THE SALVATION ARMY
CANADA & BERMUDA

Discussion paper & invitation to comment

TERRITORIAL CONSOLIDATED FINANCIAL STATEMENTS

Finance Department
September 2005

Comments must be received by the Territorial Financial Secretary by November 30, 2005

PREFACE

This Discussion Paper and Invitation to Comment has been issued by the Finance Department on behalf of the Territorial Finance Council.

The paper is intended to facilitate discussion among divisional headquarters and ministry unit personnel in order to assist the Finance Department in developing an implementation plan for presentation to the Territorial Finance Council.

Written comments on the issues raised in the paper are welcomed from any stakeholder; however, it is hoped that, as a minimum, a response will be received from every divisional finance board in the Territory, representing the consensus of the members. In addition, individual comment letters are invited from any officer, non-officer Salvationist, or employee interested in the subject.

Comments will be most helpful if they are related to specific questions raised in the Invitation to Comment. Where the proposed approach causes concern, it would be most helpful if the comment letter explained clearly the problems perceived, as well as suggested alternatives supported by specific reasoning. In considering the proposals outlined, respondents should reflect not only on the potential impacts in their current division, but on other divisions, and the Territory as a whole.

Comments should be submitted electronically by means of a Word document attached to an e-mail to the Territorial Financial Secretary, by November 30, 2005 (Paul_Goodyear@can.salvationarmy.org). Regrettably, comments received after that date may not be considered by the Territorial Finance Council. Copies of all submissions received by the Finance Department will be available to any interested party upon request.

EXECUTIVE SUMMARY

Since 1997, the Finance Department has been engaged in a process leading towards the issuance of consolidated financial statements for the entire Canada & Bermuda Territory. This paper provides information on the achievements to date, as well as a summary of the Finance Department's proposed strategy and recommendations to complete the project.

At its meeting of September 7, 2005, the Territorial Finance Council reaffirmed its commitment to the goal of producing consolidated financial statements for the Territory, and gave its approval in principle to the recommendations set out in this paper, subject to further consultation with divisions and ministry units, and the development of an implementation plan, which is to be presented to the Territorial Finance Council in January 2006.

The desire of the Finance Department and the Territorial Finance Council is that as many stakeholders as possible will have input into the final decisions that the Council will make, both to confirm or change the decisions already taken in principle, if required, as well as to guide the implementation planning process.

The decisions taken by the Territorial Finance Council were as follows:

a) The Council has reaffirmed its commitment, first made in 1997, to move the Territorial towards full consolidation, which represents the inclusion of the financial information for all ministry units into the territorial financial statements, as a goal to be achieved as soon as possible.
b) The Council has given its approval in principle to the concept of requiring all ministry units to adopt a territorial standard for accounting systems, including a territorial chart of accounts, subject to limited exceptions.
c) The Council has given its approval in principle to the concept of retaining a single national audit firm to conduct all external audit engagements of Salvation Army units, subject to limited exceptions.

CURRENT ISSUES

- There is misinterpretation of the financial statements (both THQ's audited statements, as well as the T3010 annual charity information return filed with the Canada Revenue Agency) since grants from THQ to ministry units are not recognized as direct program funding but rather as allocations to other Salvation Army entities or gifts to qualified donees.
- THQ records the administrative expenses for THQ and all DHQs without the program expenses of ministry units, thereby making THQ appear to have a significant amount of administrative overhead.
- If we have to "connect the dots" for our donors, corporate sponsors, etc., then the financial statements that we are producing are not as user-friendly as they should be, and defeat certain purposes for publishing such statements.

THE PURPOSE OF CONSOLIDATION

The purpose of consolidation is multi-faceted:

- To present an accurate and complete picture of the work and ministry of The Salvation Army in this territory.
- To clearly document program funding as such, rather than as gifts to qualified donees.
- To present administrative and fundraising costs accurately in comparison to total revenues, so as to maintain the integrity of the organization in the public eye, as well as to demonstrate that the Army's fundraising and administrative costs are low by comparison with many other charitable and not-for-profit organizations.
- To prepare for the Canadian Accounting Standards Board goal of harmonization with U.S. accounting standards and convergence with International Financial Reporting Standards ("IFRS"). The Canadian standards presently allow for an exemption from consolidation of large numbers of individual entities, while neither the U.S. standards nor IFRS permit this exemption. While it is not clear how quickly the Canadian board will act to remove the exemption, there is good reason to believe that it will be sooner rather than later due to the fact that public sector accounting standards have recently been modified to required full consolidation by government entities, and this is having an impact on certain not for profit organizations that are controlled by governments.

