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The anomaly of the classification of financial assets by South African banks

by

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Abstract

This minor dissertation investigates how the conflict in the classification of financial assets between IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 1 *Presentation of Financial Statements* is being bridged in the financial statements of banks by reviewing the classification of financial assets in the statement of financial position, accounting policies and the notes to the financial statements. IAS 39 provides specific classifications for financial instruments, while IAS 1 provides a classification based on liquidity.

The minor dissertation applied a quantitative content analysis of the annual financial statements of South African banks for the 2011 financial year. Companies in the sample selection were drawn from the FTSE/JSE classification of the Top 100 companies selected on their market capitalisation on 30 December 2011. Seven banks are included in the Top 100 companies.

The minor dissertation found that the classification of financial assets as required in IAS 39 is not shown in the statement of financial position. The statement of financial position is based on the liquidity classification in IAS 1. In contrast, the accounting policies for financial instruments are based on the IAS 39 classification. The structure of the notes to the financial statements follows the classification in the statement of financial position.

The minor dissertation further found that the conflict between the IAS 1 and IAS 39 classifications is bridged in the detail of the notes. Two methods are being used to bridge the conflict. The first method is to provide an IAS 39 reconciliation in each applicable note. In this reconciliation, the total amount of the note is allocated to an applicable IAS 39 classification. The second method is that the line items in the statement of financial position are allocated IAS 39 classifications in a table format. The table allocates the amount of individual assets and liabilities as identified in the statement of financial position in the categories required by IAS 39. Through using both Method 1 (reconciliation in each note) and Method 2 (a separate table based on the statement of financial position) the conflict
between IAS 1 (liquidity classification) and IAS 39 is bridged. However, the IAS 39 classification is not directly obtainable from the primary financial statements.

In the future, the study can be more comprehensively replicated in other countries and international research, as this exploratory research was only limited to seven banks in South Africa. Further research can also investigate entities other than banks to see how they bridge the conflict between IAS 1 and IAS 39. The review of the treatment of financial instruments resulted in the replacement of IAS 39 by IFRS 9 in November 2009. Future research of the new IFRS 9 classifications may assess how the conflict is being treated. In addition, further research can assess the quality of disclosure in the classification of financial assets/instruments in the financial statements of banks and other entities.
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Chapter 1

Introduction

1.1 Background

Convergence in global accounting standards has increasingly received a great deal of attention (Johnson, 2002). Convergence, as described in Ball (2006) and Tokar (2005), refers to a process of eliminating differences between International Financial Reporting Standards (IFRS) and the accounting standards of countries that retain their own standards. Following the Norwalk Agreement regarding the development of high-quality and compatible accounting standards, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a Memorandum of Understanding (MoU) that marks a significant step toward formalising their commitment to the convergence of United States (U.S) and international accounting standards in October 2002 (FASB and IASB, 2002; Johnson, 2002).

International Accounting Standard 39 Financial Instruments: Recognition and Measurement (IAS 39) was developed before the convergence projects with US Generally Accepted Accounting Principles (GAAP) (Buchanan, 2003). However, IAS 39 was based on US GAAP, particularly the Statement of Financial Accounting Standard (SFAS) 133 Accounting for Derivative Instruments and Hedging Instruments (Buchanan, 2003; Khoury, 2001; Whittington, 2005). IAS 39 and SFAS 133, both provide guidelines with regard to the recognition and measurement of financial instruments. The application of the provisions of both standards to recognition and measurement also deals with the classification of financial instruments.

Given that complexity is one of the most important issues in financial reporting, and that financial instruments are among the most complex with regard to clear reporting (IASB 2008a: BD12), many users of financial statements and other interested parties have told the Board that the requirements in IAS 39 are difficult to understand, apply and interpret (IASB
2009b: IN2). As a result of the complexity and difficulties experienced in applying the standard, users of financial statements urged the IASB to develop a new standard for the financial reporting of financial instruments that is principle-based and less complex than today’s requirements (IASB, 2008a).

The controversial issues concerning IAS 39 have been outlined by several studies (Bengtsson, 2011; Chan, 2010; Chatham et al. 2010; Fiechter, 2011a; Hague, 2004; Ighian, 2012; Stevenson, 2012; Walton, 2004; Whittington, 2005). Ighian (2012) points out that IAS 39 is by far the most difficult standard the IASB has produced, and it has been subjected to extended debates and improvements. The European Union (EU)’s original refusal to adopt all of IAS 39 highlights the fact that the recognition and measurement of financial instruments is a major area in which an international accounting standard has not gained acceptability by all constituents (Chatham et al. 2010). Vollrath and Schöning (2011) state that regulation under IAS 39 is very complex in terms of both understandability and application, especially with regard to the volatility and presentation of unrealised earnings. At their meetings in 2005, the boards (hereafter the IASB and FASB) confirmed a long-term objective to improve and simplify the accounting of financial instruments and to achieve increased international comparability in this area (IASB and FASB, Staff paper 2012).

Thereafter, the boards published a Memorandum of Understanding (MoU) — A Roadmap for Convergence between IFRSs and US GAAP — 2006-2008 (Street and Linthicum, 2007). The objective of such a publication by the boards is to reaffirm their commitment to the convergence of US Generally Accepted Accounting Practices (US GAAP) and International Financial Reporting Standards (IFRSs) (IASB, 2006). Progress on this roadmap for convergence based on MoU–driven–principles is the reason for the removal by the Securities and Exchange Commission (SEC) of the reconciliation requirement for non-U.S. companies that are registered in the United States and the use of the IFRSs issued by the IASB (IASB, 2008b). The removal of this reconciliation requirement may provide incentives for some market participants to request that the SEC–accepts financial statements in the future from US issuers that are prepared in accordance with IFRSs (Ernst & Young, 2011). As part of the Memorandum of Understanding (MoU), the boards published a discussion paper, Reducing Complexity in Reporting Financial Instruments, which deals with the main causes of complexity in reporting financial instruments (IASB, 2008a).
Financial reporting and accounting standards are deeply implicated in the recent global financial crisis (Arnold, 2009; Bengtsson, 2011; Laux and Leuz, 2009). During the financial market crisis, governments, regulators and investors raised concerns that the existing accounting models for financial instruments under both the IASB and the US FASB are inadequate for today’s complex economic environment (FASB 2010; Vollrath and Schöning, 2011). The recent global financial crisis is the result of the confluence of several factors (Mala and Chand, 2012:21). An accusation has been made that financial reporting has intensified the effects of the financial crisis (André et al. 2009; Laux and Leuz, 2009; Magnan, 2009). The IASB published a press release, The IASB provides update on response to the credit crisis, stressing that accounting was not the cause of the credit crisis (Ernst & Young, 2011). While supporting the view that financial reporting was neither a cause of the global financial crisis, nor that it exacerbated it, current literatures do argue that financial reporting does acknowledge that the global financial crisis has served as a wake-up call for standard-setters and their constituents (IASB, 2009b; Mala and Chand, 2012; Stevenson, 2012). All the same, some matters that have been identified in global financial crisis seem to have been generally accepted by standard-setters (Stevenson, 2012).

Following the discussion paper on reducing complexity in reporting financial instruments, responses called for the implementation of a Financial Crisis Advisory Group (FCAG). The role of such a group was to advise the IASB and FASB about the implications of the global financial crisis and to identify areas for potential changes (Stevenson 2012). In July 2009, the FCAG issued a report to the two boards, which was also sent to the Group of 20 (G20) (Ernst & Young 2011). This report recommended the application of effective financial reporting, high-quality and global accounting standards, the convergence of the US GAAP and IFRS standards, limitations of financial reporting, the independence of standard-setters and accountability (Stevenson 2012:13). Many of the recommendations that have been expressed by the FCAG arise from the classification and measurement requirements of IAS 39 (IASB, 2009b; Stevenson 2012).

Important debates after the global financial crisis attempt to resolve the issues regarding financial instruments. It was evident that accounting standards, and especially issues of financial instruments, would become a topic at the G20 summit of November 2008, since the G20 leaders called for immediate action by accounting standard-setters (Bengtsson, 2011). They put out a statement that called for a more comprehensive information system as both
prudential and accounting standards applicable to financial institutions needed be revised to ensure that they do not contribute to creating speculative bubbles in periods of growth and worsen crises at times of economic downturn (André et al. 2009). In April 2009 at the G20 summit, world leaders asked the IASB and FASB to review the existing standards relating to financial assets (Chan, 2010; Fougeron, 2011).

The global financial crisis resulted in the boards accepting a comprehensive review of the financial instrument standards. The most significant move from the IASB’s perspective has been to completely replace the IAS 39 financial instruments (Stevenson, 2012). The project to replace IAS 39 is based on a three-phase approach (IFRS 9):

- Phase 1: Classification and measurement—the IFRS 9 Financial Instruments document was issued in November 2009 and contains new requirements for measuring financial assets. In November 2012, a limited-scope exposure draft was issued to amend the classification and measurement guidelines.

- Phase 2: Impairment methodology—An exposure draft, Financial Instruments: Amortised Cost and Impairment was published in November 2009 with a comment deadline of 30 June 2010. In January 2011, the IASB and the FASB published a supplementary document to the original exposure draft.

- Phase 3: Hedge accounting—The IASB expects to publish proposals resulting from its comprehensive review of hedge accounting requirements in the near future.

In pursuing their process, the IASB has reviewed derecognition (ED/2009/3). However, it did not change the standard. The IASB is only proposing enhanced disclosure requirements, especially in situations where an entity continues to have an ongoing involvement in a financial asset that would be derecognised under the proposals (IASB Press release, 2009a).

IFRS 9 has reduced the classification model from four to two categories for the classification of financial assets (amortised cost and fair value through profit or loss), but in the November 2012 exposure draft, a fair value through other comprehensive income category was included. Classification of financial liabilities was added to IFRS 9 in October 2010.
1.2 Research problem and questions

IAS 39 contains the current provisions for classifying financial assets. The current version of IAS 39 classifies financial assets into four categories (Fiechter 2011b), identified as follows (Ernst & Young 2011):

- **Financial assets at fair value through profit or loss** — financial instruments that are either classified as held for trading, or are designated as such on initial recognition;

- **Held-to-maturity investments** — financial assets with fixed or determinable payments and fixed maturity, other than loans and receivables, for which there is a positive intention and ability to hold to maturity and which have not been designated ‘assets at fair value through profit or loss’ or ‘available-for-sale’;

- **Loans and receivables** — financial assets with fixed or determinable payments that are not quoted in an active market, do not qualify as ‘trading’ assets and have not been designated ‘assets at fair value through profit or loss’ or ‘available-for-sale’;

- **Available-for-sale** — financial assets that are designated ‘available-for-sale’ or that are not classified as ‘loans and receivables’, ‘held-to-maturity investments’ or ‘assets at fair value through profit or loss’.

The categories for classification of financial assets as described above and their measurement basis are set out in table 1.1.
Table 1.1: Summary of classification for financial assets under IAS 39

<table>
<thead>
<tr>
<th>IAS 39 category of financial asset</th>
<th>Description</th>
<th>Measurement basis</th>
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<tr>
<td>Original loans and receivables</td>
<td>Loans and receivables created by an enterprise by providing money, goods, or services directly to the debtor</td>
<td>Amortised cost, subject to impairment recognition</td>
</tr>
<tr>
<td>Held-to-maturity investments</td>
<td>Quoted fixed maturity investments that the enterprise intends to and is able to hold to maturity</td>
<td>Amortised cost, subject to impairment recognition</td>
</tr>
</tbody>
</table>
| Available for sale financial assets—normal case | Includes the designation of the following:  
  - Fixed maturity investments that the enterprise either does not intend to or is unable to hold to maturity  
  - Equity investments with a quoted market price  
  - Equity investments with no quoted market price but where it is possible to estimate fair value | Fair value: enterprise has a one-time, enterprise-wide choice to report changes in fair value in (a) net profit or loss or (b) equity until the asset is sold or otherwise disposed of, at which time the cumulative gain or loss is reported in net profit or loss. |
| Available for sale financial assets—unusual case | Equity investments with no quoted market price and where the enterprise is unable to estimate fair value | Cost subject to impairment recognition |
| Financial assets and liabilities at fair value through profit or loss (including those held for trading, those designated to this category at inception and all) | Financial assets acquired for the purpose of generating a profit from short-term fluctuations in price; includes all derivative assets and liabilities | Fair value: change in fair value in net profit or loss |
Adapted from Buchanan (2003, p. 64).

The research issue is whether preparers of financial statements have applied the classification of financial assets in IAS 39 correctly in terms of complexity. The classification categories of financial assets under IAS 39 will be discussed in length in the literature review chapter.

In assessing whether the classification of financial assets is applied correctly in practice, the following questions could be asked:

**Research Question 1**: Are the classifications identifiable in the statement of financial position?

**Research Question 2**: Are the classifications clarified in the accounting policies?

**Research Question 3**: Are the classifications identifiable in the notes to the financial statements?

**Research Question 4**: Does the classification of financial instruments differ for a selection of entities?

The minor dissertation concentrates on the classification of financial assets according to IAS 39. The enforcement of IAS 39 remains in effect as the adoption of IFRS 9 only becomes effective in the financial year beginning in 2015, and this timeframe may even be extended. Given that IAS 39 sets out requirements for the recognition and measurement of financial instruments, it does not address how financial instruments should be presented in the statement of financial position (SOFP) (Deloitte, 2007).

IAS 1 *Presentation of Financial Statements* paragraphs 51-62 sets out principles for the presentation of an asset or a liability separately as either current or non-current in the SOFP (Deloitte, 2007). IAS 1 alternatively requires all entities to classify the elements of the SOFP by their nature by using the defined sections and categories in order of liquidity. However, this standard does not prescribe the order or format in which an entity presents items and
simply lists items that are sufficiently different in nature or function to warrant separate presentation in the statement of financial position (Paragraph 57). Banks normally follow this classification by nature in the SOFP.

The research issue is how the classification of financial assets by banks in IAS 39 is combined with the IAS 1 classification by nature in the SOFP from most liquid to less liquid. It is also relevant to analyse the accounting policies that banks follow regarding the IAS 39 classification and the IAS 1 classification.

1.3 Research objectives

The objective of this minor dissertation is to assess how the conflict in the classification of financial assets between IAS 39 and IAS 1 is being bridged in the financial statements of banks. This minor dissertation focuses on the banking sector since this sector uses financial instruments the most. The banks are financial institutions and are classified by the JSE Limited (Johannesburg Stock Exchange) in the financial sector. The minor dissertation also only focuses on financial assets, since the classification of financial assets is more complex than financial liabilities.

