IFRS 18: Implementation Issues

Extract, IFRS® Accounting Standards Discussion Group Report on the Meeting – September 12, 2024

Background

In April 2024, the IASB released IFRS 18 *Presentation and Disclosure in Financial Statements*, which will replace IAS 1 *Presentation of Financial Statements* and consequentially amend several other IFRS Accounting Standards. While IFRS 18 will not change how entities recognize and measure items in the financial statements, it will affect how they present and disclose those items, particularly in the income statement.

The IASB developed IFRS 18 in response to requests from investors for more comparable subtotals and better disaggregation of information in the financial statements. This is intended to help investors better understand an entity's performance and to make it easier to compare the performance of different entities. The new standard is also expected to bridge the gap between some of the non-generally accepted accounting principles (non-GAAP) performance measures used by entities to explain their financial performance outside the financial statements and the nearest IFRS-defined subtotal.

IFRS 18 represents a substantial shift in financial reporting requirements, primarily affecting the presentation of information in the income statement and the extent of disclosures in the notes to the financial statements. Entities might need to update their financial reporting systems, processes, and controls to comply with the new requirements. The impact of IFRS 18 will likely vary depending on an entity's current reporting practices and the maturity of their reporting systems.

IFRS 18 will require entities to classify income and expenses into three new categories on the income statement: operating, investing, and financing. It will also require entities to present two new subtotals on the face of the income statement: Operating profit or loss, and Profit or loss before financing and income tax[2]. In addition to these new categories, entities will continue to present income taxes and discontinued operations (when applicable) separately.

[2] The sub-total "Profit or loss before financing and income taxes" is not permitted for an entity that provides financing to customers as a main business activity and chooses to classify income and expenses as operating for all liabilities that involve only the raising of finance (IFRS 18, BC189).

The operating category in the income statement will generally capture income and expenses arising from the entity's main business activities. The investing category will include the performance results of the entity's investments in associates and joint ventures, as well as assets that generate a return largely independent of other resources and returns on cash and cash equivalents. The financing category will include returns on liabilities related to raising funds, and interest expense on these liabilities, and other financial liabilities, such as lease liabilities. IFRS 18 includes specific requirements for entities that invest in assets and entities that provide financing to customers as a main business activity, such as banks.

Entities that already present an "Operating profit or loss" subtotal may need to change how they calculate it. Significant time and effort might be required for entities to identify into which categories their income and expenses should map within the income statement. The nature of an entity's business activities could also determine the extent of the impact. For example, entities with multiple business activities might need to exercise greater judgment to determine if income and expenses from all their activities should be classified within the operating category.

IFRS 18 also introduces updated guidance regarding an entity's analysis of operating expenses (e.g., presentation by function, by nature, or mixed), including additional note disclosures for any expenses presented by function in the income statement. There is also enhanced guidance on aggregation and disaggregation (or "grouping" of information) in the financial statements (i.e., all of the primary financial statements and the notes).

The new standard also introduces disclosures about management-defined performance measures (MPMs). MPMs are subtotals of income and expenses used in public disclosures to communicate management's view of the entity's financial performance. The new requirements on MPMs may impact current communication practices with investors and other interested and affected parties. Entities will need to determine how to explain the different presentation and disclosure changes resulting from the adoption of IFRS 18.

IFRS 18 is effective for annual reporting periods beginning on or after January 1, 2027, with early application permitted, and it should be applied retrospectively. Therefore, entities with December 31st year-ends will need to make any necessary changes to systems, processes, and controls by January 1, 2026. Additionally, entities will be required to present any new income statement headings and subtotals arising from the application of IFRS 18 in their interim financial statements in the first year of adoption.

Given the significant impact IFRS 18 is expected to have on many Canadian entities, the Group discussed some of the more substantive implementation challenges to help entities prepare for this change.

