CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

A Guide to Financial Statements of Not-for-Profit Organizations

QUESTIONS FOR DIRECTORS

SECOND EDITION

DIRECTORS' BRIEFING SERIES

A Guide to Financial Statements of Not-for-Profit Organizations

Questions for Directors

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Preface

The Corporate Oversight and Governance Board (COGB) of the Chartered Professional Accountants of Canada (CPA Canada) has developed this guide to help directors of not-for-profit organizations (NFPs) understand the financial statements of the organization they serve. Although boards may delegate the detailed aspects of financial oversight to a board committee, all directors have a personal responsibility for ensuring that they understand the financial information provided to them and the financial implications of their decisions and actions. Directors are expected to probe and question until they are satisfied with their organization's financial information and the direction in which the organization is moving. An understanding of financial statements is a prerequisite for effective oversight of the financial affairs of the organization.

Financial statements in the NFP sector can involve accounting methodologies not found in the for-profit sector. NFPs are very diverse and range from small all-volunteer groups to large highly sophisticated enterprises. Some, but not all, have charitable status. This document is directed to NFPs that are of a sufficient size to require a management team and engage the services of an external auditor.

The guide will assist NFP directors to understand:

- the role and responsibilities of the board, management and the auditor in financial reporting
- the concepts and terminology of financial reporting in the NFP sector
- the ways in which contributions (i.e., donations) to the organization can be accounted for
- the various financial statements they will encounter in their role as an NFP director

Directors of government-sponsored NFPs and NFPs that operate "social enterprises" may find this guide helpful; however, they face particular financial reporting issues that are not covered in this briefing.

Throughout the guide, there are sections entitled "Items for directors to watch for and questions to ask." These sections are intended to assist directors to undertake their governance oversight role in an effective manner. Directors are encouraged to frame additional questions in the particular circumstances they face.

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Table of Contents

Introduction 1

The Process of Financial Reporting 5

The Roles and Responsibilities Associated With Financial Reporting 7

Understanding Financial Statements 9

The Statement of Operations 11

The Statement of Financial Position 15

Items for Directors to Watch for and Questions to Ask 27

Conclusion 34

Appendix 1: Other Financial Concepts and Statements 36

Appendix 2: Fund Accounting 46

Appendix 3: Samples of the Auditor's Report Addressed to the Board of Directors — Unqualified and Qualified Opinions 58

Appendix 4: Contributed Materials and Services, Pledges, Bequests, Gifts of Life Insurance and Annuities 63

Appendix 5: Glossary of Financial Terms 65

Where to Find More Information 70

About the Author 71

Introduction

The Importance of the Sector and the Role of Directors in Oversight of Financial Affairs

It is estimated that 12.7 million Canadians volunteer with not-for profit organizations (NFPs). Many of these volunteers serve as members of their organization's board of directors.[1] NFP boards are responsible for overseeing the affairs of organizations that constitute about 8.5% percent of Canada's GDP, generate economic activity of approximately $169 billion and provide 2.4 million jobs for Canadians.[2] Being a director in the NFP sector is a vitally important role.

Board members in the NFP sector have a wide variety of skills and interests. Some may feel uncomfortable reviewing financial information and may be poorly equipped to provide the required oversight of the financial affairs of the organizations which they have been elected to govern. This gap presents a threat to the sustainability of the organization. It may also expose individual board members themselves to legal liability. The bottom line is that overseeing the financial affairs of NFPs is a key responsibility of the board, and of every member of the board.

Directors have a "fiduciary duty" to their not-for-profit organization to act honestly and in good faith in the best interests of the organization. This responsibility is sometimes referred to as the "duty of loyalty," but it is much broader than just loyalty. It speaks to concepts such as the duty of confidentiality and not participating in decisions in which the director may have a personal interest. Directors also have a "duty of care" that requires them to act with the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. This obligation means that directors must diligently apply their skill, expertise, education and intelligence to the job of being a director to make reasonable business decisions.

Directors have fiduciary responsibilities to take steps to ensure that funds are spent in accordance with donors' or funders' criteria, that statutory obligations are fulfilled, such as payroll deductions being remitted to the Canada Revenue Agency, and that internal

1 Statistics Canada (2013) *Survey of Giving, Volunteering and Participating*.

2 Statistics Canada (2017) *Satellite Account of Nonprofit Institutions and Volunteering*.

controls are in place to avoid the occurrence of fraudulent transactions within the organization. A proper understanding of the financial statements and information provided to the directors assists the directors in fulfilling these responsibilities.

A board can delegate the work to prepare financial information, but the board as a whole is ultimately responsible for financial reporting. Indeed, one of the fundamental roles of the board of directors is stewardship of the organization's resources. This duty includes the responsibility to protect the organization's assets and to oversee its financial affairs. Financial statements are the primary means of communicating information about the organization's financial position (at a point in time) and financial results of its operations (over a period of time).

Though financial information is not the only information required to develop an understanding of the organization, it is a key component. Financial information is typically measurable, objective, comparable over time, sometimes comparable across organizations, and can provide an indicator of organizational health. Board members require the ability to understand various financial statements in order to discharge their stewardship responsibility to the organization.

Each board member does not need to have financial expertise, or to be a financial expert, but all directors should develop a basic level of financial literacy. This guide for NFP Directors aims to provide a practical tool to help board members understand financial concepts and comprehend financial statements. Most importantly, this guide will help directors focus on certain elements in the financial statements and understand how they can use that information to critically assess and oversee their organization's financial affairs.

Some Common Barriers Impeding Full Board Participation in Financial Oversight

We have an experienced accountant on our board — why should I have to deal with this?

Financial experts such as accountants bring a valuable skill set to the board table, along with their field experience and their professional mindset. They are in a strong position to help their board peers deepen their understanding of financial matters. Organizations with a financial professional on the board are fortunate and should use that person as a resource. Further, that director should expect to play a key role in the oversight of financial affairs, perhaps by becoming a member of the audit or finance committee of the board. (In some NFP organizations, the functions of these two committees are combined into one board committee.) However, as noted above in the "duty of loyalty," board members cannot

abdicate their responsibility or transfer it to another board member. Each and every board member must fulfill their obligations for the oversight of financial matters to the best of their ability.

Shouldn't the board be focusing on our organization's mission?

The ultimate goal of every not-for-profit organization, and hence every organization's board, is the achievement of its mission. Consequently, a significant portion of the board's time and energy needs to be focused on the organization's mission and progress in achieving it. However, the organization must protect its assets, pay its bills, compensate its employees, receive and manage donations, and undertake a host of other financial activities. Doing so in an efficient and effective manner is critical to achieving its mission. An organization that is not financially secure cannot focus on achieving its mission, as efforts of the board and management are directed to financial survival.

Accounting is just too complex for me!

Accounting is indeed a complex subject. There are various financial concepts and accounting principles. However, all board members do not need to be accounting experts. Directors should strive to acquire a basic understanding of financial matters, and a basic ability to read, assess and question financial statements and other financial information. Turning to experts for assistance and advice is entirely appropriate, but making final decisions within the context of the organization's total financial picture is the responsibility of every member of the board.

Isn't this the job of the auditor[3] or of management?

The auditor and management both have important and distinct roles to play in ensuring fair and complete financial reporting for the organization. So does the board of directors. Management is responsible for selecting the organization's accounting policies and preparing, presenting and acting on financial information. The board is responsible for overseeing management and the processes for preparing financial information, and for satisfying itself that the resulting information reasonably reflects the organization's reality. The auditor, on the other hand, is responsible for providing an independent professional opinion on the fair presentation of the organization's financial position and its financial results. These three parties to financial reporting are inter- dependent: Each relies on the other, but each has its own role and responsibilities.

3 Depending on the legislation governing an NFP in the jurisdiction where it is incorporated, the organization may have options regarding the engagement of an auditor. These options are beyond the scope of this guide.

Outline of this Guide

This guide is designed to help directors of not-for-profit organizations to fulfill their fiduciary duties. Many NFPs have charitable status which brings additional reporting obligations and oversight duties for directors.

The guide outlines the process of financial reporting and the various roles and responsibilities within an NFP for financial reporting. It describes the concepts and terminology used in financial reporting, providing both definitions and examples. With that foundation in place, the guide describes two key financial reports that directors will encounter most frequently:

- statement of financial position (sometimes called the “balance sheet”)
- statement of operations (sometimes called the “statement of activities” or “income statement”)

This guide will use the terminology of statement of financial position and statement of operations; NFPs are free to use other designations. Appendix 1 and Appendix 2 provide descriptions and analysis of other financial concepts and statements that NFP directors may encounter, depending on the operations of their organization.

There is particular emphasis in the guide on questions directors might consider asking about various financial processes and statements that they will encounter in their oversight role.

The Process of Financial Reporting

Financial reporting must serve both the interests of internal users and the interests of external stakeholders.

Internal Financial Reporting

Internally, staff members of the organization are both creators and users of financial reports. Finance staff collect the appropriate data, manage the associated information systems and create financial reports. Managers responsible for financial integrity, risk, quality, program delivery and other key internal responsibilities use these reports in fulfilling their job responsibilities.

Certain financial reports are submitted to the board and/or board committees.

Financial reporting to the board of an NFP tends to follow a natural cycle:

- the budget for the coming year (prepared by management, usually influenced by, but not identical to, management's year-end estimates from the preceding year and other information)
- the audited financial statements for the previous year (issued usually in the first or second quarter of the next fiscal year, upon completion of the external auditor's work on the NFP's financial statements)
- internal in-year financial statements to report on actual results compared to the budget, often including projected results to year-end (prepared by management)

Directors can expect to review each of these types of financial reports at various points in time. The dates in the "calendar year" depend on the NFP's fiscal year-end. The fiscal year is the 12 month period used for calculating the figures in an annual financial statement. The fiscal year may not coincide with the calendar year. For those organizations with a December 31 year-end, directors can expect the following:

- budget review in the fall
- draft audited financial statements in the spring
- internal in-year financial reports at least every quarter (and in some organizations, every month or bi-monthly)

External Reporting to Stakeholders

Not-for-profit organizations have many stakeholders and each one has an interest in the financial affairs of the organization. All stakeholders have a common interest in areas such as:

- the protection of the assets entrusted to the organization
- the efficient and effective use of the organization's resources in furtherance of its purpose

Some stakeholders have quite specific interests. For example:

- Funders (e.g., governments or foundations) want assurances that their contributions to the organization have been used in accordance with the funding submission and subsequent approval.
- Donors (particularly major donors) want assurances that their contributions have been applied according to their wishes.
- Members have an interest in how their fees have been deployed and more generally in how the organization is performing.
- The Canada Revenue Agency (CRA) requires all NFPs to submit an annual filing that includes financial information.[4]

The organization, through its management, has a reporting duty to all of these stakeholders. Financial statements and other financial reports are communication tools that the organization uses to meet the information needs of its stakeholders.

Common information requirements are usually met through the issuance of general purpose audited annual financial statements, supported by the organization's annual report. These are good tools for communicating to a variety of audiences about the organization's financial affairs. However, they may not answer all the questions of certain stakeholders. Special purpose reports are used to supplement audited financial statements to answer these additional questions. For example, many funders require reporting about the use of "their" funds, in specific formats, as a condition of granting the funding to the organization.

4 An NFP that is not a registered charity and has assets over $200,000 or receives certain investment income over $10,000 must file Form T1044 annually. If an NFP is incorporated but not a registered charity, it must file a T2 Corporate Tax Return annually. Charitable NFPs file Form T3010 and do not file T2s or T1044s. Certain financial information submitted by charities is made available to the public on the CRA website.

