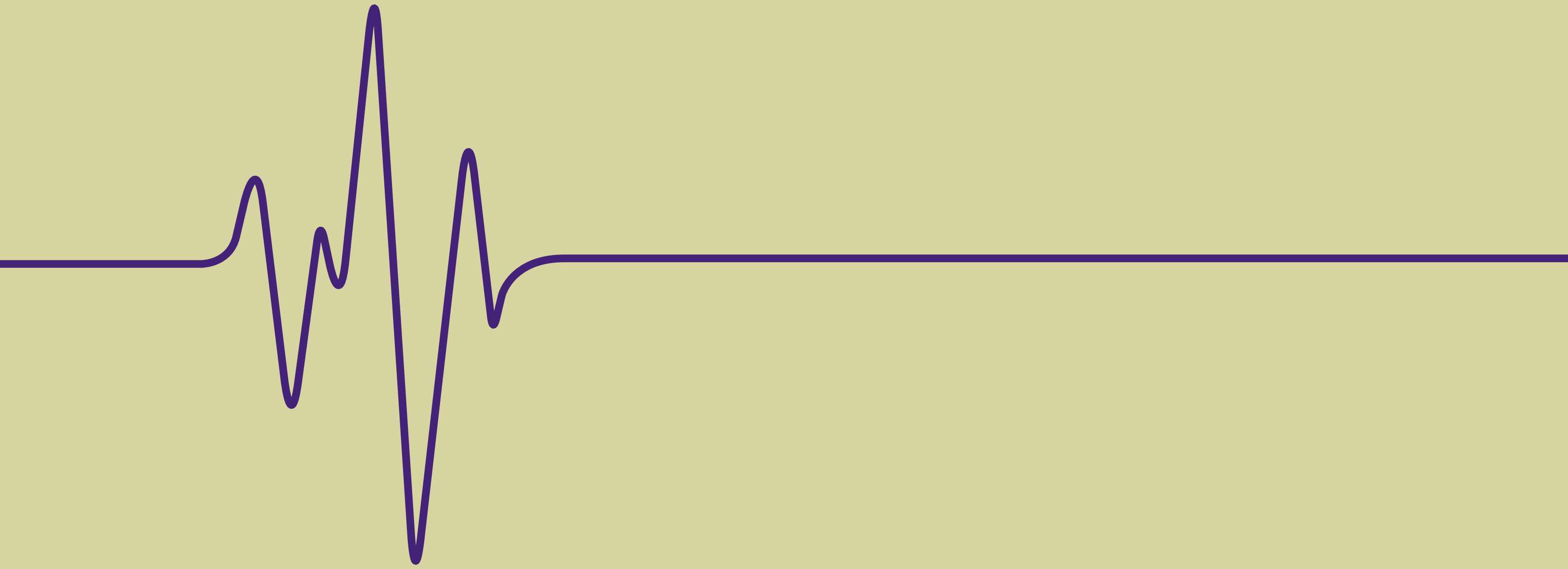
Grant Thornton

An instinct for growth™

Planning ahead: Improving financial health with reserves planning



Reserve funds offer charities and not-for-profit organizations important benefits—from funding new strategic directions to avoiding undesirable cost reduction measures—but setting them up is not without its challenges. What types of reserves are appropriate for your organization—and how should you calculate your reserve levels? Who is responsible for approving a reserves policy and how can you ensure your reserves are within the parameters set by the Canada Revenue Agency (CRA)?

Because no two organizations' operations and risk profiles are alike, the answers to these questions vary. Just as all organizations establish their own unique operating plans and budgets, we recommend that every charity and not-for-profit organization adopt a unique reserves plan to meet its specific needs and circumstances. The purpose of this paper is to help you identify those needs and the reserves policy that makes the most sense for your organization.

What is a reserve?

The term "reserve" is interpreted in a variety of ways. Our definition uses, as its baseline, the definition of unrestricted versus restricted fund balances outlined in the Canadian Accounting Standards for Not-for-Profit Organizations (ASNPO). In this definition, a restriction can be placed internally, externally or through endowment.

