7. Recognition of expenditure

Introduction

7.1. Expenditure is the amount of a charity's resources that have been spent or otherwise used up in carrying out its activities. An expense results in either a decrease in a charity's assets or an increase in its liabilities.

7.2. Examples of an expense include cash spent to purchase goods or services, the depreciation charge on tangible fixed assets, and incurring a liability when goods and services are purchased on credit.

7.3. Liabilities can result from exchange transactions that are contractual, for example the purchase of goods or services or the employment of staff. Liabilities can also arise from non-exchange transactions, such as making grants or other funding commitments to further a charity's purposes for which the charity receives no other benefit in return.

7.4. Charities should refer to sections 21, 28 and 34 of FRS 102 for more information. This module applies to all charities and sets out:

- general rules for the recognition of liabilities and expenditure;
- rules on measurement of liabilities;
- principles for recognising liabilities from constructive obligations;
- conditions that limit the recognition of a funding commitment;
- accounting for liabilities arising from performance-related grants;
- provisions for liabilities;
- treatment of commitments not recognised as provisions or liabilities;
- accounting for onerous contracts;
- treatment of employee benefits; and
- disclosure of provisions and funding commitments in the accounts.

General rules for the recognition of liabilities and expenditure

7.5. Liabilities arise from legal or constructive obligations that commit the charity to expenditure. A liability and related expenditure must be recognised when all of the following criteria are met:

- Obligation – a present legal or constructive obligation exists at the reporting date as a result of a past event.
- Probable – it is more likely than not that a transfer of economic benefits, often cash, will be required in settlement.
- Measurement – the amount of the obligation can be measured or estimated reliably.

7.6. A legal obligation arises when a charity enters into a binding contract or there is a statutory requirement to make a payment. When a charity enters into a contract for the supply of goods or services, expenditure is recognised once the supplier of the goods or services has performed their part of the contract.

7.7. A constructive obligation arises as a result of a charity's actions when it indicates to other parties that it accepts particular responsibilities and thereby creates a valid expectation on their part that the charity will meet them.

Rules on measurement of liabilities

7.8. A liability must be measured on recognition at its historical cost and then subsequently measured at the best estimate of the amount required to settle the obligation at the reporting date. The exception is that certain financial instruments must be adjusted to their present value; these include financial liabilities where settlement is deferred for more than 12 months after the reporting date. Refer to the SORP module 'Accounting for financial assets and financial liabilities' for more information.

7.9. When a charity accrues a provision in the reporting period that it will settle over several years, the future payments have a reduced value in today's terms (known as its present value). Where this adjustment would be material, the payments required to settle the obligation should be discounted to their present value.

7.10. The discount rate used should reflect the cost of money to the charity, and its current assessment of the time value of money and the credit risks specific to the provision that affect the time value of money. Depending on the charity's circumstances, the appropriate discount rate may be the market rate of interest at which the charity could borrow over the relevant time period or, if the charity has significant funds invested, the opportunity cost of income from investments foregone.

7.11. The unwinding of the discount must be treated as a financing cost in the statement of financial activities (SoFA). It should be allocated to the appropriate expenditure heading. For example, the unwinding of a discount resulting from a grant liability should be allocated to charitable expenditure.

Principles for recognising liabilities from constructive obligations

7.12. Charities frequently provide services or make grants to their beneficiaries on a non-contractual basis. Although a charity's commitments to provide services or grants are not always legally binding under contract, a liability can still arise if the charity has no realistic alternative to settling an obligation resulting from a commitment it has made. However, not all commitments to provide future services or funding will result in a charity recognising a constructive obligation as a liability or provision.

7.13. A charity may make general statements or policy statements about their future intentions, for example the aim of relieving famine in a particular location or improving the quality of care provided to a particular group of people. Such statements can be communicated in a variety of ways, including mission statements, setting out future plans within a trustee's annual report or simply making a general policy statement. Statements such as these do not create a constructive obligation as discretion is retained by the charity as to their implementation.

7.14. Evidence of a constructive obligation exists where:

- the commitment made by the charity is specific, for example a promise is made to provide particular goods, services or grant funding;
- this commitment is communicated directly to particular beneficiaries or grant recipients; and
- there is an established pattern of practice that indicates to the recipients of services or funding that the charity will meet its commitment.

7.15. It follows that a charity's decision to provide funding does not create a constructive obligation that must be recognised as a liability unless that decision has been communicated to those affected before the reporting date. The commitment must be communicated in a sufficiently specific manner so as to create a valid expectation on the recipient's part that the charity will discharge its responsibilities.

7.16. The formal written offer of a grant indicates to the recipient that it is probable that settlement will take place. In such circumstances, the charity cannot realistically withdraw from its commitment and so it is unlikely to have a realistic alternative but to meet the obligation. However, the recognition of any resulting liability would be dependent on any conditions attaching to the commitment.

