

ACCOUNTING STANDARDS BOARD ADOPTS NEW STANDARD AND PROPOSES CHANGES TO ANOTHER: THE EFFECT ON NOT-FOR-PROFIT AND CHARITABLE ORGANIZATIONS

*By Karen J. Cooper, LL.B., LL.L., TEP,
assisted by Kimberley A. Cunnington-Taylor, B. Soc. Sc., LL.B., Student-at-Law*

A. INTRODUCTION

In recent years, there has been a heightened demand for transparency and accountability of charitable and not-for-profit organizations. As a result, it has become increasingly important for these organizations to maintain proper financial records and ensure that proper financial statements are prepared. There are many other reasons why proper maintenance and presentation of financial information is important, including:

- ♦ The proper maintenance of accounting records is a legal requirement if the organization is incorporated. Both the *Canada Corporations Act*¹ and *Corporations Act (Ontario)*² require not-for-profit corporations to maintain proper accounting records. If a corporation fails to comply with this requirement, the corporation is in breach of the statute and the directors of the corporation may be held personally liable for any damages that may occur as a result of the failure;³
- ♦ Prospective donors may want to review and may rely on financial information which will allow them to make informed decisions about whether or not to make a contribution to the organization. Being able to provide properly maintained financial records is one tool a charitable or not-for-profit organization has to enable prospective donors to make such decisions;
- ♦ The Charities Directorate of the Canada Revenue Agency (“CRA”) reviews the financial records of registered charities for compliance purposes. Again, properly maintained and presented financial

¹ Section 117, R.S.C. 1970, c. C.32.

² Section 302, R.S.O. 1990, c. C.38.

³ Donald J. Bourgeois, “The Law of Charitable and Not-for-Profit Organizations”, 3d. ed. (Markham: Butterworths, 2002) at 126.

information serves the purpose of providing CRA with the information it needs to carry out its mandate of overseeing registered charities in Canada; and

- ◆ Transparency and accountability of corporations, profit-oriented and not-for-profit alike, has become the standard. Properly maintained and presented financial information helps to provide the level of transparency and accountability stakeholders have come to expect.

The Canadian Institute of Chartered Accountants (the “CICA”) has developed generally accepted accounting standards for charitable and not-for-profit organizations in Canada (hereinafter collectively referred to as “NPOs”). These accounting standards comply with statutory and other disclosure requirements for NPOs, and have been published in the *CICA Standards and Guidance Accounting Handbook*⁴ (the “CICA Handbook”). The standards for financial reporting set out in the CICA Handbook are in accordance with Canadian generally accepted accounting principles (“GAAP”). While many of the general sections apply to for-profit and charitable and not-for-profit organizations alike, sections 4400 – 4460 of the CICA Handbook (the “4400 Series”), have been developed specifically for NPOs. As well, the CICA Handbook contains various other specific items, some of which also apply to NPOs in Canada.

In 2003, the Accounting Standards Board (the “AcSB”), a branch of the CICA, established an ongoing project to improve the accounting standards applicable to NPOs. The AcSB appointed the Not-For-Profit Advisory Committee (the “AdCom”) to review the provisions of the CICA Handbook applicable to NPOs and to make recommendations for changes. The AcSB recently posted an Exposure Draft (the “Draft”) containing the proposals for amendments to the existing standards and provisions of the CICA Handbook related to NPOs (the 4400 Series).⁵ While the deadline for submitting comments relating to the Draft, expired on November 15, 2007, it is important for NPOs to understand the main issues identified in the draft and the basis for the recommended changes. A summary of a proposed additional standard relating to the disclosure of fundraising and general support costs, as well as the other proposed amendments to the 4440 series of CICA Handbook sections, will be discussed below.

It is our understanding that a further Invitation to Comment (ITC) on the future direction for setting accounting standards applicable to NPOs in the context of the general adoption in Canada by the CICA of the international financial reporting standards (IFRSs) as GAAP will be issued in mid-2008⁶ and the AcSB is

⁴ The Canadian Institute of Chartered Accountants, *CICA Handbook*, September 2007. [“CICA Handbook”]

⁵ Available at http://www.acsbcanda.org/download.cfm?ci_id=38963&la_id=1&re_id=0.

