

IFRS 18: A Game-Changer for Analysts

Mr. Anwar, a student at the Institute of Cost and Management Accountants of Pakistan (ICMAP), has a keen interest in investing in companies listed on the Pakistan Stock Exchange (PSX). This part-time hobby not only deepens his understanding of finance but also provides an additional source of income. Recently, with some extra funds at his disposal, he began considering investments in two leading textile companies—one based in Karachi and the other in Lahore.

Before committing to any investment, Mr. Anwar wisely decided to conduct a fundamental analysis of both companies. He started by reviewing their financial statements for the year ended June 30, 2023. Knowing that these statements were prepared in accordance with International Financial Reporting Standards (IFRS), as required by the Companies Act, 2017 for Public Interest Entities, Mr. Anwar expected consistency and comparability between the two companies.

However, his analysis soon led to frustration. He found significant inconsistencies in how the companies reported their financial data. While both companies presented an operating profit subtotal, one included dividend income in this figure while the other did not. Additionally, he noticed variations in the reporting of interest expenses and the treatment of exchange gains or losses.

The Introduction of IFRS 18

To address these concerns and improve financial reporting clarity, the International Accounting Standards Board (IASB) published IFRS 18, Presentation and Disclosure in Financial Statements, on April 9, 2024. This new standard, effective for annual periods beginning on or after January 1, 2027 (with earlier adoption permitted), represents a significant step forward in enhancing the transparency, clarity, and consistency of financial reporting. IFRS 18 aims to improve the comparability of financial performance across companies, thereby better serving the needs of investors like Mr. Anwar, as well as creditors.

IFRS 18 will replace the existing IAS 1, Presentation of Financial Statements. Although much of IAS 1 has been

incorporated into IFRS 18, the new standard introduces substantial changes, particularly in the presentation of profit or loss, other comprehensive income, and the statement of changes in equity.

Core Principles and Objectives of IFRS 18

The introduction of IFRS 18 marks the most significant

transformation in the presentation of the profit or loss statement since the inception of IFRS over two decades ago. The core principles and objectives of IFRS 18 are as follows:

1) Standardization and Consistency

One of the primary goals of IFRS 18 is to standardize the format and content of financial statements. By ensuring uniform presentation of financial data, the standard facilitates easier comparison of financial performance across different companies.

2) Investor and Creditor Benefits

The standardized format allows users of financial statements, such as investors and creditors, to quickly and easily find the information they need. This reduces confusion and simplifies the analysis process, enabling better decision-making.

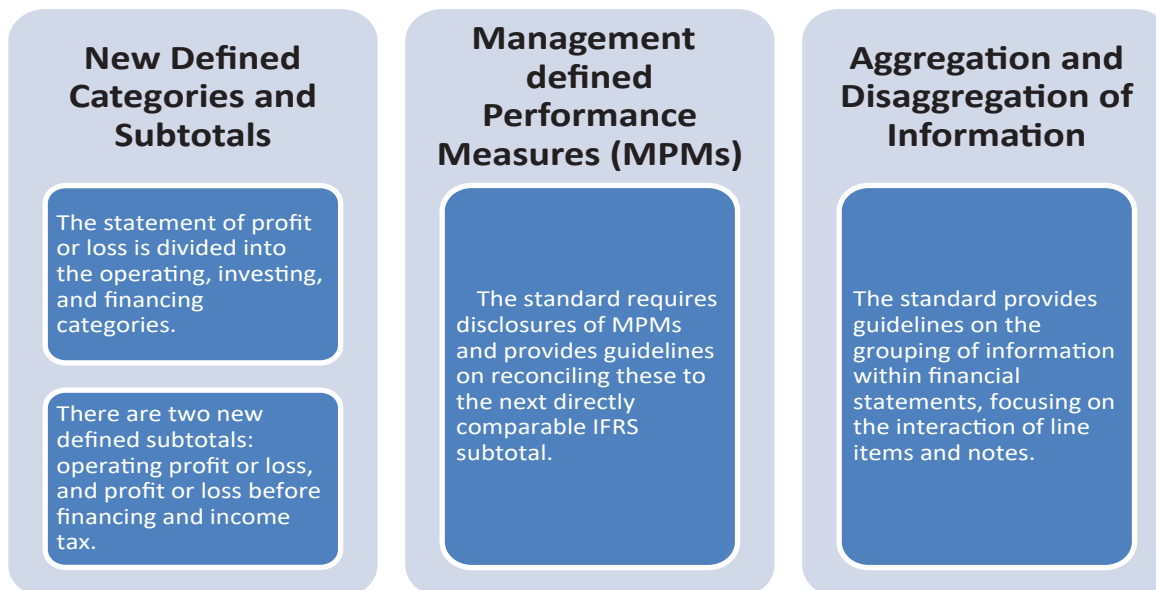
Key Changes Introduced by IFRS 18

IFRS 18 covers nearly all components of financial statements: the statement of financial position, the statement of profit or loss, the statement of comprehensive income, the statement of changes in equity, the statement of cash flows, and notes.



