IFRS

# STAFF PAPER

March 2016

## IFRS Interpretations Committee Meeting

| | |
|---|---|
| **Project** | **IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*** |
| Paper topic | Accounting for recoverable cash payments |

CONTACT(S) Jawaid Dossani jdossani@ifrs.org +44 (0)20 7332 2742



## Introduction

1. The IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify how an entity should account for a cash payment received from a government to help the entity finance its research and development project (hereafter referred to as the 'R&D project').

2. The submitter described a transaction in which:

   (a) the government makes a cash payment to an entity during the research phase of a project. The amount of the payment is calculated as a percentage (for example, 60 per cent) of research expenses incurred (hereafter referred to as 'the cash payment').

   (b) at the end of the research phase of the R&D project, if the entity decides not to exploit and commercialise the results from this phase (ie it decides to abandon the project), it does not have to refund the cash payment. Instead, in this case, the entity must transfer the rights attached to the R&D project to the government.

   (c) if the entity decides to exploit and commercialise the results from the research phase of the R&D project, it must repay the cash payment. A portion of the repayment is fixed and is payable over a specified number of years, while another portion is based on a percentage of revenue generated from the commercialisation of the research results.

(d) in cases in which the entity starts exploiting the results but subsequently decides to abandon the R&D project, the entity is exempt from future repayments (but does not receive a refund relating to past repayments), provided that some conditions are met (e.g. formal notification to the government explaining that the decision is based on rational grounds such as a negative development in the economic, technological or legal environment). In such cases, the entity must transfer the rights attached to the R&D project to the government.

(e) in typical scenarios, the cash amount repayable can range from a minimum of 50 per cent (in cases in which the entity exploits the results but the project is not successful or is later abandoned) to a maximum of 200 per cent of the cash payment (in cases in which the project is successful).

3. The submitter questioned whether the entity should account for the cash payment as a liability when received (on the basis that it is a forgivable loan as defined in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*) or in profit or loss when received (on the basis that it is a government grant as defined in IAS 20).

4. The Interpretations Committee discussed this submission at its meeting in November 2015[1]. The Interpretations Committee noted that the entity had obtained financing for its R&D project and the accounting would depend on the specific terms and conditions of the cash payment received. The Interpretations Committee observed that the arrangement described in the submission is a financial liability within the scope of IFRS 9 *Financial Instruments*. Many members of the Interpretations Committee thought that the arrangement also meets the definition of a forgivable loan as defined in IAS 20. The Interpretations Committee observed that judgement would be required in making this assessment and in determining when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

[1] Further information on the background of the submission and staff analysis presented at the Interpretations Committee's meeting in November 2015 can be found in Agenda Paper 7 for that meeting.

5. The Interpretations Committee noted that the requirements in IFRS Standards provide an adequate basis for an entity to determine the accounting for the cash payment received from a government. The Interpretations Committee observed that diversity in practice appeared to be limited on the basis of the feedback it had received from its outreach activities.

6. In the light of existing requirements in IFRS Standards and the feedback received from its outreach activities, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. The Interpretations Committee, therefore, decided to issue a tentative agenda decision outlining its reasons for not adding the issue to its agenda.

7. The purpose of this paper is to provide the Interpretations Committee with an analysis of the comments received on the tentative agenda decision and to ask the Interpretations Committee if it agrees with the staff recommendation to finalise the agenda decision.

## Comment letter summary

8. We received five comment letters, which have been reproduced in Appendix B to this agenda paper.[2]

9. One respondent (Mazars) agrees with the Interpretations Committee's decision not to add this issue to its agenda for the reasons outlined in the tentative agenda decision.

10. Three respondents (Deloitte, PwC and ESMA) also agree with the Interpretations Committee's decision not to add this issue to its agenda. However, these respondents asked the Interpretations Committee to clarify some aspects of the agenda decision and have also provided some drafting suggestions.

11. One respondent (Accounting Standards Committee of Germany) disagrees with the conclusions reached by the Interpretations Committee. In particular, the respondent disagrees with the conclusion that the cash payment is a financial liability. The

[2] The comment letter received from Mazars included comments on several tentative agenda decisions published in the *IFRIC Update* from November 2015. In Appendix B, we have included only the excerpt from the letter that is relevant to this tentative agenda decision.

respondent thinks that the entity does not have an obligation to deliver cash, because fulfilling the conditions for repayment is at the discretion of the entity. Therefore, the respondent is not convinced that the rationale in the agenda decision is appropriate. The respondent thinks that the cash payment would have to meet the definition of a forgivable loan in IAS 20 in order to be recognised as a financial liability.