⁶ See Accounting Standards Board Decision Summary, January 3, 2008, available at <http://www.acsbcanda.org/4/2/3/4/4/index1.shtml>.

seeking to generate significant dialogue and broad-based participation in the discussion of the future of financial reporting by NPOs.

In addition, on April 1, 2005, the AsCB issued section 3855, a new section of the CICA Handbook titled *Financial Instruments – Recognition and Measurement* that applies to NPOs, as well as profit-oriented organizations. The effect of Section 3855 is to change the way entities recognize and measure financial instruments. The mandatory effective date for Section 3855 was deferred for many entities, not including not-for-profits for whom the changes were effective **October 1, 2006**, and the new standard now applies to annual financial statements of all entities relating to fiscal years beginning on or after **October 1, 2007**. This bulletin also provides a brief summary of these new rules.

B. OBJECTIVES OF FINANCIAL STATEMENTS

As noted above, financial statements are often used to comply with disclosure requirements – whether statutory requirements or otherwise – and the CICA Handbook was developed, in part, to assist with the various disclosure requirements corporations have. Paragraph 1000.15 of the CICA Handbook states that one of the objectives of financial statements is to

... communicate information that is useful to investors, members, contributors, creditors and other users (“users”) in making their resource allocation decisions and/or assessing management stewardship. Consequently, financial statements provide information about:

- (a) an entity's economic resources, obligations and equity / net assets;
- (b) changes in an entity's economic resources, obligations and equity / net assets; and
- (c) the economic performance of the entity.⁷

The proper maintenance and presentation of financial and accounting information satisfies this objective. Paragraph 1000.10 of the CICA Handbook explains that because members of and contributors to NPOs are often segregated from management, there is a need for external communication of economic information.⁸ Properly prepared financial statements will provide members and contributors with the information that they require in order to make decisions in relation to the organization.

⁷ *Ibid.*, s.1000.15.

⁸ *Ibid.*, s.1000.10.

C. SECTIONS 4400 – 4460 – NOT-FOR-PROFIT ORGANIZATIONS

As noted above, sections 4400 – 4460 of the CICA Handbook apply specifically to NPOs (the “4400 Series”). The 4400 Series have been developed to address matters that are unique to NPOs or for situations where it is appropriate to provide different requirements for NPOs and profit-oriented organizations.⁹ Examples include:

- ◆ Financial Statement Presentation by NPOs (section 4400):
 - Fund accounting
 - Statement of financial position
- ◆ Contributions – Revenue Recognition (section 4410):
 - Revenue recognition
 - Measurement
 - Disclosure
 - Deferral Method
 - Restricted Fund Method
- ◆ Capital Assets held by NPOs (section 4430):
 - Recognition and Measurement
 - Presentation and Disclosure
- ◆ Reporting Controlled and Related Entities by NPOs (Section 4450); and
- ◆ Disclosure of Related Party Transactions by NPOs (Section 4460).

1. Changes to the 4400 Series

Following a review of, and solicitation of, the views of interested parties regarding the provisions of the CICA Handbook applicable to NPOs by the Ad Com, the AcSB posted an Exposure Draft (the “Draft”) containing the proposals for amendments to the existing standards and provisions of the 4400 Series. Some of the proposed changes are relatively minor in nature and result from amendments made to other sections of the CICA Handbook upon which parts of the 4400 Series are based. The objective of the proposals in the Draft was to improve financial reporting by NPOs in the context of current Canadian GAAP, prior to and separate from the implementation of the CICA’s longer term strategy of adoption of IFRSs as GAAP for publicly accountable profit-oriented enterprises. The proposed changes to the 4400 Series include the following:

⁹ *Ibid.*, Introduction to Accounting Standards that Apply only to not-for-profit organizations.

