EFFECTUS GROUP

September 11, 2022

Ms. Hillary Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: Invitation to Comment, *Accounting for Government Grants by Business Entities*

Dear Ms. Salo:

We appreciate the opportunity to provide our feedback on the Invitation to Comment, *Accounting for Government Grants by Business Entities.* We support the Board's efforts to provide a framework for accounting for grants under generally accepted accounting principles in the United States and believe that IAS 20 and the experiences of practitioners of applying it by analogy provide a helpful starting point for the Board's deliberations.

We have the following observations that we believe are necessary to improve the operability, consistency and understandability of any FASB standard for grants that starts with IAS 20 as its base:

- The scope of any standard should not be restricted to government grants but should also include non-government grants such as those from philanthropic organizations to biotechnology companies.

- The recognition threshold should be anchored to concepts that are well-understood in US GAAP such as probable or more likely than not rather than the auditing notion of reasonable assurance.

- GAAP should require an entity to identify the activity (i.e., analogous to a performance obligation under ASC 606) the respective grant is intended to incent and then recognize the grant in income as the activity is satisfied or completed using an appropriate measure of progress. In addition, a standard should provide unit of account guidance for grants that have multiple incentives or triggers to grant entitlement embedded in them.

- The presentation of grant income should be separately presented from the asset or expenses the grant is intended to subsidize.

- For cash flow statement purposes, a perspective that should be considered by the Board is that grants are a source of financing for an entity.

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Each of these observations are addressed in our responses to the practitioner questions set forth in the Appendix to this letter.

If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Brian Allen at ballen@effectusgroup.com.

Sincerely,

Brian Allen, Partner

cc. Adam Barrow
Christie Hutchinson
Natasha Khegay

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Appendix – Responses to Questions for Practitioners

Question 1:

GAAP does not have specific topical authoritative guidance on the accounting for government grants by business entities. Should the FASB consider incorporating into GAAP the guidance in IAS 20 as it relates to the accounting for government grants? If yes, what aspects of IAS 20 related to recognition, measurement and/or presentation should be incorporated and why?

The FASB should consider providing guidance on the accounting for grants by business entities but we believe the guidance should not be restricted to government grants. It should also include philanthropic grants such as those in the pharmaceutical and biotechnology industries. IAS 20 provides a useful starting point for discussing the accounting for grants but it is built on a cost matching principle rather than identifying the activity the grant is intended to incent and recognizing the grant in income as the activity is satisfied or completed. We also believe the option to offset grant income against the expenses incurred to satisfy the grant is not transparent to investors and is inconsistent with the notion of presenting in the income statement the results of the enterprise's ongoing and major operations. Consequently, the presentation of grants should generally be separately presented from the asset or expenses it is intended to subsidize .

Question 2:

a. What type of government grants do you (or the companies you audit) receive?
b. How do you (or the companies you audit) recognize, measure, and present government grants received? Do you (or the companies you audit) apply IAS 20 by analogy or another model?
c. What issues or challenges, if any, have arisen (or do you anticipate would arise) in the application of IAS 20 as it relates to government grants?

Our clients have received grants for a variety of reasons. These primarily include:

- The construction of productive facilities or capacity
- Basic or applied research and development
- Employment of personnel

On occasion, a grant may involve a combination of the above grantor objectives such as the construction of a plant followed by the employment of a minimum number of people for a period of time. IAS 20's focus on determining whether a grant relates to an asset or income is not helpful in these circumstances and we would suggest an activity/performance obligation based approach upon which to build unit of account and recognition guidance.

Historically, SEC registrants and their auditors have solicited the SEC Staff's views on whether IAS 20 can be applied by analogy to a particular grant program and the SEC Staff have on occasion objected to the application of IAS 20 by analogy to programs that appear to be in scope of IAS 20. As a result, SEC registrants have experienced financial reporting uncertainty and anxiety oftentimes during a period of crisis regarding whether IAS 20 is an acceptable analogy by an SEC registrant for a new or novel government grant program initiated and intended to mitigate the adverse effects of a crisis.

Many of our clients are in the life sciences industry and the remainder of our response to this question relates to grants received by companies in this industry. Our clients are generally for-profit entities that may receive both government and non-government grants from quasi-government or philanthropic non-profit foundations. The grants our life sciences clients receive typically fund or reimburse research and development activities in areas that are of interest to the government or non-government grantors, such as vaccine or treatment development for COVID-19, malaria, Parkinson's disease, various cancers or rare diseases.