Issue 1: IFRS 18 may require new judgments and assessments

Analysis

Level of aggregation and disaggregation

IFRS 18 may require entities to apply judgment in deciding the appropriate level of aggregation and disaggregation across the financial statements. This includes deciding when information should be included in the primary financial statements or disaggregated in the notes, based on the new requirements and guidance.

Identifying an entity's main business activities

IFRS 18 may also require entities to make new assessments to identify their main business activities. For entities with diverse operations, this process will involve evaluating their various revenue streams and determining the significance of each to the overall business, which could require extensive analysis and judgment. For group entities with specified main business activities, such as a manufacturer that provides financing to customers, the income statement classification at the consolidated level may differ from that at the operating company level if all activities are not considered main business activities for the group as a whole (paragraphs B37 and BC98-BC99 of IFRS 18).

Consider, for example, a scenario when a car manufacturer's group reporting includes several subsidiaries in the car manufacturing business, along with one subsidiary that holds investment property. In the group's consolidated financial statements, the business activity of property investment does not constitute a separate operating segment and as such may not be a main business activity. However, in the subsidiary's stand-alone financial statements, investing in property may be a specified main business activity. Therefore, if investing in property is a main business activity only at the subsidiary level, adjustments will be necessary when presenting the consolidated income statement to reclassify rental income from the operating category in the subsidiary's income statement to the investing category at the consolidated level.

Classifying income and expenses

Another area where new assessments may arise is in identifying the categories in which income and expenses should be classified. This assessment may be more onerous for income and expenses that have specific classification requirements in IFRS 18, such as foreign exchange differences, gains and losses on derivatives, and income and expenses on hybrid contracts.

When applying IFRS 18, foreign exchange differences will be classified in the same category as the income and expenses from the items that resulted in the difference. For example, foreign exchange differences arising on a foreign currency–denominated trade receivable will be classified in the operating category, while those from a foreign currency–denominated bank loan will be classified in the financing category. However, if this classification exercise would involve undue cost or effort, then the affected foreign exchange differences should be classified in the operating category (paragraphs B65-B66 and B68 of IFRS 18).

One change that may be particularly relevant for Canadian entities across multiple sectors is presentation involving joint ventures. IFRS 18 does not allow income and expenses from investments in associates, joint ventures, and unconsolidated subsidiaries that are accounted for using the equity method to be classified in the operating category, even if investing in these entities is an entity's main business activity (paragraph 55(a) of IFRS 18).

Equity method or fair value through profit or loss

IFRS 18 provides eligible entities (e.g., venture capital organizations, mutual funds, and some insurers) with an option to change their election from measuring an investment in an associate or joint venture using the equity method to fair value through profit or loss when they first apply IFRS 18. Consequently, this may be a key judgment for these entities (paragraph C7 of IFRS 18).

Method for presenting operating expenses

Entities may need to reassess which method for presenting operating expenses (i.e., by nature, by function, or using a mixed presentation) provides the most useful information about operating expenses on the face of the income statement (paragraphs 78 and B80 of IFRS 18). Given that this decision impacts how interested and affected parties perceive an entity's financial health and operational efficiency, selecting the most appropriate method to convey this in the context of these changes may require careful consideration. Even if the analysis results in retaining a mixed presentation, for example, the entity will still need to document why this approach is appropriate under IFRS 18, based on their specific facts and circumstances.

The Group's Discussion

The Group agreed with the analysis of significant new judgments and assessments that entities may need to make when adopting IFRS 18. Some Group members noted that while IFRS 18 will lead to a more standardized structure for income statements, it will still require entities to apply significant judgment. These judgments, like those outlined above, may vary among entities dependent on several factors, including their size, complexity and the nature of their operations. Some members noted that adopting IFRS 18 will require a substantial amount of work for entities even if the impact on their financial statement is minimal. That is because all preparers will be required to document their key judgments and assessments to demonstrate their compliance with the new requirements of IFRS 18. Entities are further encouraged to engage early with their auditors on aspects of their analyses that require significant judgment.

