5. Recognition of income, including legacies, grants and contract income

Introduction

5.1. Income is the inflow of economic benefits to a charity from the activities that it undertakes. Income is an inflow of resources that results in an enhancement to the charity's assets or a decrease in its liabilities.

5.2. Charities that provide goods or service under contact (exchange transactions) should refer to section 4 of the FRSSE. Aside from the recognition of government grants and gifted tangible fixed assets, the FRSSE does not deal with the recognition of income from non-exchange transactions (including gifts, donations and legacies). This SORP requires charities to adopt current accounting practice for the recognition of income from non-exchange transactions. This module of the SORP reflects current accounting practice for non-exchange transactions. Charities should also have regard to paragraphs 34.64 to 34.74 of section 34 of FRS 102 and Appendix B to section 34 of FRS 102 when developing their accounting policies for the recognition of non-exchange transactions.

5.3. This module sets out:

- understanding the nature of income;
- general rules for income recognition;
- general principles for recognising income from donations and grants;
- identification of terms and conditions;
- performance-related conditions;
- other terms and conditions that limit the recognition of income;
- deferring income where conditions that limit recognition are not met;
- terms and conditions that do not prevent recognition;
- recognising income from legacies;
- income from donated goods, facilities and services;
- income from contracts for the supply of goods and services;
- income from membership subscriptions;
- income from interest, royalties and dividends;
- settlement of insurance claims; and
- disclosures and notes to the accounts.

Understanding the nature of income

5.4. There are two broad categories of income: income from exchange transactions (contract income) and income from non-exchange transactions (gifts). It is important for charities to distinguish between the two as they are recognised differently in a charity's accounts.

5.5. Income from exchange transactions is received by the charity for goods or services supplied under contract. The income the charity receives is approximately equal in value to the goods or services supplied by the charity to the purchaser. The essential feature of income from a non-exchange transaction is that the charity receives value from the donor without providing equal value in exchange.

5.6. Income from non-exchange transactions (gifts) are donations of money, goods, facilities or services which are given freely to the charity by a donor. Grants are a form of non-exchange transaction where the grant-maker awards a grant without receiving equal value in exchange. However, even though grants are classified as non-exchange transactions, a grant may be presented as income from charitable activities where the payment is made to secure the provision of particular goods or services.

5.7. A donation or grant that can be used for any purpose of the charity is unrestricted income. However, a donation or grant may be restricted to a specific purpose of a charity. A restriction may result from a specific appeal by the charity, or from the decision of the grant-maker or donor to support a specific purpose of the charity rather than making funds available for the charity's general use. Simply because a grant is restricted to a particular purpose of the recipient charity does not mean it should be recognised as a performance-related grant. Restricted grants that are not subject to performance-related conditions are included within the SoFA heading 'Income from donations and legacies'.

5.8. Transactions must be accounted for and presented in accordance with their substance and not simply their legal form. Charities must therefore consider the substance of any conditions attaching to donations or grants and to the substance of any contractual terms when determining their entitlement to income. Similarly, the substance of any restriction placed on the use of income must be considered when determining whether or not income is presented as restricted funds in a charity's accounts. In particular, a charity should consider:

- Whether entitlement to income is subject to fulfilling performance-related conditions. Performance-related conditions distinguish a contract or performance-related grant from an unconditional gift or grant.
- The terms of a donation or grant that impose a restriction on use which is narrower than the general purposes of the charity. Terms placed on gifts that limit a charity's discretion over how income must be used are presented as restricted income in the accounts.

- The terms of a contract may limit payments to amounts expended by the charity on purposes specified in the contract and restrict the charity's use of any surplus. Income that is restricted by contractual terms may be presented as restricted in the accounts if the restrictions are in substance the same as would apply to a restricted donation or grant.
- The terms of a gift that require it to be held as endowment that must be invested and not spent. Material endowment funds must be presented as a separate class of restricted funds.

