1979

Accounting for grants received from governments; Issues paper (1979 October 16)

American Institute of Certified Public Accountants. International Technical Standards Subcommittee

10/16/79
File 3110

Issues Paper

Accounting for Grants Received from Governments

Prepared by

International Technical Standards Subcommittee
Accounting Standards Division
American Institute of Certified Public Accountants

830150

Table of Contents

INTRODUCTION

1. Many governments, including some in the U.S., have adopted programs offering grants or subsidies to enterprises to encourage the enterprises to undertake or continue certain actions. Pronouncements on U.S. generally accepted accounting principles do not provide explicit guidance on accounting for and disclosure concerning government grants. Guidance on accounting and disclosure is therefore needed.

Scope of Project

2. Governments offer grants or subsidies to specific enterprises either in cash, in nonmonetary assets, or in benefits that reduce or eliminate the enterprises' expenditures. The term grants, as used in this paper, excludes payments by governments directly to enterprises on behalf of third parties, such as Medicare, or for sales of products to the government.

3. Taxes. The term grants, as used in this paper, also excludes assistance from governments that is limited or determined by income taxes; a benefit that is a function of an income tax liability is not a grant. Accounting for income taxes is now covered by Accounting Principles Board Opinion 11, "Accounting for Income Taxes," and various other pronouncements. However, if the payment of the assistance reduces income taxes payable and any balance

of the grant not so realized is received in cash, the assistance should be treated as a grant.

4. The term <u>grants</u>, as used in this paper, also excludes assistance from governments in the form of tax holidays whereby some governments exempt from income taxes for a specified period, all or a portion of the income earned in certain activities in particular geographic areas.

5. <u>Nonprofit Organizations</u>. This paper excludes grants to nonprofit organizations other than those types of entities that operate essentially as commercial businesses for the direct economic benefit of members or shareholders. The relationship between governments and nonprofit organizations may be fundamentally different from the relationship between governments and profit motivated enterprises; the accounting for grants may therefore differ. The Accounting Standards Executive Committee has issued Statement of Position 78-10, "Accounting Principles and Reporting Practices for Certain Nonprofit Organizations" (December 31, 1978), which describes accounting for grants and donations received by nonprofit organizations. Also, the Financial Accounting Standards Board has undertaken a project on concepts underlying financial accounting by nonbusiness organizations.

6. <u>Grants to Government Owned Enterprises</u>. This paper also excludes grants to government owned enterprises. The relationship between government and government owned enterprises may be fundamentally different from the relationship between government and

investor owned enterprises; the accounting for grants may therefore differ. Accounting for grants to governments is now covered by the National Council of Government Accounting Statement 2, "Grant, Entitlement, and Shared Revenue Accounting and Reporting by State and Local Governments."

Types of Grants

7. This paper covers grants available either in the U.S. or in other countries. The more significant grant programs in the U.S. are in the agricultural and the transportation industries. Other countries have numerous types of grant programs that vary considerably and are continually changing. Rather than describe the accounting for particular programs, this paper raises issues for broad categories of programs.

8. Grants Related to Revenues. Some programs provide grants that are related to sales or other revenues, such as certain export subsidies and price control subsidies.

9. Grants Related to Current Expenditures. Many programs provide grants to reimburse current expenditures, such as

1. Research and development costs
2. Wages, training costs, or other employment related costs
3. Transportation costs
4. Moving costs
5. Utilities costs
6. Tax expenditures other than taxes on income.

10. Grants Related to Fixed Assets. Grants may be given to acquire or construct fixed assets, such as land, buildings, equipment, or other productive facilities or to develop property, such as timberlands or mineral reserves. A grant may also consist of property such as land.

11. Grants Related to Debt. Grants related to debt include

1. Low interest loans from governments
2. Interest free loans from governments
3. Loans from governments that are forgivable under specified circumstances
4. Loan guarantees by governments
5. Reimbursements of interest costs.

