



# SORP Insight Series

## Income recognition - frequently asked questions

• Crowe UK Social Purpose and Non Profit team

**Crowe UK runs a help line for the Charity Finance Group (CFG). This guidance note considers some of the frequently asked questions from charities relating to income recognition.**

**Charities SORP (FRS102) recognises that it is possible to think beyond the obvious with income recognition in a way that makes sense for a charity's circumstances. There is no need for a stereotype prescriptive approach and it is important to ensure that the accounting fits the reality of the many different funding and donative arrangements that exist in the charity sector.**

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## Question 1: What is the income recognition criteria under Charities SORP (FRS102)?

I have heard the view expressed that since FRS102 appears to have lowered the income recognition test it is likely that more income will be recognised with less deferral of income. However, I believe that any changes in the amounts recognised as income will be minimal.

To assess whether your charity has previously unrecognised income that now needs to be recognised, you need to understand what has changed and the implication of the change. SORP 2005 explained that income should be recognised when all of the following three criteria are met:

1. **entitlement** – when there is control over the rights or other access to the resource enabling the charity to determine its future application
2. **certainty** – there should be reasonable certainty of receipt
3. **measurement** – the item can be measured monetarily with reasonable certainty.

Charities SORP (FRS102) explains that:

*“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.”*

The key change arising out of FRS102 was that previously ‘probability’ of receipt was a ‘certainty’ of receipt requirement. Probable is defined as meaning that it is more likely than not that the economic benefits associated with the transaction or gift will flow to the charity. The other two criteria were broadly unchanged.

There are of course some situations in which there may be doubts as to the probability of receipt but in our experience, most charities that defer income recognition do so because they believe that they are not *entitled* to the income at the accounting reference date.

Entitlement, and therefore recognition, is dependent on the type of income stream and the substance of the terms and conditions that may apply. Charities need to identify donations or grants that are subject to terms or conditions that must be met before there is entitlement to income.

Charities SORP (FRS102) emphasises that 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.

Donor imposed conditions may also specify the time period over which the expenditure of resources on a service can take place. All these issues mean that there are many matters that could impact income recognition and these are discussed further in this guidance note.

The SORP takes a common-sense approach to much of income recognition and we always advise that charities start by thinking about what makes sense and what really reflects the substance of the transaction and whether there is flexibility in how the rules are applied to reflect what makes sense.

## **Question 2: Is grant income recognised differently from contract income?**

The focus once again is on *entitlement* as the first of the income recognition criteria. FRS 102 makes the distinction between exchange and non-exchange transactions. The former includes contracts for services and performance-related grants and the latter includes gifts even if they are restricted. Entitlement to contracts and performance-related grants will arise when the charity has earned the right to the income. Therefore with an exchange transaction income is recognised in line with performance.

Some accountants believe that only contracts would require the need to match income with performance but FRS102 explains that the same principles will apply to all income where there are related performance conditions and states:

*“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.”*

A restriction on the use of a grant will not of itself create a performance-related condition. A restriction simply creates a requirement that limits or directs the purpose for which a resource may be used but it does not prevent the recognition of income where it does not require a specific level of performance or output from the charity.

A performance-related grant is one where the grant has characteristics similar to those of a contract, in that:

- the terms of the grant require the performance of a specified service that furthers the objectives of the grantmaker; and
- the entitlement to the grant receivable is conditional on a specified output being provided by the grant recipient.

Where entitlement to grant income is subject to performance conditions income is recognised as the performance conditions are met. In effect, a performance-related grant is analogous to a contract for the supply of services. Income from the supply of services is recognised in line 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.

All this is often clear in theory but obscure in practice. In some cases, it is difficult to understand the nature of the funding agreement. Reading these agreements, it is possible to start off thinking it's a contract, then halfway through it seems to be a grant and by the end it appears to be a bit of both. It is often best to settle for what makes the most sense! In recognition of this SORP 2015 emphasises the need to focus on the substance rather than the legal form.

This also begs the question as to how performance can be measured. SORP 2015 explains that 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.

