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# ASSESSMENT OF THE APPLICATION OF IFRS 9 REQUIREMENTS BY SOUTH AFRICAN STATE-OWNED ENTITIES

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**Abstract**

The global financial crisis in 2008 nearly resulted in a possible total collapse in the financial markets, which resulted in the development of new International Financial Reporting Standard (IFRS) 9: Financial Instrument. This study's objective is to assess the quality information presented in the accounting policies in relation to IFRS 9: Financial Instruments, by the selected South African State-Owned Entities (SA SOEs) listed in Schedule 2 of the Public Finance Management Act (PFMA). The researchers have been interested in the factors of implementation and compliance of IFRS, though most of these studies are dominated by Asian and European countries with few for Africa. Using qualitative content analysis, the authors assessed the quality information in the accounting policies in relation to IFRS 9 against SOEs' financial reporting. This study found that most of the SOEs applied the requirements of the IFRS 9 standard in terms of classification and measurement of financial assets and liabilities, though there is still room for improvement on the quality of the information provided by SOEs in their financial reports. The improvement on the quality of financial reporting is critical, as it could in turn help to build trust and confidence of investors to attract further investment.

**Keywords**: State-Owned Entities, IFRS, Financial Instrument, Financial Reporting, Classification and Measurement

**JEL Classification:** F63, M41, M48, H83

## 1. Introduction

Over the years, the compilers and users of financial statements raised criticisms and concerns in relation to accounting standards on financial instruments (Huian, 2012). In addition, the global

financial crisis in 2008 became an early warning of a possible total collapse in the financial markets, where leaders of Group of 20 (G20) were urged to engage core international professional bodies of accounting standards for the creation of a particular high-quality international accounting standard (Johannes *et al.* Muksin, 2018). Bischof and Daske (2016) state that new IFRS 9: Financial Instrument became the outcome of various forces contributing to the due process of International Accounting Standards Board (IASB). This IFRS 9 standard became effective in the reporting periods commencing on or after 1 January 2018.

To that effect, all entities which have the financial instruments on their statement of financial position had to replace the International Accounting Standard (IAS) 39 with IFRS 9, even though this replacement came with major impacts on the procedures, events, decision-making, and eventually on financial statements and accounting itself (Gornjak, 2017). The development of IFRS's standards assist in promoting a uniform reporting standard for better reliability and comparability of the financial information between various entities.

Tawiah and Boolaky (2020) claim that since the adoption of IFRS, the researchers have been interested in the factors of implementation and compliance of IFRS, though most of these studies are dominated by Asian and European countries with few which are specific to IFRS in Africa. Therefore, the objective of this article is to assess the quality information presented in the accounting policies in relation to IFRS 9: Financial Instruments, by the selected SA SOEs listed in Schedule 2 of the PFMA. This study contributes to the existing knowledge because there is no study conducted specifically to assess the quality information presented in the SA SOEs' accounting policies in relation to IFRS 9: Financial Instruments. This study also makes valuable contribution to the IFRS 9 literature, and SOEs will be assisted in the identification of further relevant information that should be provided in their financial reports for the users to have insight.

## 2. Literature review

### 2.1. Practices of financial reporting

International accounting practices appear to have converged in the three prior decades despite the uncertain effective regulatory mandates to encourage comparability (Fang *et al.* 2015). The OECD (2020) states that in most jurisdictions, there is a mixture of financial practices between IFRS and national accounting standards, which may be Generally Accepted Accounting Practice (GAAP). On the other hand, there is a developed conceptual framework to guide financial reporting practices. This framework represents a consistent system of concepts, and its absence will result in bad accounting practices prevailing over good accounting practices (Măciucă *et al.* 2015). Hence, this framework aims to guide the setters of accounting standards in developing the standards aligned with consistent concepts, and for the preparers of financial statements to produce consistent accounting policies in cases where standards are not applicable or permit an option of accounting policy (Barker and Teixeira, 2018). The conceptual framework contains accounting information characteristics that are necessary for the preparation of quality accounting reports and ensures comparability in the international market (Măciucă *et al.* 2015). Therefore, financial information quality requires the following series of appropriate characteristics: accessible and reliable, consistent and comparable, relevant, transparent, and useful for decision-making (Valentinetti and Rea, 2012).

