

## made simple guides

**Made Simple guides are aimed at finance professionals working in charities. They cover technical areas such as risk assessment, accounting, tax and VAT treatments and aim to provide practical guidance to busy accountants in charities.**

The content of guides is correct at the time of going to print, but inevitably legal changes, case law and new financial reporting standards will change. You are therefore advised to check any particular actions you plan to take with the appropriate authority before committing yourself. No responsibility is accepted by the authors for reliance placed on the content of this guide.

Where the text refers to a book or other reference material, the name of the publication is highlighted ***like this*** and listed at the end in Reference and Further Information. The names and contact details of organisations from whom the publications and further information can be obtained are also listed.

### Other guides in the series

*Risk assessment made simple*

*Reserves policies made simple*

*Trading issues made simple*

*Subsidiaries made simple*

*VAT made simple*



# Grants & contracts made simple

Introduction 3

Can charities trade through contracts? 4

Restricted or unrestricted funds 5

Accounting issues 7

VAT issues 9

Conclusion 14

References and further information 15



**sayer vincent**

consultants and auditors

## Acknowledgements



This guide was produced with help from the partners and staff at Sayer Vincent, as well as support from staff and trustees of CFDG.

**CFDG** (Charity Finance Directors' Group) is the professional body for finance directors within the sector, and has over 1,400 members. CFDG provides assistance to charities on a range of issues, such as accounting, taxation, audit and other finance-related functions. CFDG's mission is to deliver services that are valued by members and enable those with financial responsibility in the charity sector to develop and adopt best practice.

For more information go to [www.cfdg.org.uk](http://www.cfdg.org.uk)



**Sayer Vincent** only works with charities and not-for-profit organisations. We have built up a wealth of sector experience as business consultants in the voluntary sector over the last 20 years. Working with a diverse portfolio of charities, we deliver rapid insights into your issues and problems and help you to find effective solutions to them.

We are keen to help charities find more effective ways of working; collaborating with other charities, sharing back-office functions and outsourcing are some of the options. We can help with each stage of the process, from feasibility through implementation to evaluation of performance.

For more information, go to [www.sayervincent.co.uk](http://www.sayervincent.co.uk)

Published by CFDG  
First published 2008  
Copyright © CFDG and Sayer Vincent  
All rights reserved

No part of this book may be reproduced by any means, or transmitted, or translated into a machine language without prior permission in writing from the publisher. Full acknowledgement of the author and source must be given.

CFDG and Sayer Vincent shall not be liable for loss or damage arising out of or in connection with the use of this publication. This is a comprehensive limitation of liability that applies to all damages of any kind, including, (without limitation), compensatory, direct, indirect or consequential damages, loss of data, income or profit, loss of or damage to property and claims of third parties.

## Introduction

Historically, charities have been set up by volunteers to promote a particular cause and as the charity has developed services to meet the needs of its beneficiaries, funding has been obtained. Frequently, this would have been grants. In recent years, the nature of the funding has been changing to more formal agreements, frequently called service level agreements. In addition, charities are more likely to bid for contracts to deliver services.

### What is a contract?

A contract is an agreement between two parties. For a contract to exist there has to be an offer and acceptance, but it does not have to be in writing. There has to be consideration, which is payment although that does not have to be in the form of money. A contract is legally binding and if either side fails to deliver they can be sued in a court of law.

### What is a grant?

A grant is a gift and as such it is freely given by the donor, with the timing, amount and frequency at the donor's discretion. There is no legal difference between a grant and a donation, it is simply that grants are often awarded by institutions and are more likely to be for specific purposes. Grants and donations are subject to trust law rather than contract law.

### What is a service level agreement?

A service level agreement ('SLA') is a document which sets out the services to be provided and it may describe the performance standards expected. An SLA may be used in the context of grant funding or a contract. It is not a legally recognised form in itself.

# 1 Can charities trade through contracts?

Charities are permitted to trade in a number of different ways. A charity trading in the course of carrying out the main objectives of the charity is known as primary purpose trading. Primary purpose or charitable trading will include the activities of charities which charge a fee for a service, such as nursing homes and schools, as well as the sale of goods produced by the beneficiaries of a charity. In undertaking these activities, the charity is furthering the objects of the charity and so the activity may take place within the charity.

It is widely thought that charities are not allowed to make a profit – this is actually untrue. Charities are allowed to make profits, but may not distribute them. In contrast to commercial entities where the profits are distributed to the owners or shareholders, charities have to apply all the profits they make to the charitable purposes. A charity delivering services for a fee or selling goods may make a profit. It may then add the profit to its reserves and spend these to further its charitable purposes.

