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IFRS 18 – practical effects on the statement of cash flows

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Background

IFRS 18 *Presentation and Disclosure in Financial Statements* is effective for annual reporting periods beginning on or after 1 January 2027. IFRS 18 supersedes IAS 1 and introduces several significant changes to how entities prepare primary financial statements and notes.

The most significant changes to primary financial statements introduced by IFRS 18 relate to the statement of profit or loss, however, IFRS 18 has also resulted in consequential amendments to IAS 7 *Statement of Cash Flows*, which must be applied at the same time as IFRS 18. These amendments will result in changes to how entities prepare the statement of cash flows. Please refer to our other IFRS Accounting Standards In Practice publications for further information on IFRS 18.

The effect of these consequential amendments on the statement of cash flows may be more significant than entities anticipate, and may significantly affect both how the statement of cash flows is prepared and how cash flows are classified.

EXECUTIVE SUMMARY

IFRS 18 primarily effects the preparation of the statement of profit or loss and notes to the financial statements (e.g. the disclosure of management-defined performance measures).

However, consequential amendments to IAS 7 may significantly affect how an entity prepares the statement of cash flows. These effects may change only the basis of how the statement is prepared (e.g. the starting point for operating cash flows if the indirect method is used), or it may affect the reported amounts of operating, investing and/or financing cash flows.

Entities should consider the effects on the statement of cash flows as they finalise the effects of adopting IFRS 18.

The consequential amendments to IAS 7 are discussed in the following sections:

1. Starting point of the indirect method
2. Classification of interest and dividend cash flows – entities without SMBAs[1]
3. Classification of interest and dividend cash flows – entities with SMBAs
4. Aggregation and disaggregation

Note that IFRS 18 requires income and expenses to be classified into one of five categories:

- Operating
- Investing
- Financing
- Income taxes
- Discontinued operations

Operating, investment and financing categories in the statement of profit or loss are titled identically to the categories required by IAS 7 in the preparation of the statement of cash flows, however, income and expenses and their corresponding cash flows may not be classified in the same category.

Entities must apply the consequential amendments to IAS 7 when IFRS 18 is applied, therefore, an entity cannot apply these amendments to IAS 7 without applying IFRS 18 at the same time (or vice versa).

This publication assumes that readers have a basic working understanding of the requirements of IFRS 18, however, you may access the following additional resources on IFRS 18:

- IFRS 18 At a Glance: condensed summaries of every IFRS Accounting Standard, including IFRS 18 summarised into four pages.
- IFRS Accounting Standards In Practice - IFRS 18: our comprehensive guide to IFRS 18 with detailed explanations, worked examples, illustrative statements of profit or loss and BDO's insights on the application of the standard.
- IFRS 18 online training resources: we have six e-learning courses on the requirements of IFRS 18 which equip learners with a basic working knowledge of IFRS 18.

[1] Specified main business activities of investing in assets and/or providing financing to customers

1. Starting point of the indirect method

Prior the adoption of IFRS 18, IAS 7 did not state which subtotal or total line item in the statement of profit or loss should be the starting point for entities that use the indirect method. In practice, many entities have historically used profit or loss as the starting point for the statement of cash flow.

IFRS 18 requires all entities to present the 'operating profit' subtotal in the statement of profit or loss, with operating profit being the total of all income and expenses classified in the operating category. The requirements for determining which income and expenses are classified in the operating category are complex – please refer to our other IFRS Accounting Standards In Practice publications for further information on IFRS 18.

Once IFRS 18 is adopted, entities preparing the statement of cash flows using the indirect method must use operating profit as the starting point for the statement of cash flows. Prior to the effective date of IFRS 18, most entities have used profit or loss before or after tax as the starting point for the statement of cash flows. Therefore, many non-cash items that have historically been adjusted out of profit or loss in preparing the statement of cash flows using the indirect method will no longer need to be adjusted because they are not included in operating profit.

For example, for entities without specified main business activities, the following will generally not be included in operating profit, and therefore, will no longer need to be adjusted in preparing the statement of cash flows using the indirect method:

1. The share of profit or loss of associates and joint ventures accounted for using the equity method;
2. Gains and losses on financial assets measured at fair value through profit or loss;
3. Gains and losses on the modification of financial liabilities, such as bank loans and debentures; and
4. Fair value changes of investment properties and the related rental income from leases.