Grants exclude debts, such as industrial revenue bonds, that have interest affected by tax attributes.

12. The government program usually specifies the use of the proceeds of a loan that is a grant. As with other grants, there is often a quid pro quo for the grant. For example, the government may offer a low interest loan to encourage an enterprise to move to a particular location or to encourage an enterprise to construct facilities at such a location.

13. Other Specific Benefits from Governments. Some programs provide benefits to an enterprise such as reduced or no rental payments for government owned facilities, goods or services to a particular enterprise in constrast to general services to a large segment of the community, or rights to develop government owned property.

ACCOUNTING CONSIDERATIONS

14. The grants are often intended to influence enterprises actions and the form of the grants may differ from their substance.

General Accounting Considerations

15. Once an enterprise fulfills the conditions required to entitle it to a grant, the two methods to account for the benefits of the grant are

1. Treat the benefits as capital contributions
2. Include the benefits in the determination of income, either immediately or in the future.

Arguments that have been advanced for the capital contribution approach are as follows:

- Government grants are financing devices since they do not reduce the enterprise's cost of assets but do reduce the amount of capital required from other sources
- Government grants are not earned but are paid gratuitously.

Arguments that have been advanced for the income approach are as follows:

- Capital is contributed only by the owners of an enterprise

- Government grants confer benefits on the enterprise and its owners, and the benefits should be reflected in income
- Government grants are intended to reimburse costs incurred by the enterprise, and that should be reflected in income
- Government grants are given to encourage enterprises to take actions they might otherwise not take. Grants are therefore not gratuitous payments but are earned.

16. If the capital approach is accepted, grants would be credited to contributed capital.

17. If the income approach is accepted, the following are possible methods of accounting for grants:

    1. A reduction of the related costs, as either
        a. a reduction of an expense, or
        b. a reduction of the capitalized cost of an asset
    2. A deferred credit to be amortized over the life of the related asset or the period of the grant
    3. Revenue or other income.

18. Some believe that grants should be accounted for as a reduction of the related expenses as described in paragraph 17(1). They point out that grants merely compensate an enterprise for part or all of the cost of taking an action it might not otherwise take. For example, many grant programs undertake assistance to train unskilled workers, to provide research and

development, or to operate in a less desirable location. The incentive for taking those actions is the grant received from governments, which reduce the net cost to the company of taking those actions.

19. Others believe that a grant should be accounted for as a deferred credit to be amortized over the life of the related assets or the period of the grant or as revenue or other income as described in paragraph 17 (2) and (3). They contend that the enterprise costs are the gross amounts. Moreover, they argue that if a grant were recorded as a reduction of related expenses or assets, this would impair comparability between enterprises and within the enterprise in periods that grants are not received and the return on asset ratio would be distorted.

Timing

20. Grants may be paid in periods other than the periods in which enterprises fulfill all the conditions required to entitle them to the grant. As a result, questions arise concerning the appropriate accounting for the receipt of the grant.

Repayment of Grants

21. Some grants may have to be repaid if the recipient fails to meet specified conditions, which usually relate to operating a facility or to retaining a labor force of a specified size for a specified period. Furthermore, a loan from a government may be forgiven if specific conditions are met; the economic effect of a forgivable loan may in substance be a cash grant with a

contingent liability for repayment.

Measurement

22. Grants received in cash generally involve no measurement problem. However, some cash grant programs have terms subject to interpretation or the amount of a grant may be determined in negotiation. It may therefore be necessary to estimate the amount of a grant to be received.

23. Measurement is more difficult for nonmonetary grants to the enterprise or on behalf of the enterprise. APB Opinion 29, "Accounting for Nonmonetary Transactions," provides guidance for recording nonmonetary assets but does not cover the accounting for the related credit.

24. Grants may be in the form of a noninterest or low interest loans. APB Opinion 21, "Interest on Receivables and Payables," states

> The use of an interest rate that varies from prevailing interest rates warrants evaluation of whether the face amount and stated interest rate of a note or obligation provide reliable evidence for properly recording the exchange and subsequent related interest (paragraph 1).

