

Feedback from Engagement Strand and Working Groups on Income Recognition

Engagement Strand: Trustees
A. Options Considered by the Engagement Strand
<p>The Trustees engagement strand considered the following options:</p> <ul style="list-style-type: none"> • Option 1: not to changes the SORP but to enhance its accessibility via: <ul style="list-style-type: none"> - the use of plain English language - using hyperlinks when appropriate - using an inclusive glossary with full indexation - applying equal importance to financial and non- financial information - clarifying in the SORP what provisions emanate from a legal requirement and what is recommended, citing relevant sources - reduced length and complexity of financial notes by better use of referencing, sign posting and cross referencing. • Option 2: to consider the introduction of different thresholds by which different sizes/complexity of charity arrangements would capture additional reporting requirements. • Option 3: to permit matching of income and expenditure to provide a more 'realistic' account of resources used and when. • Option 4: to introduce a deferred income concept for income recognition.
B. Advantages/Disadvantages of Options Considered
<p>The Trustees engagement strand provided the following:</p> <ul style="list-style-type: none"> • There is no clear steer as to the specific options the SORP committee would like the strands to discuss. • Thresholds could help smaller charities avoid much of the burden of reporting with the focus being placed on those larger/more complex charities with greater risk. • It is recognised that matching income and expenditure is no longer recognised within FRS102 but considered that there is merit in considering its reintroduction. If it is not possible to consider the reintroduction of matching, then the definition of the deferred income concept to demonstrate a more time-sensitive reporting to the expenditure of grants.
C. Conclusions
<p>The engagement strand expressed the following views:</p> <ul style="list-style-type: none"> • All of the options 1,2 and 4 are endorsed by the engagement strand for further thought. • Option 1: There is a specific need to review and revise the definitions used to cover unconditional grants, grants with conditions and contracts. These should be supported with

additional resources to provide a better overview of the legal implications of these on the role and responsibilities of trustees, especially in a situation where not all funds have been spent.

- It suggested that the next SORP adopt a similar approach to that which the engagement strand recommended for the recognition of legacies under the 'virtually certain' criteria rather than that of 'probable'. This would add some consistency to the treatment of different income within the SORP and hopefully reduce the potential for confusion or misunderstanding by preparers.
- There would be some benefit in clarifying the recording of income in relation to the provision of services, especially where the contract or agreement is a multi-year one. A deferred income approach would be better at providing a more accurate overview of the financial position of the charity where multi-year funding arrangements are in place.
- Finally, it noted the ongoing work of the IFR4NPO project and expressed the view that there may be some approaches promoted within that consultation that might be of benefit to the charity sector covered by the SORP, specifically the matching principle and the possibilities that this would present. [*Secretariat Note the IFR4NPO project does not promote the matching principle*]

D. Other comments

The engagement strand did not restrict itself to favouring one option. As many options are deemed appropriate and all are put forward to the SORP-making body for consideration.

• Engagement Strand: Larger charities

A. Options Considered by Strand

The engagement strand considered the following options:

- **Option 1:** Not to change the SORP
- **Option 2:** To consider the change from 'probable' to 'certain' within the recognition criteria.

B. Advantages/Disadvantages of Options Considered

The engagement strand provided the following comments:

- it reflected on the move from 'virtually certain' to 'probable' receipt in the FRS 102 and noted that in terms of pledged income, the recording of income when it is 'probable' can impact the position if pledges are subsequently withdrawn
- it was of the view that more examples/scenarios of 'probable' receipt would assist accounts preparers
- the most complexities for these recognition criteria were as they applied to the recognition of grant and legacy income and noted that these had been covered as separate topics.

C. Conclusions

The engagement strand concluded the following:

- generally, there are no issues with income recognition (save for other feedback as part of other topics of grant accounting and legacy income).
- more detail and examples would be helpful in relation to the interpretation of 'probable' as opposed to 'virtually certain' as, in the current climate of uncertainty, trustees are likely to understandably err on the side of certainty.

D. Other Comments

The engagement strand made the following comments:

- An engagement strand member noted the issue that they have in their charity in respect of the internal accounts being different to the financial accounts and that the unpicking is time consuming and that it is unhelpful i.e. the trustees have a different management/risk metric for what is safe to recognise as income, erring more on side of certainty than probability.
- An engagement strand member noted that the 'probable' treatment goes hand in hand with recognising provisions etc. on the expenditure side and asset valuation but accepted that it can be challenging for trustees to interpret.
- It was noted that in current climate with COVID-19 and economic impact leaning towards 'certainty' rather than 'probability' was more likely.

Engagement Strand: Smaller charities and Independent Examiners

A. Options Considered by Strand

The engagement strand considered the following:

- the key issue, regarding the timing of recognition, is the need for more detailed guidance, clarification and, worked examples within the SORP to minimise the ability for preparers to take varying opinions regarding the SORP's intentions
- whether there can be less complex reporting required from smaller charities.

B. Advantages/Disadvantages of Options Considered

The engagement strand was of the view that small charities still vary in complexity of funding, so an absolute threshold may not produce the relaxation of reporting requirements for smaller charities.