This may lead to particular challenges where the work is not properly defined or where it is difficult to assess the extent of performance – for example with contracts to carry out research or where there are multiple deliverables all bundled up into one contract or funding arrangement. In my experience, a common-sense approach without being too pedantic works best. The question is does the chosen method make sense and does it reflect the substance of the arrangement.

The SORP explains that 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.

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.

However, it is important to recognise that simply incurring costs in relation to a contract does not in itself justify the recognition of income. For example, if a charity has completed 50% of the work but incurred a greater proportion of costs and is not in a position to claim cost overruns leading to a "loss" on the contract it should take this into account when recognising income.

The expenditure matching criterion is used 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.

### **Question 3: What is the accounting treatment for multi-year funding arrangements?**

There has been considerable discussion and confusion about the income recognition criteria for multi-year funding arrangements and the treatment adopted has a significant impact on the income numbers reported. This issue is becoming even more significant as many charities receive multi-year funding from institutional funders, foundations and corporate partners. In addition, more and more charities are carrying out “trading” activities that are funded by way of contracts which are commercial in nature. Many of these activities are carried out by the charity but a number will use trading subsidiaries. These subsidiaries are consolidated into the charity group accounts and therefore group accounting policies that comply with the SORP need to be observed. Many preparers of accounts believe that the guidance in the SORP is too constrained and does not allow them to recognise income in a way that makes sense for the organisation. This is not the case and we see charities use many options that best reflect their circumstances and still comply with the SORP. This guidance note seeks to show the options that are available for the recognition of income and “profit” where relevant.

The SORP explains that *“A pre-requisite of recognition of a promised grant or donation is evidence of entitlement. Evidence will normally exist when the grant is formally expressed in writing. Where entitlement is demonstrable, and no conditions are attached, such promises should be recognised as incoming resources once the criteria of certainty and measurability are met.”*

This means that income should not be deferred simply because the income has not been received or because matching expenditure has not been incurred unless there are specific conditions (as against purpose restrictions) that require this.

Paragraph 5.13 and 5.14 of the SORP explains the difference between a restriction and a condition. *“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.”*

*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”*

Essentially, restrictions on income simply limit the type of expenditure or the use of the donated income or asset whereas conditions govern whether or not there is entitlement. The most common conditions that will lead to a charity deferring grant income are:

- a) where it is a condition of the grant that activities take place in future accounting periods or
- b) that there are performance relating conditions that govern the amount of income that can be recognised at a given point in time.

Charities SORP FRS102 explains *“The term performance-related grant is used to describe a grant that has the characteristics of a contract in that:*

*(a) the terms of the grant require the performance of a specified service that furthers the objectives of the grantmaker and*

*(b) where payment of the grant receivable is conditional on a specified output being provided by the grant recipient”.*

It is important to note that there are two prongs to the definition and that both aspects have to be considered when deciding whether a grant is a performance-related grant.

The SORP goes on to explain:

*“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.*

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

*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.”*

Income recognition is a difficult area and there are a number of possible accounting treatments that will depend on the individual funding agreements and the particular circumstances. With regards to grants, charities are using a number of different recognition methods. The scenarios being commonly adopted are discussed in this paper. It is important to recognise that the different options can only be used when they meet the SORP’s recognition criteria.

#### **Question 4: Does this mean that we can recognise income in line with related expenditure?**

It is important to understand when such a treatment is possible. It should not be adopted on the basis of trying to match income and expenditure – the “matching” concept which was much favoured by accountants has for some time been seen as inappropriate and contrary to accounting standards. FRS102 makes this quite clear and states:

*“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”*

However, in certain circumstances a form of matching can be adopted. This is where the grant is performance-related or the income is under a contract that requires the delivery of some service. The rationale for this treatment is based on the view that the funding is tantamount to performance-related grants (as discussed above) and that the most reliable method of assessing performance is considering the proportion of costs incurred for work performed to date compared with the total estimated costs to completion.

This may be the case even if there are specific deliverables which may have achieved different levels of performance or the nature of the deliverables does not allow easy quantification of performance. For example, a funder might require the charity to sign up a specified number of people to a scheme and then deliver a certain level of training. At the year-end date it might have signed on 70% of the required number of people and delivered 40% of the training – what is the level of consideration that it has earned?