Philanthropic grants are considered conditional; that is, research expenditures must be made and there may be milestones or other incentives attached to the grant. The majority of our clients recognize grant payments as a reduction to research and development expenses in the same period as the expenses that the grant is intended to defray are incurred, however diversity in practice exists, and some companies recognize a credit to income as opposed to a reduction in expenses.

If cash is received in advance of satisfying the grant conditions, it will be recorded as restricted cash, and companies will recognize a deferred income liability. The liability is released as the related expenses are incurred, generally using a cost-to-cost approach (whereby companies divide all costs recorded to date on a project by the total estimated amount of costs that will be incurred for that project or job). Where projects are a year or less and straight-line amortization of the deferred liability is concluded not to substantially differ from a cost-to-cost approach, certain companies have elected to release the deferred liability on a straight-line basis for practical purposes.

IAS 20 is generally applied by analogy for government grants. For grants received from non-government entities, ASC 958-605 is generally applied by analogy. The recognition and accounting results under these two analogies is generally not consistent even though the economics and facts and circumstances are oftentimes alike. Further, in applying 958-605 by analogy, a company may receive a non-reciprocal contribution, where the grantee must abide by certain terms and conditions that are not directly tied to the incurrence of specific expenses. In these cases, there are often no clear "performance obligations" or measures of progress against which to release the liability, or no clear point after which such grant becomes unconditional.

Diversity in practice exists for the presentation of grants, as the guidance presents two methods which are acceptable. Additionally, there is diversity in practice as to the geography of presentation for grants (such as, either presented in operating income or below operating income).

Question 4:

Is the definition of the term government in IAS 20 understandable and operable, and if not what changes would need to be made to make it operable?

The definition of the term "government" or "similar bodies" is not specifically precise in IAS 20. Paragraph 3 states "government refers to government…" which although perhaps intuitively obvious is not really a definition. This has downstream scoping effects as, for example, it is not necessarily clear whether an incentive to construct renewable energy sources to a commercial entity by a power utility that is a government enterprise fund should be considered a government grant or instead in the scope of ASC 705-20. Similarly, there may be commercial entities controlled by foreign governments that offer incentives to customers that should not be accounted for as government grants. Finally, there may be subsidies from a government that pass-through a business entity that are substantively government grants to the ultimate recipient. Finally, what would constitute "similar bodies" is left to the imagination by IAS 20. For example, CEPI is funded principally by national governments but also by private philanthropic organizations.

Question 5:

What operability or auditing concerns or constraints, if any, have arisen (or do you anticipate would arise) in applying both of the following:
a. The definition of government grants (paragraph 3 of IAS 20)
b. The scope exceptions (paragraph 2 of IAS 20)?
Please also describe the nature and magnitude of costs in applying the definition of government grants and the scope exceptions, differentiating between one-time costs and recurring costs.

As previously discussed, the application of IAS 20 as an acceptable analogy for government grants has been viewed with varying degrees of skepticism by the SEC Staff at different times in the past leading to the incurrence of costs and burden through SEC consultations to establish whether IAS 20 can be applied to a particular government grant program. Under paragraph 2 of IAS 20 it would appear that a refundable tax credit may or may not be in scope. Finally, the exception in paragraph 2(d) for agricultural grants appears unnecessary under GAAP.

We do not believe there is substantial incremental cost in applying IAS 20 versus any alternative such as ASC 958-605, ASC 606 or ASC 450 and believe cost would be reduced by a standard that was clear as to scope and applied a model that was coherent and rigorous such as applying similar principles as ASC 606 for unit of account and recognition.

Question 6:

Are there challenges associated with determining whether certain forms of government assistance cannot reasonably have a value placed upon them? Please describe. Could those challenges be overcome with the use of examples?

In general, the forms of government assistance that cannot reasonably have value placed upon them as described in the second sentence of the description of "government assistance" in paragraph 3 of IAS 20 are understood in practice. IAS 20 has helpful guidance on the forms of indirect government assistance that is excluded from its scope as well as examples in the definitions and in paragraph 38. Guidance such as this should be included in GAAP. Additional examples like this may be useful so business entities will more readily understand the scope of any standard.

Question 7:

Is the guidance clear and understandable on how to determine when a transaction with a government cannot be distinguished from the normal trading transactions of an entity? Could those challenges be overcome with the use of examples.

Establishing clear scope boundaries between ASC 606 and 705-20 will avoid implementation or interpretative issues. Examples may also be helpful in enhancing where scope boundaries exist. As an example, concepts in IAS 20 such as “normal trading transactions” should be aligned with similar but more appropriate GAAP guidance that already exists and is understood in practice.

