Briefing

Committee	Charities SORP Committee
Venue	CIPFA's Offices, Edinburgh
Date	12 March 2018
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Subject	IFRS 15 *Revenue from Contracts with Customers*

1 Introduction

1.1 This briefing provides an overview of IFRS 15 and issues around the adoption of the standard by charities.

1.2 The briefing first provides a background to the standard and sets out its main requirements in overview. It then discusses the potential adoption of IFRS 15 UK and Irish by charities and FRC's future plans for aligning UK GAAP with the standard. Given that the FRC's timetable and approach is currently not known, Section 6 of the briefing aims to alert the Committee of the impact of these potential developments. Therefore only a brief outline and analysis of the impact of the standard is given at this stage.

2 Background

2.1 The objective of IFRS 15 *Revenue from Contracts with Customers* is to establish the principles that an entity is required to apply to report useful information to the users of financial statements about the nature, amount, timing and uncertainty of revenues arising from contracts with customers.

2.2 The IASB issued IFRS 15 in May 2014. In September 2015 the IASB deferred the effective date of IFRS 15 by one year to 1 January 2018. The standard was endorsed by the European Union in October 2016.

2.3 The development of IFRS 15 took place over a long period. The project was added to the IASB agenda in 2002. The project was also a joint project between the IASB and the FASB to develop a common revenue recognition standard for IFRS and US GAAP.

2.4 IFRS 15 replaces:

- IAS 11 *Construction Contracts*
- IAS 18 *Revenue*
- IFRIC 13 *Customer Loyalty Programmes*
- IFRIC 15 *Agreements for the Construction of Real Estate*
- IFRIC 18 *Transfers of Assets from Customers*, and
- SIC 21 *Revenue – Barter Transactions Involving Advertising Services*.

2.5 IFRS 15 applies to all contracts with customers (except those within the scope of IAS 17 *Leases*, IFRS 9 *Financial Instruments*, the Group Accounts Standards and IFRS 4 *Insurance Contracts* and non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers).

2.6 The core principle in IFRS 15 is that entities should recognise revenue to depict the transfer of promised goods or services to the customer in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. To recognise revenue the standard sets out five steps (the 'five step approach'):

- Step 1 - identify the contract(s) with the customer
- Step 2 - identify the performance obligations in the contract
- Step 3 - determine the transaction price
- Step 4 - allocate the transaction price to performance obligations; and
- Step 5 - recognise revenue when a performance obligation is satisfied.

Implementation and interpretation of the standard

2.7 Given the standards effective date of 1 January 2018, views are still evolving regarding the implementation of IFRS 15.

Private Sector

2.8 For UK listed companies, IFRS 15 is mandatory for annual reporting period beginning on or after 1 January 2018. The standard is currently not reflected in UK and Irish GAAP, FRS 102 (see Section 4).

Public Sector

2.9 IPSASB develops international accounting standards on subjects specific to the public sector and also converges existing IFRS standards by adapting them to the public sector context. In 2017 IPSASB issued a consultation paper which discussed a number of proposals around accounting for revenue and non-exchange expenses. This included a proposal to replace existing standards which address revenue from exchange transactions and construction contracts (IPSAS 9 and IPSAS 11) with a new standard primarily drawn from IFRS 15.

2.10 The paper also explored options to make the distinction between exchange and non-exchange transactions easier. It also proposed approaches for dealing with revenue transactions with performance obligations that do not the requirements of IFRS 15. The following two approaches were outlined and evaluated in the paper:

- Update the standard which covers non-exchange revenue (IPSAS 23)
- Develop a new approach for revenue recognition based on IFRS 15 'five step approach' adapted for the public sector environment

2.11 In the UK, the Financial Reporting Advisory Board (FRAB) has approved the implementation of IFRS 15 for public sector reporting entities, having regard to those transactions to which it should apply. The standard is applied by HM Treasury in the Government Financial Reporting Manual (FreM) from 2018/19, and application guidance has been issued which sets out the basis of public sector interpretation. IFRS 15 has been implemented in the *Code of Practice on Local Authority Accounting in the United Kingdom* for 2018/19, which is developed by the CIPFA/LASAAC Local Authority Accounting Code Board under the oversight of FRAB.

