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International Accounting Standards Board®

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Mr. Dov Sapir
Chairman
Israel Accounting Standards Board
14 Gruzenberg Street
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Israel

Dear Dov,

Accounting for government grants received from the Office of the Chief Scientist ("OCS") in Israel

Thank you for your letter dated 28 March 2007. The appendix to this letter outlines a response from the staff at the International Accounting Standards Board to your inquiry. The response is <u>not</u> an official statement by the IASB. Official positions of the IASB are set out in the Standards and Interpretations and are determined only after extensive due process and deliberation.

Please note that the IASB does not provide a technical inquiry service. We do not have sufficient staff resources to provide such a service on a worldwide basis; nor can we provide a selective service to some inquirers and not others. Finally we do not have in-depth knowledge of the facts and circumstances surrounding particular transactions and events that a person with technical accounting expertise and resident in your country would have.

We are pleased to receive information about implementation issues concerning IFRSs. However, while we have responded to your inquiry on this occasion, we are unlikely to be able to do in the future.

Yours sincerely,

Liz Hickey
Director of Technical Activities

APPENDIX

Please note that the opinions expressed in this appendix are those of the staff. They are not an official position of the IASB. Official positions of the IASB are set out in the Standards and Interpretations and are determined only after extensive due process and deliberation.

Scope

Our response is based on the facts provided in your letter dated 28 March 2007 and your e-mail dated 7 June 2007. Our response addresses two issues from the perspective of an Israeli entity participating in an OCS Support Program:

- how to account for the funds received from the OCS for their research and development efforts; and
- how to account for the royalties and interest payable on revenues derived from the products and services developed from a project funded by the OCS.

Our response does not consider:

- whether any products resulting from the entity's research and development activities produce inventory or tangible assets;
- impairment testing for any capitalised development costs;
- the recognition of revenue derived from the products and services developed from a project funded by the OCS;
- any tax implications; and
- the accounting by the OCS.

References

- IAS 1 *Presentation of Financial Statements*
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*
- IAS 32 *Financial Instruments: Presentation*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- IAS 38 *Intangible Assets*
- IAS 39 *Financial instruments: Recognition and Measurement*

Funds received from the OCS

We believe that the funds received from the OCS satisfy the definition of a government grant in IAS 20. Accordingly, an entity should account for the funds as either a grant related to income, or a grant related to an asset, depending on the nature of the costs incurred.[1]

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[1] *Grants related to assets* are government grants whose primary condition is that an entity qualifying them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be

Section A of your letter states that Israeli entities use OCS funds for research and development activities. We have assumed that your use of these terms is consistent with the definitions in IAS 38.8, namely:

- *research* is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.
- *development* is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Research costs

IAS 38.54 states that an entity shall not recognise an intangible asset arising from research activities. Instead, an entity expenses research costs when incurred. Consequently, we believe that any OCS funds intended to compensate the entity for research costs are grants related to income.

Following IAS 20.12, an entity recognises grants related to income in its income statement when it expenses research costs. IAS 20.29 requires an entity to present grants related to income as either 'other income' or as a deduction from the related expense. If material, the entity should disclose the effect of the OCS funds on either 'other income' or the related expense in the notes to its financial statements.

Development costs

IAS 38.57 states that an entity shall recognise an intangible asset resulting from development activities if, and only if, it meets *all* of the listed criteria.

If the entity's development activities meet all of the criteria in IAS 38.57 we believe that any OCS funds intended to compensate the entity for the cost of these development activities are grants related to assets. IAS 20.24 requires an entity to present grants related to assets as either deferred income or by deducting the grant in arriving at the carrying amount of the asset. Deferred income is recognised as income on a systematic basis over the useful life of the asset. If the grant is deducted in arriving at the carrying amount of the asset, it is recognised as income over the life of the asset by way of a reduced depreciation charge. Thus, in either case, the entity would recognise the grant in its income statement over the useful life of the asset.

