IFRS 18: Classification of Income and Expenses from “Other Assets”

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Background

IFRS 18 *Presentation and Disclosure in Financial Statements* will replace IAS 1 *Presentation of Financial Statements*. 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, especially in the statement of profit and loss. Paragraph 47 of IFRS 18 notes that entities should classify income and expenses included in the statement of profit or loss in one of five categories:

a. the operating category;

b. the investing category;

c. the financing category;

d. the income taxes category; and

e. the discontinued operations category.

Paragraph 52 of IFRS 18 notes that an entity should classify in the operating category all income and expenses included in the statement of profit or loss that are not classified in one of the other categories. Therefore, the operating category is a *residual category* that should include all income and expenses arising from an entity’s main business activities.

Paragraph 53 of IFRS 18 outlines the general requirements for the investing category, which includes all income and expenses (as specified in paragraph 54 of IFRS 18) arising from:

a. investments in associates, joint ventures and unconsolidated subsidiaries;

b. cash and cash equivalents; and

c. other assets if they generate a return individually and largely independently of the entity's other resources.

This discussion focused on paragraph 53(c) of IFRS 18 and the classification of specified income and expenses related to other assets if they generate a return individually and largely independently of the entity’s other resources. The standard provides limited guidance on how to interpret the terms *individually* and *largely independently*, which are used in paragraph 53(c). However, paragraph B46 of IFRS 18 identifies typical examples:

a. debt or equity investments; and

b. investment properties and receivables for rent generated by those properties.

Paragraph B48 of IFRS 18 notes that assets that an entity uses in combination to produce or supply goods or services *do not* generate a return individually and largely independently of the entity's other resources. Such assets typically include:

a. property, plant and equipment;

b. assets that arise from the production or supply of goods and services for which the income and expenses are classified in the operating category (e,g,, receivables for such goods and services); and

c. if the entity provides financing to customers as a main business activity, any loans to a customer.

There are some exceptions to the general requirements of paragraph 53 of IFRS 18 noted above for entities with a specified main business activity of investing in assets. The standard requires an entity to assess whether it has a main business activity of either (or both): (i) investing in assets or (ii) providing financing to customers.

Paragraph 58 of IFRS 18 states for the assets specified in paragraph 53(c) (i.e., other assets if they generate a return individually and largely independently of the entity's other resources) that an entity invests in as a main business activity (see paragraph B40), the entity shall classify the income and expenses specified in paragraph 54 in the operating category.

Figure 3.1 in the Illustrative Examples of IFRS 18 illustrates the guidance noted above.

In summary, when assessing the classification of specified income and expenses generated from "other assets," an entity must first determine if those assets generate a return individually and largely independently of the entity's other resources. If they do, they should be included within the scope of paragraph 53(c) of IFRS 18 and classified in the investing category; otherwise, they should be recorded within the operating category.

When assessing classification in relation to paragraph 53(c) of IFRS 18, determining whether assets generate a return individually is often straightforward, as such assets may be separable and their related income and expenses can be isolated. However, assessing whether they generate a return largely independently may require more judgment. The entity must consider whether the assets are used in combination with other resources to produce or supply goods and services.

Issue 1: In applying IFRS 18 and the classification requirements for the investing category, do "other assets" generate a return individually and largely independently of an entity's other resources?

Analysis

Some entities are subject to contractual or regulatory requirements related to their normal operating activities, which require them to set funds aside. Entities are often permitted to invest these funds in certain types of other assets that generate a return individually. Some examples of such requirements include:

- a manufacturing entity has an asset retirement obligation and is required under legislation to set aside a certain level of funds;
- a travel agent entity is required to set aside deposits from customers;
- a lending arrangement that requires the entity as borrower to maintain a certain level of funds on deposit; and
- a retailer lessee entity that is required under its lease to maintain a certain level of funds on deposit.

For this discussion, the Group assumed that the funds set aside are invested in similar types of debt securities, which earn interest income, the interest income accrues to the entity and those debt securities are on the entity's balance sheet. The Group also assumed that the entity does not engage in a main business activity of investing or providing finance to customers.

View 1A – No, the other assets cannot generate a return individually and largely independently of the entity's other resources (i.e., classify as operating)

While these assets can generate a return individually, proponents of this view think that they do not generate a return largely independently of an entity's other resources. They note that these assets arise from activities related to the supply of goods and services or result directly from arrangements that are integral to the core business operations.

Therefore, they think the assets should be considered part of the entity's operating activities. Paragraph B48 of IFRS 18 notes that assets that arise from the production or supply of goods and services classified in the operating category are typically considered used in combination and are not considered independent of the entity's other resources.