3 What are the main accounting requirements of IFRS 15?

Five Steps to Applying the Principles in the Standard

Step 1 - Identify the Contract with the Customer

3.1 A contract is an agreement between two or more parties that creates enforceable rights and obligations.

3.2 IFRS 15 applies to all contracts with customers except for those that are within the scope of other IFRS except those listed in paragraph 2.5 above.

3.3 An entity would apply IFRS 15 to each contract with a customer that has commercial substance and meets other specified criteria. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

3.4 In order for a contract to be within the scope of IFRS 15, all of the following criteria must be met:

- the parties to the contract have approved the contract (in writing, orally or in accordance with other customary business practices) and are committed to perform their respective obligations;
- the entity can identify each party's rights regarding the goods or services to be transferred;
- the entity can identify the payment terms for the goods or services to be transferred;
- the contract has commercial substance (i.e. the risk, timing or amount of the entity's future cash flows is expected to change as a result of the contract); and
- it is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession.

3.5 In certain circumstances, IFRS 15 requires an entity to combine contracts and account for them as one contract. IFRS 15 also specifies how an entity would account for contract modifications.

3.6 IFRS 15 also provides criteria to recognise revenue where there are no contracts with customers but consideration is received. IFRS 15 requires:

a) there to be no further performance obligations to transfer goods or services, or
b) the contract is terminated.

Under both (a) and (b) above the consideration must be non-refundable.

Step 2 - Identify the Performance Obligations in the Contract

3.7 Performance obligations are promises in a contract to transfer to a customer goods or services that are distinct. In determining whether a good or service is distinct, an entity needs to consider if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer.

An entity needs to consider whether the entity’s promise to transfer the good or service is separately identifiable from other promises in the contract.

3.8 If a promised good or service is not distinct IFRS 15 requires an entity to combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. Revenue is recognised by the entity based on the satisfaction of these individual performance obligations.

Step 3 - Determine the Transaction Price

3.9 The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both. The consideration may be in a form other than cash.

3.10 The transaction price is meant to reflect the amount to which the entity has rights under the present contract. Therefore the transaction price does not include estimates of consideration resulting from future changed orders for additional goods and services.

3.11 Some or all of the estimated amount of variable consideration is included in the transaction price only to the extent that it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

3.12 Adjustments to the transaction price are also made for the effects of financing (if significant to the contract) and for any consideration payable to the customer. For contracts with a significant financing component an entity is required to adjust the promised amount of the consideration for the time value of money.

3.13 IFRS 15 includes a practical expedient that the financing component can be ignored for arrangements where the time difference between when the goods or services are provided and when payment is made is one year or less (IFRS 15, paragraph 63).

Step 4 - Allocate the Transaction Price to Performance Obligations

3.14 Once the distinct (or separate) performance obligations are identified and the transaction price has been determined, the standard requires an entity to allocate the transaction price (a stand-alone selling price) to the performance obligations.

3.15 IFRS 15 indicates that the best evidence of a stand-alone selling price is an observable price from stand-alone sales of that good or service separately in similar circumstances and to similar customers. If a stand-alone selling price is not observable, the entity is required to estimate it. IFRS 15 provides examples of suitable methods for estimating the stand-alone selling price of a good or service (IFRS 15, paragraph 79).

3.16 The transaction price in a contract may include a discount or a variable amount of consideration that relates entirely to a specific part of the contract. The requirements of IFRS 15 specify when an entity should allocate the discount or variable consideration to a specific part of the contract rather than to all of the performance obligations in the contract.

