# The 6th Element of Financial Statements


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### Abstract

***This paper presents a new approach to the accounting of grants. The author believes that the same approach may also be appropriate for the accounting of negative goodwill, revaluation and remeasurement differences.***

***The author claims that the current understanding of above items presented in the IFRSs (IASs) does not provide fair presentation of financial position, financial performance and changes in the financial position of an enterprise.***

***Moreover, the author assumes that the solution to this problem is in the change of the IASB Framework, under which Financial Statements are built on five element concept. He suggests that there must be a 6th element of Financial Statements, and grants, as well as (according to preliminary analysis) negative goodwill, revaluation and remeasurement differences, shall be presented under the 6th element.***



JEL Classification: M40, M41, M49

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# INTRODUCTION

IAS 20 stipulates two approaches for presentation of grants in the Balance Sheet: either as liability or as deduction from received assets. IAS 41 stipulates, however, that grants have to be presented as liability, suggesting that the presentation as a deduction from received assets is inaccurate.

There are on-going discussions on this matter, more actively during the last three years. In particular, the approach that grants should be directly recognized as income (equity) is discussed.

The paper is devoted to the analyses and interpretations of the provisions of IASB Framework and several IFRSs (IASs) stipulating the ways grants shall be presented in the Balance Sheet.

In particular:

1. The Author analyses the approach of presentation of grants as a liability: as a result, the consideration that ***grants do not meet liability recognition criteria is confirmed.***

2. The Author analyses the approach of presentation of grants as deduction from the received assets and confirms the corresponding consideration:
   ***this approach for presentation of grants neither arises from the definition and recognition criteria of the elements of Financial Statements, nor from the principles of accounting and preparation of Financial Statements, thus, it does not ensure the reliability of financial statements.***

3. Since the Balance Sheet consists of three elements of financial statements (assets, liabilities and equity) and in compliance with the definitions of IASB Framework, grants can be presented neither in assets nor in liabilities, the author has analysed the possibility of the presentation of grants directly in Equity, and came to the following conclusions:
   ***Grants with unfulfilled conditions can not be recognized as income and, while the conditions exist, grants do not have characteristics (indications) of Equity, i.e. they can not be directly presented in the Equity.***

Summarizing the above, the Author makes the following conclusions:

- ***All the approaches with regard to the presentation of grants within the framework of five elements of the Financial Statements are not justified;***
- ***There is a new, the 6<sup>th</sup> element of the Financial Statements which shall be presented in the Balance Sheet*** (the Author suggests the ***definition***, ***recognition*** and ***measurement*** of the ***6th element***)***;***
- The items of the ***6th element*** are ***grants, and, according to preliminary analysis, also the negative goodwill, revaluation and remeasurement differences*****;**
- Internationally accepted methodology for accounting is currently based on the ***five element*** concept of Financial Statements. The acceptance of the recommended approach will obviously cause changes in the IASB Framework and IFRSs (IASs) (In particular this refers to IASs 1, 2, 8, 12, 16, 20, 21, 28, 32, 34, 36, 38, 39, 40, 41 and IFRS 3).

Based on the analysis of the approach of the presentation of grants as income, the author makes the following conclusions[1]:

- ***A grant, provided to an enterprise in return for already incurred losses or expenses, shall be recognized as income in the Income Statement in the reporting period, when it becomes receivable;***
- ***A grant provided without conditions is recognized as income in the Income Statement, when it becomes receivable;***
- ***A grant provided with conditions is recognized as income in the Income Statement when the conditions are met: thus unrealized income presented under the 6th element is amortized (realized).***

The Author intends to write papers to address the accounting of negative goodwill, revaluation and remeasurement differences.

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[1] A similar approach is stipulated by IAS 41 and discussed in the notes of IASB meeting, in particular:

- An unconditional grant would be recognized as income when the grant becomes receivable.
- A conditional grant would be recognized as income when the conditions attaching to the government grant are met.

## PRESENTATION OF GOVERNMENT GRANTS

### *1. Presentation of Assets Provided as a Government Grant and Presentation of Government Grants in compliance with the IAS 20*

Accounting of the government grants is described in IAS 20, Accounting for Government Grants and Disclosure of Government Assistance, in accordance to which:
***"Government grants are assistance by government in the form of transfers of resources to an enterprise in return for past or future compliance with certain conditions relating to the operating activities of the enterprise"***.