Entities will have to consider whether income and expenses included in operating profit in the statement of profit or loss will have to be adjusted out of operating cash flows because the associated cash flows are classified as investing or financing activities or vice versa (IAS 7.18(b)(iii) and (iv)).

The following is a simplified example of differences that may arise in the preparation of the statement of cash flows as a consequence of the above noted amendments to IAS 7.

ILLUSTRATIVE EXAMPLE - RETAIL ENTITY

Entity Z is a retailer, and does not have any specified main business activities (i.e. it does not invest in assets or provide financing to customers as a main business activity). Entity Z owns an investment property (an office building), which it lets out to earn rental income and is accounted for using the fair value model. Following are excerpts from (1) Entity Z's statement of cash flows prepared prior to the consequential amendments to IAS 7, and (2) post consequential amendments. Notes are provided next to line items in (2) to explain the differences upon adoption of IFRS 18.

1. Operating section of statement of cash flows - prior to consequential amendments to IAS 7

Profit	1,000
Adjustments for non-cash items:	
Depreciation	150
Fair value gain on investment property	-75
Gain on sale of property, plant and equipment	-30
Income from associates - equity method	-25
	1,020
Changes in working capital:	
Trade receivables	-25
Trade payables	40
	15
Income taxes paid	-17
Cash generated from operations	1,018

ILLUSTRATIVE EXAMPLE - RETAIL ENTITY

2. Operating section of statement of cash flows - consequential amendments to IAS 7 have been adopted.

Operating profit	820	(A)
Adjustments for non-cash items:		
Depreciation	150	
~~Fair value gain on investment property~~	-	(B)
Gain on sale of property, plant and equipment	-30	
~~Income from associates - equity method~~	-	(C)
	940	
Changes in working capital:		
Trade receivables	-25	
Trade payables	40	
	15	
Operating cash flows not included in operating profit		
Income taxes paid	-17	(D)
Rental income - investment property	80	(E)
	63	
Cash generated from operations	1,018	(F)

Explanations

A. The starting point for the preparation of the statement of cash flows is operating profit, not profit or loss. The difference between profit or loss and operating profit is reconciled as follows:

Profit	1,000	
Fair value gains on investment property	-75	classified in the investing category in IFRS 18
Income from associates - equity method	-25	classified in the investing category in IFRS 18
Rental income - investment property	-80	classified in the investing category in IFRS 18
Operating profit	820	

B. Fair value gains on investment property are excluded from operating profit (see (A)), therefore, it is not necessary to adjust as a non-cash item.

C. Income from associates accounted for using the equity method are excluded from operating profit (see (A)), therefore, it is not necessary to adjust as a non-cash item.

D. Income taxes paid is an operating cash flow, however, it is not included in operating profit (see (B)), therefore, these cash flows must be added to adjusted operating profit. See the BDO comment following this example for further information on presenting income tax cash flows.

E. Rental income from investment property is an operating cash flow, however, it is not included in operating profit (see (B)), therefore, these cash flows must be added to adjusted operating profit.

F. The above noted adjustments do not change the final amount of cash generated from operations, only the preparation of the statement of cash flows.

BDO COMMENT - CLASSIFICATION AND DISCLOSURE OF INCOME TAX CASH FLOWS

IAS 7.35 requires that cash flows arising from taxes on income be separately presented. Prior to the consequential amendments to IAS 7 as a result of IFRS 18, entities may have met this requirement in one of two ways:

1. By adjusting current income tax expense from profit or loss, and then presenting the net income tax cash flow as a separate line item, generally in the operating category of the statement of cash flow; or
2. Not adjusting the current income tax expense from profit or loss, but instead presenting the change in current tax payable/receivable as a change in working capital in the operating category, and separately presenting the income tax cash flow, often as a supplementary line at the bottom of the statement of cash flows to meet the requirement of IAS 7.35.