Step 5 - Recognise Revenue when a Performance Obligation is Satisfied

3.17 An entity is required to recognise revenue when (or as) it satisfies a performance obligation by transferring a promised good or service (an asset) to a customer. A good or service is generally considered to be transferred when the customer obtains control (IFRS 15, paragraph 31).

3.18 Recognition of revenue on transfer of control is a different approach from that currently in IAS 18 (and current UK GAAP) which focuses on a transfer of risk and rewards. IFRS 15 states that 'control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset'.

3.19 At contract inception an entity is required to determine whether a performance obligation is satisfied at a point in time or over time.

3.20 Paragraph 35 of IFRS 15 specifies that an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

- the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (this would be a recurring service, for example a cleaning service)
- the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced, or
- the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date, for example building an asset that only the customer can use.

3.21 When an entity determines that one of the criteria above is met and therefore that a performance obligation is satisfied over time, IFRS 15 requires the entity to select a single revenue recognition method for the relevant performance obligation that best depicts the entity's performance in transferring the goods or services.

3.22 When none of the above criteria are met, the entity satisfies the performance obligation at a point in time (being when the customer obtains control of the goods and services being transferred).

Contract Costs

Costs to Obtain a Contract

3.23 IFRS 15 includes requirements for accounting for costs to obtain a contract. The incremental costs of a contract must be recognised as an asset if an entity expects to recover those costs. However, those incremental costs are limited to the costs an entity would not have incurred if the contract had not been successfully obtained.

Costs to Fulfil a Contract

3.24 For costs to fulfil a contract that are not within the scope of other Standards (for example, IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*), an entity recognises an asset for those costs only if the fulfilment costs meet the following criteria:

- they relate directly to a contract (or a specific anticipated contract)
- they generate or enhance resources of the entity that will be used in satisfying performance obligations in the future, and
- they are expected to be recovered.

Disclosures

3.25 One of the IASB's main objectives during the Revenue project was to improve disclosure requirements to provide more useful information to investors. The disclosures under the new standard are more detailed than under IAS 18. As with many recent new and amended standards, disclosure objectives have been introduced. IFRS 15 requires disclosures to help users understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

3.26 IFRS 15 requires an entity to disclose quantitative and/or qualitative information about:

- revenue recognised from contracts with customers, including the disaggregation of revenue into appropriate categories
- contract balances, including the opening and closing balances of receivables, contract assets and contract liabilities
- performance obligations, including when the entity typically satisfies its performance obligations and the amount of the transaction price that is allocated to the remaining performance obligations in a contract
- significant judgements, and changes in judgements, made in applying the requirements, and
- assets recognised from the costs to obtain or fulfil a contract with a customer.

4 When and if will the standard impact charities?

4.1 The impact of IFRS 15 for charities is dependent on the standard being reflected in UK and Irish GAAP, FRS 102.

Timing and approach of updating FRS 102

4.2 In 2016 the FRC consulted on the extent to which FRS 102 should be kept up to date with IFRS as IFRS changes, particularly in relation to major new changes that have been issued. The consultation document proposed that the revenue requirements of FRS 102 should be aligned with IFRS 15 as part of the second triennial review of IFRS. Any amendments from this review were expected to be effective from 1 January 2022 or a later date.

4.3 In June 2017 the FRC deferred any decision on updating FRS 102 for changes in IFRS. In a feedback statement summarising respondents' comments to the consultation, it set out plans to undertake further evidence-gathering and analysis before considering whether, and if so how, to incorporate the principles of IFRS 15 in FRS 102. This will be done as a separate phase of the triennial review. The timing of this review is not known, however, any amendments arising from it will not be effective before 1 January 2022.

4.4 Therefore, this briefing provides a context to a potential future change in UK and Irish GAAP. Whilst the FRC's timetable and approach for reflecting the principles of IFRS 15 is not currently known, it would appear likely that it will be reflected in FRS 102. This is based on the importance of revenue as a headline figures in financial statements, and the need for consistent approaches to revenue recognition and measurement.