Mumtaz Hassan, FCMA
Financial Controller,
Nishat Mills Limited
and Member, ICMA Research
and Publications Committee

However, the most noteworthy changes are highlighted below:



New Defined Categories and Subtotals

IFRS 18 addresses investors' concerns about the difficulty in comparing companies' financial performance due to the significant variation in the content and structure of companies' statements of profit or loss. One of the most frequently used subtotals, operating profit, has been defined inconsistently by companies because IFRS Accounting Standards previously lacked a standardized definition. To improve the comparability of information in the statement of profit or loss, IFRS 18 introduces the following:

Three New Defined Categories

IFRS 18 introduces three new categories—Operating, Investing, and Financing—alongside the existing categories of Taxation and Discontinued Operations in the statement of profit or loss. Under IFRS 18, companies must consistently classify their income and expenses within these categories. Although these categories are similar to those used in the indirect method of the cash flow statement, they are not identical.

The consistent classification of income and expenses is crucial for comparability. Below is an illustration for a company that primarily categorizes its operating expenses by function. Categories required by IFRS 18 are highlighted in blue, while existing categories are shown in white.

Following is the brief explanation of the new categories:

Illustration: Statement of profit or loss

Revenue	
Cost of goods sold	
Gross Profit	
Other operating income	
Selling expense	
Research and development expenses	
General and administrative expenses	
Other operating expenses	
Operating profit or loss	Operating
Share of profit or loss of associates and joint ventures	
Other investment income	
Profit or loss before financing and income tax	Investing
Interest expense on borrowings and lease liabilities	
Interest expense on pension liabilities	
Profit before tax	Financing
Income tax expense	
Profit from continuing operations	Tax
Loss from discontinued operations	
Profit for the year	Discontinued operations

- 1) **Operating Category** - The operating category includes all income and expenses not classified under the other categories, providing a comprehensive view of a company's operations. It also serves as a starting point for forecasting future cash flows.
- 2) **Investing Category** - The investing category includes income and expenses from stand-alone investments, such as rental income from investment properties or dividends from shares in other companies. It also covers income and expenses from cash equivalents and profits or losses from equity-accounted associates and joint ventures, allowing investors to separately analyze returns from investments, distinct from the company's core operations.
- 3) **Financing Category** - The financing category includes income and expenses related to financing liabilities, such as bank loans and bonds. It also encompasses interest expenses on other liabilities, including lease and pension obligations, enabling investors to evaluate a company's performance before considering the effects of its financing.

Two New Subtotals

The standard also mandates two additional subtotals: operating profit and profit before financing and income taxes. These new subtotals, highlighted in purple, are required under IFRS 18.

For companies like banks or insurance firms, where the primary business activity involves financing or investing, income and expenses that would typically be categorized as investing or financing for other companies are instead classified under the operating category. For instance, a bank's statement of profit or loss begins with interest income, followed by interest expenses, and calculates net interest income—a subtotal comparable to gross profit in the income statement of a general company.

Management-defined Performance Measures (MPMs)

Companies often present specific metrics, commonly referred to as Alternative Performance Measures (APMs) or Management-defined Performance Measures (MPMs), to offer additional insights into their financial performance. These MPMs are company-specific figures, such as Earnings Before Interest, Tax, Depreciation, and Amortization (EBITDA), that appear in public communications outside of the audited financial statements, reflecting management's perspective on performance.

Under IFRS 18, companies are required to disclose MPMs within the audited financial statements in a dedicated single note. While these measures can provide valuable insights to investors, there has been concern about the transparency of their calculation.

To address this issue, IFRS 18 mandates that MPMs be

reconciled to the most directly comparable IFRS-defined subtotal. Additionally, companies must explain why an MPM is reported, provide its calculation method, and disclose any changes to it over time. These requirements aim to enhance transparency and impose greater discipline in the use of such measures.

For example, if a company reports EBITDA, it must include a reconciliation to the IFRS-defined operating profit before depreciation, amortization, and impairment, as specified in IAS 36, Impairment of Assets.

Aggregation and Disaggregation of Information

Investors have expressed concerns that some companies either fail to provide sufficient detail or obscure critical information in their financial statements. IFRS 18 addresses these issues by establishing clear rules for the grouping and separation of information, known as aggregation and disaggregation.

IFRS 18 offers specific guidance on how information should be presented in both the primary financial statements and the accompanying notes. Aggregation is based on shared characteristics, allowing related items to be grouped together, while disaggregation occurs when distinct characteristics require further breakdown, resulting in more detailed disclosures. Additionally, any items labeled as "other" must be clearly defined and explained to enhance transparency.

Additional Considerations

Amendments to IAS 7 (Statement of Cash Flows) have introduced more structured guidelines. Previously, the starting point for presenting operating cash flows was not standardized, resulting in varying practices. Under the new amendments, the calculation of operating cash flows must now begin with Operating Profit.

Beyond these changes, IFRS 18 also offers comprehensive guidance on the classification of cash and cash equivalents, derivatives, hybrid instruments, and foreign exchange differences, as well as updates to the presentation of the statement of financial position.

Preparing for IFRS 18

The operational changes required by IFRS 18 should not be underestimated. Companies should begin preparing early, including training staff involved in financial statement preparation and updating accounting systems to accommodate the new requirements.

About the Author: *Mumtaz Hassan is a Fellow Member of ICMA International, a Fellow Member of the Association of Chartered Certified Accountants (ACCA), and an Associate Member of the Institute of Chartered Accountants in England and Wales (ICAEW). He is currently serving as Financial Controller in Nishat Mills Limited. He has more than 20 years of experience in the field of Accounts and Finance. He is also the current member of the ICMA Research and Publications Committee.*