Government Grant Accounting: IAS 20 Implementation Issues

The purpose of this paper is to discuss practical issues related to government grant accounting under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* relevant to developing economies. The paper is based on real life examples. Each government grant has unique features; in presenting the scenarios here we have tried not to give every possible detail but to include only the main features relevant to the discussion of the technical issues behind different types of government grants.

The financial crisis has significantly increased the need for assistance to be provided by governments and central banks to national economies. The volume of such assistance has in the recent years grown very much. From what we've encountered in practice, the most common types of government financial assistance take the form of zero- or low-interest rate loans, or subsidizing interest on loans, either directly to end recipients or through banks and specialised government agencies. In a high interest rate environment access to low-interest finance is a significant benefit. That may be an explanation why most of the scenarios described below involve low-interest loans or compensation of interest.

This paper does not include an analysis of the requirements of IAS 20 or of the deficiencies thereof. The conceptual issues with the standard, such as the standard being at variance with the Conceptual Framework and with newer standards, too much diversity allowed and lack of clear guidance, are outlined in a separate paper. The purpose of this paper is primarily to bring up practical implementation issues for discussion; some of them however arise directly from some of the conceptual issues.

The scenarios are grouped based on the main underlying technical issues as well as by the type of a government grant. Each part of the paper starts with a general technical discussion of the respective issue followed by description of relevant practical cases. That description elaborates on and illustrates the technical issues; these are often easier to illustrate by way of an example than by a general discussion. Some of the scenarios relate to end recipients of the government grants, and some – to intermediaries, i.e. banks or government agencies, through which grants are provided to end recipients. Many of such intermediaries prepare IFRS financial statements, and we find that technical issues of government grant accounting may often be more complicated for them than for the end recipients.

Issue 1. Identifying related costs that the benefit of a government loan at a below-market interest rate compensates

1a. Can this benefit compensate interest costs?

In accordance with para. 10A of IAS 20:

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.*

A question frequently arises, what exactly should be considered the *"costs for which the benefit of the loan is intended to compensate"*. In some cases the relevant costs are easy to identify. For example, if the purpose of the below-market rate loan is to finance the cost of acquisition or construction of a depreciable item of property, plant and equipment, it is reasonable to conclude that the grant relates to that asset and the benefit would be recognised in profit or loss *over the periods and in the proportions in which depreciation expense* on that asset is recognised (para. 17 of IAS 20).

In many cases however loans at a below-market rate of interest do not relate to a particular asset and are given with a purpose to provide immediate financial support to the entity with no future related costs. In these cases often two different views are expressed:

- In accordance with para. 20 of IAS 20, the benefit of such loans is to be recognised in profit or loss immediately when the loan is received; or
- The benefit of the loan is intended to compensate finance costs, i.e. the interest expenses on the loan. Therefore, the benefit should be recognised in profit or loss over the time of the loan to compensate the difference between the contractual rate of interest and the EIR calculated at the inception of the loan.

We believe that the first view is clearly more supportable, both because it follows the specific requirement of the standard and because the second view seems to be contrary to the intention of the IASB when last amending the IAS 20.

The second view is somewhat "circular": if a loan would be considered to "compensate its own interest costs" the result would be that the interest expense in profit or loss, net of the government grant income, would be equal to the contractual rate of interest, i.e. the only effect of the government grant accounting would be to negate the profit or loss effect of accounting for the below-market rate loan under IAS 39 (or IFRS 9 *Financial Instruments*). This would effectively comprise an exception to IAS 39 (IFRS 9) accounting for loans, which would be contrary to the IASB's intention: amendments introduced to IAS 20 in May 2008 as part of the *Improvements to IFRSs* were aimed at confirming applicability of IAS 39 to below-market rate government loans by including para. 10A and deleting para. 37, which had been in conflict with IAS 39.

Nevertheless, we've seen diversity in practice and, while the first view is used in the majority of cases, sometimes below-market rate loans from the government are effectively carried at their contractual amounts using the logic of the second view above.

Scenario 1.1. Immediate financial support to a company in financial difficulties.

Government provides a loan of CU 100 million at 2% for three years to support a company in financial difficulties. The company has suffered significant losses and its loan applications have been recently rejected by several banks; it has decided to ask for government support. The company employs a significant number of people and the government considers it important for the company to keep operating to avoid unemployment growth.

The benefit of the low-interest rate loan should be accounted for as a government grant in accordance with para. 10A of IAS 20. While the company does not have recent borrowings, to determine the benefit of the grant the applicable discount rate could be estimated e.g. on the basis of the quoted prices for the company's public debt, or from inputs such as risk-free rate and risk premium based on the company's credit rating.

The company considers that there are no future related costs. Further, while the government is concerned about unemployment, there are no specific obligations in the loan agreement for the company to maintain a certain level of employment; accordingly, the loan can be considered to have the purpose of providing immediate financial support to the company. In accordance with para. 20 of IAS 20, the company recognises the full benefit of the government grant in profit or loss immediately.

Scenario 1.2. Loan to support a bank bailout.

Bank A, a financially sound institution, has agreed to acquire Bank B, which has suffered severe losses and needed to be bailed out. To assist Bank A with restructuring and financial rehabilitation of Bank B, government provides to Bank A a below-market rate loan at 1% for three years.

The government and the central bank approved a three-year program for financial rehabilitation of Bank B. This program includes a number of targets that must be met, including gradual bringing the levels of capital adequacy, non-performing loans and liquidity of Bank B to normal levels. If such targets are not met, Bank A will be obliged to immediately repay the government loan.

The benefit of the below-market rate government loan meets the definition of a government grant, as it is given to Bank A in return for future compliance with certain conditions relating to the operations of Bank B, which has become a subsidiary of Bank A. The question would be on what basis Bank A should recognise this benefit in profit or loss.

First, while the grant has been received, it depends on certain conditions. In accordance with para. 8 of IAS 20, *"receipt of the grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled"*; a grant may not be recognised until there is reasonable assurance that the conditions of the grant will be fulfilled. If the conditions are relatively straightforward and easy to meet (e.g. it is sufficient for Bank A to make a capital injection into Bank B to meet the conditions), the grant can be recognised.

