

Accounting for Non-profit Organizations — as it is now and may be in the future — The Director's Concerns

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Information to make decisions on substantive issues

Matching needs with resources requires information on the gathering of resources, how they are put to use and the results achieved. With information we can harness our vision and our resources to produce the greatest benefit. Forecasting, gathering, recording, communicating and evaluating this information is what accounting is all about. Accounting for charities, in principle, will be little different in the 80's than it was in the parable of the talents. In detail it will not be as clear and simple.

Therefore, a director must be concerned about the accounting followed by his or her non-profit organization. The board of directors must manage the organization by:

- setting goals
- appointing top officers
- assessing performance
- taking action based on assessment.

Adequate, timely information makes this management more effective. Good directors are knowledgeable directors. The quality of information a director gets will be reflected in the decisions made on the substantive issues affecting the long-term well being of the organization. A director must understand the policy issues and ensure there is a board structure with the capacity to cope.

Directors have an obligation to intelligently monitor the financial status and progress of their organization and its programs. Each program action taken is related to finances, and the availability of resources is the dominant factor in setting policies. In addition, the measurement, reporting and interpreting of results is a prerequisite for others supplying resources for future programs.

Need for one basic framework of accounting

The highlights of the Research Study just published by the Canadian Institute of Chartered Accountants (CICA), "Financial Reporting for Non-Profit Organizations", are on the one page summary that has been handed out. The Study is an effort to pull together accounting as it is and to recommend how it should develop in the future.

Currently the CICA Handbook specifically excludes non-profit organizations from the accounting and auditing sections. Nevertheless, what is generally accepted in Canada has been evolving rapidly over the past 15 years, with CICA

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and Canadian Welfare Council Reports, as well as material by specific interest groups on accounting principles - notably the Canadian Hospital Accounting Manual and the Guide to Accounting Principles Practices and Standards of Disclosure for Colleges and Universities of Ontario.

Recognizing a need in Canada to start pulling the many threads together, in 1976 the CICA established the research study group on accounting for non-profit organizations. This was the first step in the process of establishing generally accepted accounting principles for non-profit organizations that will be recognized as such in the CICA Handbook. It is believed if the CICA does not develop meaningful accounting principles for all non-profit organizations in the near future, government will fill the gap with rules.

The CICA recruited members for the study group who were representative of many facets of the non-profit world, to ensure a multi-dimensional approach to the problems. We believe the broad representation has resulted in bringing out for consideration the major issues.

Our basic research assumption was that we were dealing with the annual financial statements most organizations publish currently to summarize the past year's financial transactions for those interested in the organization. It is these reports federal and provincial laws, and for businesses the CICA Handbook, consider to be of prime importance. They are, of course, only the top of the pyramid of inter-related monthly and special reports many organizations prepare.

Following a year and a half of research, in 1978 the study group published a discussion draft "Accounting for Non-Profit Organizations", 218 pages long. We sent out over 850 copies, received more than 50 written responses, and members of the study group met with interested groups in Canada, the U.S. and Europe, corresponded with individuals in a number of countries, appeared on panels and wrote articles.

We received many useful comments and I believe they have helped to produce substantial improvements in the contents of the Research Study.

Now that the study is published, the next step is that the Accounting and Auditing Research Committees of the CICA should propose amendments to the Handbook. We think it is realistic, but we may be overly optimistic, to hope such amendments will be in place in two years: for years commencing after January, 1983. If this occurs, then the regulations to the proposed Canada Non-Profit Corporations Act (and provincial acts that are sure to follow) could refer to the CICA Handbook for accounting principles as is done in the regulations to the Canada Business Corporations Act.

There have been developments in the U.S. and the U.K. in recent years as well, and these are outlined in the study. The Canadian proposals in a number of ways are in advance of current U.S. and U.K. proposals.

The study group concluded that in Canada there should be one basic framework for accounting in which:

- financial statement formats should be flexible
- similar items should follow similar accounting principles, and
- there should be *more* disclosure to those directly and indirectly interested of meaningful financial information

While the final Research Study is similar in size to the “Discussion Draft”, about 200 pages, this has been at the expense of dealing briefly with many conceptual and practical issues in order to produce a document that can be read fairly widely. We tell the reader who wishes to read more discussion about the sources we found useful in our deliberations.

Business organizations’ principles

We concluded there was some ambiguity and misunderstanding in current financial reports, and that generally the users would find non-profit organizations’ financial statements most useful if they followed the accounting principles of business organizations, which they are familiar with, except where because of the nature of non-profit organizations using these principles would be misleading. Some, while applauding the move to make explicit generally accepted accounting principles, seriously question this conclusion.

In particular we concluded accrual accounting should be followed and commitments should be shown as appropriations, not as expenses.

We are not pushing for cookbook accounting. Rather, our stress is on the idea that truly alike transactions should be accounted for in the same way by all organization. Development of a single set of accounting principles will not decrease the need for individual manuals for each of the various types of non-profit organizations; instead, it will increase the need.

