

THE BENEFIT OF A GOVERNMENT LOAN AT A BELOW-MARKET INTEREST RATE: ACCOUNTING FOR AND DISCLOSURE IN COMPLIANCE WITH THE INTERNATIONAL FINANCIAL REPORTING STANDARDS

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Abstract: The question of why the problem of government grants and government assistance has increasingly attracted interest worldwide was discussed in my previous articles committed to the subject matter.

The issue that is the focus of the present article is the one of how to initially recognize and assess at recognition, how to evaluate and account for subsequently, i.e. after recognition, and how to present and disclose in the financial statements (of general purpose) the benefit of a government loan lent at a below-market rate of interest. The issue is a significant one as well as an important area in the subject scope of financial accounting and international financial reporting. Under the burden of the circumstances imposed by the crisis the problem has increasingly gained relevance. No less important turn out to be the complications arising out of the requirements for recognition, assessment and accounting for such benefit and related costs supplemented by additional guidelines for disclosure introduced throughout regular improvements to the International Financial Reporting Standards.

The subject matter is comprehensively discussed in theoretical and methodological standpoint. The International Accounting Standards Board's prescriptions that the applicable standards embody are presented, analyzed and summarized in manner consistent with the author's objectives. The primary author's goal is to explore and analyze the essentials, the core principles, the guiding rules relevant to the subject endorsed by the International Accounting Standards Board, to illustrate their practical application and to search for and find out coherent arguments for the support of the change (of 2008) in the International Accounting Standards Board's policy. Heuristic methods of scientific knowledge such as analysis and synthesis, induction and deduction, descriptive method and another methods as for instance, observation, comparison and analogy are used for achieving the author's goal. An additional author's motive was to support the professional community and students interested in enlargement and enhancement of their competencies integrating theoretical and practical knowledge. The essential amendment to the respective international accounting standards on financial reporting introduced by the International Accounting Standards Board refers to the accounting for and presentation of the benefit of receiving funds on a government loan at nil or a below-market rate of interest. Logically, it can be summarized that the accounting for a government grant as well as the manner of presentation and disclosure of the benefit of a government grant and government assistance depend on the nature of the specific object. The nature and the peculiarities of the object are of crucial importance to the process of accounting for, presentation and disclosure. This means that in practice it should be primarily answered the question of whether it is about a government grant, a government loan, a government guarantee or a tax benefit. Therefore, it will be critical to the process (procedure) of accounting for the specific requirements relevant to the particular case be precisely identified in order to be properly taken into consideration.

Keywords: government grant, government loan, benefit of a below-market rate of interest, international financial reporting, International Accounting Standards, International Financial Reporting Standards

1. INTRODUCTION

In modern dimensions financial accounting and reporting should be perceived as trinity of scientific theory, methodology and practice. Regardless of the accounting model established in a certain state or jurisdiction – European continental, Anglo-Saxon or another one, plenty of questions constantly arise in both theoretical and practical viewpoint. Usually among most complicated issues facing accountants and financial statements preparers are matters of identifying and classifying objects or items, of assessment at initial recognition or after recognition, of choosing the appropriate accounting approach that in turn predetermines the methodology of accounting for, the method of presentation in financial statements, the manner of disclosure etc. The questions may regard various objects of accounting, including loans lent by a government at a below-market rate of interest. The government policy of lending funds on preferential terms aimed at stimulating an entity or a group of entities qualifying under certain criteria to take a course of action is widespread across the world. Such government policy and practice of funding give rise to a benefit and costs related with it in the viewpoint of the credited and partially financed entity that should be adequately accounted for and disclosed.

After a complicated and cumbersome process of review and reconsideration of significant parts of the Conceptual Framework for Financial Reporting (CF) that continued for more than eight years, in March 2018 the CF revision was completed and the new Conceptual Framework for Financial Reporting (CF) was issued by the International

Accounting Standards Board (IASB). Compared to the previous one the Conceptual Framework (CF) of March 2018 contains considerable differences regarding key terms and definitions and introduces innovations related to substantial theoretical issues that have been regarded as ‘the alpha and omega’ of accounting for centuries. The author does not aim to analyse the essence of the most important changes in the Conceptual Framework for Financial Reporting (CF). The author aims to primarily support the professional community and students in the speciality considering the fact that the specific issue central to the present article is an important topic area in the subject scope of financial accounting and international financial reporting. Consistent with the author’s objectives on the basis of specific example the methodology of assessing, accounting for, presenting and disclosing the benefit of receiving funds on a government loan at a preferential below-market rate of interest is illustrated. Moreover, other related accounting and financial reporting issues are highlighted and discussed.

