

AUDITOR GENERAL

Halifax Regional Municipality

Audit & Finance Standing Committee

A Performance Review of the Management of Halifax Regional Municipality's Reserve Funds[®]

January 15, 2016

Introduction to Reserves

- Organizations, including not-for-profits and public sector entities, use financial reserves as a method for strategic financial planning considering current and future needs while promoting financial sustainability.
- Reserves are savings plans for future cash expenditures; in the municipal setting maintaining reserves requires the current taxpayer to put funds away now for the future taxpayer or for unforeseen events.
- The OAG recognizes there are many benefits to having reserve funds but believes the reserves must be part of a strategic plan and effectively managed in order for these benefits to be fully realized.

Introduction to HRM Reserves

- The Halifax Regional Municipality (HRM) Charter specifies in Section 120 (1) “the Municipality shall maintain a capital reserve fund”. It also specifies in Section 120 (6) “the Municipality may maintain other reserve funds for such purposes as the Council may determine”.

- According to HRM’s Audited Financial Statements, Halifax Regional Municipality (HRM) had reserves totalling \$181,891,000 at March 31, 2015 consisting of:
 - 29 capital and equipment reserves (\$137,184,000)
 - 23 operating reserves (\$44,707,000)

Objectives

- To verify whether procedures and controls around the management of reserve funds ensures an effective use and demonstrates good stewardship of funds.
- To determine if policies and procedures adequately describe the purpose and use of reserve funds as well as the process to access the funds.
- To review how the Municipality determines the types of reserves which should be established.
- To review if effective controls and processes are in place for managing specific reserve funds.
- To review if reporting of funding and use of reserve funds is transparent and understandable.

- Reserve transactions were reviewed for the past five years to identify possible trends and patterns in the use of reserve funds.
- Only reserves listed in the consolidated financial statements of HRM were included in this review.
- Reserve funds maintained by Halifax Regional Water Commission were excluded from the review.

Overarching Commentary

- The OAG believes funds set aside for reserves should be governed by the terms set out in the HRM Charter. The HRM Charter outlines the Municipality's responsibility for maintaining the required capital fund and Council's responsibility for determining what other reserves the Municipality needs.
- In the view of the OAG, this strongly suggests Regional Council is responsible for the oversight of reserves and ensuring they are being effectively managed to demonstrate good stewardship of funds.

- The OAG had the following fundamental questions around reserves:
 - Are there Sufficient Governing Policies and Guidelines?
 - Does HRM have a Process to Determine the Necessary Types and Targeted Levels of Reserves?
 - Are the Established Internal Controls Being Followed?
 - Are there Adequate Accounting Controls?
 - Is there Sufficient Reporting on Reserves for Decision Making Purposes and Does it Provide the Proper Level of Transparency?

HRM Reserve Policies

- Regional Council approved Administrative Order Number 2014-15-ADM Respecting Reserve Funding Strategies (Financial Reserves Administrative Order) on October 28, 2014.
- Finance and Information, Communication and Technology (FICT) has developed guidelines for the establishment, funding, use, review and closure of all financial reserves.

- The OAG found these to include all the components for good control and stewardship of reserve funds however, these policies and guidelines must be followed appropriately in order for the effectiveness to actually take place.
- During the review, the OAG observed occurrences of the Financial Reserves Administrative Order and Corporate Guidelines for Reserves not being followed.

Types and Targeted Levels of Reserves

- There are three types of reserves outlined in HRM's Financial Reserves Administrative Order:
 - Contingency fund for risks
 - Contingency fund for opportunities
 - Saving fund for future obligations

- The OAG believes in order for the Municipality to be strategic and demonstrate effective stewardship of funds, HRM must first determine the possible risks to the Municipality and opportunities available as well as estimate the future expenditures required for capital replacement and how these items may be funded.

Types and Targeted Levels of Reserves Cont'd

- The OAG was not able to identify any recent discussion by Regional Council to identify the risks which reserves have been set up to mitigate or to establish a target level of reserve funding.

