P&A Grant Thornton

Insights into PFRS 18

Classification of income and expenses in the statement of profit or loss

Introduction

In April 2024, the International Accounting Standards Board (IASB) issued IFRS 18 'Presentation and Disclosure in Financial Statements'. Once adopted locally, this will be known as PFRS 18 and will replace PAS 1 'Presentation of Financial Statements'. While the headline change is a new structure of the statement of profit or loss, the most significant impact for preparers is in the classification of income and expenses. PFRS 18 introduces a principles-based framework that requires entities to classify items based on the nature of the underlying asset, liability, transaction, or event – not the nature of the income or expense itself.

Our 'Insights into IFRS 18' series explains the new requirements of PFRS 18, highlighting some areas of the Standard that we believe will be challenging to apply in practice. They also aim to help users of IFRS financial statements to understand how financial statements will change when applying the new Standard.

PFRS 18 has given the statement of profit or loss a major facelift. It requires two new subtotals above the already existing 'profit or loss' total, dividing the statement into the following five discrete sections or categories – operating, investing, financing, income taxes and discontinued operations.

Classification in accordance with PFRS 18 is not just a technical exercise – it directly impacts how users interpret financial performance. Misclassification can distort operating profit, affect covenant compliance, and influence investor perception. Preparers should understand the principles and exceptions thoroughly to avoid unintended consequences.

This article provides a **comprehensive analysis** of PFRS 18's classification requirements, exceptions, and practical challenges. It builds on the high-level overview in our **'Get ready for PFRS 18'** publication and goes deeper into application issues.

For details on the new subtotals and transition requirements, refer to our article **'Insights into PFRS 18 – A snapshot of PFRS 18's key requirements'** and our **'Get ready for PFRS 18'** guide.

Overview – Classification in the statement of profit or loss

PFRS 18 divides the statement of profit or loss into the following five discrete sections or categories:

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

Summary of classification requirements for an entity without a 'specified main business activity' as defined in the Standard (see section on 'specified main business activities' on page 5)

Statement of profit or loss

'DEFAULT'

Operating category (I)

PFRS 18 contains requirements for the presentation and disclosure of operating expenses.

While the operating category is effectively a 'default' category, income and expenses are only classified in the operating category if they do not meet the requirements for classification in the other categories or are specifically required to be classified in the operating category. Importantly the operating category may include items management considers to be 'volatile' or 'non-recurring'.

Operating profit or loss NEW

DEFINED

Investing category (II)

contains income and expenses from:

- investments in associates, joint ventures and unconsolidated subsidiaries
- cash and cash equivalents
- other assets that generate a return individually and largely independently of the entity's other resources

Profit or loss before financing and income taxes NEW

DEFINED

Financing category (III)

contains income and expenses from liabilities:

- that arise from transactions that involve only the raising of finance
- that arise from transactions that do not involve only the raising of finance (however, only 'interest' income and expenses and income and expenses arising from 'changes in interest rates' are classified in financing)

PFRS 18 contains specific detailed application guidance for the classification of:

- income and expenses from hybrid contracts comprising host liabilities and embedded derivatives, eg a payable with an early prepayment option
- fair value gains and losses on derivatives and designated hedging instruments
- income and expenses from issued investment contracts with participation features under PFRS 9 'Financial Instruments'
- insurance finance income and expenses, included in profit or loss under PFRS 17 'Insurance Contracts'

Income taxes category (IV)

Discontinued operations category (V)

Profit or loss

Adapted from Figure 2 of the IASB's PFRS 18 supporting materials.

Key

Throughout this document the following colour convention is used to assist in identifying requirements:

Green text is used for a main business activity of **investing in specified assets**

Blue text is used for a main business activity of **providing financing to customers**

Purple text is used for the **operating category**

Teal text is used for the **investing category**

Red text is used for the **financing category**.

PFRS 18 approach to classifying income and expenses

Core Principle

Classification is based on the nature of the underlying asset, liability, transaction, or event, not the nature of the income or expense itself.

PFRS 18 sets out:

General classification requirements for classifying income and expenses into the:

- operating category
- investing category
- financing category

specific **exemptions** from these general rules for certain income and expenses of entities who have either or both '**specified main business activities**':

- Investing in particular types of assets ('investing in assets')
- providing financing to customers

Specific classification requirements for:

- income and expenses from derecognition of an asset or liability or classification and remeasurement of an asset as held for sale
- foreign exchange gains and losses
- gains and losses on derivatives and designated hedging instruments.

Classification requirements for income taxes and discontinued operations that apply to all entities.

Therefore, **before applying the classification guidance**, an entity must first **assess** whether it has one or both of the two **specified main business activities** set out in the Standard.

Practical insight – Classification in PFRS 18 versus PAS 7 'Statement of Cash Flows'

Although the operating, investing and financing categories may appear familiar, they do not correspond to the similarly named activities in the statement of cash flows in accordance with PAS 7. PFRS 18 prioritises the objectives of the statement of profit or loss rather than consistency with the statement of cash flows.

Example – Property, plant and equipment (PPE):

Cash outflow for PPE purchase → cash flows from investing activities in the statement of cash flows

Income/expenses from PPE → operating category in statement of profit or loss.

However, once PFRS 18 is applied, the classification of dividends and interest received, as well as interest paid, in the statement of cash flows must align with the PFRS 18 classification of the related income and expenses in the statement of profit or loss.