2. THE IMPROVEMENTS TO THE RELEVANT INTERNATIONAL FINANCIAL REPORTING STANDARDS: VIEWS AND CRITIQUE

2.1. THE INTERNATIONAL ACCOUNTING STANDARDS BOARD’S ANNUAL IMPROVEMENTS OF 22nd MAY 2008

In the viewpoint of the author’s objectives it is essential to be highlighted that as a significant part of the Annual Improvements to the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) on 22nd May 2008 the terminology used in the International Accounting Standards (IAS) 20 *Accounting for Government Grants and Disclosure of Government Assistance* was revised. The motives of refining the wording and of achieving higher degree of consistency with the terminology of other International Accounting Standards or International Financial Reporting Standards that have been revised until that time are comprehensible. The important changes concerning the terminology comprised the following ones:

- ‘Taxable income’ was amended to ‘taxable profit or tax loss’;
- ‘Recognized as income/expense’ was amended to ‘recognized in profit or loss’;
- ‘Credited directly to shareholders’ interest/equity’ was amended to ‘recognized outside profit or loss’; and
- ‘Revision to an accounting estimate’ was amended to ‘change in accounting estimate’.

2.2. THE INTERNATIONAL ACCOUNTING STANDARDS BOARD’S SUBSTANTIAL AMENDMENT OF 22nd MAY 2008

The most significant amendment to the relevant standard made by the International Accounting Standards Board (IASB) in 2008 was specifically that paragraph 37 under the heading ‘*Government assistance*’ was removed and a new paragraph 10A under the heading ‘*Government grants*’ was added. That change was undertaken as a consequence of systematic revision of and improvement to some International Financial Reporting Standards issued by the International Accounting Standards Board (IASB) in May 2008, effective 1st January 2009. The International Accounting Standards Board (IASB) agreed that the amendment of May 2008 can be considered a deep change in the policy of the Board (IASB). Most likely, it was made one more shift towards achieving greater degree of convergence, transparency and relevance of financial statements information. In my viewpoint, this act can be regarded as a reconsideration of the kind that reveals a decision of taking action towards changing the philosophy (to a certain extent) of the International Accounting Standard (IAS) 20 *Accounting for Government Grants and Disclosure of Government Assistance*. It gives rise to the interesting question of what was the rule (imbedded in the removed text under paragraph 37). The text was the following: “37 *Loans at nil or low interest rates are a form of government assistance, but the benefit is not quantified by the imputation of interest (Emphasis added).*” Why has the International Accounting Standards Board (IASB) embarked the course of change with regard to its earlier considerations, judgements and prescriptions on the same issue is a question to be answered. The newly introduced text (rule) was the following: “10A *The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with IAS 39 Financial Instruments: Recognition and Measurement. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IAS 39 and the proceeds received. The benefit is accounted for in accordance with IAS 20. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate (Emphasis added).*” Another amendment to the IAS 20 of that time was that paragraph 43 was added: “An entity shall apply those amendments **prospectively** to government loans received in periods beginning on or after January 1st, 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.”

2.3. AMENDMENTS TO INTERNATIONAL ACCOUNTING STANDARD (IAS) 20 ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE ALONGSIDE THE ADOPTION OF REGULATION (EC) № 1274/2008 OF DECEMBER 17th 2008

Additional amendments to International Accounting Standard (IAS) 20 *Accounting for Government Grants and Disclosure of Government Assistance* were made alongside the adoption of Regulation (EC) № 1274/2008 of December 17th, 2008, enactment of the European Commission Decision of December 17th, 2008 and these amendments include the following:

- In paragraphs 14 and 15 ‘the income statement’ was amended to ‘profit or loss’.
- In paragraph 28 ‘for the purpose of balance sheet presentation’ was amended to ‘for presentation purposes in the statement of financial position’.
- Paragraph 29A was added as follows: ‘29A If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of IAS 1 (as revised in 2007), it presents grants related to income as required in paragraph 29 in that separate statement.’
- Paragraph 42 was added as follows: ‘42 IAS 1 (as revised in 2007) amended the terminology used throughout IFRSs.’ In addition, paragraph 29A was added as follows: ‘An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies IAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.’

