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to be held in autumn 2020

Draft EPSAS Screening Report
IPSAS 28 - Financial instruments: presentation

Paper by PwC in cooperation with Eurostat
- written consultation -

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.

In advance of the autumn 2020 Working Group meeting, participants are invited to provide written comments on the analysis provided and on the conclusions reached.

Pilot EPSAS screening report

IPSAS 28 - Financial instruments: presentation

March 2020

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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 28

IPSAS 28 'Financial instruments: presentation' is drawn primarily from IAS 32 'Financial instruments: presentation' (issued originally in 2003, including amendments up to December 31, 2008) and from IFRIC 2 'Members' shares in co-operative entities and similar instruments'. The principles in the standard complement the principles for recognising and measuring financial assets and financial liabilities in IPSAS 41 'Financial instruments', and for disclosing information about them in IPSAS 30 'Financial instruments: disclosures'.

In developing IPSAS 28, the IPSASB applied its 'Process for Reviewing and Modifying IASB Documents' that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

Main public sector differences between IAS 32 and IPSAS 28 are summarised below[1]:

- IPSAS 28 uses different terminology.
- IPSAS 28 contains additional Application Guidance on when assets and liabilities arising from non-exchange revenue transactions are financial assets or financial liabilities.
- IPSAS 28 contains additional Application Guidance dealing with the identification of arrangements that are, in substance, contractual.

Governments at all levels often incur large amounts of borrowings to fund their activities, including their social programs or the construction of infrastructure assets. These represent a very significant portion of liabilities in the balance sheet. They

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1 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[1]

may also provide loans as financial support to government entities or to other categories of economic operators, including in times of financial distress. The financial crisis has led some governments to intervene in various ways, including by taking an investment in financial institutions that needed a capital injection or by purchasing 'toxic' financial assets. Sometimes, governments can provide loans at below market conditions (concessionary loans).

Issuing of financial guarantees by governments on borrowing of nongovernment entities is also a significant activity in many EU Member States. Governments may issue financial guarantees for a variety of reasons, for example to support infrastructure projects, boost the economy or stabilise the financial market in times of distress, putting them at risk if the debtor defaults. Governments that have significant levels of borrowings or other financial instruments in their statement of financial position may be at risk in the case of fluctuations of exchange rates, interest rates or other variables.

The objective of IPSAS 28 is to establish principles for presenting financial instruments as liabilities or net assets/equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends or similar distributions, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

Scope of the report

The present screening report analyses the principles for presenting financial instruments as liabilities or net assets/equity and the offsetting requirements of IPSAS 28. The assessment covers authoritative pronouncements of the standard as well as non-authoritative material to support entities in applying the principles in the standard.

There are some other aspects of financial instruments, as far as they relate to the public sector, which are not addressed in IPSAS 28. The IPSASB acknowledged in the "Basis for conclusions" that future projects may be required to address:

- Certain transactions undertaken by central banks; and

- Receivables and payables that arise from arrangements that are, in substance, similar to, and have the same economic effect as, financial instruments, but are not contractual in nature.

Exposure Draft 69 'Public sector specific financial instruments', Amendments to IPSAS 41 'Financial instruments' (ED 69, issued in August 2019) proposes guidance on how to account for a number of important categories of financial instruments that are unique to the public sector (monetary gold, currency in circulation, IMF quota subscriptions and special drawing rights).

Reference to EFRAG assessment

No specific individual technical assessment of IAS 32, the IFRS equivalent of IPSAS 28, was carried out by the EFRAG, and therefore no specific individual endorsement report was produced.

The EFRAG however provided on 19 June 2002 a positive assessment of all IAS standards existing at 1 March 2002, including IAS 21, as part of the overall introduction of IAS within the EU.

The IASB's current research project on Financial Instruments with Characteristics of Equity (FICE) is a new round of a long debate on how to distinguish liabilities from equity instruments. The IASB has finalised its discussions on this project and issued a Discussion Paper on 28 June 2018.