Specified main business activities

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 PFRS 18 that have classification exceptions.

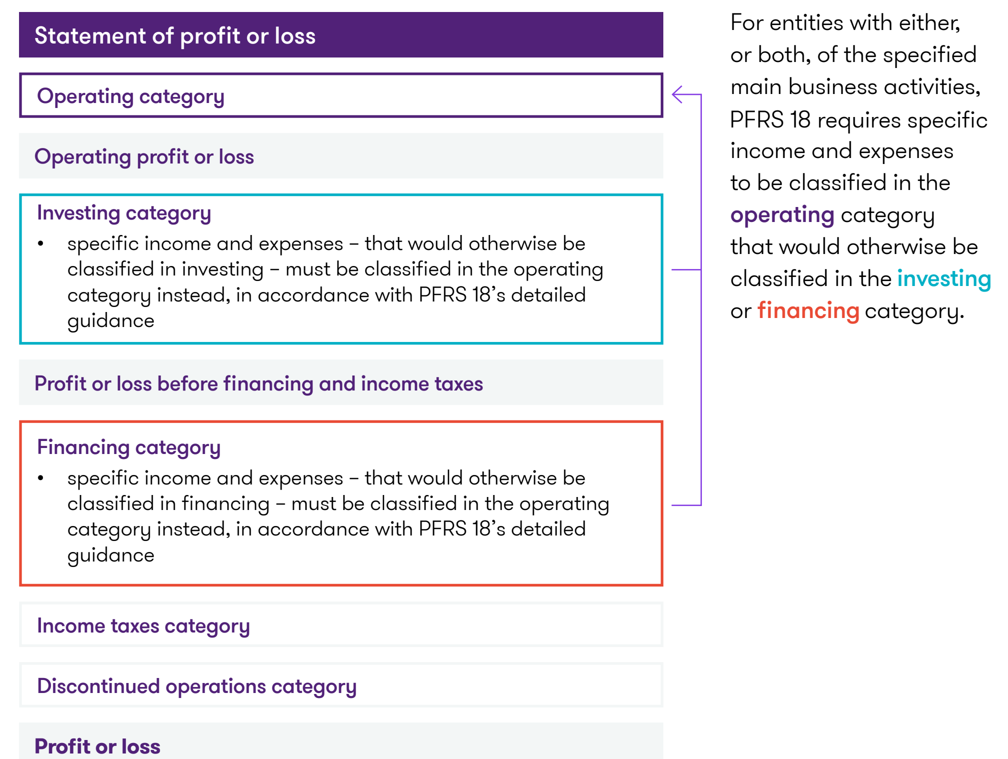
- **Investing in assets** – ie investing in either or both of the following particular types of assets:
  - associates, joint ventures or unconsolidated subsidiaries which are not accounted for using the equity method
  - assets specified by PFRS 18 which generate a return individually and largely independently of the entity's other resources

  Examples of entities that might invest in assets as a main business activity include:
  - investment entities
  - investment property companies, and
  - insurers.

- **Providing financing to customers**

  Examples of entities that might provide financing to customers as a main business activity include:
  - banks and other lending institutions
  - entities that provide financing to customers to enable those customers to buy the entity's products, and
  - lessors that provide financing to customers in finance leases.

If an entity has one, or both of these main business activities, then PFRS 18 requires specific income and expenses that would otherwise be classified as investing or financing, to be included in the operating category instead.



For entities with either, or both, of the specified main business activities, PFRS 18 requires specific income and expenses to be classified in the **operating** category that would otherwise be classified in the **investing** or **financing** category.

Assessment of whether an entity has a specified main business activity

The assessment of whether an entity has either or both of these main business activities should be performed for the reporting entity as a whole. This assessment may require significant judgement as this is not merely an assertion, but rather must be based on:

- **Evidence, in accordance with PFRS 18's detailed application guidance.**
  - In general, investing in assets or providing financing to customers is likely to be a main business activity of a reporting entity if the reporting entity uses a subtotal similar to gross profit that includes income and expenses that would otherwise be classified in the investing or financing categories as an important indicator of operating performance. When these subtotals are used to explain operating performance externally or to assess or monitor operating performance internally, this may indicate that investing in assets or providing financing to customers is a main business activity of the entity.
  - For entities applying PFRS 8 'Operating Segments':
    - If a **reportable segment** comprises **a single business activity**, this indicates that that business activity is a main business activity.
    - If an **operating segment** (that is not a reportable segment) comprises a **single business activity**, and the performance of that segment is used as an **important indicator of the entity's operating performance**, this indicates that that business activity is a main business activity.
  - The assessment of whether the reporting entity invests in assets as a main business activity is either performed on an individual asset basis or using groups of assets with shared characteristics.
- **Facts at the time of any given reporting date.**
  If facts and circumstances change, and the conclusion of the assessment changes, the change in classification of income and expenses is applied prospectively from the date of the change, and prior periods are not restated.

Practical insight – Assessment of main business activities is performed at the reporting entity level

As the assessment of whether an entity has one or both of the main business activities is done for the reporting entity as a whole, the conclusions reached at an individual entity level might be different from the conclusions reached for the group as a whole.