Conditions that limit the recognition of a funding commitment

7.17. Funding commitments can be made which give the funder the discretion to avoid future expenditure based on their assessment of whether the conditions attached to the commitment will be met by the recipient.

7.18. The award of a grant is a non-exchange transaction. A charity awards a grant to further its own charitable purposes but without creating a contractual relationship with the recipient. The award of a grant is recognised as a liability only when the criteria for a constructive obligation are met, payment is probable, it can be measured reliably, and there are no conditions attaching to its payment that limit its recognition.

7.19. Where a grant commitment is payable over a period of more than one year, a liability must be recognised for the full amount of the constructive obligation unless conditions apply to payments falling due after the reporting date. Where payments for later years are subject to performance-related conditions, the donor charity may be able to legitimately withdraw from its commitment if a particular condition attaching to the grant is not met.

7.20. Where a condition remains within the control of the donor charity, then the donor charity retains the discretion to avoid the expenditure and therefore a liability must not be recognised. For example, where a commitment is made to provide grant funding over a number of years, future payments may be subject to a review by the donor charity which gives it discretion to terminate the funding agreement. Provided the review condition has been communicated to the recipient as part of the funding agreement and the review has substance, then a constructive liability is unlikely to arise for payments relating to periods subsequent to the review date.

7.21. Alternatively, when there is no condition attaching to the grant that enables the donor charity to realistically avoid the commitment, a liability for the full funding obligation must be recognised.

7.22. Not all terms attaching to a funding commitment create a condition that gives a donor charity discretion to withdraw from its funding obligation. For example, a term in a grant offer that seeks to relieve the donor charity from a future obligation in the event of a lack of funds at a future settlement date would not normally prevent the recognition of a liability if payment is probable. The liability would only be derecognised (reversed) if a future event requires the funding offer to be rescinded. The reversal of the balance sheet provision must be recognised in the SoFA and deducted from the heading to which the expenditure was originally charged.

7.23. Grant commitments may contain conditions that are outside the control of the donor charity. For example, a charity may promise a grant payment on the condition that the recipient finds matching funding. When a condition falls outside the control of the donor charity, a liability arises and expenditure must be recognised if the payment of the grant is probable.

7.24. Certain grants may contain specific conditions that closely specify a level of output or service to be performed by the recipient of the grant. These are termed performance-related grants.

Accounting for liabilities arising from performance-related grants

7.25. The key characteristic of a performance-related grant is that the amount of the grant payable to the recipient is determined by the extent of their performance in meeting the conditions set out in the grant agreement.

7.26. The payment of a performance-related grant is conditional on the grant recipient delivering a specified level of service or units of output. For example, the payment might be conditional on the number of meals provided or the usage or opening hours of a facility. In such cases the grant-maker will often have negotiated the nature of services to be provided. The liability and expenditure arising from performance-related grants must be recognised to the extent that the recipient of the grant has provided the specified service or goods.

7.27. A grant that is restricted to a particular purpose does not create a performance-related condition, as the payment of the grant is not conditional on the achievement of a specified level of service or outputs by the recipient. Similarly, a grant that funds a project over a number of years is not recognised as a performance-related grant simply because the funding obligation is to be met over an extended period of time.

Provisions for liabilities

7.28. A charity must recognise a liability for a legal or constructive obligation as a provision when either the timing or the amount of the future expenditure required to settle the obligation is uncertain.

7.29. Charities must distinguish separately on the balance sheet provisions for liabilities. The expenditure related to a provision must be charged to the appropriate heading in the SoFA.

7.30. The amount recognised as a provision should be the best estimate of the expenditure required to settle or to transfer it to a third party at the reporting date. When calculating this amount, consideration must be given to:

- when the payments are likely to be made; and
- future events and uncertainties which may affect the amount required to settle the obligation.

7.31. Charities must review the best estimate of a provision at the reporting date and adjust it appropriately. If a transfer of resources is no longer needed to settle the obligation, the amount of the provision no longer required should be reversed, with a corresponding credit to the expenditure heading in the SoFA against which the provision was originally charged.

7.32. If a provision is likely to be settled within 12 months of its initial recognition, it need not be discounted for the time value of money as it does not constitute a financing transaction. If the expected settlement date of the obligation is 12 months or more after making the provision and the effect would be material, the present value of the provision must be calculated using an appropriate discount rate.