Functional reporting of revenues and expenses

We believe most organizations should report revenues and expenses on a functional basis - that is by program, in a manner parallel to the new CICA Handbook requirements on segment accounting. In saying this we are *not* suggesting reporting by type of expense should be dropped - in fact we like a matrix format that shows expenses by type one way and by program the other. In our view where fund raising is significant, fund raising costs should be shown as a separate functional category. We recognize fund raising costs in particular are difficult to compare among organizations - for example, agencies supported by the United Way may not appear to have any fund raising costs.

Combined statements

When the non-profit organizations are related, in many circumstances it is desirable for them to issue combined financial statements. Certainly if resources may be easily switched between organizations, it is critical that the financial statement user understand this and have some details.

Condensed statements

Now while what we are dealing with in the Research Study is annual financial information for the user with a fair degree of interest, in numbers of people the majority we believe want a very brief financial report in simple terms. They wish to know total revenues, costs and what is happening to funds available - are they increasing, decreasing, completely earmarked - or in fact non-existent. For this reader, we believe it is important that condensed statements be produced. Other readers in our experience also find the statements a good overview or framework for assisting in comprehending more detailed financial statements. All readers should have the option of seeing more detailed statements.

Depreciation

The touchiest issue seems to be that of depreciation - some believe the cost of assets with a life of many years should not be considered as an annual operating cost because it does not affect the cash flow each year. Others believe that if the annual accounts do not reflect the using up of long-term assets, the true annual costs are understated, comparisons with others are difficult, and eventually the organization is unprepared for the renewal of the asset. Business accounting says depreciation - the cost of using up a long-term asset - is an annual expense. Many organizations, particularly those that get their buildings as a gift or from a special fund raising, will show an operating loss each year if they depreciate - not a true loss they argue as the buildings are not related to their annual income or costs - when they fall down they will be replaced by a special fund raising, or the organization may even merge with a similar one or cease entirely - meanwhile they will endeavour only to balance annual revenue and out-of-pocket costs.

The majority of the study group believe depreciation accounting should not be compulsory in all circumstances. However, if it is not followed the onus is on the organization to clearly discuss its fixed assets, explain its accounting and set out the objectives of its reporting.

Non-financial information

We believe organizations are far more than can be seen from their bare financial numbers - important as they may be in indicating problems and funds available to meet opportunities. For this reason, we believe substantial amounts of non-financial information should be reported with the annual financial statements, as part of the accountability process; although not to the point where the cost of preparation exceeds the value to the users. Non-profit organizations exist to accomplish both intangible and tangible objectives. It is important to those interested in the organization, particularly directors, as part of the accounting for a stewardship and as part of the financial projections, that they receive details of accomplishment, failure and of what is hoped for and planned for in the future. The audit side of this is a movement towards what is termed "comprehensive" or "value for money" auditing. Operational audits stressing economy, efficiency and effectiveness, with reports thereon. These are reporting directions we believe should be pursued, that in the long run will be mandatory for most organizations, but in the short run should remain in the desirable and experimental stage.

Budgets

We believe organizations should publish their financial plans and budgets, but until the CICA Handbook requires forecast reporting for businesses, we believe this should not be mandatory for non-profit organizations.

Immediate Handbook changes

So far as immediate changes to the Handbook are concerned, we believe they should not put greater requirements on non-profit organizations than are required of profit making organizations. Thus, we see functional or program accounting as being similar to segmented reporting and reasonable to expect from many non-profit organizations. On the other hand, budgets and supplementary data, while desirable should not be required in annual financial statements until the profit sector ordinarily produces and publishes forecasts and extensive non-financial reports.

Materiality

The two prime factors affecting the scope of any audit are risk and materiality. On the audit side of our study, we struggled with materiality in the situation of little apparent risk. We believe if expenditures are less than \$50,000, 2% at most should be considered material; if over \$100,000, 1% is material; with ½ of 1% material over \$1,000,000. While we do not believe you can avoid considering quantitative levels of materiality, we recognize the qualitative aspects are even more important and often dictate a lower threshold.

Donations

One of the auditor's objectives in examination of the financial statements is obtaining satisfaction that the amounts reported as donations are properly stated. The voluntary nature of sources of support, and geographic dispersion of the sources and means of solicitation, create internal control, accounting and auditing problems not usually found in other kinds of organization. There cannot be complete assurance all donations are received by the organization; however, controls can usually be established to provide reasonable satisfaction that donations are not materially misstated.

We concluded the auditor should consider whether the internal control procedures relating to donations are appropriate in the circumstances and are operating effectively. His objective should be to satisfy himself the organization has taken all practicable steps to ensure all donations intended for it have been received and recorded. If he can be satisfied in this regard, he should be able, if other circumstances permit, to give an unqualified opinion on the financial statements taken as a whole. Only if he cannot be so satisfied, should he give a qualified opinion or disclaim an opinion on the financial statements.