Actually, government grant is not only the transferred resources but also reduction and cancel of liabilities, as well as services rendered by the state for an enterprise.

Within the concept of government grants (and not only the government), the following shall be specified:

1. Grants are ***assistance*** made for an enterprise;
2. The aforementioned assistance is made for certain ***conditions*** regarding the operating activity.

**Example 1:**[2]

*"Hospital No 1" CJSC (beneficiary) received the amount of 5000 unit as a grant from the Children Health Protection Foundation (donor).*

*In accordance with the Contract on the Grant Provision executed by the Parties:*

- *The beneficiary shall be obligated to acquire medical equipment at the amount of 3500 unit and medicine at the amount of 1500, as defined by the Contract;*
- *To use the acquired equipment and medicine exclusively for the children's medical treatment;*
- *The donor can attend the hospital within two year period (after which the donor terminates its activity) and to check whether the acquired medical equipment and medicine is used for purpose or not.*

[2] All transactions and names brought in the Example are conventional.

In compliance with IAS 20, grants shall be classified as follows:

- ***Grants related to assets:*** are grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire long-term assets, and
- ***Grants related to income:*** are grants other than those related to assets.

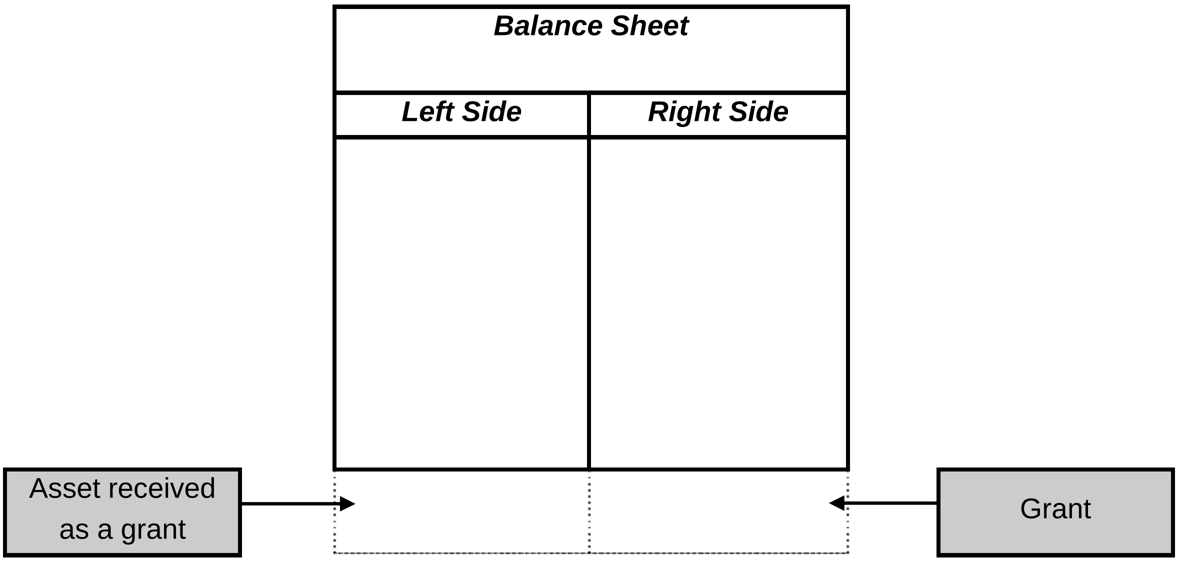
Therefore, in the Example mentioned above from the grant (assistance) received by the beneficiary.

- 3500 unit is related to assets, and;
- 1500 unit is related to income,

Upon the recognition of the grant, the assets of the beneficiary increase at 5000 unit, since the resources provided as assistance meet the recognition criteria of the asset, defined by Paragraph 89 of the Framework:

***"An asset is recognized in the Balance Sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably".***

As a result, the Assets (hereafter also referred to as the "Left Side"), as well as aggregate amount of Equity and Liabilities (hereafter referred to as "the Right Side") in the Balance Sheet[3] of the beneficiary increase at fair value of the grant.