Benefits of establishing reserves

- Create confidence in the organization's stewardship and financial management
- Become self-sufficient
- Fund a new strategic direction
- Explain why funding is needed to undertake a particular project or activity
- Plan for capital re-investment (building, equipment, etc.)
- Avoid undesirable cost reduction measures
- Prepare for market-related risks
- Reduce the impact of sector-specific risks

We take this definition one step further by saying that each of an organization's reserves is a *distinct pool of net assets that an organization manages to achieve a specified set of objectives.* The objectives should be summarized within the accounting policy notes and elsewhere in more detail for use by internal stakeholders. **The assets and, if applicable, the liabilities associated with the restricted balances should also be clearly identified and managed.** As can be seen, merely carving out and labelling a portion of the organization's net asset balance as a "reserve" does not constitute a best practice reserve.

Instead, since both charities and not-for-profit organizations can be accountable to multiple constituents for the use of the net assets in their organizations, it's important to implement formal policies surrounding reserve funds. These policies should clearly articulate and link reserves to the mission and activities of the organization while providing transparency and accountability to stakeholders.

One example of the importance of such reserve policies is the situation of not-for-profit organizations that have accumulated an excess of assets over liabilities. Typically, the CRA takes the position that a not-for-profit organization (that is not a charity) that regularly earns other than incidental profits as evidenced by an accumulated excess should lose its status as a not-for-profit organization. CRA may be willing to change this position, however, if the organization has a formal reserve policy—which explains why it accumulated the net assets, what they will be used for and how these incidental profits were communicated to the organization's stakeholders. The CRA has conceded, for example, that it can be reasonable for a not-for-profit organization to accumulate funds as part of a capital campaign in order to purchase a needed building.

The CRA judges every situation on its unique merits. A prudent not-for-profit will manage any accumulated surplus with documented intentionality, to be able to explain to its members and the CRA why it has targeted to hold or accumulate certain balances. Presentation of reserves on the financial statements in a manner that is congruent with the policy is an excellent way to communicate compliance with the policy.

Types of reserves

When establishing your formal reserves policy, one of the first things you must do is determine which type(s) of reserve fits the requirements of your organization. There are essentially four different types from which to choose:

Operating reserves

When an organization has a long-term purpose, best practice says that an operating reserve should be established to cover the normal operating costs of the organization should an unexpected funding shortfall occur. Consider this reserve as your “insurance” to ensure the long-term continuity of operations. Some organizations calculate and identify their base level of unrestricted funds as a working capital reserve. This implies that all funds beyond those needed for working capital will be specifically employed for specified purposes.

Contingency reserves

These reserves are typically established if an organization anticipates changes in laws or regulations, a new entrant in the sector, or changes resulting from political issues or potential catastrophic events. A reserve for potential payouts relating to human resource-related issues may also be appropriate. Recent changes in accounting regarding employee future benefits have resulted in organizations creating reserves to account for surpluses or deficits in funding these long-term future liabilities.

Special program reserves

Establishing funds for unique events, new programs, research and specifically-restricted grants or gifts are all examples of situations where an organization may find it helpful to establish special reserves. The amount of the reserve will typically be linked to the budget approved or the funding provided for the initiative. Externally-restricted multi-year donations are tracked in special program reserves.

Capital reserves

These reserves are established for existing or future buildings, an expansion or other major additions to property and equipment.

Once you know which reserve(s) best meets your organization’s needs, it will be easier to determine your ideal reserve level.

Separate disclosure: property and equipment investments

Under ASNPO, an organization may choose to provide separate disclosure of the net amount the organization has invested in its property and equipment, as a portion of its accumulated excess of assets over liabilities. The amount is calculated by subtracting any associated debt from the depreciated value of the property and equipment. The communication value of this disclosure is to show to members and regulators of not-for-profit organizations, and donors and funders of charities, the illiquid portion of its net assets, which is presumably employed by the organization in fulfilment of its purpose. Because these net assets are a distinct pool intentionally held to assist the organization in achieving its purpose, they meet our definition of a reserve.

Complicating matters: Charity donor restricted reserves

Charities often have the most complex types of reserve (restricted) funds because their reserved amounts can include donor-restricted amounts of two types: endowment funds and externally restricted funds.

Endowment funds hold donations given by external donors on the condition that the principal amount of the donation will be maintained in perpetuity (and therefore is deemed "unencroachable"). Sometimes these donations include a capital maintenance requirement, such as "one quarter of annual earnings must be retained with the principal". Externally restricted funds hold donations given by external donors on the condition that the donations must be used to fulfil certain purposes, with completion often taking a period of years.

