



Calgary

City Auditor's Office

Financial Reserves Audit

April 25, 2024



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Audit Objective

The objective of this audit was to assess the effectiveness of the management of The City of Calgary's (The City's) financial reserves. The objective was achieved by reviewing the design and operating effectiveness of the processes and controls that mitigate key risks that could impact the achievement of The City's reserve objectives.

Why it Matters

Reserves are used to accumulate funds over time to replace capital assets, and to provide a measure of financial flexibility to react to budget shortfalls or the financial impact of significant unexpected issues. The City had 50 reserves totaling \$4 billion on December 31, 2022 (2021: \$3.5 billion).

Effective reserve management and alignment with best practices mitigate the risk:

- Reserve balances are not adequate (underfunded) to respond to shortfalls and unanticipated/uncontrollable events.
- The City collects tax revenues in excess of service delivery costs while reserve balances are not used (overfunded).
- Reserve transactions are not consistent with reserve purpose, conditions, and City policies.

What We Concluded

Key processes and controls established to manage financial reserves are designed and operating effectively.

Finance has established a framework of governance structures, processes, and controls to support effective management of reserves. The Triennial Reserve Review (TRR) conducts a review of every active reserve at least once every three years, to ensure their proper management, ascertain if reserve activities align with terms and conditions, and determine if reserves are still necessary in their current configuration. Furthermore, the Administrative Review Committee (ARC) offers oversight by questioning appropriateness of reserve target balances, proposing the closure of reserves no longer needed in their current state, and presenting recommendations from the TRR report to the Executive Committee and Council.

We reviewed a sample of five reserves to assess the effectiveness of key processes and a sub sample of reserve transactions to assess adherence to authorizing documents. Testing results indicated key processes were designed and operating effectively, and sampled reserve transactions complied with reserve purposes, conditions/restrictions, and City reserves policies and procedures.

We raised two recommendations to better align City reserves policies and processes to best practice guidance from the Government Finance Officers Association (GFOA), which will help mitigate the risk of overfunded/underfunded reserve balances, and one recommendation to better define reserve type to support consistent practice.

Finance has agreed with our recommendations with plans to implement by December 31, 2027.

Background

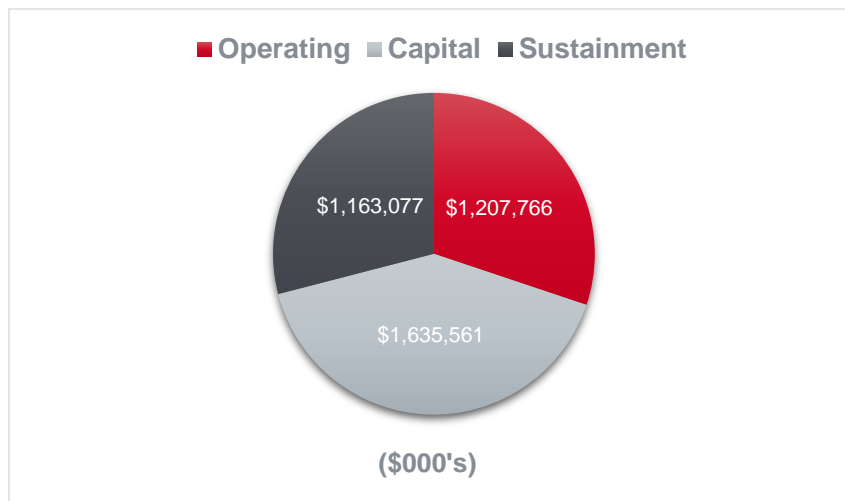
There is a comprehensive framework to manage The City's reserves, including Council Reserves Policy (CFO013) (Reserves Policy), which includes the creation, amendment and closure of all reserves. Administration Policy on Financial Reserves FA-050 (B) (Financial Reserves Policy) establishes further guidelines and criteria for financial reserves and defines the roles and responsibilities of all parties associated with administering financial reserves, which includes Procedures for Financial Reserves.