C. Conclusions

The engagement strand concluded the following:

- there are no problems with the SORPs provisions on income recognition as regards to contract income.
- guidance is required to identify performance related conditions and time related restrictions and how to recognise these. The engagement strand preferred that the entire grant is recognised, with restrictions on recognition limited to situations where control clearly does

not exist (such as securing match funding, or agreement of subsequent annual budgets in multi-year funding situations).

- more education is required, particularly for funders, on what entitlement to income means in charity accounts.
- the SORP needs to address this uncertainty, preferably with use of examples of common situations.

D. Other Comments

The engagement strand also provided the following comments:

- users of accounts still consider net income as one of the most important figures in a set of accounts. As such there is a tendency to consider the recognition of income ahead of expenditure as a distortion of the results.
- further examples would also be welcome for some specific common forms of income for many charities. While the general principles are already set out in the SORP, there is still inconsistency in terms of the timing of recognition of the following items and so clarity on timing for these specific items may still be needed:
 - Gift aid claims regarding eligible donations – some charities are reluctant to recognise the income until claims are paid over.
 - Annual memberships – ie clarity on whether income should be adjusted where this is received in advance.
 - The donating of profits from trading subsidiaries and in particular the fact that this may not necessarily correspond to the recognition of a liability within the subsidiary depending on how the subsidiary is constituted.
 - Other reliefs such as Theatre Tax Relief – this is claimed within an annual tax return; however, charities are often not required to file returns every year so situations can arise where preparers who are unaware of the mechanics of the process might fail to accrue the income or even submit a claim for the appropriate year. Equally, they may submit the return on time but be reluctant to recognise the income until the claim is paid over.

Engagement Strand: Academics, regulators and proxies for the public interest

A. Options Considered by Strand – Overall

- See below

B. Conclusions

The key points raised by the engagement strand were:

- Accountants have raised the potential to consider going back to 'certainty' rather than 'probable'. It is recognised however that this would require a change to FRS102 and SORP.
- The paper mentions reporting gross income, but should this term be defined within the SORP to differentiate it from income receivable?

- There was a consensus that members did not have strong views on income recognition and didn't feel an imperative for change.

Engagement Strand: Academics, regulators and proxies for the public interest

A. Options Considered by Strand – Regulator, A

This regulator suggested the following options:

- Option 1: Provided additional clarification of the existing provisions of the SORP
- Option 2: Review of the SORP to ensure consistency and clarity of recognition requirements for more complex income streams
- Option 3: The use of 'probable' as a basis for the recognition of income.

B. Advantages/Disadvantages of Options Considered

This regulator provided the following comments:

- Charities need clear rules they can follow and the guidance they need
- For a small number there is scope to manipulate the figures to avoid scrutiny.

C. Conclusions

- Additional clarification within the SORP through further examples such as flow charts or decision trees, when interpreting the accounting rules for legacies and multi-year grants to ensure clarity and consistency in interpretation.
- We recommend that SORP paragraphs 5.13 to 5.28 are reviewed to ensure that no loopholes are created by which a charity could artificially manipulate income recognition. Paragraphs 5.22 in particular ("time related conditions may be implied") may need clarification, or clearer cross-referencing to subsequent paragraphs.
- The regulator expressed the view that it considered that a definition of "gross income" is extremely important. Currently, charities are defined as 'larger' or 'smaller' within SORP by reference to a £500k gross income threshold without gross income being defined.
- Return to the use of 'certain' rather than 'probable' as a basis for the recognition of income, although we acknowledge this requires a change agreed to by the FRC.

D. Other Comments

- We also see inconsistency in practice with accounting for donated goods and services.

Engagement Strand: Professional and technical engagement strand A

A. Options Considered by the Engagement Strand

The following options were considered by the engagement strand

- Option 1: Changing the SORP to reduce distortion of surplus and deficit through recognition issues
- Option 2: Retain the current recognition requirements.

B. Advantages/Disadvantages of Options Considered

The following issues were considered by the engagement strand:

- The fund balances carried forward tell an important part of the charity's financial story.
- Many smaller charities operate almost completely from restricted grant funding. This particularly affects smaller, newer charities offering service delivery from council or other grant funding, without the ability to build up unrestricted resources.
- If multi-year funding, reported when received on an annual basis, is not explained in the text then it can look from the resulting SoFA presentation that the charity has limited resources. Some charities may present their accounts as if they are under-resourced without the ability to continue operations.
- The same principle applies to capital grants – if the charity has full use of the grant and the asset when it is completed (with no conditions for returning the asset) then the full amount should be shown on receipt to present the value of the resources provided to the charity. The fund balances carried forward will show the full net book value with no deferred income, as the charity would have purchased the asset outright with its own funds.
- The engagement strand noted that if recognition worked on the matching principle, these charities might show a zero surplus/deficit, with zero or almost zero fund balances carried forward.
- Very few smaller charities which report multi-year funding received on an annual basis – as income when received – will report a contingent asset recognising the remaining years of the grant.
- The 'true and fair' view of a charity's operations should reflect that availability of ongoing funding for the activity being funded and show the ability to continue operations.
- What charities do is very different from commercial operations. Charities may raise funds from donations in one year, and spend in another; they apply for multi-year grants: core-funding or project related funding and spend over the multi-year period; sell goods and services that are paid for in much the same way as any other business; provide services under contract to a local authority etc. There is a need to present those fund balances carried forward, to demonstrate that the charity has been operating good stewardship of resources and is planning for the continuing operations. If charities report on a simplified year-on-year matching principle, none of the nature of ongoing support for projects will be able to be shown clearly.
- Comment has been made of an impact on funding applications if the accounts show a 'better' financial position. As above, showing funds available for the following year(s) can make funding applications clearer, as it is easy to see which projects have ongoing funding and which do not. 'Matching' income and expenditure can lead to a position where some charities end up having projects double funded, because of the lack of clarity of ongoing funding.
- One viewpoint put forward is that the requirement to understand "probability" is too much for the non-finance stakeholder/reader and is causing real issues for funding of non-profits. However, another viewpoint was that using 'probable' as is current practice is reasonable and acceptable.
- Another consideration regarding to changing the income recognition criteria of 'probable' was that we would then need to look at the threshold for expenses which is also based on 'probable'.