Upon adoption of IFRS 18 and the consequential amendments to IAS 7, approach #2 set out above will no longer work because current income tax will not be included in operating profit or loss, the new starting point for the statement of cash flow when the indirect method is used. Instead, entities will need to directly include the net income tax cash flow in the operating section of the statement of cash flows as these are generally operating cash flows, but not included in operating profit or loss (IAS 7.20(d)).

The following simplified example compares approaches #1 and #2 above and the approach that is required by IAS 7.20(d) upon adoption of IFRS 18. This example is highly simplified to demonstrate the difference in how the effect of income taxes may be reconciled in these two approaches.

Extract from statement of profit or loss	
Operating profit	100
Income tax expense	-20
Profit or loss	80

Reconciliation of current income tax payable balance	
Opening balance	-
Current tax expense	-20
Income taxes paid	13
Closing balance	-7

Operating cash flows - prior to IFRS 18 consequential amendments, approach #1	
Profit	80
Add: current income tax included in profit or loss	20
Less: income taxes paid	-13
Operating cash flow	87 *

Operating cash flows - subsequent to IFRS 18 consequential amendments	
Operating profit	100
Less: income taxes paid	-13
Operating cash flow	87*

*Net operating cash flows are unchanged, however, the mechanics of how the statement of cash flows is prepared have changed because the starting point for the statement

Operating cash flows - prior to IFRS 18 consequential amendments, approach #2	
Profit	80
Change in current tax liability balance	7 ***
Operating cash flow	87 **

Operating cash flows - subsequent to IFRS 18 consequential amendments	
Operating profit	100
Income taxes paid	-13
Operating cash flow	87 **

** Net operating cash flows are unchanged, however, the mechanics of how the statement of cash flows is prepared may change.

*** Prior to the adoption of IFRS 18, under approach #2, supplemental information disclosing the income tax cash flows of 13 is required to comply with IAS 7.35.

2. Classification of interest and dividend cash flows – entities without SMBAs

Prior to the adoption of IFRS 18, IAS 7.31 requires cash flows from interest and dividends received and paid to be disclosed separately, and permits each of them to be classified within either operating, financing, or investing activities. The classification chosen must be applied consistently from period to period.

IFRS 18 amends IAS 7 and eliminates this accounting policy choice for interest and dividend cash flows.

For entities without specified main business activities (i.e. entities that do not invest in assets and/or provide financing to customers as a main business activity), the classification of interest and dividend cash flows is straightforward once IFRS 18 and the consequential amendments to IAS 7 have been adopted (IAS 7.33A, 34A):

Cash flows	*Classification prior to adoption of IFRS 18 and consequential amendments to IAS 7*	*Classification after the adoption of IFRS 18 and consequential amendments to IAS 7*
Interest paid	Operating or financing	Financing
Interest received	Operating or investing	Investing
Dividends received	Operating or investing	Investing
Dividends paid	Operating or financing	Financing

Interest paid is presented in the statement of cash flows whether it has been recognised as an expense in profit or loss or capitalised in accordance with IAS 23 *Borrowing Costs* (IAS 7.32).

Prior to the adoption of IFRS 18 and consequential amendments to IAS 7, neither IAS 7 nor IAS 23 specified where such interest should be classified in the statement of cash flows. For example, some entities may have classified capitalised interest as a cash flow from investing activities if it relates to an item of property, plant and equipment, while other entities may have classified such capitalised interest in the same way as other interest paid (i.e. operating or financing).

Once the consequential amendments to IAS 7 have been adopted, all interest paid shall be classified consistently. Entities that do not provide financing to customers as a main business activity are required to classify all interest paid as cash flows from financing activities (IAS 7.34A) regardless of whether interest paid is recognised in profit or loss or capitalised as part of the carrying amount of an asset as required by IAS 23 (e.g. property, plant and equipment, Investment property, intangible assets, etc.). The basis for conclusions has also been updated and clarifies that capitalised interest shall be classified as cash flow from financing activities (IAS 7.BC53(c)). Some entities will therefore have to change their accounting policy for classifying capitalised interest in the statement of cash flow when implementing IFRS 18.