If the development activities do *not* meet all of the criteria in IAS 38.57, the entity expenses the cost of these development activities when incurred. In this case, we believe that OCS funds are grants related to income. This is because the entity's development activities will not result in a long-term asset. The entity would account for these OCS

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attached restricting the type or location of the assets or the periods during which they are to be acquired or held. *Grants related to income* are government grants other than those related to assets.

funds in the same way as it accounts for OCS funds intended to compensate the entity for research costs (see above).

Royalties and interest payable to the OCS

We believe that current authoritative literature could be used to justify two alternative approaches to the accounting for royalties and interest payable to the OCS.

Alternative 1

An entity recognises a liability for royalties and interest payable to the OCS when the entity recognises the revenue that will give rise to an obligation to pay royalties to the OCS.

Alternative 1 is based on the definition of a liability in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This definition identifies a present obligation arising from a past event as an essential characteristic of a liability.[2] IAS 37.17-19 goes on to explain that a present obligation arising from a past event exists when:

- an entity has no realistic alternative to settling the obligation created by the event because settlement can be enforced by law or the entity has created a valid expectation in other parties that the entity will discharge the obligation; and
- the obligation exists independently of the entity's future actions.

According to your letter, if the entity's project does not generate income, there is no obligation to pay any royalties or interest to the OCS. Therefore:

- an entity has no obligation until a product or service generates revenue because, until that time, payment of royalties and interest cannot be enforced by law and the OCS has no valid expectation that it will receive royalties and interest; and
- developing a product or service and generating revenue is a future activity that is *not* independent of the entity's future actions.

We do not believe that it is appropriate for an entity to describe potential royalties and interest payable to the OCS as a contingent liability when it receives funds from the OCS. IAS 37.10 explains that a contingent liability is either (a) a possible obligation that arises from a past event and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that is not recognised because it is not probable (more likely than not) that an outflow of resources will occur or the amount of the obligation cannot be measured reliably. As noted above, developing a product or service and generating revenue is a future (not a past) event that is partly within the entity's control. Consequently, there is neither a possible nor a present obligation in existence as a result of a past event when the entity receives funds from the OCS. (However, we note that IAS 20.39(c) requires an entity to disclose any conditions and other contingencies attached to recognised government assistance.)

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[2] A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Alternative 2

An entity recognises a liability for royalties and interest payable to the OCS when it receives funds from the OCS.

Alternative 2 is based on the definition of a financial liability in IAS 32 *Financial Instruments: Presentation* and the definition of a derivative in IAS 39 *Financial Instruments: Recognition and Measurement*. IAS 39 goes on to explain that:

- an entity recognises a financial liability when the entity becomes party to the contractual provisions of the instrument (IAS 39.14);
- a financial liability, including derivatives that are a liability, is measured at fair value with subsequent changes taken through the income statement (IAS 39.43 and IAS 39.47); and
- an entity derecognises a financial liability when, and only when, it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expired (IAS 39.39).

Following alternative 2, an entity recognises a liability when it enters into a financial agreement with the OCS. Any uncertainty about the amount (if any) of royalties and interest payable to the OCS is reflected in measurement of that liability.

According to your e-mail, in most cases, the amount of royalties payable is limited to the amount funded by the OCS, plus interest based on LIBOR. If an entity does not expect to derive revenue from products or services developed from an OCS funded project, the entity must request an exemption from the payment of royalties from the OCS. Therefore, an entity derecognises a liability when, and only when, it repays the full amount funded by the OCS, plus interest; or project when it receives an exemption from the OCS.

We note that IAS 39.AG2 states that IAS 39 does not change the accounting requirements of royalty agreements based on the volume of sales or service revenues that are accounted for under IAS 18 *Revenue*. However, it is not clear whether this application guidance also applies to royalties payable. It does not apply to interest payable.

In your letter you asked whether an entity should recognise a liability for the potential royalties payable to the OCS as a financial liability with contingent settlement provisions when it receives funds from the OCS. We do not believe that this is appropriate. This is because the explanation of financial liabilities with contingent settlement provisions in IAS 32.25 aims to provide guidance on the classification of financial instruments as liability or equity based on the form of settlement.