Proponents of this view emphasize the importance of considering the purpose for holding the investments. These assets do not produce returns largely independently of the entity's other resources as the entity is required to set aside the funds as part of its normal operating activities.

View 1B – Yes, the other assets can generate a return individually and largely independently of the entity's other resources (i.e., classify as investing).

Proponents of this view note that the return on these assets is unaffected by the entity's other resources. Although the funds that the entity sets aside originate from the entity's operating activities, once invested the actual returns generated from the other assets in the reporting period are not affected by the entity's other resources. Therefore, they think these funds set aside and invested in debt securities are economically similar to returns generated from investing excess operating cash in debt securities.

Paragraph B46 of IFRS 18 identifies debt securities as an example of an "other asset" that typically generates a return individually and largely independently of the entity's other resources. Proponents of this view interpret the guidance in this paragraph to mean that the debt securities discussed in this issue meet that criterion, regardless of the source of the invested funds.

Proponents of this view also note that these debt securities are not used in combination with the entities' other assets to produce goods or services as contemplated by paragraph B48 of IFRS 18. The example in paragraph B48(b) for assets that arise from the production or supply of goods and services is "receivables for such goods and services" where such a receivable itself arises directly from the production or supply of goods and services. Paragraph B48(b) does not also include a separate investment in debt securities funded with the cash collected from such receivables.

Although the examples highlighted in this issue require funds be set aside and permit (or require) investment thereof in certain types of assets (i.e., the debt securities in question), proponents of this view maintain the assets generate a return individually and largely independently of the entity's other resources. This is because once invested, the returns generated from the assets in the reporting period are unaffected by the entity's other resources. Consequently, proponents of this view think the examples highlighted in this issue are not integral to the entities' core business operations. Therefore, they think the income and expenses from the assets should be classified as investing.

The Group discussed this issue and contemplated whether their views would change depending on whether the other assets are held for contractual purposes versus for regulatory purposes.

The Group's Discussion

Some Group members emphasized that it is important to consider all the facts and circumstances to determine whether funds set aside to meet contractual or regulatory requirements generate a return individually and largely independently of an entity's other resources. In this fact pattern most Group members supported View 1B because the entity is only required to set aside funds to meet the requirements; it is not required to invest those funds. Therefore, any returns generated from investing those funds is the result of an independent business decision by the entity rather than to meet a contractual or regulatory requirement. While some Group members thought an entity should consider the source of the funds when making this determination, most thought it was irrelevant in this case. Several Group members noted that their views would not change regardless of whether the other assets are held for contractual or regulatory purposes.

Fact Pattern for Issue 2

- A consolidated reporting entity (i.e., a group) has two reportable segments: one that manufactures furniture and another that provides short-term insurance contracts through a regulated insurance subsidiary.
- The group has three pools of investments in securities:

Pool 1 – Investments held by the manufacturing segment

The group's manufacturing segment invests its excess cash generated from its operations in debt securities.

Pool 2 – Investments backing insurance liabilities

In the insurance segment, the group collects premiums from policyholders and invests those premiums in debt securities, using the related returns to pay out any liabilities to policyholders upon the occurrence of an insured event.

Pool 3 – Investments held for regulatory capital purposes

The insurance segment is required by its regulator to maintain a minimum capital balance (which the group invests in debt securities) for solvency purposes. The group also maintains an "excess" of the minimum level based on internal targets to ensure a healthy capital level.

- All three pools fully invest in a similar type of fixed income investment such as debt securities.
- All are measured using the same model (e.g., fair value through profit or loss) in the consolidated financial statements.
- To explain operating performance externally and monitor operating performance internally, the group uses a subtotal similar to gross profit called "net insurance finance result." This subtotal includes the returns on the investments in Pool 2 and Pool 3 (but not Pool 1). Therefore, the group has determined it has a specified main business activity of investing. The investments in Pool 2 and Pool 3 (but not Pool 1) are part of this main business activity.

Issue 2: In applying IFRS 18 and the classification requirements for the investing category, are the "other assets" held by the entity generating a return individually and largely independently of the entity's other resources?

Analysis

While the group of entities in this fact pattern has a manufacturing segment and an insurance segment, a similar issue could apply to entities in different industries when entities engage in investing activities as both a non-main business activity (i.e., main business operations other than investing or providing financing to customers) and a main business activity. Therefore, this issue is not limited to insurance entities.

Pool 1

The manufacturing segment in this fact pattern invests excess cash generated from its operations in debt securities. Per paragraph B46 in IFRS 18, the investment in a debt or equity security is considered an example of "other assets" that generate returns individually and largely independently of the entity's other resources. Therefore, it would be reasonable to conclude that the group should classify the specified income and expenses from Pool 1 in the investing category.