General rules for income recognition

5.9. Income is recognised in the statement of financial activities (SoFA) when a transaction or other event results in an increase in the charity's assets or a reduction in its liabilities. This SORP requires that income must only be recognised in the accounts of a charity when all of the following criteria are met:

- Entitlement – control over the rights or other access to the economic benefit has passed to the charity.
- Probable – income is recognised when there is sufficient certainty of receipt (receipt is more likely than not);
- Measurement – the monetary value or amount of the income can be measured reliably and the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

5.10. All income must be reported gross when raised by the charity (or by volunteers working at the charity's direction) or its agents. Any fee charged for fundraising by a third party and deducted from the amount collected before it is remitted to the charity must not be offset against fundraising income recognised in the accounts but be reported as a fundraising expense. However, in the case of individuals not employed by, or contracted by, the charity who are acting on a purely voluntary basis and outside of the charity's control, the charity recognises the net amount remitted.

General principles for recognising income from donations and grants

5.11. This SORP requires charities to adopt current practice when accounting for income from non-exchange transactions. Income from donations or grants is recognised when there is evidence of entitlement to the gift, receipt is probable and its amount can be measured reliably.

5.12. In the case of a grant, evidence of entitlement will usually exist when the formal offer of funding is communicated in writing to the charity. However, some grants will contain terms or conditions that must be met before the charity has entitlement to the resources.

5.13. In the case of a donation, entitlement usually arises immediately on its receipt. However, some gifts may include terms or conditions which must be met before the charity is entitled to the resources.

Identification of terms and conditions

5.14. Charities need to identify donations or grants that are subject to terms or performance-related conditions or other conditions that must be met before there is unconditional entitlement to the gifted resources.

5.15. Not all terms or conditions attaching to a grant or donation prevent its recognition as income. A term or condition that simply restricts the use of a grant or donation does not affect a charity's entitlement to the gift and recognition of income. However, a restriction does affect how the gift or grant is reported in the accounts. For more information refer to the SORP module 'Fund accounting'.

5.16. When accounting for grants and donations, charities should identify:

- those donations and grants that are subject to performance-related conditions; and
- other terms or conditions that may prevent income recognition.

Performance-related conditions

5.17. Grant funding agreements may contain conditions that specify the services to be performed by a charity in receipt of a grant. For example, the grant may be in the form of a service level agreement where the conditions for payment are linked to the achievement of a particular level of service or the units of output delivered. The performance-related conditions contained in a funding agreement might, for example, specify the number of meals provided or the opening hours of a facility used by beneficiaries. Income must only be recognised to the extent that the charity has provided the specified goods or services as entitlement to the grant only occurs when the performance-related conditions are met.

5.18. Although performance-related conditions can apply to any form of gift, in practice it is unusual to see performance-related conditions apply to donations.

5.19. A restriction on the use of a grant or donation to a particular purpose or activity of a charity does not create a performance-related condition. A restriction creates a requirement that limits or directs the purpose for which a resource may be used but it does not require a specific level of performance or output from the recipient charity.

5.20. It is important at the outset of any arrangement that the charity identifies whether the funding agreement is a performance-related grant or a contract. This is important because the consequence of non-compliance with performance-related conditions and the liability for non-performance of a contract differ. The law of contract provides for the buyer to seek costs, damages and recompense for any failure or breach of contract by the seller, whereas a breach of grant conditions may lead to a partial or full repayment of the grant when repayment terms apply to the grant.

Other terms and conditions that limit the recognition of income

5.21. Performance-related conditions are not the only conditions that may apply to donations and grants. For example, a grant may be conditional on a charity obtaining matched funding, or subject to a successful planning consent. Meeting these conditions would not be wholly within the control of the recipient charity and the outcome of the specified event is uncertain. The charity would not have unconditional entitlement to the income until these conditions were met.

5.22. Donor imposed conditions may also specify the time period over which the expenditure of resources on a service can take place. Specification of a time period may amount to a pre-condition for use that limits the charity's ability to spend a grant or donation until it has performed the activity related to the specified time period. For example, a condition might specify the provision of a number of training weeks or the completion of a number of work placements in a particular period.

5.23. Time-related conditions may be implied. For example, when a multi-period grant is approved and is to be paid on the basis of agreed annual budgets, the charity may not be entitled to spend part or all of that income in advance of its budgeted year(s) without the further prior approval of the grant-maker.

Deferring income where conditions that limit recognition are not met

5.24. Where terms and conditions have not been met or uncertainty exists as to whether the recipient charity can meet the terms or conditions otherwise within its control, the income should not be recognised but deferred as a liability until it is probable that the terms or conditions imposed can be met.

