IFRS 18 Classification of Income and Expenses That Arise from Liabilities

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IFRS 18: CLASSIFICATION OF INCOME AND EXPENSES THAT ARISE FROM LIABILITIES

Background

IFRS 18 *Presentation and Disclosure in Financial Statements* is effective for annual reporting periods beginning on or after January 1, 2027, with retrospective application to the comparative period. IFRS 18 requires entities to classify income and expenses into one of five categories in the statement of profit or loss: operating, investing, financing, income taxes, and discontinued operations.

In determining what income and expenses to classify in the financing category, paragraph 59 of IFRS 18 requires an entity to distinguish between liabilities that arise from transactions that involve only the raising of finance (referred to as "Type 1" liabilities in this discussion) and liabilities other than those that involve only the raising of finance (referred to as "Type 2" liabilities in this discussion). Paragraph B50 of IFRS 18 explains how to identify Type 1 liabilities:

In such transactions, an entity:

a. receives finance in the form of cash, or an extinguishment of a financial liability, or receipt of the entity's own equity instruments; and

b. at a later date, will return in exchange cash or its own equity instruments.

IFRS 18 requires entities to distinguish between Type 1 and Type 2 liabilities because the classification of income and expenses related to such liabilities can differ. When an entity does not have a specified main business activity of providing financing to customers, it classifies all income and expenses related to a Type 1 liability in the financing category. This includes income and expenses arising on initial recognition of the instrument, including transaction costs. It also includes all income and expenses arising on subsequent measurement or derecognition of the liability (e.g., interest expense, gains and losses on modification or extinguishment, fair value changes, or other measurement changes).

In contrast, for Type 2 liabilities entities only recognize certain income and expenses in the financing category. This includes all income and expenses related to interest, or that arise from changes in interest rates, but only when the entity identifies such income and expenses for the purpose of applying other requirements in IFRS Accounting Standards (paragraph 61 of IFRS 18). Paragraph B54 of IFRS 18 lists examples of income and expenses from such liabilities that an entity is required to classify in the financing category. Entities should recognize all other income and expenses related to a Type 2 liability in the operating category. Paragraph B55 lists examples of income and expenses that arise from transactions that do not involve only the raising of finance but that are not in the scope of paragraph 61.

Paragraphs B70-B76 of IFRS 18 has specific guidance for liabilities that are derivatives, and paragraph B56 for those that are “hybrid contracts.” Preparers may also need to consider this guidance when considering classification of income and expenses under IFRS 18. However, this guidance is outside the scope of this discussion.

Paragraph B58 of IFRS 18 has specific guidance for issued investment contracts with participation features. This paragraph requires entities to classify all income and expenses related to these types of contracts in the operating category.

The classification between Type 1 and Type 2 liabilities is also necessary for entities that have a main business activity of providing financing to customers. Paragraph 65 of IFRS 18 provides different classification guidance for liabilities that arise from transactions that involve only the raising of finance (paragraph 65 (a)) versus those that do not involve only the raising of finance (paragraph 65 (b)). Specifically, there are requirements that apply to Type 1 liabilities, including certain accounting policy choices to require or permit classification of income and expenses in the operating category. However, for Type 2 liabilities these requirements and accounting policy choices do not apply. Instead, entities must classify interest and interest-related income and expenses in the financing category, and other income and expenses in the operating category.

Fact Pattern 1 – Liabilities issued for an asset acquisition – units

- Entity A is an open-ended real estate investment trust (REIT).
- A subsidiary limited partnership of Entity A issues limited partnership units (LP units) as consideration for the purchase of an investment property.
- The LP units are exchangeable for REIT units on a one for one basis at any time.
- The REIT units have a redemption feature but are recognized as equity under the IAS 32 *Financial Instruments: Presentation* puttables exception as they represent a residual interest in the REIT.
- The holders of the LP units will receive distributions in the same amount as any distributions declared on the REIT units.
- All the operations of the REIT are conducted through the limited partnership.
- In Entity A’s financial statements, the LP units are classified as a liability under IAS 32 and are measured at fair value through profit and loss.

Issue 1: How should Entity A classify the income and expenses related to the REIT units?

Analysis

View 1A – The LP units are participating contracts. Therefore, Entity A must recognize all income and expenses in the operating category; there is no need to assess whether they are Type 1 or Type 2 liabilities.