Topic 1 – Introduction

The Introduction will include a cross-reference to Section 1100 - Generally Accepted Accounting Principles, reminding readers that where matters are not explicitly dealt with within the 4400 Series or the CICA Handbook generally, reporting should be in accordance with Canadian GAAP and reference should be made to the various other sources of Canadian GAAP, including the Accounting Guidelines and EIC Abstracts that are applicable.

Topic 2 - Reporting of Net Assets

Section 4400, Financial Statement Presentation by Not-for-Profit Organizations, will be amended to eliminate the requirement to treat net assets invested in capital assets as a separate category of net assets and, instead, to treat them as a category of internally restricted assets. If presented, it may be either in a note to the financial statements or directly on the face of the statement of financial position. Additional guidance is also provided with respect to internal restrictions of net assets.

Topic 3 - Reporting gross amounts of revenues and expenses

Amendments will also be made to Section 4400 clarifying that revenues and expenses must be recognized on a gross basis when an NPO is acting as a principal.

Topic 4 - Statement of Cash Flows

The amendments propose to make Section 1540 – Cash Flow Statements applicable to NPOs such that they will no longer be permitted to group cash flows from financing and investing activities.

Topic 5 - Interim Financial Statements

The amendments propose to make Section 1751 – Interim Financial Statements applicable to NPOs that prepare interim financial statements in accordance with GAAP.

Topic 6 - Capital Assets

Section 4430 will be amended to clarify that the size test for relief from the Section is intended to allow NPOs to expense, rather than capitalize and amortize, their capital assets. It is not intended to allow NPOs to choose to capitalize but not amortize their capital assets, nor is it intended to allow different methods of accounting for various types of capital assets.

Topic 7 - Reporting Controlled and Related Entities

Section 4450 will be amended to clarify the material related to the identification of control, particularly as it relates to other NPOs; require controlled entities to be consolidated; amend the economic interest definition; enhance the disclosure requirements for economic interest relationships; and eliminate the exemption from consolidation of a large number of individually immaterial organizations.

Topic 8 - Disclosure of Related Party Transactions

Paragraph 4460.02 will be amended to be consistent with Related Party Transactions, paragraph 3840.02.

Topic 9 - Proposed New Section - Disclosure of Allocated Expenses by Not-for-Profit Organizations

The new Section will require NPOs to disclose their policy on the allocation of fundraising and general support expenses, the nature of expenses being allocated, the basis on which such allocations have been made, and the amounts that have been allocated in the notes to the financial statements (details of which are discussed below).

2. Disclosure of Allocated Fundraising and General Support Costs – Proposed Section 4470

While we recommend that the proposed amendments to the 4400 Series be thoroughly read and discussed, of significant note is the proposed addition of a new section to the CICA Handbook relating to the disclosure of allocated fundraising and general support costs by NPOs. If implemented, this section would require NPOs that classify their expenses by function and allocate a portion of their fundraising and general support costs to another function, to disclose the following:

- ◆ the amounts that have been allocated;
- ◆ the functions that they have been allocated to;
- ◆ the policies adopted for the allocations;
- ◆ the nature of the expenses being allocated; and
- ◆ the basis on which the allocations have been made.

The amendments do not require NPOs to classify expenses by function nor to allocate fundraising and administrative costs to other functions.

The rationale for the addition, as explained by the AcSB is that

[a]dditional scrutiny is often applied to the total reported cost of both fundraising and general administration of NFPOs that receive funds from the public. Disclosure of allocations that have been made in the case of these expenses, including amounts, enhances a reader's ability to understand the effect of the allocations, and thus improves the ability to conduct comparisons among NFPOs' financial statements.¹⁰

Proposed section 4470 indicates that organizations often allocate individual expenses among the functions they relate to when the organization reports expenses by function. If an expense relates to a specific program, there may be general expenses incurred as well so the organization may wish to allocate the expenses accordingly when there is a clear relationship between the expense and the function.¹¹ For example, a staff person who works on more than one specific program may have their salary allocated between the specific programs.

