

# 20 Questions Directors of Not-for-Profit Organizations Should Ask About **Social Enterprise**

Andrew Valentine, LL.B. • Partner, Miller Thomson LLP





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# Preface

The Risk Oversight and Governance Board (ROGB) of the Chartered Professional Accountants of Canada (CPA Canada) has commissioned this publication *20 Questions Directors of Not-for-Profit Organizations Should Ask About Social Enterprise* to help directors of not-for-profit organizations (NPOs) that are considering or are already conducting activities through a social enterprise address common issues and questions regarding such operations.

*20 Questions* identifies key concepts in the burgeoning sector of social enterprise including the wide range of definitions of the term and provides examples of social enterprises in Canada. The term “social enterprise” encompasses a wide range of meanings, from the organization or operation itself to an activity or program within the entity. The basic requirement for an organization, operation, activity or program to be considered a social enterprise is that there must be a socially beneficial purpose achieved through commercial or business-like activities.

Prior to establishing a social enterprise, NPO directors should carefully consider many factors. Historically there has been a high failure rate associated with social enterprises, therefore, it is important for the board to perform appropriate due diligence. Considerations such as determining a potential social enterprise’s operational goals and priorities, funding requirements and sources, business plan and budget, and control structure are all vital to setting up a financially sustainable organization. The board should also consider up front the possibility of failure and an exit strategy for the social enterprise. In addition, a key question in creating a social enterprise is whether a charitable organization will lose its tax-exempt status.

Many organizations are already set up as social enterprises. The publication addresses the risks of tax compliance for NPOs that carry on social enterprise activities directly. It also identifies the many challenges faced by social enterprises including maintaining their social missions in an environment that may be rife with tensions caused by multiple objectives and stakeholders. NPO directors may not be familiar with the business risks associated with a social enterprise—*20 Questions* sets out these risks and the board’s response. The publication gives advice on the qualifications and skills desired in social

enterprise board members, board training and the pros and cons of having paid or volunteer staff. Boards are provided with guidance on the difficult area of how to measure the success of a social enterprise. Reporting requirements and communications with stakeholders are also addressed, as well as the winding up of a social enterprise.

In summary, the NPO directors of a social enterprise are responsible for overseeing its creation and operation and have the customary fiduciary duties required by corporate law. *20 Questions* provides an overview of these duties in the context of a social enterprise.

The ROGB thanks the author, Andrew Valentine, and acknowledges the contribution of the Not-for-Profit Organizations Committee and the Directors Advisory Group for identifying the need for research and guidance in this area, and for their advice and suggestions to the author throughout the course of his work.

Brian Held, ICD.D, FCPA, FCA  
Interim Chair, Risk Oversight and Governance Board

**Author**

Andrew Valentine, LL.B.  
*Partner, Miller Thomson LLP*

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# Introduction

Social enterprise is a rapidly growing sector in Canada. More and more charities and non-profit organizations (NPO) are looking to social enterprise as a promising new vehicle for pursuing social goods while easing dependence on donations and government grants. The combination of social objectives, business-like activities and private investment presents exciting possibilities for funding and advancing socially beneficial goals.

With these possibilities come significant challenges. The directors of an organization that conducts a social enterprise need to understand the special responsibilities and risks of this activity. The experience of many board members in the not-for-profit and for-profit worlds may only partially prepare them for the unique balancing of priorities and stakeholder interests that arises in the social enterprise context.

This publication aims to provide directors of not-for-profit organizations with an overview of the issues and questions they face in establishing, running and ultimately exiting a social enterprise. This information is equally important for directors of organizations that are considering conducting activities through a social enterprise and directors of organizations that already operate one. Our objective is to give directors a better understanding of these issues and the steps they can take to meet the challenges of overseeing these operations.



# A. Key Concepts

## 1. What is social enterprise?

“Social enterprise” is used differently by different people and in different contexts. In its broadest sense, “social enterprise” refers to the use of revenue-generating business-like activities to accomplish, at least in part, a socially beneficial purpose. The term may be used to describe the entity conducting the activity or the activity or program itself (particularly when conducted in an organization that also carries on a range of other activities).

The notion of combining business-like structures with social purposes is itself very broad. For example, this can be accomplished through:

- a not-for-profit entity (registered charity or NPO) conducting business-like activities to pursue a social goal and/or to raise funds for the organization
- a business with social, cultural or environmental purposes (sometimes called a “social purpose business”)
- a specific program or venture that fulfils a social purpose.

Social enterprise generally involves an intention to generate sustainable revenue through the business activity, thereby avoiding the need to rely entirely on traditional sources of philanthropic funding: government grants and public donations. Social enterprise activities also may provide limited financial returns to private investors as a means of attracting investment. In this way, social enterprise often involves a mix of for-profit and not-for-profit elements.

In this publication, the term “social enterprise” refers primarily to business-like programs conducted by a not-for-profit entity (including registered charities and NPOs) to accomplish a socially beneficial goal. This activity may be conducted directly by the organization or through a subsidiary, which may be a for-profit entity.

## 2. What are some examples of social enterprise?

Social enterprise covers a wide range of operations. Examples of social enterprises in Canada are as follows:

- St. John's Bakery<sup>1</sup> is a social enterprise operated in Toronto as an internal program of St. John the Compassionate Mission (a registered charity). This social enterprise produces and sells organic bread and baked goods and provides employment and skills training to marginalized individuals, including welfare recipients, people with addictions and mental illness, and new immigrants. The bakery is funded through both foundation and government grants and its sales revenue.
- Blackboard Marketing<sup>2</sup> is a social enterprise program of the Remix Project (a registered charity). The Remix Project provides education for marginalized youth seeking to enter the creative industries. Blackboard Marketing offers marketing and creative design services to its public clientele while providing work experience and income for students of the Remix Project. All profits from Blackboard Marketing are re-invested in the Remix Project.
- A-Way Express Courier<sup>3</sup> operates a courier business in Toronto and provides meaningful and supportive employment for people with direct experience of the mental health system.
- Aki Energy,<sup>4</sup> based in Manitoba, works with Aboriginal communities to develop and install energy-efficient geothermal heat systems, and offers training programs to certify First Nations construction companies to install, maintain and service geothermal systems.
- Ten Thousand Villages,<sup>5</sup> a program of the Mennonite Central Committee (a registered charity), sells handcrafted gifts, jewellery, art, sculpture and similar goods made by disadvantaged artisans in developing countries. The enterprise provides income for artisans who would otherwise be unemployed or underemployed, helping them pay for food, education, health care and housing. The company encourages

1 [www.stjohnsbakery.com](http://www.stjohnsbakery.com)

2 [www.blackboardmktg.com](http://www.blackboardmktg.com)

3 [www.awaycourier.ca](http://www.awaycourier.ca)

4 [www.akienergy.com](http://www.akienergy.com)

5 [www.tenthousandvillages.ca](http://www.tenthousandvillages.ca)

artisan partners to use environmentally friendly processes, sustainable natural resources and recycled materials to ensure each product offered has been crafted responsibly.

- The Centre for Innovation and Social Enterprise Development<sup>6</sup> offers consulting services for all aspects of social enterprise development. Its stated social mission is to help build strong, vibrant and sustainable social enterprises that address the needs of the community.
- Switchback Cyclery<sup>7</sup> is operated by Sanctuary Ministries, a Christian charity that seeks to develop a holistic, inclusive and healthy community for marginalized people, offering counselling and friendship. Switchback Cyclery operates a bike sale and service business that provides employment opportunities for Sanctuary's community.

