BY
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# Accounting for Government Grants

Professor Robert Kirk analyses the Performance and Accrual models when accounting for government grants under FRS 102.

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## What is a government grant?

A government grant is normally defined as:

*"Assistance by government in the form of a transfer of resources to an entity in return for past or future compliance with specified conditions."*

The definition includes grants received from non-governmental development agencies and may well be called by a different name e.g. subsidies, subventions, premiums etc. but their overall purpose is to encourage companies to embark on a particular course of action, such as creating jobs or buying equipment, that it might not otherwise do.

The definition, however, excludes those forms of government assistance that cannot reasonably have a value placed upon them and if the transactions cannot be distinguished from normal trading.

Examples of government grants could include the following:

1. A rural development scheme to help farmers set up a cottage industry to help to supplement their income and to encourage them to continue farming.
2. A grant of 20% towards the funding of new plant and equipment.
3. The offer of interest free loans to encourage businesses to set up in a depressed industrial zone.

However, the following are not regarded as government grants:

1. The provision of factory or road infrastructure to enable businesses to set up new manufacturing units.
2. The provision of reduced rental or levels of taxation than other countries as long as those rates are for all entities in that jurisdiction.
3. The adoption of accelerated capital allowances, investment tax credits etc.

## Recognition and measurement

***SSAP 4 Accounting for government grants and IAS 20 Accounting for government grants and disclosure of government assistance***

Both the local accounting standard and its international version were created when one of the key concepts in financial reporting was to ensure that incomes (grants) were matched as closely as possible to their related expenditure i.e. the accruals concept. This has resulted in a smoothing of profit performance but unfortunately fails to correctly reflect the true amount of liabilities that should be reported on the statement of financial position (balance sheet). The standards still reflect that view.

However, when the International Accounting Standards Board (IASB) issued their specialised standard for small and medium sized enterprises (the IFRSSME) in July 2009 they decided to adopt a different approach i.e. the performance model. In that model, a single simplified methodology was introduced to deal with ALL types of government grant, whether capital or revenue. This differed from both SSAP 4 and IAS 20 which require a number of different options for accounting for government grants under the accruals model.

### *FRS 102 The Financial Reporting Standard Applicable in the UK and the Republic of Ireland*

When the Accounting Standards Board (and subsequently the Financial Reporting Council (FRC)) initially issued their version of the IFRSSME in October 2010 they also opted for the new performance approach. However, many of the comments on the exposure draft criticised the switch from the accruals to the performance model. In particular, the agriculture industry were concerned that many of their grants would be reported faster in income leading to the possibility of greater volatility in performance. Their lobbying was so successful that the FRC finally decided when publishing FRS 102 *The Financial Reporting Standard Applicable in the UK and the Republic of Ireland* that both options would be permitted for non listed companies.

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In all the standards it is clearly recognised that no grants may be recognised until there is reasonable assurance that:

The reporting entity will comply with any conditions attached to the grant; and the grants will actually be received

In addition, all the standards require grants to be measured at the fair value of the asset received or receivable. If a grant is due to be repaid it should be recognised as a liability when it passes the definition of a liability under the standards.

The two different options offered in FRS 102 are explained below:

***Performance Model***

Grants under this model should be recognised in income as follows:

(a) A grant that does not impose specified future performance conditions on the recipient is recognised in income when the grant proceeds are receivable.
(b) A grant that imposes specified future performance conditions on the recipient is recognised in income only when the performance conditions are met.
(c) Grants received before the revenue recognition criteria are satisfied are recognised as a Liability and usually referred to as deferred income.

## Example – Performance Model

On 1 January 2015 Virginia Ltd received €1,000,000 from the government as an incentive to establish and operate a manufacturing plant in a particular depressed industrial zone. Funds are remitted from the government to Virginia Ltd when Virginia Ltd incurs the expenditure.

€600,000 of the grant is conditional on the entity erecting the plant costing at least €2,000,000 and the plant commencing commercial production on or before 31 December 2016. If these conditions are not met, Virginia Ltd will be obliged to refund €600,000.

€400,000 of the grant is conditional upon Virginia Ltd maintaining commercial production at the plant for a period of four years from the date on which commercial production begins, i.e. it becomes unconditionally entitled to €8,333.33 at the end of each month for the first 48 months of the commercial operation of the plant.

During 2015 Virginia Ltd constructed the plant at a cost of €2,100,000, all of which met the type of expenditure specified under the conditions of the grant.

During the first quarter of 2016 Virginia Ltd tested the plant's manufacturing process.

On 1 April 2016 Virginia Ltd commenced commercial production at the plant. Virginia Ltd assessed the useful life of the plant to be 20 years from 1 April 2016 with a nil residual value. Furthermore, the straight-line method was assessed as the most appropriate basis for depreciating the plant.

At 31 December 2016 and 31 December 2017 Virginia Ltd's assessment of the plant remained unchanged. Since the commencement of production, the plant has operated profitably. Furthermore, Virginia Ltd intends to continue operating the plant on a commercial basis for the foreseeable future.

***Solution***
**Virginia Ltd**
**Balance Sheet (Extract) as at 31 December 2017**

| | *Note* | *2017* | *2016* |
|---|---|---|---|
| **Non-current liabilities** | | | |
| Government grant | 20 | €125,000 (a) | €225,000 (b) |
| Current liabilities | | | |
| Government grant | 20 | €100,000 (c) | €100,000 (c) |

**Notes (Extract) to Virginia Ltd's financial statements for the year ended 31 December 20X9**

***Note 5 Profit before tax***
The following items have been recognised as expenses (income) in determining profit before tax:

| | *2017* | *2016* |
|---|---|---|
| | € | € |
| Government grant received for the construction of new plant | - | (600,000) |
| Government grant received for the operation of new plant | (100,000) (d) | (75,000) (e) |

Government Assistance
To encourage export from Ballydock, the company received free promotional support from the Irish government for exhibiting its products at various international trade fairs.