In the EFRAG Draft Comment Letter, EFRAG considered that the application issues that arise with IAS 32 are pervasive enough to require standard-setting activity and welcomed the IASB’s efforts to respond to challenges in distinguishing financial liabilities from equity instruments. However, EFRAG had reservations over some of the proposals in the DP, including classification changes for financial instruments that, to EFRAG’s knowledge, do not raise concerns in practice today.

In the final EFRAG comment letter issued on 1 February 2019, EFRAG suggests the IASB to focus at this stage on targeted improvements to IAS 32, particularly on improvements to disclosure requirements and the classification guidance on complex instruments with contingent settlement provisions. EFRAG also suggests that some of the proposed supporting guidance could usefully be incorporated into IAS 32 as it could help address challenges identified in the application of IAS 32 in areas such as the fixed-for-fixed condition and the role of economic compulsion when the entity has alternative settlement options without replacing IAS 32 or introducing completely new terminology.

Reference to EPSAS issue papers and other EPSAS preparatory work

The PwC study of 2014[2] analysed the suitability of the IPSAS standards as a basis for developing EPSAS. IPSAS 28 ‘Financial instruments: presentation’ was not addressed by the comments made by Member States but it would be necessary to keep in mind that requirements included in this standard may potentially be impacted by the discussions on IPSAS 41 and IPSAS 30. IPSAS 28 is classified under category 3 ‘Standards that might be implemented with minor or no adaptation’.

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

- classification and measurement model of financial assets;

[2] See PwC, Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards, 2013/S 107-182395, 1 August 2014

- impairment using an expected credit loss (ECL) model;
- hedge accounting.

The IPSASB made some consequential amendments to the requirements of IPSAS 28 as a result of IPSAS 41. No substantive changes have been made to the principles of presentation of financial instruments in financial liabilities or equity in IPSAS 28.

During the course of developing the technical proposal on EPSAS, Eurostat commissioned a series of twenty technical issues papers (IPs), which analyse in particular key public sector specific accounting issues. The papers were discussed at the EPSAS Working Group meetings during 2016-2018. The papers are all publically available on Eurostat's website. Two EPSAS IPs addressing financial instrument topics were produced in 2018. The topics covered were the accounting treatment of loans and borrowings on the one hand, and the accounting treatment of financial guarantees on the other hand.

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

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

- the "symmetric" recognition of claims and liabilities in the creditors and debtors accounts, a key condition in national accounts, is not necessarily transferrable where it leads to a breach of financial accounting principles and in particular that of "prudence";
- overly simple solutions would not help in the case of complex financial instruments. Where entities enter in the complex financial instruments, they should also be prepared to comply with recognition and measurement principles. Appropriate information should also be reported to users about the risks relating to those instruments.

Screening of IPSAS 28 ‘Financial instruments: presentation’ 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 28 ‘Financial instruments: presentation’, published in 2010 by the IPSASB.

Financial instruments can represent a significant proportion of an entity’s assets and liabilities and play an important role in managing the risks and generating cash flows for the investors. They have different forms and different levels of complexity. Therefore, it is important to maintain a principle-based set of standards, able to provide consistent accounting treatment for a broad range of transactions in the scope of IPSAS 41 and IPSAS 28.

In order to develop recommendations, one should first consider whether IPSAS 28 would meet the qualitative characteristics of the draft EPSAS CF, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

This report considers the presentation requirements applicable to financial instruments, as well as other items in the scope of IPSAS 28 for each of the qualitative characteristics of the draft EPSAS CF.

Further, this paper includes a high-level comparison between the requirements of IPSAS 28 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 28 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

Classification principles

In accordance with IPSAS 28, the issuer of a financial instrument should classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the **substance of the contractual arrangement and the definitions of a financial liability**, a **financial asset and an equity instrument.**

When an issuer applies the definitions in IPSAS 28 para 9 to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument if, and only if, specific conditions are met, as stated below.

