Co-funded by the
Erasmus+ Programme
of the European Union

PASSFR.EU

A Digital Learning Platform for Generation Z:
Passport to IFRS®

A Digital Learning Platform for Generation Z: Passport to IFRS®

IAS® Standard 20 Accounting for Government Grants and Disclosure of Government Assistance

Funded by the Erasmus+ Program of the European Union. However, European Commission and Turkish National Agency cannot be held responsible for any use which may be made of the information contained therein.

CASE STUDY - IAS 20 ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

Introduction

Government grants are assistance made by the transfer of monetary (cash and cash equivalents) or non-monetary (land, building, machinery, etc.) resources to companies or other types of organizations. How government grants are accounted for is an issue addressed in IFRSs. There are different reasons for this. First of all, it is necessary to distinguish whether it is a government grant or a government assistance. After determining this, it should be determined what kind of government grant it is. Because the accounting treatments differs according to the type of government grant (asset related grants or income related grants). How government grants will be accounted for will also affect the financial position and financial performance results of the company. In this case, the aim is to discuss how the accounting treatment should be according to IFRS when different types of government grants received, and also to provide an understanding of its effects on financial statements.

The Case Information

Storm Company was established in Turkey in the last months of 2020. Storm Company, which will produce chemical products, planning to make some fixed asset investments necessary for its operations. Since significant amounts of investment are required during the establishment phase, the company tries to choose between different investment alternatives and to choose the most cost-effective ones. In this process, the CEO of the company learned that they could benefit from government grants in some of the investments as a result of his meetings with his legal adviser.

A factory building was purchased on January 1, 2021. The factory building purchased costs CU 3,000,000 with an estimated useful life of 50 years and an expected residual value of CU 500,000. Storm company will apply straight-line depreciation method as depreciation method. A government grant of CU 1,000,000 was received while purchasing the factory building. Storm Company decides to use the deducting from related asset method as accounting method for government grants.

On April 1, 2021, a machine was purchased to be used in production. The cost of the machine is CU 500,000, the estimated useful life is 1,000,000 kg of product production, the residual value is estimated at zero. Storm Company will apply the units of product depreciation method for the machine. A government grant of CU 100,000 was received when purchasing this machine. Storm Company has chosen the deferred income method for accounting for this government grant related to assets.

The use of the machine in 2021 and 2022 is as follows:

Year	Usage
2021	200,000 kg
2022	250,000 kg
Total	**450,000 kg**

In addition, Storm Company considers that the production process may harm the environment. In order to cover these costs, CU 100,000 government grants were received. To account this revenue-related government grant, the entity will use the other income method.

Environmental costs incurred in 2021 and 2022 are as follows:

Year	Cost
2021	CU 90,000
2022	CU 60,000
Total	**CU 150,000**

One of the conditions of the government grants used in the purchase of the factory building is to exceed a certain production amount for two years. However, Storm Company could not reach the necessary production amount at the end of 2022 and had to pay back the government incentive.

Discussion Questions

How should government grants be accounted in 2021 and 2022, and how will it affect the statement of financial position and statement of profit of loss?

SOLUTION OF CASE STUDY - IAS 20 ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

There are deducting from related asset and deferred income methods in the recognition of government grants for assets.

The method of deducting from the book value of related asset has been chosen for the factory building. In this case, before to calculate depreciation for the factory building, the grants received must be deducted from the book value of the factory while determining the depreciable amount.

$$Book\ Value = Cost - Grant\ Amount = CU\ 3{,}000{,}000\ - CU\ 1{,}000{,}000 =\ CU\ 2{,}000{,}000$$

Annual depreciation expense for the factory building will be calculated as follows.

$$Yearly\ Depreciation = \frac{Book\ Value - Residual\ Value}{Useful\ Life} = \frac{CU\ 2{,}000{,}000 - CU\ 500{,}000}{50\ years}$$
$$= CU\ 30{,}000$$

The journal entries for the factory building of the Storm Company for the year 2021 and 2022 will be as follows.

2021, Jan.1	Dr. Property, Plant & Equipment (Assets)	3,000,000	
	Cr. Bank (Assets)		3,000,000
2021, Jan.1	Dr. Bank (Assets)	1,000,000	
	Cr. Property, Plant & Equipment (Assets)		1,000,000
2021, Dec.31	Dr. Depreciation Expense – Plant (P&L)	30,000	
	Cr. Accumulated Depreciation (Assets)		30,000
2022, Dec.31	Dr. Depreciation Expense – Plant (P&L)	30,000	
	Cr. Accumulated Depreciation (Assets)		30,000

The deferred income method has been selected for the machine. In this case, the grant amount will not be deducted from the book value of the asset, but income will be recognized every year in accordance with the expensed depreciation amount.

The depreciation rate of the machine is calculated as follows.

$$Depreciation\ Rate = \frac{Book\ Value}{Useful\ Life} = \frac{CU\ 500{,}000}{1{,}000{,}000\ kg} =\ 0.5\ CU/kg$$

The depreciation expense to be recognized in 2021 and 2022 is as follows.