Consequently, charities may offer services under a contract providing the activity and the beneficiaries are within their charitable objects. They can undertake these activities in a business-like manner and apply any profits to the charity's objectives.

Some charities may choose to channel certain contracts through a subsidiary company, as they may wish to keep all commercial activity out of the charity or because it suits their VAT planning. Similarly, a charity wishing to undertake a trading activity to generate funds may use a subsidiary. Any profits can be transferred to the charity by donation under gift aid.

# 2 Restricted or unrestricted funds

Under charity accounting rules set out in the Statement of Recommended Practice (known as the 'SORP') charities have to account for their incoming and outgoing resources as two different types of funds. These are restricted funds and unrestricted funds.

Unrestricted funds are funds the charity receives to further its objects. These can be donations, grants or fees earned. If a charity has narrowly defined objects, then a grant it receives may be a perfect fit for its objects and so be unrestricted. The recipient charity has to judge whether new incoming funds are restricted or not.

Restricted funds have to be used for the purpose for which they were given. This purpose will be narrower than the charity's objects. A donor can require the charity to spend their donation in accordance with their wishes. This creates the restriction, which is an obligation under trust law. If the charity does not use the funds in accordance with the terms of the restriction, then this is a breach of trust, for which the trustees may be personally liable. In practice, this might mean that the trustees would have to replace the funds that had been used inappropriately. Note that this applies to all charitable entities including incorporated bodies such as charitable companies. Limited liability does not remove trustees' fiduciary duty in respect of donated funds.

Grants are a form of donation and can be subject to the type of legal obligations that apply to restricted funds. So a funder can specify that they wish their grant to be used to help a specific group of beneficiaries, or support a particular project. In these situations, the grant would be treated as restricted income. The

recipient charity is obliged to use the grant for the purposes for which it was given. If some of the grant is not used, then it has to be offered back to the donor.

On the other hand, contracts are by their nature not donations and therefore cannot be treated as restricted funds. Contract income should be treated as unrestricted income. The recipient charity is obliged to meet the terms of the contract, but is not required to spend all of the contract fees on the specified activity. Thus, a charity can make a surplus on a contract, which it may keep and add to its reserves. If either the funder or the charity does not comply with the terms of the contract, then this would be a matter for the courts and it would be covered by contract law.

### Key points

- Grants may be restricted funds.
- Contracts will always be unrestricted funds.
- The unspent balance on a grant can be carried forward as a restricted fund balance.
- If unused, the unspent balance on a grant should be offered back to the funder.
- If a restricted grant is used for a different purpose, then this is breach of trust and the trustees may have to replace the funds.
- Charities are obliged by contract law to deliver the service or goods specified.
- Contracts are governed by contract law and disputes would have to be resolved as set out in the contract or in the courts.
- Unspent funds on contracts are a surplus the charity may retain as reserves.

## 3 Accounting issues

The accounting treatment for grants is different to the treatment for contracts. This is because grants are charitable income, whereas as contracts are fees received in the context of a business arrangement. The main areas of difference relate to the recognition of income – in other words, the matching of income to expenditure.

There are three tests for recognising income:

- entitlement
- certainty
- measurement

A charity will become entitled to a grant once all three conditions have been met. However, income from a contract should be recognised in the accounts to the extent that the contractual obligations have been fulfilled. This will not necessarily correspond to the timing of any stage payments under the contract. Where a contract is partially completed, income should be recognised to the extent that the right to consideration has been earned through performance. The tests of certainty and measurement are usually easier to establish. This means, for example, that a grant should not be included in income until you receive written confirmation from the funder. Similarly, a contract would have to be signed by both parties.

For both grants and contracts, the timing of expenditure may not coincide with the timing of income. If any part of a grant for a restricted purpose is unspent at the financial year end, it should be carried forward as a restricted fund balance, which should be explained further in the notes to the accounts. If the grant is unrestricted, then this will increase reserves, although it may be

appropriate to then designate the amount of funds needed for future expenditure.

Usually, contract fees are only due when the charity has delivered the service in line with the contract terms, so the charity is only entitled to the income when it has earned it. If the charity has received funding in advance, then this will be deferred and shown as a current liability on the balance sheet. The same treatment will be appropriate for performance-related grants, where the funding is tied to the delivery of certain outputs. If funding is received in arrears, then you would estimate a debtor for the value of the work done.

