CICA Exposure Draft: A Comment

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A small group within the Canadian Institute of Chartered Accountants (CICA) has suggested that several major changes be made to financial reporting by nonprofit organizations (CICA. Exposure Draft. "Non-Profit Organizations".) For example, they want long-lived items such as equipment set up as assets and then amortized each year. These changes will tend to be costly to implement and maintain, thereby diverting scarce funds away from charitable programs into very questionable accounting and reporting expenses.

An even greater problem with many of the proposed changes is that their purpose is at best unclear or remote and, at worst, that the proposals are outdated, misleading, or pointless. Charitable organizations are strongly urged to study the Exposure Draft carefully (ideally through a small *independent* study group) and respond forcefully to all of those sections that they find objectionable. Otherwise, the Exposure Draft will become approved practice and auditors who are chartered accountants will be compelled to, in effect, force it upon each charity they serve. In an age of deregulation the CICA group's proposals are difficult to fathom.

In broad terms, the suggested changes are bringing to the boiling point a much larger issue in financial reporting in Canada. Unfortunately, the nonprofit organizations are being caught in the middle of a fight among chartered accountants that has been raging for about 10 years. Until recently, the debates have primarily covered government reporting. Some even-handedness existed because organized groups of government officials could raise objections and receive satisfaction. Now with charities being targeted, many letters of complaint from volunteers will have to be sent to achieve suitable results, with the ideal being a withdrawal of the proposed changes.

Some History

Charities are being told by the Exposure Draft advocates to, in effect, report in accordance with GAAP (generally accepted accounting principles). GAAP for the most part are 60-year-old "technology". They are a vague and largely uncatalogued number of accounting and reporting approaches that developed mainly after the 1929 stock market crash. Contrary to popular belief, GAAP are prone to extensive manipulation.

GAAP have to be contrasted with *cash basis* accounting (recording only cash receipts and cash disbursements) and *accrual* accounting (cash basis modified for the recording of short-term transactions such as receivables and payables). Each—cash, accrual, and GAAP—has its usefulness or legal necessity in the vast array of Canadian organizations. (Given the existence of differing ownerships, differing industries, differing sizes, and other variations, more than one approach is necessary.)

Should GAAP be used for charities? In order to respond to this question it is necessary to look at what GAAP were designed for, and whether this old technology still stands up in the 1990s in most, or any, organization(s).

GAAP are based on a series of fundamental *assumptions*, primarily derived from the 1930s and 1940s, many of which do not fit a large number of organizations and their environment in the 1990s. A few of these GAAP *assumptions* are:

1. The need to *match* costs to revenues in a time period so that the organization can *calculate profit*. (Given this matching assumption alone, one has to wonder how a system designed for profit-seeking organizations and taxation could possibly make any sense for non-profit organizations.) Clearly implied in "matching" is the practical ability of accountants to be able to match in an unbiased manner. Obviously, matching can be difficult to achieve in organizations with long-lived assets, research and development, and changing information technologies. Matching is wide open to manipulation of numbers. Hence, the validity of the matching concept is being seriously questioned today, in an era of longer-term investments and increasing litigation from readers of financial reports.

   GAAP matching could have an impact on nonprofit organizations in peculiar and unfortunate ways. One example would be that the initial setting up of previously unrecorded equipment and similar items would give the appearance of sudden wealth, which might convince prospective donors that the organization no longer required support. The subsequent writing down of these so-called assets could then create non-cash deficits. This in turn, could lead to donors feeling a need to contribute more cash to eliminate the deficit or, more probably, a management decision that important charitable programs would have to be curtailed so as to eliminate the (artificial) deficit. Who knows how donors may react to the accounting changes? But, why force them away from cash thinking unless there are overwhelming benefits to the charities? Experience has shown that many people are baffled by GAAP. Why confuse or annoy charitable donors?

