## SORP and the accruals basis for accounting for grants - discussion briefing

## Prepared by: Charities SORP-making body, July 2021

# Purpose of the briefing paper

The aim of this briefing is to assist the engagement strands to reflect on the current approach to accounting for grants and to consider the possibility of permitting charities to use the accruals basis of accounting for some or all grants.

To assist the engagement strands undertake this problem solving exercise the recommended approach is to initially consider at a high level the Charities SORP and what it has to say on the topic, the findings obtained during the exploration stage from the engagement strands and the SORP Committee, in addition to any relevant research, culminating in a rationale for change if any and what that might look like in practicable terms.

The related modules are five, seven and sixteen of the SORP with some inevitable overlap on the income recognition topic which is a subject topic in its own right for later in the year.

# What the SORP says

### Grants Receivable

Charities receive various different types of grant income. The funding may come from Government, local authority, EU or National Lottery or other charities. It is important to note that during the Covid-19 pandemic additional grants have been made available to business, however the extent to which this affects the financial statements in terms of measurement will depend on the particular facts and circumstances of the entity involved.

**Grant income** is any voluntary income received by the charity (or other transfer of property) from a person or institution. A distinguishing feature of a grant is that it is a formal offer of funding (SORP paragraph 5.11) in the form of an agreement. The income or transfer may be for the general purposes of the charity, or for a specific purpose. It may be unconditional or be subject to conditions which, if not satisfied by the recipient charity, may lead to the grant property acquired with the aid of the grant or part of it being reclaimed by the grant-maker (SORP paragraph 5.16).

Income must only be recognised in the accounts of a charity when all of the following criteria are met (SORP paragraph 5.8) .These are:

- 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.

The SORP states under Para 5.10 that the use of the ‘accrual model’ option (Sec 24 of FRS 102) for the recognition of income from **government grants** is not permitted by this SORP thus leaving the performance model as the only accounting treatment for grant income. It is important to note that the section 24 of FRS102 only addresses ‘government grants’ and the development of accounting standards in this area is framed by forms of government assistance to for-profit businesses and how to best present this income when calculating profit. In respect of other forms of non-exchange transaction including grants other than from government Section 34 of FRS102 sets out the performance model approach (see paragraph PBE 34.67).

Para 5.5 states that grants are a form of non-exchange transaction where the grant maker awards a grant without receiving equal value in exchange. However, where a charity is in receipt of grant funding certain conditions may attach to this funding. These conditions dictate the extent to which the grant can be recognised within income. i.e performance related grants. The specific performance required by the terms of the grant will have to be carried out by the charity before it can recognise the related income. Para 5.19 of the SORP provides a distinction between performance related grants and contracts and the legal status of each.

An unconditional grant should be recognised within income for the year once it has been established that the charity has entitlement to the grant with the conditions of probable and measurable also being met. The SORP distinguishes between those conditions that are within and those conditions which are outside the control of the charity. For example, a condition outside of the control of the charity might be the need for matched funding in which case the grant should be deferred and not recognised within income for the year, however if it is one of an administrative nature like a requirement to submit their annual accounts then full recognition of the grant in income for the year is required.

Para 5.24 states that 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. In such circumstances the grant should be recognised as a contingent asset.

In situations were time constraints (Para 5.22) have been added to the grant the recognition of income follows the respective time constraint, these can also be implied such as multi-period grants which were approved on the basis of agreed annual budgets. Income from grants should not be deferred where they have not been spent, but could have been.

Where funding has been specifically provided for a fixed asset then the income should be shown in the SoFA as a restricted fund in full on receipt and not be deferred over the life of the asset. The fact that the income may be for a restricted purpose i.e fixed asset does not in itself amount to a pre-condition and therefore the SORP reinforces the principle that the grant for a fixed asset should be accounted for in full in the SOFA, albeit with the asset attributed to a restricted or designated fund.