The assessment is being done on three bases:

- Firstly, to analyse the statement of financial positions to assess which classification of financial assets is obtainable from the statement of financial position.
- Secondly, to analyse the accounting policies to assess the classification of all financial assets.
- Thirdly, to analyse the notes to the financial statements to assess the classification of financial assets.

IFRS 7 *Financial Instruments: Disclosures* allows the disclosure of net interest income in the statement of comprehensive income (SOCI). IFRS 7 thus states that the disclosure of the statement of comprehensive income of “gains and losses by the measurement categories in IAS 39” complements the statement of financial position disclosure (Deloitte, 2009: 1223). The standard requires disclosure of income, expense, gains or losses either in the statement of
comprehensive income or in the notes to the financial statements (Deloitte, 2009). A sub-objective is drawn accordingly as:

- Analysing the statement of comprehensive income to assess how financial income is classified and how it is obtainable from the statement of comprehensive income or the notes to the financial statements.

1.4 Research methodology

The minor dissertation is a content analysis of the financial statements of South African banks regarding the classification of financial assets in their statements of financial position, accounting policies and notes to the financial statements. The research methodology is expanded further in Chapter 3.

1.5 Motivation

This minor dissertation seeks to provide meaningful input regarding the classification of all financial assets in the categories identified in IAS 39 using a content analysis of the financial statements of South African banks. A study of this nature would reveal to users of financial statements, investors as well as standard-setters whether companies, in this case banks, comply with the requirements of IAS 39 with regard to the classification of financial assets. Several studies have discussed the importance of the classification of financial assets under IAS 39 (Collemi, 2010; Fiechter 2011b; Vollrath and Schöning, 2011). However, in South Africa, much of the recent literature written on financial instruments is based on the nature or impact of accounting for financial instruments (Coetsee, 2006; Tosen, 2004), with limited attention paid to the categories of financial assets. The research contributes to the literature on the classification of financial assets under IAS 39 using content analysis in South Africa.

IFRSs are playing an increasingly important role in global financial reporting (Alon 2012; Ball 2006). In South Africa, the JSE Limited required that all listed companies comply with IFRS as issued by the IASB for financial periods commencing on or after 1 January 2005 (Coetsee, 2007; Zeff and Nobes, 2010). The reasons for applying the IFRS in South Africa was beneficial for attracting foreign investment companies, providing credibility to the financial statements of South African companies in the global market, and finally doing away
with the need for dual-listed entities to present financial statements in accordance with more than one set of accounting standards (Coetsee 2007; Ludolph 2006).

The rationale for choosing South African banks for this research is that the banks adopted the principles of IAS 39 in 2001. South Africa is one of the first countries that applied IAS 39. Although IFRS was adopted in 2005, IAS 39 (with AC 133 the South African equivalent) was applied as part of the local GAAP from 1 January 2001 (Coetsee, 2007).

While IAS 39 has to be applied by all companies engaged in financial instruments, it is likely to have a particularly strong effect on the banking industry, where financial instruments account, on average, for more than 90% of total assets and liabilities (Bischof, 2009:167). Given that banks are the industry affected most by the problem presented by the classification of financial assets, it has been a focus of banking research (Kwan, 2003).

The minor dissertation is also motivated by the process of simplifying the classification of financial assets. The question is whether banks were able to apply the classification of financial assets appropriately. Whether financial instrument accounting can be simplified has been on the agenda of the IASB standard-setters for a long time (PWC, 2008). The underlying simplification results from the complexity of the classification of financial assets in relation to banks (IASB, 2009b). Additionally, the many ways of measuring the categories of financial instruments and the associated rules are one of the main causes of today’s complexity (IASB, 2008a: IN4). In the effort to reduce complexity, the Discussion Paper in 2008 proposed to simplify financial instruments in the area of categorisation of financial assets by eliminating the ‘held-to-maturity’ category and the ‘available for sale’ category (PWC, 2008). Many concerns that arise from the reduction of complexity in financial reporting consider recommendations about the many categories of financial assets (IASB, 2009b). Given the features of the many financial assets, it makes sense to consider whether there should be a single accounting method for all financial assets (for example, eliminating distinctions, for accounting purposes) or for all financial assets of a single type (Leisenring et al. 2012:336). These amendments could ease the difficulties of classification by banks (PWC, 2008).
1.6 Ethical issues

The financial statements analysed in the dissertation are publically available from the websites of the individual banks. To protect the privacy of the banks, no reference is made to the names of these banks in the minor dissertation. The privacy of the banks adheres to the declaration in terms of the Ethics Policy of the Faculty of Economics and Financial Sciences of the University. The essential ethical aspect of this research is the issue of the confidentiality of the results and findings and the protection of the selected sample (Maree and Van der Westhuizen, 2007).

1.7 Structure

The thesis is structured into five significant chapters.

Introduction

Under this chapter, the background to the development of financial instruments, especially in IAS 39 Recognition and Measurement, is discussed. The accounting research problem is stated and the research questions are determined. In this way, the research objectives are elucidated. The motivation for this study is given and the research methodology defined.

Literature review

The literature review chapter provides the theoretical background of the existing classification of financial assets. The chapter discusses the development of IAS 39 and the appropriateness of fair value. It outlines the research in relation to the issues of the classification of financial instruments. The literature examines the current accounting treatment of IAS 1, IAS 32, IAS 39 and IFRS 7 as a background to their integration for the purposes of classification in order of liquidity and the classification of financial assets. The literature will also review the reclassification of financial assets with regard to the complexity of fair value and the proposed changes to financial instruments.
Methodology

The methodology chapter sets out the research methodology that is followed to assess the financial statements of South Africa banks regarding the classification of financial assets. The research methodology includes the research design, the sample selection and the research process that is applied.

Results

This chapter provides an analysis of the conflict in the classification of financial assets between IAS 39 and IAS 1, and how it is being bridged in the financial statements of banks. This includes a content analysis of financial statements of South African banks in the interests of identifying whether the classification of all financial instruments in the categories identified in IAS 39 is easily made.

Conclusions

This chapter summarises the findings and concludes the minor dissertation. Suggestions for future research are given under this chapter.
Chapter 2

Review of related literature

2.1 Introduction

It was indicated in the introduction that the objective of the minor dissertation is to assess how the conflict in the classification of financial assets between IAS 1 and IAS 39 is being bridged in the financial statements of banks. For the financial assets to be assessed in the categories identified in IAS 39, recent literature on IAS 39 must be reviewed with a focus on the classification of financial instruments. This chapter, however, does not intend to review all the issues surrounding IAS 39.

In order to review the classification of financial assets, the chapter discusses the development of IAS 39 and the appropriateness of fair value. It outlines the research in relation to the issues around the classification of financial assets. The literature examines the current accounting treatments in IAS 1, IAS 32, IAS 39 and IFRS 7 as a background to the integration of the classifications according to the order of liquidity and the classification of financial assets. The literature also reviews the reclassification of financial assets and the proposed changes to financial instruments.

2.2 Development of IAS 39

IAS 39 traces its origins to a project started in 1988 in association with the Canadian Institute of Chartered Accounts (CICA) (Chatham et al. 2010; Walton, 2004; Whittington, 2005). The development of international accounting standards on financial instruments began in 1989 (Bradbury, 2003: 390). Walton (2004) stresses that two exposure drafts were issued, namely E40 (in September 1991), which met a great deal of opposition, followed by E48 (in January 1994). In view of the critical responses to E48, the IASC and CICA decided to divide the project into two phases (Bradbury, 2003; Whittington, 2005). The first phase dealt with the disclosure and presentation of financial instruments, and resulted in IAS 32 Financial
Instruments: Disclosure and Presentation in March 1995 (Bradbury, 2003). The second phase regarding recognition and measurement standards resulted in the publication of the March 1997 Discussion Paper (DP), *Accounting for Financial Assets and Liabilities*, which proposed that fair value model be used for all financial instruments (Bradbury, 2003; Ighian, 2012; Whittington, 2005). Although the DP represented a major step toward the development of IAS 39 (Chatham *et al.* 2010), an agreement on IAS 39 was hammered out with great difficulty (Whittington, 2005). Following comment letters on the DP, Whittington (2005:138) affirms that considerable controversy and opposition was aroused around fair value, as it would not be possible to issue a standard based on a comprehensive fair value of all financial instruments. The IASC then decided in November 1997 to complete an interim standard on the recognition and measurement of financial instruments, followed by the issuance of the exposure draft (E62) in June 1998 (Chatham *et al.* 2010). IAS 39 was finally approved in December 1998 (Ighian, 2012; Whittington, 2005).

There was opposition by some European banks in particular to the development of IAS 39, even in its changed version (Walton, 2004). Many have sought changes to IAS 39 and lengthy discussions have taken place to determine whether the proposed changes are appropriate (Hague, 2004; Whittington, 2005). Ighian (2012) stresses that the changes in financial instruments were also due to the numerous scandals that rocked the US and Europe over the last decade following the inappropriate use of derivatives.

In addition, the confrontation over IAS 39 in Europe is difficult to understand when one remembers that the standard was approved by IASC Board, which included the European Commission as an observer (Walton, 2004:13). Clearly, articles by researchers (Gebhardt *et al.* 2004; Walton, 2004; Whittington, 2005) involved in the heated debates over IAS 39 have urged standard-setters to direct sentiment towards the development of a new financial instrument standard. Consequently, in November 2009 the Board issued a new financial instrument standard (IFRS 9), which includes the application of a business model (Carmona and Trombetta, 2010). The proposed changes to financial instruments (IFRS 9) including the business model will be discussed in length later.
2.3 The appropriateness of fair value

The reporting of financial instruments is increasingly moving towards fair value (Cairns, 2006:5). Accounting standard-setters, in recent years, are interested in reporting financial assets and liabilities on the basis of fair value measurement (Cairns, 2006:5). The reasons put forward by researchers (Barth, 2007; Penman, 2007) are that fair value is more relevant because it reflects present economic conditions relating to economic resources and obligations; is a faithful representation of the value of financial assets and liabilities; and that fair value is a market–based measure that is not affected by factors specific to a particular entity. However, the extent of the use of fair value in IFRS has become a key issue in the accounting debate (Walton, 2006:337).

During the recent financial crisis, the use of fair value has raised heated debates. Once the global financial crisis had erupted, in 2007, the requirement to measure certain financial assets using the fair value approach caused major concern among bankers and politicians (Bengtsson, 2011). For example, in the second half of 2008 when the crisis intensified, banks raised significant concerns that the fair value accounting was exacerbating the crisis by creating a downward spiral and that observed market prices were below the assets’ fundamental values (Laux and Leux, 2009). From the same perspective, many argue in the banking industry that although fair value gives at each instant a seemingly relevant liquidation value, it obscures the value creation process by mixing present profit with unrealised gains and losses (Boyer, 2007 in Mala and Chand, 2012).

Therefore, financial institutions in Europe put pressure on politicians to take action in this regard (Fiechter, 2011b). In response to the financial institutions call, the European Parliament (2008) issued a Committee report in which it put pressure on IASB to limit the scope of the fair value application (Bengtsson, 2011). In April 2009, the Financial Stability Forum (FSF) issued a report urging the accounting standard-setters and regulators to examine possible changes to relevant standards to dampen adverse dynamics potentially associated with fair value accounting (FSF, 2009:28).

However, proponents of fair value (Smith and Tweedie, 2008) claim that the situation might have been more severe in the absence of fair value accounting, since the magnitude of the
problems would not have been recognised as quickly under traditional accounting methods (Fiechter, 2011b: 53).

Some commonly expressed concerns over the pro-cyclical nature of fair value accounting became a major issue (Allen and Carletti, 2008; ECB, 2004; Fiechter, 2011b; Laux, 2012; Plantin et al. 2008). To show the adverse effects of fair value, prior to the crisis, the European Central Bank (2004: 45) argues that:

The pro-cyclicality of bank lending could be enhanced, especially if the extension of fair values occurs with approximately the same timing [...]. In fact, in the presence of shocks embodying a significant price component, such as an interest rate shock, a real estate crisis or a stock market crash, the immediate recognition of unrealised value changes under fair value accounting might aggravate the effects of the shock. Increased use of fair values may also embody incentives for banks to modify their portfolio mix in a direction that may move them away from their traditional liquidity transformation role, thus reducing their contribution to intertemporal smoothing.

The above is a concern when market prices are being used. Penman (2007) discussed disadvantages related to fair value, claiming that it encourages price bubbles and is misleading in regard to market inefficiencies. However, more concern is expressed when market prices are not available (Penman, 2003). Importantly, the concept of fair value measurement is a market-based assessment (André et al. 2009). The traditional debate has, however, criticised the lack of liquid market prices for many assets and liabilities (Ball, 2006; Mala and Chand, 2012). Ball (2006) shows that when market prices are not available, firms report estimates of market prices, and hence fair value introduces imperfect pricing models and imperfect estimates. The Securities Exchange Commission (SEC) (2008), however, has published a report, The Emergency Economic Stability Act on mark-to-market, which recommended additional guidance for determining fair value where market prices are not readily available (Mala and Chand, 2012).

To address the issues regarding the unavailability of market prices, fair value measurement standards (SFAS 157: Fair value Measurement) for the US were published in September 2006 according to the recommendations of the SEC. Similarly, the external expert advisory panel was created by the IASB standard-setters, followed by the publication in May 2011 of
the IFRS 13: *Fair value Measurement*. IFRS 13 followed the external expert advisory panel recommendations.

Research has been concerned with the reaction of SFAS 157 or the recent IFRS 13 to fair value and market prices. The way in which standards require fair value to be measured is evolving (André *et al.* 2009), given that fair value has been criticised for not considering market prices. Bromwich (2007) stressed that there is set of assumptions that standard-setters use to support the estimation of fair value. The standard-setters’ approach to fair value places emphasis on using hierarchies of information sources from market input (Laux and Leuz, 2009; Mala and Chand, 2012; Ryan, 2008). The SFAS 157 creates, therefore, a hierarchy of inputs into the fair value measurement (Ryan, 2008), while the IFRS make similar distinctions among inputs (Laux and Leuz, 2009). When quoted prices for identical assets and liabilities are observed in active markets it is considered a level one input (André *et al.* 2009; Penman, 2007). Mala and Chand (2012) affirm that a quoted price in an active market provides the most reliable evidence of fair value. If a quoted price for fair value is not available, the valuation is then based on market observations (Mala and Chand, 2009). This is a level two input that applies in cases for which there are observable inputs, which include quoted prices for similar assets or liabilities in active markets, and quoted prices from identical or similar assets in inactive markets (Laux and Leuz, 2009; Ryan, 2008). In the absence of quoted prices in active markets, the valuation is based on non-observable assumptions (Mala and Chand, 2012). The relevant standards and guidance in US GAAP and IFRS are quite restrictive as to when it is appropriate for managers to deviate from observable market prices (Laux and Leuz, 2009).