Establishment of Reserves

- At the time of the review there were six reserves without business cases, all being actively used; two of which were also identified as not having a business case in 2012.
- The lack of business cases is concerning to the OAG as it decreases the ability of staff to effectively make decisions in regards to reserve funding levels and potential projects to be funded through reserves.
- It is also the view of the OAG, Regional Council cannot adequately fulfill their oversight responsibility without approved business cases for each reserve.

Unclear Purposes

- Purpose of Strategic Growth Reserve (Q126): “To enable the municipality to respond to challenges posed to our service and infrastructure capability caused by population growth, rapid urban **and** suburban development expansion, changing demographics **and** rapid technological advancement.”
- The OAG sees a number of issues which, in theory, could cause this reserve not to be able to be used:
 - no benchmarks for when to use the reserve (i.e. what level of population growth),
 - the need for both urban and suburban development and
 - a change in demographics.
- The OAG sees this as an excellent example of the consequences of not having clearly defined criteria and business cases.

- The purpose of the Capital Replacement Reserve (Q130) is: “To create an internal fund to support the replacement of HRM assets. The timing of replacing most assets can be reasonably estimated based on past experience or industry standards. With reasonable planning it is possible to plan for setting aside funding to partially or fully cover the cost of replacement.”

- The OAG considers this purpose overlapping as there are also specific reserves with purposes which could be considered ‘capital replacement’. The following is list of examples, all of which have their own reserve.
 - General fleet vehicles (Q204)
 - Police vehicles and equipment (Q205)
 - Fire & Emergency Service vehicles and equipment (Q206)
 - Halifax Transit ferries (Q129) and
 - Halifax Transit buses (Q143).

Purposes Overlapping with Operations

- The OAG found many operating reserves' stated purposes overlap with what the OAG considers to be ongoing operating expenditures:
 - DNA Costs Reserve (Q316)
 - EMO Cost Recovery Reserve (Q314)
 - Strategic Studies Reserve (Q330)

- The ability to choose when to use funding from a reserve or when to treat the expenditure as an operating expense can lead to the true ongoing costs of a business unit not being reported accurately.

- The OAG found an overall lack of controls to ensure reserves are created for a unique purpose which do not overlap other funding options.

Funding Sources

- The OAG found instances:
 - where funding sources are not indicated in business cases,
 - of reserves funding other reserves (not intended use of the source reserve),
 - of Fiscal Services funding business unit specific reserves and
 - of reserves having no predetermined annual funding amount.

- It would appear annual allocations may be made based on available funds in the Fiscal Services budget and therefore not based on a requirement or need. It is not clear whether the amount allocated is sufficient to satisfy the reserves' purposes or whether 'extra' funds are being added to the reserves.

Targeted Level of Funding

- Out of the 53 reserve business cases reviewed , only 20 have specific funding minimums, maximums and/or targets and none have all three.

- Example: Snow and Ice Control Variable Operating Reserve (Q309)
 - has a minimum and maximum equal to 10% and 25%, respectively, of the past five year's average of the actual Snow and Ice Control expenditures.
 - no indication how the percentage calculations were created.
 - given this maximum, the Snow and Ice Reserve has historically been overfunded based on the formula.

- It is the view of the OAG this presents a risk to the Municipality as without these components, HRM staff have no guidance from Regional Council as to what level to fund reserves.
- For the small number of reserves which have minimums or maximums, the OAG found there are limited instructions on how to proceed when the reserve becomes over or underfunded.
- The OAG believes without minimums and maximums or procedure for dealing with over or underfunded reserves, staff's ability to plan and manage funding of reserves becomes more difficult, as there is no guidance as to what level of funding is sufficient.

Review Process

- The OAG could not find evidence of a formal review process for all reserves.
- The only review outside of the budgeting process was the ‘Ten Year History of Reserves’ Report presented to Regional Council in January 2013 as an information item.
- According to FICT staff “there has not been a formal review of all reserves”.

