CANADA COUNCIL FOR THE ARTS
NARRATIVE DISCUSSION
FOR THE QUARTER ENDED SEPTEMBER 30, 2011

FINANCIAL RESULTS

This narrative discussion relates to the financial results of the Canada Council for the Arts (the Council) for the quarter ended September 30, 2011 as set out in the accompanying unaudited Quarterly Financial Statements. Those statements, which are presented and disclosed in accordance with the requirements of the Financial Administration Act, are the second such quarterly financial statements to be published by the Council 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 prepared using the PSAS accounting framework.

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 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 accounting policies. Note 16 sets out comparative information for the prior year.

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.

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.

The Council recorded a surplus from operations of $17.4M for the quarter ended September 30, 2011. For the six month period then ended it recorded a deficit from operations of $10.9M. This loss arises from a $1.6M shortfall in investment income and the rest relates almost completely to 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 declines with each quarter.

The Council anticipates no material change to its Parliamentary appropriation for the year ended March 31, 2012. Grants expenses are forecast to be almost exactly on budget at $155.9M. However, that amount includes $2.7M for unused grants carried over from prior years and approved by the Board of the Council to be expensed 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 $5.7M during the quarter but a decrease of $22M for the first six months of the fiscal year. Net remeasurement losses, which indicate the decline in fair value of investments, represents $11.5M of this decrease This decrease occurred almost completely during the second quarter and derives from overall uncertainty and turmoil in global markets and economies. Other changes in net financial assets relate almost entirely to the quarter and six month results of operations discussed above. The Statement of Remeasurement gains and losses discloses in greater detail the net changes in fair value and a realized loss in derivatives of $340K that was reclassified to the Statement of Operations.

Note 13 to the financial statements discloses a net change in non-cash items of $30M. This arises primarily from the $23.1M increase in grants payable and from the $10M increase in deferred parliamentary appropriations in comparison to the value as at March 31, 2011. The grants payable increase arises primarily from multi-year grants expensed at the start of the year which had not been paid by the end of the quarter. Taking into account the deficit for the period, and adjusting for changes in non-cash capital items, cash provided by operating activities during the quarter was $2M and was $18.7M for the six month period. The quarterly value reflects the successful planned close match of appropriation revenues and total expenses during the period while the six month increase continues to reflect the in-year increase in grants payable due to full-year expensing of multi-year grants as at April 1. Capital, investing and financing transactions also affect cash balances. In net these provided $0.4M cash for the quarter and used $0.4M for the year to date. The result of all of these for the quarter was an increase in cash and cash equivalents of $2.4M and $18.4M for the year to date. The majority of this increase will be subsequently offset by grants payments issued during the third and fourth quarters 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 September 30, 2011 the fair value of the Portfolio was $264.4M, of which $70.9M was externally restricted. The Council's liability for these contributions was $57.3M. 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 $256K for the quarter and $314K for the year to date. A loss of $526K 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. At September 30, 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 a shortfall on investment income earned from interest and dividends that may exceed $2M. This arises largely from uncertainty regarding the global economy and corporate and sovereign returns. In late September the Council decided to terminate its relationship with one of its major global equity managers as they continued to under-perform in comparison to their market benchmark. The investments were sold in October at a realized loss for the Council of approximately $6.9M. Subsequent to September 30, 2011 Canadian and Global financial markets continue to be subject to major swings. At present, the Council cannot reliably forecast further realized or unrealized investment gains or losses for the year.

At September 30, 2011 the fair value of the Council's investment portfolio was $264.4M. 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. The Council is currently reassessing its investment policy, asset allocation mix and expenditure policy and will likely approve changes before the end of this fiscal year. These changes will address Council's long-term investment and income requirements which must take into account the up and down market changes and changes in risk and certainty that constantly occur over the shorter-term. A likely outcome will be that the Council will expect and budget significantly less 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 six month of the year, the Council's administrative expenses were less than budget, being better by approximately $585K. 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, on August 18, 2011. 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 in July to commence the negotiations for new agreements. These negotiations are still in progress.

The Council's management has recently approved plans regarding its leased space and its information systems. Both, when implemented over the next three years, 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 six month of the fiscal year is as follows:

	2011
	$M
Operating funding	
Approved annual funding – Vote 10 – Operating costs	181,761
Additional non-recurring funding for programming initiatives	-
Operating funding received and recorded in the Statement of Operations	(128,961)
Balance of Operating funding to be received	52,800