Onali *et al.* (2017) claim that policymakers are more interested in understanding the IFRS 9 capital-market results because this improves evaluation on whether the development results in high-quality financial reporting and benefits global investors. On the other hand, Gornjak (2017) states that the replacement of the IAS 39 standard for financial instruments becomes a challenge to entities because of the shifting from a backward-looking approach to a forward-looking approach.

In the context of SOEs, demand is growing for public entities to attain levels of financial accountability and transparency that are on par with their private sector counterparts (Dhliwayo, 2018). SOEs are mainly regulated by PFMA No. 1 of 1999 and the Companies Act No. 71 of 2008 in conjunction with other specific sector regulations. Capalbo and Palumbo (2013) also support that any entity operating as a limited company in the market should ensure adherence to all the

accounting requirements as established through appropriate legislations on the general economic situation and for the third parties' best interests.

### 2.2. Review of previous research conducted on IFRS 9: financial instrument

The critics of the financial instrument standard recommended certain enhancements and simplifications be made of its contents. IFRS 9 to replace IAS 39 was among the main subject matters in IASB agenda prior to commencement, where the reform advocates claimed that IFRS 9 might lessen and simplify many IAS 39 rules and improve cross-country comparisons (Onali and Ginesti, 2014). However, Lukova (2021) states that the financial instruments are still deemed as one of the most complex accounting objects, as the complexity of their accounting treatment are frequently linked with a complicated regulation of the appropriate issue within local and international standards for financial and accounting reporting. IFRS 9 will not primarily change the accounting practices on financial instruments, but a most substantial modification is likely to be observed on the new approach of expected loss to the loan's impairment (Bischof and Daske, 2016). Liubkina *et al.* (2020) note that IFRS 9 application might significantly impact an entity's capital and provide appropriate financial instruments value measurement. However, Onali and Ginesti (2014) observed that most of the investors were confident with IFRS 9's ability to deal with inherent problems of IAS 39, although cross-country variations should be expected. On the contrary, Barker and Penman (2020) argue that the accounting treatment on the hedging instrument under IFRS 9 requirements might result in mismatching.

IFRS 9 introduced principles-based accounting, while the IAS 39 was founded on the rules that permit making decisions that are more predictable in an uncertain environment (Gornjak, 2017). Gornjak (2020) attests that this IFRS 9 was developed as a principles-based standard with forward-looking information contained in the loss allowances calculation, and this approach is an innovation in accounting that is created in all other new IFRS standards. Furthermore, Lee *et al.* (2020) identifies that this IFRS system applies a principles-based approach which is utilized worldwide, and it aims to provide guidelines in assisting the accountants to produce the financial documents, instead of applying rigorous rules.

### 2.3. Application of IFRS 9: financial instruments

The IASB proposed a fair value measurement approach in IFRS 9 to give stakeholders an early warning on the fluctuations in the current market expectations (Gornjak, 2017). Measurement for non-trading financial assets was at Fair Value Through Other Comprehensive Income (FVOCI) under IAS 39, while IFRS 9 applies Fair Value Through Profit or Loss (FVTPL). This might have serious consequences for the entities that hold instruments, and their business model includes selling them or holding a portfolio of investments in equity instruments (PWC, 2017). The following sub-sections present the classification and measurement of financial assets and financial liabilities under IFRS 9: Financial Instruments.

