Updated CICA Guidelines: Comments on the Re-Exposure Draft

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Introduction

The Re-Exposure Draft issued by the CICA (Canadian Institute of Chartered Accountants) is a significant improvement over the previous exposure draft.[1] The overall thrust has been changed so that there is no longer a single general approach being mandated for NPO (nonprofit organizations) reporting. The acceptance of a restricted fund accounting basis eliminates many objectionable recommendations that were part of the earlier exposure draft. As well, the overall reporting requirements have been greatly improved and show a much better appreciation for the realities facing nonprofit organizations.

There is still one very serious shortcoming to the Re-Exposure Draft, however, and that is in the recommended treatment for capital assets. I also am distressed by the change of nomenclature used to label these organizations.

Capital Assets: Amortization

The general approach of the Re-Exposure Draft is to require that all limited-life capital assets be amortized. This recommendation is advanced without considering the nature of the organization's activities and without considering its externally mandated reporting requirements. The AcSB (Accounting Standards Bureau) has not made the case for requiring amortization of capital assets. The "Basis for the proposals" asserts that:

> The full cost of services provided is an important ingredient in economic performance and changes in economic resources. Cost of services includes that associated with using up the service capacity of the organization's capital assets.

However, there is no evidence to suggest that full-cost determination is a pervasive and over-riding objective of the highest priority. Amortization makes sense only when there are measurable units of service output and when revenues are expected to recover those costs. Such is not the case of many NPOs. How is a church to measure the full cost of souls saved? And even if it were possible, what's the point?

Many organizations operate on an expenditure basis and the relevant reporting measures are input-based. The AcSB seems insistent on ignoring the fact that

many NPOs cannot use output-based measures. To do so is impossible in many instances, such as when an NPO's services are public goods (e.g., environmental protection) rather than private goods (e.g., hospital care). In other cases, an output basis is possible but is not permitted by the major funding agency. The CICA *Handbook* should embrace at least the input-based/output-based distinction as a criterion for capitalization and should permit opting-out at the behest of the funding agency.

The revised or Re-Exposure Draft attempts to lessen the impact of this problem by providing an exemption for smaller organizations, but one wonders why the $250,000 threshold was chosen. That limit represents an activity level of only about $5,000 per week, a very small organization indeed. The threshold for exemption seems too low, but in any case it is based on the wrong criteria. The issue is not one of size; the issue is the nature of services provided and the reporting requirements of the funders. There are many small organizations in which amortization is appropriate and many large organizations in which amortization is not appropriate.

Capital Assets: Restricted Contributions

The Re-Exposure Draft recognizes the reporting problem that would arise if restricted contributions for capital assets are recognized as revenue while the expenditures for the assets are capitalized; a misleading surplus is created in the year(s) in which the contributions are recognized. The proposed solution is that revenue be deferred and matched to amortization in future periods [para.230]. The balance sheet will therefore carry largely (and often completely) offsetting asset and deferred-revenue balances.

The solution proposed by .230 does achieve matching; however, the solution is held ransom to the overbearing AcSB objective of requiring amortization. No convincing case has been made for reporting of revenue that has already been received, offset by expenditures that have already been incurred; both revenues and expenditures (or expenses) are understated in the period that a capital asset is purchased, while both are overstated in subsequent periods. The actual flow of accrual-basis revenues and expenses is obscured by the proposed dual amortization scheme.

Again, the AcSB seems to be dazzled by the allure of full cost determination. The AcSB apparently regards the distortion of resource flows on the statement of operations as being tolerable as long as the objective of amortization is served. This is not a satisfactory solution; an expenditure basis should be used for capital assets financed by restricted contributions. As is noted below, however, the use of an expenditure basis does not preclude capitalization.

Capital Assets: Fund Reporting Basis

ED paragraph .321 does not relieve NPOs that use a restricted fund basis of reporting from amortizing capital assets. However, the paragraph does offer a welcome flexibility about which fund to show the amortization in. Nevertheless, the requirement for amortization in every organization is just as onerous for fund-basis reporting as for non-fund-basis reporting in that it will be a useless but costly activity for many organizations.