In both situations it is absolutely essential that the charity maintain corresponding assets equal to the fund balances. It depends on the unique situation of the organization as to whether it is useful to disclose specifically which of the assets, very often held as investments, are those being maintained for the funds.

Determining your ideal level

An ideal reserve level is one that is high enough to allow your organization to maintain sufficient liquid assets without being considered excessive. Many methods are employed to calculate this level—from setting aside a number of months' worth of operating expenses to predetermining a dollar amount—but most of these rules of thumb are quite arbitrary. Should your organization ever come under scrutiny from the CRA, you are better served by a more reasoned and sophisticated approach—one that takes into consideration the specific needs of your organization and includes a thorough paper trail.

To establish reserves based on a defensible methodology, we suggest following our four-step plan to quantify your targets for each reserve:

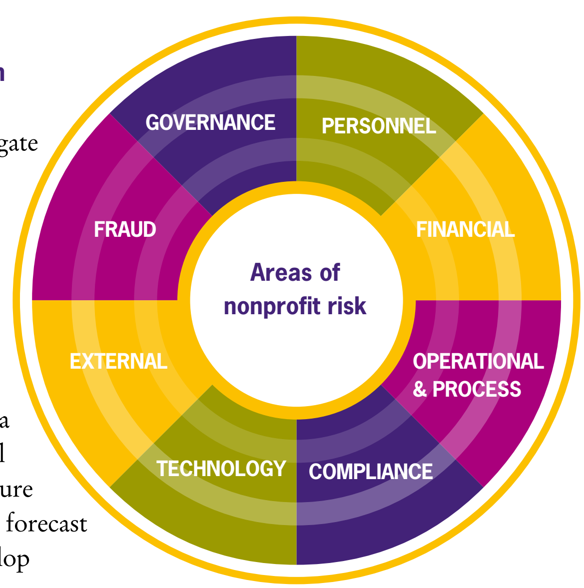
1 Build a baseline long-term financial forecast.

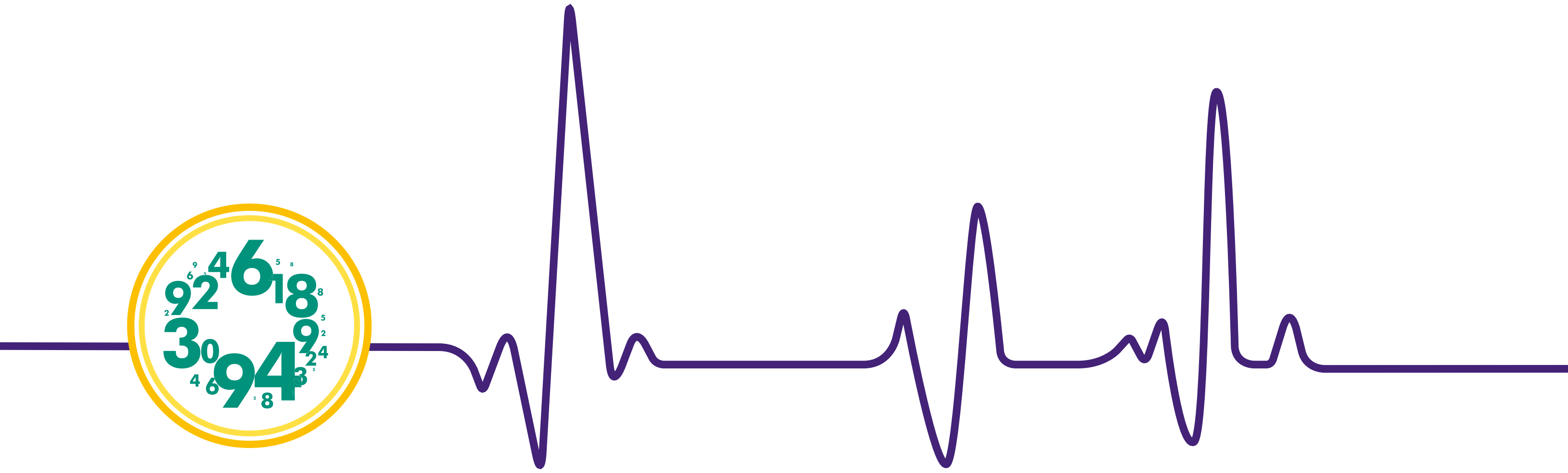
Whether the reserves are to mitigate against future adverse financial consequences, accumulate assets for capital purposes or execute major projects, they all have a multi-year time horizon. We recommend beginning the financial portion of the reserves planning process by developing a five-year financial forecast for all significant revenue and expenditure aspects of the organization. This forecast will enable management to develop insight into key drivers and see trends that are not evident in annual budgets.