Subsequent changes to the SORP

4.5 The FRC requires that SORPs should be developed in line with current FRC standards.

4.6 The current Charities SORP is based FRS 102 and covers accounting for revenue from contracts within Module 5 *Recognition of income, including legacies, grants and contract income*. This is based on the requirements of FRS 102 contained in Section 23 *Revenue*. Therefore, the SORP would have to be updated for any amendments made to FRS 102 in order to reflect the principles of IFRS 15 to ensure it continues to comply with changes in accounting standards.

4.7 Module 5 of the SORP also contains guidance based on the requirements of FRS 102 which are specific to Public Benefit Entities (PBE). This includes guidance on accounting for performance related grants and non-exchange income. The FRC have not indicated that any changes will be made to these requirements as part of the triennial review process.

5 What is currently required of charities in this area of accounting?

5.1 Appendix A provides a brief summary of the requirements for charities preparing accrual accounts, as contained in FRS 102 and Module 5 of the Charities SORP (FRS 102).

6 What will be the impact of IFRS 15?

6.1 This section examines the application of the principles of IFRS 15 by entities and identifies those aspects that may require specific consideration by charities. Given the timing of this briefing, only initial observations are given at this stage.

Affected charities

6.2 Charities which prepare accrual accounts and hold contracts and agreements to supply goods and services will be affected.

6.3 Entities will be need to evaluate all existing contracts and agreements against the five step approach set out in the standard.

Type of contracts

6.4 Contracts entered into by charities to raise funds (e.g. through non-primary purpose trading) are typically short-term and involve the supply of goods through the application of a simple business model. However, it is increasingly common for larger charities to enter into longer-term and more complex contracts for the supply of services as part of their charitable purposes (e.g. statutory contracts awarded by public bodies). It is also observed that principles of IFRS 15 apply for the recognition and measurement of gains and losses arising from the sale of non-financial assets that are not an output of an entity's ordinary activities (e.g. the sale of a property, plant and equipment).

6.5 For basic contracts it is likely that charities would reach similar conclusion under IFRS 15 as they do under FRS 102 and the revenue recognition will not change. However, for other longer-term and more complex contracts, there may be changes to the timing and amount of revenue recognised. However, this will be dependent on:

- the specific terms of the contract;
- how the charity previously accounted for the contract; and
- if the contract contains any features which were not covered in the existing guidance.

6.6 Depending on these factors, the standard may result in significant changes to these charity’s revenue profile.

Observations of the application of the five step approach

Step 1 - Identify the Contract with the Customer

Classification of grant funding agreements with performance related conditions

6.7 IFRS 15 provides a list of attributes which must be present in a contract between an entity and their customer (see paragraph 3.4). Those arrangements which do not meet this criteria are not included in the scope of the standard and are not required to apply the five step approach.

6.8 Existing guidance for charities distinguishes between performance-related grants and contracts for the supply of goods and services for financial reporting purposes. This is largely based on whether the income is received under the terms of a legal contract.

6.9 Whether performance-related grants are considered to have all the characteristics required by IFRS 15 to meet the criteria for a contract is likely to differ depending on how the characteristics of the transaction are interpreted. However, based on the traditional categorisation of these transactions as being ‘non-exchange’ in nature, it is likely grants which contain performance obligations will be considered out with the scope of IFRS 15. Therefore, grants which have very similar characteristics to contracts will be accounted for differently.

6.10 This difference is similar to the existing reporting practices of charities, as outlined in Appendix A.

Contracts with commercial substance

6.11 Only contracts which have commercial substance are included in the scope of IFRS 15. For charities, this concept can be difficult to apply to a contract where the goods and services being supplied are considered to be wholly charitable and it is unlikely that any financial surplus will be realised. However, the provision of goods or services at less than market rates does not necessarily mean that a contract will not have commercial substance.