One Group member thought that the new disclosure requirements for MPMs will provide an opportunity for entities to review the performance measures that they currently disclose and reconsider which measures remain relevant to their investors. Another Group member noted that it might be unclear which performance measures need to be disclosed under the MPM requirements in IFRS 18 and indicated that this could be another area requiring judgment.

Issue 2: Changes to processes and systems

Analysis

Disclosures about management defined performance measures

Entities using performance measures in their public communications (including management discussion and analysis (MD&A), press releases, and investor presentations) that meet the definition of MPMs in IFRS 18 will need to establish a process to capture and analyze these key performance metrics to ensure consistency with financial statement disclosures. For example, entities will need to capture relevant financial information to disclose reconciliations of MPMs to the most directly comparable IFRS subtotals, including tax effects and effects on non-controlling interests. Determining which key performance metrics constitute MPMs under IFRS 18 and deciding where they will be disclosed in the financial statements will likely involve multiple interested and affected parties and may take some time. Furthermore, since MPMs will be included in audited financial statements with requisite disclosures for the first time, entities will need to document their process for identifying which performance measures qualify as MPMs, their rationale, and how they comply with the requisite disclosure requirements in IFRS 18.

Aggregation and disaggregation

Companies may need to further disaggregate the information disclosed in existing notes. Entities must ensure they can gather, process, and report data at the level of detail required by IFRS 18, which may necessitate changes to existing workflow processes and controls. Some entities might need to adapt their financial reporting systems to track and collate the more disaggregated information and classify income and expenses into new categories. This could involve significant investments in new software or upgrades to existing systems to ensure they can capture and report the necessary information accurately. The system implications may be particularly significant for companies presenting an analysis of operating expenses by function or using a mixed presentation on the face of the income statement.

Other system implications

The adoption of IFRS 18 might also result in other system implications. For example:

- For groups of companies, the output of one company within the group might be the input for another. In some cases, the nature of expenses is lost or not tracked at the consolidated level. This may be more significant when the standard costing method for inventories is used. There might also be more than one set of business activities in the group, and the classification of items of income and expenses may be different at the consolidated level compared to the operating company level.
- IFRS 18 includes specific classification requirements for certain items, such as foreign exchange differences, fair value gains and losses on derivatives, and income and expenses from hybrid contracts. Such income and expenses may therefore need to be classified into different income statement categories. Some companies may also have separate treasury management systems to record information on financial instruments at a more granular

level compared with the enterprise resource planning systems, which may also require updates.

- Entities may need to review charts of accounts, update transaction recording systems, revise consolidation processes, add new data points for disclosures, or design revised control procedures to ensure compliance. This may mean entities will need to redefine account classifications and ensure consistency across different entities within a group.

The Group's Discussion

The Group agreed with the analysis of changes to processes and systems that entities might need to consider when adopting IFRS 18. Some group members thought the changes to processes and systems might be particularly substantial for larger and more complex entities, such as those with multiple enterprise resource planning systems, and those that operate in multiple jurisdictions. They noted that entities might need to implement manual workarounds if they are unable to implement the necessary system changes in a timely manner, which will also require adequate controls to reduce the risk of errors. Although IFRS 18 only impacts presentation and disclosure, Group members think it may take a significant amount of time and effort for most entities to implement. Therefore, they encourage entities to begin this process early to ensure the changes can properly flow through the necessary processes and controls. One Group member also noted that auditors should engage with their clients early in the process of implementing IFRS 18 so that they are comfortable with their clients' key judgments, system changes, and controls. Some Group members raised that since MPMs will be included in audited financial statements for the first time, entities will need to carefully consider which performance measures are within the scope of the IFRS 18 disclosure requirements and document their rationale and disclosure considerations.