[3] Two-side (horizontal) presentation type of the balance sheet is used in this Paper.

In compliance with Paragraph 24 of IAS 20, ***Grants related to assets, including non-monetary grants at fair value, should be presented in the Balance Sheet by setting up the grants as deferred income*** (hereafter referred to as "the first approach")[4].

In addition to the aforementioned *"**They*** (Government grants. - T. M.) ***should not be credited directly to shareholders' interests" (equity)*** (IAS 20, paragraph 12)***.***

Since, as it was mentioned above, in compliance with the first approach of IAS 20, grants related to assets are deferred income, which are not directly credited to the equity, then in the Financial Statements the grants related to assets (also grants related to income) are presented in the Liabilities.

| ***Balance Sheet*** | | | |
|---|---|---|---|
| ***Left Side*** | | ***Right Side*** | |
| **Assets** | | **Equity** | |
| Fixed assets | **3500** | | |
| | | **Liabilities** | |
| | | Grants related to assets | **3500** |
| Materials | **1500** | | |
| | | Grants related to income | **1500** |
| ***Balance*** | | ***Balance*** | |

## *2. Presentation of Grants as a Liability*

***A liability is a present obligation of an enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.***[5]

[4] The second approach: ***"by deducting the grant in arriving at the carrying amount of the asset"*** shall be discussed separately.
[5] Framework- 49 (b).

***A liability is recognized in the Balance Sheet when it is probably that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.***[6]

Whether the recognition of grants meets the definition and recognition criteria of liabilities. Particularly:

- *A present obligation occurred due to the implemented transaction (event);*
- *Fulfilment of the present obligation makes probable an outflow of resources from the enterprise embodying economic benefits;*
- *The amount which shall be used for liability settlement can be measured reliably.*

1. Grants shall be provided for certain ***conditions*** regarding the operating activity of an enterprise. In case of grants related to assets: ***"primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held" (IAS 20, paragraph 3).***
In Example 1, as a condition for the provision of the grant, the beneficiary shall be obligated to acquire a particular medical equipment (long-term asset) and use it exclusively for the children's medical treatment. Thus, costs (expenses) incurred by the beneficiary relate to the operating activity (for instance, acquisition of equipment, depreciation costs of the equipment used during the medical treatment of the children), so they ensure inflow of resources, i.e. income (revenue from the services rendered).

The conditions mentioned above (acquisition of the asset or its use) shall not be considered as a present obligation, fulfilment of which would cause an outflow of resources from the ***enterprise*** embodying economic benefits.

Let's assume that the useful life of the medical equipment is 5 years, as was specified by the beneficiary. Thus, as it will be presented below, the beneficiary will amortize (income recognition) the "liability" for the grant also within 5 year period, to comply with requirements of IAS 20. In compliance with the aforementioned, a liability will be shown in the Balance Sheet of the beneficiary within five year period.  Moreover, during the last three years there will be no fulfilment of condition associated with the grant regarding that liability (there is no present obligation) and there will be no outflow of monetary resources from the enterprise.

[6] Framework- 91.

2. Non-fulfilment of conditions associated with the grant by an enterprise can cause return of the grant, in some cases, even, enforcement of economic penalties.

In accordance with Paragraph 7 of IAS 20:
***"Government grants, including non-monetary grants at fair value, should no be recognized until there is reasonable assurance that:***

***(a) The enterprise will comply with the conditions attaching to them; and***

***(b) The grants will be received".***

Therefore, if an enterprise recognized the grant, fulfilment of the conditions associated with that grant by an enterprise becomes probable, and their further violation by an enterprise becomes improbable, that is, an outflow of resources from the enterprise embodying economic benefits is improbable.

**Example 2:**

*The State made a decision to forgive 250,000 unit tax liability of Company "A", if the mentioned Company operates a new production by making 100,000 unit investment within one-year period and creates additional 500 job positions within two-year period.*

In the case mentioned above, the Company "A" will recognize (reclassify) the tax liability as a grant, if fulfilment of conditions associated with the grant is probably to happen.