Finance presents an Annual Reserves Report to the Executive Committee containing detailed financial information on each reserve, including reserve terms and financial details. The Corporate Financial Reporting group within Finance is responsible for ensuring the reserve balances are accurately reported in The City's Annual Reserves Report.

Council mandated a triennial review process for every active reserve. The purpose of the triennial reserve review (TRR) is to ensure reserves are managed in accordance with each reserve's purpose, conditions and/or restrictions and assess if the reserve is still required in its current form.

The Administrative Review Committee (ARC) oversees the TRR and provides an annual report on the results of the TRR to the Executive Committee along with any recommendations derived from the review to Council for approval.

The City's reserves totalled \$4 billion and consisted of operating¹, capital², and sustainment³ reserves on December 31, 2022. The following illustration provides a breakdown of each reserve category based on dollar amounts.



¹ Operating reserves fund operating expenditures for one-time projects, pilot programs, to stabilize operating budgets for unanticipated fluctuations in revenues or expenditures, to comply with a contractual agreement, or for contingency funds for operational emergencies.

² Capital reserves fund approved capital programs, projects and expenditures.

³ Sustainment reserves fund both operating and capital expenditures for self-sustaining activities.

Scope & Approach

The scope of the audit included financial reserve activities from January 1, 2022, to December 31, 2022. The City's investment program, Council's Investment & Governance Policy and the Service Plans and Budgets process⁴ were out of scope.

Our audit approach included interviewing Financial Leads and Finance Managers/Reserve Owners and examining reserve policies and procedures, and supporting documentation, including reserve binders (e.g. authorizing documents, templates and forecasts). We reviewed a sample of reserves and their associated reserve activities to assess compliance with reserves policies and procedures and reserve purpose conditions/restrictions and assessed the design and operating effectiveness of the following processes to manage reserves:

- Key processes outlined in Procedures for Financial Reserves;
- Identifying and monitoring committed balances;
- Developing forecasts/long range plans;
- Establishing minimum/maximum and target balances;
- Developing action plans to return over/under funded reserves back to compliance;
- TRR follow-up; and
- ARC oversight.

We reviewed the GFOA⁵ guidance against The City's financial reserve management practices/policies to identify opportunities to better manage risk and get the best value from reserve strategies.

Results

To assess the design and operating effectiveness of financial reserve management processes and controls outlined under the audit objective, we selected a sample of five reserves from the 2022 Annual Reserve Report totaling \$2.2 billion (55% of total reserve balance):

- Fiscal Stability and Operating Budget Savings Account Merged (FSR/BSA): \$1.1 billion, Operating;
- Community Investment: \$130 million, Capital;
- Reserve For Future Capital and Lifecycle Maintenance and Upgrade Merged (RFC/LMUR): \$792 million, Capital;
- Business License Sustainment: \$10 million, Sustainment; and
- Utility Sustainment Reserve: \$200 million, Sustainment.

Results of our audit work are presented in the sections below.

Key Processes

We determined key processes outlined in Procedures for Financial Reserves were designed and operating effectively. We reviewed the following and noted no exceptions:

⁴ The City is refining The Service Plans and Budgets process, which could impact contributions to reserves (e.g. tax supported operating surplus is contributed to the Fiscal Stability and Operating Budget Savings Account Reserve Merged).

⁵ Financial Policies and Reserve Policy Template and paper: "Should we Rethink Reserves?"

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- 2022 Year End Reserves Checklists and Reserve Templates to verify they were completed and signed by Operational and Financial Leads;
 - Year-end reconciliations and corresponding supporting documentation to verify they were prepared, and amounts reconciled to the Annual Reserve Report Template; and
 - Annual Reserve Report Templates to verify they were signed by Operational and Financial Leads and reconciled to the 2022 Annual Reserve Report.