Each of these examples reflects the basic model of social enterprise: the use of revenue-generating business-like activities to accomplish a social purpose. Perhaps the most common form of social enterprise is a business that seeks to provide employment, training and income for disenfranchised people (such as the homeless, mentally ill and First Nations communities). Other purposes advanced by these social enterprises include environmental protection, relief and development, education and additional socially beneficial outcomes.

6 <http://cised.ca/we-consult>

7 [www.switchbackcyclery.ca](http://www.switchbackcyclery.ca)

## B. Structural and Pre-Operational Considerations

### 3. What planning issues should be considered when establishing a social enterprise?

When a social entrepreneur considers beginning a new social enterprise or when the directors of a charity or NPO consider introducing a new social enterprise program, a range of issues must be addressed. Having a well-considered business plan is vital to success.

This section examines some of these planning issues for directors to consider when planning to introduce a new social enterprise.

#### a. Operational priorities

Determining the operating goals and priorities of the social enterprise is crucial. What is the enterprise's fundamental purpose? Is it to further a social purpose directly, for example, by providing employment to marginalized individuals? Or is it primarily to generate a financial return that can be used to support the operations of a charity or NPO.

These questions affect both the initial structure of the enterprise and ongoing operational decisions, so thinking them through carefully is crucial. As the organization operates, it will likely encounter tension between the competing priorities of revenue and social mission. For example, if revenue from the enterprise disappoints, how flexible should the enterprise be with its business model or its willingness to seek new revenue opportunities? Should such changes be made even if they might diminish the social mission? Or should the social mission remain paramount, even if this means lower revenue and greater need to supplement revenue through grants or public donations?



These questions can be answered more coherently and consistently if the founders of the social enterprise have established a clear purpose and set priorities for the social enterprise at the outset.

### **b. Funding sources**

It is necessary to consider carefully the financial needs of the enterprise, both at the outset and on an ongoing basis, and the funding sources upon which the organization will rely. Questions that directors should consider include the following:

- Is the enterprise expected to generate sufficient revenue to be wholly self-sustaining?
- Will it require ongoing financial support from a founding charity or NPO?
- Will the organization need to seek bank loans or other commercial financing?
- Will the enterprise need to access funding from community foundations or government agencies?
- Will it require the ability to attract private investors?

The answers to these questions will influence the enterprise's structure and tax status, which are important in determining the flexibility and options that will be available for financing. The board should prioritize the funding sources that the enterprise will need access and ensure the enterprise is appropriately structured to accommodate these priorities.

Financing questions also inform the marketing and operational focus of the enterprise. If the enterprise must attract private investors who expect a financial return, then the demonstration of business efficiency, professionalism and acumen may be particularly important. If the focus is on attracting private donations, foundation or government funding, it may be more important to show success in achieving the social mission, perhaps at the expense of business efficiency. A keen understanding of funder criteria is crucial to success.

### **c. Business plan and budget**

Like any new business, a social enterprise must develop a sound business plan and budget that addresses all aspects of the enterprise. The business plan should encompass the operating model, staffing requirements, market analysis, business risks and funding needs. It should evaluate whether the organization has the capacity and skills necessary to implement the enterprise and meet both market demand for a product or service and the social needs of its target beneficiaries. It must also budget carefully and realistically for the ongoing operating needs and costs of the enterprise, as well as the expected sources of revenue.

In evaluating the operating costs, it is important to include “social related costs” needed to pursue a social mission. For example, a social enterprise that provides employment experience to physically or mentally disabled individuals should anticipate higher training and ongoing support needs. Such social related costs can increase the enterprise’s costs and reduce its efficiency. Factoring these issues into the budget is important for obtaining a realistic picture of the organization’s ongoing costs.

### **d. Structure**

The founding organization’s directors should consider several questions related to the structure of the social enterprise. A key question is whether to conduct the program internally or through a separate subsidiary (which may be not-for-profit or for-profit). Who will control the organization and how it will be governed must be decided. Will funds need to be transferred to the enterprise from the parent not-for-profit, either initially or on an ongoing basis? And how will the financing and operational requirements influence the form and tax status of the enterprise?

The options and issues with respect to structure are discussed further below.

### **e. Possibility of failure**

Charities and not-for-profits need to consider and plan for the real possibility that the social enterprise may fail to achieve financial sustainability. Like many new businesses, a large share of social enterprises fails within a few years of commencing operations.

According to a 2012 Industry Canada study,<sup>8</sup> about 30 per cent of new small businesses (those with fewer than 250 employees) cease operations within two years. After five years, that percentage climbs to 50 per cent. Statistics suggest that social enterprises face similar risks, although failure is more difficult to define in this context, given the combination of social and financial goals.

A new social enterprise entails sunk costs during the start-up phase that cannot be recouped if the enterprise fails to achieve sustainability. The costs of starting a business are often substantial, with ongoing infusions of capital needed over the first few years of operations. The board should consider the amount of start-up costs that the organization is prepared to contribute to the enterprise, keeping in mind the enterprise's potential to contribute to the founder's social mission.

The board also needs to consider the criteria—in terms of both financial and mission-oriented performance—that will determine how long to permit the enterprise to operate at a loss and when to discontinue it. This analysis is more challenging in the context of a social enterprise than a for-profit business. For-profit businesses are funded by investors who understand the risks of business failure and the loss of all or part of their investment. When the business fails to profit, it can be closed and its residual assets sold, with the proceeds being distributed among the owners. However, the pursuit of the social mission exerts pressure on the enterprise to continue operating and providing social goods, even if it cannot do so on a self-sustaining basis. This may be true for social enterprises funded by foundations or governments that prioritize social return rather than financial return. These funders may expect that the organization will continue to provide measurable social results.

Thus, careful forethought about the enterprise's priorities is important when establishing the criteria by which failure will be determined. Ongoing monitoring of these factors is equally critical. The organization should communicate these criteria to the social enterprise's funders—whether they are private investors seeking a financial return or government and foundation funders who prioritize social goods. The risks inherent in the enterprise should also be made clear.

<sup>8</sup> Industry Canada, *Key Small Business Statistics* (July 2012), available at [www.ic.gc.ca/eic/site/061.nsf/eng/h\\_02711.html](http://www.ic.gc.ca/eic/site/061.nsf/eng/h_02711.html).

#### **f. Exit strategy**

Related to the possibility of failure is the design of an effective exit strategy. The board should consider the issues that will come into play on a decision to discontinue the enterprise. Issues that may arise when seeking to wind down a social enterprise include the following:

- How will the assets of the enterprise be dealt with on wind-up? This entails consideration of:
  - the entitlement of private investors to these assets
  - terms of any funding agreements, which may dictate the use of funds contributed in the event the social enterprise is discontinued
  - regulatory requirements, which may restrict the entities to which assets can be transferred on dissolution depending on the structure and tax status of the social enterprise.
- How will staff and volunteers of the enterprise be dealt with on wind-up of the enterprise? Will they be re-purposed within the organization, or will their employment be terminated?
- To the extent that the enterprise has provided a social good, what steps can be taken to ensure that recipients of these goods can access other resources?