Financial statements of the company reflect financial position of an enterprise as at the end of the reporting period, but not the possible position in the future.

The example mentioned below is provided to clarify the aforementioned statement:

**Example 3:**

*In accordance with the executed contract, an enterprise acquired an asset. Payment for that asset shall be made within a three month period. In case of non-payment within the defined period, a penalty shall be imposed on daily basis.*

It is more probably that the enterprise will not violate the contract and will not pay a penalty. Thus, it is natural that liability for the penalty will be recognized not at the beginning but when it occurs (delay of payment from the defined period).

The same approach is applied to the grants: non-fulfilment of the conditions associated with the provision of grants that have already been recognized in the Balance Sheet is a new event, which will cause present obligation. That is, the present obligation can occur, when the event (violation of conditions) occurs. Moreover, in order to recognize a liability for that present obligation, it is necessary that fulfilment of present obligation makes probable an outflow of resources embodying economic benefits and, that the repayment amount for that liability can be reliably measured.

3. In compliance with Paragraph 10 of IAS 37, Provision, Contingent Liabilities and Contingent Assets:

***"A contingent liability is:***

***(a) a possible obligation that arises from past events 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 enterprise; or***

***(b) a present obligation that arises from past events but is not recognized because:***

> ***(i). it is not probably that an outflow of resources embodying economic benefits will be required to settle the obligation; or***
>
> ***(ii). the amount of the obligation cannot be measured with sufficient reliability".***

Grants which still have associated conditions to be fulfilled, meet the definition of contingent liability more than the definition of liability. In compliance with Paragraph 27 of IAS 37 ***"An enterprise should not recognize a contingent liability".***

## ***3. Other Approaches for Presentation of Grants***

As it was mentioned above, Paragraphs 12-15, 24 of IAS 20 define two approaches for presentation of grants related to assets:

*1) as deferred income ("income" method), excluding their direct crediting to the shareholders interests (method of "capital");*

*2) by deducting the grant in arriving at the carrying amount of the asset.*

In case of the second approach, assets and costs (expenses) incurred for those assets would have been presented in the Balance Sheet and Income Statement, correspondingly, by way of a reduced amortization charge of the grant and deferred income.

**Example 4:**

*At the end of the year 2004, an enterprise acquires a fixed asset at the amount of 2600 unit for use of administrative purposes. The enterprise shall pay only 400 unit, while the remaining 2200 unit was provided as a grant.*

*Useful life of the asset is 4 years, depreciation is calculated based on the straight-line method, residual value is ignored.*

*In compliance with the accounting policy, the enterprise adopted the second approach of the grants.*

The enterprise has a fixed asset in the amount of 2600 unit, which meets recognition criteria of the asset. In case of application of the second approach, at the time of initial recognition only 400 unit (2600 unit - 2200 unit) will be disclosed in the Balance Sheet, that is by way of reducing the amount of the grant.

| ***Balance Sheet*** | | | |
|---|---|---|---|
| ***Left Side*** | | ***Right Side*** | |
| **Assets** | | **Equity** | |
| Fixed assets | **400** | | |
| | | **Liabilities** | |
| | | Payables for purchases | **400** |
| ***Balance*** | | ***Balance*** | |

Each year (e.g. 2005) depreciation of the fixed asset is amounted to 650 unit (2600 unit/4 years), amortization of the deferred income for the grant is amounted to 550 unit (2200 unit/4 years), but only the difference of the aforementioned units (100 unit) is presented in the Income Statement as an administrative cost.

If the enterprise acquired that fixed asset paying the total amount, it is natural, that at the beginning of the year 2005 the fixed asset having the value of 2600 unit would be presented in the Balance Sheet, while in the Income Statement for the year 2005, 650 unit depreciation would be presented for administrative cost.

***Irrespective of the "origination" of the asset or other elements of Financial Statements, it would be accurate to calculate them always using the same rules.***

***I believe, that the second approach[7] for presentation of grants neither arises from the definition and recognition criteria of the elements of Financial Statements, nor from the principles of accounting and preparation of Financial Statements, thus, it does not ensure reliability of financial statements.***

In addition to the aforementioned, as it is specified in Paragraph B 66 of IAS 41 "Agriculture", this method "is inconsistent with a fair value model in which an asset is measured and presented at its fair value. Using the deduction from carrying value approach, an enterprise would first deduct the government grant from the carrying amount of the related asset and then measure that asset at its fair value. In effect, an enterprise would recognize a government grant as income immediately, even for a conditional government grant".