THE CONSOLIDATION PROJECT – BACKGROUND AND HISTORY

The Finance Department is currently working on a multi-year project to consolidate all Salvation Army units into a single set of financial statements that will accurately reflect the size and scope of the Army's operations in this territory. This project, which has been underway for the last several years, has resulted in significant changes in the Territory's accounting since 1997 when the requirement to consolidate was first introduced in standards for not-for-profit organizations.

Under Canadian accounting standards, not-for-profit organizations have been required to prepare financial statements consolidating the activities of controlled entities for all fiscal years commencing on or after April 1, 1997. An exemption was allowed for organizations with large numbers of individually immaterial units. Based on discussions with the external auditors, it was determined that while it would be appropriate to exempt ministry units in the first stage, it would be necessary to fully consolidate all territorial and divisional headquarters entities. The alternative would be to accept a qualified audit opinion that THQ's statements did not comply with generally accepted accounting standards.

The Finance Department presented a report to the Territorial Finance Council in October 1997 recommending consolidating all THQ and DHQ entities into the territorial financial statements commencing with the year ended March 31, 1998. The Council gave its approval to that project.

Subsequently, audit readiness reviews conducted at each divisional headquarters revealed that the books and records at most (not all!) of the sixteen DHQs then in existence were not in an acceptable state, and that in many cases (again, not all!), DHQ staff lacked sufficient qualifications and expertise to produce financial statements in compliance with generally accepted accounting principles.

A Finance Department report to the Territorial Finance Council in March 1998 recommended that the level of staff expertise at DHQs be upgraded, and that the Council give consideration to the establishment of a regional accounting centre that would provide accounting services to the three Newfoundland divisions and the Maritime division. It was the Finance Department's conviction that budgetary constraints in these four divisions would impede the hiring of qualified staff in each division, but that by pooling resources, there would be an ability to hire the appropriate staff for a central group to serve all four divisions.

In response, the Territorial Finance Council approved the establishment of the proposed regional accounting centre in St. John's, but also asked the Finance Department to take over responsibility for all divisional headquarters accounting, as well as for any ministry units then being accounted for at the DHQs, and to establish regional accounting centres in other parts of the territory to provide these services.

The first of these centres were established in St. John's and Winnipeg in 1998. Existing accounting staff at the DHQs in Montreal and Vancouver were transferred to the Territorial Finance Department shortly thereafter. In 1999, the Toronto centre was established, followed by Calgary in 2000. In 2001 the Vancouver office was closed, with its clients being served by the Calgary office since that time.

Commencing in the year ended March 1998 summary financial information for the DHQs, the colleges, the conference centre, Grace Communities Corporation, and National Recycling Operations was provided in notes to the audited financial statements for the first time.

In the year ended March 1999 National Recycling Operations was consolidated into the financial statements.

In the year ended March 2002 the divisional headquarters were incorporated in the consolidated financial statements.

In the year ended March 2003 the colleges and conference centre were incorporated in the consolidated financial statements.

At the time of this report, only Grace Communities Corporation is reported in a note to the financial statements, and this approach is being reviewed for the year ended March 2006.

While this work has been going on, two other key projects have been underway, which support the goal of full consolidation.

The first is the implementation of the Shelby system as the territory's mandated accounting software for corps units. Commencing in 1992, the territory adopted Shelby for corps, with the mandate that no corps were required to computerize, but if they desired to do so, they must use the Shelby system. As of March 1999, the Territorial Finance Council mandated the Shelby system as the standard territorial system for all corps. As of mid 2005, not only are most corps now using the Shelby system but many social services centres, including the largest units, are also using the Shelby system quite effectively for their accounting and financial reporting needs.