The proposed Section 4470 also contemplates the allocation of fundraising expenses between different functions. In this situation, there must be a "reasonable basis for making such an allocation, applied on a consistent basis."¹² The Application Guidance appended to the new Section provides that the allocation may be based on a number of factors, including time, usage, number of persons or space, depending upon the category of expense and the nature of the organization. With specific regard to fundraising expenses and the potential to allocate some of these expenses to educational objectives, the Application Guidance sets out detailed criteria which the expense must meet in order to be considered educational; otherwise, the expenses will be considered wholly attributable to fundraising. In addition, expenses related to fundraising activities targeted at prior donors or individuals and corporations selected based on their likelihood to donate are presumed to be wholly attributable to fundraising.

Further, the proposed Section 4470 contemplates the allocation of general support expenses. It states that general support expenses may be considered a function in their own right but alternatively, may be allocated among the relevant functions they support. Again, the allocation must be reasonable and must be applied on a consistent basis.¹³

Section 4470.08 describes the disclosure of allocated expenses. This section provides that

¹⁰ Accounting Standards Board Proposed Accounting Standards, Not-for-Profit Organizations, Exposure Draft, August 2007 at http://www.acsbcanada.org/download.cfm?ci_id=38963&la_id=1&re_id=0 [accessed September 2007].

¹¹ *CICA Handbook Supra* note 4, s. 4470.03 - 04 at 31.

¹² *Ibid.*, s. 4470.05 at 31-32.

¹³ *Ibid.*, s. 4470.06 - 07 at 32.

[w]hen allocations of fundraising and general support expenses have been made to other functions, the accounting policy disclosure should explain the policies adopted for the allocation of expenses among functions, the nature of the expenses being allocated and the basis on which such allocations have been made. In addition, the amounts allocated from each of these two functions, and the functions to which they have been allocated, should be disclosed.¹⁴

And finally, section 4470.09 explains that while the results of operations of each function are important to readers of financial statements, disclosure of the allocation of fundraising and general support expenses among the various functions they support provide readers a better understanding of the total cost of fundraising and general support.¹⁵

3. Next Steps and Implementation

The AcSB had requested comments relating to the Draft from individuals and organizations. The deadline for submitting these comments was November 15, 2007.¹⁶ Many organizations identified concerns with the proposed implementation date and the new reporting rules with respect to controlled entities. The Anglican Church of Canada and others were particularly concerned with the application of the new control rules to national religious organizations with many affiliations with local parishes, congregations, presbyteries, synagogues, temples, etc. In many instances the national organization has strong influence over the local organizations in matters of spiritual guidance, operational structures, teachings and policy, but little financial influence. The application of the new rules could result in a requirement to consolidate financial reports, which could result in loss of funding and other unintended negative consequences. However, there seems to be general agreement with the principles set out in the new section related to the allocation of fundraising expenses.

The AcSB has indicated that the final standards will be issued by the second quarter of 2008. Most of the amendments will apply to financial statements relating to fiscal years beginning on or after January 1, 2009. The exception relates to paragraph 4450.26-29 (as described in Topic 7 of the Exposure Draft summarized above), which is proposed to be effective January 1, 2012.

¹⁴ *Ibid.*, s. 4470.08 at 32.

¹⁵ *Ibid.*, s. 4470.09 at 32.

¹⁶ Responses to the Draft may be reviewed at http://www.acsbcanada.org/index.cfm/ci_id/41705/la_id/1.htm.

D. SECTION 3855 - FINANCIAL INSTRUMENTS – RECOGNITION AND MEASUREMENT: EFFECTIVE OCTOBER 1, 2006

On April 1, 2005, the AcSB issued a new section of the CICA Handbook entitled *Financial Instruments – Recognition and Measurement* (Section 3855). Section 3855 is in the “specific items” section of the CICA Handbook and applies to profit-oriented and not-for-profit organizations alike.

