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ACCOUNTING FOR GRANTS AND DEFERRED INCOME

HARAMBEE

Definitions

- Government assistance is action by **government** designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

- It does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government Grants

Government grants , including non-monetary grants at **fair value**, shall not be recognized until there is reasonable assurance that:

a) the entity will comply with the conditions attaching to them; and

b) the grants will be received.

Accounting for Government Grants

Two general approaches:

1. Capital approach   2. Income approach*

* The key assumption is that grants from government are not equity financing, they are non-shareholder-related increases in net assets and therefore items of income.

Capital Approach

Rationale behind the capital approach;

a) Government grants are a financing device and should be dealt with as such in the statement of financial position rather than be recognized in profit or loss to offset the items of expense that they finance. Because no repayment is expected, such grants should be recognized outside profit or loss.

b) It is inappropriate to recognize government grants in profit or loss, because they are not earned but represent an incentive provided by government without related costs.

Accounting for Government Grants

- Income approach: recognize government grants in profit or loss in the same periods that the related expenses are recognized
  - *If the grant is for acquisition of assets – then recognize it on the same basis as the depreciation on the assets*
  - *If the grant is related directly to incurring specific expenditures – then recognize it on the same basis as the expenditures*

Accounting for Government Grants

Presentation of grants related to assets:

Companies have a choice – recognize as

(a) deferred income **or**

(b) as a reduction in the carrying amount of the related asset.

Example: Company A receives a $25 grant toward the purchase of new equipment that cost $100; equipment has a five year life and is depreciated on a straight-line basis.

Accounting for Government Grants

Entry when grant received:

(a) Deferred Income

Dr. Cash	25	
Cr. Deferred government grant		25

Or

(b) Reduction in the carrying amount of the related asset

Dr. Cash	25	
Cr. Equipment		25

Accounting for Government Grants

Entry as asset is used:

(a) Deferred Income approach

Dr. Depreciation expense	20	
Cr. Accumulated depreciation		20
Dr. Deferred government grant	5	
Cr. Depreciation expense/grant income		5

Or

(b) Reduction in the carrying amount of the related asset

Dr. Depreciation expense	15	
Cr. Accumulated depreciation		15

Depreciation: ($100 - $25) ÷ 5 = 15

Accounting for Government Grants

Presentation of grants related to income:

Example: Company B receives a government grant equal to 10% of the payroll costs incurred. Payroll costs incurred are $100.

Entry when payroll costs incurred:

Dr. Grant receivable	10	
Cr. Wages expense/grant income		10

Accounting for Government Grants

Repayment of grants:

- If the grant becomes repayable – treat it as a change in estimate
- If the grant is related to an asset: cumulative amount of additional depreciation that would have been recognized to date is recognized in P&L
- If the grant is related to income: any necessary adjustments are made to the current year profit or loss

Government Assistance

- Grants exclude assistance that cannot reasonably be valued, and transactions between the government and the entity that are in the normal course of business.

- Other assistance (e.g., guarantee of loan, significant sales) may be of interest to financial statement readers if benefits are significant and recurring

Accounting for Government Grants

Disclosures Required

1. Accounting policy for grants and their presentation

2. Nature and extent of grants recognized, and information about other forms of assistance that have been beneficial

3. Information about contingencies or conditions not yet met related to assistance recognized

Accounting for Government Grants Illustrative Example

Rahara Ltd purchased a piece of equipment for €600,000 on the 1st January 2007.

The equipment is expected to have an economic life of 5 years and will have no residual value. Depreciation is calculated on a straight-line basis over the life of the asset.

The company received a government of €200,000 towards the purchase of the equipment.

The financial year end of the company is December 31st each year.

Accounting for Government Grants Illustrative Example (Contd.)

Required: Show the relevant extracts from the financial statements for the years ended 31/12/07 & 31/12/08 under each of the two allowable methods of presentation.

Method 1: Set up a deferred grant income account.

This involves opening a deferred grant income account when the grant is received:

Dr Bank €200,000

Cr Deferred grant income account €200,000

Accounting for Government Grants Illustrative Example (Contd.)

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Cr Deferred grant income account €200,000

Accounting for Government Grants Illustrative Example (Contd.)

Income Statement

A portion of the deferred grant income is transferred to the Income Statement as income, each year over the useful life of the asset.

In this example (€200,000/5years) €40,000 will be transferred to the Income Statement each year.

At the end of December 2007 the remaining balance in the deferred grant income account is (€200,000 - €40,000) €160,000 and this must be recorded as a liability in the balance sheet.

Accounting for Government Grants Illustrative Example (Contd.)

This liability must be split between non-current liabilities (€120,000) and current liabilities (€40,000).