Capitalization Without Amortization: A Suggested Alternative

While there are strong reasons for relaxing the requirement for amortization, the requirement for capitalization need not necessarily be relaxed or eliminated; the two issues of capitalization and amortization are separable. Capitalization without amortization will permit the entire resource base of the NPO to be displayed on the balance sheet, but without distorting the statement of operations. An organization that reports on the expenditure basis can charge its asset acquisitions as expenditures in the year of acquisition (matched to the funding revenue), and then capitalize the cost of the asset with an offsetting credit to a capital account (e.g., "net assets invested in capital assets", as suggested in ED paragraph .105). The asset can either remain at full cost or be amortized. Amortization would be accomplished by a direct charge to the offsetting and capital account *rather than through the statement of operations.*

I encourage the AcSB seriously to consider this alternative approach. When coupled with a better criterion for recognizing amortization in the statement of operations (that is, better than a size test), this alternative will achieve most of the reporting objectives underlying the Exposure Draft without undermining the reporting objectives of organizations that report on an expenditure basis due to either the nature of their services or the requirements of their funders.

Capital Assets: Summary

The Re-Exposure Draft has still not adequately addressed the issue of capital assets:

- A pre-eminent importance is attached to full-cost measurements, without justification. Unlike business organizations, NPOs often provide services that have no measurable output (i.e., services for the general good of society or groups within society); since there is no measurable output, the private sector concept of "full cost" is meaningless. Users' information needs often will be ill-served by adding an expense line that is irrelevant to their needs and may create a deficit position when none actually exits under the rules of the funder.
- The dual deferral approach to capital assets (i.e., deferring and amortizing both the asset and the revenue) financed by restricted funds has the

effect of misrepresenting the resource flows in both the year of acquisition and the years of use; this shortcoming is not corrected by the requirement for a statement of cash flows, because the issue is one of resource flows more broadly defined than just cash flows.

- The criterion for exemption from the capitalization and amortization requirements is purely numerical instead of qualitative. There are many small organizations in which amortization is appropriate and many large organizations in which amortization is inappropriate. The criterion should be based on either:

1. The basis of reporting, wherein
   (a) output-based reporting (i.e., expense-basis reporting, as in traditional business enterprise expense reporting) would include capitalization and amortization; and
   (b) input-based reporting (i.e., expenditure-basis reporting, in accordance with the preference of funders or members to see "where the money went") would exclude amortization but can still include capitalization; or
2. The nature of the goods and services provided by the organization, wherein
   (a) private goods and services (i.e., those consumed by individuals) would include capitalization and amortization; and
   (b) public or collective goods and services (i.e., those for the benefit of society and not consumable by individuals) would exclude amortization but can include capitalization.

Please note that I am not opposed to amortization of capital assets per se; I am opposed to a blanket prescription for its use when the results are meaningless (as for public goods) or when it runs directly counter to the overall reporting requirements imposed on the organization by its financial supporters.

Nomenclature

I am perplexed by the change in terminology from Non-Profit Organizations (currently used in the CICA *Handbook*) to Not-For-Profit Organizations. In addition to being a much more cumbersome label, the change seems to reflect an assumption that accountants and financial statement readers are so naive as to believe that the label "non-profit organization" might include business enterprises that are operating at a loss. If the AcSB really thinks that accountants and users are that naive, then there is hardly any point to setting accounting standards at all. Do such people then think that an asset is a small donkey?

Non-Profit Organization is a label that has been used for at least a century and has caused no great confusion. The mere fact that the FASB has embraced the more cumbersome title is not reason enough to change; nor are the bad jokes circulated by business people who are unable to earn a profit.

Accountants value continuity and consistency. Let us please reject this ill-advised literalism and continue using the simpler, time-honoured and perfectly descriptive title of Non-Profit Organizations.

FOOTNOTE

1. Beechy and Zimmerman. "Putting the Cart Before the Horse", (1992), 11 *Philanthrop.*, No. 3, p. 33.