Grant Thornton

Get ready for MFRS 18

The new financial statements presentation and disclosure standard

Classifying income and expenses

Under the new requirements of MFRS 18, items of income and expense are not classified based on their own nature, but rather they are classified based on the nature of the asset, liability or transaction from which they are derived. For example, take impairment. Where previously this may have been presented as a non-operating item, under MFRS 18 impairment losses related to assets such as property, plant and equipment (PPE) and trade receivables will have to be classified in the operating category. Whereas (unless an entity invests as a main business activity) impairment related to other specified assets such as investments in associates or joint ventures will have to be classified in the investing category.

Classification in the operating category

The operating category under MFRS 18 effectively functions as a 'residual' category. Income and expenses will only be classified in the operating category if they do not meet the definitions of the investing, financing, income taxes or discontinued operations categories.

It is also important to understand, as mentioned previously, that the objective of the categories described by MFRS 18 are not the same as the objective of the equivalent categories in the statement of cash flows. For example, when applying MFRS 107 to prepare the statement of cash flows, cash utilised to acquire PPE that will be used in the entity's operations must be classified in the investing category. However, when applying MFRS 18, in the statement of profit or loss, income and expenses generated from the use of PPE in the entity's operations must be included in the operating category.

This current misalignment is due to the fact that the MASB have prioritised the objectives of each individual primary financial statement and did not seek to align the definition of these categories between the profit or loss and statement of cash flows. That being said, the MASB has added a research project on the statement of cash flows to its current work plan, so further alignment may be possible in the future.

Classification in the investing category

The investing category includes income and expenses derived from a specifically defined set of assets. These are:

Asset type	Description
Investments in associates and joint ventures	This includes investments accounted for using the equity method, investments that an entity has elected to measure at fair value through profit or loss and investments in separate financial statements which are accounted for at cost.
Investments in unconsolidated subsidiaries	Similarly to investments in associates and joint ventures, this includes investments accounted for using the equity method, held at fair value through profit or loss, and accounted for at cost.
Cash and cash equivalents	We note here that the definition of cash and cash equivalents in MFRS 107 specifically states that cash and cash equivalents are held to meet short-term cash commitments and not for investing purposes. This is therefore another key misalignment to be aware of.
Other assets that generate a return individually and largely independently of the entity's other resources	• Assets that typically meet this definition include debt or equity investments and investment properties (and receivables for rent generated by these properties). Income and expenses from these assets can include interest, dividends, rental income, depreciation and impairment losses and reversals, as well as fair value gains or losses and any income or expense incurred on derecognition or reclassification as held for sale. • Assets that typically do not meet this definition include PPE, assets that arise from providing goods or services (the income from which are included in the operating category), and loans to customers where the entity is providing financing as a main business activity. Income and expenses from such assets are included in the operating category. For example, revenue from the sale of goods or services, interest income, depreciation of PPE etc.

There is an exception to the above classification requirements for when an entity invests in any of the described assets as its main business activity. For example, an asset management entity that collects investments from its customers and invests into a portfolio of investment properties. In this case income and expenses related to these assets and activities would be included in the operating category.
The assessment of whether investing in these assets is a main business activity of an entity is a matter that may require significant judgement by management and will be dependent on facts and circumstances. This will be covered in more detail in the subsequent section '**Classification exceptions for entities that provide financing to customers or invest in assets as a main business activity**'.

Classification in the financing category

The financing category contains income and expenses arising from financing transactions, and interest expenses on all liabilities. MFRS 18 contains detailed requirements and application guidance to help entities determine which income and expenses should be included in this category.

MFRS 18 sets general rules for classifying income and expenses relating to liabilities, distinguishing between liabilities that arise from transactions that involve only the raising of finance, and liabilities that arise from transactions that do not involve only the raising of finance, with exceptions to these rules and additional guidance for:

- hybrid contracts with host liabilities
- derivatives and designated hedging instruments
- issued investment contracts with participation features
- insurance contracts when applying MFRS 17, and
- entities providing financing to customers as a main business activity.

General rules for income and expenses relating to liabilities

1 **Liabilities that arise from transactions that involve only the raising of finance**
Income and expenses from such transactions must be classified in the financing category. MFRS 18 clarifies that these are transactions in which an entity receives finance in the form of cash, the extinguishment of a financial liability, or the receipt of the entity's own equity instruments, and at a later date will return either cash or its own equity instruments. These include liabilities such as cash settled debt instruments, liabilities under supplier finance arrangements in which the payable for goods or services is derecognised, bonds that will be settled through delivery of the entity's own shares, and obligations for an entity to purchase its own equity instruments. Income and expenses for these items may include interest expense, fair value gains and losses, dividends on issued shares.