At the end of December 2008 two years deferred income will have been transferred to the Income Statement and the remaining balance in the deferred grant income account is (€200,000 - €40,000 - €40,000) €120,000.

This balance must then be split between noncurrent liabilities (€80,000) and current liabilities (€40,000).

Accounting for Government Grants Illustrative Example (Contd.)

Income Statement Extract of Rahara Ltd for the year ended:

	31/12/2007	31/12/2008
	€	€
Depreciation (€600,000/5 years)	(120,000)	(120,000)
Deferred grant income	40,000	40,000

Accounting for Government Grants Illustrative Example (Contd.)

Balance Sheet extract of Rahara Ltd as at:				
		31/12/2007		31/12/2008
		€		€
Non-current Asset				
Equipment		480,000		360,000
Non-Current Liabilities				
Deferred grant income		120,000		80,000
Current Liabilities				
Deferred grant income		40,000		40,000

Accounting for Government Grants Illustrative Example (Contd.)

Method 2: Deducting the grant in arriving at the carrying value of the asset

Under this method the cost of the asset of €600,000 is reduced by the value of the grant of €200,000 to give an in initial carrying value of the asset of €400,000.

This will result in a reduced annual depreciation charge of (€400,000/5 years) €80,000.

Accounting for Government Grants
Illustrative Example (Contd.)

<u>Income Statement Extract of Rahara Ltd for the year ended:</u>

		31/12/2007		31/12/2008
		€		€
Depreciation (€400,000/5 years)		(80,000)		(80,000)

Accounting for Government Grants Illustrative Example (Contd.)

Balance Sheet extract of Rahara Ltd as at:				
		31/12/2007		31/12/2008
		€		€
Non-current Asset				
Equipment		*320,000		**320,000

*NBV of equipment at 31/12/07 is [€400,000 - €80,000] €320,000.

** NBV of equipment at 31/12/08 is [€400,000 - €80,000- €80,000] €240,000.

Accounting for Government Grants

Presentation of grants related to income:

Example: Company B receives a government grant equal to 10% of the payroll costs incurred. Payroll costs incurred are $100.

Entry when payroll costs incurred:

Dr. Grant receivable	10	
Cr. Wages expense/grant income		10

Illustrative Example 3

A national government makes a cash transfer of KShs. 50 million to a state government social housing entity specifying that it:

a) Increases the stock of social housing by an additional 100 units over and above any other planned increases: or

b) Uses the cash transfer in other ways to support its social housing objective

Note: If neither of these stipulations is satisfied, the recipient entity must return the cash to the national government.

How should this be accounting for by the State government social housing entity?

Solution

The State Government social housing entity recognizes an increase in an asset (cash) and revenue in the amount of KShs. 50 million.

The stipulations in the transfer agreement are not stated so broadly as to not impose on the recipient a performance obligation – the performance obligation is imposed by the operating mandate of the entity, not by the terms of the transfer.

Illustrative Example 4

The national government transfers 200 hectares of land in a major city university for the establishment of a university campus. The transfer agreement specifies that the land is to be returned if not used for a campus.

How should the university account for this transfer?

Solution

The university recognizes the land as an asset in the statement of financial position of the reporting period in which it obtains control of that land.

The land should be recognised at fair value in accordance with IPSAS 17.

The restriction does not meet the definition of a liability or satisfy the criteria for recognition as a liability.

Therefore the university recognizes revenue in respect of the land in the statement of financial performance of the reporting period in which the land is recognized as an asset.

Illustrative Example 5

The national government grants KShs. 50 million to a provincial government to be used to improve and maintain mass transit systems.

Specifically, the money is required to be used as follows:

40% for existing railroad and tramway system modernization

40% for new road and tramway systems

20% for rolling stock purchases and improvements

Illustrative Example 5 (Contd.)

Under the terms of the grant, the money can only be used as stipulated, and the provincial government is required to include a note in its audited general purpose financial statements detailing how the grant money was spent.

The agreement requires the grant to be spent as specified in the current year or be returned to the national government.

How does the provincial government account for the grant?

Solution

The provincial government recognizes the grant money as an asset.

They also recognize a liability in respect of the condition attached to the grant.

As the province satisfies the condition, that is, as it makes authorized expenditures, it reduces the liability and recognizes revenue in the statement of financial performance of the reporting period in which the liability is discharged.

Illustrative Example 6

A large corporation that makes cleaning products gives money to a public university to conduct research on the effectiveness of a certain chemical compound in quickly removing graffiti.

The corporation stipulates that the research results are to be shared with it before being announced to the public, and that it has the right to apply for a patent on the compound.