2 Conduct a detailed analysis of potential risks.

Understanding the potential financial risks that your organization may encounter in the future is critical to building an appropriate reserves target. For this step, we recommend that management identifies, quantifies and assigns likelihoods to potential downside performance within the organization's short- and long-term financial plan.

In assessing these risks, management should apply an organization-wide perspective of financial risks. The risk wheel, below, provides an overview of areas to consider for not-for-profit organizations:





3 Quantify the risks.

Once the risk universe is identified, the finance team can now synthesize the information. This can be accomplished by applying probability-weighted net present value adjusted averages of risk exposure across critical budget lines.

In the case of Not-for-Profit A, for example, the director of membership's revenue assessment—after the finance team processed the numbers—would probably look like the chart on the right.

In summary, Not-for-Profit A would require a target amount of $330,000 to be set aside today to protect itself against dues-related risks within the upcoming five years, with $66,000 being the average annual amount in today's dollars of dues-related risks.

Even if the organization doesn't have the available assets to draw upon to protect against the $330,000 discounted risk, it nevertheless will find it valuable to understand that a current year budget contingency of $66,000 will be prudent should it move ahead with its plans as currently envisioned.

This same methodology to computing the quantum of appropriate reserves can be applied to all critical reserve areas, be they working capital, special projects, capital campaign accumulation and so on.

Membership dues revenue (000s)						
	Likelihood	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Baseline performance *(Perform to plan)*	25%	1,000	1,100	1,200	1,400	1,600
Downside scenario 1 *(Off by 5% per year)*	35%	950	1,045	1,140	1,330	1,520
Downside scenario 2 *(Off by 10% a year)*	25%	900	990	1,080	1,260	1,440
Downside scenario 3 *(Off 15% per year)*	15%	850	935	1,020	1,190	1,360
Probability-adjusted outcome for each year		935	1,029	1,122	1,309	1,496
Variance from forecast		(65)	(71)	(78)	(91)	(104)
Net present value of risk (using a 7% discount rate.)		(330)				
Net present value of risk per year		(66)				

4 Establish the target reserves level and funding approach.

Armed with a disciplined calculation of an appropriate amount for the particular reserve, management is now in a position to recommend the target reserve level to the board, as well as determine its approach to accumulating or setting aside funds for the approved amount. Each charity and not-for-profit organization will have different reserves planning practices depending on its own unique situation. They will have unique appetites for risk, and operate in environments of varying financial stability.

Unless the organization has the good fortune to already possess sufficient assets to meet its reserve targets, the funding plan will directly impact its constituents. For this reason, a communication plan that links the reserve policy to the organization's mission is essential. For not-for-profits, membership and regulator perspectives will be very important. For charities, the view of supporters and the media must be anticipated. In both cases, consultation with and, ultimately, approval by the board is essential.

Reaping the benefits of proper reserves planning

The ever-increasing pace of change and uncertainty in today's operating environment requires that charities and not-for-profit organizations be proactive, nimble and financially astute. Maintaining financial health, including well thought-out reserves, enables organizations to prepare for the future and achieve their missions, while providing stability and continuity in day-to-day operations.

Reserve Planning Considerations

4 reasons why your organization should establish appropriate levels of risk reserves

1 Become self-sufficient.
Given the uncertainty of formerly stable revenue streams and budgetary belt-tightening at the national and local level, many charities and not-for-profits (CNPOs) can't count on receiving funds that may have been previously considered a given. Many organizations have already experienced significant reductions on this front, and they should be prepared for potential new cuts.

2 Be prepared for market-related risks.
When in 2008 the S&P/TSX lost 35% of its value ($700 billion), CNPOs were reminded that the equities markets should not necessarily be relied upon as a form of annuitized income. Management and boards should continue to reassess their organizations' financial position and overall financial strategies.

