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Financial Accountability for Developmental Service Organizations

MODULE 2-GAAP AND THE AUDITED FINANCIAL STATEMENTS

Overview of Module 2

- GAAP stands for Generally Accepted Accounting Principles. Many of these principles have been assembled into handbooks and other publications by the Accounting Standards Board (Canada).
- CPA Handbook Canada-Accounting includes four sections which became effective in 2010 and 2011. A fifth section was developed to show standards for transitions to the new rules. The CPA handbooks are "primary sources" for GAAP.
- GAAP is used as the basis for audited financial statements, and in many cases MCSS Reconciliation Policies differ significantly from GAAP

Overview of Module 2

- This module will discuss what GAAP is, highlight some of the special rules for NPO's, and discuss the variations from MCSS policies. It will also deal with why most agencies prepare statements in accordance with GAAP in addition to their MCSS reporting schedules.
- Because of the huge amount of information embodied in GAAP, we caution that this module can only be used to obtain a very basic understanding of what GAAP entails. Many professional development courses are available to obtain a greater understanding of GAAP.

Table of Contents

What is GAAP for Developmental Service Organizations?

Not for profit organizations must choose to adhere to the standards of either CPA Canada Handbook-Accounting Part I or CPA Canada Handbook –Accounting Part III:

- Part I- IFRS (International Financial Reporting Standards). While any NPO is allowed to choose IFRS, there are no special rules dealing with the unique circumstances of NPOs. IFRS were developed to deal with the global business economy, particularly publicly traded corporations. Because of the special complexities in IFRS, it is likely that only large global NPO's would choose this option.

- Part III-ASNPO (Accounting Standards for Not-for-Profit Organizations). Most, if not all, developmental service agencies will have adopted these standards, so this module will assume adoption of ASNPO.

What is GAAP for Developmental Service Organizations?

The other two parts of the handbook which may need to be complied with by developmental service agencies are:

- Part II –ASPE (Accounting Standards for Private Enterprises) . In addition to Part III-accounting (Standards for Not-for-Profit Organizations), NPOs must follow all of the rules in Part II for topics not covered in Part III.

- Part IV-ASPP (Accounting Standards for Pension Plans). This handbook is not dealt with in this module because it will not apply to all developmental service agencies.

Please Note: Ontario developmental service agencies are required to follow the CPA Canada- Accounting Handbook, and not the CPA Public Sector Accounting Handbook.

What is GAAP for Developmental Service Organizations?

Each agency's auditor should be a significant resource in interpreting this very complex array of rules. In addition, professional development courses through the CPA Ontario or other private professional development providers are recommended.

You can access the Handbooks online at www.knotia.ca under the "CPA Canada Standards and Guidance Collection"

Why Bother with Audited Financial Statements?

- MCSS requires auditor-prepared financial statements to be submitted with the TPAR
- Banks and financial institutions generally require auditor-prepared financial statements (or at the least accountant reviewed statements) before providing loans
- Most other funders, including municipalities, other government agencies, and large donors, require auditor-prepared financial statements
- MCSS reports only include results of operations, and many users gain valuable information from the other statements and notes included in audited financial statements.

The Users of Financial Statements and What they Might Look For

1. Banks and financial institutions
2. Donors and Other Funders (both existing and potential)
3. Members
4. All Users (including Ministry, Canada Revenue Agency)

The Users of Financial Statements and What they Might Look For

1. Banks and financial institutions
   - Ability to service existing and new debt
   - Liquidity/working capital- whether the agency's working capital is adequate to continue operations
   - Account representatives typically have a series of standard ratios and other parameters which they expect to be met or otherwise justified to the bank's risk department
   - Will pay particular attention to disclosures in the Notes to the Financial Statements

The Users of Financial Statements and What they Might Look For

2. Donors and Other Funders (both existing and potential)
   - Evidence of good stewardship of assets by the agency's board
   - Ability to continue as a going concern
   - Evidence or assurance that their contribution has been or will be used for the purpose intended, consistent with their own mandate
   - Are often critical of excessive administrative costs, while at the same time expecting proper administration of the organization

The Users of Financial Statements and What they Might Look For

3. Members
   - Evidence of good stewardship by the agency's board, consistent with the charity's mission
   - Evidence that the agency's charitable corporate objects are met

The Users of Financial Statements and What they Might Look For

4. All Users (including Ministry, Canada Revenue Agency)
    - A clean audit report (or acceptable qualification)
    - Underlying assumption that the financial statements are fairly presented

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CPA Canada Handbook Part III-Accounting Standards for Not-for-Profit Organizations

Section 1001- Financial statement concepts for NPOs

Section 1101-Generally accepted accounting principles for NPOs

Section 1401-General standards of financial presentation for NPOs

Section 1501-First time adoption of rules

Section 3032-Inventories held by NPOs

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Section 3463-Reporting employee future benefits by NPOs