### **4. How can a social enterprise be structured?**

Given the wide variety of forms that a social enterprise may take, such activity can be carried out through a range of possible structures and vehicles. Generally, most enterprises are incorporated entities. There are four main vehicles available to conduct social enterprise:

- registered charity
- NPO
- for-profit organization
- hybrid organization (e.g., BC community contribution company)

In assessing the optimal structure for the social enterprise, the board should consider and balance the following factors:

- the need for flexibility in operations
- financing requirements and anticipated funding sources
- the value of potential preferential tax treatment
- public perception of the social enterprise.

The chart below outlines some of the advantages and disadvantages of each structure.

Structure	Advantages	Disadvantages
<b>Registered charity</b>		
<ul style="list-style-type: none"> <li>• Social enterprise can be conducted as a program of a registered charity</li> <li>• To maintain status as a registered charity, the organization must be established for exclusively charitable purposes and conduct exclusively charitable activities, as the term is defined at law and subject to certain allowances under the <i>Income Tax Act (ITA)</i></li> </ul>	<ul style="list-style-type: none"> <li>• Tax-exempt</li> <li>• Receives the most favourable tax treatment under the <i>ITA</i></li> <li>• May issue official donation receipts, which incentivizes public gifts</li> <li>• Registered charities (other than private foundations) are permitted to conduct business activities provided they qualify as a “related business” of the charity (discussed below)</li> </ul>	<ul style="list-style-type: none"> <li>• The social enterprise’s activities are subject to strict restrictions under the <i>ITA</i>, consistent with the requirements for maintaining charitable status</li> <li>• Charities cannot issue shares and have limited ability to provide private returns on investment</li> </ul>
<b>NPO</b>		
<ul style="list-style-type: none"> <li>• Social enterprise can be conducted as a program of an NPO</li> <li>• To qualify as an NPO, the entity: <ul style="list-style-type: none"> <li>— must be organized and operated for social welfare, civic improvement, pleasure, recreation or any other purpose except profit</li> <li>— no income of the organization can be made available to the members</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Tax-exempt</li> <li>• More flexibility in the kinds of purposes and activities the NPO can conduct as compared to a registered charity</li> </ul>	<ul style="list-style-type: none"> <li>• May <i>not</i> issue donation receipts</li> <li>• Maintaining NPO status makes it difficult to conduct revenue-generating activities directly in an NPO</li> <li>• CRA has suggested that budgeting for a surplus, even at the individual program level, could put the NPO offside of the <i>ITA</i></li> <li>• Surpluses can only be incidental and ancillary to the NPO’s purposes</li> </ul>
<b>For-profit organization</b>		
<p>Social enterprise can be conducted using a for-profit corporation, either as a stand-alone entity or as a subsidiary of a registered charity or NPO</p>	<ul style="list-style-type: none"> <li>• <i>No</i> restrictions on activities, investments or use of assets</li> <li>• Can issue shares and debt and offer substantial flexibility in investment terms</li> <li>• Synthesizing the limitations on dividend and private returns in a regular business corporation is possible, as in hybrid forms</li> </ul>	<ul style="list-style-type: none"> <li>• Fully taxable entity</li> <li>• Cannot receive gifts from charitable foundations</li> <li>• Public perception of entity as a for-profit or business entity may deter social purpose investors</li> </ul>

Structure	Advantages	Disadvantages
<b>For-profit organization</b> (continued)		
	<ul style="list-style-type: none"> <li>• Use of for-profit subsidiary limits exposure of parent organization's assets for liabilities of the social enterprise</li> <li>• Canada Revenue Agency (CRA) has accepted that registered charities and NPOs may place activities in a for-profit subsidiary that cannot be conducted directly by the tax-exempt organization</li> <li>• For-profit organization has various options to reduce tax liability; e.g., a corporation may deduct gifts to registered charities, up to a maximum of 75% of income</li> </ul>	
<b>Hybrid organization</b>		
<p>Recent legislation in British Columbia and Nova Scotia introduced new corporate forms intended specifically to facilitate social enterprise:</p> <ul style="list-style-type: none"> <li>• British Columbia introduced the Community Contribution Company (CCC), a special form of company under the British Columbia <i>Business Corporations Act</i></li> <li>• Nova Scotia introduced the Community Interest Company (CIC) (though legislation has not been proclaimed in force at the time of writing)</li> </ul>	<ul style="list-style-type: none"> <li>• Required to have a “community benefit purpose” as one of its primary purposes               <ul style="list-style-type: none"> <li>— defined more broadly than legal definition of charitable purposes</li> <li>— can provide marketing advantage</li> </ul> </li> <li>• Can issue shares, pay dividends, and issue debt</li> <li>• Can attract socially minded investors who wish to further a social purpose while receiving a limited private return on investment</li> <li>• Statutory limitations on dividend and private returns and legal requirement to operate for a community purpose may enhance public perception and attract private investment</li> </ul>	<ul style="list-style-type: none"> <li>• Taxable entity</li> <li>• Only available in the two provinces</li> <li>• Subject to more public accountability than traditional for-profit companies; e.g., British Columbia requires annual reporting on:               <ul style="list-style-type: none"> <li>— activities that benefited society</li> <li>— remuneration of and position held by each person who made more than \$75,000</li> <li>— financial statements</li> <li>— amount of dividends declared on all classes of shares</li> </ul> </li> </ul>

Structure	Advantages	Disadvantages
<b>Hybrid organization</b> (continued)		
<p>CCCs and CICs have similar defining features:</p>		
<ul style="list-style-type: none"> <li>• cap on returns that may be paid to investors (a minimum percentage of revenue and assets must be used to further the community purpose) <ul style="list-style-type: none"> <li>— CCC dividends are capped at 40% of annual profits</li> </ul> </li> <li>• subject to an “asset lock,” which limits the assets that can be granted to shareholders or other non-qualifying entities on dissolution or during the corporation’s life</li> <li>• assets can only be granted to a registered charity or other qualifying not-for-profit entity</li> </ul>		

## 5. For registered charities, what tax compliance risks may arise?

If the social enterprise is conducted as a program of a registered charity, the board should consider whether the program would jeopardize the organization’s tax status. The main tax risk arising from a social enterprise is that CRA may view its activity to constitute an “unrelated business.” Registered charities (other than private foundations) are only permitted to conduct “related business” activities. They may be subject to intermediate sanctions and potential revocation of registration if they are found to be carrying on an unrelated business.

To assess the tax compliance risk from carrying on a social enterprise, directors should review all current and proposed activities and ask the following questions:

- Is the activity a “business?”
  - CRA defines a “business” as a commercial activity undertaken with the intention to earn a profit. Indicators of a business include the intention, potential and history of profits in the enterprise,

as well as the expertise and experience of those conducting the operations. Offering goods and services that compete with for-profit businesses also suggests a business activity.

- Not all revenue-generating activities constitute a business. A program that charges fees based on the ability of service-users to pay, or at a cost-recovery level, may not be found to be a business. Also, certain activities that generate revenue may be considered charitable activities in their own right, including:
  - » certain micro-finance and micro-enterprise programs
  - » “training businesses” that provide on-the-job training in vocational and life skills
  - » “social businesses” that address the needs of people with disabilities.
- If the activity is a business, is it a “related business?”
  - CRA identifies two types of related business:
    - » businesses run substantially (i.e., 90%) by volunteers)
    - » businesses that are “linked” and “subordinate” to the charity’s charitable purposes.
  - Businesses that are run substantially by volunteers are considered related businesses. Thus, the use of volunteers can help protect the organization’s tax status.
  - CRA identifies four categories of “linkages” that suggest a business activity is related:
    - » a usual and necessary associated business of a charitable program (e.g., hospital gift shop)
    - » an offshoot of a charitable program (i.e., exploitation of an asset incidentally created by a charitable program)
    - » a use of excess capacity
    - » the sale of items that promote the charity and its objects.
  - The question of “subordination” involves the role and prominence of the business in the context of the charity’s overall operations. For CRA, the following indicators suggest that a business is subordinate:
    - » the business activity receives a minor portion of the charity’s resources and attention
    - » the business is integrated with the charity’s operations



- » the organization's charitable goals continue to dominate its decision-making
- » no private benefit arises from the business.