The Roles and Responsibilities Associated With Financial Reporting

A Three-Way Arrangement

Responsibility for an organization's financial reporting is shared among three parties — management, the board and the external auditor — as follows:

- management, which is responsible for preparing financial reports
- the board, which is responsible for overseeing management and its financial reporting processes and satisfying itself as to the appropriateness of financial reports for those outside the organization
- the auditor, who is responsible for making an independent assessment of the financial statements, and giving a professional opinion on whether they give a fair presentation of the organization's financial position and results of operations[5]

Each party relies on the work of the other two in discharging its own responsibilities. Each one brings a unique perspective to the preparation of financial reports:

- Management has an intimate understanding of the organization's activities and plans; management also exercises judgment on how certain items are accounted for in the financial reports.
- The board offers a high-level, strategic view of the organization, coupled with due diligence duties with respect to internal policies, procedures and processes, and an accountability to external stakeholders.
- The auditor brings a different level of financial expertise that may not exist within the organization; more importantly, the auditor brings an outside, independent perspective on the organization's financial affairs

5 The auditor examines the general purpose financial statements of a not-for-profit organization prepared in accordance with generally accepted accounting principles (GAAP) as determined by the Accounting Standards Board (AcSB) and published in the *CPA Canada Handbook — Accounting*. Under GAAP, NFPs have the choice of applying International Financial Reporting Standards (IFRS® Standards) or Accounting Standards for Not-for-Profit Organizations (ASNPO). As most NFPs report using ASNPO, this guide is based on that accounting framework. Some NFPs are not required to engage the services of an auditor; nevertheless, this guide will still be helpful to directors of those organizations.

Management is responsible for preparing financial reports. The perspectives provided by the auditor and the board could not exist without management first preparing the reports for these two other parties to consider.

Management is also responsible for developing internal financial controls. Robust internal controls are essential to the integrity of financial reporting. The board has an obligation to pay close attention to the details of management's approach to internal controls and to satisfy itself that all appropriate areas have been covered to minimize the risk of financial mismanagement or fraud.

In the process of performing the independent external audit, the auditor will expect management to sign a "representation letter." This letter confirms, among other things, that the financial information provided to the auditor is, to the best knowledge of the signatories, complete and that there has been full disclosure of all material financial matters.

The Relationship Between the Board and the Auditor

A significant underpinning of external financial reporting is that the information be credible. Users must have a strong level of assurance that financial information is a fair presentation of the organization's affairs. The annual audited financial statements provide a key measure of accountability and control for not-for-profit organizations. The auditor, with a mandate to directly inspect the books and records of the organization, provides an important check on the presentation of financial information by management.

The choice of the auditor and the reporting relationship for the auditor are therefore key considerations. The board selects the auditor and recommends the appointment of the auditor for approval of the organization's members at the Annual General Meeting. Governance best practices for not-for-profit organizations dictate that the auditor reports directly to a committee of the board (in some organizations, directly to the board). The auditor is also expected as a matter of best practices to meet *in camera* (see Appendix 5) with the board committee (or the board as a whole), without management present.

Understanding Financial Statements

There are two key types of financial statements that directors will encounter most frequently, whether as part of the budgeting process, in-year monitoring of results or the review of the external auditor's formal financial statements. These are:

- *statement of operations* for a period of time
- *statement of financial position* at a point in time

Two other financial statements are included in the audited financial statements at year-end: *statement of changes in net assets* and *statement of cash flows*. These two statements are discussed in **Appendix 1**. The main body of this guide focuses on the two statements above that directors will review on a regular basis. When reviewing these statements, directors should pay special attention to the cash position of the organization, as healthy cash balances are key to long-term viability.

The Time Frame

The first thing to keep in mind is the difference between figures presented on the statement of operations, which are "cumulative sums over time," with those on the statement of financial position, which are "at a point in time."

- Financial figures calculated as *cumulative sums over time* show the total financial value of an activity during a fixed period of time, such as a full year or a quarter of a year, ending at the reporting date. For example, fees for service is the sum of all fees earned by the organization over the specified period. Another example is salaries and benefits paid in the period.
- Some financial figures are calculated at *a point in time*: in other words, as at a particular reporting date. For example, the accounts payable figure is the total dollar amount owed by the organization to suppliers at the specified date. Another example is the value of investments held by the organization at the specified reporting date.

There is a relationship between the two concepts. The "point in time" figures on the statement of financial position are the net result of all the transactions over time. As an example, the investment balance (a "point in time" figure) is the result of all transactions

that have cumulatively impacted the balance over time, which include gains, losses, dividends and interest. Each of the latter appear on the statement of operations (cumulative sums over time) in the period when they occur.

Accrual Accounting vs. Cash Accounting

An important consideration in measuring and recording revenues and expenses, as well as assets and liabilities, is when to record a transaction. Transactions need not involve cash. In these circumstances, the accounting question is when to record the event in the books of the organization (and thereby in the financial reports).

- *Accrual accounting* records transactions when they occur, regardless of when money actually changes hands between the organization and third parties. Examples are a fee-for-service delivered and invoiced but where payment has not yet been received by the NFP (this would be included in revenues and accounts receivable) or a purchase of office supplies using a credit card where payment has not yet been made (this would appear as an expenditure and account payable).
- *Cash accounting* records transactions only when there is an exchange of cash. Under this system, the sample transactions above would not be recorded until the fee-for-service was received (an increase in revenues) and until the NFP paid its credit card bill (an increase in expenditures).

Accrual accounting provides a more accurate record of financial activities because it records the economic substance of transactions, whether or not cash has been received or paid. Compliance with GAAP requires that NFPs use the accrual method.

The Statement of Operations

The primary purpose of a statement of operations is to communicate information about changes in the organization's economic resources and obligations for the period. It does this by providing a summary of the organization's revenues and expenditures over the period of time. It also shows the net balance between the two periods: in other words, the excess (or deficiency) of revenues over expenditures for the period.

Sample Statement of Operations

The following is an example of an *internal* statement of operations for a simple not-for-profit organization. We will review the statement to understand the information it is providing for decision-making. It is "internal" because it also includes the budget for the year, which is not usually included in the external financial statements. Internal financial statements are intended for board and management review.

NOT-FOR-PROFIT ORGANIZATION
STATEMENT OF OPERATIONS
For the 12 months ended December 31 A

	Budget	Current year	Prior year
Revenues			
Government Grants	8,700	8,700	8,150
Fees for Service	950	975	920
Investment Income	35	35	35
Interest and Other	12	10	15
Total Revenues **B**	*9,697*	*9,720*	*9,120*

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF OPERATIONS For the 12 months ended December 31 A	Budget	Current year	Prior year
Expenditures			
Salaries and Benefits	6,822	6,940	6,560
Rent and Building Occupancy	1,845	1,845	1,600
Office	450	490	440
Depreciation of Capital Assets G	24	24	30
Other	4	5	4
Total Expenditures B	9,145	9,304	8,634
Excess of Revenues Over Expenditures B	552	416	486

Using a "big picture first" approach, the reader of the statement of operations looks first at four key items: the time frame, total revenue, total expenditures and the excess or deficiency of revenue over expenditures.

A. What is the period over which these numbers have been accumulated? The answer shown in the statement's title (A) is that it is for the 12 months ended December 31. External financial statements are commonly presented for a 12-month fiscal period. However internal financial statements may show shorter periods, such as monthly or quarterly and so on, providing year-to-date information as the organization progresses to its 12-month fiscal year-end.

B. What are total revenues, expenditures and the excess or deficiency between them? In this case, looking at the column for the current year, observe (B) that total revenues of $9,720 exceeded total expenditures of $9,304 by $416. The reader can draw an initial big-picture conclusion that the organization had an acceptable year. Now, drill down to understand this further.

C. What are the major components of revenues and expenditures? Government grants are 90% (8,700/9,720) of total revenues. This organization is therefore critically dependent on government funding. Observe that as in many not-for-profit organizations, staffing

costs are by far the largest cost component, at about 75% (6,940/9,304) of total expenditures. The excess of revenues over expenditures is about 4% of total revenues (416/9,720). A low percentage of excess or deficiency is normal for an NFP.

D. Drill down further through comparisons. This sample statement allows comparisons with both the prior twelve months and the current twelve-month budget. In NFP's, because their objective is to maximize mission rather than profit, budgets are a particularly important benchmark for understanding how well the organization did financially.

E. Total revenues increased over last year by $600. As a percentage this is 9,720/9,120 = 6.6%. They also were higher than budget by $23. Looking at the items that add up to the total, note that the largest part of the increase is government grants, from $8,150 to $8,700. The organization budgeted for this increase. So, the unexpected component of the increase is fees for service, which are $25 higher than budget. The reader can conclude that this is the main reason total revenues are up over budget.

F. Total expenditures increased over last year by $670. As a percentage, this is 9,304/8,634 = 7.8%. They were also higher than budget by $159. Looking at the items that add up to the total, note that the largest part of the increase is salaries and benefits, increasing from $6,560 to $6,940. The expenditure is also significantly over budget by $118. Observe that office expenditures were up over last year's and over budget by $40. A director would expect explanation from management for these unplanned increases and discussion of whether the trend will continue.

G. The term "depreciation of capital assets" (**G**) bears special explanation. Depreciation (used interchangeably with the term "amortization") is the expensing of the cost of an asset spread out over its useful life. Capital assets are assets held for use on a continuing basis in the ordinary course of operations (see a full definition in the **Glossary**).

   For example, suppose the organization purchases a van for use in carrying out its operations, and it estimates that it will have a useful life of six years. The van is a capital asset. The portion of the original cost of the van that is expensed in each of the six years is its depreciation expense for the year, which is shown in the statement of operations. If the organization had purchased the van for cash, its depreciation expense for that first year would be considerably lower than the cash paid for its purchase. However, at the end of the six years the cumulative depreciation expense would equal the full cost of the van (net of any estimated value on disposition).

H. How much detail should be in the statement of operations?

   Based on the NFP's chart of accounts,[6] the statement of operations organizes revenues and expenditures in various categories, usually listed from largest dollar value to smallest.

6 A chart of accounts is a way of organizing the many hundreds — indeed likely thousands — of transactions an NFP engages in every year. See **Appendix 1** for more details.

Revenues are organized according to their type (e.g., grants, contributions, fees, sales, interest).

Expenditures are grouped together in meaningful categories and may be classified by object (e.g., salaries, rents, supplies), by function (e.g., program delivery, administration, fundraising) or by program (e.g., children's programs, youth programs, adult programs).

Management needs to develop an expenditure listing that is both short enough to digest (typically less than one page) and long enough to provide insight into the major types of revenues and expenditures. External financial statements will normally have less detail than internal statements. Materiality is a useful concept to apply in determining the amount of detail on external financial statements.

Note that when expenditures are organized by function or program, this means that expense objects, such as salaries and rent and amortization, have been allocated on a consistent basis to regroup them by function or program. GAAP requires that the basis for the allocation of fundraising and general support expenses be disclosed in the accounting policies and, where material, that a chart be provided in the notes to the financial statements showing these allocations. It is good governance for the directors to review the amount and basis for these allocations.

The Statement of Financial Position

The statement of financial position is a financial snapshot taken at a point in time. This statement is sometimes called the “balance sheet” because it shows that total assets equal (i.e., balance) the sum of liabilities and net assets.

How is it that the statement of financial position balances? The net assets (N) of an NFP are defined as its assets (A) minus its liabilities (L): A − L = N, which is known as the “balance sheet equation.” The statement of financial position shows this equation in a rearranged form: A = L + N. This proof of balance (“the books are balanced”) is important because it shows that what has been entered in the underlying accounts is complete. (However, it does not prove that everything that should have been entered has been.) An important extension of this balancing principle is that the excess or deficiency of revenues over expenditures for the period between two statements of financial position must be the same in the statement of operations as it is in the final statement of financial position. If it is not, then at least one of the statements is in error.

Sample Statement of Financial Position

The following is an example of a statement of financial position for the same not-for-profit organization at the December 31 current year-end, with comparison to the previous year-end. NFP directors can expect that their organization might use different terminology and additional categories, but the fundamental relationships within the statement of financial position will be the same as shown here.