Example 1 – Separate accounts of a non-trading parent entity

A non-trading parent entity (that is not an investment entity) holds multiple trading subsidiaries in the telecommunications sector. The parent entity's activities are limited to acquiring, managing, and selling subsidiaries in line with the group's business strategy. The subsidiaries are accounted for at cost in the parent's separate financial statements. The parent does not provide segmental analysis to shareholders, or use any subtotals to explain its operating performance in relation to its separate financial statements.

Analysis

This question was discussed by the IFRS Interpretations Committee (IFRIC) in their November 2025 meeting. They discussed the fact pattern and concluded the following:

When preparing the parent entity's separate accounts, management concludes that the parent entity has a main business activity of investing in unconsolidated subsidiaries, on the basis the parent has no substantive activity other than holding and managing these assets.

The assessment of whether an entity has a specified main business activity must be based on the objective evidence at the reporting entity level, irrespective of whether they conclude that the consolidated group as a whole has one of the main business activities specified in the standard for the purposes of preparing the consolidated financial statements. In the example given, the parent does not provide shareholders with segmental information or use any subtotals to explain its operating performance, and therefore these examples of factors to consider in assessing whether there is a specified main business activity do not apply. The absence of these factors does not imply that the parents only substantive activity is not its main business activity.

Entities that have either, or both, of the two main business activities specified by PFRS 18, must classify specific income and expenses that would otherwise be classified in the investing or financing category in the operating category. PFRS 18 contains detailed guidance on which income and expenses can or must be classified as operating for these entities.

Classification in the operating, financing and investing categories

Classification in the operating category

The operating category in accordance with PFRS 18 effectively functions as a 'residual' or **'default' category**.

It includes all income and expenses that **do not meet the criteria to be classified in one of the other categories,** even if these are volatile or non-recurring.

An entity classifies income and expenses from its **main business activities** in the operating category of the statement of profit or loss, except for any such income and expenses from investments accounted for using the equity method.

However, income and expenses will only be classified in the operating category:

- if they do not meet the requirements for classification in the investing, financing, income taxes or discontinued operations categories, or
- if they are **specifically required to be classified in the operating** category.

Practical insight – Interest income on trade receivable and contract assets

When a contract with a customer contains a significant financing component, and payment is due from the customer after the entity performs under the contract, interest income will accrue on trade receivables or contract assets.

Trade receivables and contract assets arise from the production or supply of goods and services, and therefore do not generate a return individually and largely independently of the entity's other resources. An entity therefore cannot have a main business activity of investing in trade receivables or contract assets.

Interest income on these balances will therefore always be classified in the operating category.

Practical insight – Income from government grants

PFRS 18 does not give guidance on the classification of income related to government grants. The classification of the grant income may depend on whether the entity has an accounting policy under PAS 20 'Accounting for Government Grants and Disclosure of Government Assistance' of presenting the grant income netted against the related expenses in the statement of profit or loss, or presenting grant income gross in the statement of profit or loss, in a different line item from the related expense.

Where the entity adopts an accounting policy of netting grant income against the related expense, the classification of the income will follow the expense.

However, when an entity adopts an accounting policy of presenting grant income gross under PAS 20, grant income would normally not meet the criteria to be classified in the investing category, as it generally would not arise from an asset that generates largely independent returns. In addition, as grant income is not income from a liability that arises from a transaction that involves only the raising of finance (Type 1 liability), it generally would not meet the criteria to be classified as financing. Therefore, where grant income is presented gross, it would usually be classified in the default operating category.

In the absence of guidance in PFRS 18, this is an area to watch as practice develops.

Practical insight – Subsequent remeasurement of contingent consideration in relation to an equity accounted associate

As explained in the flow chart on page 9, PFRS 18 sets out specific items of income and expenses in relation to an equity accounted investment, which must be classified in the investing category.

This means that the income generated by equity accounted investments, the income and expenses that arise from the initial and subsequent measurement of those investments, including on derecognition of the assets; and the incremental expenses directly attributable to the acquisition and disposal of the investments – for example, transaction costs and costs to sell the investments are classified in the investing category. However, the Standard does not give specific guidance on the classification of subsequent movements in the value of contingent consideration related to the acquisition.

Example 2 – Gain or loss on remeasurement of contingent consideration

Entity A acquires an associate for a combination of cash and contingent consideration to be paid in cash. Entity A recognised the initial fair value of the contingent consideration in the initial cost of the associate, equity accounts for the associate, and accounts for subsequent changes in the fair value of the contingent consideration through profit or loss.

Analysis

It is not clear that income and expenses arising from the subsequent remeasurement of the contingent consideration arise on the initial or subsequent measurement of the investment in the associate or are an incremental expense of acquiring the investment. It is therefore not clear that it meets the criteria to be classified as investing. In addition, as the liability is a Type 2 liability (see **Classification in the financing category section** on page 10), and the fair value movements are not interest or income and expenses arising from changes in interest rates, they do not meet the criteria for classification as financing. Therefore, in our view it would be acceptable for Entity A to classify these movements in the default operating category.

We note that there is a potential alternative view that as the contingent consideration relates to the acquisition of the associate and the remeasurement of the contingent consideration reflects the performance of the associate, the remeasurement gains and losses should be classified in the investing category. This is an area where practice is still developing, and therefore it is not yet certain whether common practice will develop to allow classification in the investing category as an acceptable alternative to classification in the operating category.