## *4. Presentation of Grants in Equity*

As it was mentioned above:

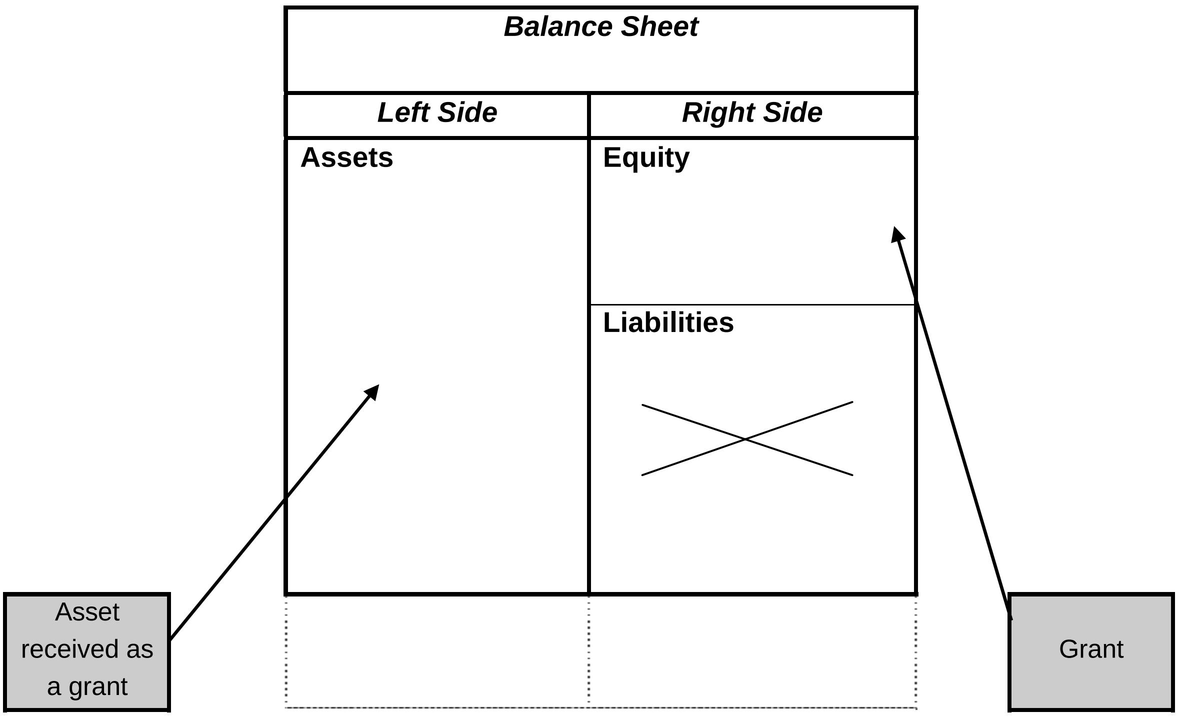
- The author does not believe it is correct to deduct the amount of grant from the carrying amount of the asset received as a grant or to present the grant as deduction from the assets in the Balance Sheet as a separate item. Therefore, grants should not be presented in the asset part of the Balance Sheet in any form. As a result of recognition of grant, assets and Right Side should increase at fair value of the grant in the Balance Sheet;
- Right Side of the Balance Sheet consists of the equity and liabilities;
- Grants do not meet the recognition criteria of a liability.

[7] Even presentation of the grant in the Balance Sheet as deduction from the assets as a separate item, for the simple reason, that grant is not an asset or adjustment of asset.

From the first glance, it can be concluded that grants should be presented in Equity, that is, to recognize them as income directly either:

- in the Income Statement, or
- in the Statement of Changes in Equity.

Therefore, the approach of IAS 20 specifying that ***the grants should not be directly credited to the Equity*** (IAS 20, paragraph 12), may not be right[8].




