related transaction costs.

### II.2.2. Measurement on the reporting date

In business accounting, equity investments are generally measured on the reporting date on the basis of the recoverable amount.

The French Accounting Regulation Committee Regulation on depreciation and impairment of assets (Regulation 2002-10 of 12th December 2002) stipulates that the "recoverable amount is the greater of the net selling price or the value in use, subject to the provisions of Article 332-3 on equity instruments and the provisions of Article 332-4 on securities valued using the equity method."

Article 332-3 of the French General Chart of Accounts stipulates that "at any other date than the date of initial recognition, listed and unlisted equity instruments shall be valued at their value in use, embodying the amount the entity would be willing to pay to acquire this investment if it had to acquire it.

As long as the changes in value are not the result of accidental circumstances, the estimate may factor in the following elements: profitability and prospects for profitability, equity, likelihood of the outcome, business conditions, average stock prices in previous month and the basis for assessment used in the original transaction."

This seems to be a difficult notion to apply to many of the Central Government's equity investments, since the utility of some of them cannot be measured in purely financial terms. Social, environmental, cultural and educational utility, or the utility of the research conducted by some operators are not easy to measure and record in the financial statements as expected cash flows or even as service potential.

On the other hand, the French General Chart of Accounts (art. 332-4) proposes an alternative measurement method, based on the value of the parent company's share of equity held in its subsidiaries. This method may only be used subject to the following conditions:

- only by companies that prepare consolidated financial statements;
- only for exclusively controlled companies;
- and subject to carrying out the regulatory consolidation adjustments (before appropriation of profit or loss and elimination of internal transfers).

The equity method seems the most appropriate for measuring the Central Government's equity investments, in view of the difficulties associated with other methods. It enables changes in the overall value of the investment (different to just the acquisition cost) to be disclosed in the accounts, whilst avoiding the Central Government the problem of tracking changes in the theoretical market value of controlled entities which does not exist in most cases. Nevertheless, the restrictive application conditions of the French Chart of Accounts do not apply to the Central Government, for the following reasons:

- the Central Government does not prepare consolidated financial statements;
- all the entities controlled by the Central Government (exclusively or jointly) are measured using the equity method;
- generally, there are no plans for carrying out the regulatory consolidation adjustments[1]. On the other hand the accounting treatment adopted by some entities may be reviewed on a one-off basis and certain individual adjustments could take place according to the circumstances.

The Standard calls for investments in controlled entities to be measured using the equity method. Investments in uncontrolled entities are to be measured at their acquisition cost and subjected to impairment testing. This is because such investments are not made for the same purposes as investments in controlled entities.

The requirement in the Standard to measure the share in equity by reference to the consolidated financial statements (excluding minority interests) rather than to the separate financial statements of the investees provides a more appropriate representation of the value of the investment, especially when the investees are indirectly owned.

[1] As the central government does not currently prepare consolidated financial statements, the consolidation rules that would apply are not known, even if it appears self-evident that they would be based on business accounting, subject to the specific characteristics of central government.

### II.2.3. Lack of financial statements for the period

There may be a one-year lag between the financial statements used to value equity investments in the Central Government financial statements and the reporting period for the Central Government. The lag shall be examined for each entity, starting with the most important entities. In principle, valuation using the equity method applies to the financial statements for the corresponding year. When this is technically impossible, the situation shall be explained on a case-by-case basis in the Central Government financial statements.

## III. RECEIVABLES RELATED TO EQUITY INVESTMENTS

Related receivables are principally made up of loans and advances granted by Central Government to entities meeting the definition of equity investments. In accordance with the requirements of the French General Chart of Accounts these receivables are not recognised with other loans and advances but together with the corresponding equity investments.

## IV. POSITION WITH REGARD TO OTHER ACCOUNTING STANDARDS ON FIRST APPROVAL OF THE CENTRAL GOVERNMENT'S MANUAL OF ACCOUNTING STANDARDS IN 2004

Under the terms of article 30 of the Constitutional Bylaw of the 1st August 2001 relating to budget acts, this Standard complies with the general principles applicable to business accounting, except for differences warranted by the specific characteristics of the activities of Central Government.