5.25. A grant that is subject to performance-related conditions received in advance of delivering the goods and services required by that condition, or is subject to unmet conditions wholly outside the control of the recipient charity, is accounted for as a liability and shown on the balance sheet as deferred income. Deferred income is released to income in the reporting period in which the performance-related or other conditions that limit recognition are met.

5.26. When income from a grant or donation has not been recognised due to the conditions applying to the gift not being wholly within the control of the recipient charity, it should be disclosed as a contingent asset if receipt of the grant or donation is probable once those conditions are met.

Terms and conditions that do not prevent recognition

5.27. When meeting terms or conditions are within the charity's control and there is sufficient evidence that they have been or will be met, then the income must be recognised. Terms or conditions such as the submission of accounts or certification of expenditure are administrative requirements and would not prevent the recognition of income.

5.28. A donation or grant without conditions should not be deferred even if the resources are received in advance of the expenditure on the activity funded by them. The timing of the related expenditure is at the discretion of the charity and the income cannot be deferred simply because the related expenditure has not been incurred. For example, where a donation or grant is given specifically to provide a fixed asset or a fixed asset is donated (a gift in kind), the charity is normally entitled to that income when it is receivable. At this point, all of the income must be recognised in the SoFA and not deferred over the life of the asset.

5.29. Similarly, a condition that allows for the recovery by the donor of any unexpended part of a grant does not prevent recognition. Instead, a liability to any repayment is recognised when repayment becomes probable.

Recognising income from legacies

5.30. For accounting purposes, entitlement to a legacy cannot arise without the charity knowing of both the existence of a valid will and the death of the benefactor. Those charities with databases of current donors may well have information about an individual donor's intention or decision to leave a gift to them in their will and charities may also employ agents or carry out their own research to review publicly available information on recent deaths including the granting of probate. Charities having such information should use this information when developing their accounting policy for recognising income from legacies. For accounting purposes, evidence of entitlement to a legacy exists when the charity has sufficient evidence that a gift has been left to them and the executor is satisfied that the property in question will not be required to satisfy claims in the estate.

5.31. Of itself, establishing entitlement is insufficient to recognise legacy income. The recognition of the gift is also affected by the probability of receipt and the ability to estimate with sufficient accuracy the amount receivable.

5.32. Receipt of a legacy must be recognised when it is probable that it will be received. Receipt is normally probable when:

- there has been grant of probate;
- the executors have established that there are sufficient assets in the estate, after settling any liabilities, to pay the legacy; and
- any conditions attached to the legacy are either within the control of the charity or have been met.

5.33. Charities which receive a significant number of legacies in a reporting period and have detailed historical information on the settlement of legacies may apply an estimation technique in measuring the value of legacies that are recognised to allow for potential variation in settlement values and the risk of a will being contested. For example, where a charity has numerous immaterial legacies by using a portfolio approach the charity may estimate the monetary value of the income that may be received from legacies to which they are entitled, by applying a formula or mathematical model. However, a portfolio approach is unsuitable for material legacies or when a charity only receives legacies infrequently, as these should be considered individually. When a portfolio approach is not adopted, charities must recognise a legacy when the executors have determined that a payment can be made following the agreement of the estate's accounts, or on notification by the executors that payment will be made.

5.34. Where a payment is received from an estate or is notified as receivable by the executors after the reporting date and before the accounts are authorised for issue but it is clear that the payment had been agreed by the executors prior to the end of the reporting period, then it should be treated as an adjusting event and accrued as income if receipt is probable.

5.35. In some cases, a charity may have entitlement to a legacy but there is uncertainty as to the amount of the payment. For example, the legacy may be subject to challenge or the charity's interest may be a residual one. If the interest of the charity in a pecuniary or residuary legacy cannot be measured reliably, details of the legacy should be disclosed as a contingent asset until the criteria for income recognition are met. Where a legacy is subject to the interest of a life tenant, the legacy would not be recognised as income until the death of the life tenant.

5.36. If it is doubtful that full settlement of a legacy debtor will be received, then an adjustment is made to reduce the amount of the legacy debtor and legacy income rather than charging the adjustment as expenditure in the SoFA.

Income from donated goods, facilities and services

5.37. Goods, facilities and services donated to a charity must be recognised as income when the criteria for their recognition are met. However, issues can arise in measuring the fair value of donated goods and services. Charities that have received donations of goods, facilities or services, including the services of volunteers, must refer to the separate SORP module 'Donated goods, facilities and services, including volunteers', which sets out the requirements for the recognition, measurement and disclosures of these income sources.

