

**CITY OF HAMILTON  
PERFORMANCE AUDIT REPORT 2017-01  
RESERVES**

**INTRODUCTION**

Reserves are a key management tool used by municipalities in Canada. Reserves are utilized to respond to uneven and unpredictable revenues and expenditures. Reserves allow for the accumulation of funds over time for future funding of large capital and other one-time expenditures. Unexpected one time revenues such as grants or surpluses can also be set aside in reserves and used for a specified purpose or held to provide financial resiliency should unexpected events occur. The use of reserves can smooth tax and rate payers' burden, moderating tax and rate increases. Holding adequate reserves contributes to a City's sustainability as it provides a measure of financial flexibility to react to unexpected budget shortfalls or significant unexpected issues or events. The accumulation and use of reserves, however also needs to consider intergenerational equity. A planned approach to the use of reserves is considered good financial management.

The 2015 City Reserve Report reflects \$924.7 million in reserves, which was a \$46.8 million or 5.3% increase over the 2014 balance of \$877.9 million. These funds were held within 154 reserves, classified within one of three major types of reserve:

- Hamilton Future Fund Reserves (\$37.7 million – 2015)
- Obligatory Reserves mandated by legislation or By-law (\$226.2 million – 2015)
- Discretionary Reserves mandated by Council (\$660.8 million – 2015)

The City's total reserve balances compare favorably to other municipalities. Appendix C shows Hamilton as holding the second highest balances on a per capita basis. With respect to tax discretionary reserves, the City's reserves as a percentage of taxation have declined from 70% in 2011 to 58% in 2015. Hamilton's experience is the reverse of the average for municipalities in Ontario, which over the same period saw improving tax discretionary reserves as a percentage of taxation revenue.<sup>1</sup> Reserves are one of the many factors that need to be considered in assessing municipal financial health.

**AUDIT OBJECTIVES AND SCOPE**

The objectives of this audit were to:

- Assess if policy and procedures are appropriate to ensure good stewardship of reserve funds and support legislated requirements and best practices;
- Evaluate if reserve activity complies with policies and procedures and other authorized directions;

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<sup>1</sup> As reported in BMA Management Consulting Inc.'s 206 municipal comparative study.

- Assess the sufficiency and transparency of reporting on reserves to Council and the public (considering accuracy, transparency and understandability). This will consider publicly available reports such as the budgets, Annual Financial Report (including the audited financial statements) Annual Reserve Report and Budget Variance Reporting; and
- Evaluate how the City's reserve funding supports the City's sustainability through:
  - Investment returns /allocations to reserves;
  - City's use and accumulation of reserves compared to best practice and generally accepted philosophy for Canadian municipalities' use of reserves; and
  - Borrowing from the reserves.

The scope of this audit encompasses all open reserves disclosed in the City Reserves Report as at December 31, 2015, which was the most current reserve report available at the time the audit was completed. While individual obligatory reserves governed by specific external agreements and legislation were not the subject of detailed review, they were included in procedures that related to reconciliation, reporting and transparency. Our detailed testing focused on the period from January 1 2015, to December 31, 2016. Trend analysis considered the five years from 2011 to 2015.

## **METHODOLOGY**

The following audit techniques were used either individually or in combination:

- Review of applicable policies, procedures, reports, agreements and legislation.
- Interviews with various City personnel.
- Examination of reports and transactions and supporting documents.
- Research of best practice and other select municipalities' reserve usage.

The Audit relied on publicly available information as well as procedures, accounting records, and other documents as well as explanation and interviews with personnel to form the basis of the audit report and recommendations.

## **FINDINGS**

### **1. Compliance with External Requirements, Policy and Procedure**

#### **City's reserves generally comply with external requirements**

Reserves balances and activity is largely compliant with requirements provided by the Ontario Municipal Act (MA), the Public Sector Accounting Board (PSAB), and the City's own policies and procedures related to reserves. This includes recognizing Obligatory Reserves as deferred revenue and the discretionary reserves as part of the City's surplus. Audit services noted discretionary reserves shown in the Reserve Report erroneously included one small reserve that was reported as deferred revenue in the financial statements. Appendix B provides the list of approved reserve policies.

