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The new IFRS 18 accounting standard introduces greater structure to the income statement and tightens the frequent use of management-defined performance measures. PHOTO: PIXABAY

# The income statement is changing for the better

New accounting rules will make it easier to compare results across companies. BY THEMIN SUWARDY

EARLIER this April, the International Accounting Standards Board (IASB) issued a new accounting standard, IFRS 18 – Presentation and Disclosure in Financial Statements, to replace the current IAS 1 – Presentation of Financial Statements.

The new standard, effective in 2027 (with earlier application permitted), will herald one of the most important developments we have ever seen for the income statement.

Indeed, IASB chair Andreas Barckow described it as the most significant change to companies' presentation of financial performance since the introduction of IFRS (International Financial Reporting Standards) over 20 years ago.

The new IFRS 18 is the result of a multi-year project to address investors' difficulties in comparing financial performance across companies, given the variations in content and structure.

As Hans Hoogervorst, the former IASB chair, puts it: "The income statement is rather form-free." Beyond a revenue number at the top and a net profit or loss number at the bottom, the middle part of an income statement has been relatively free-for-all.

This is set to change with the greater structure provided by IFRS 18.

## New operating, investing and financing sections

One oft-cited difference in practice across companies is the use of the "operating profit" subtotal on the income statement. Although this is a common measure utilised by many financial statement users, it is not defined under the current IAS 1.

According to IASB research, out of 100 companies, 63 companies reported operating profit subtotals using at least nine different definitions.

The new IFRS 18 will formalise the definition of operating profit as a compulsory subtotal, along with another new "profit before financing and income taxes" subtotal. This is part of a major overhaul of the income statement.

The new income statement will have section headings similar to those of the cash flow statement. It will have an operating section, an investing section, and a financing section.

In general, the operating section of the income statement is expected to capture income and expenses from the entity's main business activities.

The investing section includes income and expenses from investments in associates, joint ventures, cash and cash equivalents, as well as other assets.

The financing section includes interest income and expenses that arise from borrowings, as well as other liabilities such as lease liabilities or pension liabilities.

For banks, insurance and other financial institutions, where investing in assets or providing finance represents a "specified main business activity", interest and investment income and expenses would be disclosed as operating activities.

IFRS 18 also tightens the frequent use of management-defined performance measures, commonly referred to as "non-GAAP (generally accepted accounting principles) measures" or "pro forma earnings".

These measures are typically customised subtotals of income and expenses that an entity uses to convey the management's alternative view of its performance to shareholders, analysts, or other parties.

These alternative performance measures include labels such as "adjusted profit", "adjusted operating profit", "adjusted Ebitda" (earnings before interest, taxes, depreciation, and amortisation), and many others. In a letter to shareholders, Warren Buffett once said that these "phoney" measures hide the real costs of doing business. "If real and recurring expenses don't belong in the calculation of earnings, where in the world do they belong?" Buffett asked.

One infamous example of such measures is in WeWork's scuttled initial public offering in 2019, where it heavily promoted a "community-adjusted Ebitda" as an alternative measure of performance.

WeWork's alternative reality measure showed a community-adjusted Ebitda of US$866 million instead of a loss of US$933 million in its income statement.

It did this by excluding staff costs, interest, tax, depreciation, marketing, general administrative expenses and whatever else it wanted from the actual loss.

The IFRS 18 standard will require all management-defined performance measures to be included in the financial statements, and thus be subjected to audits.

Financial statement preparers must include a note to the accounts explaining why the measure is reported, how it is calculated and reconciled back to an IFRS-defined subtotal, and if there have been any changes in the measures used across reporting periods.

## Aggregation and disaggregation

Finally, IFRS 18 provides additional guidance on aggregation and disaggregation. This is because investors noted that some companies do not provide enough detailed information or that important information is often obscured and hard to find or understand. Two classic bad practices in this area are, first, the lack of details or breakdown of operating expenses; and, second, grouping significant and numerous explained expenses as "others".

IFRS 18 makes a distinction between "presenting" structured summaries of an entity's income, expenses, assets, liabilities, equity and cash flows on the financial statement, and "disclosing" subsequent material information in the notes, to supplement the summary numbers on the financial statements.

Taken together, the requirements in IFRS 18 will change how the income statement is presented and will give investors more transparent, consistent anchor points and comparable information about companies' financial performance. For that, 2027 can't come soon enough.

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