This classification is reasonable regardless of the analysis made on the similar investments in Pool 2 and Pool 3, which are part of the group's main business activity of investing. Paragraph B40 of IFRS 18 refers to assessing "an individual asset *or* groups of assets with shared characteristics" when determining whether it has a main business activity of investing in other assets.

Additionally, paragraphs BC146-BC147 in the Basis for Conclusions of IFRS 18 clarify that the requirement to classify income and expenses in the operating category is only relevant for assets in which the entity invests as a main business activity.

The Group's Discussion

The Group agreed with the analysis.

Pool 2

View 2A – No, the other assets in Pool 2 cannot generate a return individually and largely independently of the entity's other resources (i.e., classify as operating)

Like the views expressed in View 1A, while these assets can generate a return individually, they do not generate a return largely independently of the entity's other resources. This is because they arise from activities related to the supply of services in the insurance business (i.e., collecting premiums and investing them to pay claims). Therefore, these assets do not meet the scope for the general requirements of paragraph 53(c) of IFRS 18 and the related returns must be classified in the operating category.

View 2B – Yes, the other assets in Pool 2 can generate a return individually and largely independently of the entity's other resources. However, due to the main business activity of investing in this type of asset, they cannot be classified within the investing category (i.e., classify as operating)

Like the views expressed in View 1B, these assets can generate a return both individually and largely independently of the entity's other resources as the return on these assets is unaffected by the entity's other resources. Additionally, paragraph B46 of IFRS 18 lists debt securities as an example of assets that would typically generate a return individually and largely independently of the entity's other resources.

However, as shown in Figure 3.1 of the Illustrative Examples of IFRS 18, the entity must consider whether investing in these assets is a main business activity. In this fact pattern, the entity does have a main business activity of investing in these assets. Therefore, the specified income and expenses related to these other assets would be classified in the operating category.

The Group's Discussion

The Group discussed the relationship between assessing whether an asset generates a return individually and largely independently of the entity's other resources and assessing whether it has a specified main business activity of investing in assets. One Group member noted that this meeting report highlights the order in which these assessments should be performed. They said that assessing whether assets generate a return individually and largely independently of an entity's other resources is the primary assessment. If the entity concludes that the assets do not generate a return individually and largely independently of its other resources, it should classify the returns in the operating category and skip the assessment of whether it has a main business activity of investing in assets. However, if the entity concludes that the assets do generate a return individually and largely independently of its other resources, it should then assess whether it has a main business activity of investing in assets to determine whether it should classify the returns in the investing or operating category. They noted that the main business activity assessment is a secondary assessment.

Some Group members noted that their view on Pool 2 depends on the specific facts and circumstances as there are often nuances to consider with insurance contracts. Factors such as the nature of the policy, the type of insurer and the type of insurance being issued would all factor into their assessment of whether the assets generate a return individually and largely independently of the entity's other resources and whether the entity has a main business activity of investing.

Pool 3

View 3A – No, the other assets in Pool 3 cannot generate a return individually and largely independently of the entity's other resources (i.e., classify as operating)

Like the views expressed in View 2A, while these assets can generate a return individually, they do not generate a return largely independently of the entity's other resources. This is because they arise from activities related to the supply of services in the insurance business (i.e., the insurance segment needs to hold capital to operate as an insurer). Therefore, these assets do not meet the scope for the general requirements of paragraph 53(c) of IFRS 18 and the related returns must be classified in the operating category.

View 3B – Yes, the other assets in Pool 3 can generate a return individually and largely independently of the entity's other resources. However, due to the main business activity of investing in this type of asset, they cannot be classified within the investing category (i.e., classify as operating).

Like the views expressed in View 2B, while these assets can generate a return individually and largely independently of the entity's other resources, the entity must consider whether investing in these assets is a main business activity. In this fact pattern, the entity does have a main business activity of investing in these assets. Therefore, the specified income and expenses related to these other assets would be classified in the operating category. The Group was also asked whether it would assess the other assets held for minimum capital requirements differently than those held "in excess."

The Group's Discussion

Like Pool 2, several Group members noted that their view on Pool 3 depends on the specific facts and circumstances. They also said they would not assess the assets held for minimum capital requirements differently than those held in excess. They noted that the standard requires entities to consider the nature of the asset to determine how to classify its returns and that the regulatory requirements do not change the nature of the asset.

Overall, the Group's discussion raised awareness of challenges entities might face when assessing whether its assets generate a return individually and largely independently of its other resources. It also highlighted when and how to apply the assessment of whether an entity invests in assets as a main business activity. The Group encouraged entities to begin the process of performing these assessments for assets in their portfolio as soon as possible. No further actions were recommended to the AcSB.