#### **Additional procedures could better support compliance with PSAB**

Audit Services identified several older discretionary reserves funded by grants that should have been reviewed to ensure they were not deferred revenue. Financial Reporting was unable to confirm their review at the time they were established and currently does not have a process in place to confirm the appropriateness of administrative recommendations for reserve set up.

#### **Administration is not completing periodic reviews on a timely basis**

ADM-01 Policy directs Administration to complete periodic reviews of reserves for policy compliance and relevance, and to provide action plans for maintaining Council approved funding levels. Since 2014 Administration has reviewed seven of the larger and higher priority reserves. However, at this rate it will take twenty-one years to review the remainder of the current reserves.

#### **Need for better corporate oversight and decision making**

There is currently one umbrella policy, governing general direction on reserves. The umbrella policy contains contradictory statements and would be enhanced by including requirements for better support, corporate oversight, and decision making. The umbrella policy ADM-01 provided the following conflicting direction:

- Council is required to approve all reserve related transactions (set up, changes and all transactions) prior to occurrence, which can be completed through Council report, motion or the annual budget.
- Administration has the authority to "approve... ongoing activities of the reserves as per the reserves purpose, conditions and or restrictions." (Section 1.4)

Audit Services did not identify any circumstances where Administration directed reserve related activities without prior Council approval.

Audit Services noted that standard terms of reference that should be provided within policies for specific reserves were not outlined in the umbrella policy. The umbrella policy should include key terms of the reserve that would be documented when Council approves a new reserve, such as:

- The unique corporate purpose or need served by the reserve;
- Ongoing sources of funding;
- Ongoing uses of reserve funds;
- Target levels or ranges based on a related driver; and
- Corrective actions when reserve is under or over target.

This type of information ensures there is clearly documented understanding of a reserve's function. It can aid Council and Administration in better decision making, and evaluation related to reserves, and provide agreed upon content for the Annual Reserve Report.

### **Targets are lacking for the majority of reserves**

Review of the Reserve Report found only 10 reserves with a target balance. The targets for the majority of reserves are noted as either; "to be reviewed" or "not applicable as one-time funding". Audit Services' noted that the Tax Stabilization Reserve balance has remained at less than 1/3 of the target balance in both 2014 and 2015, while the Unallocated Capital Levy Reserve has remained above its target over the same period; however, this balance is exclusive of future year commitments.

### **City needs to confirm and articulate their authority over Boards' reserves**

Hamilton Library and Hamilton Police Service are governed by separate boards and consistent with existing policy maintain their annual operating surpluses in their own reserves. However, given funding reliance, existing policy and separate governance, Audit Services was unclear as to how and when the City could access these reserves if Council deemed it necessary. Once this is articulated within City policy, the Reserve Report should categorize the reserves to reflect Council's level of access and control over these funds.

## **2. Sustainability and Sufficiency of Reserves**

### **Hamilton's reserves are generally keeping pace with operating expenditures**

While discretionary reserves have become a slightly smaller percentage of annual expenditures over the last five years, Hamilton's balances are the third highest within the comparator municipalities. See Appendix C for more detail.

### **Hamilton's reserves cannot be easily assessed for sufficiency or excess using currently available information**

The reserve contributions to fund capital and operating requirements can be determined from the analysis included with the Annual Reserve Report. However, it is challenging to identify which portion of reserve funds is available to fund each of the future years' operating and capital budgets. This is significant as reserves provide the largest single source of funding (2015-26%) for the annual capital budget.

Furthermore in the Reserve Report, while each reserve has a brief caption listing whether it is sustainable, there was rarely supporting evidence for conclusions. If the reserve is identified as unsustainable, remediating actions were not often listed.

