European Securities and Markets Authority

The Chair

Date: 17 August 2015
ESMA/2015/1258

Wayne Upton
Chairman of the IFRS Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Agenda Item Request: Recoverable cash advances

Dear Mr. Upton,

The European Securities and Markets Authority (ESMA) is an independent EU Authority that contributes to enhancing the protection of investors and promoting stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. ESMA contributes to the regulation of financial services firms with a pan-European reach, either through direct supervision or through the active co-ordination of national supervisory activity.

As a result of the reviews of financial statements carried out by national competent authorities and ESMA's co-ordination activities, we have identified an issue related to the application of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* related to accounting for recoverable cash advances.

A detailed description of the case is set out in the appendix to this letter.

We would be happy to further discuss this issue with you.

Yours sincerely,

Steven Maijoor

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. As part of their monitoring and supervisory activities, ESMA and national enforcers have identified divergent application of requirements of IAS 20 regarding the accounting for recoverable cash advances (RCA). Specifically, divergence in practice exists regarding accounting of RCA funding provided by government that is recoverable, based on certain conditions. The main issue is whether a financial liability should be recognised upon receipt of the RCA, to take into account the recoverable portion of the cash advance.

Description of the issue

2. The government provides financial support to private entities for their experimental development programmes.[1] The government's financial support takes the form of either a subsidy or a RCA. RCA contracts are divided in three phases, i.e., the 'research phase', the 'decision phase' and the 'exploitation phase'.[2]
3. During the research phase, the issuer receives funds from the government in order to cover 60 % of the expenses incurred (the total of the funds received are called hereafter the 'principal amount'). At the end of the research phase (which can take about 12 to 24 months), the issuer should, within a period of six months, decide to exploit the results of the research programme or abandon it. If the issuer decides to exploit and commercialise the research results, the corresponding RCA becomes refundable (in full or partially).
4. The reimbursements of the RCAs to the government are of two different types, i.e. turnover-independent reimbursements (annual lump-sums) and turnover-dependent reimbursements (a fixed percentage of the turnover). The triggers for those reimbursements are different. The trigger for the turnover-independent reimbursements is the entity's decision to start to exploit the results of the research programme whereas turnover-dependent reimbursements are only to be made when an entity earns revenue from the development (which generally occurs several years after the decision to exploit the R&D programme is taken).
5. For instance, in a typical example the turnover-independent reimbursements are fixed by contract at 30% of the principal amount and are spread over a period of 10 years, and the annual turnover-dependent reimbursements are fixed at 5% of annual turnover.[3] The amount reimbursed can increase up to a maximum of 200% of the principal amount in case the project is successful (i.e. if the entity decides to exploit the results of the research programme and a certain predetermined turnover threshold is exceeded), or be limited to a minimum of 50% of the principal amount in case the

[1] This type of government assistance is relatively common in member states of the European Union, based on the EU community framework for state aid for research and development and innovation (2006/C 323/01).
[2] Exploitation does not mean immediate commercialisation. It can mean the use of the research results for the further development of a product. Typically, the issuer will earn revenue from the development several years after the 'decision phase'.
[3] usually in this type of contracts the range is between 0.18% and 5% of annual turnover

project is not successful (i.e. if the entity decides to exploit the results of the research programme but the turnover does not exceed a certain threshold).

6. If the issuer decides to abandon the project after the research phase, the RCA is not refundable and the rights related to the results of the research phase are transferred to the government.

7. The contract allows an issuer to initially start the exploitation phase (with the resulting repayment of the RCA), and to decide after some time to renounce the exploitation of the programme. In this case, the issuer is exempted from future repayments as of the calendar year after such decision is taken if certain formal conditions are met (i.e. formal notification providing explanations showing that the decision is based on rational grounds such as a negative development in the economic, technological or legal environment). In such situations, the rights attached to the R&D programme are transferred to the government and the issuer is prohibited from using, exploiting or selling any product or service that is (even partially) based on the results of the development project. All the amounts paid back to the government, before the decision to abandon the project is taken, remain the government's property.

View 1 – Recognition of a liability for a recoverable part of RCA

8. Proponents of View 1 argue that, upon receipt, RCAs are recognized as government grants only when there is reasonable assurance that the terms for forgiveness will be met. When this is not the case a liability should be recognised.

9. Proponents of this view argue that RCAs meet the definition of a forgivable loan defined in paragraph 3 of IAS 20 as 'loan which the lender undertakes to waive repayment of under certain prescribed conditions'. Paragraph 10 of IAS 20 requires a forgivable loan from government to be treated as a government grant only when there is a reasonable assurance that the entity will meet the terms for forgiveness of the loan.