12. PwC has suggested that the Interpretations Committee should, in the wording of the final agenda decision:

(a) include the basis for its conclusion that the cash payment is a financial liability;

(b) explain that the cash payment could meet the definition of both a forgivable loan and a financial liability. PwC thinks that the wording of the tentative agenda decision implies that it is necessary for an entity to first assess whether the cash payment meets the definition of a financial liability before considering the guidance in IAS 20 to determine whether it is also a forgivable loan; and

(c) remove the reference to limited diversity in practice. PwC states that it has observed diversity in practice in accounting for cash payments similar to those described in the agenda decision. PwC has also noted that there are many different types of arrangements, which may have different structures and objectives that could give rise to different accounting treatments.

13. Deloitte agrees with the conclusions of the Interpretations Committee that the cash payment described is a financial liability and that judgement is required in determining whether the definitions in IAS 20 are met. However, Deloitte does not think that the statement ‘many members of the Interpretations Committee thought that the arrangement also met the definition of a forgivable loan’ is helpful. They think that the agenda decision should only include statements on which the Interpretations Committee as a whole can reach a consensus.

14. ESMA, who is the original submitter of this issue, agrees that the cash payment described gives rise to a financial liability. However, ESMA thinks that the Interpretations Committee should clarify whether an entity takes into account the forgivable character of the cash payment when determining its fair value.

15. We have analysed the concerns raised by the respondents in the following section.

## Staff analysis

### *Is the arrangement described in the submission a financial liability?*

16. We think that the cash payment meets the definition of a financial liability.

17. Paragraph 20 of IAS 32 *Financial Instruments: Presentation* states that (*emphasis added*):

> A financial instrument that does not explicitly establish a contractual obligation to deliver cash or another financial asset may establish an obligation indirectly through its terms and conditions. For example:
>
> (a) a financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. *If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability.*
>
> (b)…..

18. We agree that the entity may have the discretion to abandon the R&D project and avoid a transfer of cash to the government. However, in that case, the entity has an obligation to transfer the rights attached to the R&D project to the government (ie settle a non-financial obligation). Accordingly, we think that the arrangement meets the definition of a financial liability.

19. We agree with PwC's suggestion to include in the final agenda decision the basis for the conclusion that the cash payment meets the definition of a financial liability. We have revised the proposed wording for the agenda decision (as outlined in Appendix A).

### *Determining fair value of the cash payment at initial recognition*

20. ESMA agrees that the arrangement described gives rise to a financial liability. However, ESMA thinks that the Interpretations Committee should clarify whether an entity takes into account the forgivable character of the cash payment when determining the fair value of the cash payment at initial recognition. ESMA notes that the favourability in many of the arrangements is primarily related to the fact that the cash payments are forgivable, while the interest rate charged is a market rate for a non-forgivable loan that is otherwise similar. ESMA has concerns that the interplay between paragraphs 10 and 10A of IAS 20 is not entirely clear.

21. We think the issue raised by ESMA relates to how an entity measures the financial liability at initial recognition. We note that paragraph 5.1.1 of IFRS 9 requires an entity to measure financial liabilities at fair value at initial recognition. IFRS 13 *Fair Value Measurement* contains the principles and requirements for measuring the fair value of a financial liability. We think that the principles and requirements within IFRS 13 provide an adequate basis to enable an entity to make a determination of the fair value of the financial liability.

22. We have amended the proposed wording of the agenda decision as outlined in Appendix A to clarify that the entity accounts for this financial liability applying IFRS 9 (IAS 39 *Financial Instruments: Recognition and Measurement*).

### *Other comments*

23. Deloitte suggests removing the statement 'many members of the Interpretations Committee thought that the arrangement also met the definition of a forgivable loan'. We agree with the respondent's suggestion and rationale and have revised the proposed wording for the agenda decision as outlined in Appendix A to this paper.

24. We think this revision also addresses the concern raised by PwC that the wording of the tentative agenda decision could be read as implying that an entity should first assess whether the cash payment meets the definition of a financial liability in IAS 32 before considering whether it also meets the definition of a forgivable loan in IAS 20.