Recent research by the Finance Department reveals that all but approximately 150 ministry units use the Shelby software. While a few are making use of acceptable accounting systems, most notably Accpac and Simply Accounting, about half are using a manual or spreadsheet based system. The latter causes some concern in that spreadsheets, while extremely useful from a reporting standpoint, do not provide adequate audit trail for accounting purposes.

A key component of the next stage towards full consolidation will be the migration of these remaining units to a territorial standard for accounting software.

The second project that has been underway is the upgrading of the Internal Audit Group. Prior to 1997 the group was comprised largely of officers with limited financial background. Commencing in 1997, auditors with professional accounting designations were engaged, and as a result, the quality of the work performed by the group has increased significantly over time. Part of the rationale for the Territorial Finance Council's decision to proceed with this project was so that the group could provide services to the external auditors and thereby help reduce the overall costs of consolidation. This has been realized with the group currently contributing about 500 hours per year to the external audit engagement.

The upgrading of the Internal Audit Group has also resulted in better information being available at THQ concerning the quality of accounting and financial reporting at the ministry unit level, and the group will play a key role in the next stage of the consolidation project in helping the Finance Department assess the state of audit readiness of individual units.

THE ROAD AHEAD

The next phase of the consolidation project will require multiple stages over several years and will require the assistance of the Information Technology Department, the Internal Audit Group, and external auditors. Preliminary discussions have taken place with each of these groups and they are supportive of the direction being taken by the Finance department.

Stage 1

Stage 1 involves the collection of data from ministry units and consultation with stakeholders to develop a plan for implementation.

There are a total of 458 ministry units (as defined by the charitable registration number) to be consolidated into the THQ financial statements. These include hospitals, social services, corps (along with their associated sub-ministries/programs), community & family services, thrift stores, camps, daycares, etc.

Of these, about 83 units have external audits and issue financial statements in accordance with Canadian accounting standards. About another 150 units have their accounting performed by a regional accounting centre in accordance with accounting standards. The remaining units issue statements using a cash or modified cash basis of accounting, and are unaudited.

Ministry units are not currently required to submit financial statements to THQ, except for the externally audited statements related to social services. Our research to date indicates that there are over one thousand individual budgets for which financial statements are prepared locally at these ministry units. As a result, it will require significant effort to collect the data necessary for consolidation.

The data collection is already in process with the assistance of divisional headquarters and the Internal Audit Group.

Consultations have commenced with the Information Technology Department, other territories, external auditors, and internal auditors. The next step involves consultation with divisional secretaries for business administration ministry unit personnel, primarily through this discussion paper and invitation to comment.

Stage 2

Stage 2 involves assessing the quality of data received. Our experience to date, combined with that of the internal audit group, is that there are inconsistent accounting treatments and procedures in place across ministry units that will have to be addressed prior to consolidation. In addition, there are a significant number of ministry units that are performing their accounting function on a cash or modified cash basis of accounting rather than full accrual accounting in accordance with Canadian standards. Some of them will not be able to make the conversion to accrual accounting themselves due to the lack of qualified staff or volunteers. In addition, there are numerous corps units that record their own income and expenses, but are unable to properly reconcile their bank accounts.

Ministry unit financial statements will be reviewed in consultation with internal audit staff. Internal auditors will complete an audit readiness survey for each audit they undertake. At the end of this stage, we will develop audit readiness guidelines to assist units in identifying potential problem areas and helping them to modify policies and procedures to bring them in line with territorial standards.

In some cases, ministry units who are not in compliance with the standards will be able to upgrade staff and systems, or modify policies and procedures to reach a state of audit readiness on their own, or with limited assistance. In other cases, units will require significant assistance from DHQ and the Finance Department. Some of these units may find that they will require the services of a regional accounting centre to perform their accounting function. Others may be able to handle much of the day to day transaction processing on their own, but require a regional accounting centre to review their books monthly and make adjustments to comply with accounting standards.