In compliance with Framework (49 (c)):
"***Equity is the residual interest in the assets of the enterprise after deducting all its liabilities***".

Shareholders of the enterprise shall exercise control over the residual interest in the assets (net assets) of the enterprise, for the purpose of having right towards them (net assets) and these (net assets) should be "free" of fulfilment of any condition for the third party.

[8] Particularly, in IFRS 3, Business Combination, which replaces IAS 22, the mentioned approach is defined for negative goodwill.

The following meets the criteria mentioned above:

- Investment in equity (*invested capital*);
- Accumulated profit (net profit of the reporting period, retained earnings of the previous periods), including the realized part (when the transaction of profit is completed for that part[9]) of future economic benefits arising from the revaluation and remeasurement (*earned capital*).

Shareholders of the enterprise make "benefit" from the right of possession of the net assets, that is, the enterprise will have outflow of assets, when:

- The profit from the operation of enterprise is divided between the shareholders (dividend);
- Termination of relationship with the enterprise as a shareholder (the shareholder leaves the enterprise by taking his/her share), or
- The enterprise is liquidated (all shareholders terminate their relationships with the enterprise by taking their part of the net assets).

1. Grants are proceeds (inflows) different from the investments made by the shareholders in the equity.

2. As it was mentioned above, grants are provided in the form of transfer of resources to an enterprise in return for past or future compliance with certain conditions relating to the operating activities of the enterprise. The non-compliance with the conditions can cause return of the grants, and in some cases, even, enforcement of economic penalties.

   Let's assume that in the Example 1 the beneficiary is liquidated in the second year. In this case, the provided grant will be returned to the donor in compliance with the contract. It will not be divided between the shareholders as net asset of the beneficiary.

3. There are two alternative approaches for recognizing grants as income:

   a) an enterprise should recognize a conditional grant as income, when it is probable that the enterprise will meet the conditions attaching to the grant; and

   b) an enterprise should recognize a conditional grant as income, when the enterprise meets the conditions attaching to the grant.

[9] That should be addressed in the next published Papers.

In addition to the justifications presented by IAS 41 (B71, B72) in support of approach (b), it is important to note that:

I. If the grants provided with the conditions are recognized as income directly (when it is probable that the enterprise will meet conditions associated with the grant) and the expenses incurred by the enterprise for the fulfilment of the conditions of the grant in the next reporting period, the requirement for income and expense matching will be distorted.

II. Recognition of grants provided with conditions as income more complies with the cash basis approach of income recognition than accrual basis.

With regard to the aforementioned, below is represented some situations and comments:

- Recognition of income by the Contractor is mainly stipulated by the work implementation rather than the receipt of prepayment, although at the moment of prepayment receipt the Contractor finds probable implementation of the taken responsibilities (conditions).
- Income from the loan interest provided by the bank is recognized on time proportion basis, although it is, anyhow, probable that economic benefits will flow to the bank with regard to the transaction. That basis of income recognition will not be changed even if the borrower pays for interests at the moment when borrower receives the loan.
- Income recognition for grants will not be stipulated by the fact when the grant was actually provided to the beneficiary: at the beginning when conditions are complied with or at the end. Direct recognition of grant at the moment of receipt is more implementation of cash basis.

Therefore, if there are still conditions to be fulfilled regarding the grants, they can not be recognized as income and, while the conditions exist, grants do not have characteristics (indications) of Equity, i.e. ***they can not be directly presented in the Equity.***

## ***5. Conclusions and Recommendations***

***Summarizing analysis, interpretations made in this paragraph, the following conclusions and recommendations can be respectfully provided:***

- ***The author does not believe it is correct to deduct the amount of grant from the carrying amount of the asset received as a grant or to present the grant as deduction from the assets in the Balance Sheet as a separate item. Therefore, grants should not be presented in the asset part of the Balance Sheet in any form. As a result of the recognition of grant, assets and Right Side should increase at fair value of the grant in the Balance Sheet;***

- ***Grants do not meet recognition criteria of the liability defined by the Framework;***

- ***Direct presentation of grants in equity (in the shareholders interest) in any form is not right;***