3. AN AMENDMENT ENDORSED BY THE INTERNATIONAL ACCOUNTING STANDARDS BOARD AS A RESULT OF THE ADOPTION OF THE NEW INTERNATIONAL FINANCIAL REPORTING STANDARD (IFRS) 9 FINANCIAL INSTRUMENTS

Subsequently in July 2014 the text of paragraph 10A was amended to read as it follows further down, paragraphs 44 and 47 were removed and paragraph 48 was added: “*10A The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with IFRS 9 Financial Instruments. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IFRS 9 and the proceeds received. The benefit is accounted for in accordance with IAS 20. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate (Emphasis added).*” Paragraph 48 of IFRS 9 as issued in July 2014, amended paragraph 10A and removed paragraphs 44 and 47. An entity shall apply those amendments when it applies IFRS 9 *Financial Instruments*. An entity usually accounts for the benefit of a government loan, funds on which are received at a below-market rate of interest, as a government grant under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. An entity accounts for the loan in accordance with IFRS 9 *Financial Instruments*. The benefit that in fact is a government grant is measured as the difference between the fair value of the loan on initial recognition and the amount of the proceeds received.

Similar considerations can be applied by analogy to loan guarantees provided by a government. A government guarantee for a new loan lent by a financial institution is generally accounted for as a government grant is accounted for. The entity should choose an accounting policy and approach to presentation, i.e., the entity should choose the method of gross or net presentation, and should consistently apply that policy. For example, if an entity applies the method of gross balance sheet presentation, the government guarantee is accounted for as a separate government grant under IAS 20. If it is assumed that an entity issues a debt on a government-guaranteed loan and the cash proceeds received from the lender (creditor) amount to 99 000 monetary units and the fair value of the loan without the government guarantee is 89 100 monetary units, on initial recognition the entity shall recognize a financial liability measured at 89 100 monetary units, and a government grant measured at 9900 monetary units. “If an entity applies the net approach to government assistance (in the form of a guarantee from the government for loans from financial institutions – an explanatory note), then it is considered part of the unit of account in determining the fair value of the loan” (O’Donovan, B., 2021, p. 2).

4. RECOGNITION OF AND ACCOUNTING FOR A FINANCIAL LIABILITY ON A GOVERNMENT LOAN AT A BELOW-MARKET RATE OF INTEREST

The recognition, assessment of and accounting for a financial liability on a loan at a below-market rate of interest is illustrated and discussed on the basis of an example intended for methodological purposes.

An entity qualifying under certain criteria operating in underdeveloped distant geographic region of the country receives 3 000 000 monetary units on a long-term loan agreed at a below-market interest rate under a contract with the national government. The funds on the loan are lent to the entity. Receiving the funds on the loan the entity

undertakes obligations and commitments to construct, install and commission an industrial equipment to be used for producing marketable food products for the people in the region.

In accordance with the debt repayment agreement and schedule 15 equal repayment installments should be made by the entity for the duration of fifteen years as of the end of each year. The agreed annual rate of interest is 5%. At that time (of negotiations) the prevailing current market rate of interest on loans with similar designation and risk lent by financial institutions as commercial banks, other credit institutions and lenders is 10%.

The entity classified the financial liability as subsequently measured at amortised cost and disclosed its accounting policy and approach (model) implemented with regard to financial liabilities classified into that category. The entity's accounting policy predetermines initial recognition at fair value measured under the discounted cash flows (DCF) method and subsequent measurement at amortised cost.

The interest rate of 5% is applied to forecast (estimate) the expected future annual cash outflows and the current market interest rate of 10% is applied as a discount rate in the calculations.

The present discounted value of the principal amounts to 1 521 215,90 monetary units (the annual repayment installment of 200 000 monetary units multiplied by the Present Value Annuity Factor, $AF_{(r, n)}$, equal to 7,6060795, at $r = 10\%$ per period and $n = 15$ periods) and the present discounted value of the expected future cash outflows calculated using the effective interest method is the total amount displayed under Column 7 in Table 1 that amounts to 739 383,2450 monetary units. Consequently, 1 521 215,90 monetary units *plus* 739 383,2450 monetary units is equal to 2 260 599,1450 monetary units, the amortised cost of the financial liability at the moment $t = 0$, the amount under the Column 9 in Table 1. The numbers and total amounts result of the calculations are presented in Table 1. It would be useful to emphasize the significance of the two essential definitions set out in Appendix A to IFRS 9 *Financial Instruments*: Effective interest rate (EIR) is the rate that exactly discounts estimated future cash flows through the expected life of the financial asset/liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. Gross carrying amount is the amortised cost of a financial asset before adjusting for any loss allowance. Effective interest method is the method that is used in the calculation of the amortised cost of a financial asset/liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss (P/L) over the relevant period.