The standard-setters have addressed the issue of fair value measurement by issuing SFAS 157 and IFRS 13. However, there are concerns about the effect of fair value on cycles, as well as its reliability when market prices are not available.

**2.4 Previous related research**
Various aspects of the use of fair value have been researched. There appears to have been much attention paid to the impact of fair value on earnings volatility. A number of arguments have been used to criticise earnings volatility with regard to the adoption of IAS 39, particularly the implementation of fair value (Barth et al. 1995; Duh et al. 2012; Hodder et al. 2006). Related research on the impact of IAS 39 on earnings volatility has found that the adoption of IAS 39 results in higher earnings volatility for commercial banks, as it requires that all derivatives be reported at their fair value, with fair value changes recorded in either the income statement or in comprehensive income (Duh et al. 2012). Therefore, the complex rules may discourage companies from using derivatives because they fear volatility (Abhayawnsa and Abeysekera, 2006). This research supports the evidence that fair value remains controversial, particularly with regard to earnings volatility.

The review of the previous research starts by first discussing the effect of agency theory and manipulation on the presentation of financial statements. Secondly, a discussion of a business model implemented for financial instruments is then provided. The quality of financial statements is also discussed. Finally, the disclosure requirements relevant for banking sectors are underlined.

2.4.1 Agency theory and manipulation

Research on the presentation of financial statements has focused on two accounting theory areas: the agency theory (Jensen and Meckling, 1976; Lambert, 2001) and the opportunistic manager’s presentation of special items within financial statements (Hung, 2001; Riedl and Srinivasan, 2010). Jensen and Meckling (1976) defined an agency relationship as a contract under which one or more principals engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent (Deegan, 2010:308).

Earnings management is the practice of using tricks to misrepresent or reduce transparency of the financial reports (Ronen and Yaari, 2008). Lambert (2001) stated that the agent can divert resources over differential time horizons and therefore could create relationship issues between principals (owners) and agents (financial statements preparers). The effects of the opportunistic behaviour of managers are also discussed in Hung (2001) in relation to accrual accounting within the financial statements. This implies that a higher use of accrual
accounting provides managers with more opportunities to manage earnings, resulting in weak shareholder protection (Hung, 2001). This evidence supports the view that agency theory plays a role in the presentation of financial statements, while the opportunistic behaviour of the agent may distort the financial statements.

Studies provide reason to believe that this manipulation contributes to the creative accounting that managers use to play games with numbers. Current literature (Clikeman, 2003; Collingwood, 2001; Dechow and Skinner, 2000; Parfet, 2000) has been critical of earnings management that affect the entity’s performance. Dechow and Skinner (2000) addressed the issue of whether earnings management matters if it is disclosed. By relying on investor rationality to solve or mitigate financial reporting issues, the study found that concerns about earnings management would remain even if financial statements and related disclosures include sufficient detail to allow investors to adjust earnings management. Nelson et al. (2003) reported descriptive evidence of how managers attempt to manage earnings, based on a sample of 515 earnings-management attempts from a survey of 253 experienced auditors. Their study provides evidence about the approaches managers use to attempt earnings managements. Such studies present findings according to the manipulation of earnings by managers, but do not provide direct linkage between earnings management and the issues of the classification and measurement of financial instruments by banks.

The IASB has long sought to eliminate accounting choices based on managerial intentions (Page, 2012). For instance, the IFRS provide management with a substantial variety of reporting choices for financial instruments (Bischof and Ebert, 2009). A number of studies on accounting choices found that corporate managers will be driven by self-interest, and therefore undertake activities that could be detrimental to the economic welfare of shareholders (Deegan, 2010; Lambert, 2001; Watts and Zimmerman, 1986), and that managers are motivated to opportunistically use their discretion in accounting in order to relax constraints imposed by contractual mechanisms (Heflin, Known and wild, 2002). The minor dissertation regards the classification of financial instruments in a statement of financial position as one of these kinds of choices.

The question is whether the choices available for financial instruments, such as designating certain financial instruments as at fair value through profit or loss or through equity (available
for sale) provide an opportunity for manipulation. A further question is whether an application of a business model (in IFRS 9) will reduce options that allow for manipulation.

2.4.2 A business model

The subjects of business models and management intentions have caused several debates (Brougham, 2012; ICAEW, 2010; Leisenring et al. 2012). When considering the intentions of management, it is often argued that financial reporting should possibly be independent of management intent, which is changeable, subjective and unverifiable (ICAEW, 2010). However, Leisenring et al. (2012) demonstrate that the idea of a business model is also intended to capture the idea of management.

In IFRS 9, in which the business model is applied, it is required that the business-model approach be assessed on a basis determined by the entity’s key management personnel (Paragraph B4.1.1). In assessing of the business-model approach, Leisenring et al. (2012) deduced that it is also impracticable for an entity to have a business model that management does not intend to follow and does not follow. Brougham (2012) puts forward similar arguments, but suggests that the business model concept should only be applied to a group of instruments provided that doing so results in more relevant information.

However, an approach that is possibly the opposite of prioritising a business model is that of prioritising a business strategy. Researcher such as Teece (2010) contributed to the debate by suggesting a business strategy approach over a business-model approach. Business strategy is an essential step in designing a competitively sustainable business model (Teece, 2010). Strategy is a more realistic approach than simply a business model. This argument is consistent with Page (2012) as it would have been quite possible for IFRS 9 to have issued requirements in terms of a strategy for particular assets rather than a business model.

2.4.3 Quality of financial statements

Many researchers have assessed the quality of financial statements. Daske and Gebhardt (2006) assess the quality of the financial statements of firms that have already adopted internationally recognised standards. Iatridis (2010) seeks to determine whether IFRS adoption leads to higher quality accounting numbers and also investigates the earnings
management potential under IFRS. Hodgdon et al. (2008) investigated the relationship between analysts’ earnings forecast errors and the firms’ compliance with the disclosure requirements of IFRS. Evidence on IFRS adoption documents less earnings management, more timely loss recognition and more value relevance in accounting numbers among voluntary IFRS adopters (Barth et al. 2008; Duh et al. 2012). Hodgdon et al.’s (2008) findings suggest that compliance with the disclosure requirements of IFRS reduces information asymmetry and enhances the ability of financial analysts to provide more accurate forecasts.

A question that could be researched when the business-model approach is implemented for financial instruments is whether this will improve the quality of financial statements.

2.4.4 Disclosures

Disclosure is vital when dealing with the financial statements of companies. In particular, as pointed out in Frolov’s (2007) article, the problem of information disclosure is of considerable relevance to the banking industry. Research related to disclosure and presentation affirms that IFRSs that address financial instruments (IAS 32, IAS 39 and IFRS 7) pose application problems in the banking sector, notably in the way that they interact with the new Basel Agreement on Equity (Colmant et al. 2007; André et al. 2008).

Disclosure requirements have been widely discussed in a number of papers in various ways depending on the researchers’ areas of interest (see Bozzolan, Trombetta and Beretta, 2009; Daske and Gebhardt, 2006; Hope, 2003a; Hope, 2003b; Huddart, Hughes and Brunnermeier, 1999; Schipper, 2007). Examples of investigations on disclosure include Daske and Gebhardt (2006), who assessed the perceptions of experts on the disclosure quality of financial statements of Austrian, German and Swiss firms that had already adopted internationally recognised standards (IFRS or U.S. GAAP). They found that the perceived disclosure quality increased significantly in companies applying internationally recognised accounting standards, particularly IFRS. In an Australian setting, the equivalent of IFRS (AIFRS) are published by the Australian Accounting Standards Board (AASB) (AASB, 2004). Palmer (2008) investigated the quality and quantity of disclosures in compliance with the adoption of AASB 1047.
Huddart et al. (1999) examine the effects of disclosure requirements on stock exchange listing decisions. The potential benefits of disclosure requirements, whether for listing decisions or IFRS compliance, are important means for communicating firm performance to outside investors (see Core, 2001; Healy and Palepu, 2001; Leuz and Verrecchia, 2000).

On the economic front, a commitment by firms to increased levels of disclosure reduces the possibility of information asymmetries and lowers the costs of capital (Core, 2001; Leuz and Verrecchia, 2000). Healy and Palepu’s (2001) article stress that managers should provide voluntary disclosure to reduce the cost of capital.

There is a belief that disclosures should be mandatory. Research using management communications of firm performance and governance to potential investors evidenced that regulators, standard-setters, auditors and capital market intermediaries are the institutions that increase the credibility of management disclosures (Healy and Palepu, 2001). Evidently, firms’ management express their levels of disclosure in financial statements. Schipper (2007) shows that disclosures may be used to alleviate non-comparability and present accounting alternatives when recognition and measurement standards permit, or even require, a less preferred treatment.

The minor dissertation provides evidence that disclosure requirements are essentially relevant to banking sectors. Financial instruments must be disclosed to show the important link between the way that financial instruments should be presented and contributions to the debate on disclosure.

2.5 Current IFRS

This section introduces the international accounting standards concerned with the research problem: the combination of the classification of financial assets in IAS 39 and classification according to nature from most liquid to least liquid. IAS 1 is intended to distinguish between the current and non-current presentation of financial assets and liquidity-based presentation in the statement of financial position. IAS 32 describes the presentation of financial instruments. IAS 39 is orientated to describe the accounting treatments for the classification of categories of financial assets. IFRS 7 discusses the disclosure of financial instruments.
2.5.1 IAS 1

IAS 1 *Presentation of Financial Statements* (IASB 2010: Para. 54-80A), provided the option for financial statements to either be presented based on: (1) the accounting treatments for the classification of current and non-current assets or (2) the requirements applicable to liquidity-based presentation in the statement of financial position. A study by Rossouw (2010) states that management need to select the presentation format that is most reliable and relevant to the entity. The liquidity-based presentation is regarded to be more relevant for financial institutions.

IAS 1 notes that current and non-current assets have separate classifications in the statement of financial position (IAS 1: 60). It should be clear that in essence, the current and non-current distinction is also an attempt at incorporating liquidity expectations into the structure of the statement of financial position (Robinson, Greuning, Henry and Broihahn 2009:171). By separating the classification of current and non-current assets in the statement of financial position, an entity provides useful information by distinguishing the net assets that are continuously circulating as working capital from those used in the entity’s long-term operations (IAS 1: 62). The distinction also focuses on the timing differences between current and non-current assets. Current assets are expected to be liquidated or used up within one year or one operating cycle of the business (Robinson *et al.* 2009). Non-current assets reflect long-term assets (Robinson *et al.* 2009). Accordingly, paragraphs 68 of IAS 1 explained that current assets include assets such as inventories and trade receivables that are sold, consumed or realised as part of the normal operating cycle. They also include assets held primarily for the purpose of trading (IAS 1: 68). Non-current assets, however, include tangible, intangible and financial assets of a long-term nature (IAS 1: 67).

An entity is also allowed to present all assets and liabilities in order of liquidity when a presentation based on liquidity provides information that is reliable and more relevant (IAS 1: 60). The above requirement is an exception to the current and non-current assets presentation defined in the statement of financial position. This option depends fundamentally on assessing financial liquidity to classify elements in the statement of financial position (Ishikawa, 2005). Financial institutions are following this alternative presentation.
IAS 1 also requires sensitive information to be appropriately disclosed and reported in the annual reports, such as managerial judgements and assumptions used in forming the entity’s accounting policies as well as sources of uncertainty that may have a material impact on the entity’s financial statements (Iatridis, 2010). This information is very important with regard to financial instruments due to the uncertainty and complexity involved.

2.5.2 IAS 32

The original IAS 32 provides the accounting treatments for the disclosure and presentation of financial instruments (IASB, 2003a). IAS 32 was published the first time in March 1995 (Ernst & Young, 2011). Another objective of IAS 32 is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and liabilities (IAS 32: 1; Ighian, 2012). This was addressed in a number of ways (Ighian, 2012:70):

- Clarifying the classification of a financial instrument issued by an entity as a liability or as equity;
- Prescribing the accounting for treasury shares (an entity’s own repurchased shares);
- Prescribing strict conditions under which assets and liabilities may be offset in the balance sheet.

However, IAS 32 raises a number of difficult technical issues with regard to the distinction between debt and equity (Whittington, 2005). Given that the issue of classification in IAS 32 required deeper engagement for future improvements in standards (Whittington, 2005), a more fundamental review took place in December 2003, which resulted in the publication of a revised standard (Ernst & Young, 2011). The disclosure provisions in IAS 32 were thereafter changed to those of IFRS 7 in August 2005.

2.5.3 IAS 39
The 1989 joint project between the IASC and the Canadian Institute of Chartered Accounts (CICA) to develop a comprehensive standard on the recognition, measurement and disclosure of financial instruments resulted, due to crucial debates, in IAS 39 *Financial Instruments: Recognition and Measurement* (Bradbury, 2003). The first issuance of the accounting standards on financial instruments finalised as IAS 39 was available in 1998 (Bradbury, 2003; Ighian, 2012; Whittington, 2005). Since its adoption, IAS 39 was consistently debated in academic articles (Colmant *et al.* 2007; Walton, 2004). The previous financial-instruments-based standards issued by the predecessor to the IASB have been known for their far-reaching controversy and difficulty to interpret (Hague, 2004; Vollrath and Schöning, 2011; Whittington, 2005). One of the controversial issues was the classification of financial instruments, especially financial assets.

### 2.5.3.1 Classification of financial assets

This section examines the underlying assumptions of the classification of financial assets under IAS 39. Financial assets are classified into four categories. The classification of financial assets is premised on the definition of categories as (a) financial assets through profit or loss, (b) held-to-maturity investments, (c) loans and receivables and (d) available-for-sale assets.