Paragraph 64 of IFRS 18 notes that entities should classify in the operating category income and expenses from issued investment contracts with participation features. An investment contract with participation features is not further described or defined in IFRS 18, although an example is given of an investment contract with participation features issued by an investment entity. Proponents of this view note that the LP units have characteristics of participation features as they are designed to be economically equal to a REIT unit, which represent a pro rata residual interest in all the REIT's net assets. They note that:

- The limited partnership agreement under which the units were issued represents an "investment contract" as the LP unit holder has an investment in the limited partnership that is governed by the terms of the limited partnership agreement; and
- The LP unit holder has the right to receive distributions equal to any distribution declared on the REIT units and the LP units are exchangeable for those units. Therefore, the LP unit holder participates in the performance of the limited partnership's assets and liabilities in the same manner as a REIT unit holder.

Therefore, proponents think the LP units are participating contracts in the scope of paragraph 64 of IFRS 18.

Under paragraph 64 of IFRS 18, entities should classify all income and expenses from issued investment contracts with participation features, recognized under IFRS 9 *Financial Instruments*, in the operating category, regardless of whether those contracts arose in a transaction that involved only the raising of finance.

This view may also apply to other scenarios when instruments that are classified as liabilities under IAS 32 participate in the net assets of the entity or a subsidiary of an entity and arise in a non-cash transaction. Exchange-traded funds (ETFs) when new shares classified as liabilities are created by contribution of a predetermined list of securities or specified assets is a common example.

View 1B – The LP units are not participating contracts. However, since they did not arise in a transaction that involved only the raising of finance, they are Type 2 liabilities.

Paragraph 64 of IFRS 18 applies to "issued investment contracts with participation features recognised applying IFRS 9 *Financial Instruments*," but the scope of this is not further defined. The only additional guidance in IFRS 18 is two examples of such contracts issued by an insurer and an investment entity, which are listed in paragraph B58. The LP units do not fall into either of these examples. The issuance of these units may not be considered a typical "investment contract" as the purpose of the transaction was not for the seller to obtain an investment in the REIT for cash. Given the lack of guidance as to what a participating contract is, an entity may determine that the LP units are not participating contracts in the scope of paragraph 64. Therefore, an entity would not automatically classify the income and expenses from these units in the operating category. Entity A must determine whether the LP units are Type 1 or Type 2 liabilities.

Assessment of Type 1 or Type 2

The units issued to the seller of the property do not meet the definition in paragraph B50 of IFRS 18 of those arising from a transaction that involves only the raising of finance. This is because the acquiror incurred these liabilities in a transaction in which it received an asset (in this case, an investment property) but did not receive cash, own equity, or the extinguishment an existing financial liability. The IASB may have intentionally narrowly defined "only the raising of finance" in paragraph B50 to exclude some transactions that are financing in nature, if they are not only the raising of finance. This transaction can be viewed as similar to the lease liability example in paragraph B53(c) of IFRS 18, when the financing liability arises in a transaction whereby the entity acquires a right of use asset rather than cash, own equity, or extinguishment of a financial liability.

Since the LP units meet the definition of a Type 2 liability, Entity A should only recognize the income and expenses specified in paragraph 61 of IFRS 18 in the financing category. Entity A must therefore determine if any income and expenses related to the LP units would be considered interest, or due to changes in interest rates "for the purpose of applying other requirements in IFRS Accounting Standards."

Entity A should recognize all other changes, including changes due to the fair value remeasurement of the units and the impact of distributions that are not interest (for the purpose of applying other IFRS requirements) in the operating category. This is not because they are viewed as operating items of the REIT, but because the operating category is the residual category for income and expenses that are not classified as either investing or financing.

IFRS 18 is retrospectively applied. Therefore, to appropriately classify liabilities on the balance sheet as Type 1 or Type 2, the entity would need to consider the transaction that gave rise to liability (i.e., initial recognition of the liability) even if that was in a period prior to the adoption of IFRS 18. Note that for liabilities that have been outstanding for many years, this may require significant effort on transition to IFRS 18 unless the nature of the original transaction is evident.