In such cases, expenditure may be the best proxy for performance and in such cases, income can be recognised in line with expenditure. When the measurement criteria discussed above are met. However, where there are other performance criteria specified in the funding agreement that can be measured, expenditure may not be the best approach.

There is also the issue of whether funding agreements are sufficiently material to the activity of the period that failing to record turnover and attributable profit would lead to a distortion of the period's turnover and results such that the financial statements would not give a true and fair view.

The thinking is, that owing to the length of time taken to complete some contracts or funded projects, to defer recording income until completion may result in the accounts not reflecting a fair view of the results of the activity during the year. Instead, they would be based on the results relating to contracts that have been completed in the year. In certain cases, it is appropriate to take credit for ascertainable turnover and “profit” while contracts/ projects are in progress.

Charities need to record income and related costs as contract activity progresses. Income should be ascertained in a manner appropriated to the stage of completion of the contract.

## **Question 5: What about time restrictions?**

A time restriction, unlike a purpose restriction can often lead to the deferral of income. This is because a timing restriction is similar to a condition. SORP 2005 explained that *“Incoming resources may also be subject to donor imposed conditions that specify the time period in which the expenditure of resources can take place. Such a precondition for use limits the charity's ability to expend the resource until the time condition is met. For example, the receipt in advance of a grant for expenditure that must take place in a future accounting period should be accounted for as*



*deferred income and recognised as a liability until the accounting period in which the recipient charity is allowed by the condition to expend the resource.”*

This approach is unchanged and is applied where the donor specifies when the funding can be used and, in such cases, a time restriction may require deferment of income. This is where there are specific conditions on when the funds can be used and it is not usually within the charity's discretion to make use of the funds at an earlier stage. The nature of the agreement limits the charity's ability to expend the resource until the time condition is met.

Simply because the charity decides it cannot start or complete a funded project until a later accounting period does not mean that the income should be deferred. A charity retrospectively agreeing with the funder that unspent funds will not be clawed back is not the same as a condition that limits the charity's ability to expend the funds.

But it is important to look beyond the obvious. For example, it may be clear from the funding application that the charity had asked for funding to cover a specific time period. The charity may have submitted a three-year budget with the application indicating how much will be spent each year. In some cases the grant will be clearly to meet the salary of an employee over the next three years or pay the rent over the next three years.

In such cases the grant agreement may specify that a specific amount of the grant relates to those three years. In many cases, the agreed yearly amount or budget is specified with a clause that this cannot be varied without the funder's agreement.

Charities SORP (FRS102) has clarified this area and explains that 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.

Therefore, If the application or the funding agreement specifies the period covered by the grant it may be correct to recognise the income over this period. This is not sanctioning income recognition in line with stage payments (see discussion below) but rather seeking to identify when entitlement arises. In these it would need to be clear that the specified grant period covered a period after the year-end date.

## **Question 6: Can income be recognised in line with a funder's stage payments?**

Normally, a funder's payment schedule should not be seen as defining when income should be recognised unless it inferred expenditure was limited to a future accounting period. Charities that recognise income in line with a funder's payments focus on the issue of performance conditions.

A grant that is subject to performance or other conditions needs to be carefully considered. If it is received in advance of delivering the goods and services required by that condition, or is subject to

other conditions wholly outside the control of the recipient charity income should not be recognised and should be accounted for as a liability and shown on the balance sheet as deferred income. Deferred performance or other conditions that limit recognition are met.

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 conditions are met.

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

The default position is that income recognition is not simply to be based on when a funder makes payment. However, the timing of receipts by a charity may be indicative of other persuasive factors.

The charities that, in some circumstances, recognise only the income they have received explain that the funder has not hold back an element of the funding simply to manage cash flow. But rather because the funder understands the problem with grantees delivering to time, to specification and spending all the funds granted.

In short, the preparers of the charity's accounts are taking the view that retention by the funder is recognition of the fact that there is uncertainty as to whether a charity and/or its partners will be able to meet the requirement of the full funding. This is often supported by cases of claw back and also the condition that not all the funding may be drawn down.