The instrument includes no contractual obligation:

(i) To deliver cash or another financial asset to another entity; or

(ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the issuer.

If the instrument will or may be settled in the issuer's own equity instruments, it is:

(i) A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or

(ii) A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

Classification under IPSAS 28 is complex, and it requires the assessment of each component of an instrument's contractual terms. An issuer of a financial instrument should, on initial recognition, classify it, or its "component parts", as a financial liability, a financial asset or an equity instrument, in accordance with the contractual arrangement's substance and the definitions of a financial liability, a financial asset and an equity instrument.

Definition of a financial liability

A **contractual** financial obligation is necessary to classify a financial instrument as a liability. 'Contract' or 'contractual' refers to an agreement between two or more parties with clear economic consequences that the parties have little (if any) discretion to avoid, usually because the agreement is enforceable by law. Contracts can take a variety of forms, however, the obligation must be established through the terms and conditions of the financial instrument.

Definition of a "financial liability" is generally consistent with the draft EPSAS CF:

A financial liability under IPSAS 28 is any liability that is:

- A contractual obligation:

  - to deliver cash or another financial asset to another entity; or

  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

- A contract that will or might be settled in the entity's own equity instruments and is:

  - a non-derivative for which the entity is or might be obliged to deliver a variable number of the entity's own equity instruments; or

  - a derivative that will or might be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Under the draft EPSAS CF, a present obligation is a legally binding obligation (legal obligation) or non-legally binding obligation, which an entity has little or no realistic alternative to avoid.

The criteria in IPSAS 28 centre around the existence of an "unconditional right to avoid delivering cash", the draft EPSAS CF refers to an "obligation […] that an entity has little or no realistic alternative to avoid". The standard-setter could consider staying closer to the draft EPSAS CF in defining liabilities (and so distinguishing them from equity) by referring to no realistic alternative to avoid the transfer of economic resources, however considering economic compulsion may raise more questions than answers. Further arguments are included under 'Economic compulsion' section below.

An existence of a contract is a "past event" that gives rise to a legally binding (contractual) obligation and results in an outflow of resources (either cash or other financial assets or equity instruments in the transactions that do not meet "fixed for fixed" requirement as further described below).

Contractual obligation is an appropriate classification basis for financial liabilities

With the exception of the circumstances described in IPSAS 28 para 15 and 16 or para 17 and 18 (applicable for some 'puttable instruments'), a critical feature in differentiating a financial liability from an equity instrument in IPSAS 28 is the **existence of a contractual obligation** of one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange financial assets or financial liabilities with the holder under conditions that are potentially unfavourable to the issuer.

This classification approach provides relevant information to the users of the financial statements, because it has a predictive value about the future contractual cash outflows required to settle the existing liabilities. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or

similar distributions declared, or distributions of the net assets/equity, the issuer does not have a **contractual obligation** to make such distributions because it cannot be required to deliver cash or another financial asset to another party.

Public sector entities often hold capital subscriptions to other entities such as development banks. In some cases, the instrument held may be puttable, as the articles of incorporation allow redemptions at the issuer's (development bank's) carrying value when membership ceases. The puttable instruments exception described in IPSAS 28 para 15 and 16 or para 17 and 18 is a pragmatic solution to avoid wider issues that would arise under the IPSAS 28 classification approach, in particular for cooperative and finite-life entities. It should nevertheless be noted that the 'puttable exception' runs contrary to the objective of a single conceptual basis for classification, namely the existence of a contractual obligation to deliver cash. The standard-setter might wish to consider a more consistent and principles-based solution for cooperative entities.

Contracts settled by receipt or delivery of own equity instruments

A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation.

Such a contractual right or obligation may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable other than the market price of the entity's own equity instruments (e.g., an interest rate, a commodity price, or a financial instrument price). Such a contract is a financial liability of the entity even though the entity must or can settle it by delivering its own equity instruments. It is not an equity instrument because the entity uses a variable number of its own equity instruments as a means to settle the contract. Accordingly, the contract does not evidence a residual interest in the entity's assets after deducting all of its liabilities and presenting such a contract in equity would not provide relevant information and would not comply with the draft EPSAS CF.