The definitions and criteria for assessing control with regard to equity investments were determined by reference to IPSAS 6, which is itself very similar to IAS 27. The notion of control for consolidation purposes is defined in the standards dealing with consolidated financial statements.

The section on measurement on initial recognition is compliant with the French General Chart of Accounts (except for the definition of acquisition cost, see below).

The provisions on equity investments measured at acquisition cost are also consistent with the French General Chart of Accounts. The provisions comply with the French Accounting Regulation Committee Regulation 2002-10 of 12th December 2002 on depreciation and impairment of assets. ). However, the section relating to equity method measurement was drawn up in accordance with the requirements of the French General Chart o Accounts (art. 332-4), subject to the exceptions concerning the conditions of application of this method.

The definition of acquisition cost, which includes certain transaction costs (fees and commissions) and bank charges, is consistent with the provisions of IAS 22[2]. Generally speaking, international standards call for a number of costs related to acquisitions of assets to be included in the initial valuation.

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[2] IAS 22 has since been replaced by IFRS 3; this reference has therefore been maintained in the introduction to explain the historical context.

## V. OPENING BALANCE SHEET ON 1ST JANUARY 2006

The carrying value of these investments in the closing balance sheet of the general administration of finance is deemed to be the entry value for the first application period of this Standard.

In accordance with the rules defined in Standard 14 “Accounting Policies, Changes in Accounting Estimates and Errors”, the requirements relating to the measurement of investments in the opening balance sheet apply to the correction of an error that takes place in the first period of application of this Standard.

# STANDARD 7
# FINANCIAL ASSETS

## Requirements

## 1. SCOPE

This Standard shall apply to the Central Government's financial assets. These assets are the Central Government's equity investments, which may or may not be represented by securities, receivables related to these investments and loans and advances granted by the Central Government.

### 1.1. Definitions

In this Standard, the following terms shall have the meanings given below:

#### *Central Government equity investments*

Central Government equity investments are the interests that the Central Government holds in other entities, which may or may not be represented by equity instruments and which create long-term relationships with the other entities. The interests may stem from:

> ownership of equity shares in the entities concerned; or

> the legal status of the entities concerned; or

> Central Government control (as defined below) over these entities.

#### *Entities covered by the standard*

The entities in which the Central Government holds an interest are incorporated as separate entities from the Central Government.

#### *Loans and advances granted by the Central Government*

Loans and advances are funds paid to third parties under contract provisions by which the Central Government undertakes to transfer the use of means of payment to natural and legal persons for a certain period.

Loans are granted for a term of more than 4 years and advances are granted for a term of 2 years, which can be renewed once with explicit authorisation.

In the Standard, the provisions dealing explicitly with loans and advances do not concern receivables related to equity investments.

## 1.2. Categories of equity investments

Once the interests in a given entity have been initially recognised as a Central Government equity investment, their classification shall not change, as long as the Central Government owns the interests, regardless of subsequent changes in the Central Government's share of the entity's equity.

Equity investments fall into two categories:

- equity investments in entities controlled by the Central Government;
- equity investments in entities that are not controlled by the Central Government.

### 1.2.1. Control criteria and indicators

In this Standard, control is defined as the Central Government's power to govern the operating and financial activities of another entity so as to benefit from and/or bear the risks of such activities.

Control shall be determined using the following procedures:

- the nature of the relationship between the Central Government and the entity shall be examined in light of the "general criteria for determining control" (see 1.2.1.1 below), which may lead to the classification of the entity in one or the other of the two categories;
- if these provisions are not adequate for determining control or lack of control, then the "control indicators" (1.2.1.2) shall be used.

#### *1.2.1.1. General criteria for determining control*

The Central Government shall be presumed to control another entity if at least one of the "power criteria" and at least one of the "risks and rewards criteria" presented below are deemed to be fulfilled, unless there is another element that unequivocally establishes the existence of Central Government control over the entity.