- ***Since Right Side of the Balance Sheet is presented only by components of equity and liability, and taking into consideration that grants belong to neither of them, it can be concluded that there is a new component in the Right Side of the Balance Sheet, or the 6th element of Financial Statements which has not been presented till now, and which can be conventionally called "Unrealized Income";***

- ***Grants should be presented in the Balance Sheet under the "Unrealized Income" at fair value.***

### ***Definition, Recognition and Measurement of "Unrealized Income"***

***"Unrealized Income" is an increase in future economic benefits during the reporting period related to an increase of an asset or a decrease of a liability that will not cause an increase of equity, unless an enterprise fulfils certain conditions.***

***"Unrealized Income" shall be recognized in the Balance Sheet:***

- ***When there is increase in future economic benefits relating to an increase of an asset or a decrease of a liability, which can be measured reliably, and***
- ***It is probable, that an enterprise will fulfil certain conditions ("realization" of future economic benefits will take place).***

***"Unrealized Income" is measured by the amount by which the relevant increase in assets or decrease in liabilities are measured.***

*Particularly, the following can be presented in the "Unrealized Income":*

- *Grants;*
- *Negative goodwill;*
- *Revaluation and remeasurement differences.*

| ***Balance Sheet*** | | | |
|---|---|---|---|
| ***Left Side*** | | ***Right Side*** | |
| **Assets** | | **Equity** | |
| | | **Unrealized income** | |
| | | Grants | |
| | | Negative goodwill | |
| | | Revaluation and remeasurement differences | |
| | | **Liabilities** | |
| ***Balance*** | | ***Balance*** | |

***Equity = Assets - Unrealized income – Liabilities***

Sometimes, in case of incompliance with certain conditions, grants should be subject to return. The grant, which is subject to return, shall be reflected in the accounting as review of accounting estimates (IAS 8) and should be reclassified as a liability.

In the case mentioned above, liability balance shall equal to the amount to be returned due to the incompliance with the conditions associated with the grant. If the amount of unrealized income is not enough for returning of the grant, it should be recognized as expense in the deficient amount.

*The accepted international methodology of accounting and preparation of Financial Statements is based on the five element system of Financial Statements (assets, liabilities, equity, income, expenses), thus all solutions were tried to be explained from the angle of that system.*

*Particularly, if an item is to be recognized in the Balance Sheet, it should be either an asset or a liability or equity.*

*For instance, as it was mentioned above, two approaches for presentation of grants are defined by IAS 20:*

- *As a liability, or*
- *As a deduction from assets.*

*Furthermore, in IAS 41 the opinion of the author is that the second approach for the grants presentation is considered inappropriate, and only the first approach is left.*

*Negative goodwill was presented in IAS 22 as a deduction from assets, while in IFRS 3 it was presented as income (in equity). In future it is possible that the same approach will be applied to grants.*

*It can be concluded from the aforementioned that items in the Balance Sheet were always presented in one of the three existing elements, however in certain cases this led to certain "deficiencies". For example, grant was presented in the Left Side (as Assets) when it had nothing to do with assets. Then it was presented in the Right Side (as Liability), when it is not a liability either. The only "place" for grant thus remains Equity: which is also considered inappropriate.*

*Therefore, much effort was devoted to assure the correspondence of the item with the criteria of a certain element than to explaining and presenting that item in its essence.*

*The purpose of this Paper is to show that taking into consideration the aforementioned the Financial Statements shall have six elements.*

Based on the analysis of the approach of the presentation of grants as income, the author makes the following conclusions[9]:

- ***A grant, provided to an enterprise in return for already incurred losses or expenses, shall be recognized as income in the Income Statement in the reporting period, when it becomes receivable;***
- ***A grant provided without conditions is recognized as income in the Income Statement, when it becomes receivable;***
- ***A grant provided with conditions is recognized as income in the Income Statement when the conditions are met: thus unrealized income presented under the 6th element is amortized (realized).***

[9] A similar approach is stipulated by IAS 41 and discussed in the notes of IASB meeting, in particular:

- An unconditional grant would be recognized as income when the grant becomes receivable.
- A conditional grant would be recognized as income when the conditions attaching to the government grant are met.

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