Identification of the customer

6.12 IFRS 15 defines a customer in the context of a contract. However, the characteristics inherent in many contracts held by charities can make the identification of a customer difficult.

6.13 Often the party who are in receipt of the goods and service being supplied as part of the contract (the beneficiary) will be different to the party making payment (the resource provider). This can make identifying the customer in the contract difficult to determine, and in some cases the party considered to be the customer may differ. The identification of the customers can be further complicated in contracts which involve multiple parties and collaborative arrangements, both features which are common in the charity sector.

Step 2 - Identify the Performance Obligations in the Contract

Nature of contract

6.14 The identification of the performance obligations will be dependent on the nature of the contract between the entity and its customer. This process is likely to be relatively simple where a formal and detailed agreement exists where the contracts performance obligations are clearly identified. However, where the contract is oral or implied by the entities customary business practices, this process may be potentially more difficult.

6.15 Given the variety of the sector, the formality of the funding agreements and contracts held by charities would be expected to differ. Large charities where a significant proportion of their income comes from contract provision or paid-for services are likely to have established systems and dedicated staff involved in the contracting process. However, where a charity is less familiar with the contracting process, funding relationships may evolve overtime without the performance obligations associated with the contract being formally documented and regularly updated. The detail and level of specification included in a contract will also be dependent on the type of goods or services being supplied and the funders or customers own processes.

Determining whether goods or services are distinct

6.16 The identification of performance obligations requires entities to consider whether a good or service is distinct (see paragraph 3.7). Where an entity is providing a variety of goods and services as part of a single contract, the extent to which each will require to be identified as separate performance obligation will depend on a range of factors. However, the standard does permit these to be combined into 'bundles' of good and services which are themselves distinct. This can result in an entity accounting for all the goods or services promised in a contract as a single performance obligation. This may apply where a customer requires an integrated service to be performed, and its delivery involves a range of products and services being combined. This is likely to be relevant for charities which align a variety of projects/services or taking a holistic approach in contract delivery.

Step 3 - Determine the Transaction Price

Payment in advance and arrears

6.17 Entities may enter into long-term contracts where income is paid in advance of the services being supplied. Under IFRS 15 entities have to consider existence of significant financing components in contracts, and make adjustments to the transaction provide for the effects of financing (see paragraph 3.12). Where the time between the goods or services being provided and the payment is made is more than 12 months, the entity is required to account for the financing component based on the time value of money.

6.18 Under existing guidance, charities have not been explicitly required to consider whether the payment in advance from a customer gives rise to a financing arrangement. Therefore, charities that enter into contracts with advance payment terms will need to consider whether the contract has been structures in such a way to provide finance for the charity.

6.19 Similarly, charities will have to consider financing costs in those situations where customers pay in arrears. This is not considered to be such a significant change as existing guidance requires charities to consider whether payment after the supply of goods or services represents a financing transaction.

Step 4 - Allocate the Transaction Price to Performance Obligations

Determining a 'stand-alone selling price'

6.20 The allocating the transaction price to performance obligations is dependent on there being observable evidence of the stand-alone selling price of each of distinct goods and services.

6.21 This process is likely to be straightforward where a contract clearly identify separate performance obligations and the corresponding prices, or the contract's payment schedule clearly relates to the contracts performance. Similarly, the process will also be straightforward where a contract contains a single performance obligation.

6.22 However, obtaining an observable price based on a stand-alone sale to a similar customer and in similar circumstances may be difficult where a charity is supplying services which are particular to each customer's needs or tailored to their individual circumstances. In such instances, it is unlikely that a price list would exist. Where a charity is supplying a good or service of this nature, it would be required to estimate the stand-alone selling price.

Step 5 - Recognise Revenue when a Performance Obligation is Satisfied

6.23 As noted in paragraph 6.13, the nature of charitable activities can make the identification of the customer difficult. This can also result in difficulties in determining the point in time when the customer 'obtains control' of the good or service is transferred.