In effect, the preparers of accounts are representing that this is a case where uncertainty exists as to whether the recipient charity can meet conditions within its control. In effect, they believe that they are not able to be satisfied that there is sufficient evidence that the funder's requirements will be met to create entitlement to the whole of the funding. This approach needs to be carefully considered and substantiated by the facts and operational realities.

## **Question 7: FRS 102 allows deferring the recognition grants provided to purchase fixed assets does Charities SORP (FRS102) permit this?**

The FRC has acknowledged that the approach required by the Charities SORP is the right principles-based approach. FRS102 adopted a compromise position as an interim solution. However, it is important to recognise that this only applies to government grants. FRS102 allows such grants to be accounted for under the accruals model or the performance model. This is rather counterintuitive as recognition should not be based on the source of the grant. Grants from the Government are not to be treated in a different way from other grants.

The grants need to be considered to establish whether they have conditions attached which may prevent the recognition of income.

Charities SORP FRS102 continues to support the principle that 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 Statement of Financial Activities and not deferred over the life of the asset.

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.

### **Question 8: We recognise grant and donation income when we know that we will be receiving it, does all the discussion above mean that we will need to change this and defer some of the income?**

The simple answer is no. If you are following the rules correctly it would mean that you are recognising the grants and donation income that you have received because they are not performance-related or time-restricted. This would imply that you have full entitlement to the income you have received and therefore it must be recognised as income if the receipt is probable and can be measured. Indeed, with grants or donations there may be a need to accrue income that has not yet been received if it meets the three income recognition criteria.

The SORP explains that 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. In the case of a donation, entitlement usually arises immediately on its receipt.

The SORP also explains that both grants and donations may include terms or conditions which must be met before the charity is entitled to the resources.

In practice, trying to distinguish between a grant and a donation for accounting purposes can be confusing because nomenclature should not define the accounting treatment and the reality is that there is no real difference between a donation and a grant. This would mean that entitlement to a grant or donation would prima facie arise at the same point. Conventionally though, the view has been that entitlement is linked to the “enforceability” of the offer. In effect, charities usually recognise grant income where the grant offer is unconditional and in writing.

On the other hand, a pledge from an individual donor has in practice usually not been recognised until it is received. Having said that if a charity has evidence, usually in writing, from an individual of a pledged donation then you can consider that the entitlement test is met as the source of the income would not normally define entitlement.

However, the source of income may need to be evaluated when considering the probability of receipt. You may believe that an unconditional grant offer from a grant-making trust or institutional funder means that receipt is more likely than not (the probability test). On the other hand, you may believe that a pledge from an individual may be less likely to materialise.

## Question 9: Has Charities SORP (FRS102) changed when a legacy should be recognised?

There was a view that Charities SORP (FRS102) would require legacy income to be recognised earlier than under SORP 2005. This is because under the new rules one of the income recognition criteria 'reasonable certainty of receipt' has been replaced by 'probability of receipt'. Probable is defined as meaning that it is more likely than not that the legacy will flow to the charity. Prima facie this might appear to mean that legacies will be recognised earlier. However, it is important to appreciate that the other two criteria 1) does the charity have entitlement to the legacy and 2) can it be measured are unchanged from SORP 2005.

In our experience, most charities recognise a legacy at the earlier of receipt or the estate accounts being settled.

Once again the first test is does the charity have entitlement. At present there are different approaches being adopted by charities on the recognition of income. With regard to entitlement there are essentially two policies being operated by charities;

- i. entitlement is when probate is filed
- ii. entitlement is when estate accounts are settled / there is notification of a distribution

(There is a third – where legacies are accounted for on a receipts basis. This is not seen as complying with the SORP unless the difference between received and receivable is not material.)

SORP 2005 favoured the second option. The reason for this is that when considering entitlement, although legal title to assets in an estate transfers to a legatee only when that title is actually transferred, beneficial title may transfer at another time. It is quite common for a charity to instruct the executor to sell property in an estate on their behalf - legal title may pass directly from the estate to a purchaser effectively bypassing the charity.

However, the beneficial title transfers as and when the executors conclude that the particular asset will not be required to satisfy claims in the estate. The legacy may be contested or there may be significant liabilities to meet. Therefore a charity legatee would have an interest to ensure the estate was properly managed but would not have a specific interest in the property until the executors have concluded that the property will not be needed to meet other claims.