How should the university account for the research grant?

Solution

This is an exchange transaction.

In return for the grant, the university provides research services and an intangible asset, the right to profit from the research results.

IPSAS 9 and IPSAS 31/IAS 38, intangible assets apply to this transaction

Illustrative Example 7

The national government lent a local government KShs. 20 million to enable the local government to build a water treatment plant.

After a change in policy, the national government decides to forgive the loan.

There are no stipulations attached to the forgiveness of the loan.

The national government writes to the local government and advises it of its decision; it also encloses the loan documentation, which has been annotated to the effect that the loan has been waived.

How should this be reflected in the local government books of accounts?

Solution

When it receives the letter and documentation from the national government, which communicates this decision, the local government derecognizes the liability for the loan and recognizes revenue in the statement of financial performance of the reporting period in which the liability is derecognized.

IPSAS 23 – Revenue from Non-exchange transactions

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

Objective

- To prescribe requirements for the ***financial reporting of revenue arising from non-exchange transactions***, other than non-exchange transactions that give rise to an entity combination.

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

Summary

- Exchange transactions are transactions in which one entity receives assets or services, or has liabilities extinguished, and ***directly gives approximately equal value*** (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange.

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

Summary

- Non-exchange transactions are transactions that are ***not exchange transactions***.
- In a non-exchange transaction, an entity either receives value from another entity ***without directly giving approximately equal value in exchange***, or gives value to another entity without directly receiving approximately equal value in exchange.

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

Summary

- Transfers are ***inflows of future economic benefits or service potential*** from non-exchange transactions, other than taxes.

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- ***Stipulations on transferred assets*** are terms in laws or regulation, or a binding arrangement, imposed ***upon the use of a transferred asset by entities external to the reporting entity.***
- ***Conditions on transferred assets*** are stipulations that specify that the future economic benefits or service potential embodied in the asset is required to be consumed by the recipient as specified or future economic benefits or service potential ***must be returned to the transferor.***

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- ***Restrictions on transferred assets*** are stipulations that limit or direct the purposes for which a transferred asset may be used, but ***do not specify*** that future economic benefits or service potential is required to be ***returned to the transferor if not deployed as specified.***

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- An inflow of resources from a non-exchange transaction, other than services in-kind, that meets the definition of an asset shall be recognised as an asset when, and only when the following recognition criteria are met:
  - *It is probable that the future economic benefits or service potential associated with the asset will flow to the entity; and*
  - *The fair value of the asset can be measured reliably.*

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- An asset acquired through a non-exchange transaction shall initially be ***measured at its fair value as at the date of acquisition.***

- An inflow of resources from a non-exchange transaction recognised as an asset shall be recognised as revenue, ***except to the extent that a liability is also recognised in respect of the same inflow.***

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- As an entity satisfies a present obligation recognised as a liability in respect of an inflow of resources from a non-exchange transaction recognised as an asset, it shall ***reduce the carrying amount of the liability recognised and recognise an amount of revenue equal to that reduction***.
- Revenue from non-exchange transactions shall be measured at the amount of the ***increase in net assets recognised by the entity.***

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- A present obligation arising from a non-exchange transaction that meets the definition of a liability shall be recognised as a liability when, and only when the following recognition criteria are met:
  - *It is probable that an outflow of resources embodying future economic benefits or service potential will be required to settle the obligation; and*
  - *A reliable estimate can be made of the amount of the obligation.*

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- *Conditions on a transferred asset give rise to a present obligation on initial recognition that will be recognised when the recognition criteria of a liability are met.*

- The amount recognised as a liability shall be the ***best estimate of the amount required to settle*** the present obligation at the reporting date.
- An entity shall recognise an asset in respect of taxes ***when the taxable event occurs and the asset recognition criteria are met.***

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- Taxation revenue shall be determined at a ***gross amount.*** It shall not be reduced for expenses paid through the tax system (e.g. amounts that are available to beneficiaries regardless of whether or not they pay taxes).
- Taxation revenue shall ***not be grossed up for the amount of tax expenditures*** (e.g. preferential provisions of the tax law that provide certain taxpayers with concessions that are not available to others).

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- An entity recognises an asset in respect of transfers when the transferred resources ***meet the definition of an asset and satisfy the criteria for recognition as an asset***.
- However, an entity ***may***, but is not required to, recognise services in-kind as revenue and as an asset.