***a) Power criteria:***

- The Central Government directly or indirectly owns the majority of the voting rights in the decision-making body (general meeting of shareholders or other such body) of the entity.
- The Central Government has the power, enshrined in specific legal provisions or simply under the general rules in force, to appoint or remove the majority of the members of the entity's governing body (board of directors or similar body).
- The Central Government has the power to cast a majority of the votes at the meetings of the entity's governing body; the Central Government shall be presumed to have such control when it directly or indirectly holds more than 40% of the voting rights and no other person directly or indirectly holds a greater percentage of the voting rights.
- The Central Government controls the entity by virtue of explicit provisions.

***b) Risk and reward criteria:***

- The Central Government has the power to dissolve the entity and obtain a significant level of the residual economic benefits or bear significant obligations.

- The Central Government has the power to obtain distributions of assets (e.g. monetary assets) from the entity for its benefit, and/or may be liable for certain obligations of the entity.

#### *1.2.1.2. Control indicators*

When the general criteria listed above are not adequate to determine whether the entity in question is controlled by the Central Government, the following elements, taken individually or collectively, shall be indicative of the existence of control:

#### *a) Power indicators:*

- The Central Government has the power to veto the operating and capital budgets of the entity.
- The Central Government has the power to veto, overrule or modify decisions made by the entity's governing body.
- The Central Government has the power to approve the hiring, reassignment and removal of the entity's key personnel.
- The entity's mandate is established and limited by legislation.
- The Central Government holds a special share that confers certain specific rights, such as a veto on changes in capital, asset disposals, or other such rights.

#### *b) Risk and reward indicators :*

- The Central Government holds direct or indirect title to the net assets (or liabilities) of the entity with an on-going right to access these.
- The Central Government has direct or indirect rights to a significant level of the net assets (or liabilities) of the entity in the event of a liquidation.
- The Central Government is able to direct the entity to cooperate with it in achieving its own objectives.
- The Central Government is exposed to the entity's residual liabilities.

#### *1.2.1.3. Control restrictions or exclusions*

In certain cases, there are provisions restricting or excluding Central Government control of the entity concerned.

These are constitutional, organic law or legislative provisions defining specific governance scope separate from the reporting entity "Central Government" or effectively precluding Central Government from obtaining benefits from the activity of the entity concerned.

In these circumstances, an in-depth review is required of the assignments and activity of the entities concerned by this type of provision, in order to determine whether there is a control restriction or exclusion.

### 1.2.2. Controlled entities

Controlled entities shall include directly and indirectly controlled entities. Indirect control shall be determined by having the entities concerned apply the rules on consolidation[15].

When the Central Government has a direct minority interest in an entity that is owned by another entity under the direct control of the Central Government, Central Government control shall be determined by considering the combined direct and indirect ownership.

### 1.2.3. Uncontrolled entities

Entities that do not fulfil the definition and criteria for controlled entities shall be classified in the category of uncontrolled entities.

Entities where the Central Government's control is severely restricted or excluded shall also be classified in this category of equity investments.

## 1.3. Receivables related to equity investments

Receivables (dividends, interest, income shares) shall be classified with the equity investments that give rise to them. The loans and advances that the Central Government grants to controlled and uncontrolled entities in which it has investments shall also be classified with the equity investments concerned.

# 2. RECOGNITION

## 2.1. Equity investments

Equity investments shall be recognised as assets in the Central Government's balance sheet when the corresponding rights are transferred to the Central Government.

## 2.2. Loans and advances

Loans and advances, that the Central Government grants to entities in which it has no investment, shall be recognised as Central Government assets.

Loans and advances shall be recorded in the financial statements for the period in which the corresponding rights arise.

Advances where repayment is directly subject to fulfilment of conditions duly identified upon initial recognition shall be recorded as Central Government assets and explained in the notes to the financial statements.

[1] Article 136 of Act 2002-706 of 1 August 2003 on financial security extends the requirement to present consolidated financial statements to central government public establishments subject to government accounting rules starting on 1 January 2006.