The above analysis and implications would also apply to any transaction when an entity has issued a liability as consideration for any asset acquisition. Other examples of these types of transactions might include (but are not restricted to):

a. vendor take-back mortgages and other deferred payment terms even when the deferral is considered a form of financing for the transaction;

b. liabilities with payments contingent on the performance of the acquired asset (such as those that are based on sales or usage of the asset); and

c. units issued to unitholders in exchange for the in-kind contribution of securities to an ETF, or other mutual fund, if these are not considered participating contracts.

The impact of a Type 1 versus Type 2 classification for each of the above will depend on the contractual terms, facts and circumstances, and the accounting model applied. For example, for a fixed rate interest-bearing vendor take-back mortgage measured at amortized cost under IFRS 9, which is held to maturity, there would not generally be income or expenses recognized, other than those that relate to interest. The interest in this case would continue to be recognized in the financing category. However, if that instrument is modified or extinguished with resulting income or expenses being recognized in the income statement, these changes would be recognized in the operating category, unless the changes were considered to relate to interest or changes in interest rates.

The Group's Discussion

The Group noted that the lack of guidance in IFRS 18 on participating contracts makes it challenging to determine whether a contract meets the definition of one. Some Group members noted that they could support View 1A by analogizing to the guidance in IFRS 17 *Insurance Contracts*, on the definition of insurance contracts with participation features. However, most Group members favoured View 1B, noting that the LP units in this fact pattern do not resemble the examples provided in IFRS 18. One Group member also noted that paragraph BC192 in the Basis for Conclusions for IFRS 18 mentions investment entities and insurers as types of entities that issue investment contracts with participation features. They think this might indicate that the IASB intended to narrowly define the scope of participating contracts to include only those issued by these types of entities.

The Group members who supported View 1B noted that the LP units are Type 2 liabilities because they were issued in exchange for an investment property (i.e., they did not arise from a transaction that involved only the raising of finance). They noted that both distributions and fair value changes should be presented in the operating category as neither is an interest-related expense. However, they also noted that this issue analyzed a simple fact pattern. In more complex situations involving the issuance of units with more complex features, such as embedded derivatives, an entity might reach different conclusions about how to classify the income and expenses. Furthermore, the Group noted that while this fact pattern pertained to a REIT, similar issues arise in other types of entities as well. Therefore, entities will need to consider all the facts and circumstances when determining how to classify income and expenses from liabilities issued for an asset acquisition. Differences in the fact pattern can impact whether a liability is a participating contract and whether it is classified as Type 1 or Type 2.

Fact Pattern 2A – Debt acquired in a business combination

- Entity B is a mining company.
- Entity B acquires an entity that operates a gold mine (Company Y) for cash consideration.

- The acquisition is a business combination under IFRS 3 *Business Combinations* and, accordingly, Entity B recognizes all the identifiable assets acquired and liabilities assumed at fair value on the date it obtains control.
- One of the liabilities assumed is existing material variable rate bank debt, which Company Y originally obtained by the receipt of cash to finance the construction of the mine.
- Assume the bank debt is expected to be repaid in cash in the future. Therefore, the criteria in paragraph B50(b) of IFRS 18 is met for the purposes of determining whether this is a Type 1 liability.

Fact Pattern 2B – Debt acquired in a business combination – main business activity of providing financing to customers:

- Entity C is a company whose business model is to lease out machinery and equipment under finance leases to its customers.
- Entity C has determined that they have a main business activity of providing financing to customers through these finance leases.
- Entity C acquires a competitor (Company Z) operating in the same business and accounts for the acquisition as a business combination.
- One of the liabilities assumed in the business combination is a material amount drawn on an arrangement that Company Z has with a bank under which it makes cash draws to borrow funds secured on its finance lease receivables.
- Assume the debt is expected to be repaid in cash in the future. Therefore, the criteria in paragraph B50(b) of IFRS 18 is met for determining whether this is a Type 1 liability.

Issue 2: Is the bank debt acquired in a business combination a liability that arises from a transaction that involves only the raising of finance?

Analysis

View 2A – On initial recognition by Entity B and Entity C, the bank debt of Company Y and the borrowing facility of Company Z (respectively) do not arise from a transaction that involves only the raising of finance, as they arise from a transaction that is a business combination

From Entity B's perspective, the initial recognition of the bank debt arises on the business combination with Company Y. In this transaction, Entity B did not receive cash, own equity, or the extinguishment of a financial liability when assuming the bank debt. Rather, the transaction giving rise to the bank debt on Entity B's consolidated financial statements is a business combination, which is a transaction that does not involve only the raising of finance. Therefore, proponents of this view think the bank debt is not a Type 1 liability in Entity B's financial statements as it did not arise in a transaction that meets the definition of a Type 1 liability in IFRS 18. A similar analysis would apply to Entity C's recognition of the borrowing facility it assumed from Company Z.