Classification in the investing category

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

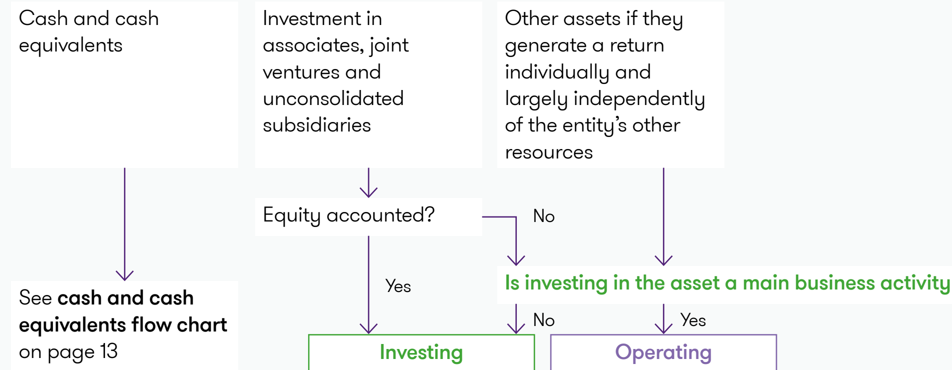
Asset type	Description
Investments in associates and joint ventures	This includes: • investments accounted for using the equity method • investments that an entity has elected to measure at fair value through profit or loss • investments in separate financial statements which are accounted for at cost.
Investments in unconsolidated subsidiaries	Similar to investments in associates and joint ventures, this includes: • investments in unconsolidated subsidiaries accounted for using the equity method in separate financial statements • investments in unconsolidated subsidiaries held by an investment entity at fair value through profit or loss • investments in unconsolidated subsidiaries accounted for at cost in separate financial statements.
Cash and cash equivalents	Note – this is another area of misalignment between PFRS 18 and PAS 7 – the 'definition' of cash equivalents in PAS 7 specifically states that cash equivalents are held to meet short-term cash commitments and **not** for investment or other purposes.
Other assets that generate a return individually and largely independently of the entity's other resources	• Assets that typically meet this definition include debt and 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 from the derecognition or classification and remeasurement as held for sale. • Assets that typically do not meet this definition include PPE, assets that arise from providing goods or services and loans to customers when 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 and impairment of PPE.

However, exceptions exist for entities that invest as a main business activity in associates, joint ventures and unconsolidated subsidiaries that are not accounted for under the equity method, or other assets that generate a return individually and largely independently of the entity's other resources. More detail on these exception can be found in the **flowchart** on page 9 and the explanatory box accompanying it.

In addition, further guidance is given on the classification of income and expenses from cash and cash equivalents for entities with one of the two specified main business activities. This is discussed further in our '**Detailed application guidance in IFRS 18**' section on page 13.

Classification of the following income and expenses from investing in specified assets:

- Income generated by the assets
- Income and expenses from measurement (including on derecognition) of the assets
- Incremental expenses directly attributable to acquisition and disposal of the assets



Based on Figure 3.1 from PFRS 18 illustrative examples

Exception for entities investing in 'specified assets' as a main business activity

As shown in the flowchart above, there is an exception to the classification requirements set out above, which applies when an entity invests, as a **main business activity**, in the specific assets PFRS 18 describes, namely, investments in associates, joint ventures and unconsolidated subsidiaries that are **not** accounted for under the equity method, or other assets that generate a return individually and largely independently of the entity's other resources. For example, an investment property entity invests in a portfolio of investment properties as a main business activity as set out in PFRS 18. Income and expenses related to those investment property assets and activities would be included in the operating category, instead of in the investing category.

Practical insight – Income and expenses of a lessor – rental income from an operating lease of PPE

When a lessor leases an item of PPE to a lessee under an operating lease, the classification of the associated rental income will depend on whether the PPE generates a return individually and largely independently of the entity's other resources.

PFRS 18 lists PPE that an entity uses in combination to produce or supply goods or services as an example of an asset that would not generate independent cash flows (and therefore related income and expenses would be classified as operating). However, when PPE is leased to generate rental income rather than used in the entities own operations, it may be possible to conclude that it generates a return individually and largely independently of the entity's other resources. If management conclude that this is the case, rental income would be classified as investing rather than operating.

Exception for an entity that invests in **these** assets as a **main business activity**:

If the entity invests in this type of asset as a main business activity, rental income would be classified in the operating category.

Practical insight – Income and expenses of a lessor – finance income on the net investment in a lease for a finance lessor

Under PFRS 16 'Leases', a finance lessor recognises finance income on the net investment in the lease.

As the net investment in the lease is an asset that generates a return individually and largely independently of the entity's other resources, the finance income generated by that asset will be classified in the investing category.

Exception for an entity that invests in these assets as a **main business activity**:

If the entity invests in net investments in leases as a main business activity, the finance income would be classified in the operating category.

Classification in the financing category

The financing category generally contains income and expenses arising from liabilities, however, PFRS 18 contains detailed requirements and application guidance for entities to determine which income and expenses must be included in this category.

PFRS 18 sets general principles for classifying income and expenses relating to liabilities. It distinguishes 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. There are exceptions to these general principles and additional guidance for:

- hybrid contracts comprising host liabilities and embedded derivatives
- derivatives and designated hedging instruments
- issued investment contracts with participation features under PFRS 9
- insurance contracts when applying PFRS 17, and
- entities providing financing to customers as a main business activity.