### **Uncertainty in the adequacy of Tax Stabilization Reserve balance**

For the Tax Stabilization Reserve there is a gap between the 2015, \$40 million target and the actual balance of \$13 million. While the desire to attain the target has been reiterated, Administration is projecting an even lower ending balance for 2016. Audit Services was unable to confirm any approved plan to move the reserve balance closer to its established target.

Audit Services also identified eight (8) reserves by description or activity that appear aligned to stabilization objectives, with a combined balance of \$88 million, which could be relevant to the question of adequacy. See Appendix D for details. In one of these reserves, we were advised that the risk of capital losses on investments may be adequately addressed with much lower balances than currently held. (Investment Stabilization Reserve, 2015- \$54 million). That balance was created by contributions of large capital gains over the last five years. There is currently no target for the reserve.

## **3. Efficiency and Effectiveness**

### **Effective and efficient use of some reserves**

There are several reserves with purposes and functions commonly seen in other Canadian municipalities, which demonstrate characteristics that support effectiveness and efficiency such as:

- The Election Expense Reserve which responds to a specific corporate need;
- The Vehicle Replacement Reserves which accumulates significant funding for uneven capital expenditures; and
- The Rate Supported Reserves that hold surpluses generated from rate supported operations and provide funding for capital and rate stabilization.

While numerous municipalities, including Hamilton, have reserves to smooth winter road maintenance expenditures, Audit Services noted that the City's 2014 & 2015 winter maintenance deficits were not actually funded by the Winter Control Reserve. They were drawn down from operating deficits leaving the Winter Control Reserve intact. It is unclear if utilizing the surplus rather than the reserve is within Administration's discretion and is advisable for transparency or consistency.

**Reserves are being used for many purposes, only some of which align to agreed upon outcomes**

The following are the most common desired outcomes that reserves provide:

- Smoothing or moderating tax and rate increases;
- Funding the capital program and thereby reducing debt levels; and
- Providing financial flexibility and resiliency to respond to unexpected financial challenges.

Audit Services noted that the City's reserves are also being used for:

- Reporting funding and activity in sensitive or high profile areas; and
- Demonstrating accountability for donations and other specific receipts.

These purposes do not align with the outcomes provided above.

**The large number of reserves does not support efficiency, effectiveness or strategy**

As the number of reserves under administration increases so does Administrative effort, related to transactional processing, reporting and oversight. The City reports on 147 discretionary reserves, which is higher than both Calgary at 47 and Toronto at 115. Furthermore, Audit Services identified 22 reserves with minimal activity in the last five years. Appendix E lists the reserves. Many of these reserves have small balances and narrowly defined scope for use of funds.

Each year smoothing tax and rate increases requires a certain contribution to and from reserves and achieving that with large numbers of small transactions is less efficient. Within the Income Stabilization Reserve, the combined funding for the Pilots and Ontario Municipal Board Appeals (OMB) of \$1,326 million was the result of 69 individual transactions ranging from \$1,000 to \$250,000. Higher volume low value transactions are typical for many of the reserves. Changes to both budgeting practices and the approved uses for the reserves could result in recognizing the same amount of reserve support more efficiently.

**Internal loans from reserves provide some benefit to taxpayers**

Council has authorized from reserves, internal loans with specified terms and rates comparable to external borrowing. The loans result in reduced external expenditures. In some cases operating savings fund internal debt servicing with no impact on property taxes, but when this is not the case, these loans impact property taxes in the same way as if the borrowing was made from a third party, as interest is provided to the loaning reserves. While these transactions result in lower corporate debt and higher interest contributions in reserves, they increase the complexity of reserve transactions, and require additional controls and reporting. Thus the use of internal loans needs to be prudently managed so as to have clear cost/benefit advantage.

**4. Strategy and Planning****An overall reserve strategy is absent**

Finance Management acknowledge that while there is analysis of various components of mid and long range financial planning there is no formal comprehensive plan in place that outlines how the City will establish, fund and utilize its reserves over the next five to ten years to achieve the City's objectives. As a result:

- Administration has no high level end target to inform their decisions; and
- Reserves outcomes are the result of tactical actions rather than strategy.