SORP 2005 recognised this distinction and explained: *"It is unlikely in practice that the entitlement, certainty of receipt and measurability conditions will be satisfied before the receipt of a letter from the personal representatives advising of an intended payment or transfer. The amount which is available in the estate for distribution to the beneficiaries may not have been finalised and, even if it has, there may still be outstanding matters relating to the precise division of the amount. In these circumstances entitlement may be in doubt or it may not be possible to provide a reasonable estimate of the legacy receivable, in which case it should not be included in the Statement of Financial Activities."*

At the time of drafting the latest SORP the SORP Committee did consider whether a more standardised approach might be desirable in view of the apparent diversity of treatment and potential inconsistency in the reporting of legacy income in the charity sector. The SORP Committee's published minutes explains the reason why it was thought appropriate not to change the fundamental approach.

It was noted that there is a difference of view amongst charity legacy officers and legal advisers as to whether probate can be considered the point of entitlement. Indeed entitlement arguably actually arose from the death of the legator and the presence of a valid will. However other legal advisers argued that until a firm communication of a settlement or a court ruling was made no entitlement could be held to exist as a will could always be successfully contested. Whilst probate provided a useful public record of total assets and liabilities it was at best a starting point.

As to there being a diversity of treatment, the SORP Committee considered it appropriate that charities deal with legacies based upon their own circumstances, the availability of historical information on income from legacies and the advice that they received.

It was noted that whilst accounting standards required the practice of depreciation of wasting tangible fixed assets, the SORP did not specify what method to use or standard economic lives for classes of assets. Arguably legacies were no different in requiring a degree of flexibility for charities to apply their own judgement and estimation techniques.

Therefore SORP 2015 continues to allow the flexibility that exists in SORP '005 and explains:

*"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.*

*"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.*

• *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."*

All three criteria must be met and the second of the bullet points above endorses that SORP 2015 favours the policy of waiting until the estate accounts are settled. Therefore, for those charities that followed a policy of recognising legacies at the earlier of receipt or estate accounts being settled

there is no need to change this policy as it is acceptable, indeed even advocated under SORP 2015.

Some charities have sufficient information on their legacies trends to take an alternate view. I know that some charities accrue their legacies when probate is filed. This treatment can be acceptable if there is evidence to show that it does not provide a result that is shown to be materially incorrect. SORP 2015 now specifically explains the use of trends and historical information and states:

*“Charities which receive a significant number of legacies in a reporting period and have detailed historical information on the settlement of legacies may (my emphasis) 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 (my emphasis) 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.*

The ‘must’ in the paragraph above emphasises that the key recognition date is when the executors have determined that a payment can be made – this is not the same as the probate date.

In our experience, most preparers of charity accounts would rather not recognise income that may not be received for a long time. So, in practice charity accountants try to find a pragmatic way of deciding on which legacies should be included in the year-end accounts. For example, when trying to establish an entitlement date many charities review the legacies received in the first few months after their year-end to establish whether entitlement was before the year-end.

This is based on the assumption that if executors had concluded before the year-end that the funds were not needed for other claims then it would not be unreasonable to assume that the funds would be received within a few months. Those preparing the accounts look at the legacies received post the year-end and then establish when the legacy had pre or post year-end entitlement.

It is important to note that these are estimation techniques and should be used as such. If there is persuasive evidence to show that they are not providing the right answers they should be reviewed. If the charity has a policy of reviewing legacies received up to two months after the year end and a material legacy was received a few days after this period it is not sufficient to say that the policy requires a cut-off at two months – it would be necessary to include the legacy if there was evidence to show that entitlement existed before the year-end.

If you are changing the way you recognise legacy income you need to consider carefully if this is a change of accounting policy that requires a prior year adjustment or whether it is a change of accounting estimate. Adjusting for changes in accounting estimates and estimation techniques

results in a change to the transaction value or carrying amount of the asset or liability in the current reporting period; no adjustment is to be made in respect of prior reporting periods.

