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Accounting for government grants: Standard-setting and accounting choice☆

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ABSTRACT

This paper provides evidence on several matters relating to accounting for government grants under International Financial Reporting Standards (IFRS). Focusing on grants related to assets, we trace the development of International Accounting Standard (IAS) 20, outline some of the problems of current accounting practice, and suggest why these have not been addressed by the standard-setter. Then, by hand-collecting data relating to 559 firms from 15 countries, we empirically analyze several issues. We show that asset grants are economically important for some firms and that the frequency of grants is significantly different across the countries. For the non-financial firms in our sample, we identify the grant-related accounting policy choice: a firm can either show the grant as deferred income or net it against the asset. The options are roughly equally popular overall but the firm's country of domicile is strongly associated with the choice. Further, as a key element of disclosure quality for this topic, we investigate whether or not the balance sheet-related numbers relating to grants are disclosed, finding that many firms do not disclose them. Disclosure quality is better for firms which use the 'deferred income' option, and it is also better in countries where a higher proportion of firms has received government grants. International differences and poor disclosure are detrimental to international comparisons, so we conclude that the policy choice should be removed from the accounting standard.

1. Introduction

Accounting for government grants has become a neglected area of standard-setting and it is little researched. Several standards of the International Accounting Standards Board (IASB) deal with the issue (e.g. separately for listed firms and for unlisted firms), but they have quite different requirements, some involving choice by preparers. Further, the issue is important in the context of the political pressure on standard-setters to increase transparency about financial flows between firms and governments (e.g. OECD, 2015). However, there is no coverage of this area (which could be called 'non-reciprocal transfers') in the conceptual framework of the IASB (2010a) which is designed to guide standard-setting. Further, there are no proposals to undertake research or to amend the framework or standards in the area. Unusually for any accounting topic, there are no requirements in US generally accepted accounting principles (GAAP). Although the IASB has not resolved the issue, for reasons discussed in this paper, other influential parties

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have acknowledged its importance (EFRAG, 2016).[1] This paper analyzes accounting for asset grants both conceptually and empirically.

International Accounting Standard 20 (IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*) deals with how to account for various types of government assistance. The general principle is old-fashioned matching: a grant should be recognized as income when the costs (which the grant is intended to compensate) are recognized as expenses (para. 12). Thus, a grant intended to compensate running costs is recognized as income in line with the costs. Similarly, a grant related to the purchase of an asset is taken to income over the life of the asset. This means that there will be a *credit* balance equal to the excess of cash received or receivable over the amount so far treated as income. IAS 20 allows two options for the presentation of this *credit* on the balance sheet: show it as deferred income (a sort of liability) or net it against the asset (para. 24). Consequently, the choice affects leverage, because the 'deferred income' option results in larger liabilities.[2] In the income statement, a government grant increases profit over several years by the same amounts under both options, either by increasing 'other operating income' or by reducing the depreciation expense.

Our empirical analysis of 559 firms from 15 countries shows that, in 2013, 43% of non-financial firms have asset grants, peaking at 89% of firms in Germany. These grants are economically important for some firms. For example, the Spanish firm, Enagas, reported government grants for the purchase of infrastructure assets[3] with a carrying amount of €253 million, which represented 11.9% of its shareholders' equity.[4] Further, if Enagas had financed the respective assets internally instead of receiving grants, its profit would have been 3.4% lower because of higher depreciation.[5] The importance of grants also varies internationally. At its peak, in Italy, grants amount on average to over 14% of equity for firms with grants.

In this paper, we analyze the international differences in the accounting requirements in this policy area. We outline the theoretical issues concerning the accounting treatment of government grants. We show how different countries arrived at different solutions. We trace the development of the topic in international standards, which has led to different answers in three IASB documents: IAS 20, IAS 41 (*Agriculture*) and the International Financial Reporting Standard for Small and Medium-sized Entities (*IFRS for SMEs*). We examine why the standard-setter has no formal plans to address these conflicts or to otherwise update the oldest unrevised international standard.[6] Our approach involves analyzing other related conceptual problems faced by the IASB, such as the extent to which financial reporting should reflect a pure asset/liability view (Sprouse, 1978).