Section 4400-Financial statement presentation by NPOs

Section 4410-Contributions-revenue recognition

Section 4420-Contributions receivable

Section 4431-Tangible capital assets held by NPOs

Section 4432-Intangible assets held by NPOs

Section 4432-Intangible assets held by NPOs

Section 4440-Collections held by NPOs

Section 4450-Reporting controlled and related entities for NPOs

Section 4460-Disclosure of related party transactions for NPOs

Section 4470-Disclosure of allocated expenses by NPOs

Section 1001-Financial Statement Concepts for NPOs

- Explains the characteristics of assets, liabilities, net assets, revenues, expenses, gains and losses
- Explains the criteria for recognition (amounts actually booked) as opposed to disclosure (a description in the notes to the financial statements)
- Explains that because it is not possible to satisfy all users, the objective of NPO financial statements focuses on the needs of members, contributors and creditors
- Includes a discussion of the concept of materiality

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Section 1101-Generally Accepted Accounting Principles for NPOs

- This section identifies Part III as the primary source of GAAP for ASPNOs, and Part II as the primary source for topics not covered in Part III.
- It requires that entities apply "every primary source" of GAAP in accounting and reporting of financial statements.
- When GAAP does not deal with an issue, the entity must use policies or disclosures "consistent" with the primary sources of GAAP, developed through the "exercise of professional judgement" and applications of the concepts described in Section 1001..
- **"Management is required to be knowledgeable about the primary sources of GAAP",** including changes as "GAAP at a particular time changes and adapts to reflect economic or social conditions."

Section 1401-General Standards of Financial Presentation for NPOs

- Defines "fair presentation in accordance with GAAP" by applying the principles in Section 1101, ensuring that sufficient information is presented about the financial position, results of operations and cash flows, with consideration to its size and nature, and necessary disclosures, and providing it in a clear and understandable manner
- Requires the use of professional judgement in all of the statements
- Requires that management assess the entity's ability to continue as a going concern. Management must take into account all available information about the future (at a minimum, 12 months from the date of the statement must be considered).
- Financial statements, including notes and schedules must include all information required for fair presentation in accordance with GAAP
- Material uncertainties relating to an organization's ability to continue as a going concern must be disclosed. If financial statements are not prepared on a going concern basis, that and the reason it is not regarded as a going concern must be disclosed

Section 4400-Financial Statement Presentation for NPOs

- Financial statements will normally include a Statement of Financial Position (or Balance Sheet), a Statement of Operations, a Statement of Changes in Net Assets, and a Statement of Cash Flows.
- The section provides definitions for **fund accounting**, the **restricted fund method** and the **deferral method.**
- NPOs must follow either the deferral method or restricted fund method to account for its contributions.
- Funds are self-balancing sets of accounts established by legal, contractual or voluntary actions of the organization, and as such can be internally or externally restricted.
- The funds require an accounting, but not necessarily a physical, segregation of its resources.

Section 4400-Financial Statement Presentation for NPOs

- The intent of proper use of these methods is to ensure that funds donated or granted (contributions) for specific purposes, are used for the purpose intended, and not "mixed" with general operating funds unless the purpose was fulfilled in the same year as the contributions were made.
- The "Net Assets" (or accumulated surplus) for each fund is shown separately in the financial statements. This concept ties in closely with Section 4410-Contributions.
- The method selected must be used consistently from year to year.
- The developmental service organizations polled by the DSFG have reported using the deferral method AND /OR the restricted fund method- the choice allowed has resulted in differences in the various financial statements within the sector.

Section 4410 - Contributions-Revenue Recognition

- Different reporting principles apply to restricted vs. unrestricted contributions (donations or grants)
- Externally imposed restrictions may be specified at the time of the contribution by the donor, or may be clear from the purpose for which the contribution was solicited.
- Restrictions might apply to a time period (ie. when a monthly funder flows the funds for a given month in the month prior)
- Restrictions may also require a specific use for the funds

Section 4410 - Contributions-Revenue Recognition

- MCSS funding is always restricted – either for specific programs and/or purposes within the annual Service Contract, or for one-time capital or other projects which may span one or more years.
- Restricted funds may have to be returned to the funder if not used for the purpose intended, unless the contributor gives permission for another use.
- When an organization receives contributed materials or services, it may choose to recognize the value in its reporting, but only when a fair value can be reasonably estimated, and when they were required for the organization's operations (and would otherwise have to be purchased).