Review Process Cont'd

- Without a proper detailed review of reserves the OAG questions how HRM Administration and Regional Council can make strategic decisions on when to establish a new reserve, when to contribute funds to existing reserves or which reserves to close.
- The OAG was advised staff are currently conducting a review of reserves however, the scope and expected completion date is not clear.

Closure Process

- 14 reserve business cases provide an approximate timeline with an approximate end date for the reserve.
- There is no clear process for closing out any of the reserves.
- The OAG observed a closed reserve had its remaining balance transferred to another reserve without any direction from Regional Council.
- Without a specified closure process or timeline for reserves, the OAG questions if the Municipality requires the number of reserves which currently exist and at the present funding levels.

Accounting Controls

- The OAG found deviations from policy in the management of funds and HRM Administration has not formalized many of their practices.
- Example: during 2013 in the establishment of the Regional Facilities Expansion Reserve (Q145) Regional Council approved \$1 million to be allocated from the Operations Stabilization Reserve (Q308) however, in reality \$2 million was transferred.

Reporting for Decision Making

- Reserves are reported to Regional Council in a variety of ways, through the regular operating budget process, quarterly financial reports and individual reports to Council.

Operating Budget

- Each business unit as well as Fiscal Services discloses general ledger account 8008 Transfers to/from Reserves in their detailed budget information. This is the net amount each business unit intends to receive or contribute to a reserve and is included as part of the 'Other Fiscal' summary.
- Also included in the budget is a separate reserves overview outlining all reserves with a brief description of their purpose and an indication if they have a business case or not.

Quarterly Reports

- The quarterly financial report provided to Regional Council includes, for each individual reserve, the opening balance, a summary of transfers in and transfers out, the current balance as well as a summary of pending expenditures and contributions. This report includes unplanned transfers in and out of reserve for the quarter in the totals but does not identify them as unplanned.
- The information in the reserve report does include variances but does not isolate the variances caused by unplanned transactions. Therefore, it is difficult for Regional Council to identify the impact of unplanned transactions on the performance of the reserves.

Council Reports

- In accordance with the Financial Reserves Administrative Order, the establishment and closure of reserves as well as withdrawals from reserves which are not included in the budgeting process are to be approved through a resolution of Council.
- There is no standard for what is included in reports to Regional Council with respect to unplanned withdrawals from reserves other than the predetermined report categories. There is a risk, without a standard for reporting on reserves, the information being brought forward is not clear or transparent enough for Regional Council or taxpayers to understand the reason for the unplanned withdrawals from reserves or the impacts on the reserve fund balances.

Financial Statements

- The individual reserve balances are also included in a note to HRM's audited consolidated financial statements.
- Due to the fact that the financial statements are presented on a consolidated basis, the statements do not identify all transfers.
- The OAG is concerned it may not be transparent enough to the average taxpayer how reserves are funded and used. Although not required by Public Sector Accounting Standards, the OAG believes additional note disclosure would provide greater transparency.

Reporting for Decision Making Conclusion

- Information on reserves is reported in multiple ways. There is a risk high-level information is not transparent enough to clearly demonstrate the effect the reserve transfers have on reserve accounts or the current or future budgets.
- Since financial information does not clearly identify all reserve fund activities, it is difficult for the taxpayer to easily understand the true cost to conduct Municipal operations and for Regional Council to make strategic decisions based on the information presented to them.

Inter-reserve Transfers

- The OAG observed in fiscal 2012/13 three inter-reserve transfers which were not included in the annual budget process or consistent with the identified use of funds in the reserve business cases.

Reserve	Transfer out	Description
Operations Stabilization (Q308)	\$2,000,000	Transfer to Regional Facility Expansion (Q145) as per council report
Snow and Ice Control Variable Operating (Q309)	\$5,000,000	Transfer to Regional Facility Expansion (Q145) as per council report
Operations Stabilization (Q308)	\$1,000,000	Transfer to Strategic Growth (Q126)

- When questioned about the impact of the Snow and Ice Control Variable Operating Reserve transfer, the Administration advised the reserve was currently overfunded.