Many social enterprise activities—particularly the provision of job training and employment support for disadvantaged and disabled individuals—constitute charitable activities. As long as the charity conducts these activities within the parameters set by the ITA and related CRA guidance, the charity can proceed without risk of sanction for inappropriate business activities. The board should review relevant CRA guidance and consult with legal counsel as necessary to ensure that such activities comply.

Where a social enterprise activity appears to constitute a business, the directors should determine whether the activity meets the criteria for related business. Where the social enterprise activity is the charity's only activity, and assuming it is not carried on substantially by volunteers, satisfying the requirement that the business be subordinate to other charitable activities will be difficult. Where the social enterprise activity is conducted as one program among other charitable programs and is linked to these programs according to CRA's criteria, the activity may constitute a related business.

Where the board identifies a risk that a social enterprise activity may be an unrelated business, it should address this issue immediately. The board should obtain legal advice, and if it appears that the business may be unrelated, remedies should be considered as soon as possible. Potential remedies include altering the activity so that it constitutes a charitable activity or related business or transferring the activity into a taxable subsidiary. Legal advice is likely needed to assist in this analysis.

## **6. For NPOs, what tax compliance risks may arise?**

Similar tax compliance risks exist for NPOs that carry on social enterprise activities directly. As noted above, NPOs must be operated for exclusively not-for-profit purposes, and cannot make income available to their members. Depending on how a social enterprise is operated, compliance with these requirements could be jeopardized.

As noted above, CRA interprets the requirement that an organization cannot have a profit purpose as a prohibition on budgeting for an operating surplus, potentially at the individual program level. CRA also takes

the position that conducting for-profit activities to finance not-for-profit activities is not itself a not-for-profit purpose. For this reason, a social enterprise activity that is expected to operate at a surplus creates risks for the organization's tax-exempt status.

Case law offers some support for NPOs conducting business-like activities to further a not-for-profit purpose. In *Gull Bay Development Corp v. MNR*, an NPO engaged in a commercial logging business was found to qualify as an NPO on the basis that the logging enterprise furthered the NPO's not-for-profit purpose, which was to provide employment and development opportunities to a First Nations community. CRA has acknowledged that incidental profits earned in the course of pursuing not-for-profit purposes are acceptable. CRA has also accepted that limited fundraising activities by an NPO are not indicative of a profit purpose. Thus, there may be some scope to conduct social enterprise activities that further the NPO's not-for-profit purposes and generate only limited surplus.

The prohibition on paying income to members means that an NPO must take care in how it uses income from its social enterprise activities. An NPO's members cannot receive any dividends or income from the corporation. CRA also says that where an NPO earns income from non-members and uses this income to reduce member fees or otherwise support its activities that benefit the members, the NPO may be making income available to the members. Generally, an NPO's tax status is most secure where its income derives from members and does not create a significant surplus.

Where a social enterprise runs a regular surplus (with income deriving from non-members) and is business-like in its operation, the board should consider whether the activity can be conducted in the NPO or whether the tax risk is too great. If an NPO is found not to qualify as tax-exempt, it can be reassessed for unpaid tax in prior years. As with registered charities, for-profit activities may be transferred to a taxable subsidiary. This approach may be needed to minimize the risk to the organization's tax-exempt status.

## 7. What are some of the challenges faced by social enterprise?

### a. Multiple objectives and tension in organizational culture

The combination of business activities, private investment and social purpose makes social enterprise a powerful tool to advance social goals. However, as noted, balancing the various goals creates tension, as these objectives sometimes run counter to one another. For example, the impetus toward business efficiency may conflict with the pursuit of a social purpose. The potential shift in the organization's culture can create conflict between different aspects and people within the organization.

For many not-for-profits, and especially charities, social enterprise presents a challenge in that it requires the combination of previously separate operational issues. Many charities separate their operational and program activities from their fundraising activities. Staff are often split between program staff and fundraising staff, with little overlap in their functions. In some cases, fundraising activities are transferred to a parallel foundation. Staff may not be accustomed to operating programs that serve both functions.

The directors themselves may be unaccustomed to evaluating programs that pursue dual objectives. Where programming and fundraising are kept separate, evaluations of their success are often not directly related. Charitable programs can be evaluated solely on how well they achieve the organization's objectives, and fundraising activities can be evaluated on how well they raise revenue. There are fewer direct trade-offs and less need to balance these goals in the context of a single program. When a charity introduces a social enterprise program, the board should adapt its evaluation process to address both issues simultaneously.

The board also must consider the cultural impact of the social enterprise on the broader organization. How will the introduction of a business-like operation change the organization's culture, and is this change desirable? If current management and staff lack the necessary expertise to operate the business-like enterprise, new staff may be needed and they may come from a very different business culture

that may clash with the organization's current culture. The business staff may also have very different perspectives on the appropriate priorities for the organization.

In order to reduce the cultural disruption and ensure that the social enterprise does not detract from the organization's social mission, directors and management should be aligned with the organization's mission and receive training to minimize these difficulties. Directors should not underestimate the challenges presented by the cultural change that new business-like activities may bring.

#### **b. Multiple stakeholders**

Related to the issue of multiple objectives is the presence of multiple stakeholders with competing priorities. These stakeholders may include:

- donors who have made outright gifts to the organization
- investors and lenders who may have contributed to the organization in part to obtain a financial return
- members who control the organization and who may or may not have made a donation or financial investment
- founder(s) who have a particular vision for the organization
- volunteers and staff
- beneficiaries or users of the program
- the public.

The nature of the board and organization's accountability to each group differs and may overlap. In some cases, as with the members and potentially founders, the board may be directly accountable. Other stakeholders, such as funders, volunteers and community members, may have less direct authority over the board but still hold it accountable through their willingness to continue supporting the organization (financially and otherwise).

One difficulty with social enterprise is that the stakeholders are varied, and there may be no dominant stakeholder among them. The board needs to consider each stakeholder's interests and manage communications with them. Depending on their backgrounds, board members may be unfamiliar with having accountability to such a range of stakeholders.

Another issue related to the multitude of stakeholders is the danger that the organization could lose sight of the outcomes needed and valued by its intended beneficiaries. For many social enterprises, the end users of their services (the beneficiaries of the organization's social mission) are not the same people who fund the organization or control it through membership rights. As a result, organizations can face a tension between the priorities and outcomes urged on them by their funders and members and the intended beneficiaries' needs. If the needs prioritized by funders and members are disconnected from those identified by beneficiaries, the value of the organization's services will diminish and potential beneficiaries will be less likely to use them. The board needs to balance these issues carefully.

Public relations with such a varied group of stakeholders are also a challenge. As discussed below, the board should ensure a coordinated and consistent communications strategy is in place to ensure stakeholders understand the enterprise's purposes, priorities and operations. The relationship between the enterprise and a founding NPO's purposes also needs careful explanation.