2 **Liabilities that arise from transactions that do not involve only the raising of finance**
These can include items such as lease liabilities, contract liabilities recognised under MFRS 15 'Revenue from Contracts with Customers', defined benefit pension scheme liabilities etc. For these liabilities, only interest income and expenses and income and expenses arising from changes in interest rates can be included in the financing category. Other items of income and expenses will need to be included in one or more of the other categories.

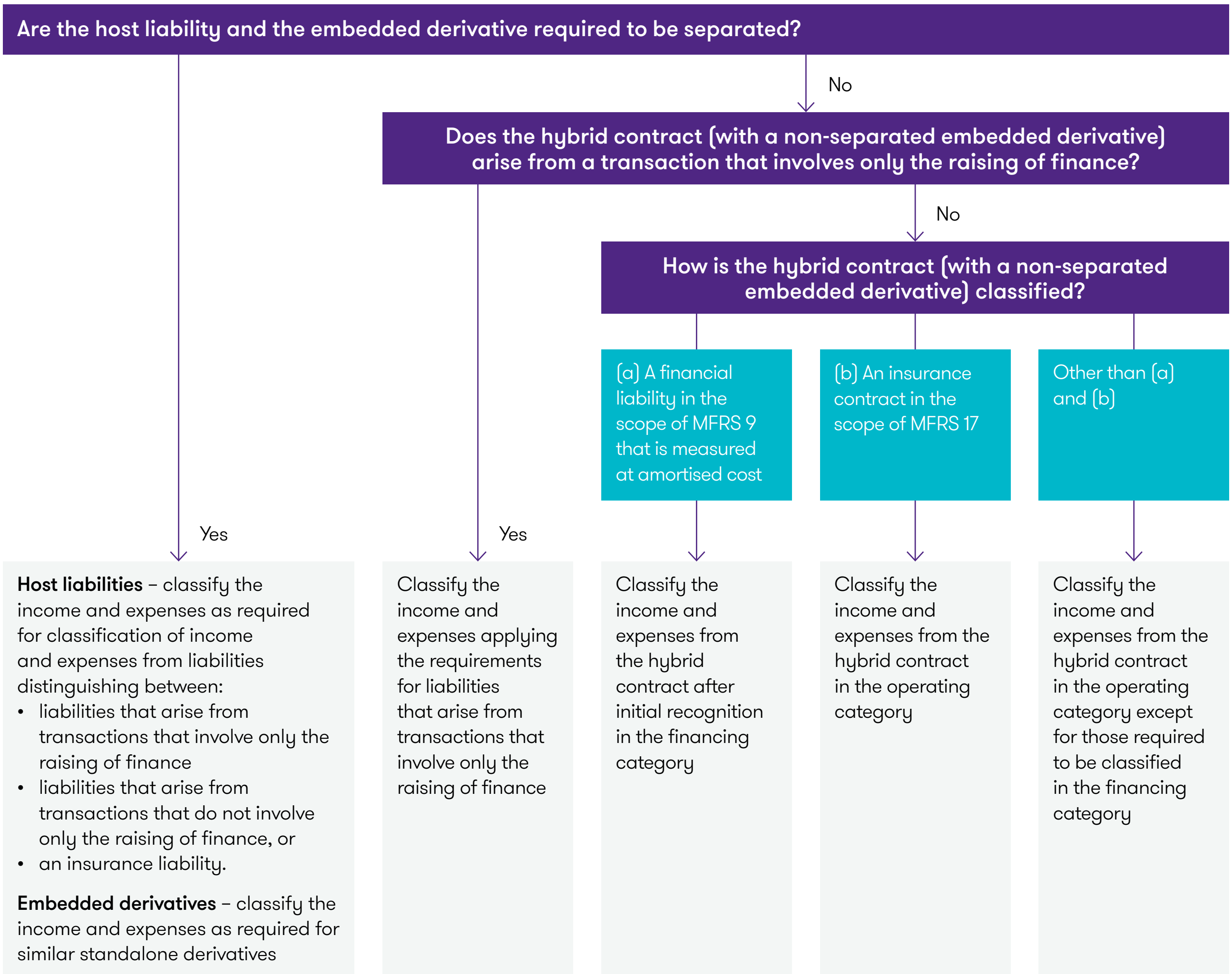
Exceptions to the general rules and detailed application guidance on the following topics

1 Hybrid contracts with host liabilities

Accounting for these contracts depends on whether the embedded derivative is separated from the host contract or not.

a If the derivative is separated from the host contract, income and expenses related to the host liability will be treated in line with the classification process we have set out above. Income and expenses relating to the derivative are treated in accordance with specific guidance for derivatives which is discussed below.

b If the contract is not separated, it is considered as a whole, and the classification of income and expenses arising from it will be dependent on a number of factors, including whether the contract is in the scope of MFRS 9 'Financial Instruments' or MFRS 17 'Insurance Contracts'. These considerations are set out in the following flowchart:



2 Derivatives and designated hedging instruments

For derivatives the general rule is that gains and losses should be classified in the same category as the income and expenses affected by the risks the derivative is used to manage. For example, a derivative may be used to manage the risk of price increases for raw materials used in producing goods. In this case, the underlying risk is related to expenses in the operating category, so the gains and losses from the derivative should be included there as well. Alternatively, a derivative may be used to manage the risk of interest rates increasing on bank loans. Assuming that income and expenses arising from these loans are included in the financing category, gains and losses recognised on the derivative will also be included in financing. There is an exception to this general rule however, if it would lead to 'grossing up' or gains and losses; for example, if a derivative is being used to hedge risks affecting items in multiple categories, in which case gains and losses on the derivative are classified in the operating category.

When a derivative is not used to manage identified risks, gains or losses should be included in the financing category if the derivative relates to a transaction involving only the raising of finance (unless the company provides financing to customers as a main business activity, and as such classified these items of income and expenses in the operating category). Otherwise, it is included in the operating category.

3 **Issued investment contracts with participation features**
These are types of income and expenses that are accounted for in accordance with MFRS 9. They are excluded from the financing category and are instead included in the operating category. An example of this type of contract could be an investment contract with participation features issued by an investment entity.

4 **Insurance contracts when applying MFRS 17**
These are also included in the operating category, rather than in financing.

Practical insight
For some entities, applying MFRS 18 may require more detailed record keeping compared to their current systems. Taking the impairment example, where MFRS 101 may have only needed one account in the general ledger for recording impairment losses, an entity may now need multiple accounts for different classes of asset in order to have the granularity of data needed for the new presentation. Some entities may already have the capability in their current reporting systems to adapt to this, but for those that do not, significant changes to reporting systems and processes may be required. On initial application, entities will also need to restate comparatives, and therefore new reporting systems will need to be in place at the start of the comparative year (ie 1 January 2026) in order to facilitate this.

5 **Entities providing financing to customers as a main business activity**
As with the investing category, there is an exception to these requirements for entities that provide financing to customers as a main business activity. For these entities, such as banks or other credit providers, a detailed assessment of their activities will be required to establish that this is a main business activity. This may involve judgement in some cases but is a matter of fact based on evidence rather than an assertion.

Specific requirements for classifying foreign exchange differences

The general requirement for foreign exchange differences which arise from the application of MFRS 121 'The Effects of Changes in Foreign Exchange Rates' is that the exchange differences should be classified in the same category as the income or expenses that have given rise to them. For example, if an entity has a receivable denominated in a foreign currency, the income from which they classify in the operating category, the foreign exchange differences arising when translating the receivable into the presentation currency will also be included in the operating category.

Practical insight
For a transaction that does not only involve the raising of finance, as mentioned above, income and expenses may be split between multiple categories. Any foreign exchange differences associated with such a transaction however, is not split between categories. Instead, the entity must use judgement to determine which part of the transaction the foreign exchange differences relate to and the differences are allocated to the relevant category. There may be significant judgement involved in determining which part of a transaction the foreign exchange differences relate to, and therefore where they should be classified in the statement of profit or loss. This could apply to liabilities such as payables for goods or services denominated in a foreign currency which also include extended credit terms. We therefore recommend that entities with foreign operations begin assessing their arrangements early to identify any such challenging areas.

There is a relief available from this general requirement. If the assessment would require 'undue cost or effort', an entity may classify all of the foreign exchange differences arising from an item in the operating category. The assessment of undue cost or effort must be made for each item that gives rise to foreign exchange differences, and it must be specific to the facts and circumstances of each item. However, if the same facts and circumstances apply to a number of items, the same assessment could be applied to all of them. For example, if all foreign exchange differences are currently captured in aggregate at an entity level as a single amount, in order to facilitate central management of net exposure (for example, by a central treasury function), and allocating foreign exchange differences to the applicable categories would entail costly enhancements to the reporting systems, management may assess that it would be appropriate to apply the undue cost and effort exemption. Entities should allocate sufficient time to perform the full assessment across any relevant liabilities.

Classification exceptions for entities that provide financing to customers or invest in assets as a main business activity

Before classifying any income or expenses in the operating, investing or financing categories, an entity must assess whether it carries out either, or both, of the two main business activities specified in MFRS 18, that have classification exceptions. As we have touched on previously, these are:

- Investing in assets, and
- Providing financing to customers.

If an entity has one, or both of these main business activities, then MFRS 18 requires some income and expenses that would usually be categorised as investing or financing, to be included in the operating category.