#### 2.5.3.1.1 Assets at fair value through profit or loss

This category of financial assets is comprised of two sub-categories: (1) financial instruments that are either classified as held for trading, or (2) are designated as at fair value through profit or loss on initial recognition (Collemi, 2010). While trading instruments are encompassed by this category, they are not a separate category (Bryer, 2004; Ernst & Young, 2011; IASB, 2008c).

Fair value through profit or loss is by far the most controversial of the categories (Fiechter, 2011b:51). In the *Financial Times* (2005:1), the British Airports Authority (BAA)’s chief financial officer expressed the view that considering assets and liabilities at fair value and recording changes in value according to profit or loss was in no way practicable (Cairns, 2006). Cairns (2006) further argues that the BAA, the world’s biggest airports group, has
ceased publishing quarterly reports to escape the rigorous requirements of reporting the fair value of assets through profit or loss.

2.5.3.1.1 Classified as held for trading

The financial assets at fair value through profit or loss include financial assets held for trading purposes (Collemi, 2010; Fiechter, 2011b). Trading generally reflects active and frequent buying and selling (IAS 39: AG14). As such, assets or liabilities held for trading consist of financial assets or liabilities acquired or incurred principally with the objective of generating a profit from short-term fluctuations in price or dealer’s margins (Hernández, 2003; IAS 39: AG14). IAS 39 dictates that an asset or liability is classified as held for trading if:

- It is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- On initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- It is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Derivative assets and liabilities are specifically included in the fair value through profit or loss classification (Duh et al. 2012). However, the definition of a financial asset or a financial liability at fair value through profit or loss excludes derivatives that are designated as effective hedging instruments (IAS 39: BC70A).

While derivatives were traditionally, accounted for before IAS 39 by using historical cost accounting (Abhayawnsa and Abeyseker, 2006), IAS 39 requires all derivatives to be recognised on the balance sheet as either assets or liabilities and measured at fair value (Duh et al. 2012), with resultant gains and losses included in the reported profit-and-loss (Beasley-Murray, 2003). Such requirements have raised concerns from various companies, including banks (Beasley-Murray, 2003). The requirement will add volatility to their reporting, thereby
troubling shareholders as to the use of fair value (Beasley-Murray, 2003). Other research has reported similar findings (Duh et al. 2012; ECB, 2004; Hodder et al. 2006).

However, for non-derivatives assets to be classified as held for trading they must be held with a view to making profits from short-term price fluctuations, or be part of a portfolio for which there is evidence of short-term profit-taking (Moore, 2002). IAS 39 also requires that assets held for trading are valued at fair value at each balance sheet date, with changes flowing directly through profit or loss (André et al. 2009).

2.5.3.1.1.2 Financial assets designated as at fair value through profit or loss

In 2003, the IASB amended IAS 39 by including an option to irrevocably designate any financial instrument at fair value through profit or loss (FVO) (Fiechter, 2011a). The original IAS 39 allows an entity to designate any financial asset, financial liability, or group of financial instruments (financial assets, financial liabilities or both) at fair value through profit or loss, provided that doing so results in more relevant information (IAS 39: Para. AG4B).

The requirement for financial instruments to be designated as at fair value through profit or loss is referred to as the fair value option (FVO). One of the IASB’s reasons for introducing the fair value option was to simplify the application of IAS 39 by mitigating some of the anomalies that result from its mixed model (Ernst & Young, 2011). Fiechter (2011a) indicates that the introduction of FVO is because of the effects of fair-value accounting on earnings volatility and accounting mismatch in the mixed measurement model.

The IASB acknowledged the concerns that the fair value option may be used inappropriately and announced its intention to limit the application of the option to specified categories of financial instruments (ECB, 2004: 7). In response to these concerns, the IASB acted progressively to restrict the FVO to the following eligibility criteria (Fiechter, 2011a: 88; IAS 39. Para: 9(b)):

1. It eliminates or significantly reduces inconsistencies in measurement or recognition (accounting mismatches) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
(2) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair-value basis.

IAS 39 specifically stipulates that investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured are not to be designated as at fair value through profit or loss (Spector, 2009a).

Ernst & Young (2011) provides reasons for the fair value option by stating that it should eliminate:

- The need for hedge accounting for hedge of fair value exposures when there are natural offsets, and thereby eliminate the related burden of designating hedges, tracking and analysing hedge effectiveness;
- The burden of separating embedded derivatives; and
- Problems arising from a mixed-measurement model where financial assets are measured at fair value and related financial liabilities are measured at amortised cost.

Evidence shows that accounting standard-setters in countries such as France and Japan voice their opposition against the fair value option (Bryer, 2004). In line with their opposition, they argue against the idea of allowing a free choice of which assets and liabilities use fair value (Bryer, 2004). In addition, the European Central Bank (ECB) and the Basel Committee on Banking Supervision (BCBS) believed that the valuation of some financial instruments designated at fair value through profit or loss (FVO) might be made on a subjective basis and hence may be subject to manipulation (Fiechter, 2011a). However, Fiechter (2011a) favours the use of the fair value option, although concerns on earnings volatility were raised in several articles (See Bryer, 2004; Cairns, 2006; Duh et al. 2012; ECB, 2004; Hodder et al., 2006; Landsman, 2006).

2.5.3.1.2 Held to maturity investments

These are non-derivative financial assets with fixed or determinable payments and fixed maturity, other than loans and receivables, that an entity intends and is able to hold to maturity (Duh et al. 2012: 26; IAS 39: 9). With respect to the definition of held-to-maturity
investments, fixed or determinable payments and fixed maturity mean that a contractual arrangement defines the amounts and dates of payments to the holder such as interest and principal payments (IAS 39: AG 17).

Reflecting on the features of held–to–maturity investments, Moore (2002) highlights that the use of this category is subject to significant restrictions designed to ensure that only investments that an entity has a positive intent and ability to hold to maturity are classified as such. These restrictions are referred to as tainting provisions. However, a positive intention to hold an investment to maturity cannot be demonstrated if:

- The entity intends to hold the financial asset for an undefined period;
- The entity stands ready to sell the financial asset in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms or changes in foreign currency risk; or
- The issuer has a right to settle the financial asset at an amount significantly below its amortised cost (IAS 39: AG16).

Furthermore, the ability to hold an investment to maturity in a financial asset is not demonstrated if:

- It does not have the financial resources available to continue to finance the investment until maturity; or
- It is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity (IAS 39: AG 23).

Therefore, there is a commonly held view that this category is deemed to be an exception for those financial assets that have specific terms, and characteristics detailed conditions to comply with in order to test management’s intentions and the ability to hold such investments to maturity (Bryer, 2004; Collemi, 2010; PricewaterhouseCoopers, 2000).

According to IAS 39, an entity shall not classify any financial assets as held to maturity if the entity has, during the current financial year or during the two preceding financial years, sold
or reclassified more than an insignificant amount in held-to-maturity investments before maturity other than sales or reclassifications that (Para. 9):

- Close enough to maturity or call date so that changes in the market rate of interest did not have a significant effect on the investment’s fair value;
- After substantially all of the investment’s original principal had been collected through scheduled payments or prepayments; or
- Due to an isolated non-recurring event that is beyond the holder’s control and could not have been reasonably anticipated by the holder (IAS 39: 9 in Ernst & Young, 2011: 2189).

IAS 39 lays down detailed implementation guidance from AG16 to AG25 to limit the use of the held-to-maturity category, but classification remains essentially subjective (Bryer, 2004). As Ernst & Young (2011) put it, while no investments are designated as held to maturity, they must be included in this category if they meet the appropriate conditions. Consequently, this is effectively a voluntary classification in practice, since it is essentially easy for an entity to selectively fail at meeting any of the conditions (Ernst & Young, 2011).

Although held-to-maturity investments are measured at amortised costs (André et al. 2009), the question could be asked of whether fair value is a more appropriate measure for such financial assets than amortised cost (IAS 39: AG20). It seems that this category of financial assets was especially introduced to make the standard more acceptable to certain enterprises that would not accept full-on fair value (PricewaterhouseCoopers, 2000 in Tosen, 2004: 34).

2.5.3.1.3 Loans and receivables

The first version of IAS (IAS 39: 10) defined loans and receivables as financial assets that are created by the enterprise by providing money, goods, or services directly to a debtor, other than those that originate with the intent to be sold immediately or in the short term, which should be classified as being held for trading (Bryer, 2004). The features that traditionally drive the classification of financial assets as loans and receivables are based on loans and receivables originated by the enterprise.
Subsequent to initial recognition, financial assets categorised as loans and receivables are recognised at amortised cost using the effective interest method, subject to an impairment test (Duh et al. 2012; Loftus, 2006). However, fair value can also affect their recognition in two ways (Duh et al. 2012: 25-26):

Firstly, IAS 39 permits entities to designate, at the time of acquisition, any loan or receivable as available for sale, in which case it is measured at fair value with changes in fair value recognised in equity. Secondly, IAS 39 requires the timely recognition of bad news for loans and receivables by means of impairment losses.

The definition of loans and receivables originated by the enterprise does not distinguish between loans that take the form of securities and those that do not (IAS 39: IG Q10-20). As an example, debt security qualifies as a loan originated by the enterprise if (1) it establishes a contractual right to receive repayment of the debt from the government and (2) the enterprise does not have an intent to sell the asset immediately or in the short term (IAS 39: IG Q10-20).

PricewaterhouseCoopers (2000: 23) indicates the different treatment of loans and receivables originated by the enterprise:

A loan acquired as participation in a loan from another lender is considered to be an originated loan as long as it is acquired on the date that the other lender originates the loan. A loan acquired through a syndication is an originated loan because each lender shares in the origination of the loan and provides money directly or indirectly to the borrower.

However, the acquisition of an interest in a pool of loans or receivables after they were originated (for example in connection with a securitisation) is a purchase, not an origination.

A transaction that is, in substance, a purchase of a loan that was previously originated by others (for example, a loan to a special purpose entity that uses the proceeds to acquire loans originated by others) is not a loan originated by the enterprise.

Later, the standard amends the term ‘originated loans and receivables’ to ‘loans and receivables’ (IAS 39: IN8). Under the revised definition, an entity is permitted to classify
purchased loans that are not quoted in an active market as loans and receivables (IAS 39: IN8). Loans and receivables are now defined as non-derivative, with fixed or determinable payments that are not quoted in an active market, with the exceptions of:

- Those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;
- Those that the entity upon initial recognition designates as available for sale; or
- Those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale (IAS 39: 9).

The first two exceptions provide for mutually exclusive categories of financial assets, while the third exception excludes financial assets from being classified as available for sale if the initial investment is not fully recoverable for reasons other than the debtor’s credit deterioration (Loftus, 2006). However, classifying financial assets as loans and receivables when a substantial amount of the initial investment is unrecoverable would be inappropriate, because this classification of financial assets is carried at amortised cost subsequent to initial recognition (Loftus, 2006: 51).

2.5.3.1.4 Available for sale

Under this category, assets that are available-for-sale are those non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity or (c) financial assets at fair value through profit or loss (Collemi, 2010; IAS 39. 9; Ernst & Young, 2011). Clearly, this type of asset does not properly belong in one of the three other categories of financial assets (Ernst & Young, 2011). Therefore, it is important to note that the available for sale category serves as the default classification for non-derivative financial assets (Loftus, 2006). This category also reflects management discretion, because management may designate the assets as available for sale (Loftus, 2006).

Reflecting on the measurement basis, available for sale financial assets are valued at fair value at each balance sheet date, but the change in fair value goes to equity and is now
reported under other comprehensive income (OCI), with gains and losses recycled through the income statement when the asset is sold (André et al. 2008:5). As a result, the requirement may increase earnings volatility (Duh et al. 2012).

Examples of assets considered available for sale include: (a) equity investments that are not designated on initial recognition at fair value through profit or loss, (b) financial assets that could have been classified as loans and receivables on initial recognition but the fund decides to designate them as available for sale and (c) financial assets where the fund is unable to substantially recover all of its initial investment (Collemi, 2010).

2.5.3.2 Classification of financial liabilities

Financial liabilities are also subject to classification by banks in their financial statements. Unlike financial assets, only two categories are classified under financial liabilities: Fair value through profit or loss and other liabilities (IAS 39). Amortised cost is a benchmark treatment, and classification under fair value through profit or loss is an exception. Similarly to financial assets, financial liabilities held for trading include (PWC, 2006: 11):

- Derivative liabilities that are not accounted for as hedging instruments;
- Obligations to deliver securities or other financial assets borrowed by a short-seller;
- financial liabilities that are incurred with the intention to repurchase them in the near term; and
- Financial liabilities that form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking.

Therefore, the only liabilities that are classified as trading are derivatives and short positions in securities (Moore, 2002: 21). However, financial liabilities can also be designated at fair value through profit or loss (PWC, 2006).

2.5.4 IFRS 7
IFRS 7 was introduced in 2005 to clarify the disclosure requirements of financial instruments. It also incorporates many of the requirements in the IAS 32 *Disclosure and Presentation of Financial Instruments* (Ighian, 2012). IFRS 7 sets out the objectives, financial instrument disclosures for financial statements, an evaluation of the significance of financial instruments, the entity’s financial position and performance and the nature and extent of risks (Ighian, 2012; Deloitte, 2009). The standard requires reporting entities, including all banks, to disclose their policies, objectives and strategies for using these instruments, and also provide information about how the associated risks are being managed and their potential impact on the company’s financial performance and condition (p. 374).

In addition, IFRS 7 specifies a number of disclosure requirements to be provided by the class of financial instruments (Deloitte, 2009). To achieve this requirement, in Paragraph 8 of IFRS 7, an entity is required to disclose the carrying amount for each financial asset category as defined by IAS 39 either in the statement of financial position or in the notes to the financial statements as follows:

- Financial assets at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those classified as held for trading;
- Held-to-maturity investments;
- Loans and receivables; and
- Available for sale financial assets.

Given that IFRS 7 does not prescribe any specific presentation format for financial instruments in the statement of financial position or for the income statement, Bischof (2009) states that the entities would meet the disclosure requirements by presenting financial instruments through measurement categories in the statement of financial position. This uncertainty of presentation is a reason why this research is being done.

However, it seems to be of considerable importance to underline the disclosure of accounting policies highlighted in IAS 1 to draw a link with IFRS 7. IAS 1 requires an entity to disclose the following information relative to (a) the summary of significant accounting policies, (b) the measurement basis used in preparing the financial statements, and the other accounting
policies used that are relevant to an understanding of the financial statements (Para. 117). Presenting financial assets in order of liquidity, as generally recommended by IAS 1, is another accounting policy option (Bischof, 2009:171).

