Canada Council for the Arts
Management's Narrative Discussion
For the three and nine months ended December 31, 2011

Introduction

This narrative discussion relates to the financial results of the Canada Council for the Arts (the Council) for the three and nine month periods ended December 31, 2011 as set out in the accompanying unaudited quarterly financial statements. Those statements are presented and disclosed in accordance with the requirements of the Financial Administration Act and are prepared in accordance with Public Sector Accounting Standards (PSAS) issued by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants. The Council's audited annual financial statements for the year ended March 31, 2012 will be the first ones to be prepared using the PSAS accounting framework.

Management is responsible for the information presented in the unaudited quarterly financial statements and this narrative discussion which have been reviewed and approved by the Audit and Finance Committee of the Council's Board of Directors. In assessing what information is to be provided in the narrative discussion, management applies the materiality principle as guidance for disclosure. Management considers information material if it is considered probable that its omission or misstatement, judged in the surrounding circumstances would influence the decisions of the primary user of this information, the Government of Canada.

This narrative discussion contains forward-looking statements that reflect management's expectations regarding the Council's results of operations. These statements are not facts but only estimates based upon information and assumptions that are currently available to, or made by, management but which are subject to a number of risks and uncertainties and may prove to be incorrect. Accordingly, readers are cautioned not to place undue reliance on the forward looking statements.

As the Financial Administration Act does not require the Council to file a Corporate Plan with the government of Canada, neither this narrative discussion nor the quarterly financial statements disclose a comparison of results as against the Council's Corporate Plan. As required by PSAS, the Council's annual audited financial statements for the year ended March 31, 2012 will disclose comparisons to the Council's approved budget for the year.

Transition

Due to the transition to PSAS, the preparation of all the Council's financial quarterly and annual financial statements relating to the 2011-12 fiscal year involves the redetermination, revision and re-establishment of accounting policies and the resolution of several significant accounting issues . Note 2 to the financial statements sets out significant matters relating to this transition and reconciles account balances and transactions from the previous accounting framework to the current method of presentation. Note 3 discloses information regarding the Council's adoption effective April 1, 2011 of new accounting standards issued by the PSAB. The adoption of PSAS 3450 - Financial Instruments is of special significance as it allows the Council to continue to use fair value accounting for its investments. Note 4 sets out the Council's significant accounting policies.

The transition to PSAS causes significant issues in relation to the presentation of comparative information. Therefore the Council obtained an exemption from the Treasury Board of Canada Secretariat. This exemption does not provide full comparative presentation relief but allows the Council to present such information using the previous accounting framework (former Canadian Generally Accepted Accounting Principles). The comparative information is presented in a condensed format in Note 16. PSAB has recently issued an exposure draft that would adjust PSAS 3450 paragraph 99 which relates to the presentation of the Statement of Remeasurement

Gains and Losses. The Council believes that application of the recommended change will resolve the issues relating to comparative information. The change will be applied in the presentation of the annual audited financial statements for the year ended March 31, 2012.

FINANCIAL RESULTS

For the quarter ended December 31, 2011, the Council recorded a surplus from operations of $23.8 M and a surplus from operations of $12.9M for the nine month period then ended. This surplus is net of realized losses of $6.9M and $6.6M from the sale of investments. Other than the investment impact, the surplus is primarily the result of the difference in timing of the recording of revenue from Parliamentary appropriations, which is recognized during the year as the appropriation is drawn down, and the recording of grants expenses. The expenses for multi-year operating grants for which budget for the current year has been approved and which meet certain other criteria are expensed at the start of the year. Most, but not all, such grants are paid during the first quarter of the year and the impact of the timing difference causes losses in the first two quarters a gain in the third quarter and, if the budget is attained, a minor profit for the full year.

The Council anticipates no material change to its $181.4M Parliamentary appropriation for the year ended March 31, 2012. Grants expenses are forecast to be almost exactly on budget at $156.1M. However, that amount includes $2.9M for grants payments carried over from prior years and approved by the Board of the Council to be paid during the current year. These are paid out of the Council's accumulated surplus.

The Statement of Changes in Net Financial Assets discloses an increase in net financial assets of $27.8M during the quarter and an increase of $5.3M for the first nine months of the fiscal year. These increases include net remeasurement gains of $3.9M for the three month period and losses of $7.6M for the nine month period. Other changes in net financial assets relate almost entirely to the three and nine month results of operations discussed above. The Statement of Remeasurement gains and losses discloses in greater detail the net changes in fair value and the realized loss on derivatives and portfolio investments of $6.9M (three month period) and $6.6M (nine month period) that were reclassified to the Statement of Operations. These realized losses primarily relate to the sale of the Council's investment with one of its global equity managers, whose mandate was terminated during the quarter. The Council continues to revise its investment structure to align it to its revised asset allocation mix that was approved by the Board in January 2012.

Note 13 to the financial statements discloses a net change in non-cash items of $8.7M for the nine month period. This arises primarily from the $7.3M increase in accounts receivable for accrued investment income and sales tax rebates in comparison to the value as at March 31, 2011. The $38.7M change for the three month period arises from this same change and primarily from multi-year grants expensed at the start of the year which were paid during the quarter and a decrease in deferred parliamentary appropriations due to the timing of receipt.

Cash used by operating activities during the quarter was $14.7M and was a net provision of $4.0M for the nine month period. The nine month value reflects the successful planned close match of appropriation revenues and total expenses during the period and the control of administrative costs while the three month decrease reflects the timing impact of the full-year expensing of multi-year grants as at April 1. Capital, investing and financing transactions also affect cash balances. In net these provided $7.4M cash for the quarter and $7M for the year to date. These funds were provided from the disposal of $61.9M of portfolio investments during the quarter offset by acquisitions of $54.3M. The result of all was an increase in cash and cash equivalents of $11.1M for the year to date. The majority of this increase will be subsequently offset by grants payments issued during the last quarter of the year.

The Council's Portfolio investments arise from a $50M endowment received from the government in 1957 when the Council was created and from externally restricted contributions received subsequently. At December 31, 2011 the fair value of the Portfolio was $261.7M, of which $70.2M was externally restricted. The Council's liability for these contributions was $59.5M. The government's original endowment is included in accumulated surplus as disclosed in Note 9.

The Council owns approximately seventeen thousand works of art. These are held by its Art Bank and rented out. The Art Bank is self-financing and reinvests its profits in new art purchases. The Art Bank recorded a loss of $18K for the quarter and $332K for the year to date. A loss of $425K is anticipated for the year. However, $320K of this loss will result from the purchase of art works funded by the accumulated net profits of prior years. The Council also operates a Musical Instrument Bank and it currently owns a fine cello bow and six quality musical instruments. In addition, the Council manages ten instruments on loan, nine of which are lent by anonymous donors. Using a donation of funds from the Council's Edith Webb Endowment, during the first quarter the Council purchased a Cello valued at $500K which has been renamed the 1730 Newland Joannes Franciscus Celoniatus Cello. Activity is currently underway to purchase an additional two violins. At March 31, 2011 the appraised value of the Council's works of art was approximately $70M and the appraised value of its musical instruments was $28M USD. These are included on the Statement of Financial Position with tangible capital assets and are valued nominally at $1.00.

RISK ANALYSIS AND SIGNIFICANT CHANGES DURING AND SUBSEQUENT TO THE QUARTER

For the full year the Council anticipates that disposable investment income, may match the total investment return target of $8.1M. However, the net investment return will be much less due to losses realized on sold investments. Uncertainty regarding the global economy and corporate and sovereign returns continues and may adversely affect portfolio values. During January and early February 2012, the Council sold a portion of its investments with its other Global Equity Manager, sold investments purchased temporarily pending the acquisition of a new investment manager and invested with the new manager and with its Canadian equities manager. The realized gains and losses from these transactions and the gains on currency hedging approximately offset each other. Subsequent to December 31, 2011, Canadian and Global financial markets continue to be subject to major swings. The Council cannot reliably forecast further realized or unrealized investment gains or losses for the year.

At December 31, 2011 the fair value of the Council's investment portfolio was $261.7M. These represent investments in units of equity, fixed income and alternative pooled funds, limited real estate partnerships and an infrastructure fund. As discussed above, global markets and the global economy are currently undergoing significant and rapid swings the impact of which cannot at present be reliably forecast. Therefore the Council reassessed its investment policy, asset allocation mix and expenditure policy. Recommended changes were approved by the Board of Directors at its January 2012 meeting. These changes address Council's long-term investment and income requirements which must take into account the up and down market changes and the changes in risk and certainty that constantly occur over the shorter-term. An important outcome is that the Council has adjusted its Expenditure Policy for the use of invested funds downwards from 4.5% to 4.0% of the rolling three-year average of the fair market value of the portfolio as at September 30. Therefore, the Council will expect and budget approximately $1.2M less in annual investment income available for use in operations for the next several years.

In compliance to a request from government, the Council has budgeted and acted in a manner to ensure fiscal restraint such that administrative expenses for the current year and the next will not exceed those for 2010-11. For the first nine months of the year, the Council's non-grant expenses were less than budget, being better by approximately $1.0M. The Council forecasts to remain better than budget for the full year.

The Government has undertaken a Deficit Reduction Action Plan with the goal of reducing certain expenditures by $4B on an ongoing basis by fiscal 2014-15. The review currently applies to 67 departments and agencies, including the Council. All are asked to develop scenarios that would implement either 5% or 10% reductions in their funding. The Council has participated actively in the process to date and provided its proposals, consistent with direction approved by its Board. These proposals have subsequently been reviewed with officials from the Department of Heritage and Treasury Board Secretariat. The outcome and impact upon the Council of the government's decisions regarding the Deficit Reduction Action Plan will not be known until Budget 2012 is tabled in Parliament, likely in March 2012.

The Council has collective agreements with two bargaining units of the Public Service Alliance of Canada. Both agreements expired on July 1, 2011. The parties met to negotiate commencing in July. In November 2011 the parties reached agreement on a new contract for the three year period ending June 30 2014. Although the Council is not part of the core public service and is not subject to related Treasury Board requirements or direction, the financial terms of the Council's new agreement are consistent with those desired by the government for the core public service.

The Council's management has recently approved plans regarding its leased space and its information systems. Both contracts have been signed and project work has commenced. When implemented over the next three years, these and other changes relating to its programs will redesign the Council's manner of operation while reducing costs.

USE OF APPROPRIATION

The following information is intended to supplement that provided elsewhere in this discussion regarding the Council's use of its Parliamentary appropriation.

The Council receives its main funding through Parliamentary appropriation voted by Parliament. The Council records the Parliamentary appropriation received in the period as revenue in the Statement of Operations. The Council submits a monthly cash flow analysis to the Department of Canadian Heritage to justify its monthly drawdown cash requirements. The monthly drawdown is invested in a short term pooled fund managed by a professional investment manager from which the Council draws its daily cash requirements.

The Parliamentary appropriation approved and received by the Council during the first nine months of the fiscal year is as follows:

	2011
	$M
Operating funding	
Approved annual funding – Vote 10 – Operating costs	181,761
Reduction non-recurring funding for programming initiatives	(500)
Operating funding received and recorded in the Statement of Operations	(161,618)
Balance of Operating funding to be received	19,643