25. PwC also suggested removing the reference to limited diversity in practice from the agenda decision. On the basis of our outreach (as presented in Agenda Paper 7 for the Interpretations Committee's meeting in November 2015), we noted evidence of some diversity, but a majority of the respondents to our outreach noted that the most common approach in practice is to account for similar cash payments as liabilities. However, we are not opposed to revising the agenda decision to remove this reference.

26. Furthermore, we note that the Interpretations Committee's decision to not take the issue onto its agenda was based mainly on its view that the requirements in IFRS Standards provide an adequate basis for an entity to determine the accounting, rather than the evidence of limited diversity in practice. Consequently, we do not think that removing this reference affects the Interpretations Committee's decision to not take this issue onto its agenda. We have revised the proposed wording for the agenda decision as outlined in Appendix A.

27. We have also made some drafting amendments to the wording of the agenda decision to improve the flow and readability of the agenda decision. These are included in Appendix A.

## Staff recommendation

28. On the basis of our analysis, we recommend confirming the tentative agenda decision as published in the *IFRIC Update* in November 2015 with some proposed drafting amendments. Appendix A of this paper sets out the draft wording for the final agenda decision for the Interpretations Committee's approval.

| Question for the Interpretations Committee |
|---|
| 1. Does the Interpretations Committee agree with the staff recommendation to finalise the agenda decision?<br><br>2. Does the Interpretations Committee have any comments on the proposed wording of the final agenda decision set out in Appendix A to this paper? |

## Appendix A—Finalisation of agenda decision

A1. We propose the following wording for the final agenda decision (new text is underlined and deleted text is struck through)

> **IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*—Accounting for recoverable cash payments**
>
> The Interpretations Committee received a request to clarify ~~whether~~ the accounting for a cash payment~~s~~ ~~made by~~ received from a government to help an entity finance a research and development project. More specifically, the request asked whether the entity must recognise the cash payments ~~should be accounted for~~ as a liability ~~when received~~ (on the basis that the entity has received ~~it is~~ a forgivable loan as defined in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*) or ~~recognised~~ in profit or loss ~~when received~~ (on the basis that ~~it is~~ the entity has received a government grant as defined in IAS 20). The cash payment received from the government is repayable ~~in cash~~ only if the entity decides to exploit and commercialise the results of the research phase of the project. The terms of the repayment can result in the government receiving up to twice the amount of the original cash payment if the project is successful. If the entity decides not to ~~proceed with~~ exploit and commercialise the results ~~from~~ of the research phase, the cash payment is not repayable, but instead ~~refundable and~~ the entity must transfer to the government the rights to the research.
>
> The Interpretations Committee noted that, in this arrangement, the entity has ~~d~~ obtained financing for its research ~~&~~ and development project ~~and the appropriate accounting would depend on the specific terms and conditions of the cash payment received~~. The Interpretations Committee observed that the arrangement described in the submission ~~was~~ is a financial liability that the entity accounts for applying ~~within the scope of~~ IFRS 9 *Financial Instruments* (IAS 39 *Financial Instruments: Recognition*). The cash payment meets the definition of a financial liability (applying paragraph 20(a) of IAS 32 *Financial Instruments: Presentation*) because the entity can avoid a transfer of cash only by settling a non-financial obligation (ie by transferring the rights to the research to the

government). ~~Many members of the Interpretations Committee thought that the arrangement also met the definition of a forgivable loan as defined in IAS 20~~.

The Interpretations Committee observed that judgement ~~would be~~ is required to determine ~~in making this assessment~~ whether the arrangement would also meet the definition of a forgivable loan in IAS 20 and, if so, ~~in determining~~ when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

The Interpretations Committee noted that the requirements in IFRS Standards provide an adequate basis ~~there was sufficient guidance in the Standards~~ to ~~help~~ enable an entity to determine the ~~appropriate~~ accounting for the cash payment received from a government. ~~The Interpretations Committee observed that diversity in practice appeared to be limited based on the feedback it had received from its outreach activities.~~

In the light of the requirements in existing IFRS Standards ~~requirements~~ ~~and the feedback received from its outreach activities~~, the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the Interpretations Committee ~~and therefore [~~decided~~]~~ not to add this issue to its agenda.

## Appendix B—Copies of comment letters