Although IAS 1 and IAS 39 focus on presentation, Bischof and Wüstemann (2008) argue that there are interesting insights into the theoretical controversy around whether a presentation by measurement categories is compatible with the general presentation principles under IAS 1. The main point in this controversy is that IAS 1 demands a separate presentation by liquidity that is not necessarily classified according to the different measurement categories of IAS 39 (Bischof, 2009).

IFRS 7 is also applicable to the statement of comprehensive income with respect to IAS 39. Paragraph 20 of IFRS 7 requires disclosure of net gains or net losses. The statement of comprehensive income with respect to financial instrument should disclose the following information (Spector, 2009b):

- Financial assets or financial liabilities at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are classified as held for trading in accordance with IAS 39;
- Available-for-sale financial assets, showing separately the amount of gains or loss recognised in other comprehensive income during the period, and the amount reclassified from equity to profit or loss for the period; and
- Financial liabilities measured at amortised cost, showing the effective interest component.

2.6 Reclassification of financial assets

Accounting standard-setters have provided a once-off reclassification of certain financial instruments owing to the credit crisis. Amendments of IAS 39 with reference to the reclassification of financial assets were made available in October and November 2008.
The reclassification of financial assets is the consequence of the recent debate, which has popularised the idea that fair value measurement is the key driver of the deepening financial crisis (Fiechter, 2011b; Paananen et al. 2012). However, some argue in favour of fair value (e.g. Barth et al. 1995; Barth, 2007; Penman, 2007). In the light of the many controversies surrounding fair value as applied in IAS 39 and in the aftermath of the financial crisis, standard-setters decided to step forward in reducing the use of fair-value accounting. Consequently, in response to various requests, the IASB introduced an amendment to IAS 39 and to IFRS 7—Financial Instruments: Disclosures on October 13, 2008 (Bengtsson, 2011; Fiechter, 2011b; Paananen et al. 2012).

Therefore, from a perspective of avoiding having to report losses in the financial position of banks, the reclassification possibilities are expected to affect financial statements, as a change in category may result in reduced losses (Fiechter, 2011a).

It is not within the scope of this research to discuss the reclassification of financial assets in detail.

2.7 Proposed changes to financial instruments

The value of IAS 39 has been debated by several researchers (Bengtsson, 2011; Chan, 2010; Chatham et al. 2010; Hague, 2004). The existing standard had too many classes of financial instruments each with their own requirements; too many anti-abuse clauses and too many exceptions to principles (Stevenson, 2012:15). Although the Board has amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it has not previously undertaken a fundamental reconsideration of reporting for financial instruments (IASB, 2009b: IN2). Thus, owing to the high number of derogations and exceptions, the accounting standards of IAS 39 have become opaque and complex to implement (Fougeron, 2011).

Many of the concerns that have been expressed by adherents arise from the classification and measurement requirements of IAS 39 (IASB, 2009b). As a result, the board is working toward changing the classification and measurement of financial instruments in IAS 39 (IFRS 9, 2010).

2.7.1 Classification of financial assets
As the new IFRS document, and as part of the project to replace IAS 39, IFRS 9 – Financial Instruments: Classification and Measurement was issued in November 2009, and became effective from annual periods beginning on or after 1 January 2013, with early application permitted (Carmona and Trombetta, 2010; Fiechter, 2011b).

IFRS 9 has resulted in the simplification of the classification and measurement model for financial assets into two categories (amortised cost and fair value), with a single impairment model (IASB and FASB, 2012a:17). This new standard modified the many categories of financial instruments (Carmona and Trombetta, 2010). IFRS 9 has a mixed measurement model and originally only addressed financial assets (IASB and FASB, Staff Paper 2012a), by classifying them in two categories of financial assets, namely financial instruments at amortised cost and financial instruments at fair value (Fiechter, 2011b; IFRS 9, 2010).

In November 2012 exposure draft, the IASB proposes limited changes to IFRS 9 – related-classification and measurement requirements (IASB, Snapshot 2012b). The IASB had three primary objectives for publishing the ED and limited the discussions to matters consistent with those objectives (IASB, Snapshot 2012b: 2):

(a) The consideration of the interaction between the classification and measurement of financial assets and the accounting for insurance contract liabilities. The IASB stated that the interaction between IFRS 9 and its insurance contracts project would be considered once the insurance contract model was developed sufficiently.

(b) The clarification of a narrow range of application questions, such as the amount/frequency of sales that would be consistent with a ‘hold to collect’ business model and how to apply the contractual cash flow characteristics assessment when there is an interest rate mismatch or the interest rate is leveraged.

(c) The reduction of key differences between the IASB’s requirements for classification and measurement of financial instruments and the tentative classification and measurement model considered by the FASB, thereby achieving increased comparability internationally in accounting for financial instruments.

Under IFRS 9, there is explicit reference to business models in the requirements for deciding whether certain items should be measured at fair value or amortised cost (ICAEW, 2010;
IFRS 9 (2010); Singleton-Green, 2012). IFRS 9 (2010) specifies that a financial asset shall be measured at amortised cost if two conditions are met. The first is that the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows, and the second is that the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (paragraph 4.1.2).

The entity’s business model for managing the financial assets and the contractual cash flow characteristics of the financial assets seem to simplify issues of classification and measurement of financial instruments.

2.7.1.1 Business model approach

IFRS 9’s first condition is that the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows. While it is difficult to make a direct connection between the theory of the firm and accounting measurement, one way of relating the two to each other is via firms’ business models (ICAEW, 2010). It is not surprising that standard-setters have moved away from the original banking model, which depended on the categories of financial assets, towards a more simplified business model (Al Hayek and El Haija, 2011; Chan, 2010).

However, Singleton-Green (2012) makes the assumption that a business model may provide a basis for choosing between a cost and fair-value basis for accounting. The underlying assumption is based on Penman’s (2007) article.

Relying on Penman, Singleton-Green (2012) developed two types of firms (Type 1 and 2), which reflect two different types of business models. Under a Type 1 business model, the firm transforms its inputs and adds value to them, and therefore the historical cost is the right approach (Singleton-Green, 2012, Penman, 2007). The author goes on to stress that under a Type 2 business model a firm may buy assets in a liquid financial market and sell them back into the same market without transforming and adding value to the asset. Fair value is therefore the right approach under a Type 2 business model.
In terms of business models in accounting, Penman (2007) and Singleton-Green (2012) discussed a number of different measurement bases such as historical cost, recoverable historical cost, replacement cost, recoverable replacement cost and fair value, and assessed whether they can be described as business-model-based approaches. However, Singleton-Green (2012) identifies a problem with the business-model approach to fair value measurement. The claim that fair value can be seen as a business-model-based approach, as required in IFRS 9, may be regarded as surprising in view of the argument developed in relation to Type 1 firms (Singleton-Green, 2012). The explanation is that if all the items in a Type 1 firm’s balance sheet were at fair value, most of the measurements would not really be at market prices (Singleton-Green, 2012).

Furthermore, the essence of a business model reflects management intention in order to organise the enterprise (Teece, 2010). As a consequence of management intention ambiguity, at least in some instances, the entity’s business model does not depend on management intentions for an individual instrument, as this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation (IFRS 9: B4.1.2). That is, the intentions of management, according to Nobes (2005:29), are a poor principle that is not to be found in the frameworks, because intentions can change, cannot directly be audited, and are sometimes unclear to management.

There is currently considerable attention paid to the business model in financial reporting. Relying on traditional literature, the theory of business models is constructed around the models, including the intention of management (Brougham, 2012; Leisenring et al. 2012), the business strategy (Page, 2012; Teece, 2010) and the entity concept (IASB Reporting Entity, 2010c). Because no generally agreed definition of the term ‘business model’ has emerged (Leisenring et al. 2012; Morris et al. 2005), references to firms’ business models in relation to financial reporting are quite recent, and have appeared mainly in relation to accounting for financial instruments (ICAEW, 2010).

In considering the business model, the IASB Standard-setters published a discussion paper entitled A Review of the Conceptual Framework for Financial Reporting in July 2013, introducing the use of the business model in the conceptual framework (IASB, DP 2013b). The classification and measurement of financial assets under IFRS 9 depends on the entity’s business model for managing those assets (IFRS 9). As reflected above by Leisenring et al. (2012), IFRS 9 does not define an entity’s business model (IASB, DP 2013b). While the
business model should provide insights in IFRSs into how the entity’s business activities are managed, there is a view that it provides entities with a choice about how to report economic phenomena or transactions (IASB, Staff paper 2013a:4-5).

2.7.1.2 The contractual cash flow characteristic of financial assets

The basis of the requirement in the second condition for a financial asset to be measured at amortised cost is that the asset only be held for the collection of contractual cash flows.

An example of contractual cash flows is given in IFRS 9 paragraph B4.1.13, which relates to instrument A as a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected. The analysis in IFRS 9 (2010:A343) gives rise to the following:

_The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding. However, if the interest payments were indexed to another variable such as the debtor’s performance (e.g. the debtor’s net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the interest payments are not consideration for the time value of money and for credit risk associated with the principal amount outstanding. There is variability in the contractual interest payments that is inconsistent with market interest rates._

Leverage is also discussed under the contractual cash flow characteristic. Leverage is a contractual cash flow characteristic of some financial assets; however, they do not have the economic characteristics of interest, and they do not meet the requirement of IFRS 9 in paragraph 4.1.2 (IFRS 9: B.4.1.9). In the exposure draft, _Limited Amendments to IFRS 9 (2010)_ released in November 2012, the board proposes to clarify when contractual cash flows are still considered to consist of a principal and interest when the interest rate is leveraged or is reset for a period that does not match the rate used (Finnegan, 2012; IASB Snapshot, 2012b). The ED, therefore, proposes that the financial asset has cash flows that are solely
payments of principal and interest if the effect of such a leverage or mismatch feature could not be more than insignificant when compared with the cash flows of an instrument that does not contain such a feature but that is otherwise identical (IASB Snapshot, 2012b: 5).

A financial asset should be measured at fair value unless it is measured at amortised cost (IFRS 9: 4.1.4). This requirement is driven by the equity investment features because they do not contain contractual terms that give rise to cash flows on specified dates that are solely payments of principal and interest on the principal amount outstanding (Chan, 2010). While an entity manages the performance of a portfolio of financial assets with the objective of realising cash flows through the sale of the assets, a portfolio of financial assets is thus evaluated on fair value and that is not held to collect contractual cash (IFRS 9: B4.1.5-4.16). The reason for this is that, interest rate changes, changes in the expected cash flow, and possible market distortions including changes in risk and liquidity premiums, affect the fair values of debt securities (Laux, 2012). The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (IFRS 9: 4.1.2(b)).

2.7.1.3 Third measurement category

In November 2012, the IASB introduced a third measurement category in relation to the classification and measurement of financial assets (Finnegan, 2012; IASB Exposure Draft, 2012a). The proposals is a limited scope exposure draft that proposed the introduction of a fair value through other comprehensive income (FVOCI) measurement category for debt instruments that would be based on an entity’s business model (IASB Exposure Draft, 2012a). Many interested parties have asked the IASB to provide requirements for sales of debt instruments consistent with the firm’s business model (IASB Snapshot, 2012b). It is thus evident that the ED proposes to clarify the business model criteria by providing additional application guidance on the types of business activities and the frequency and nature of sales that could qualify for amortised cost measurement (IASB Snapshot, 2012b).

2.7.2 Classification of financial liabilities

In the new developments of IFRS, the need to consider the improvement of financial liabilities within IFRS 9 has been clarified by standard-setters. Thus, in October 2010 the
IASB added requirements for the classification and measurement of financial liabilities to IFRS 9 (IASB and FASB, Staff paper 2012). The Board had discussed one of the reasons for the inclusion of financial liabilities in IFRS 9 (2010: IN7):

*Most of the requirements in IAS 39 for classification and measurement of financial liabilities were carried forward unchanged to IFRS 9. Under IAS 39 most liabilities were subsequently measured at amortised cost or bifurcated into a host, which is measured at amortised cost, and an embedded derivative, which is measured at fair value. Liabilities that are held for trading (including all derivative liabilities) were measured at fair value. Although the Board had originally proposed a symmetrical approach for financial assets and financial liabilities in the exposure draft published in 2009, the Board decided to retain most of the requirements in IAS 39 for classifying and measuring financial liabilities because constituents told the Board that working well in practice. Consistently with its objective to replace IAS 39 in its entirety, the Board relocated those requirements from IAS 39 to IFRS 9.*

Therefore, the requirements for financial liabilities have not been changed from IAS 39 to IFRS 9. The standard (IFRS 9: Para. 5.7.7), however, requires that the amount of change in fair value attributable to changes in the credit risk of the liability be presented under other comprehensive income.

### 2.8 Conclusion

The literature review revealed that the original intention of the standard-setters was to move to a full fair-value model. Although the IASB had an intention to move to fair value for all financial instruments, IFRS 9, which was issued after the credit crisis, changed the standard-setters intention to move to a full fair-value model. Fair value is, however, applied with concerns. The effect of the pro-cyclical nature of fair value and its reliability when market prices are not available are still being debated. Moreover, this research supports the evidence in the literature review that fair value remains controversial, particularly with regard to earnings volatility.

It further suggests in relation to previous research that the agency theory plays a role in the presentation of financial statements, while the opportunistic behaviour of the agent distorts the financial statements in opposition to the IFRS requirements. Studies present findings
according to the manipulation of earnings by managers, but do not provide direct linkage between earnings management and the issues of the classification of all financial instruments by banks.

Furthermore, the literature review confirmed that although IAS 1 and IAS 39 focus on presentation, there is a possible conflict around whether the presentation by measurement categories in IAS 39 are compatible with the general presentation principles under IAS 1 (Bischof, 2009). The results of this research will serve as information for future research around how this conflict is being bridged and whether the banks adhere to the requirements of IAS 39. As explained in Chapter 1 of this thesis, the focus is on how the conflict between the two classifications is being bridged and whether the banks adhere to the requirements of IAS 39.

In addition, the literature review also suggested that the financial instruments standards in IAS 39 have been known for a level of complexity, especially regarding the classification of financial assets. Accordingly, the standard-setters intend to replace IAS 39 with IFRS 9, in particular in order to use the business-model approach to provide relevant information for IFRS.