#### 2.3.1. Measurement and classification of financial assets

Kvaal *et al.* (2023) states that all the financial assets should be evaluated based on the cash flows characteristics and/or business model where they are kept. The business model entails how an entity manages the financial assets portfolios in practice to create cash flows by selling assets or collecting the contractual cash flows or both (Sichirollo, 2015). These factors aim to determine how financial assets must be measured, either at an amortized cost, FVOCI or FVTPL (Johannes *et al.* 2018). Ha (2017) clarifies that the current assets that were classified as per IAS 39 such as receivables and loans, held to maturity and those available for sale have to be reclassified according to new categories in IFRS 9. Hence, amortized cost is used to measure the financial assets after initial recognition, but only when the following criteria are both met: an asset is held in the business model with the intention for holding those assets to accumulate contractual cash flows; and contractual terms of the financial asset gives rise on the indicated dates to the cash flows that are exclusively payments for capital and interests on the outstanding capital amount (Huian, 2012).

The shared effects of application of the “characteristics of contractual cash flow” and “business model” tests might lead to variations on the treatment of financial assets that are then measured at a fair value or amortized cost, as compared with that of IAS 39 (Johannes *et al*. 2018). IFRS 9 established different criteria from that of IAS 39 to determine when amortized cost, FVOCI or FVTPL categories apply. Gornjak (2017) notes that the treatment of the initial measurement and initial recognition is the same between the IAS 39 and IFRS 9, however, major changes are noted on the financial instruments’ classification and its subsequent measurement.

### 2.3.2. Measurement and classification of financial liabilities

Kvaal *et al.* (2023) identifies that accounting treatment on financial liability stays greatly unchanged under IFRS 9. However, changes were only made to deal with own credit issues where entities opt to use fair value when measuring financial liabilities (Kvaal *et al.* 2023). Johannes et al. (2018) also identify that the financial liabilities’ classification is basically unaffected where some liabilities are measured at a fair value but gain or loss concerning own credit risk changes should be part of other comprehensive income. Sichirollo (2015) notes that IFRS 9 adopted the prohibition stated in IAS 39 that the financial liabilities should not be reclassified.

## 2. Research methodology

The qualitative research approach is applied in this study because the focus is on assessing the quality of financial reporting in applying the IFRS 9 standard. An interpretative approach in research is considered as being highly valuable in accounting practices and in the profession as it enhances knowledge for improved corporate reporting (Scapens, 2008). Hence, this approach is more relevant to responding to this study’s objective of assessing the content of financial reports and interpreting the results.

### 3.1. Sample selection

All 21 SOEs listed under Schedule 2 of the PFMA represent the population. However, only 15 SOEs that adopted IFRS standards and already published all of their financial reports for the yearly periods ending 31 March 2019, 2020, and 2021, represented the sample selected for the purpose of this study. The purposive sampling technique is appropriate for this study because the aim is to focus on the content analysis of the specific major SOEs that participate in the global markets, and their financial reporting also conforms to international reporting standards. The aspects of the IFRS 9 standard covered in the scope of this study include classification and measurement of financial assets and financial liabilities. A checklist of classification and measurement requirements in the IFRS 9 standard is designed to assist in assessing the selected SOEs’ financial reports.

### 3.2. Qualitative content analysis of annual financial reports

Elo *et al.* (2014) describe qualitative content analysis as one of numerous qualitative methods available at present for data analysis and the interpretation of its meaning. As a result, a three-scale coding system was used in the thematic content analysis to assess the quality of the information presented, comprising of the following codes: Below standard, Standard, and Excellent, as described in Table 1 below.

**Table 1. Three-scale coding system for quality assessment**

| Guideline | Below Standard | Standard | Excellent |
|---|---|---|---|
| Accounting Policies | If any part of the information is not clearly or sufficiently presented, or irrelevant information is provided, then it is marked as **Below standard.** | If the information presented is relevant, clear and sufficient, but quoted directly from accounting standards (thus generic and not entity specific), then it is marked as **Standard.** | If the information presented is relevant, clear and sufficient; and if the information is tailored to provide more specific information to the entity, then it is marked as **Excellent.** |

### 3.3. Analysis of the annual financial reports

The following steps were considered when collecting secondary data for the purpose of assessing the SOEs' financial reports: The SOEs' annual financial reports for the three financial years were extracted from their websites and other sites; The IFRS 9: financial instruments standard was downloaded from the IFRS website, and its contents were analyzed to identify relevant paragraphs; The contents of the accounting policies in each financial report were assessed against each IFRS 9 requirement populated in the checklist to determine the quality information presented; and The findings on the checklist were customized into a table to provide narrative explanation and interpretation.