Economic compulsion

In accordance with IPSAS 28, financial instruments are classified in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. However, the standard is silent on the role of economic compulsion and incentives. Based on the current definitions, economic compulsion by itself does not result in a financial instrument being classified as a liability under IPSAS 28.

The issue is related to the fact that even though the terms and conditions of a financial instrument might grant the entity the right for either equity or liability settlement (leading to equity classification), there may be economic incentives for an entity to choose the liability option.

The classification criteria should, in principle, be consistent with the draft EPSAS CF, and refer to obligations which the entity “has no practical ability to avoid”. This modification would ensure that the economic compulsion is reflected in classification decisions under EPSAS.

Faithful representation / Reliability

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

Completeness

The completeness of the requirements of the standard should be assessed together with additional extensive disclosure requirements of IPSAS 30.

Contingent settlement provisions

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate, or taxation requirements, or the issuer’s future revenues, surplus or deficit, or debt-to-equity ratio.

The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless the instrument meets conditions in IPSAS 28 para 30. One important exception applies when the issuer can be required to settle the obligation in cash or another financial asset only in the event of **liquidation of the issuer**.

It follows that obligations to deliver cash or other financial assets, that are contingent only on the issuer’s liquidation, are ignored for debt/equity classification purposes. Taking these obligations into consideration would be inconsistent with the going concern application principle in the draft EPSAS CF. A provision that provides for payment in cash or another financial asset, only on the entity’s liquidation, is similar to an equity instrument that has priority in liquidation. Therefore, non-recognition of such instruments is not inconsistent with the Completeness QC.

A mandatory distribution of all proceeds to shareholders, following the sale of all of the assets of the entity (such that a shell is all that would remain), would fall within the scope of a ‘liquidation’, even though the legal process of a winding up has not been concluded.

Offsetting of financial assets and financial liabilities

IPSAS 28 allows offsetting of financial assets and financial liabilities, when and only when conditions in IPSAS 28 para 47 are met. Draft EPSAS CF requires that ‘assets and liabilities… shall not be offset unless so required or permitted by an EPSAS’.

The standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity.

For example, a master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of operations. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in IPSAS 28 para 47 are satisfied. In other words, a right of set-off should be legally enforceable in the normal course of business and not only following an event of default. Further, IPSAS 28 clarifies that in the transfers of financial assets failing derecognition under IPSAS 41, the offset of the transferred assets and the associated liability will not be appropriate.

In addition, IPSAS 30 require quantitative information about recognised financial instruments that are offset in the statement of financial position, as well as those recognised financial instruments that are subject to master netting or similar arrangements, irrespective of whether they are offset.

The offsetting requirements in IPSAS 28 are appropriate and do not conflict with the QC of 'Completeness' or the AP of 'Aggregation/offsetting'.

Prudence

If an entity reacquires its own equity instruments, those instruments ('treasury shares') should be deducted from net assets/equity. No gain or loss is recognised in surplus or deficit on the purchase, sale, issue, or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the economic entity. Consideration paid or received shall be recognised directly in net assets/equity rather than as a financial asset in the statement of financial position. This approach is both neutral and prudent, because treasury shares are not items with service potential or the ability to generate economic benefits for an entity (so they do not meet definition of an asset under the draft EPSAS CF).

Neutrality

IPSAS 28 provides consistent classification principles for all financial instruments in its scope, achieving neutral presentation of the inflows and outflows of economic benefits and thus the economic reality.

IPSAS 28 aligns classification of distributions to the holders of financial instruments with the classification of the financial instruments as financial liabilities or equity instruments. So, interest, dividends or similar distributions, losses, and gains relating to a financial instrument or a component that is a financial liability is recognised in

surplus or deficit. Distributions to holders of an equity instrument are debited by the entity directly to net assets/equity, net of any related income tax benefit.