We selected a sample of reserve transactions to evaluate compliance with authorizing documents, reserve purposes/restrictions, and City reserves policies. We leveraged testing conducted during the 2023 TRR for the FSR/BSA sample to avoid duplication of effort. Overall, the reserve transactions were in accordance with reserve authorizing documents/reserve terms and conditions and policies.

During our review of the year-end reconciliation for the LMUR, we noted annual transfers to the Public Arts reserve met conditions/terms of the reserve. However there was no formal approval obtained from the Executive Leadership Team (ELT). The exception was also identified in the 2023 TRR Report with a recommendation to ensure proper approvals for the annual reserve funding moving forward.

The Financial Leads are responsible for preparing and managing reserve binders, which house crucial reserve documents including authorization, checklists, reconciliations, and more. We observed that certain reserve binders were a mix of paper and electronic formats, complicating document retrieval. The issue was identified in the 2022 TRR with a recommendation to transition reserve binders to electronic format by the end of 2024.

Commitments

The City's committed reserve balance was \$2.35 billion as of December 31, 2022. These commitments encompass various types such as Council approved budgeted reserve inflows/outflows for the 2023-2026 budget cycle, capital projects, balance conditions and restrictions (e.g. FSR restricted minimum of 5% of The City's tax-supported gross expenditures net of recoveries) and external commitments.

Based on our sample of five reserves and review of supporting documentation, the process to monitor and report on commitments is designed and operating effectively. Financial Leads tracked commitment activity and performed reconciliations, which agreed to balances in the Annual Reserve Report.

We also selected a sub-sample of commitments from reconciliations and confirmed they were approved by Council, where applicable, and consistent with authorizing documents.

Forecasts/Plans

The GFOA advocates for local governments to engage in long-term forecasting to ensure alignment of financial resources with strategic goals and to anticipate future financial challenges. Similarly, the Procedures for Financial Reserves emphasize the importance of preparing long-range plans for reserve contributions and expenditures.

Upon reviewing the long-range planning for the five samples selected, all five reserves sampled had completed long-range plans. However, the long-range plan for the FSR/BSA reserve was included in the Year-end Checklist under Related Budget Activity with an explanation rather than under the long-range plan section. We shared an opportunity to align the terminology in reserves policies and procedures with checklists and templates.

Over/Underfunded

According to Administration's Procedures for Financial Reserves, the Chief Financial Officer is provided with an annual exception report listing all reserves that are non-compliant with their approved minimum and maximum balances, including action plans to bring the reserves to compliance. The Chief Financial Officer and the Chief Administrative Officer review the action plans, which are reported to the Executive Committee and Council as part of the Annual Reserves Report. The 2022 exception report did not contain any non-compliant reserves related to minimum and maximum balances. There were no instances of reserves not complying with their maximum/minimum reserve balances in the 2022 Annual Reserve Report.

Of the five reserves sampled, one had a minimum and target balance (FSR/BSA), and two had target balances only (RFC portion of RFC/LMUR and Utility Sustainment). We reviewed the calculations over minimum and target balances and noted target and minimum balances complied with their respective reserve authorizing documents/conditions and the FSR/BSA reserve was above minimum target.

Targets (Min./Max.)

In addition to our sample testing for over/underfunded reserves, we reviewed the 2022 Annual Reserve Report with a focus on cash flow and contingency reserves and noted a mix of reserve practices when it came to establishing reserve minimum and maximum targets. The Reserves Policy does not require minimum and maximum reserve target balances. Section 1.1 of the Reserves Policy indicates the report to request a new reserve should include minimum and maximum target balances for the reserve (if applicable). The Reserves Policy does not state if/when a reserve should have minimum and maximum target balances.