2. Historic, original-transaction, cost must be used in GAAP accounts and financial statements. That is, current replacement costs of assets, or their current resale prices, are *not* to be accounted for under GAAP as long as the asset is still owned. In brief, if you want information about the cost of replacing one of the charity's assets, or what the asset may be sold for, do not expect the GAAP records to tell you. Indeed, the GAAP figures could be quite misleading for a decision about asset replacement. Of what relevance are historic costs to managers of charities? The CICA Exposure Draft appears to ignore this type of user/use question and presses on with what could easily be called arbitrary allocations of historic cost, for unspecified uses. Probably most charitable organizations will find that adherence to historic cost GAAP incurs significant accounting cost with no discernible benefit, or creates confusion. Those not trained in accounting, for example, could easily be confused by the historic numbers and might well not understand why the managers of the charity are using them. Decisions to curtail a charitable program could be erroneous because historic numbers were used in arriving at the cost of the program.

3. Long-run continuity (often referred to as the going-concern assumption) is assumed by GAAP, with the outlook often being towards long-term profitability. Current liquidity or current cash flows are downplayed under GAAP because they tend to assume stability in the organization and the economy. (With such an assumption, and the use of GAAP, it is hardly surprising that in the past 10 years in Canada we have seen banks fail because they ran out of cash, i.e., failure occurred in cases where the current GAAP financial statements showed that operations were profitable.) Supreme Court of Canada Justice Willard Estey in his report on the Alberta bank failures made the liquidity versus profitability contrast a highlight of his criticisms of GAAP accounting. Like banks, charities have to focus on cash, both to survive and to comply with Revenue Canada requirements. GAAP deflect the cash and liquidity emphasis that is essential to management if it is to ensure organizational survival. Often, what GAAP may claim to do is actually accomplished more cost-effectively through cash management or managerial accounting—which tend to be in the realm of certified management accountants and not those chartered accountants who perform audits.

4. The presumption of bargained, arm's-length, objective transactions is another underpinning of GAAP. Does this make sense in the operations of a charity, especially smaller ones that rely on the good intentions of donors, volunteers who provide services, and difficult-to-quantify guarantees from supporters for any bank loans? Does a

bank actively seek GAAP financial statements of a charity or is it content with other documentation such as cash budgets? These types of questions do not seem to have been addressed by the advocates of the CICA Exposure Draft. Sometimes they want fair market value figures; mostly they do not. The inconsistency is puzzling, given that proponents of the changes are seeking comparable accounting among charities.

Current Canadian GAAP deal with non-arm's-length transactions such as the provision of assets or services between related parties in a highly questionable manner. That is, readers of financial statements of large corporations are *not* provided with either the current market value of the asset or service or the difference from whatever non-arm's-length figures are shown in the financial statements. Yet, this Exposure Draft is trying to hold charities to higher standards than chartered accountants require from their large corporate clients. (See Capital Assets and Donated Materials and Services)

GAAP's Deficiencies

At our university we often teach students that Canadian GAAP primarily apply to large, public, audited, widget corporations at the plateau of their life cycle. GAAP often do not apply (unless a group forces them upon the organization) to small private corporations, unincorporated business, governmental bodies and similar enterprises. GAAP have severe limitations for readers of financial statements when they are used for many resource companies: logging, mining, oil, gas, farming, and others where historic cost bears little relationship to current worth. For the most part GAAP exist because of corporate, and some income-tax, legislation. GAAP financial statements do not tend to be helpful tools in decision-making by managers of organizations because GAAP intermingle cash, accrual receivables, historic costs and similar items that are measured in different ways.

As we move from the industrial era to an information-technology era, assets will tend to be computer software, trained people, patents, copyrights, investments in research, and related intangibles. The historic cost and matching assumptions of GAAP will continue to be less and less applicable to the organizational reality of the 1990s and the next century. What charities do not need is 60-year-old technology that was designed for large, public, profit-seeking companies—unless some clear benefits can be identified.