Treatment of commitments not recognised as provisions or liabilities

7.33. Not all funding commitments are recognised as liabilities or provisions and so it is important that charities disclose the existence of unrecognised commitments and explain how these will be funded. For example, a grant offer may have been made but there is uncertainty as to whether the recipient charity will be able to proceed with its proposal. If it becomes clear that the payment is possible but not probable, then a liability for the commitment should not be recognised. Instead, the funding commitment should be disclosed as a contingent liability. Further guidance on accounting for contingent liabilities is provided in the SORP module 'Balance sheet'.

7.34. A charity may intend to use unrestricted funds held at the reporting date to meet a funding commitment and may decide to designate a portion of unrestricted funds for this purpose. This SORP permits the use of a designation on the balance sheet to identify that portion of unrestricted funds that have been set aside to meet the commitments. However, activities that are to be wholly financed from future income must not form part of such a designation.

Accounting for onerous contracts

7.35. Situations may arise where the unavoidable costs of fulfilling a contract exceed the expected economic benefit derived from it. In such circumstances, a charity must recognise these irrecoverable costs. An onerous contract may arise, for example, when a charity leases a property which it subsequently leaves unused and the property cannot be sub-let to recover the charity's costs.

7.36. Routine purchase orders and contracts which can be cancelled by agreement without paying compensation should not be regarded as onerous. However, a charity must make a provision for a material loss-making contract which cannot be cancelled without the payment of compensation. If a charity identifies a contract as onerous, it must make an immediate provision for the unavoidable loss. This provision is the lower of the costs involved in completing the contract and the cost of any compensation payable as result of withdrawing from the contract.

7.37. However, a charity may choose to provide a level of service to its beneficiaries over and above the minimum requirements of a contract as part of its charitable activities. Any additional costs incurred in providing a level of service above contractual requirements do not create an onerous contract even when these costs cannot be recovered. Costs that are incurred on a discretionary basis from which the charity can withdraw should be excluded from any assessment of whether a contract is onerous.

7.38. Before calculating the provision for an onerous contract, the charity must undertake an impairment review of the fixed assets used in supplying the contracted service(s). For more information refer to the SORP module 'Impairment of assets'.

7.39. A contract entered into on a full cost recovery or cost plus margin basis is only likely to become onerous if unavoidable costs arise in meeting the contract which cannot be recovered under the terms of the contract.

Treatment of employee benefits

7.40. Employee benefits include all costs incurred by the charity in exchange for the services of its employees and any remunerated trustees. Expenditure is recognised for all employee benefits resulting from their service to the charity during the reporting period unless the staff costs have been capitalised as part of the cost of an asset.

7.41. Charities must recognise a liability for the cost of all benefits to which employees are entitled at the reporting date that have yet to be paid. Employee benefits are measured as follows:

- Short-term employee benefits such as wages and salaries are measured at the amount expected to be paid in exchange for that service and not discounted for the time value of money.
- A liability for paid annual leave and paid sick leave is recognised, if a material component of total expenditure, and not discounted for the time value of money.
- Termination benefits are measured at the best estimate of the expenditure required to settle the obligation at the reporting date. If the expected settlement date of the termination payments is 12 months or more after making the provision and the effect would be material, the present value of the obligation must be calculated using an appropriate discount rate.
- Post-employment benefits arising under defined benefit plans are measured at the present value of the obligation under the plan at the reporting date less the fair value of the plan assets at the reporting date (reference should be made to the SORP module 'Retirement and post-employment benefits').

7.42. Disclosure requirements for expenditure on staff costs are set out in the SORP module 'Disclosure of trustee and staff remuneration, related party and other transactions'.

Disclosure of provisions and funding commitments in the accounts

7.43. All charities must analyse the expenditure resulting from recognised funding commitments and provisions across the appropriate heading(s) in the SoFA and provide in the notes to the accounts:

- a reconciliation of the movements in provisions and funding commitments showing:
  - the carrying amount at the beginning of the reporting period;
  - additions during the reporting period, including adjustments that result from changes in measuring the discounted amount;
  - amounts charged against the provision during the reporting period;
  - unused amounts reversed during the reporting period; and
  - the carrying amount at the end of the reporting period;
- a brief description of the nature of the provision or commitment made and the expected amount and timing of any resulting payments;
- an indication of the uncertainties about the amount or timing of those payments, including any performance-related conditions attached to the commitment; and
- the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

7.44. Charities must also disclose for any funding commitment that is not recognised as a liability or provision:

- details of commitment made;
- the time frame of that commitment;
- any performance-related conditions attached to that commitment; and
- details of how the commitment will be funded.

7.45. Comparative information for prior periods is not required for any of the disclosures set out in this section.

7.46. This SORP requires that if unrestricted funds have been designated to fund a commitment on the face of the balance sheet, the notes to the accounts must disclose:

- the nature of any amounts designated; and
- if not explained in the trustees' annual report, the likely timing of that expenditure.