NOT FOR PROFIT ORGANIZATION STATEMENT OF FINANCIAL POSITION as at December 31 of current year	Current year	Previous year
ASSETS		
Current Assets		
Cash and Cash Equivalents	2,370	2,005
Grants Receivable	100	65
Accounts Receivable	25	20
Prepaid Expenses	42	35
	2,537	2,125
Investments	500	500
Capital Assets (Property and Equipment)	1,126	1,150
Total Assets	4,163	3,775
LIABILITIES AND NET ASSETS		
Current Liabilities		
Bank Indebtedness	85	115
Accounts Payable	122	87
Government Remittances Payable	65	48
Current Portion of Mortgage Payable	75	75
	347	325

NOT FOR PROFIT ORGANIZATION STATEMENT OF FINANCIAL POSITION as at December 31 of current year	Current year	Previous year
Mortgage Payable	825	900
Other	65	40
	890	940
Net Assets	2,926	2,510
Total Liabilities and Net Assets	4,163	3,775

The statement of financial position organizes assets and liabilities based on how close each is to cash (liquidity). Consequently, in the assets section, current assets are shown first followed by assets not expected to become cash in the next twelve months — investments and capital assets. Similarly, in the liabilities section, current liabilities expected to be paid within twelve months are shown first, followed by longer-term items — in this case the balance of the mortgage payable.

Shown below liabilities is the result of subtracting the liabilities from assets, which is normally "net assets." If the result is negative, it is titled "net deficiency."

Using a "big picture first" approach, the reader of the statement of financial position looks first at four key items: the time frame, total assets, total liabilities and the net assets or deficiency.

A. What is the point in time of the statement? The answer in the title (A) is that it is prepared as at December 31 with the first column showing the current year and, for comparison, the second column showing the balances as they were twelve months prior.

B. What are the total assets, liabilities and their net? The assets are $4,163, the liabilities are $347 plus $890 = $1,237. When the liabilities are subtracted from the assets, the result is net assets of $2,926. It is essential to understand that the net asset balance is not another type of asset. It is simply the arithmetical result of subtracting the liabilities from the assets. That said, it is a very important figure. A large net asset balance usually indicates that the organization is financially strong and, conversely, a net deficiency

(where liabilities exceed assets) usually indicates the organization is in financial difficulty. In this case, the reader can draw an initial big-picture conclusion that the organization is in a very strong financial position. Now, drill down to understand this further.

C. What are the major components of the assets? The major current asset is "cash and cash equivalents" with a balance of $2,370. Cash equivalents are short-term highly liquid investments that are readily convertible to cash. Note that the organization is in a strong cash position because cash is 93% (2,370/2,537) of current assets, and a portion of that cash is earning income.

   There are some grants and accounts due to be received, but they are proportionately small. The balances are higher than the previous year, which might prompt a question as to why. When receivables grow in amount, it can be a sign of difficulty in collecting. In this case, it could be a sign of the increase in fees for service revenue over last year. Prepaid expenses are expenses paid in advance, very often including insurance and rent.

   The investment balance stayed the same, meaning there were no withdrawals or new investments. In particular, this means that the amount earned on investments of $35, (shown on the statement of operations), was not reinvested. Observe that the capital assets amount went down by $24, which is the amount of the amortization shown on the statement of operations.

D. Drilling down on current liabilities, note that their total ($347) is well within the means of the organization to be paid, given its cash balance. The bank indebtedness has decreased and accounts payable have increased by similar amounts. These changes may be due to later payments to suppliers compared to last year. Government remittances, which include employee tax withholdings, have increased. This may partly be due to the increase in salaries shown on the statement of operations. However, the size of the increase, which is greater than the percentage increase in salaries, might prompt a question as to why.

   The largest item in long-term liabilities is the mortgage payable. Note that it went down as expected by the amount due in the year. A reader would look in the financial statement notes to see when the full balance will come due.

Restricted Contributions, a Special Type of Revenue

NFP organizations often receive donations from their supporters. For some NFPs, especially charitable organizations, the amounts can be significant. The accounting term for donations is contributions.

Contributions are a type of revenue unique to not-for-profit organizations. The main characteristic of a contribution that sets it apart from other types of revenue is that it is a non-reciprocal transfer. In other words, the contributor does not receive anything in exchange for the contribution. Government funding to an NFP is considered to be a contribution.

A not-for-profit organization typically has multiple goals, and its supporters may choose to support one or another of these goals or place some other restriction on the use of the contributions they provide. For example, a restriction might be to use the contribution only for one particular program, or to purchase a capital asset, or it may be that the contribution is not to be used at all, but rather invested as an endowment with the income from the invested funds to be used for a particular program. Accepting such restricted contributions places an obligation on the organization to respect those restrictions, and to use those monies only in accordance with donors' wishes.

Accordingly, there are three types of contributions:

1. An *unrestricted contribution* has no externally imposed conditions and the NFP is free to use the funds in any manner it chooses. (It is neither a restricted contribution nor an endowment contribution.)
2. A *restricted contribution* is a contribution subject to externally imposed stipulations as specified by the donor.
3. An *endowment contribution* is a special type of restricted contribution requiring that the resources contributed be maintained permanently.

Accounting for Contributions

NFPs are required to distinguish between contribution revenues and other revenues, and to report on them and on unspent restricted contributions in their financial statements. As each of the three types of contributions has different stipulations as to their use, each one needs to be tracked separately and reported on separately.

There are two methods of revenue recognition for contributions:

1. the *deferral method* (the default method)
2. the *restricted fund method*

An NFP typically makes a choice of revenue recognition policy early in its existence, when contributions are first received. Altering the method after that is a significant accounting change which would need to be disclosed in the audited financial statements as a change in accounting policy.

The two methods can result in significant differences in the amount of revenue recognized each year and in presentation of the related balances on the statement of financial position. Each method has advantages in the information it provides for decision-making. Choosing the method most suitable for a particular organization requires careful consideration.

Below we discuss the application of each method to the sample financial statements.

Deferral method of accounting for restricted contributions

The overall concept of the deferral method is that restricted contributions are recognized as revenue on the statement of operations in the same period that the related expenditures are recognized. Until the related expenditures are recognized, the restricted contributions are recorded on the statement of financial position.

To achieve this, the accounting treatment depends on which type of contribution is made and the nature of the item it is intended to be spent on.

- An unrestricted contribution is taken into revenue in the period it is received.
- An externally restricted contribution for which the related expenditures are made in the current period is also included in the current period revenue.
- Where the related expenditures of an externally restricted contribution are not made in the current period, the contribution is recorded on the statement of financial position as a *deferred contribution*. In a future period when the related expenditure is made, the deferred contribution balance is reduced and revenue on the statement of operations is increased by the corresponding amount.
- If the externally restricted contribution is for the purchase of a capital asset, (e.g., a building or a vehicle), as the related capital asset is amortized into expenditures, the deferred contribution is amortized at the same rate, meaning that it is reduced and revenue increased by the corresponding amount.
- In the sample statement of operations below, the contribution revenues of $270 and $180 are a combination of any unrestricted, current-year restricted and previously deferred restricted contributions. Since any restrictions on these revenues are fulfilled in the current year, the term “restricted” is not required.
- A special situation occurs when there will never be a corresponding expenditure for a restricted contribution:
  - An endowment contribution, which is essentially an asset contribution to be held in perpetuity, is never recognized in revenue. Instead it is recorded on the statement of financial position as an increase in a category within net assets called *net assets restricted for endowments*.
  - An externally restricted contribution for the purchase of land is also never recognized in revenue but is instead recorded on the statement of financial position as a direct increase in net assets.

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF OPERATIONS (deferral method) For the 12 months ended December 31	Current year	Previous year
Revenues		
Government Grants	8,700	8,150
Fees for Service	975	920
Contributions	**270**	**180**
Investment Income	35	35
Interest and Other	10	15
Total Revenues	9,990	9,300
Expenditures		
Salaries and Benefits	6,940	6,560
Rent and Building Occupancy	1,845	1,610
Office	490	440
Depreciation of Capital Assets	24	30
Other	5	4
Total Expenditures	9,304	8,644
Excess of Revenues Over Expenditures	686	656

Despite any underlying complications in computing which portion of deferred contributions should be recognized in the statement of operations, as shown above the statement using this method is typically quite concise.

The deferral method has the effect of reducing swings in excess or deficiency of revenues over expenditures that can occur, for example, when a major restricted contribution is received in one year and spent in the subsequent year. If instead the restricted contribution had not been deferred, then the organization would show a large excess in the first year and a large deficiency in the subsequent year when the expenditure is made.

Because of the way it reduces swings in net results, this method is popular with organizations that receive government funding for programs, where there is a requirement to report a matching of program revenues and expenditures. Examples would be community care organizations and municipally and federally supported arts organizations.

A disadvantage of the deferral method is that the contributions reported on the statement of operations can be very different from the total amount of restricted contributions the organization received in the year. The amount of restricted contributions received can be found in a note to the financial statements, explaining the changes in the deferred contributions balances.

NOT FOR PROFIT ORGANIZATION
STATEMENT OF FINANCIAL POSITION (deferral method)
as at December 31 of current year

	Current year	Previous year
ASSETS		
Current Assets		
Cash and Cash Equivalents	2,585	1,938
Restricted Short-Term Investment	**75**	**50**
Grants Receivable	100	65
Accounts Receivable	25	20
Prepaid Expenses	42	35
	2,827	2,108

NOT FOR PROFIT ORGANIZATION STATEMENT OF FINANCIAL POSITION (deferral method) as at December 31 of current year	Current year	Previous year
Investments	330	350
Restricted Investments	**170**	**150**
Capital Assets (Property and Equipment)	1,126	1,150
Total Assets	4,453	3,758
LIABILITIES AND NET ASSETS		
Current Liabilities		
Bank Indebtedness	85	115
Accounts Payable	122	87
Government Remittances Payable	65	48
Current Portion of Mortgage Payable	75	75
Deferred Contributions	**75**	**50**
	422	375
Mortgage Payable	825	900
Other	65	40
Deferred Contributions — Capital Assets	**35**	**43**
	925	983

NOT FOR PROFIT ORGANIZATION STATEMENT OF FINANCIAL POSITION (deferral method) as at December 31 of current year	Current year	Previous year
Net Assets		
Net Assets Restricted for Endowments	**170**	**150**
Unrestricted Net Assets	2,936	2,250
	3,106	2,400
Total Liabilities and Net Assets	4,453	3,758

Above are new line items that can result on the statement of financial position with the deferral method of accounting for restricted contributions. Notice the new line for deferred contributions, being restricted contributions that have not yet been expended. In this statement they are divided into two groups: those in current liabilities, which are expected to be expended within the next twelve months ($75 and $50), and the restricted contributions accumulated to pay for capital assets ($35 and $43), which are expected to be drawn down over a period of years and so have been grouped with long-term liabilities.

While the presentation above, splitting the deferred contributions into current and long-term, is common practice, its level of detail is not strictly required. The applicable accounting standard simply requires that deferred contributions balances be presented outside of net assets. The standards do require that the changes in the balances of deferred contributions be reported. The change information is typically provided in a note to the financial statements showing opening balances plus receipts and less expenditures, to equal the closing balances for each significant type of deferred contribution. The receipts total in this note is the amount of restricted contributions given to the organization in the year.

Notice the new line showing net assets restricted for endowments. The reader can see that the increase for the year was $20. Detail on changes in this balance would be included in the statement of changes in net assets, which is described further in Appendix 1.

A concern with the deferral method disclosure on the statement of financial position is that it does not make clear where the assets are that will be used to fund the expenditures required by the deferred contributions. In this example, the organization has followed a best

practice of restricting the cash (into short-term investments) of $75 that will be needed to meet the requirements of the current deferred contributions. Similarly, it has disclosed the $170 restricted portion of the investments that provide the endowment.

This additional disclosure is not always provided. A discerning director will investigate whether sufficient funds have been set aside to meet restrictions, particularly in situations where the organization liquidity is low.