Inter-reserve Transfers

- The OAG questions the rationale for transferring funds classified as operating into a capital reserve when there is no apparent connection to the purpose or support for the decision.
- The OAG reviewed the Snow and Ice Control Variable Operating Reserve balance and found the balance to be greater than the specified maximum from 2010/11 onward until the transfer in 2012/13.
- The practice of leaving reserves overfunded for extended periods of time may cause them to be perceived as a parking lot for excess funds.
- If Regional Council was made aware of the amount of overfunding in the reserves then a strategic decision could be made as to how to proceed with reallocation but in the current practice Regional Council is only made aware of the overfunding when a recommendation to transfer the funds is being proposed.

Transfers to Fund Deficit

- To cover the 2014/15 deficit, HRM Administration recommended to Regional Council a number of transfers out of reserve accounts to the operating fund; which Regional Council approved.
- Funds were transferred out of five different reserves, two of which were capital reserves.
- The OAG expected to see detailed information around the impact to the reserve balances or plans for replenishment of the capital reserves but could not find any.

Transfers to Fund Deficit

Exhibit 6: Unplanned Reserve withdrawals to fund the 2014/15 general rate deficit.

Reserve	Transfer Out
Waste Resources Capital (Q123)	\$7,978,000
Self-Insurance (Q306)	\$300,000
Snow and Ice Control Variable Operating (Q309)	\$1,700,000
Operating Surplus (Q328)	\$1,714,470
Sustainable Communities (Q127)	\$120,525
Total transferred out of reserves to fund deficit	\$11,812,995

Transfers to Fund Deficit

- The variance from the budgeted amounts to the actual amounts is significant and the OAG questions why there was no discussion around this impact.
- Should these funds not have been needed, one would assume they should have been part of the annual budget discussions and perhaps a reduction in the HRM tax rate could have taken place.

Transfers to Fund Deficit

- It is concerning to the OAG reserve funds may be transferred in and out without a supporting business case, capital funds may be transferred to operating without a replenishment plan and transfers are being made from reserves contrary to the purpose of the reserve.

Key Recommendations

- 2.0.1 The OAG recommends HRM Administration conduct a corporate risk assessment to identify all risks and then determine whether these risks should be mitigated using reserve funds.

- 2.0.5 The OAG recommends HRM Administration have discussions with Regional Council regarding the targeted level of reserves.

Key Recommendations

- 3.0.4 The OAG recommends HRM Administration ensure all reserve business cases have a specific funding source(s), supported by a calculation to fund to a specific level.
- 3.0.6 The OAG recommends HRM Administration ensure each reserve business case has a specific targeted funding level, including a minimum and maximum funding amount and have these amounts evaluated on a regular basis to ensure they are sufficient given the purpose of each reserve.

Key Recommendations

- 3.0.7 The OAG recommends HRM Administration ensure there are clear instructions for how to proceed when a reserve is over or underfunded according to its' minimum or maximum. This includes whether or not interest can be allocated to reserves when overfunded.
- 3.0.8 The OAG recommends HRM Administration develop and document a formal review procedure, including a presentation to Regional Council on the current status of all reserves. It is also recommended HRM Administration ensure any review procedure is comprehensive.

Key Recommendations

- 3.1.7 The OAG recommends HRM Administration provide legal advice to Regional Council to interpret the HRM Charter in regards to the guidelines for the capital reserve fund and the use of capital reserves.
- 4.0.1 The OAG recommends HRM Administration work with Regional Council to decide what information Regional Council requires to make strategic decisions with regards to reserve funds and have it incorporated into the financial reporting.
- 5.0.1 The OAG recommends HRM Administration report the amount of overfunding by reserve to Regional Council as a part of the annual budgeting process so there can be discussion around the appropriate re-allocation of these funds.

Key Recommendations

- 5.1.1 The OAG recommends HRM Administration, when recommending a transfer from a reserve outside of the business case purpose, present a schedule to replenish the reserve, in addition to presenting the impact on the reserve fund. If no replenishment is required, there should be a documented explanation as to why. If the reason is overfunding, a description of how this occurred and how this will be prevented from happening in the future should be included.