The GFOA recommends developing a comprehensive reserve policy that addresses reserve balances and includes minimum and maximum targets. Setting a minimum target will allow The City to respond effectively to shortfalls and unanticipated events, while establishing a maximum target ensures that excess reserve balances can be used to positively impact service delivery by being transferred to some other purpose. Since the appropriate target range for a reserve can vary depending on specific reserve purposes, conditions, and risks, the GFOA recommends performing a detailed analysis of potential risks and impact on reserves to establish target reserve levels. Where possible, the risk assessment should include quantifying the risks and forecasts of future reserve contributions and expenditures. GFAO best practice suggests reserve policies should include developing a plan to bring reserve balances to the desired amount where minimum targets are not maintained, and provisions to spend excess reserves where maximum targets are exceeded.

We recommended an update to the Reserves and Financial Reserves Policies and a risk-based analysis of current reserves (recommendations 1 and 2), which will provide an opportunity to better manage risk and get the best value from reserve strategies as outlined in GFAO Best Practices. These recommendations can be incorporated into current reviews underway such as the strategic review of the FSR/BSA and the RFC/LMUR reserves, and TRR follow-up recommendations to analyze targets for several reserves (e.g. Planning & Development Sustainment, Snow and Ice Control and 911 Communications Centre Capital Financing).

Reserve Classification

Reserve types are categorized in the Annual Reserve Report as Contingency, Cashflow, Endowment and Legislative/Contractual Requirement reserves, with the majority of reserves classified as Contingency, and Cashflow. The Reserves Policy does not define or provide guidance on determining the type of reserve (recommendation 3). Clearly defining reserve types by distinguishing between Cashflow and Contingency in the Reserves and Financial Reserves Policies, supports consistency when creating and amending reserves and will facilitate the risk-based approach to developing target reserve ranges and strategic decision making related to specific reserve types.

TRR Follow-up

Every active reserve is reviewed at least once every three years through the TRR. The ARC may make a recommendation to follow-up on reserves in a future TRR where Reserve Owners require additional time to assess potential revisions.

The 2022 TRR included a list of reserves to be followed up in subsequent years due to ongoing strategic analysis. We determined the follow up process was designed effectively. However, we could not assess operating effectiveness as there were no follow-ups in 2022 due to the suspension of the TRR in 2020 and 2021.

ARC Oversight

The ARC oversees the TRR and provides a report to the Executive Committee and Council. The report includes a summary of findings, any applicable recommendations, and follow-up of the previous year's review recommendations. The ARC is comprised of the Chief Financial Officer, two Finance Managers, one General Manager and one Business Unit Director.

We confirmed the ARC met eight times in 2022 and meetings were minuted. We reviewed a sample of two meeting minutes to assess if action was taken based on the findings presented at the meeting from the TRR finance group. Based on our review, we determined the ARC was fulfilling its governance role by:

- Approving the reserves to be included in 2023 TRR;
- Discussing and evaluating reserves stated purposes and relevance to ensure alignment with current organizational goals and needs;
- Questioning the appropriateness of reserve target balances, which is crucial for financial health and strategic alignment;
- Recommending closing a reserve that was no longer required in its current form; and

- Bringing forward meeting recommendations to Executive Committee and Council in the TRR Report, including the 2023 TRR reserves and follow-ups.

Guidance on the ARC in the Reserve Policies and the Financial Reserve Procedures was designed effectively. However, we noted the reserves policies did not define term limits for committee members. We shared an opportunity with Finance to consider setting minimum/maximum term limits for General Managers and Directors. When reviewing term limits consideration should be given to terms that allow for both continuity and renewal within the committee.