Transaction costs incurred on transactions in net assets/equity should be accounted for as a deduction from net assets/equity, net of any related income tax benefit.

Verifiability

It is debateable whether more granular information about the contractual terms of financial liabilities, such as interest rates and the maturity of specific financial instruments, would be decision-useful for users. Disclosures relating to the terms and conditions of financial liabilities are already required under IPSAS 30.

The standard-setter may wish to consider strengthening the disclosure requirements around terms and conditions for equity instruments, to address the information needs of the users of financial statements. This additional information will help addressing an important issue of equity instruments in the public sector as noted under QC 'Substance over form'.

Substance over form

IPSAS 28 (as a principle-based standard) is designed to reflect the substance of an economic phenomenon instead of merely providing information about its legal form. In case the legal form differs from the substance of an economic phenomenon, relevant information is provided in order for the users to understand the difference.

In some accounting frameworks, classification and measurement of financial instruments is driven by legal form rather than by economic substance. An approach based on economic substance is superior to one based on the legal form; therefore IPSAS 28 is more appropriate in this regard. The requirements of the standard properly address the need to reflect in a transparent way the substance of the (sometimes complex) financing arrangements, the financial risks that are taken by governments when they enter into significant and risky transactions, including financial guarantees, derivatives or compound financial instruments. The substance of these transactions should be reflected in the financial statements as either financial liabilities or equity instruments.

Under IPSAS 28, the substance of a financial instrument, rather than its legal form, governs its classification on the entity's statement of financial position. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity instruments but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities.

For example:

A preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability.

A financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability, except for those instruments classified as equity instruments in accordance with para 15 and 16 or para 17 and 18.

Another example is a financial instrument that provides that on settlement the entity will deliver either cash or another financial asset or its own shares whose value is determined to exceed substantially the value of the cash or other financial asset. Although the entity does not have an explicit contractual obligation to deliver cash or another financial asset, the value of the share settlement alternative is such that the entity will settle in cash. In any event, the holder has in substance been guaranteed receipt of an amount that is at least equal to the cash settlement option. The instrument is therefore a financial liability.

Equity instruments in the public sector

The application guidance addresses an important issue of equity instruments in the public sector, with focus on the substance of the transaction other than its legal form.

The issuance of equity instruments in respect of a transfer of resources is not essential for the transfer to meet the definition of a contribution from owners. Transfers of resources that result in an interest in the net assets/equity of an entity are distinguished from other transfers of resources because they may be evidenced by the following:

- A formal designation of a transfer of resources (or a class of such transfers) by the parties to the transaction as forming part of an entity's net assets/equity, either before the contribution occurs or at the time of the contribution. For example, on establishing a new entity, the budget office of the department of finance may deem that the initial transfers of resources to an entity establish an interest in the net assets/equity of an entity rather than provide funding to meet operational requirements.
- A formal agreement, in relation to the transfer, establishing or increasing an existing financial interest in the net assets/equity of an entity that can be sold, transferred or redeemed.

Even though transfers of resources may be evidenced by a designation or formal agreement, IPSAS 28 stipulates that 'an entity assesses the **nature of transfers of resources based on their substance** and not merely their legal form'.

For the purposes of IPSAS 28, the term 'equity instrument' may be used to denote the following instruments:

- A form of unitized capital such as ordinary or preference shares;
- Transfers of resources (either designated or agreed as such between the parties to the transaction) that evidence a residual interest in the net assets of another entity; and/or
- Financial liabilities in the legal form of debt that, in substance, represent an interest in an entity's net assets.

Classification of financial instruments with settlement options

Financial instruments with settlement options are addressed in IPSAS 28 para 31. When a derivative financial instrument gives one party a choice over how it is settled (e.g. the issuer or the holder can choose settlement net in cash or by exchanging shares for cash), it is a financial asset or a financial liability unless all of the settlement alternatives would result in it being an equity instrument.