# 3. MEASUREMENT

## 3.1. Equity Investments

### 3.1.1. Measurement on initial recognition

When equity investments are first recognised in the Central Government's financial statements, they are measured at their acquisition cost.

The acquisition cost of equity investments is equal to the price at which they were acquired or the initial contributions from the Central Government. The acquisition cost shall include such costs as commissions, fees and bank charges, if they are directly attributable to the transaction.

When the Central Government is not the prime contractor, the funding by the Central Government of works made on properties controlled by an operator is recognised in the Central Government equity investment of the operator. The same accounting method shall be applied on the delivery of the property when the Central Government is the prime contractor during the work in progress.

### 3.1.2. Measurement on the reporting date

On each reporting date the Central Government shall measure its equity investments as follows:

- equity investments in controlled entities shall be measured using the equity method;
- equity investments in uncontrolled entities shall be measured at acquisition cost.

#### *3.1.2.1. Equity investments measured using the equity method*

The equity method value of an equity investment shall be equal to the Central Government's directly owned share in the equity of the entity concerned.

When the entity prepares consolidated financial statements, the equity to be considered shall be the consolidated equity less minority interests.

On the reporting date, changes in the overall equity value of investments since the previous reporting date are recognised in equity method revaluation differences.

If the aggregate equity method value of equity investments is less than their aggregate initial value, an aggregate impairment loss shall be recognised. The impairment loss recognised in the financial statements for the period shall give rise to an impairment allowance recognised as an expense for the period.

If the aggregate equity method value is negative, a provision for aggregate risks shall be set aside to cover the negative amount and an aggregate impairment loss equal to the initial aggregate value shall also be recognised. The provision recognised in the financial statements for the period shall give rise to an allocation to provisions that shall be recognised as an expense for the period.

#### *3.1.2.2. Equity investments measured at their acquisition cost*

An impairment test shall be performed at the end of the period, if there is evidence that the value of an asset has declined significantly. The carrying amount of the equity investment shall be compared to its recoverable amount.

If the recoverable amount of the equity investment is deemed to be significantly lower than its carrying amount, an impairment loss shall be recognised.

The carrying amount shall be equal to the initial amount, less any impairment losses. The recoverable amount shall be assessed according to the utility of the asset for the Central Government. For Central Government equity investments, the equity method value of equity investments is used instead of the recoverable amount.

#### 3.1.3. Measurement of equity investment disposals

On disposal equity investments are derecognised at their entry value.

### 3.2. Loans and advances

Loans and advances shall initially be recognised at their nominal repayment amount.

The carrying amount of loans and advances shall be equal to their recoverable amount, which is an estimated amount assessed with regard to the utility of the claim for the Central Government.

An impairment loss shall be recognised when a likely loss arises, meaning when the carrying amount is lower than the nominal repayment amount.

Loans and advances where the nominal repayment amount has declined shall give rise to:

- recognition of an expense if the decline is certain and irrevocable;
- recognition of an impairment loss if the decline is reversible.

Loans and advances where the nominal repayment amount has increased shall give rise to recognition of revenue if the increase is certain and permanent. If the increase is reversible, the claim shall continue to be carried at its initial value.

Accrued interest shall be allocated to the principal amount of the Central Government's claim.

## 4. DISCLOSURES IN THE NOTES

The notes to the financial statements shall contain the following summary tables.

***Equity investments:***

- List of significant equity investments in directly controlled entities, with the percentage of equity owned.
- Table of changes in equity investments (disposals, acquisitions and mergers) over the period.
- Breakdown of the equity method revaluation difference by equity investment category.
- Table of equity investments in entities with negative equity.

***Loans and advances:***

- Amount and nature of advances where repayment is subject to conditions.

## 5. REQUIREMENTS APPLICABLE TO THE OPENING BALANCE SHEET ON 1ST JANUARY 2006

The carrying value of these investments in the closing balance sheet of the general administration of finance is deemed to be the entry value for the first application period of this Standard.

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