Stage 3

Stage 3 involves a further assessment of the state of audit readiness after units have converted systems and/or staff and modified policies and procedures to conform to territorial standards. In this stage, it is expected that we will be able to access ministry units' financial records electronically, although it is possible that in a few cases, on-site visits may be required.

Stage 4

Stage 4 involves the full consolidation of financial information into the territorial statements. It is the Finance Department's intention to fully consolidate all 464 charitably registered units. However, because of the sheer number involved, and the number of related-party transactions, it is unrealistic to perform full consolidation in a single step. Instead, we are considering a two step approach, starting with note disclosure (in the first instance, for internal publication only) and ending with full consolidation of our audited financial statements.

POTENTIAL OBSTACLES

The next phase of the project will face the following challenges:

- Although a territorial chart of accounts exists for use with the Shelby system, units that are not using Shelby will require their chart of accounts to be adapted to the territorial standard.

- The various accounting systems will require some level of integration to facilitate the consolidation process. The preferred approach is that all ministry units use the same accounting system.

- Compliance of all ministry units in adopting territorial standard accounting polices and procedures. In a large and diverse organization, compliance with national policies is always a challenge.

- Our ability to collect information from all units. Even the task of compiling basic information such as: total expenses, whether units are audited externally, and what accounting system they use, has been a daunting challenge for the Finance Department and DHQs. A spirit of cooperation and an understanding of the desirability of consolidation will be essential if the project is to be successful.

- The ability of all ministry units to close their year-end and submit statements within a reasonable deadline. Clearly, for consolidated statements to be useful, they must be produced within a reasonable period of time after the year-end date. The challenge will be to coordinate the project and ensure that all ministry units meet the reporting deadlines necessary to ensure release of the territorial statements in a timely manner.

- The cost of implementing a new accounting system or hiring qualified staff to perform the work or retaining the services of a regional accounting centre or other source of accounting expertise will be a financial burden for some ministry units.

CHART OF ACCOUNTS AND ACCOUNTING SYSTEMS

The ability to produce financial statements that are in compliance with generally accepted accounting standards is dependent on a strong accounting system, manual or computerized. A project of the magnitude of consolidation essentially dictates that computerized systems are used to facilitate the electronic transfer of data. Attempting to consolidate information from manual records would be extremely costly and time-consuming.

At present, ministry units are using a variety of systems. Based on the data compiled to date, there are 952 financial statements produced at the ministry unit level (this represents individual budgets, but not necessarily individual units, as in some cases, separate books are being maintained for several separate programs or ministries within a single ministry unit). Of these, over 800 are prepared using the Shelby software.

Other acceptable systems in place for producing financial statements are Accpac (23 instances) and Simply Accounting (12 instances). In at least 37 cases, statements are being prepared using an Excel spreadsheet, which is inadequate from an audit standpoint, and 36 are being prepared using manual systems.

The Shelby system was originally mandated as the computerized accounting system for corps. In fact, it is now being used effectively by corps and social services units, large and small.

The task of consolidation will be much simpler and economical if all units use a common chart of accounts and accounting system. As a result, the Finance Department is of the view that the Shelby system should be mandated as the territorial standard for accounting software, and that all units who perform their own accounting should be given a timeframe within which to convert their existing system.

Units using Accpac or Simply Accounting could be given a longer timeframe to change systems, provided they come into line with the territorial chart of accounts, and are able to produce the information required for consolidation purposes in the appropriate format and according to the required timelines. For example, one proposal would be to allow such units to retain and use their existing system for five years or up to the time of their next system upgrade, whichever occurs first.

Units, such as hospitals, which are subject to government regulation over their choice of accounting and financial reporting systems, would be exempt. The Finance Department would work with these units to develop an appropriate template to capture information needed for consolidation purposes.

Units with their accounting performed by a regional accounting centre would use whatever system is employed by the Finance Department. At present the THQ accounting is performed using the Masterpiece system, while accounting for regional accounting centre clients is performing using the Shelby system. The Finance Department is engaged in a review leading to the adoption of a single accounting system for use across the department in order to facilitate more efficient processing.

