Reserve Funds – Budgeting for the Future

Ninette Bishay, CPA, CA

T +1 416 607 2753
E Ninette.Bishay@ca.gt.com

Agenda

- What are reserves
- Types of reserves
- Why establish reserves
- How to establish an appropriate level of reserves
- Adopting a formal reserves policy
- Explaining reserves to stakeholders

What are reserves?

“An organization’s financial reserves are a **discrete subset of its liquid net assets**. They are a distinct pool of assets [set aside] that an organization can access either to **mitigate** the impact of [potential] unbudgeted and undesirable financial events or to **pursue opportunities** of strategic importance that may arise in the future.”

Types of reserves

- Operating (working capital) reserves
- Special program reserves
  - Stewardship fund
  - Property defense fund
  - Land acquisition fund
- Endowment funds
- Contingency reserves
- Capital reserves

Why establish reserves?

- Plan to secure new donations or acquisitions of land or easements
- Become more self-sufficient
  - Tightening of spending by individual donors
  - Tightening of spending by governments
- Avoid undesirable cost-reduction measures
  - Limit "knee-jerk" reactions (staff reductions, spending cuts) in a financial crunch

Why establish reserves?

- Be prepared for market-related risks
  - Fluctuating equity markets impact investments
- Plan for capital re-investment (e.g. building, equipment)
- Reduce the impact of risks
  - Unique to sector, mission or operational activities
- Take organization in a new strategic direction
- Create confidence in organization's stewardship and financial management

Establishing an appropriate level of reserves

- Priority for management and the Board
- Important that the reserve level is "appropriate"
- Specific to YOUR organization
- Relies on assessment of risks

6 steps to establishing an appropriate level of reserves

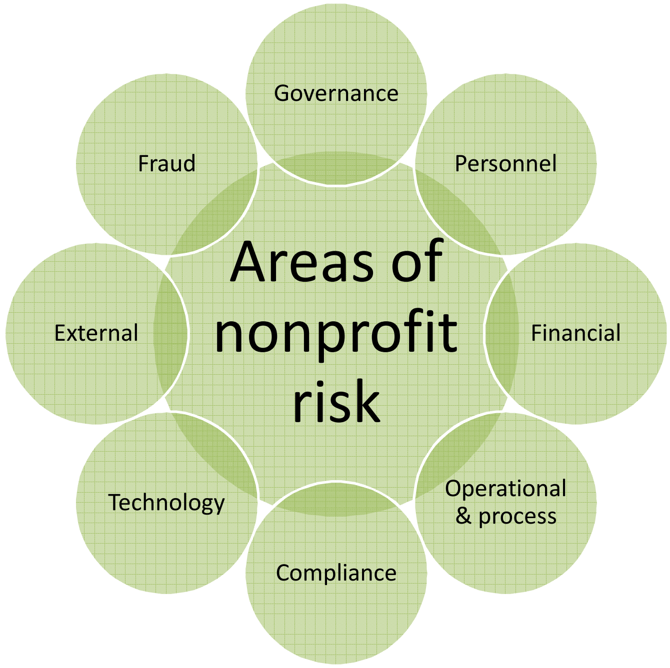
1. Create baseline long-term financial forecast
2. Perform detailed analysis of potential risks
3. Quantify risk exposure
4. Establish target reserve levels
5. Determine funding approach
6. Formalize reserves policy

Step 1
Create baseline long-term financial forecast

- Sufficiently robust
- Approximately 5 years in length
- Include all aspects of the organization’s operations

Step 2
Perform detailed analysis of potential risks

- Formal risk assessment process is very helpful
- Important to have consensus among management regarding risks
- Organization-wide perspective of financial risks



Step 2

Perform detailed analysis of potential risks

- Identify, quantify, and assess probability of potential negative performance
  - Revenue
  - Expenses
  - Other contingencies with financial impact
- Consider each key budget line

Step 3

Quantify risk exposure

- Evaluate negative performance risk across all identified one-time or recurring budget line items
- Quantify risks
- Aggregate
  - Provide a picture of the organization's overall risk profile ("portfolio approach")

Example

Donations (CDN, millions)						
	Likelihood	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Perform to plan	25%	10	11	12	14	16
Off 15% per year	15%	8.5	9.35	10.2	11.9	13.6
Off 10% per year	25%	9	9.9	10.8	12.6	14.4
Off 5% per year	35%	9.5	10.45	11.4	13.3	15.2
Probability adjusted outcome		9.35	10.29	11.22	13.09	14.96
Variance from forecast		(0.65)	(0.71)	(0.78)	(0.91)	(1.4)
NPV of risk (7%)		(3.3)				
NPV of risk per year		(0.66)				

Step 4
Establish target reserves level

- Five year and annual net present value calculations are a good place to start
- Likely to end up with a range of what reserve should be
- Set reserve level based on unique circumstances:
  - Needs
  - Risk tolerance
    - The ***higher*** the risk tolerance, the ***lower*** the reserve level

Step 5
Determine funding approach

- Identify appropriate, existing balance sheet assets to invest in established reserves
- Determine contingency that needs to be built into annual budget to fund up to target level
- Consider any by-laws to ensure reserves plan does not contradict them

Step 6
Formalize reserves policy

- Best practice to have a formal reserve policy
- Makes justification of reserves easier
- A formal plan provides a clear outline for management to follow when making decisions

Step 6
Formalize reserves policy

- Plan should document responsibility
  - Management to present recommendations
  - Board to approve target level and funding approach and provide oversight
- Establish how to monitor actual reserve levels against planned levels

Step 6
Formalize reserves policy

- Consider investment policy
- Establish the process to draw upon reserve funds when needed
- Regularly review policy for relevancy as circumstances change

Explaining reserves to stakeholders

- Establish communications plan that links reserves policy to organization's mission
- Consider different perspectives of:
  - Donors
  - Grantors
  - Charities Directorate
  - Others

Objective is to explain <u>why</u> you need reserves so stakeholders continue to support

Explaining reserves to stakeholders

- Carefully consider presentation and disclosure of reserves in financial statements
- Use the correct terminology
  - Unrestricted, internally restricted, externally restricted
- Be careful not to overly restrict fund balances by using incorrect terms
  - e.g. Endowments
- Keep it simple
  - "Externally endowed internally restricted" – confusing

Charities—
Disbursement quota on inactive capital

The disbursement quota is minimum amount a registered charity is required to spend each year on its own charitable activities, or on gifts to qualified donees. It is calculated based 3.5% of average value of a charity's property ***not*** used for charitable activities or administration.

Helpful hints

- Remember that your budgeting process impacts reserves
  - Budget serves as the baseline
- Determine frequency of risk profile evaluation
- Benchmarking provides little value
- Need to consider change management
  - Accumulating reserve funds can be a major shift for an organization
- Periodically drawing upon your reserves should be expected, that is why they are established

Questions?

Ninette Bishay, CPA, CA

Grant Thornton LLP

T +1 416 607 2753
E Ninette.Bishay@ca.gt.com

Grant Thornton | An instinct for growth™

Grant Thornton
An instinct for growth™

Thank you