Restricted fund method of accounting for restricted contributions

The overall concept of the restricted fund method is that restricted contributions are accumulated in funds. The funds are then drawn down when expenditures compliant with their restrictions are made. The method is particularly useful to organizations that have long time horizons for spending and receive contributions where the eventual timing of their expenditure is flexible and varying in amount. It is useful for educational institutions, hospital foundations and many faith-based organizations.

The restricted fund method is a specialized use of fund accounting (see **Glossary**). A sure sign of fund accounting is when the statement of operations consists of multiple columns showing the results for the current year (rather than a single column). Under the restricted fund method, the organization reports a *general fund* (sometimes called an *operating fund*) and at least one *restricted fund* and, if it receives endowment contributions, an *endowment fund*. Each of these funds is displayed as a column on the statement of operations, or it may have its own page. Depending on the organization and usually based on the complexity of the funds, the statement of financial position may (if complex) also have multiple columns for the current year. However, all funds and their totals must be included within the statement of financial position.

Once again, the accounting treatments of restricted contributions differ depending on the type of contribution and the nature of the item it is intended to be spent on:

- An unrestricted contribution is taken into revenue in the period it is received.
- An externally restricted contribution is immediately reported as revenue of its corresponding restricted fund. Note that if there is *no* restricted fund corresponding to the nature of the restriction of the contribution, the contribution is recognized in the general fund using the deferral method.
- An endowment contribution is reported as revenue of the endowment fund.

An illustration of financial statements using the restricted fund method can be found in **Appendix 2**.

The Concept of Materiality

The figures in financial statements may not be perfectly accurate for a variety of reasons including inadvertent omission of entries, accounting coding errors that place an amount in the wrong account, or other similar factors. *Materiality* is the term used to describe the significance of financial statement information to decision-makers. Misstatements of financial information are said to be material if they (individually or in aggregate with other misstatements) could reasonably be expected to influence the economic decisions of users of the organization's financial statements.

Materiality is a matter of professional judgment in the particular circumstances where misstatements are identified. If the misstatements are not material, there is no requirement under Canadian accounting standards to correct the financial statements. Nevertheless, management is encouraged to correct discovered errors.

The auditor's application of their professional judgment in determining materiality can be a complex process. An auditor of an NFP may begin their determination by considering differing percentage ranges applied to benchmarks, such as total assets, gross revenue or total expenses. The results will be very different, for example, for an asset-rich but low-transaction foundation, compared to an organization running many programs from a low asset base. Consequently, some benchmarks may be much more relevant than others in particular circumstances.

To these benchmark ranges, the auditor will consider many matters such as:

- the volatility of the benchmark
- the overall financial strength of the organization
- its nature
- trends in its economic environment
- the question of whether there are items of particular focus to the financial statement users
- the specific nature of the types of revenue, expense, assets and liabilities
- their risk of misstatement

It follows that the auditor's determination of materiality may quite reasonably be different for two organizations that initially appear similar. It also follows that, in order to make a sound judgment of materiality, it is important that the auditor have sufficient knowledge and experience of the nature of the activities and environment of the organization being audited, including access to relevant experts.

Items for Directors to Watch for and Questions to Ask

Oversight of the Two Key Financial Statements

The statement of operations and the statement of financial position are inextricably linked. For instance, investment income shown on the operations statement is linked to the size and return on investment assets shown on the financial position statement. Consequently, oversight review and questioning by directors may well arise on essentially the same topic from either of the two statements.

Nevertheless, presented below are some possible questions directors may wish to ask based on the major categories in each statement. The statement of financial position traditionally comes first in audited financial statements, and hence it comes first below.

Questions to ask about the statement of financial position

- What are the components of *cash and cash equivalents*? Are any of these at risk of losing value?
- Who owes us the *accounts receivable*? What is the age profile of these accounts? Is there likely to be a problem in collecting these amounts? Has any provision been taken for uncollectable amounts?
- What are the components of *prepaid expenses*? (These often arise from amounts paid for services before they are rendered, like insurance or rent.) Do we have any choice about paying in advance?
- What are the major types of *invested assets (investments)* we hold? Do we have an investment policy? Are the investments in accordance with that policy? What are the prospects for future changes in value and income from these investments? What are the risks associated with these types of investments? Are the risks appropriate for our organization at this time?[7] What happens to these assets if we wind down the organization?

7 If the organization has significant investments, the board may establish an investment committee and engage professional investment advisors. In their oversight role, board members still need to review the major elements of the investment portfolio.

- What are the *capital assets* we own? Where in the organization are they used? How are these assets depreciated or amortized? That is, how do we record the "consumption" or use of these assets over time to reflect their declining useful life and utility to the organization? Does this charge reflect reality? Do we have plans to replace these assets as needed? Are we building a replacement fund to pay for replacements? Do we have appropriate insurance on these assets in case they are damaged or lost?
- To whom do we owe *accounts payable*? Do we pay these amounts on a timely basis, and specifically, in accordance with the payment terms that suppliers or others have specified in order to avoid further costs?
- Are government remittances being paid promptly? In certain circumstances, directors can be held liable for non-payment of government remittances.
- What is the renewal date for the *mortgages or loans* outstanding? What new interest rates can be anticipated and how do they compare to the rates we are currently paying? We have a large cash balance — what are the penalties, if any, involved in paying down the mortgage? Should we consider doing so, or do we have plans for the use of the cash balance in the future?
- What is included in *other liabilities*? To whom are these owed and why? When will these amounts come due, and will we have the cash resources to pay them?

Directors will want to have a keen eye for comparing the figures for the current year compared to the previous year. Significant changes over time (both increases and decreases) may well spark questioning. Directors can themselves undertake simple calculations for items not shown directly on the statement such as the working capital ratio (see **Glossary**), the percentage change in the value of invested assets, or the percentage change in capital assets.

Questions to ask about the statement of operations

The questions that apply to *revenues* raised to support operations tend to be identical for the many potential sources. They are:

- Who provides each category of revenue to the organization and why? Are there restrictions on how these revenues are used?
- Where the organization conducts fundraising, what are the costs associated with raising this kind of revenue? Is the effort of raising these funds worthwhile? Are there opportunities to increase this type of revenue?

- What are fundraising expenditures as a percentage of funds raised?[8] How does this compare with similar charitable NFPs?[9] Are the fundraising costs warranted, relative to the benefits received? Do we have fundraising protocols that provide guidance to management?
- Who are our competitors for these revenues? Do they represent possible collaborators?
- Have we remained true to our mission in pursuing funding for specific programs, or have we focused too much on acquiring the revenues, even if the activities funded blur our focus (so-called "mission creep")?
- Are there revenues devoted for a specific program, project or activity? Do these revenues include funding to sustain the organization's overhead (so-called "core funding")? If not, how is infrastructure to be funded as the program, project or activity places greater stress on it?
- How do we go about soliciting these revenues? Are we adhering to board policies or standards around ethical fundraising activities?
- How secure is each source of revenue for future periods?

There may be additional questions related to certain components of revenues:

- What is the source of *investment income*? What is our target return on investments? Is this achievable in the current economic climate?
- What is included in *other income*? Should any of these components be reported separately?

Here are some potential questions related to the major components of expenditures:

- What lies behind the expenditures on *salaries and benefits*? Where in the organization are employees deployed? What is our compensation policy? When did we last award raises and when is the next scheduled change? What benefits do we provide our employees? How do we handle vacations and vacation pay? How does our compensation stack up in the marketplace? How senior is our staff group? What costs would we incur if we had to lay off staff?
- What explains *rent and occupancy* costs? What spaces do we rent (or own)? What are they used for? Are they sufficient? What are the major lease or rental terms? How long until we have to move or negotiate a new lease?
- What is the nature of our *marketing and communication* costs? How do we select communications channels to use, especially new, digital media channels? How do we identify, select and reach our target audiences?

8 As this percentage may not be evident from the financial statements, management may have to prepare a separate report.

9 As noted earlier, certain financial information provided by charitable NFPs is publicly available on the CRA website. Also available on the CRA website is *Guidance on Fundraising by Registered Charities* (Document CG-013); among other topics it includes a section on the CRA's concerns when the ratio of fundraising costs to revenue exceeds 35%.

- What is the policy for *amortization of capital assets*?
- What is included in *other expenses*? Should any of the items be disclosed separately?

As with the statement of financial position, directors will want to compare the figures in the statement of operations for the current year to the previous year. Significant changes over time (both increases and decreases) may well spark questioning. Directors will have particular interest in comparing the results to budget. Since the budget is based on the organization's mission, variances in the budget are signals of how well the organization is achieving its mission.

Directors are encouraged to undertake their own calculations of certain items not appearing directly on the statement of operations, such as the percentage of total revenues each revenue source represents. Some organizations, for instance, are heavily dependent on government grants (and, indeed, in some cases, government grants from a single source). Other organizations may be heavily dependent on donations, which in turn are dependent on the state of the economy.

Oversight at Points in Time

At various points in time — during the budgeting process, when monitoring the internal in-year financial statements, and later when reviewing and approving the audited statements — there are certain additional things directors should watch for.

When approving the budget as a forward-looking financial statement

A budget is a powerful and useful tool to help boards discharge their fiduciary responsibilities. By satisfying itself that budgets reflect appropriate and prudent uses of an organization's funds, boards are well on their way to meeting their responsibility for overseeing the effective use of the organization's assets.

Directors should be familiar with their organization's plans. It is often the case that they have been directly involved in strategic planning toward achieving the organization's mission. Plans provide the roadmap directing the NFP's efforts toward achieving its mission. The budget is the financial dimension of an approved organizational plan.

A budget is also a prediction. It is based on various assumptions about the future. There is obviously uncertainty about how the future will unfold, and it may be prudent for management to produce various draft budgets based on different scenarios (e.g., inflation rates, government funding renewals, donation levels) for review by the board before one version is selected as the approved budget for the coming year.

Here are some questions that directors may wish to ask during the budget review and approval process:

- What are the key assumptions behind the estimates of revenues and the estimates of expenditures for the coming year?
- Are there significant differences between the current year-end projections and the budget estimates for the upcoming year? If so, what are the explanations for these differences?
- What is the plan for staffing levels and staff compensation for the coming year?
- Are there any significant changes planned for programs and services inherent in the budget?
- Is the budget fully in accord with our strategic plan?
- What “scenarios” have been considered in the budget planning process?
- How much of a cushion do we have against unanticipated adverse events?

It is important to note that operational plans can change during the year as situations crystalize. On that basis, budgets can also change. However, best practice is to maintain a single budget, once approved, and monitor the effect of changed plans on the actual results. Any changes in budgets should be approved by the board.

When monitoring the internal financial statements

The internal financial statements prepared by management during the fiscal year will show budget figures versus actual results, and will show the difference between the two, called the *variance*. As noted above, a budget is a prediction. It would be rare if everything unfolds as assumed; consequently, budgets are unlikely to be precisely achieved, as shown by the variances. When actual results have significant variance to budget, good practice is to include reporting of projected results to year-end and compare them to the year-end budget. Directors and management can then see the extent of remedial action necessary.

By carefully monitoring activities against the plan — and financial results against the budget — boards can assess the effectiveness of the organization’s use of its resources and can determine whether any in-year alterations in the operational plan are warranted. Here are some questions that may assist in that regard:

- Are the variances related to revenues or to expenditures or to both?
- What is the explanation for the significant variances (both “over” and “under”)?
- Are variances arising from external factors beyond the organization’s control (e.g., an unanticipated increase in utility usage or utility rates)?
- What are management’s plans for responding to the variances?

- How realistic are the projections to year-end? What are the assumptions that underpin those projections?
- Is there a need for action now related to our operations to deal with the variances and/or projections to year-end?

In extreme circumstances, the board may need to consider a change to the strategic plan in order to respond to a financial crisis as evident from large variances from budget projections.