This issue is especially relevant as the City moves to multi-year budgeting. Reserve strategies can impact many areas including administrative burden, behavior, and transparency and ease of understanding for stakeholders, Council and administration. Once strategy has been formalized, reserve policy can be aligned.

**Funding strategy for employee related liabilities is needed**

The City's significant employee benefit liabilities are partially funded from a variety of reserves that align to different components of the liability. In addition to these reserves, the Claims Fluctuations Reserves intended for smoothing annual budgeted employee benefit costs have a combined balance of \$23.6 million. Over the last 5 years only surpluses have been transferred to the Claims Fluctuations Reserves, suggesting reserve overfunding. Audit Services was unable to find support justifying the need for the high reserve balance. The 2015 employee future benefits liability compared to 2015 funding is shown in Appendix F-1.

Reserves compared to the total liability has remained consistent at around 30% over the last five years, however the funding approach is fragmented and Administration confirms that they have not developed formal funding strategies. There are no targets for funding each component, nor the liability in total. Audit Services notes that not fully funding these liabilities increases the risk that intergenerational funding could be required in the future. Appendix F-2 shows funding levels for 2011-2015.

## **5. Reporting and Transparency**

### **Reporting around reserves is voluminous and fragmented**

Reserves information is provided in the Audited Financial Statements, the Reserve Report, Budgets and Periodic Budget Variance Reports.

However, variance reporting is aggregated to a level that hinders transparent reporting, meaning that some reserve transactions and reserves activity is not fully disclosed. For example, within 2015 Non Program Revenues, unbudgeted capital gains of \$3.1 million (2014- \$8.3 million) were transferred to the Investment Stabilization Reserve, eliminating a large favorable variance, and no discussion is provided within the year end variance reports (FCS15052 (b) FCS14047 (b)). The result is that a significant revenue variance is buried in other transactions. A better approach would be to have a system and format that provides full accountability and transparency. Toronto's reporting of unbudgeted transfers to and from reserves is an example of how increased transparency can be provided.

### **Reconciliation and explanation of differences between Reserve Report and Audited Financial Statements is not completed**

In the course of our audit work we found differences between the Annual Financial Statements and the Reserves Report. Although 2015 differences were immaterial, there was no evidence of a process to reconcile the numbers in the two reports, or identify how the information in the reports agrees or differs. Linking Reserve Report totals to the Audited Financial Statements would provide more transparency and assurance to the report reader.

### **Usefulness of the Reserve Report falls short of expectations**

The Reserves Report provides large amounts of information for a large number of reserves and requires a significant investment of time to generate and review. However, it's not easily understood. At least partially due to staff changes, the 2015 report was also not available until January 2017 which further impacted its usefulness. The benefits provided to users such as the staff, Council and the citizens are uncertain and in our view could be enhanced.

Our basic premise is that the Reserve Report's value is dependent upon its understandability to the users. Audit Services noted individual reserve narratives that to varying degrees were incomplete, out of date, or not easily understood. The use of acronyms and inconsistent levels of detail compromised its quality.

Also, reporting by major types of reserve transactions could be improved. The Reserve Report summary report provides valuable summary information related to the major types of funding into and out of the reserves broken down by reserve category.



However within the individual reserves, while interest revenue is disclosed separately, other activities are described in a large variety of ways, which all fall under one of the following categories:

- Allocations to Capital Fund;
- Allocations to Operating Fund;
- Allocations from Operating Fund;
- Allocations from Capital Fund;
- Repayment of internal loans;
- Internal loans; or
- Transfer between reserves.

We note that other municipalities provide reserve reporting in various formats that are more transparent. While Calgary provides a similar detailed presentation of each reserve, Toronto provides periodic reporting in tabular format, relating to budgeted and actual reserve activity and loans activity.