Unfortunately, the Exposure Draft does not set forth specific benefits but relies on vague generalities such as section 305 where the purpose is described as "... enables users of the financial statements to make comparisons with other organizations". But who are these users? Are they donors who would benefit the charity? What sort of comparison would make any sense given the diversity of size, purpose and method of operation of Canadian charities?

Much of the thinking underlying the Exposure Draft can be traced to what is called in accounting the "general purpose user/reader". From a validation or research point of view a concept of "general purpose reader" is meaningless. A person who is trying to evaluate the benefits of an accounting proposal cannot test for relevance or benefit because "general purpose" is a fiction, an unknown character. Hence, supporters of "general purpose" can *advocate anything*, because there is no way of dealing with the amorphous "general".

Rejections of General Purpose

Why should managers of charities have to tolerate the "general purpose" mentality? As stated, more beneficial management tools can be found in the fields of cash and management accounting (e.g., cash budgets). The purpose of financial reporting by charities is not to please a school of accounting thought that praises "general purpose" and illogical beliefs about the need to compare.

Fortunately, "general purpose" has recently *lost* several battles. In dealing with accounting litigation cases in Canada, most courts have adopted a specific user/use orientation. Public accountants owe a duty of care to specific individuals or similar classes of individuals who are "foreseeable" as users, with a "proximate" or close connection between accounting figures and the suffering of damages. The judges have to assess whether a *specific complainant*, and not a "general purpose" one, was misled.

The court interpretations are consistent with a concept in accounting called "materiality". A material transaction is one that will influence the decision of a foreseeable user. For some reason the concept of "materiality" does not appear within the Exposure Draft. Materiality requires the identification of the specific users/readers of financial statements.

"General purpose" has also not fared well with the Ontario Securities Commission (OSC). In 1972, the OSC gave chartered accountants a chance to develop more effective financial statements for investors. Opinions will differ, but I believe the chartered accountants have dropped the ball badly. Apparently, the OSC is not overly impressed with GAAP financial statements for public companies because it has introduced a "Management Discussion and Analysis" (MD&A) requirement. MD&A involves extensive supplementing of GAAP figures and presentations in order to overcome GAAP deficiencies and disclosure limitations. Each year the OSC publishes a commentary on GAAP reporting and identifies GAAP deficiencies and manipulations.

Other jurisdictions and regulators are currently taking a second look at general purpose GAAP requirements and their usefulness to the Canadian public. It is too early to say, but there may also be federal *Business Corporations Act* changes that reflect poorly on GAAP reports.

In the United States, GAAP has been severely criticized by senior officials of the Securities and Exchange Commission for its role in many Savings and Loan failures. A number of lawsuits have been launched against public accountants for losses that are alleged to be in the billions. Several public accountants have been settling out of court by providing multi-million-dollar payments.

Meanwhile, a group in Canada wants charities to adopt the GAAP model of reporting. To serve whom?

Time for Action

I have spent over 30 years teaching chartered accountants and students of chartered accounting. It is not unfair to say that in my experience a large number of them do not adequately understand several aspects of GAAP. As a consequence, even if a person thought that matching and GAAP were worthwhile, what practical accounting consistency would exist in Canada among thousands of nonprofit organizations? Can charities afford to subscribe to the GAAP fantasy?

Which charities need historic cost? Who will decide what is the life of equipment? How will the amortization basis be chosen, given that several GAAP methods exist? Who is this genius who is able to match in an uncertain world?

The foregoing and similar questions are plaguing GAAP in profit-seeking organizations. Why, in 1992, should nonprofit organizations buy into a depreciated accounting theory?

Managers of charities and powerful volunteers must write at once to the CICA and forcefully express their opposition if we are not to return to an era where donors will start objecting to "funds going into overhead instead of to charitable causes".

Knowledgeable donors will then have no recourse but to mark their donations, "Not to be used for GAAP reporting".