Performance obligations satisfied over time or at a point in time

6.24 Entities may encounter situations where there is uncertainty about whether revenue should be recognised at a point in time or over time based on the criteria included in the standard. Where revenue is considered to be recognised over time, entities are required to measure their progress towards satisfying that performance obligation. The standard specifies the following two methods for measuring progress towards complete satisfaction of a performance obligation:

- Output Method: *revenue recognised based on direct measurement of the value of goods or services transferred to date in comparison with the remaining goods or services to be provided under the contract (i.e. appraisals of results, milestones reached, units produced and units delivered)*
- Input Method: *revenue recognised based on the entities efforts or inputs towards the satisfaction of a performance obligation (e.g. resources consumed, labour hours expended, costs incurred, time lapsed)*

6.25 These methods give entities a considerable amount of choice regarding how to measure progress, however, the standard requires the method selected to be applied consistently. Depending on the contract, it may be the case that a method can be used which is similar to the existing method being used to measure the contract's 'stage of completion', as required under current guidance. In such instances, the charity will be required to make limited changes to their internal reporting systems.

6.26 The standard notes where the Output Method would faithfully depict the entities progress towards the satisfaction of a performance obligation, but the information required to apply it would not be available without undue cost, then the Input Method may be necessary. Therefore, charities may elect to use the 'simpler' Input Method where the value of the goods and services transferred are not directly observable and the costs to obtain this information is considered to be impracticable.

7 Analysis of impact

Preparatory work required

7.1 The impact of IFRS 15 on charities individual financial statements will depend on the type and nature of contracts held. However, the standard will require all charities to consider their existing contracts against the five-step approach.

7.2 Charities which hold a large number of service contracts and funding agreements with a variety of bodies will be required to invest a substantial amount of time and resource in this exercise, given the volume and complexity of these documents.

7.3 This undertaking is comparable to the assessment required as a result of the change to the income recognition criteria introduced by FRS 102. The assessment will still require charities to first determine if the transaction represents a grant or a contract, and whether the income can be recognised at a point in time or overtime – however, different criteria will be used to do so.

Changes to contract negotiations

7.4 Under IFRS 15, the pattern of income recognition can vary dependent on the features and terms of the contract. Therefore on an ongoing basis, the standard may change charities approach when entering into new contracts, and renegotiating current contract agreements.

Grant vs Contract

7.5 IFRS 15 is an extensive standard, which includes a large amount of detailed criteria and application guidance. However, it is written for private sector for-profit entities. As a result the standards does not address the differences between the accounting treatment of grants and contracts as described in 6.9. The standard does however provide a criteria for entities to determine whether a contract is in the scope of IFRS 15. This is likely prove useful to entities as they examine their existing contracts and funding agreements. As noted in 6.10, this situation is not new. Different approach are taken to this area of accounting based on preparer's interpretation of the SORP and individual funding agreements themselves.

Current action required

7.6 The action required by charities will be determined by the FRC's decision on whether to update FRS 102 to reflect the principles of the IFRS 15. Until this time, it is recommended that the joint SORP-making body monitor the implementation and interpretation of the standards by the various standard setting bodies noted in Section 2.

7.7 The adaptation of the standard for public benefit entities will be especially relevant as part of this exercise. It is noted that ongoing development around the distinction between exchange and non-exchange transactions would be expected to influence this process.

Appendix A: Summary of current revenue recognition guidance for charities

Income recognition criteria for contracts

Revenue from the sale of goods is recognised when the charity is entitled to the income; receipt is probable; and the income and costs of the goods sold can both be measured reliably.

The key income recognition criteria is when the charity is entitled to the income which arises where the 'significant risks and rewards' of ownership are transferred to the buyer. This usually occurs on the supply of the goods to the buyer and is determined in the terms of the contract.