#### **Unclear reporting of operating surplus distributions**

The City's annual operating surplus created by the excess of revenues over expenditures is transferred to reserves in accordance with Council's direction. Audit Services expected that approved transfers to specific reserves shown in the Year-end Variance Reports would occur in the same year as they were created and match to the specific reserves noted. While the 2015 reporting on the Rate Supported and Police surpluses matched the Reserve Report, other amounts reported were not shown in the 2015 Reserve Report (however may be reflected in 2016) and the Library reserve transfer was shown as one amount but recorded between two reserves in the Reserve Report. With such presentation, and lacking full explanation, it makes it difficult for the public to understand the impacts on the reserves.

#### **Reporting of prior commitments of reserve funds is not formalized**

Audit Services noted that future year projections provided for each reserve are being generated inconsistently. Some projections include only the following year's approved amounts. Others include amounts that have been approved in budget, report or plan for a number of future years. To ensure that reserves are not overcommitted, Administration identified a need to have readily available information on all commitments, which should be consistently defined.

#### **Adequate and transparent reporting on loans from reserves is lacking**

Reporting of the loans is limited to the recorded total repayments of \$18.2 million in the 2015 Reserve Report analysis as well as the details within the individual reserves. Reporting related to the cumulative loans repayable to reserves was not readily available as at each year end, and Administration did not undertake formal oversight processes to ensure that loan repayments were made according to schedule.

## **RECOMMENDATIONS**

1. That Financial Planning & Policy ensure that Reserves are being employed to support corporate sustainability. Accordingly, Management should:
  - Develop a reserve strategy in conjunction with longer term financial plans including the capital management plan; and
  - Provide ongoing education and communication of the strategy to ensure that tactical reserve activities are aligned with strategy.

*Management Response: Agreed. Initial work can begin in 2017 towards developing strategies related to obligatory and discretionary reserves. These strategies will have to be amended from time to time to reflect draws on reserves for unplanned corporate or council priorities. Completion by Q4 2019.*

2. That Financial Planning & Policy ensure that Employee Benefit Liabilities are appropriately funded in accordance with an approved funding strategy and the related applicable reserves strategy, giving consideration to the impact on fiscal responsibility and intergenerational equity.

*Management Response: Agreed. Completion by Q2 2018.*

3. That Financial Planning & Policy ensure that reserve strategies outlined in recommendation 1 & 2, include targets based on appropriate drivers for key reserve areas, such as Stabilization, Vehicle Replacement and Employee Benefits. Plans to achieve and maintain the reserve targets should be approved by Council and then financial requirements included within annual operating budgets.

*Management Response: Agreed. Targets and strategies for Stabilization, Vehicle Replacement and Employee Benefit Reserves will be updated and presented for Council's consideration by Q3 2018. Management will continue to work annually with internal clients in an effort to deliver the planned development of three reserve policies and targets. As part of the annual budget processes, staff will present to Council strategies confirming the required investments or service level amendments to achieve said targets, recognizing competing interests, including tax competitiveness.*

4. That Financial Planning & Policy rationalize and streamline the existing reserves, with the goal of building and retaining reserves with significant ongoing funding sources, and a defined corporate purpose. Management should close the majority of low activity reserves, particularly when those reserves do not serve a corporate need. The goal of the reduction in total reserves should be to increase the effectiveness and efficiency of reserve and Administrative activity.

*Management Response: Agreed. Staff and Council will be consulted annually as reserves are rationalized and the number of reserves is reduced. By Q4 2017, staff will present options for Council's consideration in an effort to begin the rationalization of reserves, including those referenced in this report.*

5. That to facilitate better analysis, and improve transparency, Financial Planning & Policy should classify the discretionary reserves according to the operating or capital activities they fund. The larger number of categories currently used should be reviewed and kept only if they provide useful information for analysis and understanding of reserve activity.