Revenue Recognition- a few of the basic rules

Deferral Method

- Any unused restricted contributions for operations would be shown as a liability on the balance sheet as "deferred contributions". They would be taken into income as the expenditures for which they were given are made.
- In the deferral method, restricted contributions used for acquiring capital assets are shown on the balance sheet as deferred contributions as well, and amortized- the basis for recognizing the amortized income should be on the same basis as that used for depreciation of the assets acquired. If the assets will not be amortized, the contribution should be shown as a direct increase in net assets.
- Unrestricted contributions should be recognized as revenue in the period received.
- Changes in the nature and amounts of deferred contributions should be disclosed.

Revenue Recognition- a few of the basic rules

Restricted Fund Method

- The restricted fund method allows the use of a single general fund, and one or more restricted funds. Receipts and expenditures subject to the restrictions are reported in the period received or spent, within the fund. The deferral method should be used within the general fund for any restricted contributions not being reported in a separate restricted fund.

There are additional rules related to endowment funds, interest on restricted contributions, and contributions received to be used in financing debt- and the rules vary depending on whether the deferred contribution or restricted fund method is being used.

Section 4431 -Tangible Capital Assets Held by NPOs

- Tangible capital assets (commonly called fixed assets) include land, buildings, equipment and vehicles.
- Should be recorded at cost (capitalized) on the Statement of Financial Position (balance sheet) and amortized over its useful life in an appropriate rational, systematic manner. Amortization is recognized as an expense in the Statement of Operations. Land is not normally amortized.
- Contributed tangible capital assets should be recorded at fair market value, and if that value cannot be determined, at a nominal amount.
- In practice, most agencies should have a "capitalization policy" which allows the expense of equipment purchases under a specified value.
- Small NPO's (Revenues less than $ 500,000) may decide not to capitalize these assets. The policy, information about the major categories not recorded on the statement of financial position, and the amount expensed in the current period must be disclosed.

Section 4450- Reporting Controlled and Related Entities by NPOs

- Includes definitions of control (continuing power to determine an entity's strategic, operating, investing and financing policies), joint control (contractually agreed sharing of continuing power to determine these policies), joint ventures (when an economic activity is jointly controlled by two parties),significant influence (ability to affect the those policies), and economic interest (one holds resources that must be used to produce revenue or provide services for the other; or one is responsible for the liabilities of the other)
- Reporting requirements include consolidation, proportionate consolidation and/or disclosures
- The complexities of this section are beyond the scope of this module, and agencies identifying any of the indicators above should investigate thoroughly what their reporting requirements might be.

Section 4470-Disclosure of Allocated Expenditures by NPOs

Establishes disclosure standards for NPO's that choose to classify expenditures by function. This would appear to apply to MCSS allocated administration, should an entity decide to report its expenditures by program instead of on a consolidated basis in its audited financial statements. Fairly extensive disclosure is required, including amounts, policies and basis of allocation.

Other Sections of CPA Canada Handbook Part III

Section 1501- First-time adoption by NPOs

- Not dealt with in this module as adoption was mandatory as of January 1, 2012

Section 3032- Inventories held by NPOs

- Describes the treatment of inventoried contributed materials and services

Section 3463- Reporting Future benefits by NPOs

- Not dealt with in this module as it applies to retirement benefits (essentially defined benefit pension plans)

Section 4420- Contributions receivable

- Recognition as income of pledges (generally not recognized until received) and bequests (not recognized until received)

Section 4432-Intanglible assets held by NPOs

- Intangible assets might include goodwill, technical knowledge or patents, customer portfolios- all of which are non-monetary but which might be separated or sold by an entity. Not dealt with in this module.

Section 4400-Collections held by NPOs

- Not dealt with in this module. Collections include works of art, historical treasures, or similar assets

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The Auditors Report

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purposes of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the ABC Agency as at March 31, 2017, and its financial performance and its cash flows for the year then ended in accordance with Canadian accounting standards for not-for—profit organizations.

Name of firm

Date

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Some comments on the Auditors Report

- This example is an unqualified audit opinion.
- Management, not the auditor, is responsible for fair presentation in accordance with GAAP for NPOs.
- Management, not the auditor, is responsible for developing and enforcing internal controls to prevent material misstatement from fraud or error.
- The NPO's board is the top level of management.
- The auditor gives an opinion on whether the statements are fair, not whether they are accurate, and only in material respects, and only in accordance with GAAP for NPOs.

Engagement Letter

- Before commencing the audit, the auditor will have requested the board to sign an engagement letter.
- The anticipated form and content of the audit report, and management's responsibilities in regard to presentation in accordance with GAAP and the establishment of internal controls, will have been made clear in the letter, and the board will acknowledge by signing that it understands the responsibility.
- The board must acknowledge and understand that it is their responsibility to provide unrestricted access to persons within the entity that the auditor will wish to talk to, access to all information of which management is aware that is relevant to the financial statement preparation, and additional information the auditor might request.