$Yearly\ Depreciation\ (2021) = \ Depreciation\ Rate\ x\ Usage = 0.5\ x\ 200{,}000\ kg = CU\ 100{,}000$

$Yearly\ Depreciation\ (2022) = \ Depreciation\ Rate\ x\ Usage = 0.5\ x\ 250{,}000\ kg = CU\ 125{,}000$

Government grant income should be recognized in proportion to the annual depreciation expense.

$$Yearly\ Income = \frac{Depreciation\ Expense}{Book\ Value}\ x\ Government\ Grant$$

$$Yearly\ Income\ (2021) = \frac{CU\ 100{,}000\ (2021)}{CU\ 500{,}000}\ x\ CU\ 100{,}000 = CU\ 20{,}000$$

$$Yearly\ Income\ (2022) = \frac{CU\ 125{,}000\ (2022)}{CU\ 500{,}000}\ x\ CU\ 100{,}000 = CU\ 25{,}000$$

The journal entries of the Storm Company for the year 2021 and 2022 regarding the machine will be as follows.

2021, Apr.1	Dr. Property, Plant & Equipment (Assets)	500,000	
	Cr. Bank (Assets)		500,000
2021, Apr.1	Dr. Bank (Assets)	100,000	
	Cr. Deferred Income (Liabilities)		100,000
2021, Dec.31	Dr. Depreciation Expense – Equipment (P&L)	100,000	
	Cr. Accumulated Depreciation (Assets)		100,000
2021, Dec.31	Dr. Deferred Income (Liabilities)	20,000	
	Cr. Other Income – Government Grants (P&L)		20,000
2022, Dec.31	Dr. Depreciation Expense – Equipment (P&L)	125,000	
	Cr. Accumulated Depreciation (Assets)		125,000
2022, Dec.31	Dr. Deferred Income (Liabilities)	25,000	
	Cr. Other Income – Government Grants (P&L)		25,000

Government grants related to income must be matched with the relevant expense and systematically recognized in profit or loss.

Year	Costs	Ratio of Annual Cost to Total Cost	Grants Recognized by Year
2021	CU 90,000	CU 90,000/CU 150,000 = **0,60**	0,60 * CU 100,000 = **CU 60,000**
2022	CU 60,000	CU 60,000/CU 1,600,000 = **0,40**	0,40 * CU 100,000 = **CU 40,000**
Total	**CU 150,000**	**1,00**	**100.000 PB**

The accounting for the government grants received by the company for environmental expenses will be as follows.

2021	Dr. Bank (Assets)	100,000	
	Cr. Deferred Income (Liabilities)		100,000
2021, Dec.31	Dr. Environmental Expenses (P&L)	90,000	
	Cr. Bank (Assets)		90,000
2021, Dec.31	Dr. Deferred Income (Liabilities)	60,000	
	Cr. Other Income – Government Grants (P&L)		60,000
2022, Dec.31	Dr. Environmental Expenses (P&L)	60,000	
	Cr. Bank (Assets)		60,000
2022, Dec.31	Dr. Deferred Income (Liabilities)	40,000	
	Cr. Other Income – Government Grants (P&L)		40,000

The company could not fulfill the conditions regarding the government grants it benefited from in the purchase of the factory building. Government grants affected both tangible assets in the statement of financial position and annual depreciation expenses in the statement of profit and loss. When the government grant is repaid, the tangible assets and accumulated depreciation must be adjusted.

The cost of the factory building is CU 3,000,000 but is reported in the property, plant and equipment account as CU 2,000,000, because of government grants received. Depreciation expense for 2021 and 2022 also totals CU 60,000 (CU 30,000 + CU 30,000).

If the government grants had not been taken, the annual depreciation expense would have been calculated as follows.

$$Yearly\ Depreciation = \frac{CU\ 3{,}000{,}000 - CU\ 500{,}000}{50\ years} = CU\ 50{,}000$$

In this case, the depreciation expense to be recognized in profit or loss would be CU 50,000 per year instead of CU 30,000. Total depreciation expense for 2021 and 2022 would also be CU 100,000 (CU 50,000 + CU 50,000).

The adjusting entry to be made in case of repayment of the government grants is as follows.

2022, Dec.31	Dr. Property, Plant & Equipment (Assets)	1,000,000	
	Dr. Depreciation Expense – Equipment (P&L)	40,000	
	Cr. Bank (Assets)		1,000,000
	Cr. Accumulated Depreciation (Assets)		40,000

The effects of government grant on the financial statements in 2021 and 2022 will be as follows.

Statement of Financial Position Dec.31, 2021 CU			
Assets			**Lia.&OE**
PP&E	2,500,000	Deferred Income	120,000
Acc.Depreciation	(130,000)		

Statement of Financial Position Dec.31, 2022 CU			
Assets			**Lia.&OE**
PP&E	2,500,000	Deferred Income	55,000
Acc.Depreciation	(325,000)		

Statement of Profit & Loss (2021) PB		**Statement of Profit & Loss (2022) PB**	
Operating Expenses		Operating Expenses	
Depreciation Expense	(130,000)	Depreciation Expense	(195,000)
Environmental Expenses	(90,000)	Environmental Expenses	(60,000)
Other Income		Other Income	
Government Grants	80,000	Government Grants	65,000