When reviewing and approving the year-end audited financial statements

The audit offers a key measure of accountability and control for not-for-profit organizations. The auditor, with a mandate to directly review the books and records of the organization, provides an important check on the activities of management.

Very simply put, an auditor reviews what an organization's finance staff creates. This checking is referred to as "gathering audit evidence," which means that auditors look for evidence that the accounting information audited is correct. This "audit trail" may be well documented within organizations. However, some organizations sponsor events where significant cash or cheques are collected, possibly by a single volunteer. This situation is problematic for the auditor, since it may be impossible to be satisfied that all the cash has been collected, deposited and recorded properly in the organization's accounts. Some charitable organizations go to great lengths to implement procedures and controls regarding cash and cheque donations, thereby providing documentation that the auditor can review.

The auditor will also assess internal controls and procedures in the organization, to the extent that this might impact the assessment of the validity of information recorded in the accounts.

In very small organizations, controls and procedures may be extremely limited due to lack of formal systems and limited resources available to implement them. On the other hand, in a very large organization, there might be extensive documentation of accounting policies and procedures, the use of computer systems and internal controls. If these systems are determined to be strong and well-functioning, the auditor might be able to reduce the other evidence needed to be gathered to form the audit opinion.

The auditor will also analyze much of the information in the accounts to see whether it is consistent with the organization's activities. Finally, the auditor will look at the financial statements and the accounting policies used by the organization.

In view of all the information the auditor has gathered about the organization, and with all of the auditor's professional experience, the key question the auditor will answer is: *Do the financial statements paint a picture that is a fair presentation of the organization's financial position and results of operations?* At the end of the auditor's engagement, the auditor communicates that opinion to financial statement users through the auditor's report.

The report contains both the audited financial statements with accompanying notes and the auditor's opinion. The notes provide additional important information that support certain figures in the audited statements. Notes are often essential to clarify or further explain the items in the financial statements. They have the same significance as if the information or explanations were set out in the body of the statements themselves.

The opinion can be unqualified or qualified, the latter situation most often due to the auditor's inability to verify the completeness of donations. See **Appendix 3** for samples of the auditor's report addressed to the board of directors, one illustrating an unqualified opinion and one illustrating a qualified opinion.

When reviewing the draft audited statements, directors may wish to consider these questions of the auditor:

- Did the auditor initiate any significant changes to management's year-end financial information prior to issuance of the audit opinion and approval of the financial statements? (In the language of accountants, did the auditor require significant adjustments through "journal entries" to the statements originally prepared by management?)
- Are the audited financial statements consistent with the results shown in the internal financial statements that have been monitored by board members during the year? Internal financial statements should be more detailed than external financial statements but consistent with them. If not, then their reliability for decision-making is in question.
- Did the auditor find any weaknesses in internal controls or accounting policies?
- Did the auditor have any concerns about the activities of the organization that have impacted on the financial results?
  - Did management make significant estimates in the financial statements and did the auditor have any concerns about them?
  - Were there any issues that might have caused the auditor to issue a qualified report?
  - Was there an *in camera* meeting with the auditor (without management present) and an *in camera* meeting with management (without the auditor present)?

  Once satisfied with the audited financial statements, the board will approve them and make them available for wider distribution.

Conclusion

The board of directors is obliged to fulfill its stewardship responsibilities on an ongoing basis. It will do so by regular reviews of financial information prepared for that purpose, by engaging in thorough questioning and probing of the information presented and by continuing to do so until satisfied with the answers to questions. Directors should pay particular attention to variances between budget and actual figures, to major differences between the current year figures and the previous year results, and to consistency between the various statements (operations, financial position, changes in net assets, cash flows).

Questioning and probing by the board serves many purposes, including helping directors to develop a sound understanding of the organization's operations and of both the accounting treatment and the choice of accounting policies in financial statements. It also serves as a jumping-off point for substantive debates about the organization's strategies, tactics, plans, policies and risks. There is a time and place for each type of questioning. A comprehensive understanding of the financial state of the organization will be developed over time, rather than in a single, marathon session.

Boards typically review financial reports, including at least a statement of operations and a statement of financial position, at a minimum quarterly. However, the exact frequency and level of detail of such reviews will be influenced by many factors, including the adequacy of internal financial processes, the level of expertise of management in financial matters, the complexity of the organization, the financial position of the organization, and the involvement of board committees such as the audit or finance committee.

The board needs to satisfy itself that general purpose reporting documents (audited financial statements and supporting annual reports) are fair and balanced communications of the affairs of the organization, and that the reports address the common questions that many stakeholders may have. The board will do this by reviewing drafts of these reports including any note disclosures and accompanying narrative commentary, comparing them to the more detailed internal reports that the board has used, and by satisfying itself that the financial reporting is sufficient to inform stakeholders who do not have access to the detailed information available to the board.

The board will oversee the process for preparing other specialized reports, satisfying itself as to the adequacy of this process, and will review, as appropriate, specific reports to stakeholders. Where many reports to different funders are prepared, based extensively on financial data that the board has already reviewed (i.e., where the preparation is essentially

reformatting rather than new reporting), the board may choose to rely upon management for preparation of these reports. On the other hand, extensive new reporting, or reporting that is critical to the ongoing operations of the organization, may well be reviewed directly by the board or one of its committees before issuance. The board may choose to establish protocols to determine which reports require its review prior to release. Although there may be a number of specialized reports prepared, there is only one set of complete financial statements for an organization, and specialized reports must be consistent with the figures in the financial statements.

As noted earlier, the board may delegate some or all of these tasks to an audit or finance committee. Doing so can be particularly effective. The board can rely in good faith on the work of its committees. However, the board cannot delegate its ultimate responsibility; the entire board remains responsible for the work delegated to its committees.

In sum, the board of directors of a not-for-profit organization has serious duties with respect to oversight of the organization's financial affairs. Directors do not need to be financial experts, but they do need to have an understanding of how financial information is presented. They need to actively review what is presented and participate in the discussions. They need to be able to question and probe management and the auditor, until they are satisfied that their issues have been addressed. In the end, it is the board of directors that holds ultimate accountability for the financial affairs of the organization.

APPENDIX 1

Other Financial Concepts and Statements

1. Other Financial Concepts

This appendix deals with certain additional concepts and statements that NFP directors are likely to encounter.

Accounts and chart of accounts

Even a small organization can have hundreds or perhaps even thousands of transactions every year. All this information needs to be recorded in one place, historically in a set of ledger books and now, almost without exception, in a computerized accounting system. Every organization needs someone assigned to collect and input every financial transaction.

Keeping track of all this activity in a way that allows for the preparation of many different kinds of reporting requires careful organization of the basic data.

- The *account* is the fundamental unit of organization for all this information. Accounts are established for every type of asset, liability, net assets, revenue and expense that the organization is likely to encounter, and in as much detail as practical, to allow for maximum flexibility in reporting later on. An ordinary, mid-sized NFP can easily have hundreds of accounts to record all its different activities.
- The *chart of accounts* is a highly structured document that shows all accounts, organized in various ways. The chart delineates accounts within the major categories and sub-categories of assets and liabilities, revenues and expenditures, and also, for example, by program or activity or by type of transaction. It is the structure of the chart of accounts that is the key to all subsequent summarization, analysis and reporting of financial information.

It is management's responsibility to develop and maintain a coherent chart of accounts. Directors see the product of the chart of accounts as financial reports are provided to them showing various categories, based on the organization's chart of accounts.

2. Other Financial Statements

Two additional statements will appear in the audited financial statements. These two are not typically included by management in budgets or in-year internal reports:

- statement of changes in net assets
- statement of cash flows

Statement of changes in net assets

The statement of changes in net assets provides details about what has happened to the balance of net assets over a period of time (usually a year). Net assets are disaggregated into categories, and the statement will identify the changes that have taken place in each category. We have previously seen two categories within net assets on the statement of financial position: "net assets restricted for endowments" and "unrestricted net assets." Two other categories that are sometimes shown within net assets are "invested in capital assets" and "internally restricted net assets."

The purpose of showing "invested in capital assets" (which is an optional disclosure) is to separate within net assets the portion that is Illiquid. This amount is calculated by subtracting from the net balance of capital assets any related debt or deferred contributions. In the case of the sample financial statements, this is $1,126 − $75 − $825 − $35 = $191. This portion of net assets would not be available to the organization in liquid form unless the organization sold or financed the capital assets.

Internally restricted assets occur when the board decides to set aside a portion of net assets for a special purpose. It is called "internally restricted" because the action is done by the board and can be undone by the board. Normally the purpose of doing so is to signal to readers a key intention, such as setting aside net assets for a contingency. Corresponding assets also need to be set aside to provide the actual funds required. Note that increases or decreases in internally restricted funds have no impact on the statement of operations.

Sample statement of changes in net assets (deferral method)

The following is a sample statement of changes in net assets. This NFP has received endowment contributions during the year. It has created an internally restricted fund, and it has chosen to show the amount invested in capital assets.

NOT-FOR PROFIT ORGANIZATION STATEMENT OF CHANGES IN NET ASSETS (deferral method) For the current year ended December 31						
			Current Year $000			Previous Year $000
	Invested in Capital Assets	Endowment	Internally Restricted For Special Projects	Unrestricted	Total	Total
Balance, Beginning of Year	132	150	315	1,803	2,400	1,744
Excess (Deficiency) of Revenues Over Expenditures	-16*			702	686	656
Endowment Contributions		20			20	
Mortgage Principal Payment	75			-75		
Transfer to Internally Restricted Fund			15	-15		
Balance, End of Year	191	170	330	2,415	3,106	2,400

NOT-FOR PROFIT ORGANIZATION STATEMENT OF CHANGES IN NET ASSETS (deferral method) For the current year ended December 31						
			Current Year $000			Previous Year $000
	Invested in Capital Assets	Endowment	Internally Restricted For Special Projects	Unrestricted	Total	Total
*Consists of:						
a) Revenue From Amortization of Deferred Capital Contributions	8					
b) Depreciation Expense for Capital Assets	-24					
	-16					

A review of this sample statement of changes in net assets generates the following observations:

- The end of year balance totals of net assets are identical to the values shown in the net asset section in the statement of financial position ($3,106 and $2,400).
- The excess of revenues over expenditures for the current year of $686 is shown in the current year total column and equals the amount in the sample statement of operations. Note the $20 below the $686. This is the total of endowment contributions received for the year, which (in accordance with the deferral method) are not included in the statement of operations, but nevertheless increase total assets, as shown here.
- The mortgage principal payment of $75 has the effect of increasing the net amount invested in capital assets and decreasing the unrestricted net asset balance.
- The transfer into the internally restricted fund for special projects of $15, which would have required a board resolution, has the effect of decreasing unrestricted net assets by the same amount.

We have provided an explanatory calculation for the portion of the change in the amount invested in capital assets resulting from operations. The amount invested decreases by the depreciation of $24, which is shown as an expense on the statement of operations, but this is offset by the amortization of the deferred contributions made to fund capital assets, which is $8, and is included in contributions on the statement of operations. This explanatory calculation would not normally be provided with the financial statements.

For simplicity, this sample statement does not include new capital asset purchases. Had there been any, paid out of current funds, their amount would show in exactly the same manner as the mortgage principal payment. Invested in capital assets would increase by the value of the purchases, and unrestricted net assets would decrease by the same amount. If a portion of the purchase was funded by debt secured by the capital assets, thereby increasing debt, then the statement would show a decrease in invested in capital assets, by the amount of the debt, and a corresponding increase in unrestricted net assets.

Statement of cash flows

The statement of cash flows provides additional information that explains how cash has been used or generated by the organization from operations, through investments and through financing.

As an example, suppose during the year an organization had a significant increase in revenue and excess of revenue over expenditure, yet now found itself short of cash to pay its bills. One reason this could happen would be that payment of the fees for the revenue had not been received. Accounts receivable had greatly increased, which accountants think of as a use of cash. A reader could detect this change from the comparative statement of position. However, on the statement of cash flows it is specifically highlighted, as the statement directly shows the increase in accounts receivable as using up cash.