The effect of Section 3855 is to change the way organizations recognize and measure financial instruments. While the impact of the new standard will be modest for most organizations, in some cases, the new standard will require significant accounting changes.

The mandatory effective date for Section 3855 was deferred until **October 1, 2007** for many organizations; however this deferral was not applied to NPOs. Section 3855 has been in force for NPOs for financial statements relating to fiscal years beginning on or after **October 1, 2006**.

The following review is a summary of the more significant parts of section 3855. It is recommended that NPOs become acquainted with this new standard to ensure that financial instruments are being properly reported.

1. Overview:

Section 3855 is the follow up to section 3860, which provided guidance over the presentation and disclosure of financial instruments. Section 3860 did not provide any guidance over the recognition of financial instruments or the measurement of same. As a result, many financial instruments were not recognized on the financial statements, and those that were, were measured at an amount that may not have been particularly relevant.¹⁷ Section 3855 sets out the standards for recognizing and measuring financial instruments (assets, liabilities and non-financial derivatives) and prescribes when a financial instrument must be recognized on the financial statements and at what amount. It also specifies how financial instrument gains and losses are to be presented.

This new section applies to all financial instruments, except for those listed in section 3855.07. Financial instruments include loans and notes receivable and payable, investments in debt and equity securities

¹⁷ Canadian Institute of Chartered Accountants, “Not for Profit Organizations and Registered Charities – Accounting and Taxation Issues”, module 2-8.3. [“*CICA Seminar*”].

and derivative contracts such as forwards, swaps and options. If an NPO has no financial instruments other than cash, accounts receivable, accounts payable and arms' length debt, there will not be a significant difference in accounting for these instruments. However, an NPO with equity securities or derivatives, or one that trades other types of financial instruments, will probably be significantly affected.¹⁸

The purpose of the new standard is to establish "... standards for recognizing and measuring financial assets, financial liabilities and non-financial derivatives"¹⁹ and is based upon the following four basic principles:

- (a) financial instruments and non-financial derivatives represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements;
- (b) fair value is the most relevant measure for financial instruments and the only relevant measure for derivative financial instruments;
- (c) only items that are assets or liabilities should be reported as such in financial statements; and
- (d) special accounting for items designated as being part of a hedging relationship should be provided only for qualifying items.²⁰

Financial assets and liabilities are recognized when the organization becomes a party to the contractual provisions of the financial instrument or non-financial derivative contract because it is only at this point when the asset or liability arises. Similarly, the asset or liability is only removed from the balance sheet when the obligation set out in the contract has been discharged or cancelled, or it expires.²¹

2. Classification and Measurement

Section 3855 works in two steps: first each financial instrument must be **classified** using one of the models outlined in Section 3855; then, each financial instrument must be **measured**.

¹⁸ Accounting Standards Board, "Financial Instruments – Proposed new Accounting Standards – A Summary for Not-for-Profit Organizations", p. 2 at http://www.acsbcanda.org/multimedia/Download_Library/Standards/Accounting/English/e_FINPOSummary.pdf [accessed September 2007]. ["AcSB Summary"]

¹⁹ *CICA Handbook*, *Supra* note 4, s. 3855.01.

²⁰ *Ibid.*, s. 3855.02.

²¹ *Ibid.*, s. 3855.03; s. 3855.39.

Section 3855 sets out the following categories into which each financial instrument must be classified:

1. Held to maturity;
2. Held for trading; or
3. Available for sale.

Financial instruments ‘**held to maturity**’ are defined in section 3855.19(g) as those instruments that the NPO acquires with the intention to hold until maturity. In order to be classified as a ‘held to maturity’ instrument, the instrument must meet the following conditions:

- ◆ The instrument must have a fixed or determinable maturity date;
- ◆ The organization must have a positive intent and ability to hold the investment to maturity; and
- ◆ If the organization sells a significant amount of the instruments in this category prior to maturity, it must reclassify all of the instruments in the category to the available for sale category.²²