In overview, grants which are unrestricted in their nature are recognised in full when received . Time constrained grants can result in deferred income. For restricted grants ,which do not relate to a future period, any unspent balance is carried forward to future years in funds. Income recognition is not based around matching income to expenditure incurred. In funding tangible fixed assets or revenue, the SORP makes no distinction as to what form the funding took or the source of that funding and requires the same approach to recognition and measurement. In the case of an acquiring an asset, the accumulation of funds in advance of purchase, the proceeds of an appeal or the receipt of a grant to finance the purchase are all treated in the same way.

When a charity receives income in a capacity as agent ,the income should not be recognised. However, where a charity has applied for the funds e.g as a grant ,and is required to pass them on then the funds should be recognised in the accounts as the charity will have responsibility for the application of the funds

## Grants Payable

**Grant payments** are any voluntary payments (or other transfer of property) in favour of a person or institution made by a charity in furtherance of its charitable aims. The payment or transfer may be for the general purposes of the recipient, or for some specific purpose such as the supply of a particular service. It may be unconditional, or be subject to conditions which, if not satisfied by the recipient, may lead to the grant, or property acquired with the aid of the grant or part of it being reclaimed by the charity.

A charity may make a performance-related grant, in which case it recognises its liability, as the goods or services specified in the grant terms are provided by the recipient.

As charities often do not receive anything in exchange for expenditure, particularly in respect of grants, the charities liability is defined in terms of obligations to a third party. As with income there are three criteria to be met for a liability to be recognised (para.7.5) These are:

- 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.

In the case of grant expenditure relating directly to charitable activity, it is a non-exchange transaction since the grant-maker is not looking to directly benefit but is looking to fund activities for the benefit of others and so no exchange is involved. This contrasts with the commercial contracts based on exchange where a liability is treated as not incurred until something is received in exchange for the expenditure.

Para 7.18 of the SORP states that any liability and related expenditure should be recognized in full by the charity as soon as the criteria for a constructive obligation has been met, payment is probable, it can be measured reliably and there are no conditions attached which limit its recognition. This includes the principal that recognition of liabilities should include not only a legal obligation but also a constructive obligation (Para 7.14).

There are cases where grant-making charities will only recognise grant commitments when certain conditions are met by the receiving charity or third party (SORP paragraph 7.17). Where satisfaction of the conditions is within the control of the donor charity then the donor charity can avoid the expenditure and so a liability is not recognized (paragraph 7.20). A multi-period grant must be accounted for in full in year one unless conditions apply (SORP paragraph 7.19). Where conditions are outside the control of the donor charity, the liability is recognised once it is probable that the conditions will be met.

For performance-related grants ,the amount payable to the recipient is determined by the extent their performance has met the conditions of the grant agreement. The payment is conditional on the recipient delivering a specified level of service or output. However,a restriction as to charitable purpose is not a performance– related grant. The liability and expenditure recognised by the charity arising from such a performance- related grant will be the extent that the recipient has provided the service or output.

The SORP reinforces the principal that there is a distinction between those commitments of a binding nature and those that are a discretionary intention. The making of a non-contractual promise would not be a binding commitment for accounting purposes if there were no legal or constructive obligation. Where conditions of the SORP have been met (paragraph 10.77) a provision should be accounted for in the charity accounts and shown on the balance sheet.

## Engagement strand feedback during the exploration stage

Comments from the engagement strands regarding accounting for grants were as follows (see Appendix 1 for abbreviations):

Charities are only able to account for grants using the performance model. However, FRS 102 gives an accounting policy choice, also permitting the accrual model to be used in the case of government grants. Could the SORP permit charities the same accounting policy choice (at least for smaller charities)? Should section 34 of FRS102 be amended to allow wider application of the accruals model to other forms of non-exchange transactions and other grants?