10. IAS 20 does not provide a definition of '*reasonable assurance*'. However, IAS 41 *Agriculture* deals with government grants related to a biological asset. Paragraph B69 of the Basis for Conclusions on IAS 41 states that 'it would inevitably be a subjective decision as to when there is reasonable assurance that the conditions are met and that this subjectivity could lead to inconsistent income recognition'. Paragraph B70 outlines two alternative approaches for deciding whether an entity should recognise a conditional government grant under IAS 41: (a) when 'it is probable that the entity will meet the conditions attaching to the government grant' and (b) when 'the entity meets the conditions attaching to the government grant'. Paragraph B73 states that the Board concluded that approach (b) is the more appropriate and thus paragraph 35 of IAS 41 explicitly requires that a government grant should only be recognised when the conditions attached to it are met. Therefore, proponents of the View 1 argue that

'reasonable assurance' is on a scale between 'probable' ('more likely than not')[4] and 'certain'. Consequently, an entity cannot recognise government grants before it is at least more likely than not that it complies with the conditions attached to them.

11. If upon receipt of the RCA there is no reasonable assurance that the project will be fully abandoned before the exploitation phase (for example, because similar projects with similar risks continue in the exploitation phase), and therefore there is no reasonable assurance that the full amount of the principal loan will be forgiven, then the RCA cannot be accounted for as government grant in its entirety.

12. Proponents of this view argue that, when analysing whether there is reasonable assurance that an entity will meet the terms for forgiveness of the loan, it might be necessary to make a distinction between the turnover-dependent and turnover-independent reimbursements as the criteria triggering their respective repayments are different. As indicated above, turnover dependent-reimbursements have only to be made when an entity earns revenue from the development, whereas the trigger for the turnover-independent reimbursements is the entity's decision to start to exploit the results of the research program.

13. Therefore, considering a situation where the issuer until now decided to start exploitation of the results in almost all funded programs, it is not probable upon receipt that the turnover-independent reimbursements will be forgiven. Consequently, no reasonable assurance exist that the terms for forgiveness of this part of the loan (30% in the case described) are met and the liability for this part of the loan should be recognised.

14. However, when upon receipt of the loan the likelihood that an entity will actually earn any significant revenue within a period of 10 years from the exploitation is small, it can be argued that reasonable assurance exists that the terms for forgiveness of a portion[5] of the turnover-dependent part of the loan are met. Therefore, the turnover-dependent reimbursements that are expected not to be repaid should be accounted as government grant in operating income.

View 2 – accounting of the full RCA as a government grant

15. Proponents of View 2 argue that, upon receipt, the full amount of advances should be accounted for as government grants in operating income. The advances should not be deferred as they are linked to costs already incurred. If the beneficiary of the RCA decides to exploit the results of the RCA, the relevant RCA becomes refundable and a liability and an operating expense for the full RCA received is recognised.

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[4] Appendix A of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* or paragraph 23 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

[5] As explained in paragraph 5 a minimum of 50% of the principle amount has to be reimbursed if the project is exploited even if unsuccessfully

16. Proponents of this view argue that no liability can be recognised until the decision to exploit because the definition of a financial liability in paragraph 11 of IAS 32 *Financial Instruments: Presentation* is not met. Accordingly, there is no contractual obligation to deliver cash to the government as it is the issuer's own decision to exploit the results of the research phase and therefore the obligation to reimburse can be avoided (assessment at the time when the decision whether to exploit the results is made).

17. Furthermore, when the eligible expenses or losses have already been incurred, government grants are recognised as a profit in the period in which the issuer is qualified to receive it, as required by paragraph 20 of IAS 20. As in substance RCAs are government grants with conditional repayment features which are different from forgivable loans that might become government grants if certain conditions are met, paragraph 10 of IAS 20 cannot be applied.

18. As the grant is recognised only after the expenses have been incurred and after the subsidy has been cashed in, there is a certitude (rather than only a 'reasonable assurance') that the entity complies with the conditions attached to it and thus that the grant has been received. The decision to exploit the results remains at any time in the hand of the issuer so that the reimbursement can be avoided if the entity decides so.

19. According to paragraph 32 of IAS 20 when a government grant becomes repayable, it shall be accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Therefore, in the event the company decides to exploit the results under an RCA, the relevant RCA becomes refundable and at that moment a financial liability is recognised and debited to the statement of comprehensive income.

Request

20. ESMA seeks clarification on whether RCAs should be recognised as government grant or as forgivable loan and whether distinction should be made between the turnover-dependent and turnover-independent reimbursements. Furthermore, ESMA requests clarification on whether the fact that the decision to exploit the results remains at all time in the hands of the issuer and that the reimbursement can be avoided under certain conditions have an impact on the analysis. Consequently, if a part of the RCA cannot be treated as a government grant, ESMA seeks clarification on whether a financial liability should be recognised upon receipt of the RCA.

21. ESMA is aware of divergent practices in various European jurisdictions. Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee considers clarifying the accounting requirements in this respect.