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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**11 March 2008, London**
Project:	**ED Annual Improvements Project—Comment Analysis**
Subject:	**IAS 20 Government Loans with a below-market rate of interest (Agenda paper 8A, question 19)**

BACKGROUND

1. IAS 20.37 states:

   'Loans at nil or low interest rates are a form of government assistance, but the benefit is not quantified by the imputation of interest.'

2. The Board noted that the requirement to not impute interest on government loans with nil or low interest is inconsistent with the requirements of IAS 39. The Board therefore proposed that IAS 20 be amended to require interest to be imputed on government loans with nil or low interest rates.

3. This paper sets out a summary of the comments received in response to this proposal along with the staff's recommendations as to how the Board should respond to those comments.

STAFF RECOMMENDATION

4. The staff recommends that the Board finalise the proposal it published in the Annual Improvements ED. In making this recommendation, the staff proposes that the wording for paragraph 10A in the ED be changed to clarify how the

benefit of below-market rate loans should be computed and accounted for (as described in paragraph 23 below).

SUMMARY OF COMMENTS RECEIVED

5. Of the 75 letters received, 32 specifically commented on this issue. 3 objected to the Board's proposals. Whilst the overwhelming majority supported the proposals in the ED, a number also had specific comments. These comments are discussed further below.

6. Many commentators believed that the application of IAS 39 to government loans may present practical difficulties. In particular, government loans may include specific terms that are not present in commercial loans:

> *the [respondent] notes the difficulties for determining a benchmark market rate when the borrowings incorporate specific conditions and (or) restrictions to use the funds. [CL19]*

7. Some suggested that IAS 39 should be amended to include an example of how the revised standard should be applied. One argued that all loans outside of the scope of IAS 39 should be required to be measured at fair value[1].

8. One expressed concerns about how the guidance could be applied based on experiences of applying IFRS to public sector entities:

> *...the IASB should consider the practicality of this proposal based on Australia's experience with the application of IAS 39 to the public sector.*
>
> *The nature of loans issued by governments are typically not equivalent to those issued in private markets. Principally, this is because the government usually wants to achieve a policy objective that cannot be done through existing market mechanisms. For example, the loans may be for extended terms, contain flexible or deferred repayment options and / or incorporate non-market features such as government-to-government financing.*

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[1] The staff believes that an amendment to measure all loans outside of the scope of IAS 39 at fair value would be beyond the scope of the annual improvements project. The staff has not therefore considered this comment further.

Given that IAS 39 focuses on the market rate rather than the cost of capital, governments would have to adopt a technique based on a hypothetical market rate that would be determined by:

- *artificially equating the instrument to an instrument in the private sector (which may not satisfy paragraph AG 79 and / or AG 82); or*
- *building up a market rate using the individual elements contained in paragraph AG 82. Note this has produced questionable results as participants perception of the combined package of risks may not equate to the sum of individual risks.*

In the past, both approaches have resulted in considerable subjectivity which creates audit verification difficulties. [CL5]

9. Some questioned the usefulness of the information given by treating government loans in this way when they are given for other than commercial purposes:

We see no tangible benefits or usefulness of this new requirement. In addition, there would be practical difficulties to impute such benefit in the absence of a market for the government loan. Also, most of the time there might not even be a comparable market rate for such loan.

We understand that the imputation of market interest rate may reveal the viability of an entity because of the government subsidised interest rate. However, government loans are normally given to entities with different developmental objectives and are 'non-profit' driven. Government loans are not uncommon in developing economies and are normally granted for specific purposes and for the interests of the country. Hence, to equate such government loans to commercial loans, and requiring the differential in the interest rates to be imputed and recognised as benefits may not represent faithfully the transaction it purports to represent as the objective and characteristics of these two types of loans are substantially different. [CL56]

10. Some questioned the amendment on the basis that the Board appeared to be reviewing IAS 20 on a piecemeal basis instead of through its ongoing project to address the accounting for government grants.

…the Board has had a project on its agenda for a number of years to revise the whole area of accounting for government grants. This project has been deferred until further work is completed on the revenue recognition and liabilities projects. We are therefore concerned with the Board taking a piece-meal approach to amending this inconsistency while not considering the numerous other inconsistencies both within IAS 20 and between IAS 20 and other standards. [CL50]

11. Some observed that the change could be seen as being inconsistent with other parts of IAS 20:

The [respondent] notes that the proposed amendment does not address the benefit a holder would derive from financial guarantee contracts issued by a government for which a below market price is charged. [CL23]

We do not agree with the proposed amendment as we consider it is fundamentally inconsistent with the approach taken in IAS 20. Specifically the proposal is inconsistent with IAS 20.23 which does not require an entity to fair value non-monetary grants received. In addition, it is also inconsistent within IAS 20 if the proposed amendments only apply to "forgivable loans", since these are, in substance, the same as government grants which become repayable if certain conditions are not met. [CL64]

12. One expressed concerns over the wording of the amendment:

We agree in principle with the proposed amendment. However, the proposed wording requires the benefit to be quantified by "the imputation of interest on the loan" and cross refers to IAS 39 Financial Instruments: Recognition and Measurement. *IAS 39 does not use the term "imputation of interest". We recommend that IAS 20.10A is reworded to be more consistent with IAS 39 [CL14]*

STAFF ANALYSIS

Practical Implications

13. Some respondents argued that the change would create practical difficulties. Those difficulties arise because commercial loans do not include the same terms and restrictions as government loans. For example, a government loan may be interest free so long as an entity continues to employ a specific number of employees at one location.