An example of a derivative financial instrument with a settlement option that is a financial liability is a share option that the issuer can decide to settle net in cash or by exchanging its own shares for cash.

To summarise, contracts accounted for as derivatives under IPSAS 28 include contracts that are:

- Settled net in cash (or other financial assets), where the party with a loss delivers to the party with a gain a cash payment equal to the gain and no own equity is exchanged.
- Settled net in the entity's own equity, where the party with a loss delivers equity with a current fair value equal to the gain to the party with a gain (such that the entity's own equity is used as a settlement currency).
- Settled net in cash or net in own equity at the option of the entity or the counterparty.

The principles of IPSAS 28 for financial instruments with settlement options provides the appropriate accounting treatment. Any other method would necessitate a consideration of the economic incentives to determine the most likely settlement outcome, which could lead to divergent practice and might imply reclassification of instruments if those probabilities were to change.

Compound financial instruments

Under IPSAS 28, an entity recognises separately the components of a financial instrument that (a) creates a financial liability of the entity and (b) grants an option to the holder of the instrument to convert it into an equity instrument of the entity.

For example, a bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the entity is a compound financial instrument. From the substance over form perspective, such an instrument comprises two components: a financial liability (a contractual arrangement to deliver cash or another financial asset) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert it into a fixed number of ordinary shares of the entity).

The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase ordinary shares.

Based on the assessment of the substance over form QC, the principle-based presentation requirements of IPSAS 28 achieve consistent classification of financial

instruments. The standard requires an assessment of the substance of contractual arrangements for classification purposes, and limits the negative impact of legal structuring opportunities on presentation of economically similar transactions.

Understandability

Based on our assessment, complexity of some of the requirements of IPSAS 28 does not impair understandability, provided appropriate disclosures be given as required by IPSAS and assuming users have a reasonable knowledge of financial instruments. Therefore, the standard satisfies the understandability criterion.

Comparability

Statutory versus contractual rights and obligations

In certain jurisdictions, arrangements in the public sector may arise through statutory powers. In addition, some public sector entities are precluded from entering into formal contracts, but do enter into arrangements that have the substance of contracts. To assist entities in identifying contracts, the IPSASB issued additional application guidance (IPSAS 28.AG 20) explaining the factors an entity should consider in assessing whether an arrangement is contractual or non-contractual.

For example, to be within the scope of IPSAS 28, financial guarantees should have the key features of a contractual arrangement. Thus, a statutory right to issue guarantees, of itself, is not within the scope of the standard. This additional guidance for the public sector entities should enhance consistent application of the standard across the EU member states.

Alignment with other frameworks

ESA 2010

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

The definitions of financial liabilities and equity instruments under ESA 2010 are broadly comparable to IPSAS 28, although IPSAS 28 provides more guidance on the classification of specific types of contracts as either a financial liability or an equity instrument (or both in case of compound financial instruments).

Under ESA 2010, a financial claim is the right of a creditor to receive a payment or series of payments from a debtor. Financial claims are financial assets that have corresponding liabilities (ESA 2010 5.05).

Maintaining symmetry in the macroeconomic statistical system is a fundamental principle.

Liabilities are established when a debtor is obliged to provide a payment or a series of payments to a creditor (ESA 2010 5.06).

Equity is defined in ESA 2010 5.141 as follows: equity is a financial asset that is a claim on the residual value of a corporation, after all other claims have been met. Ownership of equity in legal entities is usually evidenced by shares, stocks, depository receipts, participations, or similar documents.

Other equity comprises all forms of equity other than those classified in sub-categories listed shares (AF.511) and unlisted shares (AF.512).

When communicating on financial reports to users, it can be helpful to explain how the concept of financial liabilities compares to the related concepts and indicators used to measure the Maastricht Debt (EDP debt) and in ESA 2010.