CALCULATIONS UNDER THE DISCOUNTED EXPECTED FUTURE CASH FLOWS METHOD

Table 1

Column 1	Column 2	Column 3	Col 4 = Col 3 (the cell against the previous year) $\times 5\%$	Col 5 = Col 3 (the cell against the previous year) $\times 10\%$	Column 6	Column 7	Col 8 = Col 6 – Col 7	Column 9 = Col 9 + Col 8
Periods (years)	Repayments (payments) on the principal, monetary units	Unrepaid principal, monetary units	Contractual interest at an interest rate of 5%, monetary units	Market interest at a market interest rate of 10%, monetary units	Present discounted value of the market interest at a discount rate of 10%, monetary units	Present discounted value of the interest cash outflows at a discount rate of 10%, monetary units	Amortisation of the loan (interest income of the grant) for the period, monetary units	Amortised cost at the end of the period, monetary units
t=0	x	3 000 000	x	x	x	x	x	2 260 599
First	200 000	2 800 000	150000	300000	272727,2727	136363,6364	136363,6364	2 396 963
Second	200 000	2 600 000	140000	280000	231404,9587	115702,4793	115702,4793	2 512 665
Third	200 000	2 400 000	130000	260000	195341,8482	97670,9241	97670,9241	2 610 336
Fourth	200 000	2 200 000	120000	240000	163923,2293	81961,6146	81961,6146	2 692 298
Fifth	200 000	2 000 000	110000	220000	136602,6911	68295,4087	68307,2824	2 760 605
Sixth	200 000	1 800 000	100000	200000	112894,7860	56444,5255	56450,2605	2 817 055
Seventh	200 000	1 600 000	90000	180000	92368,4613	46184,2306	46184,2306	2 863 240
Eighth	200 000	1 400 000	80000	160000	74641,1808	37320,5904	37320,5904	2 900 560
Ninth	200 000	1 200 000	70000	140000	59373,6666	29686,8333	29686,8333	2 930 247
Tenth	200 000	1 000 000	60000	120000	46265,1947	23132,5974	23132,5974	2 953 380
Eleventh	200 000	800 000	50000	100000	35049,3899	17524,6950	17524,6950	2 970 904

Twelfth	200 000	600 000	40000	80000	25490,4654	12745,2327	12745,2327	2 983 650
Thirteenth	200 000	400 000	30000	60000	17379,8628	8689,9314	8689,9314	2 992 339
Fourteenth	200 000	200 000	20000	40000	10533,2502	5266,6251	5266,6251	2 997 606
Fifteenth	200 000	0	10000	20000	4787,8410	2393,9205	2393,9205	3 000 000
Total:	3 000 000	x	1200000	2400000	1478784,099	739383,2450	739400,8538	x

The Present Value Annuity Factor at the respective r and n is equal to: $AF_{(r,n)} = 7,606079506308364$ at $r = 10\%$ per period and $n = 15$ periods, in which equal repayments will be made at regular intervals of time, and it is calculated under the following formula used as the appropriate one in the case:

$$AF = \left[\frac{1}{r} - \frac{1}{r \cdot (1+r)^n} \right], \text{ in which it is replaced as follows:}$$

$$AF_{(r,n)} = 1 / 0,1 - 1 / 0,1 \times (1 + 0,1)^{15} = 10 - 1 / 0,1 \times 1,1^{15} = 10 - 1 / 0,1 \times 4,177248169415651 = 10 - 1 / 0,4177248169415651 = 10 - 2,393920493691636 = 7,606079506308363516125925051823.$$

An alternative manner of presenting the formula of calculating the Present Value Annuity Factor at the respective r – the interest rate also known as a discount rate, and n – the number of the periods, during which equal payments will be made at regular intervals of time, commonly found in the specialized literature on finance is the following:

$$AF_{(r,N)} = \frac{(1+r)^N - 1}{r(1+r)^N}$$

It will be useful to discuss the question of what the accounting double entries should be in the specific case since it is an interesting one in both methodological and practical viewpoint. It is stated in Paragraph 10A of IAS 20 that: “The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with IFRS 9 *Financial Instruments*. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with IFRS 9 and the proceeds received. The benefit is accounted for in accordance with this Standard”, i.e., IAS 20. It is stated in IFRS 9 that: “The fair value of a financial instrument at initial recognition is normally the transaction price (i.e. the fair value of the consideration given or received, see also paragraph B5.1.2 A and IFRS 13). However, if part of the consideration given or received is for something other than the financial instrument, an entity shall measure the fair value of the financial instrument. For example, *the fair value of a long-term loan or receivable that carries no interest can be measured as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument* (similar as to currency, term, type of interest rate and other factors) with a similar credit rating [B5.1.1].” In the specific case the economic benefit of receiving funds on a government loan at an interest rate lower than the market interest rate amounts to 739 400 monetary units rounded – the amortisation of the debt (the total interest revenue) for the fifteen periods that should be initially recognized as a government grant (a liability in the form of deferred income) and presented under the income approach in IAS 20. The benefit of such kind of grant is measured as the difference between the proceeds received – 3000 000 monetary units, and the initial carrying value of the financial liability, at which the liability will be initially recognized – 2 260 600 rounded.