Chapter 3

Research Methodology

3.1 Introduction
The objective of the minor dissertation is to assess how the conflict in the classification of financial assets between IAS 39 and IAS 1 is being bridged in the financial statements of banks. In Chapter 1 it was identified that there is a possible conflict in the classification of financial assets between the classification of financial assets according to IAS 39 and the classification by nature from most liquid to least liquid in terms of IAS 1. Banks following IFRS are required to comply with both IAS 1 and IAS 39. This chapter explains the methodological approach followed to assess the conflict between the classification of financial assets in IAS 39 and the classification by nature of liquidity in IAS 1. It also outlines the population and sample selection used to collect data from the annual reports of banks. The chapter explains the sources of documents for this research, the procedure of data collection and the research instrument. Finally, the chapter describes how the data was analysed and the limitations of the study.

The above objective is achieved by firstly analysing the statement of financial position to assess whether the classification of financial assets is obtainable from the statement of financial position, which presents assets and liabilities from most liquid to least liquid. Secondly, the accounting policies used by the banks are analysed to assess the appropriateness of the classification of all financial assets in terms of IAS 39. Thirdly, the notes to the financial statements are analysed to assess the classification of financial assets. Finally, the statement of comprehensive income is analysed to assess whether the information required for financial instruments is obtainable from the statement of comprehensive income or the notes to the financial statements.

3.2 Research methodology

This minor dissertation is a case study of the major banks in South Africa. Content analysis is used to analyse the financial information in the financial statements of these banks. A wide variety of research studies describes content analysis as a research method that draws inferences from data by systematically identifying characteristics within the data (Jones and Shoemaker, 1994). Krippendorff (2004) states that it is a research technique for making replicable and valid inferences from texts, while Duriau et al. (2007) define it as any methodological measurement applied to text. According to McConnell, Haslem and Gibson
(1986), a content analysis is the systematic enumeration, coding and classification of words and phrases for the purposes of analysing message content. In this minor dissertation, as in the Gordon et al. (2002), Gouws and Cronjé (2008) and Smith and Taffler (2000) studies, the focus is on the extent of narrative disclosures in corporate annual reports.

The vast majority of researchers use content analysis to examine the content of annual reports (Gouws and Cronjé, 2008; Ingram and Frazier, 1983), chairman’s statements (Smith and Taffler, 2000), presidents’ letters to stockholders and shareholders (D’Aveni and McMillan, 1990; McConnell, Haslem and Gibson, 1986), the content of accounting standards (Bradbury and Schröder, 2012) and comment letters to exposure drafts (McArthur, 1988).

As such, content analysis is widely used in accounting research to reveal insights into accounting practices (Beattie and Thomson, 2007; Steenkamp and Northcott, 2007). The advantage of such a methodology is that the coding scheme can be corrected if flaws are detected as the study proceeds (Durian et al. 2007). The potential contribution of this method is that it can enable researchers to go behind the text as presented to make valid inferences about hidden or underlying meanings and messages of interest (Steenkamp and Northcott, 2007).

The minor dissertation could also be regarded as exploratory research as such research has not been done before in South Africa. The exploratory research design is used when a researcher studies a topic where no theory exists or when a researcher does not know which constructs are appropriate (Ivankova et al. 2007). In this minor dissertation, the classification of financial instruments is explored by following a specific coding system.

The characteristic of this exploratory research design is also described from the perspective that the study involves a very small sample size of banks (Creswell and Plano Clark, 2011; Ritchie et al. 2003). The sample consists of the ‘Top 7’ banks in South Africa. The selection of banks in South Africa is chosen because they have particular features or characteristics that will enable detailed exploration and understanding of the classification of financial assets and classification in order of liquidity.

The study mainly follows a quantitative research design, but qualitative aspects are included in the interpretation of the quantitative results. From this research perspective, the study uses
both quantitative and qualitative research methods. The mixed research approach (quantitative and qualitative) is gaining great attention by researchers (see Onwuegbuzie and Leech 2005; Johnson and Onwuegbuzie, 2004), because the approaches are being considered complementary.

3.3 Population and sample selection

One of the listing requirements of the JSE Limited is that South African listed companies must apply IFRSs (Rossouw, 2010). The 2011 annual reports of the selected banks listed on JSE that apply IFRSs were selected accordingly. The population consists of the Top 100 largest companies in the FTSE/JSE Top 100 index based on the importance of their market capitalisation. The population of the Top 100 firms listed in the JSE is contained in Annexure A.

Companies in the sample selection were drawn from the list of JSE listed securities on 30 December 2011. Seven Banks were included in the FTSE/JSE classification of the Top 100 companies selected based on their market capitalisation. The minor dissertation is therefore restricted to the Top 7 banks, which includes the major banks. It is also restricted to the Top 7 banks because of its exploratory nature. The sample selection is presented in Annexure B.

3.4 Sources of documents

The source used this research is the annual financial statements of the seven banks for the 2011 financial year. Annual reports were collected directly from company websites (Cairns et al. (2011)). Corporate annual reports are the classic vehicle for companies to communicate their financial performance (Santema and De Rijt, 2001). In other words, corporate annual reports, including narratives, are used extensively in forecasting processes, which frequently builds explicitly on information about past performance and current position (Rutherford, 2005).

Disclosure in annual reports is viewed as the crucial element in achieving the desired improvements in the quality of corporate reporting (Beattie, McInnes and Fearnley, 2004). Several studies have shown the importance of the information disclosed in the narrative part of annual reports (Santer and De Rijt, 2001). In a parallel study, Rogers and Grant (1997)
state that narratives are an important information source for analysts and a critical component of annual reports (Balakrishnan, Ying Qiu and Srinivasan, 2010).

The focus of this research is on narratives and not accounting numbers. The following parts of the financial statements are specifically analysed:

- The classification in the SOFP;
- The accounting policies;
- The notes to the annual financial statements; and
- The identification of financial income and expenses in the SOCI.

3.5 Data collection and research instrument

The data for the analysis was collected for the purpose of identifying the basic nature of the conflict between IAS 1 and IAS 39. The research utilised a quantitative content analysis checklist based on narrative disclosures in order to collect data on categories of financial assets and classification by nature of liquidity. Quantifying thematic content analysis is used to count the number of times a specific code was applied to a particular item or unit of analysis (Guest, MacQueen and Namey, 2012). In this context, content analysis was selected mainly with the aim of quantifying the disclosures of the classification of financial assets in IAS 39 and the classification by nature of liquidity in IAS 1 (Beattie and Thomson, 2007).

The analysis is subject to quantitative information from the checklist instrument (see Annexure C). For the purpose of making quantitative assessments, the checklist instrument addresses the following questions:

- Firstly, with regard to the SOFP, whether the banks use classification by liquidity and whether the classification identified in IAS 39 is obtainable from the SOFP.
- Secondly, whether the accounting policy notes are based on the classification prescribed in the statement of financial position or the classification prescribed by IAS 39.
• Thirdly, whether the notes to the financial statements are structured based on the classification given in the statement of financial position and how banks combine this with the classification prescribed by IAS 39.

• Finally, whether the statement of comprehensive income discloses interest income and expenses, the impairment of financial instruments, fair-value adjustments of financial instruments and fair value through OCI as required by IAS 39 and IFRS 7.

The checklist contains nine questions and focuses on the basis of the categories defined in IAS 39. The checklist for the data collection instrument is based on the literature review (Chapter 2.5).

3.6 Data analysis

The content analysis in the minor dissertation uses a two-tier coding system to quantify the nature of the conflict between IAS 39 and IAS 1. Firstly, the scoring codes used are “’yes’” and “’no’”, which indicate whether or not a specific classification is applicable. The classification of financial instruments is scored as follows:

• Yes, if the classification is identifiable.
• No, if the classification is not identifiable.

The first scoring code is related to the frequency codes, which is defined as the number of times the categories of financial assets are counted for classification purposes.

Secondly, the minor dissertation used another coding system to test the reliability of the classification of financial assets. The yes/no classification of both the classification by liquidity and IAS 39 is combined in one table and Scott’s Pi and Cohen’s Kappa coefficient are used (Table 3.1).

| Coder 1 | Coder 2 |  
|---------|---------|---
|         | Yes | No | Total |
| Yes     | 81  | 9  | 90    |

Table 3.1
Example Data for Illustration of Scott’s Pi and Cohen’s Kappa
The integration of two yes/no coding systems in one table provides four different options for classifying the data in a sample:

- A double “‘no’” coding illustrates that neither both coding system is applicable. For instance, in this minor dissertation, this where neither classification by liquidity (IAS 1) nor classification by financial instrument (IAS 39) are applicable.
- A “‘yes/no’” or “‘no/yes’” coding indicates that only one of the classification options is applicable.
- A double “‘yes’” coding indicates that both classifications are applicable, and therefore illustrates that the conflict between the IAS 1 and IAS 39 classification has been bridged, without identifying how the conflict is being bridged.

Scoring techniques provide a way to combine a large amount of information and to draw a conclusion from the information (Boolaky, 2006:122). The minor dissertation scores the presence and absence of categories of financial assets and the classification in order of liquidity included in the statement of financial position, accounting policies and the notes to the financial statements. In this way, the scoring scheme was developed and implemented for the purpose of scoring and interpreting the issues observed in relation with the classifications within the financial statements. The development, refinement, and implementation of the scoring scheme are central to the quality of textual analysis, particularly in the case of content analysis (Carley, 1993; Gephart, 1993 in (Duriau et al. 2007)).

In order to facilitate the assessment of the classification of financial assets in IAS 39 and the classification by nature of liquidity in IAS 1, tables are constructed in Chapter 4 to record the coding scores for each bank sampled for this minor dissertation. Furthermore, the construction of tables summarises the data gathered in such a way as to outline the frequency counts of the coded scores and present this as a percentage (Bühner and Möller, 1985; Ingram and Frazier, 1983; McConnell, Haslem and Gibson, 1986). The objective of those tables is to

<table>
<thead>
<tr>
<th>No</th>
<th>9</th>
<th>1</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>90</td>
<td>10</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: (Lombard et al. 2002:592).
analyse the results regarding the classification of financial assets and classification by nature of liquidity from the quantitative results.

3.7 Limitations of the study

Several issues associated with the content analysis have been observed. Since content analysis is central to this study, some of the criticisms of this methodology are revealed. Firstly, while content analysis is a safe methodology, allowing the coding scheme to be corrected if flaws are detected as the study proceeds (Duriau et al. 2007), one of the criticisms of this line of research has been that documents such as annual reports are intentionally biased for specific audiences (Huff, 1990 and Morris, 1994 in (Duriau et al. 2007)). Secondly, a key aspect of content analysis is that it focuses on text, but the scope and meaning of the text can be differently interpreted (Steenkamp and Northcott, 2007). Thirdly, Deegan and Rankin (1996) and Frost and Wilmshurst(2000) stress that the major limitation is the subjectivity involved in scoring (Guthrie et al., 2004); and that content analysis depends on the judgement and interpretation of the investigator (Steenkamp and Northcott, 2007). As defined in the limitations, scoring system can suffer from many problems. The approach to scoring items is limited in that the categories of classification are not clearly and appropriately defined (Guthrie et al. 2004). One of the more major effects is that scoring is not free from bias.

Chapter 4

Results

4.1 Introduction
The research was conducted to assess how the conflict in the classification of financial assets between IAS 39 and IAS 1 is being bridged in the financial statements of banks. The minor dissertation concentrates on the research issue of how the classification of financial assets by banks in IAS 39 is combined with the IAS 1 classification by nature in the SOFP from most liquid to least liquid. In this chapter, the analysis of the results is structured as follows:

- Firstly, the statements of financial position are quantified;
- Secondly, the accounting policies are quantified;
- Thirdly, the notes to the financial statements are quantified and the detailed information on how the conflict is being bridged is analysed;
- Finally, the quantification is applied to the statement of comprehensive income.

Under each heading, the chapter presents the results of the quantitative content analysis checklist, followed by the interpretative analysis. Firstly, the results of the first coding system, the frequency counts are presented. This coding system is based on a yes/no assessment.

Secondly, the integration of frequency codes is a measure of reliability that has been used abundantly in a variety of different settings (Guggenmoos-Holzmann, 1996:775). It also accounts for the distribution of values across the frequency codes (Lombard et al. 2002).

Thirdly, the results of the quantitative assessment are interpreted and the methods used to bridge the conflict between the classification of IAS 1 and IAS 39 are identified and discussed.

**4.2 Results from statements of financial position**

**4.2.1 Assessment of frequency counts**

With regard to the classification in the statement of financial position, Table 4.1 presents the results of the questions of whether the banks use the classification by liquidity and whether the classifications in IAS 39 are identifiable in the SOFP.
Table 4.1: Frequency classification in the statement of financial position

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>Frequency counts</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Does the bank use the classification by liquidity?</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Is the classification identified in IAS 39 obtainable from the SOFP?</td>
<td>0</td>
<td>7</td>
</tr>
</tbody>
</table>

With reference to the SOFP, the research answered ‘Yes’ to the question related to the liquidity-based classification. The scoring results show that all of the banks (100%) disclosed information regarding the liquidity-based classification in the SOFP. However, by the complete response of ‘no’ to the visibility of the IAS 39 classification, the results indicate that the classification of financial assets in terms of IAS 39 is not obtainable from the SOFP of banks.

4.2.2 Integration of frequency codes

Table 4.2 indicates the presence of a combination the two different coding systems within the statements of financial position.

Table 4.2: Integration of frequency codes in the statement of financial position

<table>
<thead>
<tr>
<th>Code 1: Liquidity</th>
<th>Yes</th>
<th>No</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code 2: IAS 39</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>No</td>
<td>7</td>
<td>0</td>
<td>7</td>
</tr>
</tbody>
</table>
This integration table shows that only the liquidity classification (IAS 1) is available from the SOFP. Classification of financial assets in terms of IAS 39 is therefore not obtainable from the SOFP.

**4.2.3 Interpretation**

This section seeks to answer the question of whether the classifications of both IAS 39 and IAS 1 are identifiable in the statement of financial position (RQ1). The results show that only the classification by liquidity is available from the SOFP. The classification of financial assets in terms of IAS 39 (as held for trading, loans and receivables, held to maturity or available for sale) is not available. Most banks refer to other classifications, such as trading assets, financial investments, pledged assets, loans and advances, investment securities and other investments in the SOFP.