## 4. Results
### 4.1. Introduction

The IFRS 9 standard provides lists of the requirements to guide the application of the standard in each aspect of classification and measurement. The main objective for the entities to ensure compliance with these IFRS 9 requirements is to produce information that is relevant and useful to the users of the financial statements in assessing the timing, amounts, and uncertainty of the future cash flows of the entities. Another objective of classifying and measuring the financial assets and liabilities according to the requirements under IFRS 9 is to avoid over- and under-valuation, thereby protecting the entities from risks (such as credit and price risk) in the future (Gope, 2018).

### 4.2. Quality of the IFRS 9 requirements presented in the accounting policies

Table 2 reflects a summary of all seven sections consolidated to provide a comprehensive scenario on the quality of the compliance information presented by the SOEs in their annual financial reports. These results only include those entities who applied the applicable requirements of IFRS 9 in the preparation of their financial statements.

**Table 2. Overall results on quality of compliance information**

| Paragraph Covered | Number of Entities | 2018/19 | | | 2019/20 | | | 2020/21 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Below standard | Standard | Excellent | Below standard | Standard | Excellent | Below standard | Standard | Excellent |
| Classification of Financial Assets (Paragraph 4.1) | 15 | 13% | 24% | 63% | 13% | 25% | 62% | 13% | 22% | 65% |
| Classification of Financial Liabilities (Paragraph 4.2) | 15 | 0% | 23% | 77% | 0% | 23% | 77% | 0% | 23% | 77% |
| Reclassification (Paragraph 4.4) | 15 | 57% | 10% | 33% | 57% | 10% | 33% | 72% | 3% | 25% |
| Initial measurement (Paragraph 5.1) | 15 | 29% | 27% | 44% | 31% | 26% | 43% | 37% | 18% | 44% |
| Subsequent measurement of financial assets (Paragraph 5.2) | 15 | 0% | 9% | 91% | 0% | 11% | 89% | 0% | 9% | 91% |
| Subsequent measurement of financial liabilities (Paragraph 5.3) | 15 | 3% | 13% | 83% | 3% | 13% | 83% | 3% | 10% | 87% |
| Reclassification of financial assets (Paragraph 5.6) | | - | - | - | - | - | - | 100% | 0% | 0% |

**Source:** Annual reports (own analysis)

#### 4.2.1. Classification of financial assets

The results indicate that an average of 63% of the SOEs performed extremely well and have a robust tendency of providing more relevant information than just generic information. In all the financial years, this excellent performance is observed in most of the requirements as it is noted that the entities presented the information in their financial reports that is tailored to provide more specific disclosure/information related specifically to the entity in terms of the recommendations of IFRS 9. It was also observed that an average of 24% of the entities' accounting policies have room for some improvements as they were found to be generic and simply quoted directly from the standard. For example, an average of 40% of the entities across the financial years were simply stating that classification of financial assets depends on the business model and characteristics of contractual cash flow. It would have been more useful and more understandable if it was tailored to an entity's specifics by discussing the entity's specific business model and contractual cash flow characteristics linked to financial assets.

Only 13% of the sample in each financial year failed to provide accounting policies that are clear and contain adequate and relevant information. This is primarily due to information not being adequate and clear with regard to whether or not the entity irrevocably designates financial assets as measured at FVTPL. This practice would eliminate or at least reduce measurement inconsistency significantly (otherwise referred to as accounting mismatch). Information that is not adequate, clear, and relevant may result in uncertainty surrounding the future of the business. Dratwińska-Kania *et al.* (2023) confirm that reporting transparency is crucial for the value creation of an entity, especially tools applied in the policy for preparing financial statements.