Value for money audit

In the non-profit area the various incentives for better performance, such as profitability reported to shareholders and others, a competitive environment, and the searching reviews carried out by investment analysts are absent and as a consequence the study states it would be appropriate to extend the audit of such enterprises, experimentally and gradually, to encompass the economy, efficiency and effectiveness of the enterprise's operations (the "comprehensive" or "value for money" audit). Such is the nature of the audit now required for federal and some provincial bodies.

Directors' concerns

So accountants are refining their procedures. While they are polishing their mumbo-jumbo, what should a director watch for in what accountants produce so he can recognize substantive issues and ensure he is seeing them in the right light?

- Are all liabilities and revenues accrued? Watching cash flow only can lead to nasty surprises.
- Are commitments recognized? If not, programs may grind to a halt.
- What are the costs by program? If you do not have an idea, you cannot allocate scarce resources properly.
- Are there resources available from, or obligations to, related operations? If there is a related foundation able to fund programs, a director must know about details of this.
- Does the general supporter understand the financial picture? If not,

should condensed statements be produced. Supporters and critics must be well informed of progress or lack thereof if a director is to be able to encourage support and minimize recriminations.

- How are buildings, equipment and land reported? For an organization with substantial capital assets, such as a hospital, an understanding of these assets - their capacity, value, deferred maintenance, useful life and need for replacement is critical. If a director only hears of original cost, or even depreciation based on original cost, he or she cannot appreciate a key factor in the maintenance of the organization. Rather than address program and people costs, it is far easier to balance the budget by allowing equipment and buildings to become obsolete and by deferring maintenance. Ultimately severe accidents may occur. In some cases the organization ceases when finally the capital assets cannot function in the environment, and the massive resources needed for renewal cannot be found in a short period of time.
- Non-profit organizations provide human services - is relevant non-financial information being provided and evaluated?
- Are budgets prepared?
- Is there long range planning, say 3 to 5 years out? Without planning, both strategic and operational, the directors will eventually fail to anticipate the changes occurring in and outside the organization and catastrophe is likely.
- Is there an audit - and an audit committee of the board that hears in some detail from the auditor on internal control and any unresolved issues with management?
- Is there adequate information presented on fund raising: costs, procedures, reporting to tax authorities, the issuing of donation receipts, tax status as a registered charity? Failure to control this area can lead to the drying up of support and the revoking of the charter.
- Are salaries, pensions and benefits understood and controlled? Inadequacies can cause employee discontent and suffering, unfunded pensions can cause bankruptcy.
- And finally, is the organization insured adequately? If not, when disaster strikes, as it so often does, the directors will have failed to provide the resources for continuing the program.

Being a director can be gratifying, satisfying and fun. However, you need to get the important information regularly. We hope the CICA Research Study will encourage the production of such information and thus assist directors and supporters of non-profit organizations in improving the quality of the life we share together.

Summary

- The objective of financial information is to provide the users of general purpose financial statements with information to make decisions.
- Annual financial reporting by non-profit organizations is hampered by the absence of generally accepted reporting standards.
- Most of the Recommendations in the CICA Handbook can be applied readily to non-profit organizations.
- There should be one basic framework of accounting at a general level, with scope for a variety of information depending on the type of organization. Similar items

should follow similar accounting principles for all enterprises.

- Information provided to users should be worth its cost. Therefore, excessive detail should be avoided.
- Non-profit organizations should use the accrual basis of accounting. Commitments should be shown as appropriations, not liabilities and expenses.
- Most non-profit organizations should report revenues and expenses on a functional basis.
- Fund accounting may be appropriate in some circumstances but it is not essential, although significant restrictions on a non-profit organization's resources should be disclosed.
- When non-profit organizations are related, in many circumstances it is desirable for them to issue combined financial statements.
- Condensed financial statements are helpful to those users who desire a brief overview rather than the full set of financial statements.
- Accounting for fixed assets and depreciation are among the most contentious issues in financial reporting for non-profit organizations. The majority of the members of the Study Group believe that depreciation has significance where fixed assets are purchased (or related debt repaid) from operating funds, but has less significance and even could be misleading, where fixed assets are purchased from special fund-raising or grants. Information on capacity, useful life, and need for repairs and replacements is desirable.
- The reporting of important non-financial information together with the annual financial statements is encouraged.
- It is desirable for non-profit organizations to include current and future budget information in annual reports.
- The CICA Handbook can generally be used by the auditor in preparing his report. His report currently should refer to the accounting principles described in the notes rather than to generally accepted accounting principles. In principle, the audit of a non-profit organization does not differ from that of a profit-oriented enterprise and generally accepted auditing standards should be followed.
- For non-profit organizations, auditing materiality should be based on total expenses and quantitative guidelines are suggested based on a sliding scale: $\frac{1}{2}\%$ above \$1,000,000, 2% below \$50,000. The qualitative aspects of materiality can be even more important than the quantitative.
- A broad interpretation of the scope of an audit is developing under which the auditor undertakes the task of determining whether an organization has received value for money expended, i.e., audits stressing economy, efficiency and effectiveness. At present techniques are in the experimental stage, but this expansion of reporting is desirable.