### **c. Tension between parent not-for-profit and social enterprise subsidiary**

If a social enterprise is structured as a separately incorporated subsidiary of a parent charity or NPO, it is important to consider how the two organizations will operate together. There is a risk that a subsidiary organization may drift in its mission and focus, thus diminishing its effectiveness in carrying out its purpose.

Part of the issue relates to the control of the subsidiary. The board of the parent organization should determine how it can maintain enough control over the subsidiary to keep its pursuit of its social mission on track, while still giving appropriate discretion for the subsidiary's board and management to pursue the social enterprise. Among other approaches, a founding organization can control a subsidiary by:

- establishing the founding organization as the sole member or shareholder of the subsidiary, with the exclusive right to elect directors (discussed below)
- establishing an affiliation agreement under which the founder provides funding and/or intellectual property and resources to the subsidiary, subject to requirements that the subsidiary act in conformity with the founder's directions.

In addition to formal control, the organizations should consider the extent to which the board and management of the two organizations should overlap. Will the subsidiary's board mirror that of the parent, and will there be common managers and staff? Such overlap may ease tension between the entities but compromise the effective operation of the enterprise, which may require more business expertise than is available from the parent's board and management.

By contrast, if the subsidiary's board and management have different members with different backgrounds, regular and appropriate communication between the organizations, as well as reporting by the subsidiary, are needed to harmonize and coordinate their respective operations. The founder will need to ensure that it is aware of the subsidiary's operations and can exert influence—through both formal control and less formal discussions as appropriate. As discussed below, training of the board and management of the social enterprise should emphasize the organization's social mission, and the board should regularly evaluate the subsidiary's success in fulfilling that mission.

## 8. How should the board think about business risks?

For many charities and NPOs, engaging in a social enterprise activity (either directly or through a subsidiary) introduces business risks that may be unfamiliar to directors who have never dealt with a market-oriented enterprise. Before embarking on a social enterprise, it is important for directors of charities and not-for-profits to appreciate these risks.

Business risks include internal factors within the organization's control and external factors beyond its control. These factors include:

- *Sales volume and price*—The risk that sales volume may decrease or that the enterprise must reduce the price of its goods and services.
- *Management and staffing issues*—The risk that inefficiencies in management or staffing may adversely impact profitability. Directors should consider the management structure of the enterprise carefully, including whether the management of the charity or NPO starting the enterprise should also operate it, or whether separate staff should be brought in. The balance between paid staff and volunteers also needs to be considered, as discussed below.

- *Input and operational costs*—The risk that key operational costs may increase and exert pressure on the profitability of the enterprise. These may include increases in the costs of materials used in the organization’s products, rental prices, gas prices and utility costs.
- *Market environment*—The risk that significant factors in the market in which the business operates will change in ways that are detrimental to the business. These factors include the introduction of new competitors, products or technologies that affect the enterprise’s position in the market. Careful analysis of the market in which the enterprise will operate is crucial to assessing these risks.
- *General economic conditions*—The risk of drops in sales and available financing and funding when general economic conditions are poor.
- *Financing risk*—The risk that available capital may not be enough to meet the enterprise’s ongoing financial needs or that income may be insufficient to meet the payments of principal and interest.
- *Regulatory environment*—The risk that changes in government regulation may adversely affect the enterprise and increase compliance costs. In the context of a social enterprise, regulatory issues may include tax compliance issues related to the charitable or not-for-profit tax status of the operating (or parent) entity and issues specific to the enterprise’s industry.

The board of a charity or NPO that is considering a new social enterprise must ensure that it has fully considered the risks to the proposed enterprise. Does the charity (or the subsidiary conducting the enterprise) have a strong balance sheet that can withstand these risks? Has the management considered how the enterprise’s operating model may need to change in the face of these factors and planned accordingly? The directors should address these questions at the planning stage.

## **9. How can/should a social enterprise be controlled?**

When a new social enterprise is established as a subsidiary or stand-alone enterprise, determining its control structure is crucial. Where the social enterprise is conducted in a corporation, that corporation is controlled by its shareholders (if it is a for-profit corporation) or its members (if it is a non-share capital corporation).

In the context of a non-share capital corporation, the members control the corporation through their power to elect and remove the directors and their approval rights over certain fundamental corporate decisions (e.g., changes to governing documents, amalgamation and winding-up). Thus the members have the ultimate ability to ensure that the organization remains true to its purpose and founding vision.

Membership in a non-share capital corporation does not depend on financial contribution. As such, there is flexibility in how the membership can be structured. Membership can be held widely or can be limited to the organization's founder or directors. There may be different classes of membership with different voting rights attaching to each class.

The appropriate control structure depends on the nature of the social enterprise. For some social enterprises, closely held control may be appropriate. For example, where a social enterprise operates as a subsidiary of a registered charity or NPO, the parent charity may wish to be the sole member. It may also choose to limit membership to the directors from time to time, thus establishing a closed board structure in which board members elect their own successors. These approaches enable the founder and/or board to maintain close control over the direction and operations of the organization.

By contrast, if community participation and democratic representation are important to the organization's mission, then a broader membership may be appropriate. This may be necessary to demonstrate that the organization is "owned" by the community and formally accountable to it. The charging of membership fees can aid in fundraising. A broad membership also offers a pool of potential volunteers, funders and directors.

However, a wide membership can entail trade-offs. Members may elect directors that take the corporation in a direction different from that envisioned by its founders. A large number of members complicates the logistics of meetings, limiting the organization's ability to act quickly in certain circumstances. Founders or directors should weigh these trade-offs carefully at the outset, as it can be difficult to regain control once it has been diffused among a broad membership.



## C. Post-Implementation Guidance

### 10. What are the board's fiduciary duties in the context of a social enterprise?

The directors of a social enterprise are subject to a range of duties. Under corporate law, directors have a duty to act honestly and in good faith in the best interests of the corporation. Directors also are required to exercise a certain standard of care when performing their board functions.

Within these general standards, several discrete duties have been identified:

- *Duty of knowledge*—Directors are required to be familiar with the corporation's governing legislation, constating documents (e.g., articles of incorporation, Letters Patent) and bylaws so they can ensure the corporation operates in compliance with its governing legislation and documents.
- *Duty of care*—Acting honestly and in good faith means that directors must keep the rest of the board informed of information relevant to the corporation and its operations, and they must be forthright with the other board members.
- *Duty of skill and prudence*—Directors must exercise a requisite degree of skill and diligence in carrying out their board duties. In some jurisdictions, the standard is *objective*: the director must exercise the care and skill that a “reasonable person” would exercise in comparable circumstances. In others, the standard is *subjective*: directors may be held to a higher standard where the director has special skills and expertise.

- *Duty of diligence*—A director must maintain familiarity with the ongoing operations of the corporation, including its purposes and policies. In practice, this means that a director must:
  - attend meetings of board and committees, having reviewed agendas and supporting material
  - prepare for and participate in meetings knowledgeably
  - vote on all issues (unless prevented by law or conflict)
  - record objection to unlawful action.
  
- *Duty to avoid conflicts of interest*—Directors cannot profit at the expense of the corporation and must be sure to place the corporation's best interests ahead of their own. Directors must declare all conflicts and abstain from voting on matters in respect of which they are conflicted. Conflicts generally arise where a director stands to gain personally from a transaction involving the corporation (either directly or indirectly) or where a director is on the board of two corporations involved in the same transaction (and thus owes competing fiduciary duties).