#### 4.2.2. Classification of financial liabilities

The assessment results indicate that across the financial years, an average of 77% of the accounting policies' information in the financial reports is categorized as excellent, while 23% represents standard information. This means that there is no information presented in these SOE's financial reports that was classified as below standard in terms of the requirements under classification of financial liabilities. It is worth noting that, in each financial year, 100% of the entities provided clear, adequate, and relevant information that is tailored to the specifics of the entity's financial liabilities items that are designated at FVTPL, and the rationale given behind this designation complies with the requirement.

From the information disclosed, it was clear which financial liabilities are classified at amortized cost or FVTPL and what is included in each of those liabilities. These entities which achieved excellent ratings would, in some instances, also cross-reference their information in the accounting policies to other notes in their financial reports. The concern is that this trend over the financial year shows no improvement. Although it is commendable that no entity presented below standard information under this requirement, it is imperative for the entities to improve the information and ensure that information addresses the specifics of the entity. This will assist the entities to gradually gain the trust of the financial capital providers in terms of being able to determine what is entailed in each financial lability item and what informed the classification thereof.

#### 4.2.3. Reclassification

It is uncommon for the entities to change their business models. Hence, no entity changed its business model across these three financial years, which might have resulted in the reclassification of financial assets. The aggregated results on the assessment for the quality of compliance information under this reclassification aspect show that 57% of the entities in 2019 and 2020, and 72% in 2021, reported information that is categorized as below standard. This trend mainly emanates from the IFRS 9 requirement for information that relates to the reclassification of financial liabilities. Most of the entities sampled in all the financial years were silent in their accounting policies and other notes in terms of the reclassification of financial liabilities.

The majority of sampled entities provided clear, adequate and relevant information that addresses the specifics of the entity in terms of the treatments of reclassification of their items that are designated as hedging instruments. On the other hand, few entities provided more information on the hedged instruments but were silent on the accounting policies on how they treat the reclassification thereof. It is imperative for the entities to provide better and more understandable information that is tailored to an entity's specifics by deliberating on what instigated the reclassification of their items designated as hedged instruments and how that reclassification is treated.

#### 4.2.4. Initial measurement

The results reveal that an average of 44% of the sampled SOEs performed extremely well and have a robust tendency of providing more relevant information beyond the generic. In all these financial years, this performance is mainly observed where information on the treatment of difference between fair value and transaction price was tailored specifically to the entity in terms of what instigated the differences are and how those differences in each financial instrument were treated. Those entities rated under the excellent category provided information that is linked to each entity's specific financial instrument and clearly describe what is included in the transaction costs.

There is a concern that most of the entities across all the financial years provided information below standard when applying settlement date or trade date accounting, which contributed to this average of 32% under below the standard category. These entities presented information that was not adequate and clear if the financial assets were recognized by applying settlement date or trade date accounting. In terms of the requirement for treatment of trade receivables, most of the entities were rated between the below standard and standard categories in each financial year. This is because most of the information provided in their accounting policies or other notes was not adequate and clear with regards to the treatment of trade receivables where these receivables do not contain a significant financing component. In some instances, it was also observed that there is room for improvement on information that was generic and simply quoted directly from the standard (24%). It would have been more useful and more insightful if the entities provided more information addressing their specifics. A potential solution would be for the entities to indicate what constitutes a trade receivable without a significant financing component and an implicit statement as to how those receivables in that particular financial year were treated.

#### 4.2.5. Subsequent measurement of financial assets

The assessment results indicate that across the financial years, high and commendable averages ranging between 89% and 91% of the accounting policies information in the financial reports are categorized as excellent while averages ranging between 9% and 11% represent information classified as standard. This resulted in a desired outcome of 0% on information rated under the below standard category.

The information that is rated as standard was informed by the entities that have a strong tendency of providing generic information on the subsequent measurement of their financial assets without tailoring it to the specifics of an entity. This is a concern because the transparency of information is critical, particularly the disclosure of measurement about financial asset and its figures for the financial capital providers to make a proper informed assessment on the value of an entity. Nonetheless, those entities rated under excellent category, provided information linked to each financial asset item of an entity and some went further to the extent of cross-referencing their information in the accounting policies to other notes in their financial reports. This steering away from generic information is positive because statements of general measurement imply that there is a risk of an information gap and consequently some of the financial statement users would not be able to sufficiently make their analysis based on their need.