Upon receiving the funds on the government loan at an interest rate lower than the market interest rate (or fulfilment of the conditions under which the loan is granted) the accounting entry is drawn up:

- Debit an account of group 50 Cash and cash equivalents 3 000 000
Credit an account of group 15 Debt instruments (liabilities) 2 260 600
Credit an account of group 75 Deferred income
and funding (government grants) 739 400

Upon making the first repayment instalment the accounting entry shall be drawn up:

- Debit an account of group 15 Debt instruments (liabilities) 200 000
Debit an account 621 Interest expenses (in P/L) 150 000
Credit an account of group 50 Cash and cash equivalents 350 000

Upon accrual of an interest expense up to the amount of the present discounted value of the market interest (and amortisation of the debt for the period) the accounting entry shall be drawn up:

- Debit an account 621 Interest expenses (in P/L) 136 363
Credit an account of group 15 Debt instruments (liabilities) 136 363

Upon accrual of an interest revenue (income) in the amount of the benefit (for the period) of the government loan lent at a below-market interest the accounting entry shall be drawn up:

- Debit an account of group 75 Deferred income
and funding (government grants) 136 363

Credit an account 721 Interest revenue (in P/L)	136 363
Or Credit another account of group 72 Financial revenues	with the same amount

As a result of the double entries an interest cost at 10% is presented as charged to profit or loss rather than the actually paid at 5%, which is offset, i.e., counterbalanced by the government grant revenue (income) recognised in profit or loss. Therefore, the benefit of a government loan lent at a below-market rate of interest accounted for as a government grant recognized in profit or loss and presented in the statement of profit or loss *does not affect the financial result*. The accounting for a financial liability at amortised cost means that the effective interest on the liability charged as a finance cost to expense (recognized in profit or loss) is presented in the statement of profit or loss, *not the interest actually paid as cash*, and that the changes in market interest rates are ignored, i.e., the financial liability is not revalued at the reporting date. That way the total finance cost is allocated and recognized as charged to profit or loss in portions for the duration of the relevant repayment period.

Alongside the addition of one more object of accounting for with the inclusion of a new Paragraph 10A in IAS 20 a supplementary requirement for disclosure was added – the benefit of a government loan at an interest rate lower than the market interest rate should be disclosed in the explanatory notes. The entity should provide the disclosures required by IFRS 7 *Financial Instruments: Disclosures*. Additional disclosures explaining how the entity derives benefit from a government assistance may also be necessary under IAS 1 *Presentation of Financial Statements*. In IAS 20 (paragraph 43) it is stated that paragraph 37 was deleted and paragraph 10A added by Improvements to IFRS issued in May 2008. An entity shall apply those amendments *prospectively* to government loans received in periods beginning on or after 1st January, 2009. Earlier application is permitted, and if an entity applies the amendments for an earlier period it shall *disclose* that fact.

5. CONCLUSION

The decision for inclusion of a new paragraph 10A in International Accounting Standard (IAS) 20 *Accounting for Government Grants and Disclosure of Government Assistance* represents a change in the policy undertaken by the International Accounting Standards Board. Most likely the main argument of the IASB's authoritative members was to achieve greater degree of consistency as well as uniformity and homogeneity in regard to the guiding principles and the philosophy of other related standards (in respect of loans with a below market-rate of interest) for example, International Accounting Standard (IAS) 39 *Financial Instruments: Recognition and Measurement*, International Financial Reporting Standard (IFRS) 9 *Financial Instruments* and others. The entity should consider all the conditions, obligations and commitments that have been, or must be, met when it identifies the costs for which the benefit of the loan is intended to compensate. The accounting for government grants and the presentation and disclosure of government grants and government assistance in the financial statement can be considerably different as they depend on the nature and the form of the grant or the assistance. Therefore, the comprehensive answer to the question of whether it comes about a government grant, a government loan granted on preferential terms, a government guarantee or a tax benefit is of crucial importance. It is critical to the process of accounting for the object the requirements relevant to the particular case be prudently identified in order to be taken into consideration. The requirements set out in the International Financial Reporting Standards comprise a wide range of rules relating to the issues of how to recognise, assess, present and (or only) disclose government grants and other forms of government assistance that considerably differ. For that reason, the entities reporting in compliance with the International Financial Reporting Standards should above all identify the exact standard or standards intended to be implemented in the specific case in order to apply the appropriate accounting policy and approach.

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