If there is no reasonable assurance that the conditions will be met, the grant cannot be recognised until they are met. A question is whether in this case the grant can be recognised gradually as some of the conditions are met; apparently this is not something that would be allowed by pp. 7 and 8 of IAS 20.

Another argument that Bank A may put forward though is that the benefit of a below-market rate loan is used up as time passes; if, for example, Bank A has to return the loan after one year because the targets have not been met, by that time it would have already used the benefit for one year, and by returning the loan it only gives up the benefit of financing at a below-market rate for two of the three years of the loan. While there's no explicit guidance in IAS 20 on this, such an argument appears to be reasonable; therefore there may still be a case for gradual recognition of that part of the benefit of a below-market loan that the Company would no longer be obliged to give up.

The conditions of the grant do not explicitly specify that Bank A needs to incur certain costs[1]; further, the grant is given with a purpose to provide immediate financial support to Bank A. Therefore, as soon as the grant, or part of it as discussed above, can be recognised, it would appear that para. 20 would require immediate recognition of the government grant income.

Questions for discussion – Issue 1a

Question 1
For a government loan at a below-market rate of interest that does not relate to a particular asset and has the purpose of providing immediate financial support to the entity with no future related costs, do you believe that the benefit should be: a) recognised in profit or loss immediately when the loan is received; or b) recognised in profit or loss over the time of the loan to compensate the difference between the contractual rate of interest and the EIR calculated at the inception of the loan?

[1] Strictly, there may be some costs involved e.g. costs of restructuring of Bank B: termination benefits etc. If these are significant, Bank A would need to estimate which part of the grant compensates for those costs and should therefore be recognised in the same periods as the related costs.

Question 2
For a government loan at a below-market rate of interest that is provided subject to the entity meeting certain conditions, do you believe that, insofar as there are no future related costs, the benefit: a) should be recognised in profit or loss when there's reasonable assurance that the conditions would be met, or b) can be recognised in profit or loss gradually as the benefit is used up with passage of time?

1b. Bank or government agency acting as an intermediary in providing below-market rate loans

The question of matching government grant income with related costs often arises in situations where a government program for providing below-market rate loans to a certain industry (e.g. agriculture), type of companies (e.g. small and medium businesses) or individuals is effected through one or more intermediaries. Typically, such lending is done through a government agency, a specialised bank, or a number of banks selected by the government based on certain criteria. Such an agency or a bank often prepare IFRS financial statements, and need to match grant income with related costs in line with para. 12 of IAS 20.

Sometimes an argument is made that, for the bank/agency, the whole program is "at market rate" and both the financing received from the government and the loans granted to end recipients should be recognised at the amounts received/given without any fair value adjustment. This argument, although relatively common, is flawed because the unit of account under IAS 39 (or IFRS 9) is a financial instrument, i.e. normally each contract, which per para. 43 of IAS 39 (para. 5.1.1 of IFRS 9) should be initially measured at fair value adjusted for transaction costs. The loans granted and the loans received are separate contracts and their counterparties are different. Therefore, they should be considered on an individual basis, which means that for of each of them the initial carrying amount would differ from the respective amount given/received.

Next, what is being compensated here by the government to the bank/agency is the difference between the market rate of interest and the rate at which the bank/agency grants the loans to the end recipients. In practice questions often arise as to how exactly should the benefit of the grant be recognised in profit or loss; in accordance with para. 12 of IAS 20 it should be recognised over the period when the related expenses are recognised. The intermediary recognises the expense for the below-market loans granted to end recipients, based on para. AG64 of IAS 39 (para. B5.1.1 of IFRS 9), at inception, equal to the difference between their initial carrying amount and the amount given. Therefore, recognition of the benefit in profit or loss should also occur at inception of the respective loan.

The question of how exactly should the benefit be allocated is illustrated in the below example. The example also illustrates some related questions, including how repayment of a below-market rate government loan should be treated, as well as how changes in estimates of future cash flows under that loan should be dealt with. For the latter questions, which may be relevant not only for an intermediary but also for an end recipient, IAS 20 does not provide enough guidance.

Scenario 1.3. Long-term loan to an intermediary to finance shorter-term loans

Bank C participates in a government program of providing preferential loans to small and medium businesses. On 1 January 2012 it has received a loan from a government agency in the amount of CU 100 million bearing annual interest at a below-market rate of 2% and repayable on 31 December 2027.

The Bank has to utilise funds received, i.e. issue the loans qualifying under the program terms, within one year from the date of receipt; it should repay to the agency any unutilised funds at the end of the one-year period. The Bank bears the credit risk on the qualifying loans.

The loans to small and medium businesses qualifying under the program have a term of 5 years repayable at maturity and bear interest at 6%. The market rate for the comparable loans, used by the Bank to estimate the fair value of the loans granted to customers, is 12%. To the extent these loans are repaid to the Bank, the Bank has to provide new qualifying loans or return the unused amount to the government agency.

To determine the fair value of its loan payable to the government agency at inception, the Bank has used a discount rate of 10% based on the government bonds yield curve and the Bank's own risk premium. When determining the fair value on 1 January 2012, the Bank estimated that it would be able to meet all the program requirements, and would repay the full principal at maturity, i.e. on 31 December 2027. For simplicity we will assume there are no transaction costs. On the above basis, the initial carrying amount of the government loan was determined to be CU 39 million. Therefore, the benefit of the government grant determined in accordance with para. 10A of IAS 20 is CU 61 million.

The question is then how should this benefit be recognised in profit or loss. To determine that, the Bank would need to estimate the related costs, i.e. the difference between the initial carrying amount of the qualifying loans and the amount given. At 1 January 2012 the Bank has estimated that, if it would have issued CU 100 million of qualifying loans in 2012, their initial carrying amount would have been CU 82 million, and therefore the Bank’s expenses recognised in accordance with para. AG64 of IAS 39 would have been CU 18 million.