The statement of cash flows identifies cash provided by, or used in, three areas over the year:

- operations (i.e., cash generated by an operating surplus; cash used to fund an operating deficit); operations includes working capital items (see **Glossary**) such as accounts receivable, prepaid expenses, accounts payable and similar items)
- investing activities (i.e., using cash to acquire investments; generating cash from selling investments)
- financing activities (i.e., generating cash through borrowing; paying cash to repay borrowing)

There are two methods for presenting the statement of cash flows:

- The direct method focuses on cash transactions: Cash acquired increases the cash balance; cash expended decreases the cash balance. Under the direct method, the equation that underpins the statement of cash flows is *Ending cash balance = Opening cash balance + Cash acquired − Cash expended*.

- The indirect method focuses on the operating surplus derived from the statement of operations and makes certain adjustments to that figure. As this method is used by most NFPs, it is described in more detail below.

For an NFP that did not engage in any investing activities or financing activities during the year, the fundamental equation for a statement of cash flows under the indirect method is: *Opening cash balance + Surplus from operations + Adjustments for operating items not requiring cash + Changes in non-cash working capital = Ending cash balance.*[10]

Under this method, the statement of cash flows is typically presented in a "reconciliation" format, starting with the excess (deficiency) of revenues over expenditures, then adjusting for the non-cash items in operations and the changes in non-cash working capital items, to arrive at cash provided by (or used in) operations. In equation form, this mode of presentation involves two equations:

1. *Surplus from operations + Adjustments for operating items not requiring cash + Changes in non-cash working capital = Change in cash balance*
2. *Ending cash balance = Opening cash balance + Change in cash balance during the year*

Although this formula appears more complicated than the one for the direct method, it is typically easier to prepare and — because it ties directly into the changes in the statement of financial position — it is often more useful to the reader.

Sample statement of cash flows

The following sample statement of cash flows is based on the reconciliation method, starting with the excess (or deficiency) of revenues over expenditures, as taken from the statement of operations for the same not-for-profit organization.

10 If the organization did engage in investing and financing activities, the equation becomes: *Opening cash balance + Surplus from operations + Adjustments for operating items not requiring cash + Changes in non-cash working capital + Investing activities + Financing activities = Ending cash balance.*

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF CASH FLOWS For the current year ended December 31	Current year	Previous year
Operating Activities		
Excess of Revenues Over Expenditures	686	656
Add (deduct) Items Not Involving Cash:		
Depreciation of Capital Assets	24	30
Amortization of Deferred Capital Contributions	-8	-10
	702	676
Change in Non-Cash Working Capital Balances		
Grants Receivable	-35	5
Accounts Receivable	-5	10
Prepaid Expenses	-7	-1
Accounts Payable	35	-20
Government Remittances Payable	17	
Deferred Contributions	25	5
	30	-1
Cash (Used in) Provided by Operating Activities	732	675
Investing Activities		
Restricted Short-Term Investments	-25	12
Purchase of Restricted Investments	-20	-85

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF CASH FLOWS For the current year ended December 31	Current year	Previous year
Sales of Investments	20	85
Endowment Contributions	20	5
Deferred Contributions — Capital assets	-	10
Purchase of Capital Assets	-	-250
	-5	-223
Financing Activities		
Bank Indebtedness	-30	-60
Mortgage Payment	-75	-75
Other	25	-2
	-80	-137
Net Increase (Decrease) in Cash During the Year	647	315
Cash Balance, Beginning of Year	1,938	1,623
Cash Balance, End of Year	2,585	1,938

The statement of cash flows is perhaps the most difficult one for directors to “decode,” most likely because positive and negative entries can occur within the same category.

Further, a positive entry in one year can become a negative entry in the next year and vice-versa. Always note that the amounts in this statement are changes that occurred during the year. In reviewing this sample statement of cash flows, directors can determine the following:

- The "end of year" cash balance of $2,585 for the current year as shown above is identical to that amount shown on the statement of financial position.
- The cash balance increased from the previous year by $647, even though the excess of revenue over expenditures for the year was $687.
- One of the drivers of the increase in cash was donor contributions since deferred contributions for operations increased by $25. In other words, certain new contributions were received during the current year but were not used during the year. The unspent balance was added to deferred contributions, leading to an increase of $25.
- New endowment contributions of $20 were also received during the year. They were invested in restricted investments.
- Another source of cash was a significant increase in accounts payable of $35; this amount was included in expenditures but cash was not yet expended in the current year to pay for these obligations.
- On the other hand, grants receivable in the current year increased by $35 and accounts receivable increased by $5. In total, $40 was added to revenues related to these two items, but cash was not received for them in the current year.
- Cash of $75 was expended in both years to pay mortgage obligations.

3. Items for Directors to Watch for and Questions to Ask

The statement of changes in net assets and the statement of cash flows provide an opportunity for the board to review in detail its trusteeship over restricted contributions, to understand the prior year cash flows and anticipate any upcoming cashflow concerns.

Questions to ask about the statement of net assets

- For each category, what caused the change in net asset value? What changes are anticipated in the coming year?
- Is the amount invested in capital assets appropriate for the needs of organization? It is a common problem that NFPs run down their assets, without sufficient replenishment. Is there any repayment risk of the long-term debt associated with the capital assets?

- Are the investments corresponding to the endowment fund prudently invested? Have the terms of the endowment specified by the donors been honoured? Have the calculations of endowment principal and amounts available for expenditure been correctly computed?
- Is the amount being accumulated in the internally restricted fund sufficient for its intended purpose? Have the corresponding assets been set aside? Has the purpose and progress of the internally restricted fund been clearly communicated to the stakeholders of the organization?
- One of the most significant accumulated balances of an NFP is its unrestricted net asset balance, as this is a clear indicator of its net financial strength and ability to withstand downturns. After reviewing the balance within the context of the statement of net assets, do the directors have any concerns about the financial strength of the organization?

Questions to ask about the statement of cash flows

- What is the explanation for any significant differences, year to year, in the entries on this statement?
- Are there any concerning trends in working capital (see **Glossary**) as shown by the cash used in or provided by operations? Is surplus cash idle? Should it be employed in the organization's mission?
- Where "invested in capital assets" is not separated out of net assets, these questions could be triggered from review of the statement of cash flows: Is the amount invested in capital assets appropriate for the needs of organization?
- Are the investments prudent (neither too conservative nor too risky or illiquid)? Is the organization earning returns commensurate with market results? Is there a long-term investment strategy? Are knowledgeable board members exercising appropriate oversight of significant investments?
- Are there any major financing activities anticipated in the near future? Are cash resources sufficient for debt repayments?

APPENDIX 2
Fund Accounting

1. The Use of Fund Accounting

How fund accounting works

When an organization presents its financial statements using fund accounting, the statement of operations shows columns containing revenue and expenditures for each fund, with a column cross totalling all the funds. For example, a sports organization may choose to have a column for its youth programs, one for adult programs, one for its property including facility fees and expenses, another for bursaries, and an administration column. This presentation provides readers with the ability to rapidly see which revenues and expenditures are trending up or down and the degree of cost recovery of each area generated from its associated fees and sponsorships.

However, to be a true application of fund accounting, the funds *must carry forward their balances* on the statement of financial position. In this example, the organization chooses that the net balance of the property fund (capital assets less associated debt) will be carried forward with accumulated earnings and that the bursary fund balance is carried forward. The other programs' excess or deficiency are closed out (added together) into the net asset balance.

The property and bursary fund balances would appear separately within net assets (now called the fund balances). Alternatively, the statement of financial position could be presented with a full column for each of these two balances, one for all the other items, and a cross total. This level of detail would only make sense if there were many items associated with the balances, such as segregated cash and investments, accounts receivable and payable, and capital assets and related debt. It is fairly common for NFPs to show columns on the statement of operations, but much less common for them to also do so on the statement of financial position.

Restricted fund accounting

As noted earlier, restricted fund accounting is a specialized type of fund accounting. It is designed with a focus of making clear to readers what restricted funds have been received, how they are being managed and how expended. It applies a revenue recognition policy — the

restricted fund method (in which restricted contributions may be recognized in revenue when received rather than deferred from revenue until expended), with the use of fund accounting to show the receipt, expenditure and carryforward balances of restricted contributions.

Restricted funds on the statement of financial position may be shown in detailed columns or as balances within the “fund balances” section (which has replaced the “net assets” section) along with note disclosure of restrictions. In the sample we provide below, the funds are shown in full-column format.

Restricted funds in the statement of operations will always be shown as separate columns. A key difference between the restricted method and regular fund accounting is that there is no requirement to cross add the columns of the statement of operations (although this is common practice). The basis for this exemption is that it is sometimes not meaningful to cross add the revenue and expenditures of operating activities with those of restricted fund contributions, earnings and expenditures.

Sample statements using restricted fund accounting

Under fund accounting, the statement of changes in fund balances can often be conveniently combined with the statement of operations, resulting in only three financial statements:

- statement of financial position
- statement of operations and changes in fund balances
- statement of cash flows

As discussed above, the statement of financial position may utilize columns, and the statement of operations will do so. It is common practice to show the statement of cash flows on a total basis, without separation into funds.

The sample set of statements shown below demonstrating restricted fund accounting includes three funds for the not-for-profit organization, defined as follows:

1. an operating fund, which holds the accumulated unrestricted operating surpluses, the internally restricted funds (in this example for special projects), and any restricted amounts for which there is no applicable restricted fund
2. a property fund, which is an externally restricted fund to provide capital assets
3. an endowment fund, which is an externally restricted fund for endowment contributions from donors

The three sample statements that follow are based on the same financial information presented in the previous sample statements.

Comparative balances

Note that for each of the statements of financial position and operations and fund balances shown below, there are five columns: one for each of the three funds, one for the current year total and one for the previous-year total.

It can be helpful for the user of the financial statement to instead be presented with the current-and prior-year results for each column. This would result in two columns for each of three funds and one column for each of the two total funds, for a grand total of eight columns.

It is a matter of judgment whether the additional detail provided is helpful to the user of the financial statement. Many comparative changes may be readily determinable from the five-column presentation. Users may find an eight-column presentation to be overwhelming in its size. On the other hand, important details of comparative changes may otherwise be hidden in the five-column presentation.