C. Conclusions

The engagement strand concluded the following:

- There was no consensus for changing the SORP. It would be helpful if current income recognition criteria were better understood rather than changed. It was felt that examples would be useful. For example:
 - a clearer definition of the three recognition criteria
 - perhaps for each type of income the questions that need to be asked in relation to entitlement; probability of receipt and measurement need to be provided, or clearer guidance as to how to determine the criteria for each type of income.
 - illustrations should be provided of how to treat different types of income, with different conditions relating to the timing of recognition
 - clearer requirements to report receipt of multi-year funding, particularly when not reported as income,
 - more education for charities; their advisers; funders and wider public about fund balances carried forward showing good stewardship, forward planning and ability to continue operations.
- It could be argued that grants and contracts could contain clear conditions on this basis, it was thought that flexibility should be given to reflect the “substance” of these donations/funding and that the choice should be given to defer income to reflect this. A clear explanation could be provided by the organisation on the justification.
- Where the use of the performance model leads to ‘lumpy’ presentation of income, there could be a requirement in SORP to include an explanation in the trustees’ annual report.

D. Other Comments

- As above.

Engagement Strand: Professional and technical group B

A. Options Considered by Strand

The engagement strand considered the three recognition criteria of ‘entitlement’, ‘probable’ and ‘measurement’.

B. Advantages/Disadvantages of Options Considered

The engagement strand expressed the following view:

- The probability and measurement criteria pose the biggest challenges. The move to ‘probable’ from ‘sufficiently certain’ has in some instances led to the over recognition of income by charities in the view of engagement strand members.
- ‘Measurement’ can also cause difficulties in relation to establishing meaningful values for non-exchange transactions, particularly for donations in kind. In the view of engagement strand members, the measurement of items is sometimes required where the measurement base does not in fact deliver a reliable value.

C. Conclusions

- The engagement strand is of the view that it will not be possible for the recognition criterion on receipt of income when it is 'probable' to be amended and its recommendations are based on this premise.

D. Other Comments

The engagement strand made comments on the types of income recognition not covered in its other reports these included:

- pledged donations.
- income from contracts for the supply of goods and services (discounting).
- membership subscriptions.

Pledged donations

The engagement strand was of the view that some charities are not properly recognising pledged donations. It considered new material should be introduced to the Charities SORP which set out the circumstances under which pledged donations meet the income recognition criteria. The engagement strand was of the view that pledged donations should only be recognised, as a minimum, where there is a legally binding agreement in place.

Discounting of contract income

Paragraph 5.47 should be amended to reflect that income should only be discounted when the impact of the discounting itself is material.

Membership subscriptions

The treatment of membership subscriptions should be more clearly specified in paragraph 5.48 by recognising that income from a subscription is not necessarily uniform in nature with elements relating to both public and private benefit. Updated requirements should be mindful of the HMRC criteria on claiming Gift Aid on membership subscriptions and it set out three possible options in its report.

Charities SORP Working Group (A)

The working group concluded:

- There was no case for change. Rather, additional guidance would be useful.
- Multi-year funding and performance related conditions were seen as creating issues.
- Multi-year funding can cause distortions where charities are not able to defer income.
- This was perhaps best addressed through education and training aimed at improving written explanations in the trustees' annual report and to discourage users of the accounts from focussing on the bottom line.

- Guidance on entitlement would be beneficial (and may lead to charities finding they can recognise multi-year income over time rather than up-front). Guidance could cover
 - how a charity can decide whether it has entitlement
 - what to do if the charity's and the funder's year ends do not coincide.
 - clarification on the use of designated funds to provide clarity.
- Further clarification on performance related conditions (examples) would be helpful. Guidance could cover how performance related conditions are defined and applied.

Charities SORP Working Group (B)

The working group agreed the following:

- this section of the Code should be reviewed as a whole committee exercise, and consider how the wording of the section could be made clearer
- that it concurred with the underlying principles of income recognition and had no recommendations for change
- there needs to be further clarity of the criteria when there is entitlement to income and the circumstances where it should be deferred.