However, APB Opinion 21 states that it is not intended to apply to

> ... transactions where interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (e.g., industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlement) (paragraph 3(e)).

Guidance is therefore needed on whether a benefit should be imputed for interest on debt subsidized by a government.

SURVEY OF PRACTICE

25. A NAARS search was made to determine present practice in accounting for government grants to investor owned enterprises. A summary of the search follows.

26. Grants Related to Revenues. Grants related to revenues are accounted for as revenues.

27. Grants Related to Current Expenditures. Grants related to current expenditures are accounted for as reductions of expenses or other income.

28. Grants Related to Fixed Assets. Grants related to fixed assets are accounted for as reductions of the cost of the related assets or deferred credits and amortized over the life of the assets, or they are accounted for as income as received or as contributed capital.

29. Grants Related to Debt. No benefit is imputed on grants related to debt.

ISSUES

Basic Issues

30. The basic issues in accounting for the benefits of government grants are (a) should the benefits be credited to contributed capital or should they be included in the determination

of income and (b) if they are included in income, over what periods should they be recognized?

Factors for Consideration in Resolving the Basic Issues

31. In resolving the first basic issue, consideration should be given to the economic substance of grants to the recipient. Are grants given gratuitously or are they given to encourage an enterprise to take an action it might otherwise not take? Are grants financing devices that reduce the additional capital required from other sources or are they earned by the enterprise?

32. In resolving the second basic issue, consideration should be given to the periods in which the enterprise earns the benefits of the grant. Grants may be paid to the enterprise in periods other than those in which the enterprise fulfills all the conditions required to entitle it to the grant or in which the enterprise incurs the expense related to the grant.

A. Should grants be recognized in the periods in which they are paid to the enterprise, in the periods the enterprise fulfills all the conditions required to entitle it to the grant, or in the periods the enterprise is benefitted by the grants?

B. If an enterprise receives a noninterest or a low interest loan as an incentive to finance specific activities that must be undertaken to comply with conditions of the loan, should the enterprise account for the debt at an imputed normal interest rate and record the additional interest as a grant, and, if so, over what period? Should the answer to the issue vary depending on the use of proceeds of the loan specified in the grant program? Furthermore, it may not always be practicable to determine an imputed interest rate; therefore, consideration should be given to alternative methods of computing the interest rates or in otherwise accounting for the grant.

C. If an enterprise obtains a loan guaranteed by the government, should the enterprise account for the debt at an imputed interest rate equal to the rate that would be paid in the absence of the guarantee?

D. If an enterprise receives benefits other than direct payments (see paragraph 13), should the enterprise impute the cost of benefits received and, if so, how should the enterprise account for them?

E. If an enterprise receives a grant to purchase fixed assets, consideration should be given to the period in which the grant is recognized in income. Should it be accounted for as a reduction of the cost of the assets, with a resulting decrease in depreciation charge over the life of the asset, or as a deferred credit to be amortized over a specified period? Under U.S. statutes, enterprises may be eligible for investment tax credits on the acquisition of certain depreciable assets, and the accounting treatment is specified in APB Opinions 2 and 4. APB Opinion 4 states that it is preferable that the investment tax credit "should be reflected in net income over the productive life of the acquired property." APB Opinion 4 goes on to state that "the alternative method of treating the credit as a reduction of Federal income taxes of year in which the credit arises is also acceptable." The arguments for recognizing all of an investment tax credit in the period it arises is that the credit is a selective reduction of the income taxes of the period. That, however, does not apply to grants for the acquisition, construction, or development of fixed assets since grants are not related to income taxes.

F. If an enterprise receives land or cash to acquire land as a grant, consideration should be given to the period in which the grant is recognized in income since land has an indefinite life and the related grant cannot be amortized over an indefinite life. Should such grants be recognized when received or should they be recognized over the useful life of the depreciable fixed asset built on the land?