The CU 18 million is not the full amount of the related costs, as the Bank also expects to provide new qualifying loans as the original loans get repaid. Assuming no prepayments, the Bank also expects to issue CU 100 million of qualifying 5-year loans in 2017 and another CU 100 million in 2022. Making another assumption that the interest rates would not change, the Bank expects that it would recognise further expenses of CU 18 million in each of those years. The total estimate of the related costs is therefore CU 54 million.

The excess of the government grant benefit over the estimate of the related costs arises due to a number of factors such as the difference between the terms of the loan received and the loans provided and the difference in the extent to which each of them is below market. IAS 20 is not clear about how such an excess should be treated; para. 20 of IAS 20 is only applicable to the situations where there are no future related costs or where the purpose of the grant is to provide immediate financial support to the entity, none of which is the case here.

A possible approach could be to defer this excess within deferred government grant income indefinitely and recognise it in profit or loss if the actual related costs exceed the original estimate, or when there remain no future related costs. Another possible approach, which may seem to be more systematic, would be to recognise it in profit or loss proportionately to the related costs. The latter approach would require periodic re-estimation of the amount of future related costs.

In this scenario, Bank C selected the first approach.

As at 1 January 2012, the Bank has recognised the loan received from the government at its fair value of CU 39 million. The difference was recognised as deferred government grant income within liabilities (all entries in CU millions):

Dr Cash	100	
Cr. Loans payable to government	39	
Cr. Deferred government grant income		61

During 2012, the Bank issued CU 80 million of qualifying loans with the initial carrying amount of CU 66 million. Accordingly, it has recognised an expense of CU 14 million:

Dr Loans to customers	66	
Dr Other expenses (P&L)	14	
Cr Cash		80

At the same time, Bank C recognised government grant income in the amount equal to the related costs. In accordance with the Bank's accounting policy, as allowed by pp. 29 and 31 of IAS 20, government grant income is recognised by reducing the related expense.

Dr Deferred government grant income	14	
Cr Other expenses (P&L)		14

By 31 December 2012 the Bank issued only CU 80 million of qualifying loans and returned the remaining CU 20 million to the government agency. The carrying amount of the loan payable at that time, after interest payment, was CU 41 million. The next question is how should the difference between the carrying amount of the part repaid (rounded to CU 8 million) and the amount repaid be treated.

In accordance with para. 41 of IAS 39 (para. 3.3.3 of IFRS 9) such a difference should be recognised in profit or loss. However in substance this difference largely represents a repayment of a government grant, which, in accordance with para. 32 of IAS 20, *"shall be applied first against any unamortised deferred credit recognised in respect of the grant"*.

There is unfortunately no explicit guidance on this in IAS 20, so one could argue that the only standard that is applicable is IAS 39 (IFRS 9). This may be formally right but would lead to accounting that does not well reflect the economic reality. Another approach however would be to say that part of the cash repaid represents – in accordance with its economic substance – repayment of a government grant, and therefore para. 32 of IAS 20 is applicable to that part of the payment[2].

In this example the latter approach is followed. The Bank makes the following entry:

Dr Loan payable to government	8	
Dr Deferred government grant income	12	
Cr Cash		20

The Bank also revised the estimates of future cash flows on the remaining part of the loan payable in accordance with para. AG8 of IAS 39 (para. B.5.4.6 of IFRS 9). It now expects that it may not be able to replace all qualifying loans as they are repaid, and would therefore have to return part of the principal before maturity. The revised carrying amount of the loan, calculated using the original effective interest rate of 10%, is CU 39 million. A question, similar to the one above, arises whether this difference of CU 6 million (= CU 39 million less the carrying amount of the remaining part of the loan before the adjustment, CU 33 million) should be recognised in profit or loss or whether it should be treated as an adjustment to the deferred government grant income.

[2] To be more precise, the part representing repayment of the grant should be calculated as the difference between the *fair value* of the repaid part of the loan and the amount repaid. In this example we assume that this fair value equals the carrying amount of the repaid part.

Unlike the previous question however, there's no actual cash repayment, only a change in the estimate of future cash repayments. Therefore, it is harder to make the same argument as above. Nevertheless, there is still the "substance" argument: the changes in the estimates of future cash flows mean that the Bank would be receiving a different amount of benefit from the below-market loan, and it would therefore be appropriate to adjust the amount of the deferred government grant income.

In this example however we assume that the change in the estimate is recognised in profit or loss in accordance with para. AG8 of IAS 39 (para. B.5.4.6 of IFRS 9):

Dr. Other expenses (P&L)	6	
Cr. Loan payable to government		6

The remaining deferred government grant income is CU 35 million, in accordance with the method chosen by Bank C, is to be matched with the related costs when they arise, and any remaining amount is to be recognised in profit or loss once there are no future related costs, i.e. when the Bank expects to issue no more loans under the program.

Questions for discussion – Issue 1b

Question 3

Where an intermediary receives a below-market rate loan from the government and, in turn, provides a below-market rate loan to the end recipient (the intermediary bearing the credit risk on the latter), do you believe that:

a) both the loan received and the loan given should be initially recognised at their fair value adjusted for any transaction costs, or
b) the whole arrangement can be considered to be "at market rate" from the point of view of the intermediary, and accordingly no fair value adjustments on initial recognition would be needed?

Question 4
This question assumes the first approach is selected in Question 3. If, for the intermediary, the benefit of a below-market rate loan received from the government exceeds the estimated total expense from providing loans to end recipients at a below-market rate, do you believe that such an excess should be: a) recognised in profit or loss on a proportionate basis together with the related costs, b) deferred until there remain no future related costs, or c) recognised in profit or loss immediately?

Question 5
What guidance, in your view, should apply to early repayment of a below-market rate government loan: a) only the guidance of extinguishment of financial liabilities in IAS 39 (IFRS 9), or b) the above guidance should be considered together with the guidance on repayment of government grants in IAS 20?

Question 6
How should changes in estimates of future cash flows under a below-market rate government loan be treated: a) they should be recognised in profit or loss in accordance with para. AG8 of IAS 39 (para. B5.4.6 of IFRS 9), or b) they should first adjust any deferred credit recognised in respect of the grant?