14. The staff believes that determining the correct rate to use to impute the interest charge on a below-market rate loan from a government may be difficult. This is because there may not be commercial loan instruments in existence that include the terms and conditions inherent in a government loan. However, the staff does not believe that this means that it will be impossible to determine such a rate by, for example, considering the rate on a commercial loan and adjusting to take into account the specific conditions attached to the government loan.

15. The staff notes that any computation of a notional interest rate will be supported by disclosure of 'the nature and extent' of the government grant as required by IAS 20.39.

16. The staff does not therefore believe that the practical difficulties outweigh the benefits of applying a consistent approach in this area.

17. The staff considered whether including an example in IAS 39 would be helpful. The staff notes that, to be useful, such an example would need to demonstrate how the effective interest rate could be determined for a government loan. Developing such an example that would be helpful to all situations without developing lengthy detailed application guidance may be extremely difficult. The staff does not therefore propose creating such an example.

Relevance of information

18. Some commentators questioned the relevance of information on how much interest would have been charged on a below-market rate government loan if it were granted on an arms length commercial basis. In contrast, some commentators believed that an imputed interest charge on a below-market rate loan would show the users of the financial statements whether the entity is only

making profit because of government support. It may alert investors to entities that would not be viable were it not for the support of government.

19. The staff believes that the benefit of a nil interest rate loan is that the government pays the interest on behalf of the entity. If no interest is imputed, the value of this benefit will not be shown. The staff therefore concludes that imputing interest on below-market rate government loans does have a value to users of financial statements.

Piecemeal changes to IAS 20

20. Some observers cautioned that the amendment could be seen as instigating a piecemeal approach to amending IAS 20 in advance of the Board's project to address the accounting for government grants. In addition, the amendment does not address the accounting for other forms of low-interest government assistance, for example, government guarantees.

21. The staff notes that the Board's project to address the accounting for government grants is currently on hold. The change proposed by the annual improvements project is a minor improvement of a specific item. It is not intended to commence a piecemeal review of the entire standard. Neither is it intended to address all of the inconsistencies between IAS 20 and IAS 39 (or other IFRSs).

22. Whilst the staff agrees with constituents that a piecemeal approach to government grant accounting is unlikely to succeed and that there are still inconsistencies in the accounting for other items in IAS 20, the staff does not believe that these are reasons not to make the proposed amendment.

Drafting comments

23. One commentator argued that IAS 39 does not refer to 'imputation of interest'. The commentator proposed that paragraph 10A of the draft amendment should be changed so not to refer to imputation of interest and proposed the following wording:

The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with IAS 39 Financial Instruments: Recognition and Measurement. *The benefit of the below-market rate of interest shall be measured as the difference between* *the initial carrying value of the loan determined in accordance with IAS 39 and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate. [CL14]*

24. In considering this wording, the staff considered how the Board's proposed change was intended to be applied to the accounting for a below-market rate government loan. The staff considered an example in which an entity received an interest free loan of CU 100 from a government. The loan was repayable 1 year later. In order to qualify for the interest free loan, the entity had to continue to employ 100 staff in a deprived area.

25. The staff believes that the Board's intention in developing the amendment was that the entity would first recognise and measure the loan payable in accordance with IAS 39. This would require the loan to be measured initially at fair value. The entity would therefore recognise a payable of CU 90 (CU 100 discounted to current value). The entity would then recognise the benefit of the below-market rate loan which would be measured as the difference between the initial carrying value of the loan (CU 90) and the cash received (CU 100).

26. During the year, the loan would be measured using IAS 39. At the end of the year, it would be valued at CU 100. The difference of CU 10 would be recognised as an interest charge in the income statement for the year. The benefit of CU 10 would be accounted for in accordance with IAS 20.

27. In the staff's view, the wording proposed in the comment letter reflects this treatment. Furthermore, it does so without introducing the term 'imputation of interest'. It also describes how an entity would measure the benefit of the loan which the wording in paragraph 10A of the ED did not. Because the revised wording better describes the proposed accounting treatment without introducing new terms, the staff recommends that it replace the wording in the ED.

CONCLUSIONS AND RECOMMENDATION TO THE BOARD

28. The staff agrees with the majority of the respondents that the proposed change should be pursued as part of the annual improvements process. In recommending this change, the staff proposes that the wording in paragraph 10A of the ED be replaced with the wording in paragraph 23 above.