General principles for income and expenses relating to liabilities:
The classification of income and expenses relating to liabilities depends on the nature of the liability. PFRS 18 divides liabilities up into two classes, which are commonly referred to as Type 1 and Type 2 liabilities:

Type 1 liabilities

Liabilities that arise from transactions that involve only the raising of finance

An entity:
- receives finance in the form of cash, the entity's own equity instruments, or extinguishment of a financial liability, and in return
- will pay cash or its own equity instruments in the future.

For example:
- corporate bonds
- bank loans
- mortgages

The purpose is solely the raising of finance for an entity's operating and investing activities.

Income and expenses from those liabilities are classified in the financing category.

Type 2 liabilities

Liabilities that arise from transactions that do not involve only the raising of finance

For example:
- trade payables
- contract liabilities
- pension liabilities
- lease liabilities
- litigation provisions

Mixed purpose – contribute to an operating (or investing) activity and provide finance to an entity

Some **income and expenses** that are **financing in nature** from these liabilities are classified in the financing category.

Liabilities that arise from transactions that involve only the raising of finance (Type 1 liabilities)
Income and expenses from such transactions must be classified in the financing category. PFRS 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 the 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 or dividends on issued shares.

Liabilities that arise from transactions that do not involve only the raising of finance (Type 2 liabilities)
These can include items such as payables for goods or services, lease liabilities, contract liabilities recognised under PFRS 15 'Revenue from Contracts with Customers', defined benefit pension scheme liabilities, decommissioning or asset restoration, provisions and litigation provisions.

For these liabilities, **only interest** income and expenses **and income and expenses arising from changes in interest rates** are included in the financing category.

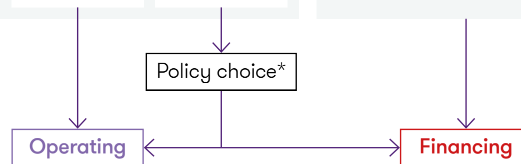
Other items of income and expenses must be included in one or more of the **other categories**, for example, the current and past service cost arising from a defined benefit pension scheme must be classified in the operating category.

Exception for entities providing financing to customers as a main business activity

As with the investing category, there is an exception to the general principles set out above, for entities that provide **financing to customers** as a main business activity.

Classification of specific income and expenses by entities that provide financing to customers as a main business activity

Cash and cash equivalents	Liabilities that arise from transactions involving only the raising of finance (Type 1)	Other liabilities (Type 2)
• Income generated • Income and expenses from measurement (including on derecognition) • Incremental expenses directly attributable to acquisition and disposal See **cash and cash equivalents flow chart** on page 13	• Income and expenses from measurement (including on derecognition) • Incremental expenses directly attributable to the issue and extinguishment of the liabilities related to providing financing to customers** / not related to providing financing to customers**	• Interest income and expenses • Income and expenses arising from changes in interest rates



Based on Figure 3.2 from the IASB's PFRS 18 supporting materials

* Accounting policy choice must be consistent (where applicable) with that made for the classification of income and expenses from cash and cash equivalents – see **cash and cash equivalents flow chart** on page 13

** If the entity cannot distinguish which of the liabilities that arise from transactions involving only the raising of finance relate to providing financing to customers, income and expenses from all such liabilities are classified in the operating category.

Practical insight – It may not always be clear if a liability is a Type 1 or Type 2 liability

PFRS 18 sets out examples of liabilities that arise from transactions that involve only the raising of finance (Type 1 liabilities), including loans, bonds and mortgages. PFRS 18 explains that in these transactions an entity receives finance in the form of cash, extinguishment of a financial liability, or receipt of its own equity instruments, and at a later date returns cash or its own equity instruments.

Where the reporting entity itself draws down financing from a lender, such as obtaining a loan from a bank or a mortgage from a mortgage lender, it is usually clear that this is a Type 1 liability. However, PFRS 18 does not give specific guidance on a situation where the reporting entity acquires an obligation as part of a business combination or asset acquisition. We have set out our current thinking in the examples below – however, this is an area to watch as practice develops.

Example 3 – Type 1 liabilities acquired on a business combination or as part of an asset purchase

During the reporting period, Entity B completes a business combination in which it acquires Entity C. Assume that PFRS 3 'Business Combinations' has been correctly applied in accounting for the acquisition. As part of the net assets and liabilities acquired, Entity B recognises a bank loan originally entered into by Entity C. Assume that Entity B does not have a main business activity of providing financing to customers.

Analysis

When a reporting entity acquires a liability – such as a loan or mortgage – indirectly, as part of the assets and liabilities acquired on a business combination or by purchasing a property with an existing mortgage, it is less clear whether this arises from a transaction that involves only the raising of finance. This is because the reporting entity obtains the liability as part of a transaction (such as a business combination) that does not involve only the raising of finance, and the reporting entity was not the entity that received cash, extinguishment of a financial liability or own equity instruments on origination.

In our view, when determining whether an obligation is a liability arising from a transaction that involves only the raising of finance, 'arising' should be interpreted as meaning on the point of origination. Using this approach, where the reporting entity acquires a loan or mortgage as part of a business combination or asset acquisition, and the liability would have met the definition of a Type 1 liability on origination, it would be appropriate for the reporting entity to classify them as Type 1 liabilities.