Additional narrative disclosures, for example on performance conditions, could be introduced to supplement the accounting information under the accrual model (for all sizes of charity). The ability to use the accrual model could help those more familiar with the concept of profit and loss in a commercial entity, including charity trustees and funders, to better understand a charity's financial performance. The recognition of income in advance of related expenditure being incurred can give the impression that the charity's financial position is better than it is and this may impact on funding applications. Conversely, the recognition of related expenditure in future years, creating deficit position, may be interpreted as the charity being in a less favourable financial position than is the case. (PTS(B))

Should flexibility be maintained in SORP or would it be preferable to mandate a specific treatment? Is the current accounting treatment of grant income for capital projects appropriate? (PTS(A))

The income recognition and grant funding commitment recognition requirements can distort the SoFA and are confusing for trustees and funders. The distortion comes from recognising income and grant funding commitments relating to future years, where no conditions are attached (also see our comments on accounting for grant income). There could be an opportunity to draw on the IFR4NPO's initiative around the recognition of restricted income. (PTS(B))

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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 (PTS(B))

Treatment of capital grants can be distortive to service provider debtors (MFDGPB)

## Observations from the SORP Committee:

At its meeting on 16th December 2020 it was noted that revisiting recognition of income from capital grants would be worthwhile to have a debate on this and look at the advantages and disadvantages of the current approach. At its meeting of 16th February 2021 it was noted that the retired SORP Committee had considered the accruals model for grant accounting as a good option. However, a committee member was concerned that for smaller charities that this may obscure the presentation of financial information in this area. The committee agreed to take this topic forward for further consideration at the reflection stage.

## Relevant SORP research findings

The SORP research exercise undertaken by the SORP-making body in 2016 (Analysis of research exercise-responses-22) invited respondents to identify those elements of grant accounting in relation to income recognition that could be improved and suggested the following changes (some of which have been addressed in the current edition of the SORP):

- Clearer definition of 'performance-related conditions' within grants funding agreements
- Greater guidance, examples and methodologies for the recognition of grant funding agreements with performance-related conditions'
- Greater examples and additional guidance on when it is appropriate to accrue and defer grant income
- Greater and clearer guidance for the following situations:
    - Multiyear grants
    - Unexpended grant repayment options
    - Grants on a reimbursement basis
- Change the requirements which prevent grants which do not have performance-related conditions being included in the 'income from charitable activities' SoFA heading In particular the fact that some incoming resources are recognised in full in the year of receipt or award (including capital grants) but the related expenditure may be incurred in future years, was viewed as especially problematical.

Other research presented to the SORP Committee with reference to grants is noted below:

*Building Public Trust Awards (PwC)*

- Committee members were receiving feedback from clients that capital grants are an area that SORP may be able to provide more recommendations.

*SORP and Irish Charities*

- Income recognition– allow amortisation of multi-annual and capital funding/grants

## What needs to be done now?

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

A need for change in relation to whether or not there is a strong desire to change the existing SORP and permit the accruals basis of accounting for all grants, this should be based around the engagement strand feedback and SORP Committee discussions to date and from the findings of the 2016 research. At this stage, clarity is required as to what changes are actually required and the reasons that support these changes. **Without a case for change, no change will be considered because its rationale cannot be explained to those affected.**

### Step 2 - Advising the change required to the SORP

Having made the case for change, the detailed changes required to the SORP need to be set out. Consideration should be given in as much detail as possible as to what that change would look like in a draft form and its application to financial statements. 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.

### Step 3 – Recommendation

- The case made by each strand or combination of strands will inform the deliberations of the SORP Committee and so there needs to be a clear recommendation.
- The SORP Committee will be having its own discussion about what needs to be done and taking the evidence and views from the process as a whole, the Committee will settle on a recommended approach for drafting the SORP based on the evidence presented.

### Appendix 1 - Abbreviations - Engagement Strands

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| Smaller charities and independent examiners | S&IE |
| Larger charities | L |
| Charity trustees | T |
| Academics and regulators and proxies for public interest | A&R&PPI |
| Professional, audit and technical strand A | PTS(A) |
| Professional, audit and technical strand B | PTS(B) |
| Major funders, donors and government and public bodies | MFDGPB |