Issue 2. Do government-financed loans constitute a separate market?

A common issue is whether low-interest rate loans provided by the government under a particular program should, in fact, be considered to be below market rate. This question typically arises in situations where, apart from these government loans, there are no other available sources of similar financing (e.g. financing for a similarly long period) for the borrowers covered by the program. In such situations, it is often argued that such government loans comprise a separate market and the interest rate on them should not be compared to interest rates on other instruments existing in the country's financial markets.

While this issue may be seen as falling under the scope IFRS 13 *Fair Value Measurements,* it is specific to government grants and therefore we believe it would be appropriate to discuss it in the context of government grants.

The proponents of the "separate market" point of view argue that, even if the interest rate on such government loans is significantly below the average level of interest rates on commercial or retail loans in the country, or even below the yields on government debt, the above government loans are still considered to be issued at market rates, i.e. the rates prevailing in their "separate market" niche.

Their opponents argue that in absence of comparable loans market interest rate should be modelled based on available inputs such as e.g. government debt yield curve, country risk premium, borrower risk premium determined based on other existing financial instruments of these or similar borrowers, etc. In other words, even though there may be different segments in the financial market, they are interrelated and market interest rates need to take into account the overall level of interest rates in the country.

Clearly each government financing program is different and there are more factors than those given above to be taken into account in determining whether there exists, in fact, a separate market for a particular type of government-financed loans. Some of the scenarios are analysed below.

Scenario 2.1. No separate market

Government supports agricultural enterprises by providing to them long-term (15-20 years) low-interest rate loans through a specialised government-owned bank. Agricultural enterprises do not have any other sources of long-term finance other than through this program. The loans under the program are provided at 2-4%, which is significantly lower than the interest rates on corporate loans in the country and is lower than the government debt yield.

The question is can the loans provided under the program be considered to constitute a separate market, and be therefore considered to be "at market rate"? In other words, in determining the fair value of these loans at initial recognition as required by para. 43 of IAS 39 (para. 5.1.1 of IFRS 9), can an entity disregard the overall level of interest rates in the country and determine that the fair value of the long-term loans equals the transaction price?

Strictly speaking, each loan is a different asset (or liability, from the borrower's point of view), therefore there's no "market" as such. It is common however to speak about a market in loans where, even though each loan is an individual asset, there are a number of similar lending transactions between lenders and borrowers which make it possible to estimate the rate at which a particular lending transaction could occur. When using information from such a market for valuation, in accordance with para. 22 of IFRS 13 one needs to look at the assumptions made by market participants.

Let's consider who could be "market participants" in this case. While the specialised bank and the borrowers could be considered to be independent from each other and knowledgeable, the bank would arguably not be a "willing participant" as it would be compelled by the government to provide loans at a certain rate. The bank acts as an instrument of government policy.

There is only one lender, and it is not motivated by market considerations and therefore may not be considered a "market participant" as defined in IFRS 13. For this reason, the rates of lending under the government program would not be considered "market rates" or rates in an orderly transaction between market participants. It cannot therefore be presumed that the transaction price equals fair value for these loans.

The fair value of the loans may be determined based on valuation techniques that could involve estimating a risk-free interest rate for a comparable period taking into account e.g. government debt yields, or international benchmark rates and a premium for the particular country risk and for the currency difference, and a borrower's risk premium.

Scenario 2.2. Separate market

Government program for support of small and medium businesses operates as follows: government offers loans at 2%, which is below the local interbank borrowing rate, to local banks under a condition that banks will issue the same amount as loans to small and medium businesses, satisfying certain conditions, at 7%, which is below the average market lending rate for corporate loans. The difference between 7% and 2% is considered to be a normal margin for this type of lending, reflecting the risk profile of the loans to such businesses. The banks bear all the credit risk on the loans.

Government lending is available under this program, on the same conditions, to all banks operating in the country; consequently, the majority of loans to small and medium businesses in the country are issued under this program. The loans can be transferred between banks; the selling bank would have to repay government loans and the purchasing bank would be entitled to government loans at the same conditions.

While some of the considerations in Scenario 2.1 above hold for this scenario as well, the difference is that there are a number of market participants, who are motivated by market considerations. Any sale transaction between these market participants, provided the loans are performing, would likely be priced without discount or premium, as both the seller and the buyer would primarily look at the margin rather than at the interest rate on the loans by themselves. Therefore, it can be argued that there is indeed a market niche which is separate from the rest of the corporate lending market in the country.

Question for discussion – Issue 2

Question 7
Do you believe that, in certain situations, it may be possible to consider loans provided under a government program as a "separate market" and therefore consider the loans to be at market rates? If yes, under what circumstances, in your view, would that be possible?

Issue 3. Companies where government is a shareholder: government grant vs. equity contribution

When an entity where government is a shareholder receives resources from the government in the form of a transfer of assets or a below-market rate government loan, one of the questions is whether the benefit of the loan represents, in substance, a government grant or an equity contribution.

While government participation in the ownership of the entity is outside the scope of IAS 20 (para. 2(c)), transactions between a government and a government-owned entity not related to ownership participation may fall within the scope of IAS 20. It is reasonable to interpret this scope exception as excluding transactions with the government in its capacity as the entity's owner.

In the case of the government providing resources to an entity with government participation, it can sometimes be difficult to judge whether the government acts in the capacity of an owner or in its capacity as government – in fact, it often acts in both capacities. We need to understand therefore whether we can identify criteria that could be used to distinguish between the two possibilities (government grant vs. equity contribution). First of all, we can look at the definition of a government grant:

> *Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity* <…> (para. 3 of IAS 20)

Based on this, a distinction between a government grant and an equity contribution could be whether the transfer of resources bears conditions relating to the operating activities of the entity. In other words, if government provides resources subject to operating conditions, the benefit would satisfy the definition of a government grant. However this wouldn't suffice as a criterion.

First of all, if the benefit has the form of a below-market rate loan, it would typically contain conditions such as financial or non-financial covenants; some of those may relate to the entity's operations. Therefore the above criterion would be almost always met. It is easy however to enhance the criterion and say that the conditions must not be of a protective nature typical for loan covenants.