3 Avoid unplanned cost-reduction measures.
Throughout the fiscal crisis, due to solvency and liquidity issues, management of many CNPOs were forced to react in a relatively "knee-jerk" manner by undertaking staff reductions and program cuts. Unfortunately, without adequate reserves, many of these entities were forced to compromise their strategic trajectory and long-term attainment of their mission for the sake of near-term financial savings.

4 Reduce the impact of industry-specific risks.
In addition to broad, systemic issues, every CNPO must establish reserves to mitigate against potential risks specific to their own unique sector, mission and business activities. For example, leadership at many advocacy and religious organizations are concerned about pending litigation costs that their organizations may encounter in the near future. Further, charitable organizations have cyclical susceptibility to downturns in public support as a result of high unemployment, declining disposable income and reduced family net worth, as well as increasing competition with other charities. Membership organizations are similarly affected with regard to dues revenue.

About the Charity and Not-for-Profit sector at Grant Thornton

Our not-for-profit practice serves the audit, tax and advisory needs of many charities and CNPOs, large and small, public and private. These organizations come to Grant Thornton to find professional advisers with an independent perspective who are knowledgeable about current issues and challenges facing the sector today—managing risk, refining strategy, enhancing operations, leveraging technology, improving internal controls, governance, and accountability, and succeeding in the face of changing economic circumstances with operating budgets under pressure. We bring value to our CNPO clients because we understand the issues and challenges they face, drawing upon our years of experience serving a wonderful base of clients across Canada.

Leaders in CNPO organization services

We are thought leaders who provide personalized attention and quality service. Our team includes professionals with experience in strategy, governance, operations, technology and risk management—services that can increase constituent value, deliver on mission, improve productivity, contain costs and streamline processing. Together we can provide solutions that help you:

- Increase effectiveness
- Enhance efficiency
- Comply with changing legislation
- Manage risk
- Improve controls

For additional information on the issues discussed, consult a Grant Thornton client service professional.

Deryck Williams
Mississauga, ON
T +1 416 360 4954
E Deryck.Williams@ca.gt.com

Donna Diskos
Vancouver, BC
T +1 604 443 2163
E Donna.Diskos@ca.gt.com

Rob Collins
Kelowna, BC
T +1 250 712 6862
E Rob.Collins@ca.gt.com

Tracey Zehl
Calgary, AB
T +1 403 260 2502
E Tracey.Zehl@ca.gt.com

Sandra Pietrzyk
Edmonton, AB
T +1 780 401 8236
E Sandra.Pietrzyk@ca.gt.com

Dale Varney
Markham, ON
T +1 416 607 2799
E Dale.Varney@ca.gt.com

Jeffrey Busniuk
Thunder Bay, ON
T +1 807 346 7203
E Jeffrey.Busniuk@ca.gt.com

Anita Ferrari
Toronto, ON
T +1 416 360 4961
E Anita.Ferrari@ca.gt.com

Blair Northcott
Saint John, NB
T +1 506 634 2851
E Blair.Northcott@ca.gt.com

Gerry Lacroix
Halifax, NS
T +1 902 491 7747
E Gerry.Lacroix@ca.gt.com

Kim Simms
St. John's, NL
T +1 709 778 8807
E Kim.Simms@ca.gt.com

Grant Thornton
An instinct for growth™

Audit • Tax • Advisory
www.GrantThornton.ca

Grant Thornton LLP. A Canadian Member of Grant Thornton International Ltd

About Grant Thornton in Canada
Grant Thornton LLP is a leading Canadian accounting and advisory firm providing audit, tax and advisory services to private and public organizations. We help dynamic organizations unlock their potential for growth by providing meaningful, actionable advice through a broad range of services. Together with the Quebec firm Raymond Chabot Grant Thornton LLP, Grant Thornton in Canada has approximately 4,000 people in offices across Canada. Grant Thornton LLP is a Canadian member of Grant Thornton International Ltd, whose member firms operate in over 100 countries worldwide.

About Grant Thornton International Ltd
Grant Thornton is one of the world's leading organizations of independent assurance, tax and advisory firms. These firms help dynamic organizations unlock their potential for growth by providing meaningful, forward looking advice. Proactive teams, led by approachable partners in these firms, use insights, experience and instinct to understand complex issues for privately owned, publicly listed and public sector clients and help them to find solutions. More than 35,000 Grant Thornton people, across over 100 countries, are focused on making a difference to clients, colleagues and the communities in which we live and work.