The benefit of the SOFP classification is that the investor can assess the liquidity of a bank and compare more liquid assets with more liquid liabilities. The negative part is that the classification of IAS 39 is not available from the SOFP and therefore the investor needs to assess more information to obtain the IAS 39 classification for banks. The reason for this is that the classification of financial assets by liquidity is not compatible with the classification in IAS 39.

A further issue is that no specific guideline is provided in IAS 1 for how the classification of liquidity should be applied. Banks therefore used different classifications of financial assets in the SOFP that are not always compatible with those of other banks.

Some information mentioned in IAS 39, such as trading assets and derivatives, are, however, sometimes identified in the SOFP. Only three banks have disclosed derivative financial assets in their SOFP. Derivative financial and trading assets and liabilities are included in IAS39 under the fair value through profit or loss classification.

**4.3 Results from accounting policies**
4.3.1 Assessment of frequency counts

Table 4.3 provides the results for whether the classification distinctions of financial assets are clarified in the accounting policies.

Table 4.3: Frequency classification in the accounting policies

<table>
<thead>
<tr>
<th>Accounting policies</th>
<th>Frequency counts</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Are the accounting policies notes based on the classification in the SOFP?</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Are the accounting policies notes based on IAS 39?</td>
<td>7</td>
<td>0</td>
</tr>
</tbody>
</table>

The above results showed that the accounting policy notes are not based on the classification in the SOFP, as none of the banks did so. Furthermore, all of the banks used accounting policies based on IAS 39. In terms of the results, banks revealed 100% of information related to the accounting policies classification in IAS 39. The accounting policies follow the classification in IAS 39, and therefore the accounting policies are not compatible with classification based on liquidity in the SOFP.

4.3.2 Integration of frequency codes

Table 4.4 presents the combination of the application of the two different coding systems (yes or no) within the accounting policies.

Table 4.4: Integration of frequency codes in the accounting policies
<table>
<thead>
<tr>
<th>Code 2:</th>
<th>Yes</th>
<th>No</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAS 39</td>
<td>0</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>0</td>
<td>7</td>
<td>7</td>
</tr>
</tbody>
</table>

The integration table shows that the accounting treatment in terms of IAS 39 is available from the accounting policies. The classification of liquidity is therefore not available from the accounting policies.

### 4.3.3 Interpretation

This section seeks to answer the question of whether the classifications of financial instruments are clarified in the accounting policies of the banks (RQ2). The result regarding whether the accounting policy notes are based on the classification in the SOFP is totally negative. Most of the financial assets classified in the statement of financial position are not discussed in the accounting policies. The results of the classification of financial assets are based on IAS 39, and therefore the accounting policies agree with the requirements of IAS 39. However, the accounting treatment of each classification in the SOFP is not directly obtainable from the accounting policies. Therefore, to understand the accounting treatment of each classification in the SOFP, the information regarding the bridging the conflict between the IAS 1 classification in the SOFP and IAS 39 classification in the accounting policies is required. The next section assesses whether this information is obtainable from the notes.

### 4.4 Results from the notes to the financial statements

There are two aspects to be considered in the notes to the financial statements. The first question is whether the classification of financial instruments is obtainable from the structure of the notes. Second, the question is whether the classification of financial instruments is obtainable in the detail of information in the notes.

#### 4.4.1 Structure of the notes
4.4.1.1 Assessment of frequency counts

Table 4.5 presents the results of whether the notes to the financial statements are based on the classification in the SOFP or IAS 39.

Table 4.5: Frequency classification in the structure of the notes

<table>
<thead>
<tr>
<th>Notes to the financial statements</th>
<th>Frequency counts</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the structure of the notes based on the liquidity classification in the SOFP?</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Are the notes based on the classification in IAS 39?</td>
<td>0</td>
<td>7</td>
</tr>
</tbody>
</table>

The results gave the indication that the structure of the notes to the financial statements is based on the classification in the SOFP. For all the banks, it is clear that the structure of the notes is not based on the IAS 39 classification.

4.4.1.2 Integration of frequency codes

Table 4.6 presents the combination of the application of the two different coding systems within the notes to the financial statements.

Table 4.6: Integration of frequency codes in the structure of the notes

<table>
<thead>
<tr>
<th>Code 1: Liquidity</th>
<th>Code 2:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>0</td>
</tr>
</tbody>
</table>
The integration table shows that only the information regarding liquidity in the SOFP is available directly from the structure of the notes. The classification of financial instruments in terms of IAS 39 is therefore not obtainable from the structure of the notes to the financial statements.

4.4.1.3 Interpretation

The section seeks to answer the question of whether the classifications of financial assets are identifiable from the structure of the notes. The results indicate that the notes are based on the classification in the SOFP and not the classification in IAS 39. The assessment of how the classification of financial assets required by IAS 39 may be obtainable from the detail of information in the notes as assessed in the following section.

### 4.4.2 Detail of information in the notes to the financial statements.

#### 4.4.2.1 Assessment of frequency counts

This section seeks to answer the question of how the differences between the classification of financial assets required by IAS 39 and the classification by nature of liquidity are being bridged. Table 4.7 identifies whether both the information regarding the classifications by liquidity and IAS 39 is obtainable from the notes.

**Table 4.7: Detail of liquidity and IAS 39 information in the notes to the financial statements**

<table>
<thead>
<tr>
<th>IAS 39</th>
<th>No</th>
<th>7</th>
<th>0</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>7</td>
<td>0</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>Detail of information in the notes to the financial statements</td>
<td>Frequency counts</td>
<td>Percentage (%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>---------------------------------------------------------------</td>
<td>------------------</td>
<td>----------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Is the liquidity information obtainable in the detail of the notes?</td>
<td>7</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Is the IAS 39 information obtainable in the detail of the notes?</td>
<td>7</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
</tbody>
</table>

The above results showed that 100% of banks provide the details regarding liquidity and IAS 39 classifications in the notes to the financial statements.

4.4.2.2 Integration of frequency codes

Table 4.8 indicates the presence of the combination of the application of the two different coding systems within the detail of information in the notes to the financial statements.

**Table 4.8: Integration of frequency codes in the detail of information**

<table>
<thead>
<tr>
<th>Code 1: SOFP</th>
<th>Code 2: IAS 39</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>No</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>7</td>
<td>0</td>
</tr>
</tbody>
</table>
Both the classification of financial instruments (IAS 39) and classification of liquidity (IAS 1) are available in the notes, but the classification according to IAS 39 is in the detail of information in the notes and is therefore not directly obtainable by reviewing the SOFP or the structure of the notes. This makes it difficult for investors to obtain information regarding the classification of financial instruments according to IAS 39.

4.4.2.3 Interpretation

This interpretation seeks to answer the question of how the conflict is being bridged between the classification of financial assets as identified in IAS 39 and the classification of liquidity according to IAS 1. The banks follow two methods to bridge the conflict. The first is through the detail of each relevant note (refer to Table 4.9) and the second is in a table format (refer to Table 4.10), in which the amount of each separate assets identified in the SOFP is allocated one of the categories required by IAS 39.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Held for trading</td>
<td>X</td>
</tr>
<tr>
<td>Designated at fair value through profit or loss</td>
<td>X</td>
</tr>
<tr>
<td>Held-to-maturity investments</td>
<td>X</td>
</tr>
<tr>
<td>Loans and receivables</td>
<td>X</td>
</tr>
<tr>
<td>Available for sales</td>
<td>X</td>
</tr>
<tr>
<td>Total amount of the notes</td>
<td>----</td>
</tr>
</tbody>
</table>

Table 4.9: IAS 39 reconciliation in each note
Table 4.10: Notes allocating the total amount of individual assets as identified in the SOFP in the categories determined by IAS 39.

<table>
<thead>
<tr>
<th>Total amount of each individual assets in the SOFP (for example)</th>
<th>Held for trading</th>
<th>Designated at fair value through profit or loss</th>
<th>Held-to-maturity investments</th>
<th>Loans and receivables</th>
<th>Available for sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading assets</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Financial investments</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Short-term deposits and cash</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Table 4.11 below is a frequency classification to identify which of the two methods are being used by the seven banks in the sample. The first method is presenting the IAS 39 reconciliation in each note, and the second is a separate table based on the SOFP.

<table>
<thead>
<tr>
<th>How many banks are following each method to bridge the conflict?</th>
<th>Method 1</th>
<th>Method 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (14.3%)</td>
<td>6 (85.7%)</td>
<td></td>
</tr>
</tbody>
</table>

Most of the banks (85.7%) follow the table format, in which the amounts in the SOFP are allocated to the different IAS 39 classifications. The benefit of such a table is that the IAS 39
classification for all financial assets (and similar liabilities) is available from one table. The alternative (used by 14.3% of banks) of presenting the IAS 39 classification as a reconciliation in each note makes it more difficult to gain an overall view of the application of the IAS 39 classification. The total amount of each IAS 39 classification can only be obtained by adding the information under each IAS 39 classification in each note together.

Through using Method 1 (reconciliation in each note) and Method 2 (a separate table based on the SOFP) the conflict between IAS 1 (liquidity classification) and IAS 39 is bridged. From reviewing both of the methods, the following liquidity classifications are represented in each of the IAS 39 classifications:

**Fair value through profit or loss**

Derivative assets, trading assets, pledged assets, investment or other investment securities and certain short-term securities are included in the fair value through profit or loss category.

In addition, in some instances, investment or investment securities, government securities, loans and advances, and certain short-term securities are designated at fair value through profit or loss.

**Held-to-maturity investments**

Advances, investment or investment securities and government securities are included under held-to-maturity investments, if they meet the held-to-maturity requirements.

**Loans and receivables**

Cash and cash equivalents, loans and advances to banks, loans and advances to customers, and account receivables are included under loans and receivables.

**Available for sale**

Advances, investment securities and other investments as well as government and other securities are included under available for sale.
4.5 Results of the statement of comprehensive income

The purpose is to assess whether the information required by IAS 39 and IFRS 7 is presented in the SOCI.

4.5.1 Assessment of frequency counts

Table 4.12 presents the results of whether the interest income and expenses, impairment of financial instruments, fair-value adjustments or trading profit of financial instruments and fair value through OCI are separately identifiable in the statement of comprehensive income.

Table 4.12: Frequency classification in the statement of comprehensive income

<table>
<thead>
<tr>
<th>Statement of comprehensive income</th>
<th>Notes to the financial statements</th>
<th>Frequency counts</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
Are the following identified separately in the SOCI?

<table>
<thead>
<tr>
<th></th>
<th>7</th>
<th>0</th>
<th>7</th>
<th>0</th>
<th>100</th>
<th>0</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Interest income and expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Impairment of financial instruments</td>
<td>6</td>
<td>1</td>
<td>7</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>• Fair-value adjustments or trading profit of financial instruments</td>
<td>7</td>
<td>0</td>
<td>7</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>• Fair value through OCI</td>
<td>4</td>
<td>3</td>
<td>7</td>
<td>0</td>
<td>100</td>
<td>0</td>
</tr>
</tbody>
</table>

The results indicate that all the information required by IAS 39 and IFRS 7 are presented in the SOCI or the notes to the financial statements.

4.5.2 Interpretation

The statement of comprehensive income has been analysed to assess whether interest income and expenses, impairment of financial instruments, fair-value adjustments of financial instruments and fair value through OCI are obtainable from the statement of comprehensive income or the notes to the financial statements. Firstly, from the analysis relating to interest income and expenses, the results (100%) indicate that the information by banks is available in the SOCI. Secondly, with regard to the impairment of financial instruments, 85.7% of information by banks is available in the SOCI and 14.3% of information is available in the notes to the financial statements. Thirdly, all the information regarding fair-value adjustments is available in the SOCI (100%). Finally, the results show that with regard to fair value through OCI, 57.1% of information by banks is available in the SOCI and 42.9% of information is available in the notes to the financial statements. Overall, the results indicate that the interest income and expenses, impairment of financial instruments and fair value through OCI are available from the SOCI or the notes to the financial statements.
4.6 Conclusion

The minor dissertation assesses whether the conflict in the classification of financial assets has been bridged in the financial statements of banks. The results show that the conflict is being bridged through two methods: in the first, the IAS 39 reconciliation is included in each relevant note, and in the second, the line items in the SOFP are allocated one of the IAS 39 classifications in a table. Both of those methods are incorporated in the notes to the financial statements and a full picture of the classification of financial assets is not obtainable from the SOFP. The accounting policies reveal that only the accounting classification of IAS 39 is available from the notes. The classification based on liquidity is therefore not available from the accounting policies. The overall classification of financial assets could be summarised as follows in Figure 4.1.

Figure 4.1: Overall presentation

The conflict in the liquidity classification based on IAS 1 and the IAS 39 classifications is overcome in the notes to the financial statements. Banks therefore adhere to both the requirements of IAS 1 and IAS 39.

In addition, the minor dissertation has also assessed how the interest income and expenses, impairment of financial instruments, fair-value adjustments of financial instruments and fair value through OCI are obtainable from the SOCI or the notes to the financial statements. The results show that the information regarding the interest income and expenses, impairment of
financial instruments, fair-value adjustments of financial instruments and fair value through OCI is available in the SOCI or in the notes to the financial statements.

Chapter 5

Conclusion

5.1 Introduction
This minor dissertation has investigated how the conflict in the classification of financial assets between IAS 39 and IAS 1 is being bridged in the financial statements of banks by reviewing the classification of financial assets in the SOFP, accounting policies and the notes to the financial statements. IAS 39 provides specific classification for financial instruments, while IAS 1 provides a classification based on liquidity.

This conclusion briefly reviews the findings of each chapter starting from the literature review in Chapter 2. An overview of the methodology and sample of the selection of banks discussed in Chapter 3 is outlined. The results in Chapter 4 are also summarised in this chapter. Opportunities for future research are proposed at the conclusion of this chapter.

5.2 Literature review

Chapter 2 discussed the development of IAS 39, which traces its origins to a project started in 1988 in association with CICA. It was discussed that the development of international accounting standards on financial instruments began in 1989; and two exposure drafts were issued, namely E40 (September 1991) and E48 (January 1994). The literature review revealed that there was opposition by some European banks in particular to the development of IAS 39, even in its changed form. Many have sought changes to IAS 39 and lengthy discussions have taken place urging standard-setters towards developing a new standard for financial instruments. Consequently, in November 2009 the board issued a new financial instruments standard (IFRS 9), which includes the application of the business model.