The assessment of whether an entity has either or both of these main business activities will require significant judgement as this is not merely an assertion, but rather must be a matter of fact based on:

- **Evidence, in accordance with detailed application guidance.** In general, investing in assets or providing financing to customers is likely to be a main business activity if a reporting entity uses particular subtotals as an important indicator of operating performance. Where subtotals include income and expenses normally classified in the investing or financing categories, and these subtotals are used to explain operating performance externally or assess or monitor performance internally, this may indicate that investing in assets or providing financing to customers is a main business activity of the entity.
- **Facts at the time of the assessment.** If facts and circumstances change, and the conclusion of the assessment changes, the change in categorisation of income and expenses is applied prospectively, and prior periods are not restated.

In general, this assessment should be performed for the reporting entity as a whole. However there are circumstances in which the assessment needs to be more granular and as such will be more onerous. These circumstances are when an entity invests in associates, joint ventures and/or unconsolidated subsidiaries which are **not** accounted for using the equity method, and when investing in assets which generate a return individually and largely independently of other resources. In these cases the entity must assess whether it invests in these assets as a main business activity, on an individual asset basis, or using groups of assets with shared characteristics.

Practical insight

Although an entity does not need to assess whether it invests in cash and cash equivalents as a main business activity, the classification of income and expenses from cash and cash equivalents still depends on whether the entity has one of the two main business activities. Generally, an entity will classify income and expenses relating to cash and cash equivalents in the investing category. However, where an entity invests in assets as a main business activity it will classify income and expenses on cash and cash equivalents in the operating category. And where an entity provides financing to customers as a main business activity, income and expenses may be classified in the operating or investing category, depending on the type of transaction and accounting policy choices. If cash and cash equivalents relate to providing financing to customers as a main business activity, then the related income and expenses should be classified as operating, otherwise, there is an accounting policy choice to classify either as operating or investing.

Entities that have either, or both, of the two main business activities specified by MFRS 18, classify some income and expenses that would otherwise be classified in the investing or financing category in the operating category. MFRS 18 contains detailed guidance on which items can or must be classified as operating for these entities. Additionally, MFRS 107 was amended such that classification of dividends and interest receivable and interest paid in the statement of cash flows must be consistent with how the corresponding income and expenses are classified in the statement of profit or loss in accordance with MFRS 18. Furthermore, while entities that provide financing to customers as a main business activity can avail themselves of an accounting policy choice in relation to the classification of certain income and expenses, that accounting policy choice must be consistent (where applicable) with that made for the classification of income and expenses from cash and cash equivalents, all of which will therefore require careful monitoring.

Income and expenses arising on derecognition of assets and liabilities

MFRS 18 includes detailed application guidance relating to the classification of income and expenses arising from the derecognition of assets and liabilities, the remeasurement of an asset or liability when designated as held for sale, and upon a change in use of an asset or liability. When dealing with single assets and liabilities this may be straightforward. The principle of MFRS 18 is that income or expe nse resulting from derecognition will be classified in the same category as would have been required immediately before recognition.

However, when dealing with a group of assets and liabilities this could become more complicated and therefore the Standard gives additional guidance on dealing with derecognition and changes in classification of groups of assets and liabilities.

Applying this guidance will again require detailed record keeping and information to enable entities to apply it correctly.

Challenges with transition

MFRS 18 will be mandatorily applied for the first time for reporting periods beginning on or after 1 January 202 7, however it is required to be applied retrospectively, meaning that the comparative information should be restated. Early adoption is also possible. Many entities may find the transition challenging, especially if the information required has not previously been captured by their systems. In addition to changing the classification of income and expenses, MFRS 18 requires the following in the first year of applying MFRS 18:

- If an entity applies MFRS 134 'Interim Financial Reporting' in preparing condensed interim financial statements – the condensed interim financial statements should present each heading the entity expects to use in applying MFRS 18, as well as the subtotals required by MFRS 18. This is specified in MFRS 18 despite the requirem ent of MFRS 134 to only present at minimum the headings and subtotals included in the most recent annual financial statements. They must also include a reconciliation from the previously reported amounts to the restated amounts reported for the comparative periods.
- In the entity's annual financial statements – a reconciliation of each line item in the statement of profit or loss for the comparative period, from the amounts previously presented under MFRS 101, to the restated amounts presented when applying MFRS 18.
- As such, some entities may need to start their assessment of the impact of MFRS 18 early, in order to comple te the assessment of which income and expenses must be reclassified, as well as to assess whether their existing systems and processes are adequate to respond to MFRS 18 's requirements going forward. For those entities preparing interim financial statements, the MFRS 18 transition journey may need to start even earlier, in order to be in a position to have the required information for the disclosures for the first interim reporting date.

What is next?

In our next series, we will be looking at **Management-defined performance measures** in MFRS 18.

How we can help

We hope you find the information in this article helpful in giving you some insight into aspects of MFRS 18. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact.