Income Recognition and the Charities SORP - Discussion Briefing

Prepared by: CIPFA and Reviewed by the Charities SORP-making body, July 2021

Purpose of the briefing paper

To assist the engagement strands and the Charities SORP Committee in their reflections on the current approach to income recognition within the SORP (excluding grant income, legacies and donated good and services as these are separate topics) and to undertake a problem-solving exercise to identify:

- how charity income should be recognised and particularly consideration of the recognition in the accounts of multi-period funding
- whether changes might be requested regarding the treatment in FRS102 to permit the desired accounting method and the option(s) for changing what the SORP specifies about the reporting of multi-period funding, if any and if so,
- a preferred option with a recommendation as to what the change to the SORP should be, if any.

Reflection - what does the SORP say about income recognition?

Module 5 (Recognition of income, including legacies, grants and contract income) contains the relevant provisions of the current Charities SORP (FRS 102) for income recognition. The following provisions are the general rules within section 5.8 of the SORP for the recognition of income:

5.8. *"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. 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 – it is more likely than not that the economic benefits associated with the transaction or gift will flow to the charity.*

- *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.*

5.9 *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."*

Charities generate income from a wide range of sources, which particularly because of the non-exchange nature of the transactions eg income from donors or funders mean that specific additional guidance has been included in the SORP. This is presented in the table in Appendix 1 to this Briefing.

Other Briefings will deal with the recognition of grant income, legacies and donated goods and services. This Briefing focuses on the timing of recognition and other income recognition provisions. The income recognition provisions from modules 5 and 6 cover terms and conditions that impact on the recognition of income, income from contracts for the supply of goods and services, income from membership subscriptions, income from interest in royalties and dividends and the settlement of insurance claims.

The income recognition provisions in the Charities SORP follow those of FRS 102 *The Financial Reporting Standard Applicable in the UK and Republic of Ireland*. FRS 102 includes separate provisions for the recognition of (Incoming Resources from Non-Exchange Transactions) (see below) and provides detailed guidance for initial recognition of income within its section on 34 (Specialised Activities).

Paragraphs PBE34.67 to PBE34.73 and the accompanying guidance at Appendix B to section 34 apply to other resources received from non-exchange transactions by public benefit entities or entities within a public benefit entity group.

PBE34.67	**Recognition and measurement** An entity shall recognise receipts of resources from non-exchange transactions as follows:

	(a) Transactions that do not impose specified future performance-related conditions on the recipient are recognised in income when the resources are received or receivable. (b) Transactions that do impose specified future performance-related conditions on the recipient are recognised in income only when the performance-related conditions are met. (c) Where resources are received before the revenue recognition criteria are satisfied, a liability is recognised.
PBE34.68	The existence of a restriction does not prohibit a resource from being recognised in income when receivable.
PBE34.69	When applying the requirements of paragraph PBE34.67, an entity must take into consideration whether the resource can be measured reliably and whether the benefits of recognising the resource outweigh the costs.
PBE34.70	Therefore, where it is impracticable to estimate the value of the resource with sufficient reliability, the income shall be included in the financial period when the resource is sold.
PBE34.71	An entity shall recognise a liability for any resource that has previously been received and recognised in income when, as a result of a subsequent failure to meet restrictions or performance-related conditions attached to it, repayment becomes probable.
PBE34.72	Donations of services that can be reasonably quantified will usually result in the recognition of income and an expense. An asset will be recognised only when those services are used for the production of an asset and the services received will be capitalised as part of the cost of that asset.
PBE34.73	An entity shall measure incoming resources from non-exchange transactions as follows: (a) Donated services and facilities, that would otherwise have been purchased, shall be measured at the value to the entity. (b) All other incoming resources from non-exchange transactions shall be measured at the fair value of the resources received or receivable.

Appendix B to which is an integral part of section 34 of FRS 102 includes additional guidance on recognition, measurement, legacies and donated services. Legacies has been subject of a separate Briefing paper, so the relevant provisions are not included here.

Resources in the form of services

PBE34B.8	Donated services that can be reasonably quantified shall be recognised in the financial statements when they are received.

PBE34B.9	Donated services that are consumed immediately are usually recognised as an expense. However, there may be circumstances when a service is used in the production of an asset, for example erecting a building. In these cases, the associated donated service (eg plumbing and electrical services) would be recognised as a part of the cost of that asset.

Performance – related conditions

PBE34B.13	Some resources are given with performance-related conditions attached which require the recipient to use the resources to provide a specified level of service in order to be entitled to retain the resources. An entity will not recognise income from those resources until these performance-related conditions have been met.
PBE34B.14	However, some requirements are stated so broadly that they do not actually impose a performance-related condition on the recipient. In these cases the recipient will recognise income on receipt of the transfer of resources.

What is the reporting difference between 'all' and 'larger' charities?

There are no specific additional requirements for larger charities to adopt when recognising income within the current SORP.

Engagement strand feedback during the exploration stage

Income recognition

The most raised issue with regard to income recognition is the general requirement to recognise grant income when received unless specific conditions apply, this is subject of a separate briefing. There are also separate briefings on donated goods and services and legacies. This Briefing focusses on comments made on other issues relating to income recognition.

Recognition of income and funding commitments was raised as an issue for nearly all the engagement strands although it was not always raised for the same reasons. One strand in particular mentioned the matching principle and that if expenditure and income is not matched it can have an impact on reserves another spoke about a mixed option on the strand about legacy recognition whether there should be flexibility around income recognition or a fixed treatment.

The CIPFA Secretariat would note that the principle of 'matching' is no longer a concept in financial reporting rather the accruals concept would require that income is recognised in accordance with the principles in paragraph PBE3.67 of FRS 102 above and should be a faithful representation of the transaction. Specifically, FRS 102 comments

2.45	Generally this FRS does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or of liabilities

	regardless of whether they result from applying the notion commonly referred to as the ‘matching concept’ for measuring profit or loss.

More specific comments from the following engagement strands are:

Professional and Technical Strand (A)

- The conditions for income recognition per the SORP are not generally well understood particularly when deciding whether an adjusting event was necessary (paragraph 5.33, Charities SORP FRS 102). Should flexibility be maintained in SORP or would it be preferable to mandate a specific treatment?

Note paragraph 5.33 refers to legacies this is subject of a separate Briefing so has not been included in Appendix 1.

Professional and Technical Strand (B)

- Concern that the SOFA can be distorted and the current rules result in confusion for trustees and funders - this distortion comes from recognising income and grant funding commitments relating to future years where no conditions are attached.

- The recognition of income in advance of related expenditure can give the impression that the charity’s financial position is better than it is and this may impact on funding applications.

- Income recognition was specifically mentioned as an area which could be simplified for smaller charities perhaps by also providing a decision tree to assist them.

Larger Charities

- Although there are finite categories of income recognition and some issues on interpretation and application of multi-annual funding and legacies, for larger charities it is felt that the present SORP is okay and mostly needs more guidance and more education for preparers of accounts, understanding many of these preparers are independent professionals.

- More clarity on income recognition [is needed] especially for [the] smaller end of [the] large charities range. [This] would help consistency of interpretation and application i.e. [it would provide] less choice on approaches.

- In particular on multi-annual funding where, depending on clarity of performance specified by the funder, the funding is recognised immediately where expenditure may take place over multiple years – [this] needs clarity – the principle of ‘matching’ would seem to be more likely to give a ‘true and fair view’ as applies to other entities.

(See above comments on matching).

Income recognition

Observations from the SORP Committee:

At the second February 2021 meeting when SORP Committee members were invited to share their key conclusions on topics that had arisen during the exploration stage and that should inform the reflection stage, the committee considered that revisiting recognition of income should be included in the list of topics.

Relevant SORP research findings

The 2016 research exercise identified a number of provisions in the SORP where there might be inconsistencies between the SORP and FRS 102 with regard to income recognition see paragraphs 5.23, 5.36 and 5.47.

The research provided by the Journal of Accounting & Organizational Change (noted to be published January 2021) *Legitimating accounting change in charities: When values count more than regulation* Ciaran Connolly, Noel Hyndman* and Mariannunziata Liguori Queen's Management School, Queen's University Belfast, Northern Ireland, United Kingdom included the following commentary:

'*Many of the interviewees were particularly critical of the change in the income recognition criterion (from certain to probable, meaning that, for example, legacies, a major source of income for many large charities, would be recorded earlier), and the new way of accounting for gains and losses on investment assets in relation to reporting net income/expenditure (with, for example, any gain on the value of investments being recorded 'above the line'). These two changes, especially, were delegitimated not only in terms of rationalisation, but also through normalisation strategies, on the basis that charities are not privates sector businesses seeking to make profit*.'

The Research Report SORP and Irish Charities issued by the Charities Institute Ireland, Carmichael, Benefacts and the Wheel commented:

The most common difficulties experienced with using Charities SORP were issues related to 'Technical/Income Recognition/Presentation/Tiers.' This included distortions caused by recognition of capital and multi-annual funding, preparation and use of allocations for fund accounting, and too few tiers for reporting requirements.

What needs to be done now?

Step 1- Making the case for change - a 'basis for conclusions'

There is a need to consider the reporting requirements for the recognition of income and particularly of multi-period funding. Most engagement strands raised income recognition issues though not highlighting a specific aspect (with the exception of multi-period funding). The SORP Committee agreed that this should be subject to review.

At this stage, there is a need to decide:

(i) whether any changes to the recognition requirements specified in both FRS102 and in the Charities SORP are needed and

(ii) what those changes might be to either improve the understanding of the users of the accounts or to assist accounts preparers with the decisions and judgements required to recognise multi-period funding received by charities.

Step 2 - Advising the change required to the SORP

Having made the case for change, the detailed changes required to FRS102 and the SORP need to be specified. Consideration should be given in as much detail as possible for the reporting requirements income – for example, initial recognition and measurement. If no detail is given, the conclusion drawn is that the detail is left wholly to the discretion of the SORP Committee and SORP-making body.

Undertaking an assessment of the impact (savings or costs on the preparer and benefits or disadvantages to the reader)

The FRC will require an impact assessment but until the implications of change are worked through the SORP framework, the impact is unlikely to be clear and so this will be considered at the drafting stage of the process.

Step 3 - Recommendation

The case made by each engagement strand or combination of strands will inform the deliberations of the SORP Committee and so there needs to be a clear recommendation from the engagement strands and the SORP Committee.

Following evidence provided by the engagement strands the SORP Committee will have its own discussion about what needs to be done and taking the evidence and views from the process, the Committee will settle on a recommended approach for drafting the SORP based on the evidence presented.

Appendix 1

Additional requirements for the recognition of charity income streams

SORP reference	SORP Text
5. Recognition of income, including legacies, grants and contract income	
Understanding the Nature of Income	
5.3	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.
5.4	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.
General rules for income recognition	
5.10	'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 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	
5.13	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.
5.14	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.
5.15	Charities should identify:

SORP reference	SORP Text
	• those donations and grants that are subject to performance-related conditions; and • other terms or conditions that may prevent income recognition.
Performance related conditions	
5.16	Abbreviated: 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	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.
5.19	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	
5.20	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.

SORP reference	SORP Text
5.21	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.
5.22	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	
5.23	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.
5.24	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.
5.25	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

SORP reference	SORP Text
	grant or donation is probable once those conditions are met.
Terms and conditions that do not prevent recognition	
5.26	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.
5.27	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.
Income from contracts for the supply of goods and services	
5.39	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.
5.40	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

SORP reference	SORP Text
	relevant disclosures required for a restricted fund must be made.
5.41	Entitlement to the income from the sale of goods arises when the ‘significant risks and rewards’ of ownership are transferred to the buyer. The income must be recognised in the SoFA when the income from the sale and the costs of the goods sold can both be measured reliably and receipt of the income is probable.
5.42	Income from the supply of services is recognised with the delivery of the contracted service provided that: the stage of the completion, the costs incurred in delivering the service and the costs to complete the requirements of the contract can all be measured reliably.
5.44	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.
5.45	Simply incurring costs in relation to a contract does not in itself justify the recognition of income. The cost criterion is met where the costs incurred and the costs to complete the transaction can be measured reliably. If the costs incurred and the costs to complete cannot be measured reliably then the receipt should be treated as an advance payment and deferred.
5.46	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.
5.47	Abbreviated: If extended credit terms are offered on contract income) the amount receivable should be discounted by the time value of money at a rate of interest that reflects the

SORP reference	SORP Text
	financing transaction involved. This is not required where: • normal credit terms are offered; • extended credit terms provide for payment within 12 months of the invoice date; or • the transaction amount is not material.
Income from membership subscriptions	
5.48	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 earned from the provision of goods and services as income from charitable activities.
Income from interest, royalties and dividends	
5.49	Income from interest, royalties and dividends must be recognised when its receipt is probable and the amount receivable can be measured reliably.
5.50	Interest is recognised using the effective interest method. However, interest on concessionary loans and interest receivable on bank deposit accounts and from government gilts will not require this adjustment.
5.51	Royalties and income from the exploitation of intellectual property rights are accrued in accordance with the relevant agreement.
5.52	Dividends are accrued when the shareholder's right to receive payment is established. In the case of a Gift Aid payment made within a charitable group, income is accrued when the Gift Aid payment is payable to the parent charity under a legal obligation.

SORP reference	SORP Text
Settlement of insurance claims	
5.53	An insurance claim must be recognised when a charity is entitled to the reimbursement of the insured loss, the receipt is virtually certain and the amount can be measured reliably.
Module 6. Donated goods and services including volunteers	
6.6	Donated goods, facilities and services must be recognised as income when the following criteria are met: Entitlement – control over the expected economic benefits that flow from the donation has passed to the charity and any performance-related conditions attached to the donation have been fully met. Probable – it is more likely than not that the economic benefits associated with the donated item will flow to the charity. Measurement – the fair value or value to the charity of the donated item can be measured reliably.
6.7	Donated goods, facilities and services are unlikely to be subject to performance-related conditions which would result in the deferral of income until those conditions are met. A restriction on the use of a donation does not prevent its recognition as income.
Accounting for donated facilities and services, including volunteers	
6.13	If a charity is given facilities and services for its own use which it would otherwise have purchased, these must be included in the charity's accounts when received, provided the value of the gift can be measured reliably.

SORP reference	SORP Text
6.16	Donated facilities and services that are consumed immediately must be recognised as income, with an equivalent amount recognised as an expense.
Accounting for donated goods for resale	
6.27	In accepting donated goods for resale, the charity is receiving a gift in kind on trust for conversion into cash to fund the charity's activities. Where practicable, donated goods for resale are measured at fair value on initial recognition, which is the expected proceeds from sale less the expected costs of sale.
6.28	Charities accepting goods for resale under the UK retail Gift Aid scheme are acting as agent in selling the goods on behalf of the donor and are in law entitled only to an administration fee until such time as the donor waives their entitlement to the sale proceeds. Charities which have historical data may use an estimation technique to recognise income from such arrangements from the point of sale, for example by applying a formula or mathematical model to estimate the likely amount of the donations that will result from their subsequent sale. Income may be recognised from the point of sale where this reflects the substance of the transaction provided the income recognised is adjusted to reflect the risk that some sales will not result in a donation. Where a donor does not waive their entitlement to the sale proceeds, the administration fee is analysed as 'Income from other trading activities' in the SoFA.