Observations & Recommendations

#1: Minimum and maximum target balances	
OBSERVATION	RECOMMENDATION
<p>The Reserves Policy and the Financial Reserves Policy do not require minimum and maximum reserve target balances. In Section 1.1, the Reserves Policy indicates the report to request a new reserve should include minimum and maximum target balances for the reserve (if applicable). The Reserves Policy does not state if/when a reserve should have minimum and maximum target balances.</p> <p>The Reserves Policy provides guidance in Subsection 1.3.4 on over and underfunding and developing an action plan when a reserve does not maintain its minimum target balance or exceeds its maximum target balance. However, there is no guidance indicating over and underfunding is based on uncommitted balances.</p> <p>We noted inconsistent reserve practices when it came to establishing reserve minimum and maximum targets. Of the five reserves sampled, only one (FSR/BSA) had a minimum target, which we verified was maintained. None of the reserves sampled had a maximum target. Three reserves had target balances in authorizing documents, which were not described as maximum targets. We noted there was no action plan developed for the Utility Sustainment Reserve or the RFC/LMUR when the target balances were exceeded since the targets were not maximum targets. Inquiry with Reserve Owners indicated they were unclear on expectations to establish reserve minimum and maximum targets.</p> <p>In addition, based on a review of the 2022 Annual Reserve Report (AC2023-0830 ATTACHMENT 1) focused on Cash Flow and Contingency Reserves⁶, there is a mix of practices across the 40 reserves categorized as Operating, Capital, and Sustainment:</p> <ul style="list-style-type: none"> • Two reserves had a minimum and maximum target balance⁷; • One had only a minimum target; • Six had only a maximum target; • Five had a target; and • The remaining 26 had no minimum or maximum target and no target. 	<p>1. The Chief Financial Officer update the Reserves and Financial Reserves Policies and supporting procedures to include:</p> <ul style="list-style-type: none"> • Using a risk-based approach to determine target reserve ranges with minimum and maximum targets where required; • Documenting rationale if a reserve does not require a minimum and maximum target; and • Clarifying calculation of over and underfunding based on uncommitted balances. <p>MANAGEMENT RESPONSE Agreed.</p> <p>ACTION PLAN Reserves are part of the long-term fiscal strategy at The City and are used for a variety of purposes: to accumulate funds over time to replace capital assets, to provide a measure of financial flexibility to react to budget shortfalls and to manage the financial impact of significant unexpected issues in a timely manner. The City has a balanced approach to the planning and use of reserves and has an established policy framework in place for guiding the responsible stewardship of reserves.</p> <p>The Reserves and Financial Reserves Policies will be updated to include details around minimum, maximum and target balance for certain reserves where required, and calculations of over and underfunding based on uncommitted balances as a part of continuous improvement to ensure that policy aligns with best practices.</p>

⁶ Endowment and Legislated reserves are not expected to maintain specific minimum and maximum target balances.

⁷ One of these was a combined Cash Flow and Legislated reserve.

In their paper “Should We Rethink Reserves” the GFOA provides opportunities for local governments to better manage risk and get the best value from reserve strategies. The GFOA recommends developing a comprehensive reserve policy that addresses reserve balances and includes minimum and maximum targets. Setting a minimum target will allow the City to respond effectively to shortfalls and unanticipated events, while establishing a maximum target ensures that excess reserve balances can be used to positively impact service delivery by being transferred to some other purpose. Since the appropriate target range for a reserve can vary depending on specific reserve purposes, conditions, and risks, the GFOA recommends performing a detailed analysis of potential risks and impact on reserves to establish target reserve levels. Where possible, the risk assessment should include quantifying the risks.

The Reserves and Financial Reserves Policies are currently being reviewed and updated and will include these updates.

LEAD

Chief Financial Officer

SUPPORTED BY

Director of Finance/Deputy Chief Financial Officer, Deputy Director Corporate Finance, and Manager, Corporate Financial Reporting.

COMMITMENT DATE

December 31, 2024

2. The Chief Financial Officer conduct a risk-based reserve analysis of current reserves to determine whether a target range with minimum and maximum targets for each reserve is required that aligns to GFOA guidance.

MANAGEMENT RESPONSE

Agreed.

ACTION PLAN

Setting risk-based minimum and maximum target ranges for reserves aligns with the GFOA guidance and allows The City to be agile when responding to dynamic operating and capital needs. The GFOA guidance does not take into consideration all types of reserves, therefore there are some reserves for which a target range would not be applicable such as a legislated reserve, causing challenges to align all reserves with the GFOA guidance.