Income from contracts for the supply of goods and services

5.38. Income earned from the sale of goods and services under contract is normally classified as unrestricted funds because it is not a gift and so cannot be restricted by trust law and any surplus may normally be spent on any purpose of the charity.

5.39. However, if a contract specifically requires all income received under it to be spent on a particular purpose of the charity and any unspent income to be returned to the funder or only applied for that particular purpose, then in substance, the income may be regarded as restricted. If contract income is presented as restricted then all relevant disclosures required for a restricted fund must be made.

5.40. Section 4 of the FRSSE sets out principles for the recognition of income arising from exchange transactions. Entitlement to the income arises as the charity obtains the right to consideration in exchange for its performance under the contract. Usually, entitlement to income occurs with the supply of goods to the buyer. Income is measured at the amount of the consideration receivable which will usually be the contract price, net of discounts and value added tax. If there is a significant risk of a default in the payment and that amount is material to income, then it will be necessary to adjust the amount of income recognised.

5.41. Where a contract for services has distinguishable phases or stages in its delivery, it may be appropriate to recognise income for each phase provided the value of each phase can be reliably estimated. Where a contract involves the provision of a service or a number of services that form a single project that runs across different reporting periods, it should be accounted for as a long-term contact if the effect of such contacts in aggregate is material. Charities should refer to Appendix III of the FRSSE for more information on the practical considerations arising when accounting for long-term contracts.

5.42. Where the obligations under a contract are performed gradually over time, revenue should be recognised as the contract activity progresses to reflect performance. The income recognised should reflect the right to receive payment by reference to the value of the work performed. A charity must select a method to measure the stage of completion of a service contract that provides the most reliable estimate of the right to receive payment for the work performed. Possible methods include:

- the proportion of costs incurred for work performed to date compared with the total estimated costs to completion; or
- surveys of the work performed; or
- completion of a physical proportion of the service contract work.

5.43. It may also be appropriate to recognise income based on the time spent in providing a service as a proportion of the total time to be spent to fulfil the contract when this provides the most reliable estimate of a charity's entitlement.

5.44. Where income is received in advance, then a charity may not have entitlement to the income until the goods or services have been provided. For example, where a charity sells gift vouchers, the income should be deferred until such time as the goods or services have been provided or the voucher has expired. Income received in advance should be deferred until the charity becomes entitled to it.

5.45. Where the effect of the time value of money is material to reported income, the amount of income recognised must be adjusted to the present value of the expected cash inflows to be received. The unwinding of the discount is credited to the SoFA as finance income from the transaction and if reporting on an activity basis shown under the same heading as the related income.

Income from membership subscriptions

5.46. Membership subscriptions received by a charity may be in the nature of a gift, or the member may buy a right to services or other benefits. When the substance of the subscription is that of a gift, the income and any associated Gift Aid or other tax refund should be recognised on the same basis as a donation. If the subscription purchases the right to services or benefits, the incoming resource should be recognised as income from charitable activities.

Income from interest, royalties and dividends

5.47. This SORP requires:

- income from interest, royalties and dividends to be recognised when receivable;
- royalties and income from the exploitation of intellectual property rights to be recognised when receivable in accordance with the substance of the relevant agreement; and
- dividends to be recognised when the shareholder's right to receive payment is established.

Settlement of insurance claims

5.48. This SORP requires that an insurance claim must be recognised when a charity has established its entitlement to the reimbursement of the insured loss, the receipt of that reimbursement is virtually certain and its amount can be measured reliably. Receipt is usually regarded as virtually certain when an offer of settlement is received from the insurer.

5.49. A charity must recognise the amount of the insurance reimbursement either as an item of other income or by offsetting it against the related expense heading in the SoFA. The amount reimbursed through an insurance claim is recognised as an addition to the fund that initially suffered the insured loss.

Disclosures and notes to the accounts

5.50. This SORP requires that all charities must:

- explain in the notes to the accounts the accounting policies adopted for the recognition of each material category of income; and
- analyse income in the SoFA using the headings required by the SORP module 'Statement of financial activities'.

5.51. This SORP also requires that when a charity has deferred income, the notes to the accounts should explain the reasons why income is deferred and should analyse the movement on the deferred income account, identifying income deferred in the current year and the amounts released from previous reporting periods.