NOT-FOR-PROFIT ORGANIZATION
STATEMENT OF FINANCIAL POSITION
As at December 31 of current year

	Current year				Previous year
	Operating Fund	Property Fund	Endowment Fund	Total	Total
ASSETS					
Current Assets					
Cash and Cash Equivalents	2,585	33		2,618	1,938
Restricted Short-Term Investments	75			75	50
Grants Receivable	100			100	65
Accounts Receivable	25			25	20
Prepaid Expenses	42			42	35
	2,827	33	–	2,860	2,108

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF FINANCIAL POSITION As at December 31 of current year					
	Current year				Previous year
	Operating Fund	Property Fund	Endowment Fund	Total	Total
Investments	330		170	500	500
Capital Assets (Property & Equipment)		1,126		1,126	1,150
	330	1,126	170	1,626	1,650
	3,157	1,159	170	4,486	3,758
LIABILITIES AND FUND BALANCES					
Current Liabilities					
Bank Indebtedness	85			85	85
Accounts Payable	122			122	135
Government Remittances Payable	65			65	
Mortgage Payable		75		75	75
Deferred Contributions	75			75	
	347	75	–	422	295
Mortgage Payable		825		825	900
Other	65			65	40
	65	825	–	890	940

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF FINANCIAL POSITION As at December 31 of current year					
	Current year				Previous year
	Operating Fund	Property Fund	Endowment Fund	Total	Total
Fund Balances					
Unrestricted	2,415			2,415	1,803
Internally Restricted Special Project Fund	330			330	315
Externally Restricted Property Fund	–	259		259	175
Endowment	–		170	170	150
	2,745	259	170	3,174	2,443
	3,157	1,159	170	4,486	3,758

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF OPERATIONS AND CHANGES IN FUND BALANCES For the current year ended December 31					
	Current Year				Previous year
	Operating Fund	Property Fund	Endowment Fund	Total	Total
Revenues					
Government Grants	8,700			8,700	8,150
Fees for Service	975			975	920

NOT-FOR-PROFIT ORGANIZATION
STATEMENT OF OPERATIONS AND CHANGES IN FUND BALANCES
For the current year ended December 31

	Current Year				Previous year
	Operating Fund	Property Fund	Endowment Fund	Total	Total
Contributions	262	33	20	315	180
Investment Income	35			35	35
Interest and Other Income	10			10	15
Total Revenues	*9,982*	*33*	*20*	*10,035*	*9,300*
Expenditures					
Salaries and Benefits	6,940			6,940	6,560
Rent and Building Occupancy	1,845			1,845	1,610
Office	490			490	440
Depreciation of Capital Assets		24		24	30
Other	5			5	4
Total Expenditures	*9,280*	*24*	–	*9,304*	*8,644*
Excess of Revenues Over Expenditures	702	9	20	731	656
Fund Balances, January 1	2,118	175	150	2,443	1,787
Transfer to Fund Mortgage Payment	-75	75			

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF OPERATIONS AND CHANGES IN FUND BALANCES For the current year ended December 31					
	Current Year				Previous year
	Operating Fund	Property Fund	Endowment Fund	Total	Total
Transfer to Internally Restricted Special Project Fund	15				
Transfer From Unrestricted Fund	-15				
Rent and Building Occupancy	1,845			1,845	1,610

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF CASH FLOWS For the current year ended December 31		
	Current year	Previous year
Operating Activities		
Excess (Deficiency) of	731	656
Revenues Over Expenditures		
Add (Deduct) Items Not Involving Cash:		
Depreciation of Capital Assets	24	30
	755	686
Change in Non-Cash Working Capital Balances		
Grants Receivable	-35	5

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF CASH FLOWS For the current year ended December 31	Current year	Previous year
Accounts Receivable	-5	10
Prepaid Expenses	-7	-1
Accounts Payable	35	-20
Government Remittances Payable	17	-
Deferred Contributions	25	5
	30	-1
Cash (Used in) Provided by Operating Activities	785	685
Investing Activities		
Restricted Short-Term Investments	-25	12
Purchase of Restricted Investments	-20	-85
Sales of Investments	20	85
Purchase of Capital Assets	–	-250
	-25	-238
Financing Activities		
Bank Indebtedness	-30	-60
Mortgage Payment	-75	-75
Other	25	-2
	-80	-137
Net Increase (Decrease) in Cash During the Year	680	310

NOT-FOR-PROFIT ORGANIZATION STATEMENT OF CASH FLOWS For the current year ended December 31	Current year	Previous year
Cash Balance, Beginning of Year	1,938	1,623
Cash Balance, End of Year	2,618	1,938

We now review each of the statements to see how the results contrast with those of the same statements previously presented using the deferral method of revenue recognition.

The reader is presumed to have read the explanations of the meanings of the accounting terms as well as the explanation of the two revenue recognition methods, which are provided in the main body of this document.

Observations about the statement of financial position

- When readers unfamiliar with fund-based statements are first introduced to them, they often find the increased level of detail challenging to absorb. However, once they are used to the format, they find a clarity resulting from the accountability inherent within the method.
- To compare the sample statement balances with the previously presented deferral method statements, focus first on the total column, and then work back through each of the fund columns.
- The endowment column shows investments of $170 that match the endowment fund balance at the bottom of the statement. Contrast this with the deferral statement where the $170 investment is optionally segregated and shown as restricted. Had that not been done, a reader of those statements would not know whether the endowment investments were in fact segregated. This is an example of the increased accountability provided by the restricted fund method. In fact, were the assets of the endowment fund being used by another fund in order to balance the restricted fund method, it would force presentation of an amount due from that fund to show in the endowment fund column. Since such a borrowing of endowment funds would likely be improper, it would encourage corrective action.

- The property fund column shows the arithmetic that results in the fund balance and makes clear that as the mortgage is paid off, the fund balance increases. For illustration, we have added a restricted contribution of $33 received in the year. The presentation makes clear that the contribution is held in the fund but has not yet been expended on capital asset purchases.
- The operating fund column contains all other assets and liabilities. Note that it also contains a deferred contribution balance of $75. This means that an externally restricted contribution has been received that is intended for a purpose other than property or endowment. As previously stated, where a restricted contribution is received for which there is no corresponding restricted fund, it is presented in the operating (or general) fund with the deferral method.
- Note also in this column that the board has created an internally restricted fund of $330 for special projects. The balance has been extracted from the unrestricted fund balance.

Observations about the statement of operations and fund balances

- Once again, the reader will find it beneficial, when contrasting these statements with the previously presented deferral method statements, to focus first on the total column and then work back through the fund columns.
- The endowment fund column shows revenue of $20 being the contributions given to the fund in the year. Under the deferral method, this amount is recorded as a direct increase in net assets and included in the statement of changes in net assets.
- Note that while in this example there is a single endowment fund, it is not uncommon for the funds presented on the statements to be the aggregate of many underlying funds of the same nature (e.g., endowment or externally restricted) but with different restrictions on their expenditure. The notes to the financial statements will usually provide additional detail on the underlying funds.
- The property fund shows $33 in revenue (as mentioned above this is included for illustration, it was not included in the deferral statements). It also shows the depreciation of $24, which does appear on the deferral statements. However, note that contributions in the operating fund have gone down by $8 from $270 to $262. Recall that under the deferral method, the restricted contributions for capital assets were being amortized into revenue over the estimated useful of the associated capital assets that they originally funded. This type of amortization does not occur in the restricted fund method. Consequently, the contribution revenue is lower by the amount of the amortization. Note that in the year the restricted contribution was made, revenue would have been higher, in the same way the property fund revenue has been increased by $33 this year, even though the contribution has not been expended on a capital asset.

- An item of particular note is the transfer to fund the mortgage payment that is shown in the second last row of the statement. Each fund within this statement is a self-balancing set of accounts. What this means is that the movement of assets or liabilities between the funds must be accounted for. Such a movement is a transaction, and it will either result in an amount payable or receivable between the funds or be satisfied by a board authorized transfer between the funds.
- In this example, the annual mortgage repayment of $75 has been paid by the operating fund. Rather than show this as an amount receivable by the operating fund from the property fund the board has chosen to transfer a corresponding amount out of the unrestricted fund balance of the operating fund to the property fund balance.
- Finally, note that the excess of revenue over expenditures is different between the two methods. Under the restricted fund method of revenue recognition, the $20 endowment fund contribution is included in revenue but not included under the deferral method. And the amortization of deferred capital contributions of $8 is not included in revenue under the restricted fund method but is included under the deferral method. In this example, the difference in the excess of revenue over expenditures between the two is not large, but there are many instances where it can be.[11]
- Canada is the only accounting jurisdiction where NFPs may choose between revenue recognition methods that produce differing results. There are many who consider this problematic, and a research project is in progress at the Accounting Standards Board to determine if a single method can be developed that meets the different needs of users.

2. Items for Directors to Watch for and Questions to Ask Related to Fund Accounting

Fund accounting is a different way of organizing and presenting the same financial information for an NFP. Consequently, most of the questions directors might have about the statement of financial position and statement of operations and changes in balances and the statement of cash flows are the same as in the main body of the guide and are not repeated here. However, as the example for the same not-for-profit organization has shown, fund accounting does give prominence to each of the fund categories, leading to additional questions directors might wish to ask:

- Is the use of fund accounting still warranted in the current circumstances?
- For each externally restricted fund, has the use of the monies been in accordance with the restrictions imposed by the donors?

11 For those interested in reconciling the two amounts, beginning with the $686 excess or revenue over expenditures on the deferral statements, subtract the $8, add the $20 and add the $33 contribution, which was added for illustration, to equal the $731 excess of revenue over expenditures on the restricted fund statements.

- For each internally restricted fund, has the use of monies been in accordance with the restrictions created by the board?
- Have all the inter-fund transfers as shown on the statement of operations and changes in fund balances been approved by the board?
- Are the summary categories for reporting on restricted funds and unrestricted funds the most appropriate ones?

APPENDIX 3

Samples of the Auditor's Report Addressed to the Board of Directors — Unqualified and Qualified Opinions

As mentioned in the discussion of **the roles and responsibilities associated with financial reporting**, responsibility for an organization's financial reporting is shared among three parties — management, the board and the external auditor. Considerable effort is applied to clearly express the auditor's opinion of the organization's audited financial statements. The auditor's report details management and the auditor's responsibilities and the limitations that must be applied when relying on the auditor's opinion.

Below is an auditor's report of an NFP, prepared in accordance with Canadian accounting standards for not-for-profit organizations and containing no qualification to the opinion. It is well worth careful reading by members of the board and management. Auditors will always welcome discussion and clarification of the meaning of the report.

INDEPENDENT AUDITOR'S REPORT

To the board of directors of "NFP Society"

Opinion

We have audited the financial statements of NFP Society (the Society), which comprise the statement of financial position as at December 31, 20X1, the statements of operations, changes in net assets and cash flows for the year then ended and the notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Society as at December 31, 20X1, and its financial performance and cash flows for the year then ended in accordance with Canadian accounting standards for not-for-profit organizations.

Basis for opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the section of our report entitled *Auditor's Responsibilities for the Audit of the Financial Statements*. We are independent of the Society in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of management and those charged with governance for the financial statements

Management is responsible for the preparation and fair presentation of the financial statement in accordance with Canadian accounting standards for not-for-profit organizations and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Society's ability to continue as a going concern and for disclosing, as applicable, matters related to going concerns; management must also use the going concern basis of accounting unless they intend to either liquidate the Society or to cease operations or unless they have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Society's financial reporting process.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also carry out these activities:

- Identify and assess the risks of material misstatement of the financial statements (whether due to fraud or error), design and perform audit procedures responsive to those risks and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than it would be for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Society's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Society's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Society to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

City — Name of Licensed Public Accountant
Date

Qualified Audit Opinion

It is common for auditors to qualify their opinion of the financial statements of charities that receive substantial revenue through donations. This results from the auditor being unable to verify the completeness of some or all of the types of donation revenues being received.

A contribution is a non-reciprocal transfer to a not-for-profit of cash or other assets. Its non-reciprocal nature means that it is not generated by a service or sale and has not been invoiced by the charity. This means the charity may have no way of determining the *completeness* of the contributions it is to receive. A contribution may be received but not recorded, may be discovered well after its intended delivery, or may go astray or be misappropriated.

When the auditor is unable to verify the completeness of contributions, the auditor will qualify their opinion. The qualification means that the organization revenue may have been higher or lower than shown in the current and prior year, and consequently the cash flows and assets may have been different than shown.

Note that there is a trend for charities to reduce the scope of the qualification to only specific types of revenue and, at times, to eliminate the qualification altogether. This is coming about through a combination of additional internal controls and opportunities provided by the increasing use of digital methods to make donations.

Below is an example of the first two paragraphs of the independent auditor's report containing a qualification with respect to the completeness of contribution revenue. The remaining paragraphs of the auditor's report would be substantially the same as the example above.

INDEPENDENT AUDITOR'S REPORT

To the board of directors of "NFP Society"

Qualified opinion

We have audited the financial statements of NFP Society (the Society), which comprise the statement of financial position as at December 31, 20X1, the statements of operations, changes in net assets and cash flows for the year then ended and the notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, the financial position of the Society as at December 31, 20X1, and its financial performance and cash flows for the year then ended in accordance with Canadian accounting standards for not-for-profit organizations.