G. If an enterprise receives a loan that will be forgiven if it meets certain conditions specified at the time the loan is granted, should the loan be accounted for as a cash grant at the time the enterprise meets the condition entitling it to the loan or at the time the loan is forgiven?

Related Issues

33. If grants are given to an enterprise in the form of non-monetary assets, APB Opinion 29 states that those assets should be accounted for at their fair market value. Should credits arising from those grants be treated in the same manner as credits arising from cash grants?

34. If grants should be accounted for using an income approach, under what conditions should they be accounted for as a reduction of expenses, as a reduction of the cost of the related assets, as a deferred credit, or as revenue?

35. A grant may require repayment if the enterprise fails to meet certain conditions. Are conditions such as those described in paragraph 21 similar to those that must be met to avoid recapture of the investment tax credit or are they loss or gain contingencies? The following issues need to be resolved for grants that require repayment:

- If a grant was originally recorded as an increase in revenue, how should repayment in the current period be reflected?
- If a grant was originally recorded as a reduction of the cost of an asset, should repayment be treated as an increase in the cost of the asset? If so, should the increase in the cost of the asset be treated as a change in accounting estimate and the depreciation adjusted prospectively, or should the change in depreciation charges be recognized as a cumulative adjustment based on retroactive computation?

- If a grant was originally recorded as a deferred credit, should the unamortized balance be adjusted by the repayment, and, if so, should future amortization of the deferred credit be based on the resulting balance or should the charge be recognized as a cumulative adjustment based on retroactive computation?
- If a grant was originally recorded as a deferred credit and the repayment is greater than the unamortized deferred credit, how should the excess be accounted for and over what period?

36. Because grants may have a material effect on the financial statements of an enterprise, guidance is needed on the appropriate disclosures. The following disclosures may be necessary in the periods of the grant or in subsequent periods:

1. The amount of the grant received in cash or in property during the period
2. The amount of the grant taken into income in the period and the amount deferred to future periods
3. The relevant terms or conditions of the grant affecting current income, including whether the grant program is expected to expire while the related activities of the enterprise are expected to continue
4. The contingencies related to the grant.

Also, if an enterprise receives benefits other than direct payments (paragraph 13) and does not impute a value for the benefits received, disclosure of the nature of the benefits may be appropriate.

* * * * * * *

ADVISORY CONCLUSIONS

Accounting for Specific Types of Grants

37. General Accounting Considerations. The committee believes that grants that are recognized should be recorded in income and should not be recorded directly to stockholders' equity.

38. Grants Related to Revenue. The committee believes that grants that relate to revenue (paragraph 8) should be recognized as revenue of the period of the related events.

39. Grants Related to Expense Items. The committee believes that grants related to current expenses (paragraph 9) should be treated as reductions of the related expenses. Grants related to expenses of future periods should be deferred and reflected as reductions of expenses as the related expenses are recognized.

40. Grants Related to Fixed Assets. The committee believes that grants related to depreciable fixed assets (paragraph 10) should be taken to income over the useful lives of the assets and grants related to land should be amortized over the life of the depreciable fixed assets built on it.

41. Grants Related to Debt. The committee believes that no benefit should be imputed on grants related to debt (paragraph 11).

42. Other Specific Benefits from Governments. The committee believes that other benefits such as free rents from a government (paragraph 13) should not be imputed.

43. Grants Related to Future Periods. The committee believes that if the enterprise receives the benefits of a grant before fulfilling the conditions of the grant, the enterprise should record those benefits as liabilities or deferred credits.

44. Refundable Grants. The committee believes that if it is probable that a grant will be refunded (or a forgivable loan repaid), the grant should be reported as a liability. Otherwise the grant or forgivable loan should be accounted for in accordance with paragraphs 37-43.

45. Disclosures of Grants. The committee believes that the disclosures described in paragraph 36 should be made.