ACCOUNTING PRINCIPLES OVERVIEW

This chapter provides an overview of the principles that underlie financial statements and, in particular, items of interest to arts managers. (I will quote from the CPA Canada Handbook, 2019, to introduce the recommendations of CPA Canada as expressed in the professional language of accountancy.)

This material offers tools that will help you discuss your statements with your **auditor** and board **members**. It's probably worth saying that *you* are the expert at doing *your job*. Board members are community volunteers charged with the responsibility of overseeing the sound management of the company and the fulfillment of its **mandate** — but unless they have direct experience, they may not understand how to achieve effective financial reporting tailored to the not-for-profit[79] arts. Your auditor is an expert at accountancy and **generally accepted accounting principles (GAAP)** but may not bring expertise with arts organizations. As the professional manager, you can — and should — learn as much as you can from these important resources, while developing skills that will help you define the financial statement presentation that you believe will best serve your company. Don't accept advice uncritically!

> "He who loves practice without theory is like the sailor who boards a ship without a rudder and compass and never knows where he may cast."
>
> —Leonardo da Vinci, visual artist and inventor

KNOWLEDGE CHECK

Wait — shouldn't the expert be telling you what to do? Wouldn't challenging them be a bad idea?

This is a matter of opinion and personal comfort — and you are welcome to disagree with me! I have found that asking questions and even objecting (nicely) to something I thought I didn't like has been the springboard to a deeper and clearer understanding — and occasionally to better financial statements, when I spotted a reasonable change. Plus, I've learned that experts appreciate an engaged client. Take advantage of the added value that the auditor and your board members can bring to your management process.

Accounting does not operate by hard-and-fast rules, but rather by a set of concepts and principles that must be applied appropriately within each organization's context.

[79] There is a slight variation in the definitions of not-for-profit and nonprofit, but many people in the arts sector use the terms interchangeably. The use of not-for-profit throughout this chapter encompasses both terms.

KNOWLEDGE CHECK

Wouldn't it be more straightforward if accounting functioned according to a clear set of rules — no interpretation required?

Rules may sound more straightforward but would likely be impossible to create, since the accounting profession must address the reporting needs of an endless variety of organizations within an ever-changing landscape. Instead, the focus is on equipping practitioners with the information they need to apply sound judgment consistently in a variety of circumstances.

Rather than approaching the drafting of financial statements as a cut-and-dried task, it is more productive to think of it in light of resumé-writing. We can all evaluate truths, exaggerations and out-and-out falsehoods in peoples' resumés. Moreover, within the boundaries of the truth, we can evaluate who has done a better job of presenting themselves. Financial statement preparation is comparable. By applying accounting principles effectively, we can do a better job of presenting, fairly and accurately, the financial status of our organization.

Generally accepted accounting principles do not constitute a finite body of knowledge: what constitutes GAAP changes over time and includes the accounting recommendations in the *CPA Canada Handbook* and evolving accounting practice. GAAP was built up over time by research undertaken by the Canadian Institute of Chartered Accountants (CICA), now the **Chartered Professional Accountants Canada (CPA Canada)**, into how **accountants** in the working world were compiling financial statements. The first edition of the Handbook was issued in 1968. Prior to that, the Institute issued periodic bulletins on financial disclosure, principles and **procedure**s, terminology and other facets of good practice. In 1975, the Canada Business Corporations Act was revised to require financial statements and auditors' reports to be prepared in accordance with the recommendations published in the Handbook.

CPA Canada continues to research current accounting practice, consult broadly, and issue revisions and updates to address evolving needs under the title *CPA Canada Handbook*.

KNOWLEDGE CHECK

In what ways is this requirement for compliance a benefit to financial statement users, both internal (board, staff) and external (funders, **sponsors**, **donors**, etc.)?

Common standards provide a basis for applying judgment. They create a platform for communication, evaluation, practitioner training and more. A shared understanding of process supports discussion and analysis within organizations, and "apples to apples" comparison and assessment by external readers.

Since 1975, adherence to GAAP as captured in the Handbook has been a requirement of corporate law in Canada.