The income categories in the statement of financial activities that are relevant here are:

- voluntary income
- incoming resources from charitable activities

Grants may be in either category, whereas contracts for the charity's services will be included under incoming resources from charitable activities. Grants should be included in voluntary income when they have not been obtained for a specific purpose, for example to fund core costs.

### Key points

- Treat contract income as you would sales for a business.
- Bring all grant income in to accounts once conditions have been met.
- Contract income and performance-related grants should be recognised as income when entitlement has been earned.
- Contracts are more likely to give rise to deferred income.
- Restricted grants are likely to have fund balances carried forward.
- Grants may be voluntary income.
- Contracts will be incoming resources from charitable activities and grants may be.

## 4 VAT issues

VAT is a significant issue because the treatment for contracts is usually different to the treatment for grants. A contract is usually a business activity and therefore within the scope of VAT. By contrast, grants are usually outside the scope of VAT.

A grant is funding which is freely given with the timing, amount and frequency at the discretion of the grantor. It should not be a purchase of goods or services, although the grantor may attach conditions or specify the purpose for which the grant should be used. This means that no VAT has to be charged on the grant sum, but it also usually means that no VAT on related purchases may be recovered. So in practice, a charity costing a grant-funded service needs to ensure that it includes VAT on relevant expenditure.

There have been particular difficulties with establishing the VAT category applicable to a range of funding agreements which have grown up between government bodies and voluntary organisations. Each case will be looked at on its merits, but it is also possible that different interpretations will be encountered for very similar funding agreements.

A charity may wish funding to be subject to VAT in order to recover VAT on costs. For a funding agreement to be within the scope of VAT:

- There should be a direct link between a particular payment and a particular service
- There must be a legal relationship between the parties involved
- There should be consideration (payment) in return for the service

It does not matter what the funding agreement is called – what is important is the underlying nature of the transaction and that will determine how it should be treated for VAT.

There have been a number of important VAT cases in recent years that may help us with the underlying principles in operation in this area.

### Case law

There have been two cases where the voluntary organisation wished the funding to be treated as taxable so that it could recover VAT paid on purchases, but this was challenged by the VAT Office and the voluntary organisations lost.

- In Bowthorpe Community Trust, the local authority provided funding for the training of disabled people and also referred disabled people to the Centre. However, it was held that the training service was being provided to the trainees not to the local authority. The only service provided to the local authority was the annual report and this not held to be sufficient.
- In Wolverhampton Citizens Advice Bureau there was a service level agreement with the local authority, so the intention to create a legal binding agreement and a taxable supply for VAT purposes was in evidence in the agreement. Nonetheless, it was held that the CAB was providing a free service to the public and was not providing a service to the local authority. As a consequence, Wolverhampton CAB was not able to recover all the VAT on costs incurred in refurbishing their premises.

Another argument put forward against contracts being a business activity is based on an old case, Apple and Pear Development Council. Here the argument was put that the Council was under a statutory duty to provide the service anyway, so the fees it charged to growers for the services supplied were not consideration for the service. This is similar to the argument used for the Citizens Advice Bureau case – they were providing the service anyway and so the grant funding was a subsidy for an existing non-business activity.

On the other side, there has been a ruling that Legal Services Commission funding is standard-rated where this is part of the legal franchise arrangements, which have been extended to some

voluntary organisations providing advice. Although these are similar to grants in the hands of the receiving voluntary organisation, the payments are part of a scheme which sets out to purchase advice services for the public.

This area is still very uncertain, but we have to learn from the cases and rulings we have:

- There has to be a quid pro quo – an exchange of consideration for a service supplied to the person paying for the service – for a transaction to be categorised as a business transaction for VAT purposes.
- A subsidy for a service supplied to others is not converted into a purchase of services simply by creating a new legal relationship. If the voluntary organisation would provide the service to that client group anyway, then it is likely that the funding will be a subsidy for a non-business activity. There would have to be a direct relationship between the service provided and the funder for this to be within the scope of VAT.
- A voluntary organisation providing services to a public authority may be making a business supply where the public authority is deriving benefit from the supply.

### Characteristics of grants and contracts for VAT purposes

Broadly, these are the likely indicators:

Contract	Grant
<ul style="list-style-type: none"> <li>• commissioned service</li> <li>• specification of services to be provided</li> <li>• direct link between service provided and the recipient</li> <li>• binding agreement between the parties</li> </ul>	<ul style="list-style-type: none"> <li>• existing service seeking funding</li> <li>• indication of likely areas to benefit</li> <li>• beneficiaries receive the service and a third party funds it</li> <li>• grant is a donation freely given with timing, amount and frequency at the discretion of the donor</li> </ul>

However, the circumstances of each situation will affect exactly how it should be treated. If in doubt, then seek a ruling from your local VAT office.