Assuming that the bank loan met the definition of a Type 1 liability on origination, Entity B would also classify it as a Type 1 liability, and subsequent gains or losses related to the loan would be classified in the financing category.

Example 4 – Type 2 liabilities acquired in a business combination or as part of an asset purchase

Entity D completes a business combination in which it acquires Entity E. Entity E has an existing lease for its office building, and the resulting lease liability is recognised by Entity D following the business combination.

Analysis

Entity D does not consider the fact that the liability was acquired in a business combination and instead considers the nature of the underlying liability. At lease inception, the acquiree (Entity E) received a right-of-use asset rather than finance in the form of cash, extinguishment of a liability or receipt of its own equity instruments. Therefore, the acquirer (Entity D) accounts for the lease as a Type 2 liability.

Only interest income and expenses, and income and expense arising from changes in interest rate for this liability are classified in the financing category by Entity D. All other income and expense related to the lease is classified in the operating category.

Example 5 – Deferred consideration on an asset acquisition

Entity F acquires an asset and agrees to deferred payment terms with the seller. The deferred consideration is recognised as a financial liability measured at fair value on the acquisition date.

Analysis

Although Entity F could have alternatively arranged financing with a bank, the deferred consideration does not meet the definition of a Type 1 liability as Entity F does not receive finance in cash, extinguishment of a financial liability or receipt of its own equity instruments. Therefore, in our view it should be treated as a Type 2 liability.

If there is any interest agreed in the deferred payment terms, interest income or expense and income and expense arising from changes in interest rates are classified by Entity F in the financing category. All other income and expense related to the deferred consideration is classified in the operating category.

Detailed application guidance in PFRS 18

In addition to the general guidance on classification discussed above, PFRS 18 contains detailed application guidance on a number of areas. Key areas where specific application guidance is given are discussed below:

Cash and cash equivalents

An entity does not need to assess whether it invests in cash and cash equivalents as a main business activity. However, 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 specified in PFRS 18, and if so, which one.

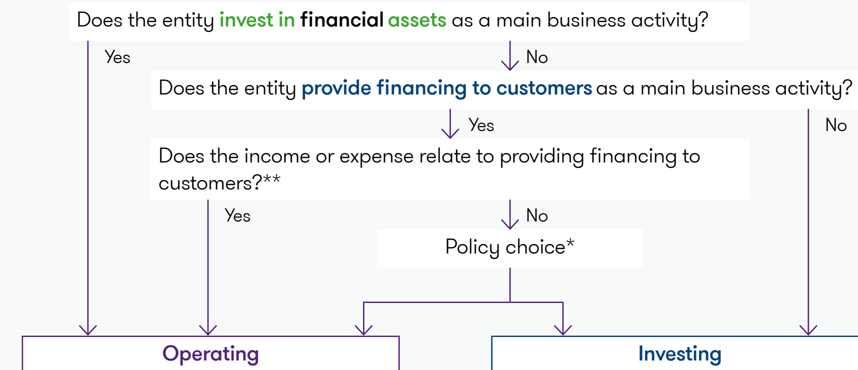
Generally, an entity will classify income and expenses relating to cash and cash equivalents in the **investing category**.

However, when an entity **invests in financial assets** (other than investments in associates, joint ventures and unconsolidated subsidiaries, and cash and cash equivalents) as a main business activity it will classify income and expenses on **all** cash and cash equivalents in the operating category.

When an entity **provides financing to customers** as a main business activity, and the income and expenses from cash and cash equivalents **relate to providing financing to customers** then the related income and expenses must be classified as operating, otherwise, there is an accounting policy choice to classify the income and expenses either as operating or **investing**.

Classification of the following income and expenses from cash and cash equivalents:

- Income generated
- Income and expenses from measurement (including on derecognition)
- Incremental expenses directly attributable to acquisition and disposal