Even if IPSASs do not specifically define debt or net debt, they require a comprehensive statement of financial position, including all assets and liabilities (financial and non-financial). IPSASs do not emphasize individual line items, such as financial liabilities, or components of individual line items, such as debt in isolation from other liabilities. This is because IPSASs emphasize fair presentation, which is the complete view of the financial position of an entity, including its resources and the claims on those resources (from IPSASB Staff Questions and Answers, May 2015)

IFRS[3]

IPSAS 28, Financial Instruments: Presentation is drawn primarily from IAS 32 'Financial instruments: presentation' (issued originally in 2003, including amendments up to December 31, 2008) and from IFRIC 2 'Members' shares in co-operative entities and similar instruments'.

The principles in the standard complement the principles for recognising and measuring financial assets and financial liabilities in IPSAS 41 'Financial instruments', and for disclosing information about them in IPSAS 30 'Financial instruments: disclosures'.

Additional guidance in IPSAS 28 compared to IAS 32 includes for example:

- Application Guidance dealing with the identification of arrangements that are, in substance, contractual.
- Application Guidance dealing with equity instruments in the public sector.

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

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

EU Accounting Rules

EU Accounting Rule (AR) 11 prescribes the accounting treatment of financial instruments and applies to the classification, presentation, recognition and measurement of financial instruments as well as to disclosures on financial instruments and the risk management in the context of financial instruments. EU AR 11 is derived from IPSAS 28-30.

IPSAS 29 has been superseded by IPSAS 41 that is effective for annual periods beginning on or after 1 January 2022. A detailed comparison of the requirements of AR 11 and IPSAS 41 would therefore include differences for all the consequential amendments to IPSAS 28 as a result of IPSAS 41.

European Public Good

Assessing whether IPSAS 28 is conducive to the European public good

The assessment of whether IPSAS 28 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 28 would not be conducive to the European public good:

- IPSAS 28 will contribute to improving financial reporting when compared to heterogeneous reporting requirements currently applied in the EU.

- The information needed for the application of IPSAS 28 can be available in a timely manner, provided the necessary systems and procedures are in place. Implementation of the standard may result in moderate one-off costs and should be relatively cost neutral on an ongoing basis for preparers. The benefits derived from the improvements should however outweigh the costs. A proportionate pragmatic approach to implementation contributes to this objective.

Conclusion

Assessing IPSAS 28 against the criteria formulated in the draft EPSAS framework

The analysis has not revealed major conceptual issues with IPSAS 28 'Financial instruments: presentation' and has not identified any major inconsistencies between IPSAS 28 and the draft EPSAS framework.

Following the screening analysis summarised in the present report, the future standard setter could consider following conclusions. The information resulting from the application of IPSAS 28:

- 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.

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

- *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.

- *Economic compulsion.* In accordance with IPSAS 28, financial instruments are classified in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument. However, the standard is silent on the role of economic compulsion and incentives. Based on the current definitions, economic compulsion by itself does not result in a financial instrument being classified as a liability under IPSAS 28. The classification criteria should, in principle, be consistent with the draft EPSAS CF, and refer to obligations which the entity 'has no practical ability to avoid'. This would ensure that economic compulsion is reflected in classification decisions, however such a modification would further increase the level of judgment required to achieve proper classification.

- The *puttable instruments exception* described in IPSAS 28 para 15 and 16 or para 17 and 18 is a pragmatic solution to avoid wider issues that would arise under the IPSAS 28 classification approach, in particular for cooperative and finite-life entities. It should nevertheless be noted that the 'puttable exception'

runs contrary to the objective of a single conceptual basis for classification, namely the existence of a contractual obligation to deliver cash. The standard-setter might wish to consider a more consistent and principles-based solution for cooperative entities.

- *Additional disclosures for equity instruments*. The standard-setter may wish to consider strengthening the disclosure requirements around terms and conditions for equity instruments, to address the information needs of the users of financial statements.

For effective communication of the financial information to users, the future standard setter could consider preparing guidance on presentation of conceptual differences between the financial accounting and statistical frameworks.

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 28 as a starting point in implementing the equivalent EPSAS.