*Management Response: Agreed. While reserves are categorized for existing reporting purposes including categories for capital related reserves, further review will be undertaken. Completion by Q2 2018.*

6. That Financial Planning & Policy should implement budgeting processes that align with the following principles:
  - Establishment and utilization of reserve funding primarily for corporate purposes;
  - Requiring fewer and higher value transfers to and from reserves; and
  - Transparency for both budgets and reserves.

*Management Response: Agreed. The principles above will be considered in the development of the reserve strategies and multi-year budget development. Completion by Q4 2019.*

7. That Financial Planning & Policy should develop umbrella policies aligned with the Corporate Reserve Strategy. In addition to the content provided in the current umbrella policy there needs to be:
  - Clearly articulated and aligned roles and responsibilities of Administration and Council; and
  - Guidance on acceptable reserve purposes and areas that may generally be less appropriate, including low value funding or reserves, one-time funding and very specific purposes.

Specifically required documentation of terms and conditions prior to reserve approval, such as:

- Ongoing sources of funding;
- Ongoing uses of reserve funds;
- Target levels or ranges based on a related driver;
- Corrective actions when a reserve balance is under or over target; and
- Direction for subsidiaries' responsibility for reserves and retention of surpluses.

*Management Response: Agreed. With respect to corrective actions, those would be presented through budget reports/deliberations or stand-alone reports. Completion by Q2 2019.*

8. That in conjunction with the rationalization of reserves, Financial Planning & Policy should ensure that Council approved amended terms and conditions for each individual reserve are complete, consistent and are readily available as Policy or in some other similarly accessible format.

*Management Response: Agreed. Completion by Q2 2019.*

9. That Financial Planning & Policy should investigate alternative formats for Reserve Reporting, including tabular formats for their value to external users, and the ease of preparation.
  - Management needs to ensure that any information provided is timely and understandable.
  - Management should provide appropriate linkage of information related to reserves reported in the audited financial statements and budget variance reporting.

*Management Response: Agreed. Completion by Q2 2019.*

10. That to ensure transparency, Financial Planning & Policy should provide annual reporting on:

- The details on the outstanding loan balances for internal loans provided from specific reserves, as well as loan terms including annual repayments; and
- Significant variances between budgeted and actual reserve transactions.

*Management Response: Agreed. Completion by Q3 2017.*

11. That Financial Planning & Policy ensure that processes for creating reserves funded by specific grants, support maintaining compliance with PSAB. Management should update reserve set up processes to include review by Financial Services for financial reporting requirements.

*Management Response: Agreed. Formal procedures to ensure that grants provided by provincial and federal governments are appropriately recorded will be developed by Q4 2018.*

12. That once the reserves have been rationalized, Financial Planning & Policy needs to develop an ongoing review plan for all active reserves, to ensure that they are reviewed within a reasonable timeframe. Management needs to determine clear and understandable criteria for evaluating the appropriateness of a reserve, informed by the desired corporate outcomes for reserve usage.

*Management Response: Agreed. A plan will be developed which incorporates the staffing resources required to review all reserves and considers other divisional priorities. The plan will be developed by Q4 2018.*

13. That Financial Planning and Policy should develop readily available reporting on approved reserve funding commitments for each reserve. Rules and processes are required to ensure that the information is provided on a consistent and comparable basis, supporting understandability.

*Management Response: Agreed. Completion by Q3 2017.*

## **CONCLUSION**

Like many municipalities, the City utilizes reserves to respond to uneven revenues and expenditures, and support financial flexibility. The 2015 Reserves Report reflected \$924.7 million in reserves, of which \$660.8 million were discretionary reserves mandated by Council. While the City's reserve balances compare favorably to other municipalities, corporate strategy including targets is needed to determine the adequacy of reserves to support sustainability. Strengthened policy stipulating the requirements for reserves could facilitate more efficient and effective activity by having fewer and larger reserves supporting corporate objectives. Improved reporting on annual reserve activity, as well as reserves loans and commitments of reserve funds will provide greater transparency, accountability and understandability. Periodic evaluation of reserves and related reporting is required to ensure that reserves continue to meet their specified objectives as priorities and the environment changes.