The literature review then discussed the appropriateness of fair value. The literature review drew the conclusion that the original intention of the standard-setters was to move to a full fair-value model, but after the credit crisis, the standard-setters accepted that a mixed measurement approach should be applied in IFRS 9. Scholars have expressed concerns about the pro-cyclical nature of fair-value accounting. Additionally, more concern is expressed regarding cases where market prices are not available. The standard-setters have addressed issues of fair value measurement by issuing SFAS 157 and the IFRS 13, which specifically require additional disclosures when fair value is not based on market prices.
The literature also reviewed previous research relating to the use of fair value. Studies presented findings regarding the manipulation of earnings by managers, but do not provide direct linkage between earnings management and the issues in the classification of all financial instruments. Previous research also indicated that disclosure requirements are essentially relevant to the banking sector. The question is whether the choices available under financial instruments, such as designating certain financial instruments at fair value through profit or loss equity (available for sale) provides opportunities for manipulation. The question is further whether an application of a business model (in IFRS 9) will reduce such opportunity for manipulation.

The chapter also examined the current accounting treatments in IAS 1, IAS 32, IAS 39 and IFRS 7 as a background to the integration of the classification in order of liquidity and the classification of financial assets. Although both IAS 1 and IAS 39 focus on presentation, the presentation by measurement categories in IAS 39 is not compatible with the general presentation principles of IAS 1. The main point in this controversy is that IAS 1 demands a separate presentation by liquidity that differs from the measurement categories of IAS 39.

The chapter finally reviewed the proposed changes to financial instruments. In IFRS 9, the standard-setters introduced the use of a business-model approach to provide relevant information regarding financial assets, owing to the high level of complexities in IAS 39. The entity’s business model for managing the financial assets and the contractual cash flow criterion seem to simplify issues of the classification and measurement of financial assets.

5.3 Methodology and sample

Chapter 3 explained the methodological approach followed in assessing the conflict between the classification of financial assets in IAS 39 and the classification by nature of liquidity in IAS 1, and outlined the sample used to collect data. The minor dissertation is a case study of banks in South Africa. It is also regarded as exploratory research, as such research has not been done before in South Africa. The main research method is a quantitative content analysis of the financial statements of banks using:

1. Frequency counts;
2. Integration of frequency codes; and
3. Interpretation.

The population is the Top 100 companies of the JSE Limited. Seven banks were included in the FTSE/JSE classification of the Top 100 companies selected according to their market capitalisation on 30 December 2011.

5.4 Results

The results of the analysis of the conflict of the classification of financial assets between IAS 39 and IAS 1 were analysed by focusing on the following:

1. SOFP,
2. Accounting policies,
3. Notes to the financial statements and

5.4.1 Statement of financial position

The results firstly assessed whether the classifications of financial assets are identifiable in the statements of financial position. The SOFP of banks is based on the liquidity classification in IAS 1. In particular, the financial assets classifications required by IAS 39 (held for trading, loans and receivables, held to maturity and available for sale) are not available from the statement of financial position. Most of the banks refer to other classifications, such as trading assets, financial investments, pledged assets, loans and advances, investments securities and other investments in the SOFP.

5.4.2 Accounting policies

The results assessed whether the classifications of financial assets are clarified in the accounting policies of the banks. The accounting policies are based on the classifications in IAS 39. Information regarding the classification of liquidity is therefore not available from the accounting policies. The accounting treatment of each classification in the SOFP is not
directly obtainable from the accounting policies. Therefore, to understand the accounting treatment of each classification in the SOFP, the information that bridges the conflict between the IAS 1 classification in the SOFP and IAS 39 classification in the accounting policies is required.

5.4.3 Notes to the financial statements

The results assessed whether the conflict in the classification of financial assets between IAS 1 and IAS 39 is being bridged. The analysis indicated that the structure of the notes is based on the classification in the SOFP and not the classification in IAS 39. The classification of financial assets as required by IAS 39 is obtainable from the details of the information in the notes. The banks used two methods to bridge the conflict between IAS 1 and IAS 39. The first method is an IAS 39 reconciliation in each applicable note, allocating the total amount of the note to the applicable IAS 39 classification. The second method is a table in which the line items in the SOFP are allocated to the IAS 39 classification. Through using Method 1 (reconciliation in each note) and Method 2 (a separate table based on the SOFP), the conflict between IAS 1 (liquidity classification) and IAS 39 is bridged. Banks therefore adhere to both the requirements of IAS 1 and IAS 39.

5.4.4 Statement of comprehensive income

The results also assessed whether the interest income and expenses, impairment of financial instruments, fair-value adjustments of financial instruments and fair value through OCI are obtainable from the SOCI or the notes to the financial statements. The results show that the information regarding the interest income and expenses, impairment of financial instruments, fair-value adjustments of financial instruments and fair value through OCI is available in the SOCI or the notes to the financial statements.

5.5 Future research

There are opportunities for future research regarding the classification of financial assets. The study can be replicated in other countries and international research, since this exploratory research was limited to seven banks in South Africa and a more comprehensive study could be done. Further research can investigate entities other than banks to assess how they bridge
the conflict. The replacement of IAS 39 with IFRS 9 resulted in radical changes in the classification of financial assets. There is a possibility for future research to assess how the IFRS 9 classification will be integrated with the IAS 1 classification by banks.

This minor dissertation only focused on quantitative analysis. The appropriateness and quality of financial instruments presentation and disclosure can be assessed. In particular, a study of the classification of financial assets that are disclosed in the financial statements can assess the appropriateness of the disclosure.

The following questions could also be reviewed in future research: whether the choices available under financial instruments, such as designating certain financial instruments at fair value through profit or loss or through equity (available for sale), provide manipulation options; whether an application of a business model in IFRS 9 will reduce such manipulation options; whether the application of a business model to financial instruments will improve the quality of financial statements.

References


Annexure A: Population and market capitalisation of companies selected

This table presents data about companies’ classification from the JSE listed securities. The order of the table follows the FTSE/JSE Classification based on market capitalisation.

<table>
<thead>
<tr>
<th>Company’ names</th>
<th>Industry</th>
<th>Market capitalisation (Rand)</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Company Name</th>
<th>Industry</th>
<th>Market Value (ZAR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>British American Tobacco</td>
<td>Tobacco</td>
<td>776 936 315 024</td>
</tr>
<tr>
<td>BHP Billiton plc</td>
<td>Mining</td>
<td>500 508 251 872</td>
</tr>
<tr>
<td>SAB Miller plc</td>
<td>Non-cyclical consumer good &amp; services</td>
<td>470 504 559 898</td>
</tr>
<tr>
<td>Anglo American plc</td>
<td>Mining</td>
<td>399 370 717 216</td>
</tr>
<tr>
<td>MTN Group Ltd</td>
<td>Mobile Telecommunication</td>
<td>270 903 966 812</td>
</tr>
<tr>
<td>Sasol Limited</td>
<td>Chemicals--commodity</td>
<td>248 300 324 868</td>
</tr>
<tr>
<td>Compagnie Fin Richemont</td>
<td>Apparel/Accessories</td>
<td>212 819 400 000</td>
</tr>
<tr>
<td>Kumba Iron Ore Ltd</td>
<td>Steel industry</td>
<td>161 029 312 000</td>
</tr>
<tr>
<td>Standard Bank Group Ltd</td>
<td>Bank</td>
<td>156 888 779 088</td>
</tr>
<tr>
<td>Naspers Ltd -N-</td>
<td>Broadcasting</td>
<td>143 877 967 683</td>
</tr>
<tr>
<td>Anglo American Plat Ltd</td>
<td>Mining</td>
<td>140 124 289 172</td>
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<tr>
<td>Vodacom Group Ltd</td>
<td>Mobile Telecommunication</td>
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<td>AngloGold Ashanti Ltd</td>
<td>Mining</td>
<td>131 261 325 545</td>
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<td>FirstRand Ltd</td>
<td>Bank</td>
<td>116 930 910 630</td>
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<td>Precious metals/minerals</td>
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<td>ABSA Group Ltd</td>
<td>Bank</td>
<td>101 267 616 063</td>
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<tr>
<td>Old Mutual Plc</td>
<td>Insurance – Life/Health</td>
<td>98 837 180 484</td>
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<td>Gold Fields Ltd</td>
<td>Precious metals/minerals</td>
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<tr>
<td>Shoprite Holdings Ltd</td>
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<td>Remgro Ltd</td>
<td>Financial services -- Diversified</td>
<td>57 068 837 609</td>
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<td>Bidvest Ltd</td>
<td>Diversified trading and distributing</td>
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<td>Tiger Brands Ltd</td>
<td>Non-cyclical consumer good &amp; services</td>
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<td>Mining</td>
<td>40 974 704 315</td>
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<td>African Rainbow Min Ltd</td>
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<td>Retail – Department stores</td>
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<td>Growthpoint Prop Ltd</td>
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<td>Assore Ltd</td>
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<td>ReinetInvSoc Anon</td>
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<td>Discovery Holdings Ltd</td>
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<td>Private hospital group</td>
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<td>21 511 209 240</td>
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<td>21 042 898 126</td>
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<td>Mr Price Group Ltd</td>
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<td>Netcare Limited</td>
<td>Private hospital network</td>
<td>19 466 869 376</td>
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<td>The Spar Group Ltd</td>
<td>Finest produce, freshest meat and produce daily baked goods retailer</td>
<td>18 672 116 088</td>
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<td>Capitec Bank Hldgs Ltd</td>
<td>Bank</td>
<td>17 672 231 600</td>
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<td>Barloworld Ltd</td>
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<td>Uranium One Inc</td>
<td>Uranium producers</td>
<td>16 316 190 977</td>
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<td>Pretoria Port Cement Ltd</td>
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<td>Wine industry</td>
<td>15 212 850 900</td>
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<td>Communications company</td>
<td>15 128 772 237</td>
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<tr>
<td>Capital Property Fund</td>
<td>Property investment and management</td>
<td>14 157 549 118</td>
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<td>AVI Ltd</td>
<td>Food products sector</td>
<td>13 589 999 003</td>
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<td>Aveng Group Limited</td>
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<td>13 252 407 201</td>
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<td>HypropInv Ltd</td>
<td>Shopping centre fund</td>
<td>12 945 776 249</td>
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<td>Sappi Ltd</td>
<td>Coated fine paper and sustainability</td>
<td>12 783 405 163</td>
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<tr>
<td>Reunert Ltd</td>
<td>Electrical engineering, information and communication technologies and defence and allied technologies</td>
<td>12 569 595 255</td>
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<td>Clicks Group Ltd</td>
<td>Retail group</td>
<td>12 512 247 138</td>
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<td>Bank</td>
<td>12 164 211 139</td>
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<td>Pioneer Foods Group Ltd</td>
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<td>12 077 465 520</td>
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<td>Northam Platinum Ltd</td>
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<td>11 472 485 700</td>
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<td>Illvo Sugar Ltd</td>
<td>Sugar producer</td>
<td>11 291 223 979</td>
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<td>Hosken Cons Inv Ltd</td>
<td>Investment holding company</td>
<td>10 923 093 225</td>
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<td>Adcock Ingram Hldgs Ltd</td>
<td>Pharmaceutical and hospital products business</td>
<td>10 773 408 324</td>
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<tr>
<td>JD Group Ltd</td>
<td>A differentiated furniture, household appliance, consumer electronic goods, home entertainment, office automation and building supplies retailer</td>
<td>10 661 755 000</td>
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<tr>
<td>Tongaat Hulett Ltd</td>
<td>Agricultural and agri-processing</td>
<td>10 606 432 281</td>
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<td>Industry</td>
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<td>FirstRand Ltd</td>
<td>Bank</td>
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<td>ABSA Group Ltd</td>
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<td>31 Dec. 2011</td>
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<td>African Bank Inv. Ltd</td>
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<td><strong>Total</strong></td>
<td></td>
<td><strong>7</strong></td>
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<tr>
<td>SOFP Statement of financial position</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>-----------------------------------</td>
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**Annexure C: Checklist instrument for data collection**
<table>
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<th></th>
<th>Does the bank use the classification by liquidity?</th>
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<tbody>
<tr>
<td>2</td>
<td>Is the classification identified in IAS 39 obtainable from the SOFP?</td>
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**AP Accounting policies**

<table>
<thead>
<tr>
<th></th>
<th>Are the accounting policies notes based on the classification in the SOFP?</th>
<th></th>
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<tbody>
<tr>
<td></td>
<td>Are the accounting policies notes based on the classification based on IAS 39?</td>
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</table>

**NFS Notes to the financial statements**

<table>
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<tr>
<th></th>
<th>Is the structure of the notes based on the liquidity classification in the SOFP?</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Are the notes based on the classification in IAS 39?</td>
<td></td>
</tr>
</tbody>
</table>

**Detail of information in the notes to the financial statements**

<table>
<thead>
<tr>
<th></th>
<th>Is the liquidity information in the notes?</th>
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</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Is the IAS 39 information in the notes?</td>
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</tbody>
</table>

**SOCI Statement of Comprehensive Income**

<table>
<thead>
<tr>
<th></th>
<th>Are the following identified separately in the SOCI:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Interest income and expenses?</td>
</tr>
<tr>
<td></td>
<td>- Impairment of financial instrument?</td>
</tr>
<tr>
<td></td>
<td>- Fair value adjustments or trading</td>
</tr>
</tbody>
</table>
- Profit of financial instrument?
- Fair value through OCI?
Content

**Paragraph 2.4**

To create linking sentences as required by the external assessor, I deleted the introduction section under paragraph 2.4. In fact, this paragraph introduces the section below. Structure for the following paragraphs is provided under par. 2.4

**Paragraph 2.5**

The same as above

**Paragraph 2.7**

I also deleted the section 2.7.1 Introduction to align the paragraph with the sentences below.

**Recommendation from external assessor: Page ends and spaces on pages 19, 25, 43, 50, 54 55, 56, 57, 59, 62, 65, 68, 70, 76.**

The recommendation from the external assessor revealed that I should not create spaces at the end of the paragraph and the new paragraph. We need to consider that the rationale for the spaces is the fact that the new headings should start on new page. No change was made according to this recommendation

**Page 52**

The change “Y” to “Yes” was made.

**Pages 18-19**

Definition of Earnings management is provided on page 18.

**Paragraph 52-53, 54-55, and 60**

The definition of the codes and methods for “checklist of data collection”, which is the frequency counts, is given on page 48 under Data analysis.