3. Classification of interest and dividend cash flows – entities with SMBAs

The classification requirements are more complex for entities with specified main business activities (i.e. entities that invest in assets and/or provide financing to customers as a main business activity), as these entities may classify interest and dividend cash flows in more than one category of the statement of profit or loss. Such entities will generally include banks, insurance companies, financial institutions and entities if they provide financing to customers to enable those customers to buy the entity's products.

BDO COMMENT - INVESTMENT PROPERTY ENTITIES

The requirements set out below for entities with specified main business activities permit such entities to make certain accounting policy choices relating to how interest and dividend cash flows are classified. However, these accounting policy choices will not be applicable to all entities with specified main business activities.

For example, Entity A's primary business is investing in commercial real estate. Entity A borrows funds from financial institutions and investors and invests in commercial real estate, which it leases out to tenants in the form of operating leases. Entity A invests in investment property as a main business activity, and therefore, it classifies certain income and expenses (e.g. fair value gains and losses on investment property, etc.) in the operating category of the statement of profit or loss.

Entity A also has interest expense from bank loans, which are used to fund its acquisition of commercial real estate. Entity A classifies that interest expense in the financing category of the statement of profit or loss. Entity A does not provide financing to customers as a main business activity; therefore, it does not classify any interest expense in the operating category. As all interest expense is classified in a single category in the statement of profit or loss (the financing category), Entity A is required by IAS 7.34B to classify all of the associated interest paid cash flows as financing activities.

Therefore, the specific requirements for entities with specified main business activities described below apply to only a subset of such entities: (1) entities with specified main business activities; and (2) those entities that classify interest paid, interest received and/or dividend received cash flows in more than one category in the statement of profit or loss.

For such entities with specified main business activities, interest and dividend cash flows are classified as follows (IAS 7.34B-34D):

<table>
<tr><th>Cash flows</th><th>Classification prior to adoption of IFRS 18 and consequential amendments to IAS 7[2]</th><th>Classification after the adoption of IFRS 18 and consequential amendments to IAS 7</th></tr>
<tr><td>Interest paid</td><td>Operating or financing</td><td rowspan="3">A single category for <u>each</u> item - operating, investing or financing (no 'splitting' for each item in the SCF)

See following explanation</td></tr>
<tr><td>Interest received</td><td>Operating or investing</td></tr>
<tr><td>Dividends received</td><td>Operating or investing</td></tr>
<tr><td>Dividends paid</td><td>Operating or financing</td><td>Financing</td></tr>
</table>

IAS 7.34B sets out specific requirements for classifying interest and dividend cash flows if the entity invests in assets or provides financing to customers as a main business activity. Such entities classify these items by referring to how it classifies the related income amounts in the statement of profit or loss.

[2] Interest paid and interest and dividends received were usually classified as operating cash flows for a financial institution.