Based on Figure 3.3 from the IASB's PFRS 18 supporting materials

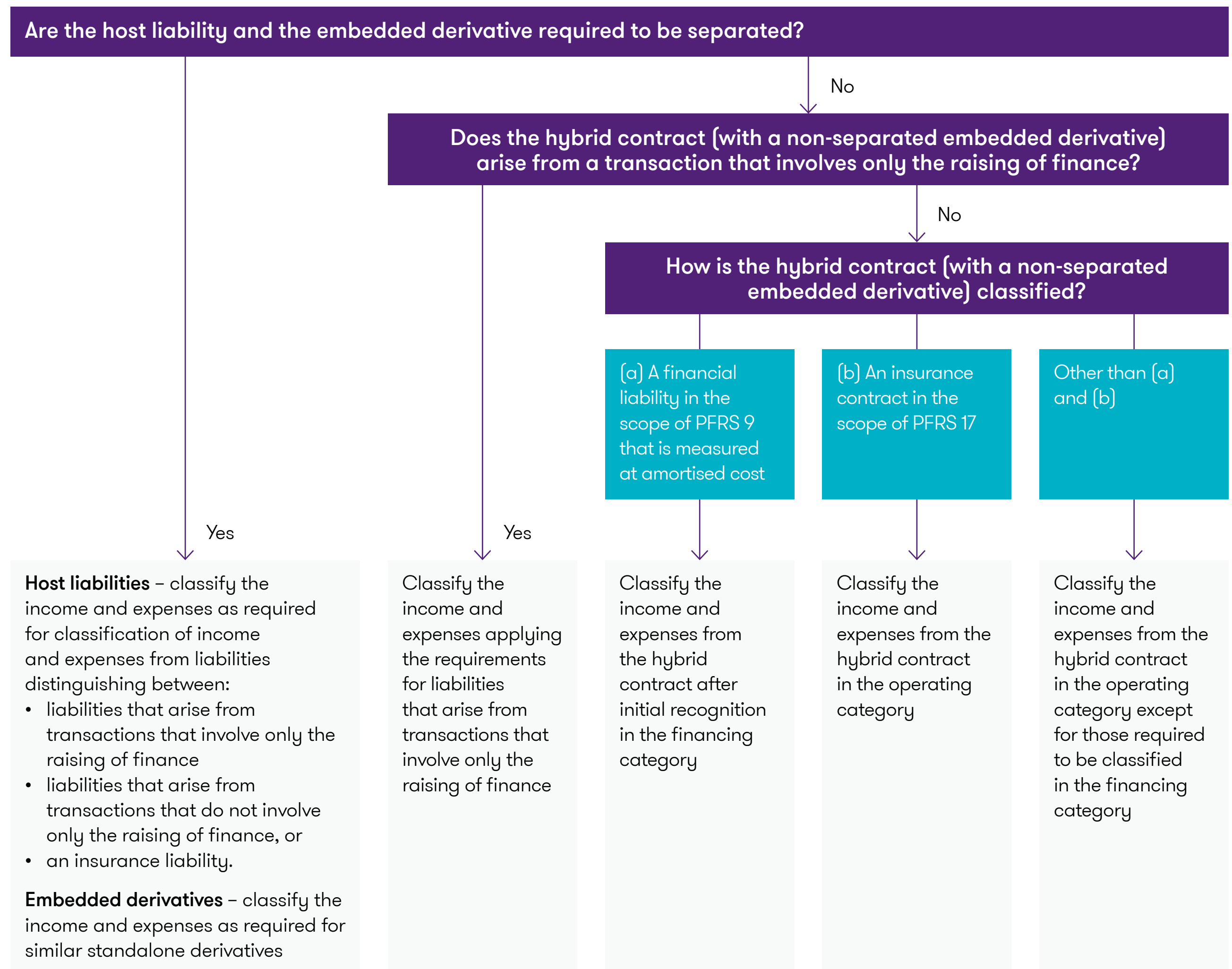
* Accounting policy choice must be consistent (where applicable) with that made for the classification of income and expenses from liabilities that arise from transactions that involve only the raising of finance that do not relate to providing financing to customers – see **Exception for entities providing financing to customers as a main business activity flow chart** on page 11.

** If the entity cannot distinguish which cash and cash equivalents relate to providing financing to customers, income and expenses from all cash and cash equivalents are classified in the operating category.

Hybrid contracts comprising host liabilities and embedded derivatives

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

- If the embedded derivative is separated from the host contract, income and expenses related to the host liability will be treated in line with the general principles for liabilities. Income and expenses relating to the embedded derivative are treated in accordance with **specific guidance for derivatives** (see page 15).
- 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 host contract is in the scope of PFRS 9 or whether the hybrid contract is scoped into PFRS 17. These considerations are set out in the following flowchart, reproduced from Figure 4 of the IASB's PFRS 18 Supporting Materials:



Derivatives and designated hedging instruments

Core Principle

Gains and losses on derivatives must be classified based on the purpose for which the derivative is used

Derivatives used to manage identified risks

If a **derivative is used to manage identified risks** (whether designated as a hedging instrument applying PFRS 9 or not), classify gains and losses on the derivative **in the same category as the income and expenses affected by those risks.**

Example 6 – Derivatives used to manage risks

A derivative is used to manage the risk of price increases for raw materials used in producing goods → the underlying risk is related to expenses in the operating category → the gains and losses from the derivative are classified in the operating category.

A derivative is used to manage the risk of interest rates increasing on bank loans → income and expenses from the loans are included in the financing category → gains and losses recognised on the derivative are classified in the financing category.

Exception to avoid 'grossing up'

If applying this general principle **would lead to** the '**grossing up**' of gains and losses (for example if a derivative is being used to hedge risks affecting items in multiple categories) classify all gains and losses on the derivative in the operating category.

Undue cost and effort exception

If applying the general principle to a derivative that is **not designated as a hedging instrument** applying PFRS 9 would involve undue cost or effort, classify all gains and losses on the derivative in the operating category.

Derivatives not used to manage identified risks

Classification depends on whether the derivative relates to a transaction involving **only the raising of finance**:

- **Relates to a transaction involving only the raising of finance**

  If the entity does not provide financing to customers as a main business activity → classify gains and losses in financing category.