If the organization is a charity, the directors owe a higher fiduciary duty to safeguard its charitable property and optimize its use in furthering the corporation's charitable purposes. Thus, when considering a new social enterprise, the board must consider whether it would be the best use of the corporation's assets to further its charitable objects (either directly or by raising funds for the charity's operations). Directors also should address this question in their ongoing evaluations of the social enterprise and whether it continues to serve the charity's purposes.

The directors of a charity must consider this fiduciary duty when deciding whether the charity should invest in a social enterprise being conducted by a separate for-profit entity (including a subsidiary of the parent charity). Investments by charities are subject to the "prudent investor standard" under provincial trust law, which prescribes the level of prudence required when investing charitable property. In Ontario, for example, the *Trustee Act* provides that, in investing trust property (which includes charitable property), the directors must "exercise the care, skill, diligence and judgment that a prudent investor would exercise in making investments." These investment standards tend to be interpreted as prioritizing financial return. However, the investment standards do allow the board to consider an investment's special relationship to the charity's purposes, which seems to give the board scope to invest in social enterprises that

further the charity's purpose, even at the expense of financial return. The board should be comfortable that the charity's overall investment portfolio is invested prudently with a view to financial returns.

In the context of a for-profit social enterprise, tension can arise regarding the directors' duties. The fiduciary duties of directors of for-profit corporations typically focus on maximizing financial return for the benefit of the corporation and its shareholders. In the United States, corporate directors have faced lawsuits from shareholders seeking to prevent the corporation from directing corporate assets towards socially beneficial activities. Where the directors must also further a social purpose, it may be difficult to reconcile these two responsibilities.

In practice, where a for-profit corporation is controlled by a founding charity or NPO, the board is unlikely to face shareholder action for failing to prioritize financial returns (although, as always, having a clear vision of the enterprise's purpose is important). However, for business corporations that have higher numbers of shareholders and investors seeking financial returns on their investment, the tension between directors' duties may present challenges. Hybrid corporate forms address this issue explicitly, by requiring directors to act with a view to the corporation's community purposes when exercising their board functions. This requirement should help directors manage complaints from shareholders and investors (who presumably have invested on the understanding that the directors must balance these issues).

## **11. What qualifications or skills should board members have?**

Board members can contribute to a social enterprise in a variety of ways, for example:

- by bringing specific skills or expertise on matters directly related to the social enterprise's activities, supplementing management's expertise and improving the board's ability to monitor and evaluate management's performance
- by bringing specific knowledge or information on relevant issues (e.g., government policy, legislative developments and funding opportunities)
- by bringing connections and contacts that broaden the organization's potential sources of funding, resources and stakeholders

- by representing one or more stakeholders, giving greater transparency and legitimacy to the decision-making process and ensuring decisions benefit from stakeholder perspectives.

Successful boards typically include directors with different skills who can contribute in different ways. Ideally, some directors would have business experience while others would have experience in the voluntary sector. At least some directors should have backgrounds and skills specific to the organization's activities and goals; this is essential for smaller organizations where directors are more hands-on in managing operations. For example, if the social enterprise provides construction work to disadvantaged youth, appropriate board expertise might include construction workers and managers, social workers and youth counsellors. Legal and accounting expertise is also generally beneficial.

All directors should be aligned with the enterprise's values and social purpose. As noted, tensions may arise between directors with a "business bias" and those with a "charity bias." Contentious issues are easier to resolve when all directors are united in their support of the enterprise's common purpose.

## **12. What are the pros and cons of paid versus volunteer staff?**

The board of a social enterprise should determine the optimal mix of paid versus unpaid staff. Social enterprises can face challenges in determining the right balance, and there are advantages and disadvantages to both types of staff.

The most obvious advantage of using volunteer staff is the associated savings in employee salaries. Where the board can acquire adequate services from volunteers rather than paid employees, the board should strive to make the most of this opportunity. For new or smaller organizations, reliance on volunteers may be financially necessary.

A volunteer staff can offer benefits beyond financial savings. Because they work without financial incentive, they are often more committed to the organization's social mission than paid staff who may be motivated by the desire for personal gain and financial rewards for performance. The presence of a "volunteer ethos" has been found to confer greater legitimacy on the organization in the public eye. A volunteer staff may

also help keep the organization focused on the pursuit of a social benefit, while paid staff sometimes prioritize focus on business-like metrics for success, such as efficiency, growth, competitiveness and professionalism.

For social enterprises that are structured as registered charities, the use of volunteer staff is also advantageous from a tax compliance standpoint. As discussed above, registered charities (other than private foundations) are only permitted to conduct “related business” activities. Under the *ITA*, a business activity is a related business to the extent that “substantially all” (i.e., 90 per cent) of the individuals employed to carry on the business are volunteers. Thus, where a charity conducts an activity that could be viewed as a business, the use of a volunteer staff provides certainty that CRA will not find the activity to constitute an unrelated business.

However, volunteer staff have some disadvantages. Relying on volunteers may require the organization to accept staff with lower expertise and skills than those of professional, paid employees. The ability of volunteers to commit time and energy to the organization is generally more limited. While volunteers may be passionate about supporting the organization’s social purpose, they likely have paid jobs that demand the majority of their time and attention, leaving only limited time for volunteer commitments.

The advantages of using paid staff mirror the disadvantages of relying on volunteers. Paid staff generally have greater expertise and can be expected to devote greater time and energy to the job. Certain types of expertise may only be available from paid employees, and most organizations require at least some paid staff in senior management positions.

Special considerations may apply to the remuneration of the directors themselves. For social enterprises that are structured as charities in Ontario, trust law rules generally prohibit a director from receiving any form of remuneration from the charity, whether for the individual’s services or for performing other services for the corporation (for example, a lawyer on the board providing paid legal services to the organizations). Paying a director is only possible with judicial authorization (or an authorization from the Public Guardian and Trustee).

There is no single optimal mix of paid and unpaid staff. The board should consider the optimal balance in the context of the organization’s purpose, resources and operational needs.

### **13. What training should a social enterprise provide to board members and employees?**

Any organization conducting a social enterprise is advised to establish an orientation and training program for its board and staff. While this is important in any organization, it is particularly important for a social enterprise to ensure that all directors and staff understand the organization's mission and ethos.

New board members should familiarize themselves with the organization's governing documents and operations as soon as possible. If the organization is a charity or NPO, specific issues related to the organization's tax status should be explained. The orientation should emphasize the organization's social mission and fundamental purpose. This can help to deal proactively with potential tensions in the future regarding the organization's priorities.

Similarly, staff training should be as systematic as possible and emphasize the organization's social purpose. While the specifics of a training program depend on the job in question, all training should address the social mission, especially for the staff hired for their business background. Instilling in staff members an understanding of the enterprise's social benefit can help align the corporation's operations with its fundamental purpose. It also helps avoid mission drift or over-emphasis on revenue or business metrics.

### **14. How can the board measure the success of a social enterprise?**

Most social enterprises measure success by assessing both financial results and social outcomes. Balancing these aspects and determining what ultimately counts as success depends on the vision and priorities for the enterprise. It is important for the organization to consider and, to the extent possible, measure all outputs that are of value to the organization's stakeholders. By tracking such items, the organization can demonstrate its awareness of stakeholder values and priorities.