The entities have done exceptionally well in all the financial years in terms of both the requirements on the treatments of impairment and items designated as hedge instruments, as

they had achieved 100% under the excellent category. This is because the information as presented in their accounting policies and other notes were more linked to each item in the entity in terms of what informed that impairment on the particular item, how the impairment was treated, what constituted hedge items and how it was treated (as fair value hedges or cash flow hedges). These entities were also clear on documenting their assessment both at hedge inception and on an ongoing basis.

#### 4.2.6. Subsequent measurement of financial liabilities

The results indicate that over the financial years assessed, an average ranging between 83% and 87% of the SOEs performed extremely well and have a robust tendency of providing more relevant information beyond standard generic information. In all these financial years, this excellent performance is mainly related to both the requirements on treatments of items designated as hedge instruments, as they had achieved 100% under the excellent category. That is because the information as presented in their accounting policies and other notes was more linked to each item in the entity in terms of what constitute hedge items and how they were treated (as fair value hedges or cash flow hedges). An average of 12% of the entities presented the information that was too generic, and in most cases, lacks a basis for linking the information to the specifics of an entity. Only 7% in each financial year represent failure by the entities to provide accounting policies that are clear with adequate and relevant information.

#### 4.2.7. Reclassification of financial assets

It is also notable that Table 2 reflects only the 2020/21 financial year because one entity applied the requirement for the reclassification of the equity instrument from FVOCI to FVTPL in 2020/21. However, it was found that this entity was silent in its accounting policy about this specific reclassification. It was only identified in other sections of the financial reports (such as statements of comprehensive income and profit and loss, and other notes) that there was a reclassification. Furthermore, the information presented in those sections and notes was not clear and adequate because the information was more on the accounting treatment of the amounts. Lack of reported information suggests limited transparency in the reporting. It would have been preferable and more understandable if an entity had provided information specifically on this reclassification in the accounting policy including information as to what constitutes this reclassification.

### 4.3. IFRS 9 requirements: overall results

Overall, the results present evidence that almost all the SOEs applied the requirements of the IFRS 9 standard in terms of the aspect of classification and measurement of the financial assets and liabilities. However, it is apparent that the SOEs did not comprehensively apply the accounting policies as would be expected in terms of IFRS 9. The quality of the information presented in the accounting policies is of significant importance. It is worth noting that where the accounting policies are not tailored to the entity's specifics this may bring uncertainties and the risk of perceived untrustworthiness by users. Furthermore, where information presented is below standard, this may imply that there is a risk of an information gap and consequently, some of the financial statement users would not be able to effectively analyse the performance of an entity.

## 5. Conclusion and recommendations

The SOEs have significant roles in the economic development of countries. Therefore, quality financial reporting by SOEs within the emerging markets is critical to attract private sector investment participants. This study revealed that most of the entities that gave attention to their accounting policies did so in an excellent manner in most of the aspects. It was also observed that the SOEs with excellent accounting policies did so because of their robust tendency to provide information that is more tailored and linked to the specifics of an entity instead of providing generic information by directly quoting from the standard. However, it is evident that there is no

sign of improvement over the financial years, in terms of percentage of entities increases under excellent category, as it would have been expected considering that it is the third financial year since the SOEs commenced with the application of this IFRS 9 standard. It is a normal expectation that the entities should have known what is expected of them at the end of the third financial year.

The major concern is about information that is below standard because it might imply that there is a risk of an information gap and consequently some of the financial statement users would not be able to sufficiently make their analysis on an entity. The results and recommendations of this study might demonstrate a valuable contribution to the SOEs by identifying further relevant information that should be included in SOE's annual financial reports for the users to have insight and be able to effectively analyze the entities' financial instruments. This will help on improving the quality of the financial reporting which could in turn help to attract further investment. Future research may be conducted on the Top 40 companies listed on the JSE and a comparison could be made between the quality information provided by public sector and private sector entities with regards to IFRS 9 requirements.

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