Financial instruments ‘**held for trading**’ are those instruments that the organization intends to sell at some point, the purpose of which being to recognize a profit. Any financial asset or liability can be designated as ‘held for trading’ when it is first recognized. Section 3855.19(f) sets out the conditions a financial asset or liability must meet in order to be considered held for trading. Financial instruments that do not fit into one of the other categories, or that are not classified in one of the other categories, will be classified as ‘**available for sale**’. Note that these classifications apply regardless of whether the financial instruments are subject to internal or external restrictions that specify how resources must be used.²³

Once the instrument has been classified, it must then be measured. Initially, all financial assets and liabilities will be measured at the fair value of the consideration given or received when the organization becomes a party to the contract creating the item, as noted above. However, after that initial measurement, instruments in each category may be treated differently.

After the initial classification, financial instruments are measured as follows:

²² *Ibid.*, s. 3855.19(g). Note that there are some exceptions to these conditions. It is important to review section 3855 carefully to determine precisely what may be done with a financial instrument without requiring a reclassification.

²³ *AcSB Summary* at 2.

1. Held to Maturity:

- financial instruments in the ‘held to maturity’ category are measured at the amortized cost, using the effective interest method. Any impairment losses are recognized immediately.²⁴
- section 3855.32 states that “[a]n entity assesses its intention and ability to hold its held-to-maturity investments to maturity not only when the financial assets are initially recognized, but also at each subsequent balance sheet date.”²⁵

2. Available for Trading:

- subsequent measurements for financial instruments in the ‘available for trading’ category are at fair value and any gains and losses for changes in fair value are included in net investment income in the period they arise.²⁶

3. Available for Sale:

- subsequent measurements of financial instruments categorized as ‘available for sale’ are also measured at fair value. Any gains and losses for changes in fair value are included in the net assets or in the appropriate deferred contributions balance until the asset is removed from the statement of financial position. Losses due to impairment are also included in net investment income.²⁷

Section 3855 identifies loans and receivables as a separate category for classification and measurement purposes. However, it is also permissible to designate loans and receivables as ‘held for trading’.²⁸

The above is only a summary of section 3855. For a more comprehensive review, we recommend the following sources:

- CICA *Standards and Guidance Accounting Handbook*, Section 3855 – Financial Instruments – Recognition and Measurement;
- Accounting Standards Board, *Financial Instruments – Proposed new Accounting Standards – A Summary for Not-for-Profit Organizations*, at http://www.acsbcanada.org/multimedia/Download_Library/Standards/Accounting/English/e_FINPOSummary.pdf; and
- PricewaterhouseCoopers, *The New CICA Financial Instrument Rules: Have you Started Implementation Yet*, March 2006, at [http://www.pwc.com/extweb/pwcpublishations.nsf/4bd5f76b48e282738525662b00739e22/2910563410008e30852571390069f2d1/\\$FILE/fr_0306.pdf](http://www.pwc.com/extweb/pwcpublishations.nsf/4bd5f76b48e282738525662b00739e22/2910563410008e30852571390069f2d1/$FILE/fr_0306.pdf).

²⁴CICA Handbook *Supra* note 4, s. 3855.66.

²⁵*Ibid.*, s. 3855.32.

²⁶*Ibid.*, s. 3855.66.

²⁷*AsCB Summary* at 3.

²⁸CICA Handbook *Supra* note 4, s. 3855.05. See also *AsCB Summary* at 2.

E. CONCLUSION

Proper maintenance and presentation of financial records can be a very daunting task for many charitable and not-for-profit organizations. Many organizations do not have the resources, expertise or time to devote to maintaining such records. However, all NPOs have statutory and other compliance issues in relation to financial records that must be addressed. In addition, donors are becoming more involved in their decision-making concerning which organizations to support; and members are becoming more active in reviewing the progress of NPOs. Proper presentation of financial information is important for these reasons as well as to form an objective basis to measure the performance of the organization.

The CICA Handbook provides guidelines related to financial reporting. It is incumbent upon all NPOs to become familiar with the CICA Handbook, and in particular the sections that relate to not-for-profit organizations.