Question 9:

Are the recognition and measurement requirements in paragraphs 7–22 of IAS 20 operable and understandable? Please describe the nature and magnitude of costs and any operability or auditing concerns on applying those requirements, differentiating between one-time costs and recurring costs.

The recognition threshold should be anchored to concepts that are well-understood in US GAAP such as probable or more likely than not because reasonable assurance is an auditing concept rather than an accounting notion. Recognition of a grant should occur over the time period that the activity required by the grant is conducted. There are useful analogies and parallels that can be made to ASC 606's over time recognition guidance rather than the matching principle that permeates IAS 20. Using that framework would reduce the amount of learning curve for a grant standard.

Measurement in GAAP has evolved to a point where the ability to estimate fair value even for difficult or highly subjective items is presumed.

Question 10:

Is the guidance operable in paragraph 19 of IAS 20 on identifying the conditions that give rise to costs and expenses to determine the periods over which a grant will be earned? Please explain why or why not.

Paragraph 19 does not provide useful guidance for accounting for grants with multiple conditions and its application would likely lead to diversity and inconsistency in practice. We would suggest considering concepts like performance obligations and the over time or point in time recognition guidance from ASC 606 as a possible framework for addressing unit of account and related recognition questions.

Question 11:

Should there be different accounting requirements for grants related to assets and grants related to income? If yes, is the distinction between the types of grants clear?

There should not be a separation between grants related to assets and grants related to income. Grants are fundamentally a source of financing that are not required to be repaid if the grant conditions are satisfied. The recognition for grants should be linked to the activity required by the grant such as constructing and operating a plant for a period of time or maintaining a minimum number of employees rather than specifically matching grant income against specific expenditures unless the incurrence of the expenditures is an appropriate measure of progress for completing the activity required by the grant. For example, assume there is a government grant to build and operate a plant for a minimum period of 5 years and the plant is expected to have a 30 year expected life. Under the capital approach, some or all of the grant would be deferred and amortized over 30 years. We do not believe it is decision-useful information to report the benefit of a grant in, say, year 25 when the grant was fully earned out in year 5.

In addition, for transparency purposes and conceptual reasons, offsetting grant receipts against separate expenditures for assets or expenses to satisfy, or complete the activity required by, the grant should not be permitted.

Question 12:

What are the challenges, if any, associated with determining the timing and pattern of the recognition of a government grant, or what do you anticipate they would be? Please explain.

Beyond the customary challenge of estimating future expenditures and interpreting management intentions, the principal difficulty with determining the timing and pattern of the recognition of a grant is evaluating whether it should be separated into component parts when the entity is subject to multiple conditions before the grant is earned out. Our suggestion would be to use concepts similar to those in ASC 606 related to evaluating whether a promise is distinct in the context of the grant and the guidance regarding determining measure of progress towards completing the activities required by the grant.

Question 13:

a. The term reasonable assurance is not defined in IAS 20. How is the application of reasonable assurance interpreted in practice or how do you anticipate the application would be interpreted in practice? Do you have concerns about the operability of determining reasonable assurance? Please explain.
b. Topic 606, Revenue from Contracts with Customers, indicates that one of the criteria that must be met for an entity to account for a contract with a customer is that it is probable that the entity will collect substantially all the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraph 606-10- 25-1(e)). Would a similar probability threshold as that noted in paragraph 606-10-25-1(e) be a workable solution to apply the guidance in either paragraph 7(a) or 7(b) of IAS 20 for determining reasonable assurance?

There likely is diversity in practice regarding the interpretation of reasonable assurance ranging from more likely than not to probable to virtually certain. Porting many of the concepts from ASC 606 to an accounting standard for grants would achieve a more consistent outcome for similar grant activity, be understandable to users of the financial statements and reduce the possibility of differing interpretations or unintended consequences resulting from attempting to define reasonable assurance for accounting purposes.

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Question 16:

Which measurement approach has been applied (or do you anticipate would be applied) to account for nonmonetary government grants received? If only one measurement approach was permitted, which measurement approach would you prefer?

To be aligned with the accounting for nonmonetary transactions according to GAAP, specifically ASC 845-10-30-1, nonmonetary grants should generally be measured at fair value.

Question 18:

For grants related to assets and grants related to income, which presentation requirements have been applied or do you anticipate would be applied given the option to elect gross or net presentation? Please explain why. Are grants related to assets fundamentally different than grants related to income since acquired assets are recorded on a cost accumulated basis?

From an accounting standpoint and as previously discussed, there should not be a separation between grants related to assets and grants related to income. Rather, the focus should be on the activity that must be completed to be entitled to the grant and recognition of grant income as that activity is completed.