The second difficulty is that, per the definition, a government grant may envisage not only future but also past compliance with certain conditions. It may be difficult to ascertain in practice whether the entity having met those conditions in the past was, in fact, the reason why the government has thereafter transferred resources to it. This could be an area potentially open to manipulations, as the distinction between a transfer without any operational conditions and a transfer in return for compliance with past conditions – given that such conditions can be formulated very broadly – may be rather formal.

SIC-10 *Government Assistance—No Specific Relation to Operating Activities* confirms that operating conditions for a government grant can indeed be very broad. It clarifies that a transaction may meet the definition of a government grant "*even if there are no conditions specifically relating to the operating activities of the entity other than the requirement to operate in certain regions or industry sectors"* (para. 3 of SIC-10).

The definition of a government grant by itself, therefore, is not sufficient for distinguishing between a government grant and an equity contribution. To support the preparers' judgement in this area, we suggest to additionally consider whether the purpose of the government was to benefit the economy in general, or a particular sector of the economy, which would be consistent with a government grant, or whether it was to provide financial assistance to the particular company, which may point to an equity contribution. The latter could also be a government grant though, as mentioned in para. 20 of IAS 20; in this case the judgement as to the purpose of the transfer is more difficult, as further illustrated in the examples below.

Additionally, if the benefit was provided under a program in which both government-owned and non-government-owned companies participated under similar conditions, this would be a strong indicator that the benefit represents a government grant.

Scenario 3.1. Government loan to a company with government participation

Company D, a large manufacturer, 30% of shares of which are owned by the government, received an interest-free government loan repayable in two years. There are no operating conditions attached to this loan. The company has suffered recent losses, and the government considers it strategically important to support this company to strengthen the competitive position of local manufacturers.

We should first consider whether the government acts in its capacity as a shareholder or in its capacity as the government. In practice it is difficult to separate the two, however one can argue that, as a shareholder, its concern is primarily about the financial performance and capitalisation of the company; providing an interest-free loan while other shareholders don't do the same goes against government's interest as a shareholder. Therefore, the purpose of the loan must have been to support the company in the capacity of government.

If the other shareholders would have simultaneously provided similar loans or other support to the company, this would be an indicator that the government acted in the capacity of a shareholder.

If the government in this situation would have been a 100% owner of the company, the judgement would have been more difficult. In such a case the company should analyse in detail the purpose for providing this particular loan, e.g. whether it is provided in the context of wider economic policy actions of the government, or whether the primary considerations behind the loan related only to the company's own financial indicators, e.g. the need to boost the company's equity.

Scenario 3.2. Transfer of assets to a government-owned company

A 100% government-owned company received a plot of land from the government free of charge (not as a capital contribution, i.e. the company didn't issue any new shares to the government). The land is to be used for construction of a recreational facility that the company would later operate. Construction and operation of such recreational facilities under a government program aimed at improvement of public health is the primary purpose of the company.

Similarly to the previous scenario, we should consider whether the government acts in its capacity as owner or in its capacity as the government. Here, it is more difficult to distinguish between a government grant and an equity contribution as the main purpose of the company is to facilitate a government program, i.e. the company largely acts as an arm of the government. Even an equity contribution would be aimed at meeting government policy goals.

In this situation, we could see arguments for either approach. While the definition of a government grant is met – the resources are received from the government in exchange for meeting certain operating conditions, i.e. construction of the recreational facility – the same result would be achieved if the government contributed this land into the company's share capital. The increase in assets resulting from a contribution from the owner, based on the definitions of the elements of financial statements in the Conceptual Framework, would be considered as an increase in equity. On balance though, it would seem that the specific requirements of IAS 20 would prevail over the general principles of the Conceptual Framework.

Scenario 3.3. Government-owned intermediary providing subsidised loans

Company F, a government-owned entity specialising on providing financial support to agricultural businesses, obtains below market rate loans from government. These loans bear zero interest. The proceeds from these loans are used to provide low-interest rate (4%) loans to customers that operate in the agricultural industry. The loans payable to the government are matched with loans provided to customers in terms of maturity and structure. In addition, the list of individual borrowers is preapproved by the government.

To apply the considerations above to this situation, first of all we should note that the Company receives government loans on condition that it will, in turn, provide low-interest loans to agricultural businesses. Therefore, there is indeed a condition relating to the Company's operating activity, and the transaction satisfies the definition of a government grant in IAS 20. Further, the purpose of the arrangement is for the government to provide support to the agricultural industry, rather than to support Company F itself. The transaction therefore appears to be a government grant from the point of view of Company F.

To illustrate accounting by Company F, let's consider the following example. On 1 January 2015 the Company has received a zero-interest government loan of CU 500 thousand repayable on 31 December 2024, and on the same date it has provided a 10-year loan in the same amount to an agricultural producer at 4%. To determine the fair value of the government loan, it uses yield on government bonds with the respective maturity, which comprises 7%, as it considers it to be a proxy to the Company's risk: as the Company is government-owned and effectively acts as a government vehicle, it expects that the government will stand by it and therefore its debt carries no premium over the government debt. To determine the fair value of the loans given to customers, the Company uses a discount rate of 12%, which is the weighted average market rate on loans provided by banks to agricultural companies in the country. For simplicity let's assume there are no transaction costs.

As at 1 January 2015, the Company recognises a loan to the customer with an initial carrying amount of CU 274 thousand, which represents its fair value:

Dr Loans to customers	274	
Dr Other expenses (P&L)	226	
Cr Cash		500

On the same date, the Company recognises the loan received from the government at its fair value of CU 254 thousand:

Dr Cash	500	
Cr. Loans payable to government		254
Cr. Other expenses (P&L)		226
Cr. Government grant income (P&L)		20

In this example, like in Scenario 1.3, government grant benefit exceeded the related costs. However, unlike that scenario, here the Company has already fulfilled the operating condition for the grant by providing the customer loan, and there are no future related costs. Therefore, it is appropriate for the Company to recognise the excess benefit in profit or loss immediately.