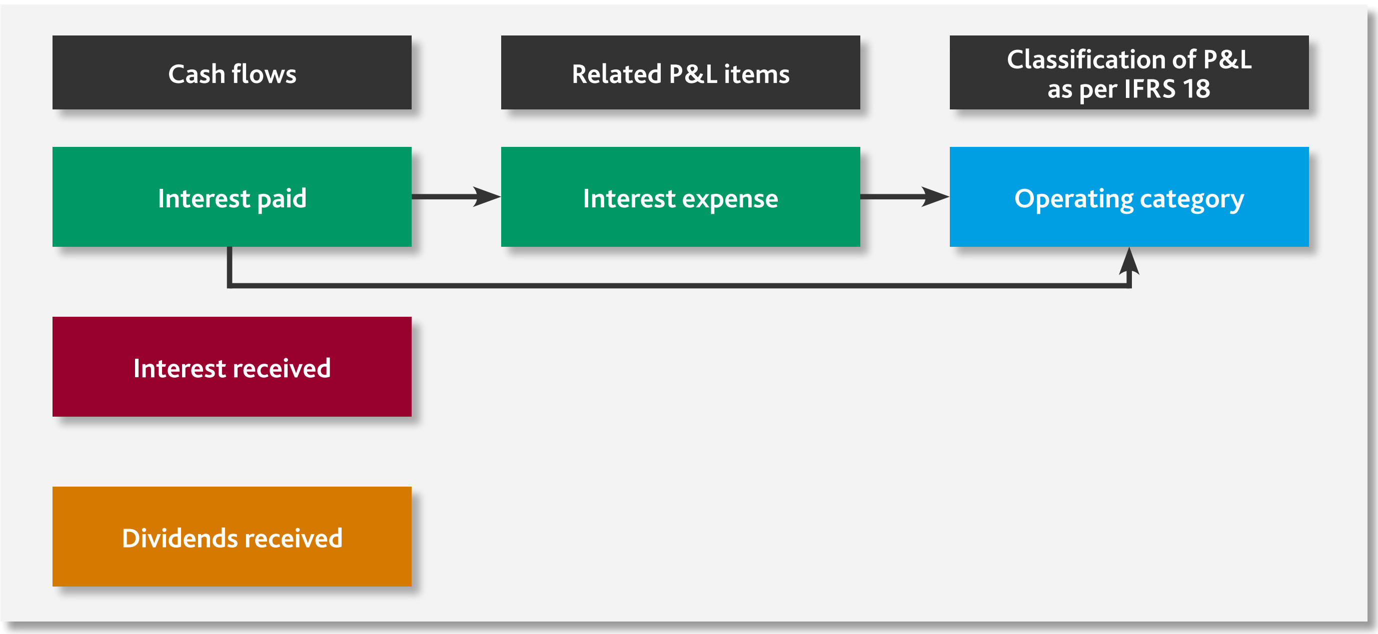
BDO COMMENT - CLASSIFICATION OF CAPITALISED INTEREST FOR ENTITIES WITH SPECIFIED MAIN BUSINESS ACTIVITIES OF PROVIDING FINANCING TO CUSTOMERS

Entities may have historically classified interest capitalised into the carrying amount of assets (e.g. property, plant and equipment) applying IAS 23 as investing cash flows, as this reconciles to other notes in the financial statements (e.g. the property, plant and equipment reconciliation required by IAS 16). Upon adoption of the consequential amendments to IAS 7, capitalised interest paid can no longer be classified as an investing cash flows, as operating or financing are the only classification possibilities depending on whether an entity has specified main business activities of providing financing to customers and related accounting policy choices.

Entities that classify dividend income, interest income and interest expense in a single category in the statement of profit or loss

If an entity classifies the total of each of dividend income, interest income and interest expenses in a single category of the statement of profit or loss, the entity is required to use the corresponding category in the statement of cash flows (IAS 7.34C). For example, if a bank classifies all its interest expense in the operating category of the statement of profit or loss, then the entity is required by IAS 7.34C to classify the corresponding interest paid cash flows as operating activities in the statement of cash flows.