With respect to gross or net presentation, our experience is that a majority of entities analogizing to IAS 20 use net presentation but there is diversity in practice. We believe gross presentation is preferable for transparency and conceptual reasons since these are separate cash flows and the receipt of grant income is typically not part of most entities ongoing or major operations.

Question 19:

IAS 20 does not provide guidance on where in the statement of cash flows an entity should present the cash inflows from the receipt of cash grants. How are government grants presented in the statement of cash flows or how do you anticipate they would be presented?

Our experience in practice is that cash flow statement classification under an analogy to IAS 20 depends upon whether the grant is considered an asset or income grant – asset grants may be presented either as investing or financing activities and may be presented gross or net while income grants are generally presented as operating activities. A perspective that should be considered by the Board is that grants are a source of financing of an entity. Following this thinking to its logical conclusion and similar to equity financing or financing through debt, cash flows from the receipt of cash grants would be presented as cash flows from financing activities.

Question 21:

Is the accounting guidance in IAS 20 on forgivable loans clear and understandable? Please explain why or why not.

The definition of a forgivable loan is again linked to the notion of 'reasonable assurance' as it pertains to meeting the terms for forgiveness of the loan. Instead, and as noted in our response to Question 9, the recognition threshold should be anchored to concepts already articulated and understood under GAAP such as probable or more likely than not. As far as accounting, we concur that a forgivable loan from a grantor should be treated as a grant (or any grant in general) once an appropriate recognition threshold is met.

Question 23:

a. Should the FASB consider making changes to GAAP that would require the benefit of a below-market interest rate loan from a government to be accounted for as a government grant, similar to the guidance in IFRS 9?
b. How frequently do you (or the companies you audit) receive loans with below-market interest rates from a government?
c. If the FASB requires recognition of the benefit of a below-market interest rate loan from the government, should such accounting be extended to other forms of government lending such as government guarantees and/or government-facilitated lending programs?

We believe the application of ASC 835-30-15-3(e) which scopes out "…transactions where interest rates are affected by the tax attributed or legal restrictions prescribed by a governmental agency (for example, industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements)" is sufficient guidance for government loans with purportedly below market interest rates. Because we believe most grant income should be presented as other income where interest expense is also presented, there does not appear to be much financial reporting benefit to grossing up these two numbers for an esoteric accounting exercise. Finally, if the Board elects to continue with IAS 20's asset versus income distinction between government grants, it is unclear how the grant aspect of a below market interest loan should be accounted under that framework.

Question 25:

a. What issues or challenges, if any, have arisen (or do you anticipate would arise) when accounting for contingent assets and/or contingent liabilities relating to government grants in applying IAS 37?
b. What issues or challenges, if any, have arisen (or do you anticipate would arise) when accounting for contingent assets and/or contingent liabilities relating to government grants in applying Topic 450 instead of IAS 37?

For those companies applying IAS 20 by analogy under US GAAP, we do not believe they should further analogize to IAS 37 for contingent assets or liabilities since contingencies are directly in the scope of ASC 450. ASC 450 has on occasion in the past been used to account for government grants rather than an analogy to IAS 20. Therefore, we believe any proposed standard should be clear about scope to distinguish between a bona fide government grant and something else that is merely a game of chance (e.g., an entity buying lottery tickets). With respect to loss contingencies and grants, the standard should be clear on the accounting when the recognition threshold has been met (e.g., probable or more likely than not) and grant income has been recognized that any reversal resulting from that threshold no longer being met should be through grant income under the same standard (i.e., similar to ASC 606) rather than ASC 450.

Question 26:

a. Has your organization (or your clients) had to repay a government grant? If yes, please describe the type of grant and reason for repayment.
b. What issues or challenges, if any, have arisen (or do you anticipate would arise) when accounting for a repayment of a government grant by applying Subtopic 250-10 (instead of IAS 8)?

We have observed infrequent repayment of grants and these have occurred either due to a change in management intentions with respect to an entity's business priorities, other circumstances that could not be foreseen at the time of grant initiation or misinterpretations regarding eligibility. We anticipate that application of Subtopic 250-10 in the case of government grant repayment would have similar challenges to the application to IAS 8, consisting primarily of disclosure requirements and income reversal considerations.

Question 27:

Are there any other areas relating to IAS 20 and the accounting for government grants that the FASB should consider? Please explain.

On occasion, commercial entities are used as a conduit for government grants to the ultimate beneficiary. This could raise principal versus agent questions for the conduit entity in accounting for government grants and consideration should be given to providing presentation guidance for these circumstances.