Like in Scenario 1.3, the Company's accounting policy, as allowed by para. 29 and 31 of IAS 20, is to recognise the government grant benefit as a reduction of the related expenses. The excess benefit can only be recognised as income.

Question for discussion – Issue 3

Question 8
Do you believe that a transfer of resources by the government to a government-owned entity can, in certain cases, be treated as a government grant under IAS 20? If yes, what criteria would you propose to distinguish between situations where such a transfer represents a government grant and those where it represents an equity contribution?

Issue 4. Compensation of interest

Another common form of a government grant is compensation of interest. For the government, it has the benefit of not requiring a significant outflow of cash compared with providing below-market loans. These programs vary significantly, however the most typical ones we've seen involve the government selecting a number of qualifying banks, who are entitled to receive interest compensation on the loans that satisfy certain criteria, e.g. being provided to a particular industry, having a certain credit quality, and bearing an interest not higher than a certain below-market rate.

Usually, the government's obligations to compensate the interest are not contractual but are rather established by a law or a government decree. A government acts within the budget approved by the legislative body; therefore often a feature of such programs is their limited time frame, or at least lack of assurance that the program would be continued after the end of the budget cycle. Therefore, a bank participating in such a program is not always certain whether it will receive compensation of interest for the full term of the loan, which means that the loan contracts sometimes include interest step-up clauses conditional on the government program being continued.

The most significant accounting issue here is the period and the manner of recognition of the benefit of the government grant in profit or loss. If the government does not have a contractual obligation, the lender cannot recognise a financial asset being a receivable from the government. At the same time, it recognises the expense for the below-market loan at the time of inception based on para. AG64 of IAS 39 (para. B5.1.1 of IFRS 9). In this case, the question is whether, to ensure recognition of government grant income in the same period as the related expense, it can recognise a non-financial asset for the compensation it expects to recover from the government, and if yes, in what amount (cash flows for what future periods can be included, discounted or not).

For the end recipient, two situations may arise: that it receives the compensation directly, or that the compensation is paid to its lender. In the latter case, the accounting by the recipient is straightforward as it only has to account for the below-market rate loan contract. The benefit of the grant would be determined based on para. 10A of IAS 20, and its recognition in profit or loss would depend on what costs are compensated.

Scenario 4.1. Compensation of interest to the borrower.

In accordance with a government program to subsidize one of the industry sectors, manufacturers in that sector are entitled to a subsidy compensating interest expense related to loans borrowed for investment or innovation purposes. Government compensates 75% of the loan interest rate, but in each given year the amount of compensation is limited by the amount budgeted for that year. Subsidies are provided on a semiannual basis.

Company G is a manufacturer entitled to the subsidy. On 1 January 2012 the Company received a loan from Bank H in the amount of CU 200 million at 12%, which is a market rate. The purpose of the loan as stated in the agreement is investment and innovation. The Company expects to comply with the terms of the program and receive compensation of interest expenses related to the loan.

To qualify for the subsidy, the manufacturer must (for each subsidy, i.e. semiannually) prepare a set of documents and send it to the government; the ministry can reject the application only if the loan proceeds were not spent in line with the guidance in the program, the documents are prepared incorrectly, or if there are not sufficient funds budgeted. The first two conditions depend on actions of the Company itself, and therefore the Company may ensure that they are met. The third condition is outside of control of the Company, and one needs to assess whether there is reasonable assurance that the subsidy will be received. For this example we will assume that the receipt of the subsidy is reasonably certain.

There is no contractual link between the loan and the government program; the loan bears a market rate. The payments under the loan do not depend on the government subsidy. Para. 10A of IAS 20 is therefore not applicable.

Part of the interest expense on the loan is eligible for capitalisation in accordance with IAS 23 *Borrowing Costs*. While there is no guidance on how IAS 20 and IAS 23 should interact, we believe there needs to be no conflict between the two standards. The basic principle of IAS 20 is for the benefit of the government grant to be recognised in the same period as the related expenses; this can be achieved irrespective of whether the related costs are expensed or capitalised. The government grant would need to be analysed into asset-related and income-related parts, depending on where the related costs are recognised.

In each quarter, the Company separates the interest expenses into the part capitalised under IAS 23 and the part expensed as finance costs. At the same time, the Company splits the amount of the subsidy it expects to receive in two parts proportionately to the split between the capitalised and the expensed interest.

The subsidy in respect of the interest that is not capitalised is recognised immediately in profit or loss in accordance with para. 20 of IAS 20, as there are no future related costs. The Company's policy selected in accordance with para. 29 of IAS 20 is to recognise income from income-related grants as a reduction of expenses. The subsidy in respect of the capitalised interest is deducted from the carrying amount of the qualifying asset, in accordance with the Company's policy selected in line with para. 24 of IAS 20.

On 1 January 2012 the Company recognises a loan payable to Bank H:

Dr. Cash	200	
Cr. Long-term loans		200

During the first half of 2012, the Company recognises interest expenses on the loan of CU 12 million. Of this amount, CU 8 million qualified for capitalisation under IAS 23. The company accrued interest on the loan as follows:

Dr. Long-term assets	8	
Dr. Finance costs	4	
Cr. Long-term loans		12

Since the Company is reasonably certain that it would receive interest compensation of CU 9 million, it recognises the government grant partly as a reduction in long-term assets, and partly as a reduction of finance costs.

Dr.Compensation receivable from government	9	
Cr. Long-term assets		6
Cr. Finance costs		3

Scenario 4.2. Compensation of interest on car loans to banks

Government has a program of compensating to banks interest on loans provided to individuals for the purchase of locally produced cars. Bank K was included in the list of participating banks.

To be eligible for government compensation of interest, the loan should satisfy certain conditions; there are thresholds as to the amount, loan to value ratio and the loan term. The interest rate per the loan agreement should represent the Bank's normal rate effective for this type of loan less the compensated interest calculated as 2/3 of a certain benchmark interest rate.