If you've been thinking that you'll just hire a good CPA and let them worry about this stuff for you, think again: "Management is required to be knowledgeable about the primary sources of GAAP. As well, management is required to be aware of changes to the primary sources, because what constitutes GAAP at a particular time changes and adapts to reflect economic or social conditions."[80]

According to the Handbook, managers have a responsibility to understand financial statement preparation and to stay current with changes to the standards over time. Managers are expected to apply GAAP through setting appropriate accounting policies and in selecting appropriate disclosures for their financial statements.

(Parenthetically, my experience is that, as a practical matter, a good CPA will, indeed, provide advice and direction. However, you will get the best value from them if you acquire enough knowledge and skill to be able to respond to their questions and discuss accounting issues with a reasonable degree of comfort.)

PUBLIC SECTOR AND PRIVATE SECTOR NOT-FOR-PROFITS

CPA Canada recognizes distinctions amongst commercial business, the not-for-profit sector, and the government sector and, through multiple publications, including the Handbook, provides recommendations for best practices in all three.

Think carefully about responsibility for financial statements. Hiring a CPA as controller is one route. Small organizations are usually helmed by generalists — but they are just as much on the hook for appropriate reporting.

Since 2012, when Canada aligned itself to International Financial Reporting Standards (IFRS), significant changes have been adopted. Private enterprise standards were revised to give businesses the choice between preparing financial statements according to IFRS, or to newly developed accounting principles for private enterprise. The IFRS initiative was essential for international trade, not so much for organizations working in a local market. Although geared to commerce, the process of harmonizing Canada's GAAP with that of other nations caused a ripple effect that changed aspects of reporting for the not-for-profit sector.

Canadian not-for-profits are now subdivided into two groups: private sector and public sector. Most not-for-profits in the arts belong to the private sector: that is, they are independent **corporations**, as described in Chapter 1. The hallmark of public

[80] Chartered Professional Accountants Canada, *CPA Canada Handbook – Accounting*, Part III, Section 1101.05.

sector not-for-profits is that they are government-controlled. That is, like private not-for-profits, they are separate entities that have the power to contract in their own name (e.g., hire **employees**, sign **leases**) and to sue or be sued. They are organized and operated for not-for-profit purposes, and they have counterparts in the private sector (indicating that their function is not exclusive to government). However, they are subject to government control. For example, the government has the power to govern the financial and operating policies of a public not-for-profit, and the government may gain benefits or risk losses arising from the not-for-profit's activities.

You might think that private and public not-for-profits would be easy to tell apart based on, for instance, their legal form of organization or obvious signs of control such as seats on the **board of directors** held by politicians. This isn't necessarily the case, though. It's important to recognize that governments carry out their objectives in all sorts of ways. At one end of the continuum, government control might be obvious, while at the other end, government may influence an organization without exerting control. Government may have the ability to control a certain entity without directly exercising its power. Managers and boards of directors are responsible for understanding the status of their organization. Auditors can assist with this definition and with ensuring that the organization is adhering to appropriate accounting standards.

Private sector not-for-profits can prepare their statements following the accounting standards for not-for-profit organizations (ASNPO), or they can follow IFRS. The vast majority of not-for-profits opted for ASNPO and experienced relatively little change. Public sector not-for-profits follow the Public Sector Accounting Standards, which contain provisions for not-for-profits.

KNOWLEDGE CHECK

Consider the following entities. Are they more likely to be private or public not-for-profits?

1. A municipal heritage organization receives over half its funding from the city, along with occasional **project grants** from other levels of government. It sells memberships and runs walking tours and other public programs that generate **earned revenue**. To secure its annual city grant, the organization must follow the municipal budget process, including submitting forecasts and year-to-date reports through the city's budget portal. Any operating losses are covered by the city. By the same token, any operating **surpluses** are owed to the city, but the practice has always been to allow the organization to keep its surpluses as a reserve.
2. A provincial museum is governed by a 21-person board of directors consisting of 15 provincial appointees, 3 ex officio directors, and 3 directors elected by the museum's membership. The museum is a registered **charity** and generates substantial revenues through fundraising, **sponsorship**, memberships and admissions. It also receives a **budget** appropriation from the provincial ministry of culture.