Issue 3: Changes to contractual arrangements linked to financial performance

Analysis

Currently, some companies present self-defined subtotals in their income statements, which will likely need to change to align with the new defined subtotals in IFRS 18. For example, the introduction of the mandatory defined subtotal for operating profit under IFRS 18 may require companies that currently present an "operating profit" subtotal to change how they calculate this subtotal.

Employee compensation arrangements, bonus programs, covenant tests, or performance-based contracts that link to or use existing self-defined subtotals, such as operating profit or loss as a starting point for the relevant assessment, will need to be reviewed for any potential impact under IFRS 18. Depending on the specific arrangements in place, it may be necessary to amend existing terms and conditions. In such cases, entities should identify the required changes, communicate them to relevant counterparties, and assess the implications of the new terms.

The Group's Discussion

The Group agreed that entities should consider changes to contractual arrangements, including employee compensation arrangements, as a result of the new IFRS 18 defined subtotals in the income statement. Some Group members also raised that some employee compensation arrangements are linked to MPMs, which will now be included within audited financial statements with requisite disclosures. They thought this will improve transparency and increase comprehension of how compensation-linked MPMs are prepared, which will help facilitate conversations about employee and executive compensation arrangements.

Issue 4: Communication to investors and other interested and affected parties, and next steps

Analysis

The annual report is a key aspect of a company's communication with its interested and affected parties. It is common to use non-GAAP or alternative performance measures, such as adjusted operating profit or earnings before interest, taxes, depreciation, and amortization (EBITDA), to assess progress against strategic objectives and measure business performance in the MD&A. IFRS 18 may cause companies to revisit these non-GAAP performance measures discussed in the front-half of their annual report. Additionally, ensuring that investors and other interested and affected parties understand how the income statement and disclosures will change before the release of the first interim financial statements and annual report after adopting IFRS 18 will be critical. Involving investor relations teams early will be important so that, when mandatory reporting under IFRS 18 begins, all key interested and affected parties already understand the impact of the new standard, helping to avoid potential misinterpretations. Similarly, companies will need to educate their staff members on the requirements of IFRS 18 and changes to processes, systems, and controls.

Developing a robust communication strategy is essential. Companies should assess how IFRS 18 will affect their key performance indicators (KPIs) and consider developing transitional KPIs to bridge the gap between the old and new reporting standards. This approach can help maintain consistency in performance evaluations and external reporting during the transition period. To manage the transition effectively, companies should form cross-functional teams that include representatives from finance, information technology, operations, and investor relations. These teams can collaborate to address the various aspects of IFRS 18 implementation, ensuring a coordinated approach across the organization.

Canadian entities should begin preparing for IFRS 18 implementation as early as possible. Conducting a comprehensive gap analysis to identify areas of significant change is a crucial first step. This analysis should cover financial statement presentation, systems capabilities, data collection processes, and potential impacts on KPIs. Entities will need to allocate time to prepare for required reconciliations comparing IAS 1 presentation to IFRS 18 restated amounts for each line item presented in the interim income statement for the comparative periods immediately preceding the current and cumulative periods in which IFRS 18 is first applied.

The Group's Discussion

The Group agreed that entities should communicate the impact of IFRS 18 to their investors and other interested and affected parties as early as possible so that they have time to process and understand the changes. One Group member also noted that entities will need to comply with regulatory requirements to disclose in their MD&A the impact of adopting a new accounting standard on their financial statements and business practices. Some Group members raised that the Canadian Securities Administrators are assessing the impact of IFRS 18 on regulatory requirements, including their guidance on non-GAAP measures. One Group member noted that, since regulators are still evaluating potential regulatory changes related to IFRS 18, entities opting for early adoption should be aware that further regulatory changes may occur after they have adopted the standard.

Overall, the Group's discussion raised awareness of the more substantive implementation challenges associated with the adoption of IFRS 18. Since entities are still in the process of planning their implementation of the standard, the Group plans to discuss additional implementation challenges at future meetings.