Government undertakes to compensate to the Bank the difference between a market interest rate and the contractual interest rate on these loans. The reimbursement is performed monthly upon submission by the Bank of a report containing the details of loans issued under the program and the total amount of compensation. The application for reimbursement is reviewed within one month and is satisfied provided all the above requirements are met. The Bank believes that there is a high probability that it will receive interest reimbursement for all the performing loans issued in accordance with this program.

While government's obligations under the program are legal rather than contractual, sometimes an argument is made that in the case such as this, where government is obliged to provide compensation on any performing loan satisfying certain thresholds, the Bank can consider the government's obligation effectively being an integral part of the loan agreement and consequently treat the whole contract as being at market rate.

This argument is strengthened if the right to receive compensation from the government is transferrable with the loan. As the list of program participants is extensive and every bank has possibility to apply this program filing application for participation. So the Bank can transfer performing loans issued under this government program with below-market rates to another participant who will continue to receive the compensation from the Government upon transfer of rights on asset. As the right to receive government compensation is transferable with the loans, the selling price would take into account the interest compensation.

A stricter view would be that government compensation of interest should not be treated as part of the loan agreement as the government is not part of the contractual arrangement.

In this case the question is whether the Bank can still recognise compensation receivable from the government. As the probability of receiving government compensation on qualifying performing loans is high, arguably the Bank would be able to recognise a non-financial asset for the compensation receivable during the whole period of the loan.

In this example, a situation is illustrated where the Bank recognises a non-financial asset for the compensation receivable from the government.

The car loans provided by the Bank bear a below-market rate. At inception of a loan the Bank recognises a loss being the difference between the amount of the loan and the present value of future cash flows from the loan discounted using the market interest rate on similar car loans. The difference between the initial carrying amount and the loan principal would be amortised to interest income over the loan period in accordance with IAS 39.

The compensation receivable by the Bank from the government under this support program qualifies as a government grant. In accordance with para. 7 of IAS 20 government grants can be recognised when there is reasonable assurance that entity will comply with conditions attaching to them and that the grants will be received. In our case the Bank and the loans provided under the program comply with all the requirements of the program.

The interest compensation receivable from the government is recognised as a non-financial asset as of the date when the loan is granted. Bank K selected an accounting policy to recognise this asset on the same basis as it would apply to financial assets, i.e. at the present value of the estimated future cash flows. The discount rate on these cash flows would be the same as that on the related loans, since the Bank bears the same credit risk on both (government compensation is subject to the customer performing the required payments). The asset would be then carried at amortised cost in the same way as this is done for financial assets.

Because the related costs are recognised on the same date and there are no future related costs, at the same time the government grant income is recognised in profit or loss based on para. 20 of IAS 20. The amount of government grant income, because of the way the Bank accounts for the amounts receivable from the government, would be expected to equal the related costs.

To illustrate the above: Bank K issued CU 100 million worth of loans qualifying under the program. Their fair value is CU 70 million. The net present value of government compensation receivable over the term of the loans, discounted at the market rate applicable to car loans, is CU 30 million. The Bank's accounting policy for the government grant income is that it is deducted from the related expense. For simplicity we assume there are no transaction costs.

The accounting entries by Bank K would be as follows:

1) Initial recognition of loans granted at a below-market interest rate:

Dr. Loans to customers	70	
Dr. Loss on initial recognition of loans (P&L)	30	
Cr. Cash		100

2) Recognition of compensation receivable from the government and government grant income:

Dr. Other assets	30	
Cr. Loss on initial recognition of loans (P&L)		30

The main point of this example is that it may be difficult for the intermediary in such a program to achieve the objective set in IAS 20 and recognise the government grant income and the related costs in the same period. It is only possible if the intermediary, at inception of the loan, can recognise an asset in respect of the compensation payments for the whole term of the loan, like illustrated in this scenario. If recognition of such an asset for some reason is not possible, the second entry above would not be made, and the government grant income would be recognised in profit or loss later than the related costs.

Scenario 4.3. Trilateral agreement

In 2012, Company M obtained a 10-year loan from Bank N of CU 100 million at a market rate of 10% for construction of a factory. The Company determined that the fair value of the loan equalled the transaction price. The loan was recorded at CU 100 million; there were no transaction costs.

In 2014 the Company entered into a trilateral loan subsidy agreement between the Company, the Bank, and a government agency. In accordance with the subsidy agreement, the government agency took an obligation to compensate part of the interest directly to the Bank in the amount of 6% for the remaining term of the loan; the remaining 4% was to be paid by the Company.

For the Company, signing the trilateral agreement constitutes a substantial modification of the financial liability in accordance with para. 40 and AG62 of IAS 39. Reduction of the interest payment from 10% to 4% leads to a reduction in the net present value of the future cash flows discounted at the original effective interest rate of 10%. Accordingly, at the date of signing the trilateral agreement the previous loan should be derecognised and a new loan should be recognized at fair value.

The market interest rates have increased and in 2014 the market rate for a similar loan would comprise 12%. The fair value of the new financial liability, determined using the market rate in 2014, is CU 60 million. The difference between the previous carrying amount of CU 100 million and the CU 60 million can be analysed as follows: CU 10 million would be attributable to the change in fair value of the original financial liability between 2012 and 2014 (in 2014 it decreased to CU 90 million), and the remaining CU 30 million are attributable to subsidizing the interest rate by the government.

While the new financial liability resulted from the modification of an old one, rather than from receiving a loan in cash, we believe that para. 10A of IAS 20 would be applicable to the difference between the fair values of the old and the new financial liabilities, i.e. the CU 30 million. We again point out here the lack of guidance and clarity on the interaction between IAS 20 and IAS 39, but believe that such an interpretation of para. 10A of IAS 20 would not be a big stretch. The remaining CU 10 million would be recognised in profit or loss in accordance with para. 41 of IAS 39.