Basis for qualified opinion

In common with many not-for-profit organizations, the Society derives revenue from fundraising activities, the completeness of which is not susceptible to satisfactory audit verification. Accordingly, verification of these revenues was limited to the amounts recorded in the records of the Society. Therefore, we were not able to determine whether any adjustments might be necessary to donations revenue, excess of revenues over expenses, and cash flows from operations for the years ended December 31, 20X1 and December 31, 20X0, current assets as at December 31, 20X1 and December 31, 20X0 and net assets as at December 31, 20X1 and December 31, 20X0. Our audit opinion on the financial statements for the year ended December 31, 20X0 was modified accordingly because of the possible effects of this limitation in scope.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the section of our report entitled *Auditor's Responsibilities for the Audit of the Financial Statements*. We are independent of the Society in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

APPENDIX 4

Contributed Materials and Services, Pledges, Bequests, Gifts of Life Insurance and Annuities

There are several other types of contributions that create special accounting considerations.

Recognizing Contributed Materials and Services

Organizations may receive substantial contributed materials and services. In these situations, recognition of the fair value of these contributions may provide useful information. Examples include contributed food for food banks and gifts of clothing and construction materials for certain charities. Fair values can be determined from published prices, by industry trading values and through appraisals.

Judgment is required in determining the practicality and cost of the record keeping required to determine the fair values and the cost of its audit against the benefit of the recognition. For example, it is normally impractical to recognize a fair value for the work of volunteers because valuing the hours worked is difficult.

Where the fair value of contributed materials and services can be reasonably estimated, the organization may want to establish a policy to record the amount on the financial statements.

Recognizing a Pledge

Whether collection of a pledge is reasonably assured determines whether it can be recognized. Since its collection depends on factors outside the organization's control, such as changing economic conditions and the continued goodwill and the donor's ability to pay. in almost all cases pledges do not meet the criteria for recognition. They are therefore not recognized until the pledge is actually received. Arguments have been made for recognizing certain pledge agreements that are enforceable in law when the organization would be willing to go to court to enforce them. However, recent jurisprudence has increased the uncertainty of collection, even in these cases.

There is an exception to the above non-recognition of pledges. Certain organizations that have large annual fundraising campaigns are able to provide a reasonable estimate of how many pledges will be received, based on their previous annual experience and the high volume of individual low-value pledges. For these organizations, the ability to compare campaign revenues has a high value to the readers, justifying the effort in calculating the estimate of the net pledges to be received.

Recognizing a Bequest

Although the trustee of an estate may signal to the organization that they have been included in a bequest, there remains uncertainty with when the bequest will be received and the amount that will be received. It is increasingly common for gifts in large estates to be litigated, leading to further uncertainty. Organizations should not record bequests until they know the timing and amount of the gift with reasonable certainty.

Recognizing Life Insurance Policies and Gifts of Annuities

Financial planning for gifts can involve many tax and accounting complexities and is best undertaken by professionals trained in the field. Gifts of life insurance and the creation of gift annuities are two examples of these types of gifts. The amount and timing of revenue recognition will depend on the specific terms of the gift and the associated financial instrument. For example, for life insurance, it will depend on whether the policy is whole life or term and who is paying the premiums. Annuities will typically require the cost of an annual independent valuation.

Organizations should accept these types of gifts only when they have a full understanding of both the net amount of the gift and any risks involved. For example, there have been situations with gift annuities where financial results over time have been a net loss to the receiving organization.

APPENDIX 5

Glossary of Financial Terms

The following definitions are taken from the *CPA Canada Handbook* and other sources, as appropriate.

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Accounts payable are amounts owed by an organization.

Accrual accounting records transactions when they occur, regardless of when money actually changes hands between the organization and third parties.

Amortization is the writing off of the cost of an asset, less any residual value, in a rational and systematic manner over its useful life. Depreciation accounting is a form of amortization applied to tangible capital assets.

Assets, in general, are possessions having value. In accounting, assets are resources owned, or in some cases controlled, by an individual or organization as a result of transactions or events from which future economic benefits are expected to flow to that individual or organization.

Capital assets, comprising tangible properties, such as land, buildings and equipment, and intangible properties, are identifiable assets that meet all of the following criteria:

- They are held for use in the provision of services, for administrative purposes, for production of goods or for the maintenance, repair, development or construction of other capital assets.
- They have been acquired, constructed or developed with the intention of being used on a continuing basis.
- They are not intended for sale in the ordinary course of operations.

Cash accounting records transactions only when there is an exchange of cash.

Contributions are non-reciprocal transfers to a not-for-profit organization of cash or other assets or non-reciprocal settlements or cancellations of its liabilities. Government funding provided to a not-for-profit organization is considered to be a contribution.

Current assets are those assets that are in the form of cash or expected to become cash within the coming year.

Current liabilities are those obligations that have to be paid within the coming year.

Deferral method Under the deferral method of accounting for contributions, restricted contributions related to expenses of future periods are deferred and recognized as revenue in the period in which the related expenses are incurred. Endowment contributions are reported as direct increases in net assets. All other contributions are reported as revenue of the current period. Organizations that use fund accounting in their financial statements without following the restricted fund method would account for contributions under the deferral method.

Deferred contribution is a restricted contribution received or receivable but carried forward to be taken into income in future periods as the related restrictions are met.

Endowment contribution is a type of restricted contribution subject to externally imposed stipulations specifying that the resources contributed be maintained permanently, although the constituent assets may change from time to time.

Endowment fund is a self-balancing set of accounts which reports the accumulation of endowment contributions. Under the restricted fund method of accounting for contributions, only endowment contributions and investment income subject to restrictions stipulating that it be added to the principal amount of the endowment fund would be reported as revenue of the endowment fund. Allocations of resources to the endowment fund that result from the imposition of internal restrictions are recorded as interfund transfers.

Expenditures / Expenses are decreases in economic resources, either by way of outflows or reductions of assets or incurrences of liabilities, resulting from an entity's ordinary activities.

Fair value is the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

Fiscal year is the twelve month period designated by the organization for its "business year."

Fund accounting comprises the collective accounting procedures resulting in a self-balancing set of accounts for each fund established by legal, contractual or voluntary actions of an organization. Elements of a fund can include assets, liabilities, net assets, revenues and expenses (and gains and losses, where appropriate). Fund accounting involves an accounting segregation, although not necessarily a physical segregation, of resources.

General fund is a self-balancing set of accounts which, under the restricted fund method of accounting for contributions, reports all unrestricted revenue and restricted contributions for which no corresponding restricted fund is presented. The fund balance represents net assets that are not subject to externally imposed restrictions.

In-camera is a legal term taken from the Latin for "in a chamber" and means "in private." A board of directors would normally meet along with management at least annually with its auditors. It is best practice for time to be set aside for the board to meet in-camera with the auditors — i.e., without management present. It is also common for boards to arrange time to meet simply in-camera as a board.

Internal controls are all measures taken to safeguard assets, check the accuracy and reliability of accounting data, promote operating efficiency and ensure compliance with the organization's policies and legislation under which it operates.

Liabilities, a synonym for debt, represent amounts that it is expected will require settlement in the future as a result of events and transactions that occurred prior to the accounting date, or obligations for future delivery of goods or services for which payment has already been received.

Long-term assets (or capital assets) are not expected to be converted to cash within a year.

Long-term liabilities are obligations to make payments in the future, beyond one year.

Materiality is the quality of being important. As a general rule, in the context of financial reporting, materiality may be judged in relation to the reasonable prospect of an item or aggregate of items being significant to financial statement users in making decisions.

Net assets, sometimes referred to as equity or fund balances, is the residual interest in a not- for-profit organization's assets after deducting its liabilities. Net assets may include specific categories of items whose use may be either restricted or unrestricted.

Not-for-profit organizations are entities, normally without transferable ownership interests, organized and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose. A not-for-profit organization's members, contributors and other resource providers do not, in such capacity, receive any financial return directly from the organization.

Note disclosure is explanatory or supplementary information that elaborates on data summarized in the main body of the financial statements or provides additional information that is important to understanding the situation being reflected in the statements.

Related parties exist when one party has the ability to exercise, directly or indirectly, control, joint control or significant influence over the other. Two or more parties are related when they are subject to common control, joint control or common significant influence. Two not-for-profit organizations are related parties if one has an economic interest in the other. Related parties also include management and immediate family members.

Related party transaction is a transfer of economic resources or obligations between related parties, or the provision of services by one party to a related party, regardless of whether any consideration is exchanged. The parties to the transaction are related prior to the transaction. When the relationship arises as a result of the transaction, the transaction is not one between related parties.

Restricted contribution is a contribution subject to externally imposed stipulations that specify the purpose for which the contributed asset is to be used. A contribution restricted for the purchase of a capital asset or a contribution of the capital asset itself is a type of restricted contribution.

Restricted fund is a self-balancing set of accounts, the elements of which are restricted or relate to the use of restricted resources. Under the restricted fund method of accounting for contributions, only restricted contributions, other than endowment contributions, and other externally restricted revenue would be reported as revenue in a restricted fund. Allocations of resources that result from the imposition of internal restrictions are recorded as interfund transfers to the restricted fund.

Restricted fund method of accounting for contributions is a specialized type of fund accounting which involves the reporting of details of financial statement elements by fund in such a way that the organization reports total general funds, one or more restricted funds and an endowment fund, if applicable. Reporting of financial statement elements segregated on a basis other than that of use restrictions (e.g., by program or geographic location) does not constitute the restricted fund method.

Restrictions are stipulations imposed that specify how resources must be used. External restrictions are imposed from outside the organization, usually by the contributor of the resources. Internal restrictions are imposed in a formal manner by the organization itself, usually by resolution of the board of directors. Restrictions on contributions may only be externally imposed. Net assets or fund balances may be internally or externally restricted. Internally restricted net assets or fund balances are often referred to as “reserves” or “appropriations.”

Revenues are increases in economic resources, either by way of inflows or enhancements of assets or reductions of liabilities, resulting from the ordinary activities of an entity.

Statement of changes in net assets provides information about changes in the portions of net assets attributable to endowments, internal and external restrictions, and unrestricted net assets.

Statement of cash flows provides information about the sources and uses of cash by the organization in carrying out its operating, financing and investing activities for the period.

Statement of financial position presents the organization's economic resources, obligations and net assets as at the reporting date.

Statement of operations presents information about changes in the organization's economic resources and obligations for the period.

Unrestricted contribution is a contribution that is neither a restricted contribution nor an endowment contribution.

Working capital is the difference between current assets and current liabilities.

Working capital ratio describes how many dollars of current assets are on hand for each dollar of current liabilities.

Where to Find More Information

CPA Canada Publications on Not-for-Profit Governance

Available at www.cpacanada.ca/nfpgovernance

About the Author

Deryck Williams, FCPA, FCA

Although he had no idea what the word "auditor" meant, Deryck was inspired at a young age to follow in the footsteps of his uncle, a Chartered Accountant. Then, while studying accounting at Queen's University, Deryck inadvertently discovered a passion for not-for-profit work and became intensely involved — to the detriment of his marks — as a volunteer in a charity that takes kids in trouble with the law on ten-day wilderness canoe trips. And the rest, as they say, is history! Deryck met and married a fellow volunteer, and together they now have five wonderful children. His wife spent her entire career teaching troubled youth while he exclusively audited and primarily consulted with NFPs including some of Canada's largest, as well as a great many that are not so large. Along the way, they both served as volunteers and board members in a variety of different charities and not-for-profit organizations.

Deryck has long been present in the halls of CPA Canada and its predecessor organization, advocating for the not-for-profit sector. He has travelled the country delivering seminars and helping organizations troubleshoot. He has always enjoyed helping leaders of NFPs to achieve excellence — for on their shoulders rests the quality of life for millions of Canadians. At the time he retired, Deryck was the national leader of the not-for-profit sector practice of Grant Thornton and a member of both the Not-for-Profit Advisory Committee of the Accounting Standards Board and the Not-for-Profit Organizations Committee of the CPA Canada Corporate Oversight and Governance Board.

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