A territorial chart of accounts has already been developed and is published in the Territorial Finance Manual. To date, it has been adopted by most ministry units using the Shelby system, with no significant problems noted. The chart is not, however, linked to the chart of accounts in use at Territorial Headquarters. The Finance Department plans to review both charts, with a view to making any improvements necessary in the territorial chart and then adapting the THQ chart to bring it in line with the territorial chart.

One of the significant advantages of the current territorial chart is that it is designed to bring consistency across units on the core account number used (e.g. Cash at bank is recorded in account #111000) with the ability of the individual ministry unit to capture additional detail or multiple accounts through the use of sub-accounts (e.g. if a unit had two bank accounts, the accounts #111001 and #111002 could be used), and a flexible reporting structure that allows the roll up of all sub-accounts into the master account (e.g. the total of accounts #111001 and #111002 would be combined as a total for #111000). In this way, the territorial chart is maintained for consolidation purposes, while allowing individual units to adapt the chart to their particular circumstances.

Where unique reporting formats are required for presentation of financial statements to funding agencies, the Finance Department would work with the units concerned to develop special purpose reports that could be generated from the Shelby system to meet any external reporting obligations.

EXTERNAL AUDIT

Preliminary consultation with external auditors suggests that current external audit fees would increase by approximately 50% with the implementation of fully consolidated financial statements assuming that all units are in a state of audit readiness. These costs could potentially be reduced if a single national audit firm appointed as the sole auditor of all Salvation Army facilities, due to the reduced audit work that would be required for consolidation purposes. In addition, preliminary research has suggested that if a single audit firm were engaged, a significant volume discount could be negotiated to reduced costs overall, as well as to individual ministry units.

Apart from potential cost savings, the engagement of a single national audit firm would be highly desirable from several other points of view. The task of ensuring completion of the audit work and issuance of consolidated financial statements on a timely basis would be greatly simplified by the ability for the lead audit partner to be able to give direction to colleagues in the same firm concerning deadlines for completion of audit work and ensure compliance.

In addition, it is the Finance Department's experience that in many cases (not all!), individual units are poorly served by the relationship they have with their auditors, in that there is no one on staff with technical expertise who can engage in an informed dialogue with external auditors concerning financial statement presentation and disclosure issues, or to articulate Salvation Army accounting policies.

The engagement of a single audit firm would help ensure that auditors of each ministry unit are better connected to resource staff in the national office of their firm with expertise in the interpretation of Salvation Army accounting policies and proper disclosure of the unique relationship of the Governing Council of The Salvation Army in Canada to each ministry unit, particularly as it relates to the ownership and control of fixed assets and investments.

INVITATION TO COMMENT

Respondents are encouraged to answer each of the following questions, as well as to supply any other comments they feel relevant.

1. Are you in agreement with the decision to move towards full consolidation of ministry unit financial information in the territorial finance statements? If not, why not?
2. Do you support the adoption of a territorial chart of accounts? If not, why not? Are there unique circumstances in ministry units that you are aware of that would prohibit adopting a standard chart of accounts, provided there was flexibility to add sub-accounts to each major account grouping as indicated in the paper? Are there other unique factors that are not captured in the existing territorial chart of accounts?
3. Do you support the adoption of the Shelby system as the standard for accounting at all ministry units, subject to the proposed exceptions. If not, why not? Are there any other exceptions that should be made?
4. Do you support the proposed timeline for grandfathering units that are presently using Accpac or Simply Accounting? If not, what alternative would you suggest?
5. Other than those units noted in question #4 above, what period of time should be provided for existing units to convert to the Shelby system?
6. Do you support the idea of engaging a single audit firm as the best way to ensure cost minimization at all levels, as well as to help ensure timely issuance of consolidated statements? If not, why not, and what alternatives would you suggest that would be as effective in accomplishing a timely issuance of consolidated statements?
7. For financial statements to be most useful, they must be issued in a timely manner. During the past few years the THQ audit has been completed by the end of May and financial statements approved by the Governing Council during the first week of June. Do you see any reason why ministry units could not complete their year-end work, close their books, and be audited by the end of May? Are there factors that you are aware of that would make this goal impossible?