The benefit of CU 30 million would constitute an asset-related government grant, as the trilateral agreement specifies that the loan should be used for construction of the factory. There are no other substantial conditions; the factory was in the process of construction in 2014. The Company selected an accounting policy, as allowed by para. 14 of IAS 20, to recognise deferred government grant income on asset-related grants as a separate liability. Accordingly, at the date of signing the trilateral agreement the Company recognised the CU 30 million as a liability (deferred government grant income), which would be subsequently amortized to income statement over the periods and in the proportions in which depreciation expense on the related asset is recognized. On signing the trilateral agreement the Company performed the following accounting entry: Dr. Long-term borrowings 40 Cr. Deferred government grant income 30 Cr. Gain from derecognition of a financial liability 10

Questions for discussion – Issue 4

Question 9
Where government's obligations under the program of compensation of a below-market interest under a loan are legal rather than contractual, do you believe that the recipient of such compensation can consider the government's obligation effectively being an integral part of the loan agreement? If yes, what criteria would you propose for such an approach to be applied?

Question 10
If the entity cannot treat the interest compensation as effectively being part of the loan agreement as per question 9 above, do you believe that it may be appropriate for the entity to recognise an asset in respect of the interest compensation receivable from the government? If yes, what would be the criteria for recognition of this asset, e.g.:

a) it being probable that the entity would meet the conditions associated with the compensation,
b) the respective government expenditure having been included in an approved budget,
c) it being probable that the government program would continue for the periods not covered by the currently approved budget?

Issue 5. Compensation of lease payments or leases at preferential rates

Governments support acquisition of equipment by entities operating in particular industries by either providing leases at low rates, or by compensating lease payments to them. The difference between this and the previous issues is that lease receivables and payables are not covered by IAS 39 or IFRS 9 except for certain aspects such as impairment and derecognition. Therefore, para. 10A of IAS 20 would not be applicable to a lessee.

For the lessee, the government grant would most often be asset-related, the related asset being equipment (under IAS 17 *Leases*) or a right-of-use asset (under IFRS 16 *Leases*). If the lessee receives periodic compensation of lease payments, the accounting issue would be how to match that compensation with the related costs, i.e. the depreciation of the related asset (in line with para. 17 of IAS 20).

One question is whether the lessee can recognise the compensation receivable as an asset (similarly to the discussion in Issue 4) and recognise the corresponding credit (either as a liability or as a deduction from the carrying value of the asset) up front (e.g., at the lease commencement date). If not, then each compensation payment would be recognised on the balance sheet in a different period, which would lead to constant changes in the depreciable amount of the government grant liability or of the net related asset.

If the lessee receives a lease at preferential rates, the accounting is more straightforward, since the initial carrying amount of the leased asset would be based on the present value of the lease payments (which – what's relevant for IAS 17 – would likely be less than the fair value of the equipment). There would be no separate benefit of the government grant to account for; the benefit would be already included in the carrying amount of the related asset.

In some cases, an intermediary (a bank or a leasing company) is involved, which receives below-market rate government loans and provides finance leases to program beneficiaries at low rates. For such an intermediary, para. 10A of IAS 20 would be applicable; however, unlike in the Scenario 3.2, the benefit of the grant would be recognised over the term of the related lease. A lower interest rate implicit in the lease leads to a lower periodic finance lease income, and income from the grant would compensate it, also on a periodic basis.

We believe no separate example is needed to illustrate the issues discussed above.

Question for discussion – Issue 5

Question 11
Similarly to question 10 above, do you believe that it may be appropriate for the entity to recognise an asset in respect of the compensation of lease payments receivable from the government? If yes, what would be the criteria for recognition of this asset, e.g.: a) it being probable that the entity would meet the conditions associated with the compensation, b) the respective government expenditure having been included in an approved budget, c) it being probable that the government program would continue for the periods not covered by the currently approved budget?

Issue 6. Compensation for low rates in rate regulated industries

Sometimes governments provide subsidies to certain industries in the form of lower prices on goods or services of rate-regulated entities e.g. transportation or utilities companies. The government then compensates the lost revenues to the rate-regulated entity. Some of the accounting issues are illustrated in the below example.

Scenario 6.1. Compensation of reduced rates.

Company P is a utilities company; the government has the power to regulate its rates but is obliged to compensate to the Company any difference between the actual rates and the "required" rates. The "required" rates are calculated in line with a methodology developed by a government commission (the "rate regulator"), and are approved by the rate regulator.

The procedure for the payment of compensation is not prescribed in the legislation; in practice the compensation each time requires a government decision. Such decisions are made at irregular intervals, and it is difficult to predict the exact timing of that compensation.

The first question is when the Company can recognise the benefit of the government grant. Para. 7 of IAS 20 includes two conditions for recognition of a government grant: there needs to be reasonable assurance that the entity will comply with the conditions of the grant, and that the grant will be received. Company P complies with the conditions for the grant by providing goods and services at the reduced rates; it needs to make a judgement as to whether there is reasonable assurance that the compensation will be received.

By itself, the irregular timing of the payments would not necessarily preclude recognition of a government grant before a government decision, as long as there is reasonable assurance that the compensation will be received. A history of significant delays in compensation however may call such assurance into doubt. Depending on its judgement on this, the Company would either recognise the compensation in profit or loss at the same time it recognises revenues at reduced rates (recording simultaneously a non-financial receivable from the government), or at the time when a government decision on compensation is made (assuming this decision is made after the goods or services at reduced rates have been provided).

The next question is whether the Company can recognise the compensation in the revenue line. In accordance with para. 29 of IAS 20, the possible ways of recognising government grant income are separately, within “Other income”, or by reducing a related expense. For the government grants compensating reduced revenue, the standard apparently does not allow recognition of government grant income in the same line as the compensated revenue. There thus seems to be an inconsistency in IAS 20 between treatment of grants that compensate costs and those that compensate a reduction in revenues. Since the grant compensates revenues, it would not be appropriate to present government grant income as a reduction in certain expenses e.g. costs of those inputs that are taken into account when calculating the “required revenues”. The only presentation options available to the Company seem to be to present government grant income as a separate line or within “Other income”. Since the grant compensates revenue, it may be appropriate for the Company to present income from it in a separate line next to the revenues line.

Question for discussion – Issue 6

Question 12
Where a government grant compensates a reduction in an entity’s revenues, would you agree that IAS 20 does not allow presentation of the income from the grant in the same line as the related revenues? If yes, would you agree that such presentation should be allowed?