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- An entity shall disclose either on the face of, or in the notes to, the general-purpose financial statements:
  - *The amount of **revenue from non-exchange transactions** recognised during the period by major classes showing separately taxes and transfers.*
  - *The amount of **receivables** recognised in respect of non-exchange revenue.*
  - *The amount of **liabilities** recognised in respect of **transferred assets subject to conditions**.*

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

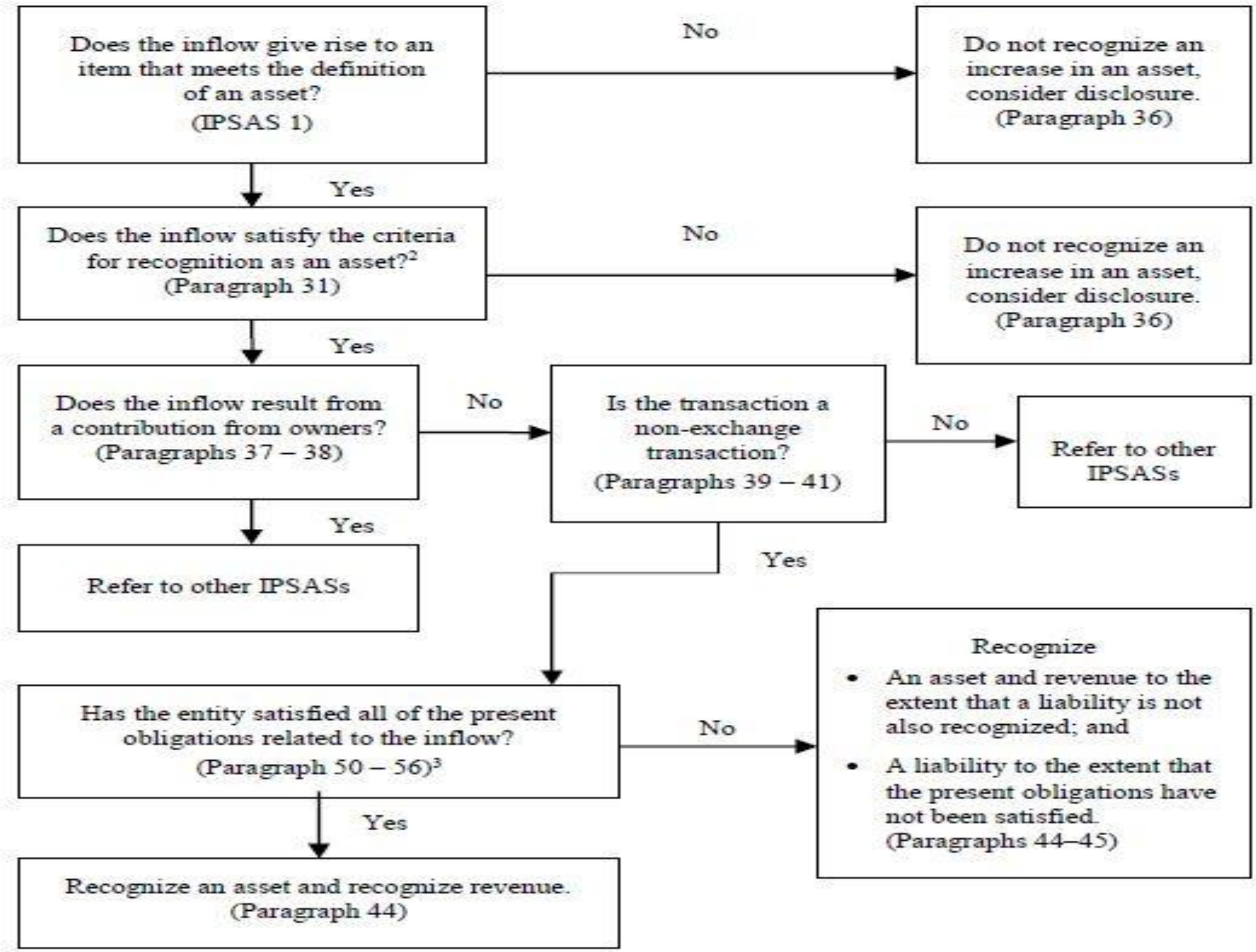
- The amount of ***assets recognised that are subject to restrictions*** and the nature of those restrictions.
- The existence and amounts of ***any advance receipts*** in respect of non-exchange transactions.
- The amount of any ***liabilities forgiven***.

- An entity shall disclose in the notes to the general-purpose financial statements:
  - The ***accounting policies*** adopted for the recognition of revenue from non-exchange transactions.

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

- For major classes of revenue from non-exchange transactions, the ***basis on which the fair value*** of inflowing resources was measured.
- For major classes of taxation revenue which the entity ***cannot measure reliably*** during the period in which the taxable event occurs, information about the nature of the tax.
  - The nature and type of major classes of bequests, gifts, donations showing separately major classes of goods in-kind received.

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)



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