Administration will analyze the current reserves to determine which reserves are in scope for the recommendation. Operational Leads with support from the Financial Leads will perform an analysis of their business and the associated reserve to determine an appropriate minimum and maximum target range (Phase 1). These proposed changes will be reviewed by the Administrative Review Committee through the Triennial Reserve Review Process with all reserve changes requiring council approval (Phase 2).

	<p>LEAD Chief Financial Officer</p> <p>SUPPORTED BY Director of Finance/Deputy Chief Financial Officer, Deputy Director Corporate Finance, Manager, Corporate Financial Reporting, and all reserve operational and financial leads.</p> <p>COMMITMENT DATES June 30, 2025 (Phase 1), December 31, 2027 (Phase 2).</p>
<p>#2: Defining Reserve Types</p>	
<p>OBSERVATION</p> <p>Reserve types are categorized in the Annual Reserve Report as Contingency, Cashflow, Endowment and Legislative/Contractual Requirement reserves, with the majority of reserves classified as Contingency⁸, and Cashflow⁹. The Reserves Policy does not define or provide guidance on determining the type of reserve.</p> <p>We reviewed the Utility Sustainment Reserve in our sample testing and noted the reserve was categorized as a Cashflow/Contingency reserve. The authorizing documents indicated the purpose was to provide cash flow to fund minor fluctuations in both operating and capital expenditures to mitigate the risk of revenue shortfalls, which is consistent with the definition of a cash flow reserve in the Annual Reserve Report. However, the terms cashflow and contingency were both used to describe minor fluctuations. For example, the purpose was also described as providing a contingency fund to weather minor revenue fluctuations.</p> <p>We noted the authorizing documents for the FSR indicated it was a contingency reserve to handle unexpected events (e.g. natural disaster) or circumstances (e.g. drop investment income) with significant financial impacts. The definition in the Annual Reserve Report does not address the impact of the unexpected event (e.g. significant/minor).</p> <p>Clearly defining reserve types by distinguishing between Cashflow and Contingency in the Reserve Policy supports consistency, which will facilitate the risk-based approach to</p>	<p>RECOMMENDATION</p> <p>3. The Chief Financial Officer update the Reserves and Financial Reserves Policies to define the reserve types.</p> <p>MANAGEMENT RESPONSE Agreed.</p> <p>ACTION PLAN Enhancements to the 2018 Reserves and Long-term Liabilities report were made at the request of the previous Priorities and Finance Committee (now Executive Committee) to provide additional clarity and transparency in the presentation of the report. These enhancements included defined terms which will be reflected in the Reserves and Financial Reserves Policies and supporting procedures.</p> <p>The Reserves and Financial Reserves Policies and the supporting procedures are currently being reviewed and updated and will include updates to definitions.</p> <p>LEAD Chief Financial Officer</p> <p>SUPPORTED BY</p>

⁸ C- Contingency Reserve: A reserve to fund approved actions during an unexpected event. Reserve is not expected to have a budget but will generally have conditions as to adequacy of balances.

⁹ CF- Cashflow Reserve: A reserve to fund planned future actions with the purpose of smoothing cash demands. These reserves will generally have a budget for expenditures.

developing target reserve ranges and strategic decision making related to specific reserve types. For example, developing strategies to centralize contingency reserves into the FSR/BSA reserve, which is the largest contingency reserve with an uncommitted balance exceeding \$1B as of 2022.	Director of Finance/Deputy Chief Financial Officer, Deputy Director Corporate Finance, and Manager, Corporate Financial Reporting. COMMITMENT DATE December 31, 2024
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Acknowledgements

The City Auditor’s Office conducts projects, including this audit, in conformance with the International Standards for the Professional Practice of Internal Auditing.

The City Auditor’s Office would like to thank staff from Finance for their cooperation and support during this audit.