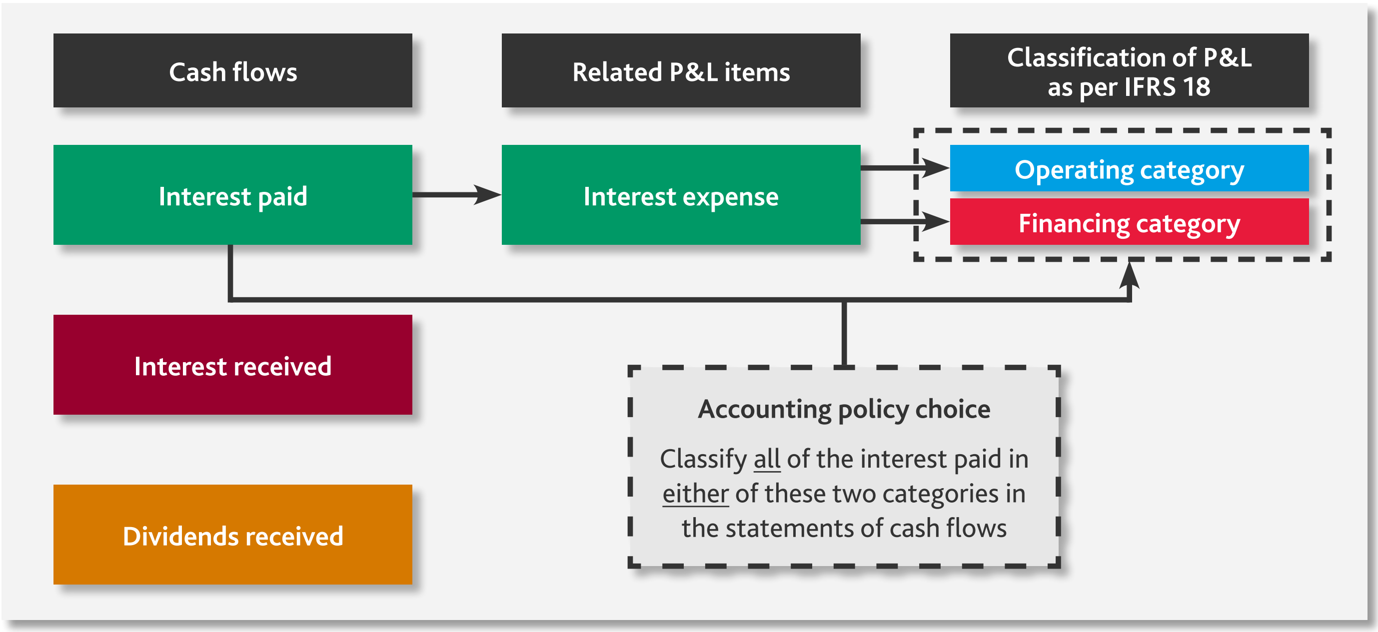
The relationship between these items of income and expense and the associated 'matching' requirement in IAS 7.34C may be represented as follows using interest paid as one example:



Entities that classify dividend income, interest income and interest expense in more than one category in the statement of profit or loss

If an entity classifies each of dividend income, interest income and interest expenses in more than one category of the statement of profit or loss, then the entity is required to make an accounting policy choice to classify all of the associated cash flows from each of those three items in a single activity in the statement of cash flows (IAS 7.34D). For example, a bank may classify some of its interest expense in the operating category and some in the financing category of the statement of profit or loss.[3] In preparing the statement of cash flows, the bank is required to choose to classify all the associated interest paid cash flows as operating or financing activities.

The relationship between these items of income and expense and the associated accounting policy choice in IAS 7.34D may be represented as follows using interest paid as one example:



In all cases, IAS 7.34B requires an entity to classify <u>all cash flows</u> from each of these three items in a single line item; the cash flows cannot be sub-divided or 'split' into more than one activity. For example, an entity may classify interest expense in more than one line item in the statement of profit or loss, however, entities are <u>not</u> permitted to classify the related cash flows (interest paid) in more than one category in the statement of cash flows.

BDO COMMENT - EFFECT ON REPORTED CASH FLOWS

Unlike the consequential amendments affecting the starting point for the statement of cash flows (see section 1), these amendments may affect the amount of cash flows reported in the operating, investing and financing sections of the statement.

4. Aggregation and disaggregation

IFRS 18 sets out new principles of aggregation and disaggregation, which may affect the level of disaggregation of cash flows in the statement of cash flows.

See our other IFRS Accounting Standards In Practice publications for further information on IFRS 18, including an explanation of IFRS 18's aggregation and disaggregation requirements.

[3] See section 3.8.2.1 in IFRS Accounting Standards In Practice - IFRS 18 for further information.

Additional resources on IFRS 18

Entities should refer to BDO's tools and resources on IFRS 18, including:

- IFRS 18 At a Glance: condensed summaries of every IFRS Accounting Standard, including IFRS 18 summarised into four pages.
- IFRS Accounting Standards In Practice - IFRS 18: our comprehensive guide to IFRS 18 with detailed explanations, worked examples, illustrative statements of profit or loss and BDO's insights on the application of the standard.
- IFRS 18 online training resources: we have six e-learning courses on the requirements of IFRS 18 which equip learners with a basic working knowledge of IFRS 18.

Contact your jurisdiction's IFRS Country Leader for further information.

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For further information about how BDO can assist you and your organisation, please get in touch with one of the IFRS country contacts:

BDO's IFRS Country Leaders