Measuring social outcomes can be difficult. They are often intangible and inherently more difficult to quantify than direct financial returns to the corporation or its investors. Organizations often are challenged in determining how to measure such outcomes and in finding the necessary expertise to accurately evaluate these factors. However, many organizations have developed and refined methods of measuring social outcomes and social returns on investments. Some of these methods are as follows.

### a. Social return on investment

One approach to the evaluation of social outcomes focuses on quantifying the “social return on investment.” This approach is summarized as follows, using the example of a social enterprise that provides employment training services to homeless and disabled individuals:

- i. Determine the *Inputs*, *Outputs*, *Outcomes* and *Impacts* of the program:
  - *Inputs* = the resources of the organization devoted to operating the program (e.g., program funds, staff, office space)
  - *Outputs* = the immediate results of the program (e.g., number of individuals who used the organization’s services and learned a new skill)
  - *Outcomes* = the medium- and longer-term results of the program (e.g., number of individuals who were able to find and maintain employment)
  - *Impact* = the *Outcomes* less an estimate of the outcomes that would have happened even without the program (e.g. number of individuals who would have found a job anyway).
- ii. Determine a monetary value for the program’s *Impact*, which can be estimated by identifying and valuing the benefits to direct users (e.g., employment income) and the benefits to society in the form of lower expenditures on items such as unemployment insurance, public housing and policing (with resultant savings in enforcement, and prosecution, etc.). If the program’s *Impacts* will extend across multiple years, the social return on investment should take this into account.
- iii. Compare the amount of *Inputs* relative to the *Impacts* to determine the social return on investment.

The advantage of this approach is that it allows for a quantified evaluation of the value of the social outcomes of a social enterprise, purportedly offering a direct “apples-to-apples” comparison of the resources invested in the program to the value of the social return on investment. Many funders and social investors require such quantified results before they will invest in or financially support an organization. In particular, the world of social finance frequently relies on quantifiable social metrics as the basis for structuring social purpose investment products. These products include “social impact bonds” and pay-for-performance contracts in which returns on investment are paid on the basis of achieved social outcomes.

## **b. Social accounting and audit**

Other approaches focus on tracking indicators for social improvement. For example, the practice of social accounting and audit has developed as a way of reviewing and reporting on a social enterprise's success at achieving its social aims. The process generally involves the following:

- i. *Planning*—The enterprise identifies core social aims and purposes in relation to each of its stakeholders, the ways in which each stakeholder group interacts with the organization, and the intended benefits to be derived from these activities.
- ii. *Accounting*—The enterprise identifies indicators that allow it to measure its activities over time and develops a method of collecting relevant data on these indicators. Such methods may include:
  - surveys of stakeholders on the organization's services and performance
  - data on users of the enterprise's services (e.g., how many people use the services, how many are within the target beneficiary group)
  - case studies reviewing the impact of programs on selected beneficiaries.
- iii. *Reporting and auditing*—The data collected in the accounting phase is collated and analyzed in a single document. These results are then review by an external reviewer to ensure that the information reported is accurate and has been gathered and interpreted reasonably.
- iv. *Publication*—The report is then published and made available to stakeholders.

The appropriate metrics and methods of evaluating program outcomes depend on the enterprise's specific purposes and operations. Depending on the nature of the outcomes, it may be difficult to identify direct monetary savings or proxies for value. Further, in the context of complicated social problems, it is often difficult to demonstrate linkages between the organization's inputs and longer-term social change, and there are limits on how well the full social impact of an organization's programs can be quantified.



Despite these difficulties, evaluating the social outcomes of programs is an important task of any social enterprise. As noted, these social outcomes should be weighed alongside any direct financial returns to the organization or its investors.

## **15. How can the board ensure that the social enterprise maintains its mission focus?**

As discussed, a social enterprise's success generally depends on establishing a sustainable stream of revenue from its activities. Board members and staff with business experience and acumen are needed to give the business its best chance at financial success. The pursuit of financial sustainability is important to a social enterprise and should be a measure of its success. The board should be open to new ideas for achieving growth, whether through marketing, increasing efficiency, cost cutting or focusing on top revenue-earning activities.

The board also needs to ensure that the organization does not lose sight of its social mission. Numerous observers of the social enterprise sector have noted the risk that an enterprising mentality can overwhelm the enterprise's social impetus. This risk stems in part from the increasingly competitive nature of the social enterprise and not-for-profit landscape, in which multiple organizations must compete for limited contracts and funding. This competition can foster an adversarial spirit that prevents cooperation between organizations and obscures the focus on social mission.

To keep the organization on track with its social mission, the board should conduct regular social audits to review the social metrics it has developed to assess the organization's continued performance at meeting its social goals. The board should monitor carefully whether social objectives are compromised, particularly if the operations change. Where changes appear to diminish the enterprise's success in its social mission, the board should consider whether to pull back or alter course. Some organizations establish specific working groups or committees to track social outcomes and mission success.

Another means of ensuring the maintenance of the social mission is to ensure a balance between business-oriented board members and staff and those with experience and expertise in the voluntary sector. Charity-oriented directors and staff can be expected to naturally prioritize social outcomes and keep them at the forefront of board and management

discussions and decisions. As noted, training of board members and staff is important for introducing individuals to the organization's mission and ethos.

## **16. What are the social enterprise's regulatory reporting requirements?**

Depending on the jurisdiction of incorporation and the tax status of the organization conducting the social enterprise, several reports are required to be filed each year. Directors need to ensure that these reports are filed on time, as serious consequences can ensue if these deadlines are not met.

Most corporate statutes require the filing of annual information returns each year. These are generally straightforward filings that require the corporation to confirm its current board members and officers and other basic information. Filing deadlines vary depending on the statute of incorporation, but generally these returns are due within one or two months following the corporation's fiscal year-end. Maintaining these filings ensures the corporation remains in good standing under its governing legislation.

If the organization is a registered charity, the charity must file a T3010 Information Return with CRA within six months of its fiscal year-end. The T3010 is used to report on the operations and finances of a charity in the preceding year. Failure to file the T3010 on time leads to an automated series of notices from CRA, followed by automatic revocation of charitable registration. Re-registration requires that the organization submit an entirely new application for charitable registration. To avoid this, it is important that registered charities complete and file this return on time each year.

Most NPOs are required to file a T1044 NPO Information Return within six months of their year-end. If the NPO is a corporation, it also must file a T2 Corporation Income Tax Return by the same deadline.

## **17. How should the board communicate with stakeholders?**

For most social enterprises, stakeholder communication is key to success. Communication is essential to enable the board and management of the social enterprise to understand the needs of the people and communities it serves. It is also important for the Board to demonstrate its commitment to transparency and accountability to its stakeholders, which can

be done by regularly communicating with them. Regular communication builds trust between the social enterprise and its stakeholders and improves the quality of the relationship.

Given the range of stakeholders that may be involved, the need for communication and transparency among stakeholders is particularly acute for social enterprises. As discussed above, a social enterprise's stakeholders—which may include members, employees, funders, investors, beneficiaries—may have different priorities and different views on the direction of the organization. As some stakeholders may not understand the linkages between the social purpose and fee-generating and businesslike services, a coordinated communications strategy is critical. The enterprise needs to transmit consistent messages about its goals and priorities, its metrics for success, and how it operates. At the very least, all stakeholders will be informed about these issues, even though some may not always agree.