No income or expense has been recognised in respect of this government assistance as the assistance cannot reasonably have a value placed on it.

(a) 48-month grant period less 21 months recognised to 31 December 2017 = 27 months remaining. 27 months x €8,333.33(f) = €225,000 total. €225,000 less €100,000(c) current portion = €125,000 non-current portion.
(b) 48-month grant period less 9 months recognised to 31 December 2016 = 39 months remaining. 39 months x €8,333.33(f) = €325,000 total. €325,000 less €100,000(c) current portion = €225,000 non-current portion.
(c) 12 months in the next year x €8,333.33(f) = €100,000.
(d) 12 months in commercial production in 2017 x €8,333.33(f) = €100,000.
(e) 9 months in commercial production 2016 x €8,333.33(f) = €75,000.
(f) €400,000 ÷ 48 months = €8,333.33 per month.

## Accruals Model

Most readers will already be familiar with this model as it has been the only model acceptable in the UK and Ireland to date (SSAP 4 *Accounting for Government Grants)* and requires a classification between revenue and capital based grants. Revenue based grants are reported in profit and loss on a systematic basis to match against the related costs unless those costs have already been incurred in which case the grant is reported immediately in profit.
Capital based grants are spread over the economic useful life of the related asset. Under both FRS 102 and the IFRSSME they must be recorded initially in deferred income ONLY and they may not be netted off against the cost of the assets concerned. In practice that represents no change from existing UK/Irish practice as there is a 'health warning' in SSAP 4 that the net of cost approach should not be used for companies if they wish to comply with existing Company law.

### Example – Capital based grant under both methods

On 1st April 2015 Bundoran Ltd acquired a piece of plant and machinery for €100,000 with a 20% grant attached. The asset has a useful life of 4 years and the only conditions attached to the grant is that it must be used for a particular purpose for two years. Its expected residual value is €20,000.

***Solution***

**Performance Model**
Assuming the company adopts the deferred income method the following should be the accounting treatment:

| | | | |
|---|---|---|---|
| Dr Plant | €100,000 | | |
| Cr Bank | | €100,000 | |
| Dr Bank (20% x €100,000) | €20,000 | | |
| Cr Deferred income | | €20,000 | |

Being the initial recording of the purchase of the plant and receipt of grant.

| | | |
|---|---|---|
| Dr Income | €20,000 | |
| Cr Accumulated depreciation | | €20,000 |
| Dr Deferred income (50%) | €10,000 | |
| Cr Income | | €10,000 |

Being the depreciation charge on the depreciation amount of the asset (€100,000 – 20,000 = €80,000 ) spread over the useful life of the plant of 4 years and the release of capital grant NOT over the life of the plant but over the period of potential clawback of 2 years. It could be argued all of the grant be released only after year 2 but it depends on the clawback provision. It is assumed in this example that it can be clawed back proportionately over the 2 years.

***Accruals Model***
The initial double entries would be the same. The depreciation charge would also be the same. However, the capital grant, instead of being released to profit and loss over two years, will be spread to profit over a four year period to match against its related depreciation charge which is also spread over four years. The release each year would therefore be 25% x €20,000 = €5,000.

If the FRC were to apply the principles contained in Section 2 of FRS 102 then, in theory, the only method to adopt should be the performance model as it concentrates on getting assets and liabilities reported correctly on the balance sheet whereas the accruals model concentrates on matching income and related expenditure and could result in an overstatement of liabilities on the balance sheet for deferred income not yet matched against expenditure but also not repayable to the government. Undoubtedly the IASB will have to revisit the subject again when reviewing IAS 20 and this could result in the withdrawal of the accruals model in due course.

## Disclosure

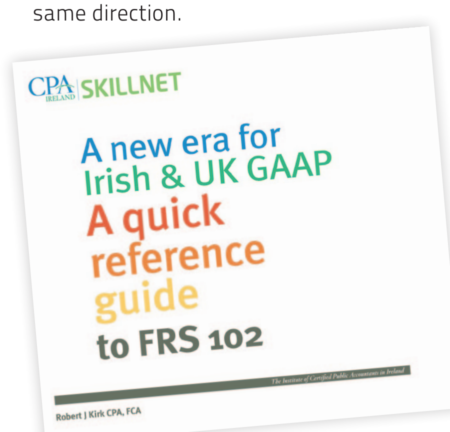
The following should be disclosed in FRS 102 and IAS 20 would be very similar (apart from choice of model):

(a) the accounting policy adopted for grants i.e. the accruals or performance models
(b) the nature and amounts of government grants recognised in the financial statements
(c) unfulfilled conditions and other contingencies not recognised in income; and
(d) an indication of other forms of government assistance from which the entity has benefited.

For (d) it represents action by government designed to provide economic benefits specific to the entity. Examples include free technical or marketing advice, provision of guarantees, and loans at nil or low interest rates. An illustration of the disclosure is provided in the Virginia Ltd example above.

## Conclusion

Although reporting entities will be provided with a clear option of two different methods of accounting for government grants in FRS 102 it is very likely that the majority of companies will opt for the accruals model as they are already familiar with that approach, it reduces volatility in their profits and it saves them having to change their accounting policy. However, in the long term, it is likely that the IASB will change the full IAS 20 to a performance only approach and ultimately FRS 102 is likely therefore to have to move in the same direction.




**A New Era for Irish and UK GAAP – A quick reference guide to FRS102 is available to order online at www.cpaireland.ie**