Revenue from the supply of services is recognised when these contracted services are delivered (i.e. the income is earned), provided that the following can be measured reliably:

- Stage of completion;
- Costs incurred in delivering the service; and
- Costs to complete the requirements of the contract.

The key income recognition criteria is the stage of completion, which generally results in income being recognised using the 'percentage of completion' method. The stage of completion is based on an estimate or proxy measure, which charities are required to select. The method selected must provide the most reliable estimate of the charity's right to receive payment for the work performed.

Accounts disclosures

Category line

The category line which the SORP requires charities to use for contract income depends on the nature of goods and service being supplied. Income will typically fall into one of the following line headings used in the SoFA:

- *Income from charitable activities* – Contracts which involve the supply or products or services undertaken for the charitable purposes of the charity.
- *Income from other trading activities* – Contracts entered into to raise funds for the charity.

Notes to the accounts

Where a charity defers income, the following information is required in the notes to the accounts:

- an explanation of the reasons why the income is deferred;
- an analysis of the movement on the deferred income account which identifies income deferred in the current year and the amounts released from previous reporting periods.

Therefore the above information would be required where a charity defers contract income received as an 'advance payment', where the income does not meet the income recognition criteria.

Fund accounting

The recognition of income from contracts typically creates unrestricted funds. However, where there are restrictions in place which specifically requires all income to be spent on a particular purpose of the charity and any unspent income requires to be returned to the funder or only applied for that particular purpose, it may be appropriate to treat a contact as restricted income.

Grant funding with performance related conditions

The above requirements are based on Section 23 of FRS 102, and relate to income from contracts for the supply or goods or services (exchange income). However, the SORP separately distinguishes between the income recognition criteria for grants with performance-related conditions.

The term 'performance-related grant' is defined as follows:

> *… a grant that has the 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 grant maker; and*
> - *entitlement to the grant receivable is conditional on a specified output being provided by the grant recipient.*

Whilst the nature of the income from performance-related grants is similar to contract income, the financial reporting considerations differ. This is based on whether the income is received under the terms of a legal contract.

The following provides a brief summary of these considerations. It is noted that whilst this area is covered in sections 24 and 34 of FRS 102 and Module 5 of SORP (FRS 102). This summary is limited to the guidance contained within these sources, given that the interpretation and application appears to differ in practice.

Income recognition criteria for grants with performance related conditions

Income from grants is recognised when the charity is entitled to the income; receipt is probable; and the income and costs of fulfilling the grant's performance related conditions can both be measured reliably.

For performance-related grants, the key income recognition criteria is entitlement. Typically the charity will only meet this criteria when it has provided the specified services and any performance-related conditions are met. The charity must use the conditions contained within the formal funding agreement to determine which performance measures should be used to recognise the grant income.

Income received in advance of delivering the specified goods or services required by the performance-related conditions contained in the funding agreement should be recognised as a liability on the entity's balance sheet as deferred income. The deferred income is then released to income in the reporting period in which the performance-related conditions are met.

Accounts disclosures

Category line

Income from grants with performance related conditions will typically be included in the *'Income from charitable activities'* line heading used in the SoFA.

Notes to the accounts

The disclosures required where a charity has deferred income are the same, regardless if the income has arisen from a contract or grant.

SORP paragraph 5.58 specifies additional disclosures which are required of charities in receipt of government grants.

Fund accounting

The grant will contain a restriction and will represent restricted income where the funding agreement directs the purpose for which the funding can be used. A condition which specifies a specific level of performance or output from the recipient charity does not represent a restriction.

How do charities distinguish between grants and contracts?

The SORP definition of contract income focuses on the existence of a legally binding contract. Where there is no contract, the rights and obligations of the parties will depend primarily on the law of trusts and conditional gifts, rather than the law of contract. The SORP terms these arrangements as performance-related grants.

In distinguishing between grants and contracts, the SORP also encourages charities to consider the substance of funding agreements with funders/customers, and not just the legal form.