Social audits and/or program evaluation—which should be conducted regularly to assess the social impact of the enterprise—offer an opportunity to engage stakeholders while allowing them to communicate with and provide feedback to the organization on its performance. Interviewing and providing questionnaires to stakeholders during a social audit can solicit valuable feedback. The organization should make it clear that it welcomes input from the groups it seeks to serve.

Communication also occurs at the corporation's annual meetings. At these meetings, the board presents the organization's financial statements to the members and reports on its operations over the past year. This is also the appropriate forum to distribute the results of the social audit. As a matter of corporate law, only the members of the corporation are legally entitled to attend the annual meeting. However, subject to the corporation's bylaws, the board can invite other stakeholders to the meetings to attend and potentially participate. Inviting a broader spectrum of stakeholders enhances the public perception of the organization as transparent and open.

## D. Winding Up a Social Enterprise

### 18. When should a social enterprise wind-up?

When starting a social enterprise, a key issue to consider is the enterprise's primary objectives. These objectives should guide the enterprise during its operation and guide the board in determining when it is appropriate to wind up or discontinue a social enterprise.

Circumstances that may influence a decision to wind-up or discontinue a social enterprise include the following:

- the enterprise is failing to produce the desired level of social outcomes
- the enterprise fails to generate adequate revenue on a sustainable basis
- the enterprise fails to attract necessary funding
- the structure of the social enterprise jeopardizes the tax status of the organization conducting the activity
- the social enterprise has drifted from its original intended purpose
- the community or stakeholders served by the organization have changed such that its services are no longer required.

Fundamentally, the board should decide to discontinue the social enterprise when it determines that the fundamental objectives of the enterprise are no longer being served. When the enterprise stops achieving its intended goals and the board concludes that changes to the enterprise's activities are impossible or undesirable, it likely is appropriate to wind up the enterprise.

## 19. How should the assets of a social enterprise be dealt with on wind-up?

When a social enterprise discontinues its operations, the distribution of assets used by the social enterprise presents a significant issue.

If the social enterprise is an internal program of a registered charity or NPO that conducts a range of other activities, it may be possible to re-purpose the assets of the social enterprise for use in the organization's general operations. A key issue is whether the funds used in the social enterprise were acquired subject to restrictions on their use. Restrictions generally arise in the context of grants and donations to registered charities, which may be made subject to a requirement that the funds be used only for certain purposes or programs. Such funds are generally referred to as "externally restricted." Where the organization holds funds that are subject to an external restriction that the funds can only be used for the social enterprise, the organization generally cannot re-purpose these funds unilaterally. An exception may be available where the terms of the gift or grant allow the organization to re-purpose the funds if the original program is discontinued. Organizations are well advised to include such terms in any gift agreements.

If the organization is a charity and holds funds that are externally restricted to being used in a social enterprise program that is being discontinued, and if the terms of the gift do not allow the organization to re-purpose the funds on its own, it may be necessary to obtain a *cy pres* order from the Superior Court of Justice in the province. Under this doctrine, where a gift has been given for a charitable purpose that is impossible or impractical to carry out, the Court can make an order permitting the charity to use these funds for a purpose that is as near as possible to the gift's originally intended purpose. This would allow the gift to be used in other programs of the charity or for its general purposes. However, obtaining such an order is time-consuming and expensive. To the extent possible, the board should ensure that all gift agreements and funding contracts that restrict the use of funds include provisions for the re-purposing of funds in the event the original purpose cannot be fulfilled.

Where the social enterprise is being conducted in a corporation that will be wind-up, the terms of the corporation's governing documents dictate how the funds are distributed. Depending on the organization's tax status, specific restrictions apply to the distribution of assets:

- If the organization is a registered charity, all assets must be distributed to "qualified donees" under the *ITA*, a category that includes other registered charities, registered Canadian amateur athletic associations, and all levels of Canadian government.
- If the organization is an NPO, no income can be paid to the members of the organization, including on wind-up, so any funds that represent income of the organization cannot be distributed to members.
- If the organization is a hybrid corporate form, it is subject to caps on the portion of its assets that can be distributed to shareholders, with the remainder being required to be distributed to registered charities or other qualifying organizations.

The board should consider an appropriate recipient or recipients of the organization's funds, keeping in mind these limitations. If other organizations engaged in similar work are available to receive the funds, this may be appropriate.

## **20. What steps must be taken to wind-up the social enterprise?**

If the corporation that operated the social enterprise also winds up, the governing statute dictates the process for winding up and dissolving the corporation. The board's final responsibility is to see that the corporation is properly wound up and dissolved. Generally, the process involves the following steps:

- a. Directors approve the wind-up.
- b. Members approve the wind-up.
- c. Some form of public notice may be required to alert possible creditors to the wind-up.
- d. The corporation pays its outstanding liabilities and distributes any residual funds (as discussed above).
- e. The corporation files any final corporate and/or tax information returns.

## E. Conclusion

Directors of organizations that conduct social enterprises face a unique set of challenges. They must balance conflicting objectives of operating businesslike activities while pursuing socially beneficial ends. Directors also must balance the competing priorities of a broad range of stakeholders. As this publication shows, many of these issues can be accommodated through careful planning and the development of clear objectives before the social enterprise is established. A social enterprise can help a charity or NPO reduce its reliance on external financing and achieve its philanthropic goals sustainably.

# Where to Find More Information

## **CPA Canada publications on governance\***

(available at [www.cpacanada.ca/governance](http://www.cpacanada.ca/governance))

## **The Not-For-Profit Director Series**

### **20 Questions Series**

- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Board Recruitment, Development and Assessment
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Fiduciary Duty
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Human Resources
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Risk
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Strategy and Planning

### **Director Alerts**

- Cloud Computing for Not-For-Profit Organizations—questions for directors to ask
- Increasing Public Scrutiny of Not-For-Profit Organizations—questions for directors to ask
- New Accounting Standards for Not-For-Profit Organizations—questions for directors to ask
- New Rules for Charities' Fundraising Expenses And Program Spending—questions for directors to ask
- The New Ontario Not-For-Profit Corporations Act—questions for directors to ask
- The New Canada Not-For-Profit Corporations Act—questions for directors to ask



- The New “Ineligible Individual” Provisions—Considerations for Directors of Registered Charities And Registered Canadian Amateur Athletic Associations
- Pandemic Preparation and Response—questions for directors to ask

### Other Publications

- Accountants on Board—A Guide to Becoming a Director of a Not-For-Profit Organization
- A Guide to Financial Statements of Not-For-Profit Organizations—Questions For Directors to Ask
- Improved Annual Reporting by Not-For-Profit Organizations
- Liability Indemnification and Insurance for Directors of Not-For-Profit Organizations

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# About the Author

**Andrew Valentine** is a partner in the Charities and Not-for-Profit Group of Miller Thomson LLP in Toronto. His practice focuses on providing advice to charities and non-profit organizations on a full range of issues, including gift planning, incorporation and registration, non-profit corporate governance, ongoing tax compliance matters, and audits.

Andrew is a member of the Ontario Bar Association Charity and Not-for-Profit Law Section Executive as well as a number of other professional organizations. Andrew writes and speaks regularly on a range of charity and not-for-profit topics.











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277 WELLINGTON STREET WEST  
TORONTO, ON CANADA M5V 3H2  
T. 416 977.3222 F. 416 977.8585  
WWW.CPACANADA.CA

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