Some charities treat pecuniary and residuary legacies in a different way. This is on the basis that with a pecuniary legacy that is of a size that it is apparent from the notification or probate that the fixed amount will be paid then it would not be unreasonable to treat the legacy as receivable before formal communication is received that it is to be paid.

## Question 10: What about gifts in kind?

The accounting treatment differs for the type of gifts.

**Gifts for resale** – this would usually be through charity shops and FRS102 has raised the stakes on this. Previously charities recognised the income when the donations were sold FRS102 requires that income should be recognised once the items for resale have been received. However after a strong lobby for the charity sector practicality considerations have been included in the standard and the SORP explains that although goods donated for sale are normally recognised at the point of receipt, practicability may dictate that they are recognised only on their sale.

Before undertaking a valuation, the charity should consider the materiality of the donations received and whether the cost involved in undertaking a valuation is justified by the benefits to the users of the accounts in terms of their better understanding the resources available to the charity and to the charity itself from having this financial information. In practice I believe that in most cases this will mean that goods for resale through charity shops will continue to be recognised when sold.

**Gifts for onward distribution** - The rules for when these goods should be recognised are similar to goods for resale and similar practicality tests will apply. They should normally be recognised at fair value. However the SORP explains that it may be necessary when valuing the donation to consider any restriction on the sale of the asset or the factors that may reduce the fair value of the asset.

- Factors to consider include proximity to a product expiry date or the availability of lower-cost substitutes for the donated item, for example a generic version of a drug. Donated goods held in stock for distribution must be assessed for impairment at the reporting date

**Donated facilities and services** – The SORP explains that facilities such as office accommodation or services supplied by an individual or an entity as part of their trade or profession can usually be reasonably quantified and must be included in a charity's accounts. Donated facilities and services are therefore measured and included in accounts on the basis of the value of the gift to the charity. The services of general volunteers are not recognised as income. This is based on practical considerations rather than a principles-based approach.

## Question 11: What about the time value of money

The SORP explains that *“Income is recognised at the fair value of the consideration received or receivable after making an adjustment for any extended credit terms offered. If extended credit terms are offered on exchange transactions (contract income), the amount receivable should be discounted by the time value of money at a rate of interest that reflects the financing transaction involved. The unwinding of the discount represents the interest receivable from the buyer. No discounting is 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.”*

*Discounting is also particularly relevant for legacies and the SORP explains, “If the distribution is to be deferred for more than 12 months and an estimate can be made of the likely date of distribution, the legacy, if material, may be discounted by the interest rate the charity anticipates it would earn on a comparable deposit over a similar time frame using the effective interest method set out in section 11 of FRS 102. The unwinding of the discount should be reported as an adjustment to legacy income and not as interest receivable.”*

It is important to recognise that if it is expected that the value of the income flow will itself increase over time due to inflation this should be taken into account when considering the need for and amount of discounting.



## **In conclusion:**

Preparers and auditors of charity accounts need to carefully consider the substance of the transaction. Charities often believe that the SORP requirements are forcing them to account for income in a way that seems to be counter-intuitive to their understanding of the donor/funder's expectations. In many cases the funding agreement/contract or other documentation does not help with considering income recognition.

To deal with this, many charities have started obtaining supporting documentation from the donor/funder to support the income recognition treatment they are using. Where charities want to establish some linkage to recognise grants, for example, in a particular year or in relation to particular expenditure it should be clear through the supporting documentation that this is what the funder requires/desires.

The documentation which can be in correspondence that is additional to the grant agreement should clarify that the funder's intention was/is that entitlement to the income is in the way that the charity is proposing to recognise the income.

This is a complicated area and care needs to be taken to ensure that the accounting treatment reflects the operational realities and the nature of the funding agreements. Contrary to popular misconception there is opportunity for reflecting all or any of the options discussed above so long as the criteria in the SORP are met.

Preparers and auditors of accounts need to recognise the options that are available and discuss appropriate treatments at an early stage.

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*This guidance which is based on an article written for the Charity Finance Directors Group 2009 yearbook is written in general terms and is not intended to be comprehensive. No responsibility attaches to the author or the firm and before taking any decisions on the basis of the suggestions and indications given in this paper you should consult your professional advisers.*



## Start the conversation

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