We then empirically analyze two aspects of accounting choice regarding government grants for assets: the policy choice for the balance sheet treatment; and whether or not a firm discloses the corresponding number, i.e. the balance of deferred income or the amount by which the asset is reduced. Since IAS 20 is an old standard, it contains rudimentary disclosure requirements: it merely requires disclosure of the accounting policy, 'the nature and extent of government grants', and any unfulfilled conditions (para. 39). We investigate whether this vague phrasing leads to varied or inadequate information.

Our empirical analysis is based on hand-collected data relating to 559 firms, though we mostly examine a sub-sample of 421 non-financial firms. Regarding policy choice, the options are roughly equally popular in our sample overall, but we find highly significant international differences in choice. The data supports a hypothesis which we develop that a firm's IFRS policy choice is influenced by prior or current national regulations. To the extent that data on pre-IFRS practices is available, there is even clearer support for a proposition (not statistically tested) that a particular firm continues with its pre-IFRS policy. There is no evidence in the regulations, in the literature or in firms' reports that the differing accounting treatments relate to different economic features of asset grants. Regarding disclosure quality, many firms do not disclose the balance sheet-related numbers on grants. We hypothesize and find that disclosure quality, as measured on this basis, is better for firms which use the 'deferred income' option and better in countries where a higher proportion of firms has received government grants. International accounting differences (if unrelated to underlying economic differences) and poor disclosure are detrimental to international comparisons. We conclude that the policy choice should be removed from the accounting standard.

Our specific contributions are as follows. First, we are not aware of any previous analysis of international differences in accounting regulations on grants which includes reference to IASB documents or which was carried out after widespread adoption of IFRS. Also, firms' policy choices on grants are not investigated by most of the prior papers on IFRS policy choice (e.g. Kvaal and Nobes, 2010; Nobes and Stadler, 2013). Ours is the first comprehensive empirical study on this topic. Furthermore, disclosures on this topic have not been researched before. Our findings of poor disclosure are important because, without disclosure, an investor or analyst is unable to adjust balance sheets so that they are all on the same basis. We find highly significant international differences in these areas.

The paper proceeds as follows. In Section 2, we outline the technical problem and the responses of standard-setters. In Section 3, we review empirical research on IFRS policy choice. In Section 4, we develop our hypotheses. Section 5 explains our sample and data. The next two sections contain our empirical analyses: Section 6 on policy choice, and Section 7 on disclosure quality. Section 8 is a brief discussion of the economic importance of asset grants to our sample of firms. In Section 9, we record our conclusions and policy

[1] The European Financial Reporting Advisory Group has launched a 'proactive' research project, though not yet produced any papers.

[2] Investors and analysts could adjust for this if there is sufficient disclosure, but we show that there is not sufficient disclosure for many firms.

[3] The reported government grants for assets of Enagas relate to investments in regasification plants, gas transport infrastructure and underground storage facilities, and were received from EU structural funds, Spanish regional authorities and the Spanish state (Annual Report 2013, p. 298).

[4] Calculation (all in thousands of euros, except percentages): 253,234/2,118,427 = 11.9% (Annual Report 2013, pp. 246 + 295).

[5] Calculation (all in thousands of euros, except percentages): $[19{,}028 * (1 - 28.45\%)]/404{,}256 = 3.4\%$ (Annual Report 2013, pp. 245 + 294). We have assumed that the depreciation has an effect on tax, and have calculated the tax rate using the information in the income statement: 160,749/565,005 = 28.45%.

[6] IAS 20 has not been revised since its issue in 1983, apart from a re-formatting in 1994. All earlier IASs (and most of the later ones) have been withdrawn or revised since 1983.

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