Representation Letter

- The auditor will require management (and those charged with governance) to sign a letter with details on the various representations of management that he or she relied on in forming the audit opinion.
- The auditors' responsibility to obtain written representations, from the board or those charged with government, as required by CPA Canada Handbook-Assurance (yes, another handbook!) are set out in the next two slides.
- This representation letter shifts virtually all of the responsibility onto management and those charged with governance, and away from the auditor should any of the representations prove to be false or misleading, whether intentional or not.

Canadian Auditing Standards requiring Written Representations as defined in the CPA Canada Handbook- Assurance. (Words in quotations are quoted directly from the identified section in the handbook)

Paragraph 240.39 regarding Fraud

"The auditor shall obtain written representations from management and, where appropriate those charged with governance that:

a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;
c) The have disclosed to the auditor their knowledge of fraud, or suspected fraud, affecting the entity involving:
    i) Management
    ii) Employees who have significant roles in internal control; or
    iii) Others where the fraud could have a material effect on the financial statements; and
d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or other."

Paragraph 250.16 A24 regarding Laws and Regulations

"The auditor shall request management and, where appropriate, those charged with governance, to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor."

Paragraph 450.14 regarding Evaluation of Identified Misstatements

"The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. Summary of such items shall be included in or attached to the written representation."

Paragraph 501.12 regarding Litigation and Claims

"The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework."

Paragraph 540.22 regarding Accounting Estimates

"The auditor should obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable."

Paragraph 550.26 regarding Related Parties

"Where applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that:

a) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework."

Paragraph 560.9 regarding Subsequent Events

"The auditor shall request management and, where appropriate, those charged with governance to provide a written representation in accordance with CAS 580 that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed."

Paragraph 570.16(e) regarding Going Concern

"If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include: e) Requesting written representations from management and, where appropriate, those charged with governance regarding their plans for future action and the feasibility of those plans."

The Management Letter

- Canadian Auditing Standards require an auditor to communicate appropriately to management and those charged with governance, any deficiencies in internal control that the auditor has identified during his or her audit.
- If no deficiencies are noted, commonly no "management letter" is issued.
- MCSS requires a "management letter" as part of the reporting process for housing projects, many auditors prepare a letter noting that no significant deficiencies were encountered. This letter never says that there "are no deficiencies", only that none were found.

How MCSS Reporting Rules Differ from GAAP

- The following table shows the most significant variations between MCSS Reconciliation Policies and Generally Accepted Accounting Principles
- An understanding of these differences is necessary to complete Section IV of the TPAR

MCSS vs. GAAP

Category	MCSS	GAAP
Vacation pay owing but not paid	Not an eligible expense	Report in statement of operations as an expense and on the statement of financial position as a liability
Equipment purchases	Report as expenditure under "IT Supplies and Equipment" "Supplies and Equipment related to Repairs and Maintenance" or "Other supplies and equipment"	If under the amount set in the entity's capitalization policy, report as expense in the statement of operations. Otherwise, report as an increase in tangible capital assets on the entity's statement of financial position

MCSS vs. GAAP

Category	MCSS	GAAP
Mortgage interest	Report as expenditure only if the Ministry has an interest in the property. Otherwise, it is not an eligible expenditure	Report as expense in the statement of operations
Mortgage principal	Report as expenditure only if the Ministry has an interest in the property. Otherwise, it is not an eligible expenditure	Not an expenditure on the statement of operations-report as a reduction of liability on statement of financial position
Vehicle loan payments	Report as an expenditure (travel)	Report interest as an expense in the statement of operations, and principal as a reduction of liability on the statement of financial position

MCSS vs. GAAP

Category	MCSS	GAAP
Renovations to buildings including roofs, driveways, etc.	Report as expenditure under "Supplies and maintenance related to repairs and maintenance"	May be capitalized or expensed depending on the entity's capitalization policy, and sometimes the nature and/or timing of the renovation.
Amortization of capital assets	Not an eligible expenditure unless under the Supported Housing Program, which requires amortization to equal mortgage principal paid (thus resulting in land being amortized)	Report as an expense in the statement of operations. Land is never amortized.

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MCSS vs. GAAP

Category	MCSS	GAAP
Grants received for capital expenditures	If funded through program funding, show as revenue	Show as revenue in the capital fund if using the restricted fund method where one of the funds is a capital fund. Otherwise show as deferred revenue on the statement of financial position, and report amortization of revenue in the statement of operations.
Unpaid pay equity adjustments	MCSS says this should never happen (See Module 1-Explanation of Service Description Schedule for Pay Equity)	Discuss with auditor whether the amount should be expensed in the statement of operations and reported as a liability on the balance sheet.