3. In the 1960s, a province passed legislation enabling it to take on management of a playhouse. The associated theatre company continues to run a home season and tours. It is the largest theatre organization in the province, with a mandate that includes celebrating and supporting local artists. Twenty years ago, the municipality purchased the building from the province, and the theatre company became formally incorporated with a board of governors drawn entirely from the community. The company is supported by all three levels of government through regular granting programs, as well as by ticket sales and donations.

Each of these micro-cases supplies a few details — enough to ask you to think but, of course, insufficient to make a professional determination. The municipal heritage organization is embedded in the city's financial systems. Very likely a public not-for-profit. The provincial museum's directors are mostly government appointees, and the ministry of culture sets its budget allocation; again, very likely a public not-for-profit. In the third scenario, there are no overt signs that the theatre organization is under government control, but, given the history with the province and the current landlord-tenant relationship with the municipality, more exploration would be needed to evaluate the scope of government influence or perhaps control.

Notwithstanding these distinctions, certain core elements of GAAP apply to every organization. Every accounting system in Canada, from the smallest to the largest, follows a coherent body of principles, applied appropriately and consistently to their sector and to their specific operations. In general, the bigger the company, the more complex the records-keeping system and the resulting financial statements need to be — but once you grasp the basics, you have a transportable skill set that can be applied in any workplace.

Accounting is an evolving body of knowledge and practice. We can expect the profession to continue its work on developing accounting standards to address a changing environment.

> What's mine is mine and what's yours is yours.
>
> —Old saying

THREE FUNDAMENTAL CONCEPTS

The concepts outlined below are not part of the current *CPA Canada Handbook*; rather, I have drawn them from past editions, as they continue to provide valuable insight into the thinking that underlies accounting principles and so are worth a look.

BUSINESS ENTITY CONCEPT

The affairs of a company are distinct from the affairs of its owners. This applies most directly to sole proprietors and partners. Although there is no legal distinction between these organizations and their owners (see Chapter 1), there is a practical distinction where the financial statements are concerned. The records of the company's activity must be kept separate and distinct from the owner's personal records.

In the case of not-for-profit and **charitable organizations**, there is no ownership, rather a corporate structure intended to support community trusteeship and accountability.[81] Nonetheless, this concept may apply in our sector, perhaps most commonly in small, founder-driven companies, where the affairs of the founder(s)/leader(s) may overlap with those of the company. For example, especially where money is tight, it sometimes happens that individuals pay expenses directly out of their own pocket. These must be carefully tracked as loans to the company. When things loosen up, the individuals may be tempted to recoup the debt by having the company cover personal expenses in return. This is poor practice under the business entity concept: the company should reimburse the staff person and let them take care of their personal affairs.

It is essential to achieve clarity in the relationship between the company and the individuals involved, and, where "overlap" has occurred, to clearly delineate amongst loan **transactions**, **donations** and fees for service.

KNOWLEDGE CHECK

A small group of friends decided to form a community theatre **club**. The idea was — eventually — to pay production costs out of box office. To get started, though, they all had to contribute time, money and other resources (costume pieces, use of a car, space for meetings, etc.). Over time, it became clear that some were contributing more than others, and a discussion needed to be had about what was equitable.

If friend A donated set/prop/costume items and friend B only lent items, should friend A receive some greater form of acknowledgement? What about the gas and parking friend C paid for? Friend C was out-of-pocket for cash expenses, while friend A and friend B just pulled stuff from their closets. Discuss with reference to the business entity concept.

Volunteer situations can easily get murky. People may start off with enthusiasm and realize as they go along that they each have a different understanding of what they agreed to do. There can be strong feelings of ownership around founding a new organization — but, under the business entity concept, the individual(s) involved need to treat the organization as a separate entity with its own interests. Policies (e.g., on receiving donations and incurring expenses) can help to avoid friction. For instance, friend A could receive a charitable donation receipt for the value of in-kind gifts, and friend C could submit receipts to be reimbursed by the company. With those transactions clarified, perhaps the three would find it easier to compare their volunteer efforts.

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[81] Important reminder: board members, often referred to as trustees, hold the organization in trust in both commercial and not-for-profit settings. The difference lies in who benefits from that trust — owners versus the community at large.