Paragraph B50 of IFRS 18 provides criteria for an entity to determine whether a liability arose in a transaction that involves only the raising of finance. The criteria are explicit and require that an entity receives finance and that financing is in the form of either cash, or receiving own equity instruments, or the extinguishment of a financial liability to be received in the transaction.

Paragraph B51 of IFRS 18 provides examples of transactions that involve only the raising of finance and explains how each meets the criteria in paragraph B50. For example, paragraph B51(a) provides the following example: “a debt instrument that will be settled in cash, such as debentures, loans, notes, bonds and mortgages—an entity receives cash and will return cash in exchange.” Proponents of this view note that Entity B did not receive cash for assuming the liability, and therefore the example in paragraph B51(a) does not apply.

Paragraph B55 of IFRS 18 provides examples of income and expenses that relate to other liabilities and clearly notes that contingent consideration for a business combination is a Type 2 liability. Therefore, a business combination itself is not a transaction in which the entity “receives finance in the form of cash, or an extinguishment of a financial liability, or receipt of the entity’s own equity instruments” (see paragraph B50). Therefore, other liabilities that arise for the entity in a business combination also do not arise in a transaction that involves only the raising of finance.

Implications of View 2A on the financial statements of the acquirer

If the acquired liabilities are Type 2, consistent with the discussion under Issue 1 above, Entity B and Entity C should only classify income and expenses specified in paragraph 61 of IFRS 18 in the financing category. For Entity B, this would include interest on the bank debt of Company Y, and any changes that related to changes in interest on the variable rate debt. For Entity B, there may not be other items of income or expense that are recognized in net income over the life of the instrument, if it is carried at amortized cost and held to maturity. However, if that liability is modified or extinguished with resulting income or expenses being recognized in the income statement, these changes would be recognized in the operating category, unless the changes were considered to relate to “interest” or “changes in interest rates.” Therefore, considering materiality, it might be important for Entity B to identify liabilities that were acquired in a business combination, either on transition to IFRS 18 or when a liability is modified or extinguished, to ascertain how it should classify the income or expense.

For Entity C, whose main business activity is providing financing to customers, it should also classify interest on Type 2 liabilities in the financing category, under paragraph 65(b) of IFRS 18. This is regardless of whether the assumed liabilities relate to providing financing to customers, as the assumed debt does in Fact Pattern 2B. The requirement in paragraph 65(a) of IFRS 18 to present interest on liabilities that relate to providing financing to customers in the operating category, or to apply an accounting policy choice for interest on liabilities that do not relate to providing financing to customers, applies only to Type 1 liabilities (i.e., those that arise on transactions that are only the raising of finance). In this view, the liabilities assumed are Type 2 liabilities and so the options under paragraph 65(a) do not apply. Instead, if the income and expenses are specified in paragraph 61 of IFRS 18, they are classified in the financing category; if the income and expenses are not specified in paragraph 61 of IFRS 18 they are classified in the operating category. A similar credit facility obtained directly by Entity C (i.e., a credit facility that relates to providing finance to customers that was not acquired through a business combination) would be classified as a Type 1 liability because it involves only the raising of finance. In accordance with paragraph 65(a)(i), interest on this credit facility would be categorized in the operating category. Therefore, interest on two similar liabilities would be categorized into different categories (i.e., financing and operating) for the same reporting entity.

Generally, entities should apply IFRS 18 at the reporting entity level, which is the consolidated group in this fact pattern. If Company Y or Company Z continue to prepare stand-alone financial statements, this could create consolidation differences. From the perspective of Company Y or Company Z, these entities received cash on initial recognition of these liabilities, and so such liabilities would be classified as Type 1 in their financial statements.