### **Changing from grant to contract – unforeseen consequences**

For many years, St Ethelbert's Hospice has provided services for free, receiving donations from supporters and families, as well as grants from the local authority and health trust. Now it wishes to build a new wing for the hospice, to expand the range of services they offer and allow them to admit more patients. They are negotiating with the local authority, which has indicated that they wish to buy in some daycare spaces at the hospice. They are also anticipating that hospice places will be bought by the health authority.

In terms of VAT, the hospice has moved from non-business activities funded by donations and grants to business activities funded by contracts. The services provided are exempt from VAT so no VAT has to be charged on them, so there is no apparent difference in day-to-day operations. However, zero-rating for new construction work is only available to charities undertaking non-business activities. So now the hospice will not be eligible for this relief on the building of the new wing and it will therefore cost them more to build it.

The consequences of a change to a contract arrangement may be quite complicated for some organisations. If you change from providing services under grant to a contractual basis you may have to register for VAT and budget for your costs in a different way. On the other hand, many services provided by charities are exempt and so no VAT has to be charged. This may still have consequences for new building work, as exempt business activities means that you cannot claim special zero rates, but you are also blocked from recovering VAT on purchases.

To guard against changes in VAT status or rulings which change the VAT treatment, it is wise to incorporate a clause into a contract or funding agreement to state that any fees are exclusive of VAT. This way, you will be able to add VAT to the fee charged if it becomes apparent that it is subject to VAT. If you do not include such a clause, then the fee will be assumed to include VAT. A change in VAT status would then mean that the output VAT would be payable without an increase in the amount charged, thus reducing your actual income.

### **Key points on VAT**

- Grant funding is outside the scope of VAT when it is freely given.
- Funding is a business supply when it is directly linked to the service being provided.
- The substance of the arrangement determines the VAT treatment, not what the funding agreement is called.
- Remember, many services provided by charities are exempt.
- If in doubt, make a written enquiry to the HMRC charities unit to confirm the correct treatment.

# 6 Conclusion

Charities may provide services under contract, as long as the service is within the charity's objects. If they receive contract funding, it is a business arrangement and so needs to be treated as unrestricted funding in the accounts. It may be performance related or the funding may be provided for a certain time period. This may give rise to an adjustment at the financial year end so that only the income earned is recognised in the statement of financial activities, with funding received in advance going to the balance sheet as deferred income.

By contrast, a grant is freely given although the grantor may expect certain services to be provided to beneficiaries, so making the funding restricted. A grant will be recognised as income as soon as all recognition conditions have been met, and so balances may be carried forward within the charities funds for future expenditure.

A contract will usually be business income for VAT, whereas a grant will usually be outside the scope of VAT. However, a contract may be for exempt services and a grant may be a subsidy for a business activity. At an early stage, clarify the VAT status of the activity in a contract situation and in a grant situation. Assess the impact on the organisation under both options so that you can assess how you would like the funding to be treated.

As a precautionary measure, incorporate a clause into all funding agreements, service level agreements and contracts that states that any fees payable under the agreement are subject to VAT if it applies. This will allow you to add VAT to the fees charged. Otherwise the fee has to include VAT.

## References and further information

***Statement of Recommended Practice:  
Accounting and Reporting by Charities***

Charity Commission, March 2005

***CC35 Trustees, trading and tax – How charities may lawfully trade***

Charity Commission, April 2007 [www.charitycommission.gov.uk](http://www.charitycommission.gov.uk)

***CC37 Charities and Public Service Delivery***

***Financial Reporting Standard 5 Application Note G –  
Amendment to FRS 5***

published by the Accounting Standards Board, November 2003  
[www.frc.org.uk/asb](http://www.frc.org.uk/asb)

***Working with the Third Sector***

National Audit Office, June 2005 [www.nao.gov.uk](http://www.nao.gov.uk)

***A Practical Guide to Financial Management for Charities***

Kate Sayer

published by Directory of Social Change ISBN 1 903991 72 2  
(third edition September 2007)

***A Practical Guide to VAT for Charities***

Kate Sayer and Alastair Hardman

published by the Directory of Social Change (new edition May 2008)

**HMRC charities unit**

helpline: 08453 02 02 03

written enquiries: HMRC Charities, St John's House, Merton Road,  
Bootle, Merseyside L69 9BB