  Exception for an entity that **provides financing to customers** as a main business activity

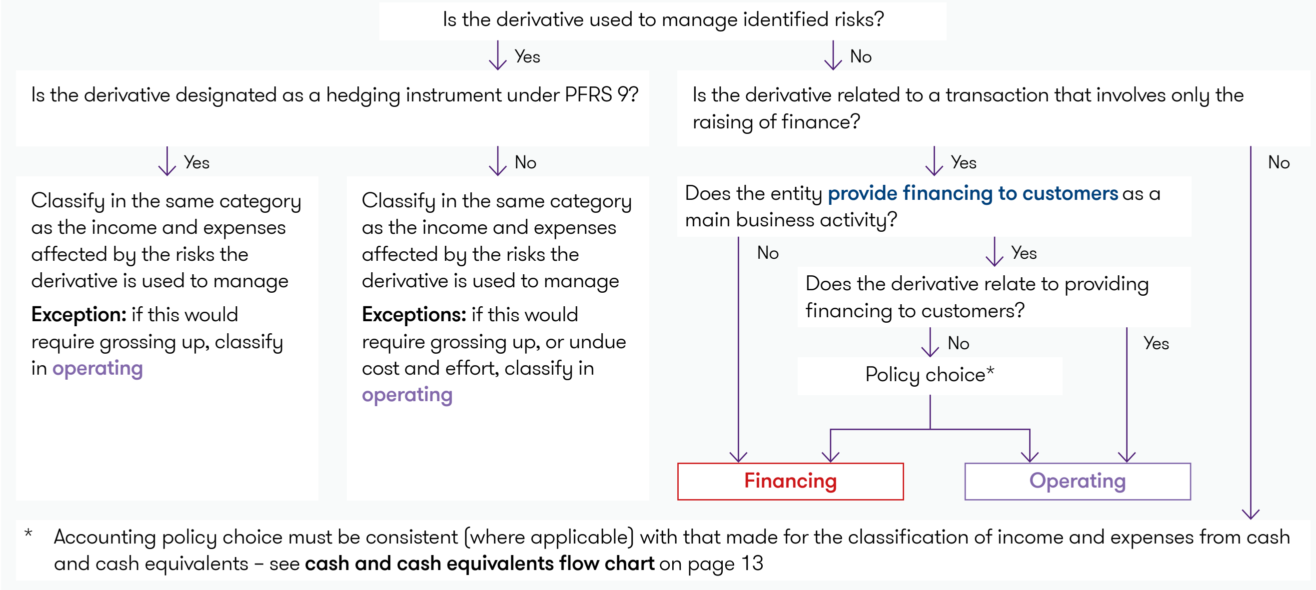
  - If derivative relates to providing financing to customers → classify in operating category.
  - If derivative does **not** relate to providing financing to customers → entity may choose an accounting policy to classify in operating **or** financing category (policy must be applied consistently).

- **Does not relate to a transaction involving only the raising of finance**

  Gains and losses are classified in the operating category.

This is illustrated in the flow chart (right), based on Figure 5 of the IASB's PFRS 18 Supporting Materials:

Classification of gains and losses on derivatives:



* Accounting policy choice must be consistent (where applicable) with that made for the classification of income and expenses from cash and cash equivalents – see **cash and cash equivalents flow chart** on page 13

Issued investment contracts with participation features under PFRS 9

Income and expenses from liabilities arising from issued investment contracts with participation features, which are accounted for in accordance with PFRS 9, are excluded from the financing category and are instead included in the operating category. An example of this type of contract is an investment contract with participation features issued by an investment entity.

Insurance contracts when applying PFRS 17

Insurance finance income and expenses are also included in the operating category, rather than in financing.

Specific requirements for classifying foreign exchange differences

The general requirement for foreign exchange differences which arise from the application of PAS 21 'The Effects of Changes in Foreign Exchange Rates' is that the exchange differences must be classified **in the same category as the income or expenses from the items that gave rise to them**.

Example 7 – Foreign currency denominated receivable

An entity has a receivable denominated in a foreign currency, from the sale of the entity's goods which are classified in the operating category → the foreign exchange differences arising when translating the trade receivable into the functional currency will also be included in the operating category.

There is a relief available from this general requirement. If the assessment would require 'undue cost or effort', an entity may classify affected foreign exchange differences in the operating category.

See our Insights article **'Insights into IFRS 18 – Classification of foreign exchange differences in the statement of profit or loss'** for further details on the requirements for classifying foreign exchange gains and losses.

Classification of income and expenses arising on derecognition of assets and liabilities

PFRS 18 includes detailed application guidance relating to the classification of income and expenses arising on derecognition of assets and liabilities, the classification and remeasurement of an asset when designated as held for sale, and upon a change in use of an asset. When dealing with an individual asset or liability this may be straightforward. The principle of IFRS 18 is that **income and expenses on derecognition or reclassification will be classified in the same category as was required immediately before the derecognition or reclassification**.

However, when dealing with a group of assets, or 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, or a group of assets and liabilities.

Practical insight – Income and expenses of a lessor – profit or loss classification when a lessor enters into a finance lease

When a lessor enters into a finance lease, the lessor derecognises the asset subject to the lease and recognises a finance lease receivable. The classification of any resulting gain or loss (the 'profit on sale') will follow the classification of the income and expenses from the asset immediately before derecognition:

- Finance lease of an asset previously used in combination to produce goods or services (eg PPE) – the lessor's profit on sale will be classified in the operating category
- Finance lease of an asset that previously generated a return individually and largely independently of the entity's other resources (eg an investment property) – the lessor's profit on sale will be classified in the investing category

There is an exception for a lessor that invests in assets (eg investment property) subject to lease as a **main business activity**:

If the entity invests in this type of asset as a main business activity, profit on sale would be classified in the operating category.

How we can help

We hope you find the information in this article helpful in giving you insights into aspects of PFRS 18 If you would like to discuss any of the points raised, please contact and visit https://www.grantthornton.com.ph/Contact/.

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