View 2B – On initial recognition by Entity B and Entity C, the bank debt of Company Y and the borrowing facility of Company Z (respectively) arises in a transaction that involves only the raising of finance

Proponents of this view note that while the transaction in which Entity B recognizes the bank debt is a business combination and does not directly involve the receipt of cash, own equity, or an extinguishment of an existing financial liability, the original transaction by Company Y involved the receipt of cash. Therefore, they think it meets the criteria of a transaction that involves only the raising of finance. They note that the purpose and the nature of the underlying transaction have not changed upon acquisition. As the liability to the bank arose in a transaction that involved only the raising of finance this results in a Type 1 liability. Proponents of this view think this characteristic is retained by Entity B upon acquisition of Company Y.

This view is a broader interpretation of what is the “transaction” and “the entity” in paragraph B50 of IFRS 18. Proponents of this view note that this interpretation is in line with the intent of the IASB in paragraph BC159(a) of the Basis for Conclusions for IFRS 18, which describes the objective to define only the raising of finance liabilities as “liabilities that arise from transactions that involve only the raising of finance, such as corporate bonds, bank loans, and mortgages. The purpose of such transactions is solely the raising of finance for an entity’s operating and investing activities, so income and expenses from those liabilities are classified in the financing category.”

The fundamental purpose of such assumed liabilities remains solely the raising of finance for the subsidiary’s operating and investing activities, so proponents of this view think income and expenses from those liabilities should be classified in the financing category.

This view would result in Entity B and Entity C being able to classify the income and expenses, such as gains and losses on extinguishment, related to the bank debt or the borrowing facility (respectively) in the consolidated statements in the same way as its Subsidiary Y or Subsidiary Z (respectively) and in the same way as its other Type 1 bank debt and bank borrowings. Consistency of classification of similar types of expenses is an objective of IFRS 18, and this view aligns with that objective. Conversely, recognizing remeasurements or extinguishment gains and losses on some bank debt in operating and on other, similar, bank debt in financing is inconsistent with the objective of IFRS 18 to provide consistency of the classification of income and expenses in the income statement.

The Group's Discussion

Most Group members supported View 2B, as they think it better aligns with IFRS 18's objective to ensure financial statements provide relevant information that faithfully represents an entity's income and expenses. They noted that this view results in more consistent classification of income and expenses that arise from liabilities, regardless of whether the liability was originated by the parent entity or assumed on the business acquisition.

To support View 2B, one Group member noted that the word "arose" in paragraph B50 of IFRS 18 might be interpreted to mean the origination of the liability by the subsidiary rather than the assumption of the liability by the acquirer. Another Group member noted that paragraph B53 of IFRS 18 provides examples of liabilities that arise from transactions that do not involve only the raising of finance, and that business combinations are not included in those examples.

Some Group members also highlighted paragraphs in the Basis for Conclusions for IFRS 18 that provide insight into the IASB's intentions and thought process for determining how entities should classify income and expenses that arise from liabilities. One Group member highlighted paragraph BC155, which notes that the IASB's approach best meets the information needs of users of financial statements and that the requirements in IFRS 18 provide a consistent basis for classifying income and expenses in the financing category. They think View 2B better aligns with this approach. Another Group member highlighted paragraph BC159, which notes that the IASB developed a practical approach that focused more broadly on income and expenses that are financing by nature. They think that a business combination does not change the underlying nature of a liability, and that the classification of income and expenses that arise from liabilities should be consistent, whether they arise on a business combination or not.

Some Group members also noted that this discussion pertained to two fact patterns involving the acquisition of an entity. They noted that their analysis and views might change under alternative fact patterns. For example, they might analyze a business combination involving the acquisition of assets and liabilities that constitute a business differently than those involving the acquisition of an entity. While the Group did not have a detailed discussion of alternative fact patterns, it highlighted that entities should ensure they fully understand the facts and circumstances when determining how to classify income and expenses that arise from liabilities.

Under Fact Patterns 2A and 2B, the Group supported View 2B. However, several Group members noted that they could not preclude View 2A based on a narrow interpretation of the words in paragraph B50 of IFRS 18.

The Group's discussion highlighted that while the Group supported View 2B, View 2A is also supportable. While a narrow interpretation of the words in paragraph B50 of IFRS 18 provides support View 2A, a broader interpretation of this paragraph and an analysis of the Basis for

Conclusions of IFRS 18 might support View 2B. Considering this discussion, the Group recommended that the AcSB be made aware of this issue and discuss if any further actions (e.g., discussions with IASB staff) are required.