



## STAFF REPORT ACTION REQUIRED

# TA8.2

<b>Date:</b>	April 18, 2016
<b>To:</b>	Board of Directors
<b>From:</b>	Richard Rysak, Director of Finance
<b>Re:</b>	Financial Management Policy - Stabilization Fund

### SUMMARY

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This item addresses the Motion adopted at the Board meeting held on February 11, 2016:

*“That the Chief Executive Officer, Toronto Atmospheric Fund review the stabilization policy, its relationship to the budget process and associated surplus, and report back to TAF Board next meeting on April 28, 2016.”*

An overview of TAF’s budgeting and financial management process is provided below and a policy is proposed to cap the size of the Stabilization Fund.

### RECOMMENDATION

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It is recommended that, starting with financial statements for the year ending December 31, 2015, the Board of Directors approve capping TAF’s Stabilization Fund at 25% maximum of the Net Asset Value (NAV).

### FINANCIAL IMPACT - None

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### COMMENTS

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TAF’s budgeting and financial management process includes attention to various important checks, balances and best practices to ensure the sustainability of the endowment and ability to consistently deliver on TAF’s mandate.

**Budget Approval Process** - TAF submits its operating Budget for approval through the City’s budget process including review and analysis by City staff, review by two members of the City’s budget Committee, submission to the City’s Budget Committee and approval by City Council. The City controls TAF’s core staff count and TAF follows City’s guidelines related to salary increases.

**Payout Ratio** -- TAF follows this best practice in endowment management, recognizing that the endowment fund is TAF’s primary source of revenues. In general, endowments establish a Payout Ratio (where the numerator are the operating expenses and the denominator is the

NAV) to preserve their capital by constraining expenses for operations and grants. In 2006, TAF's Board established the Total Payout Ratio as 5 to 6 percent of the NAV based on a 4-year rolling average; TAF uses a cumulative rolling average to calculate the annual payout ratio.

**Conservative Budgeting** – Generally TAF underestimates investment revenues, has ambitious fundraising targets and overestimates expenses including contingent expenses. For instance, the past four annual budgets contemplated operating deficits which were to be bridged by drawing on the Stabilization Fund, but instead TAF's publicly-traded securities achieved substantial revenue surpluses on realized and unrealized basis.

**Administrative Cost Control** - In keeping with non-profits' best practices, TAF follows a budgeting practice whereby its administrative costs (Communications, Governance, Development and Administration) do not exceed 20% of the budgeted revenues.

**Stabilization Fund as a Buffer**- TAF also uses this endowment management practice which is designed to reduce variability in annual program spending due to fluctuating values of its publicly traded securities. TAF focuses on its Stabilization Fund in conjunction with TAF's annual audit and budgeting processes. Basically, operating "surpluses" from strong financial years are put aside to be used in 'lean' years, thus enabling endowments such as TAF to maintain their core level of program spending on a year-to-year basis.

The Stabilization Fund, first established by the TAF Board in 2003, is a notional accounting reserve (ie: no dedicated cash is held in a separate bank account) and it forms part of TAF's Net Asset Value (NAV).

In practice, the amount "contributed" annually to the Stabilization Fund is the investment income from publicly-traded securities which exceeds the budgeted revenue for that year. Conversely, the shortfall between budgeted and actual revenues from publicly-traded securities is withdrawn from the Stabilization Fund to cover that year's revenue gap.

The table below provides an overview of TAF's Stabilization Fund for the past 4 years.

\$ in 000's	<u>2012</u>	<u>2013</u>	<u>2014</u>		<u>2015-a</u> Per established policy	<u>2015-b</u> If new policy caps at 25%
A–Budgeted Rate of Return for the year	6.6%	5.6%	5.8%		5.8%	5.8%
B–Actual Rate of Return for Public Securities (Balanced portfolio of equities and fixed income holdings - per Proteus Performance report)	8.5%	18.3%	13.4%		18.9%	18.9%
C–Stabilization Fund contribution	\$550	\$3,677	\$1,918		\$2,841	\$54
D–Stabilization Fund Balance – end of Yr	\$1,555	\$5,232	\$7,149		\$9,990	\$7,203
E–Net Asset Value (NAV) which includes the Stabilization Fund	\$ 21,667	\$ 24,479	\$ 26,092		\$ 28,476	\$28,476
F–Stabilization Fund as % of NAV	7.2%	21.4%	27.4%		35.1%	25.3%

The drawback of a large Stabilization Fund is that it may be perceived as being only available for bridging future revenue shortfalls and not being available for general operations. In fact, our discussion with TAF's Auditor indicates that there are no legal restrictions on the use of the Stabilization Fund and that TAF's Board can decide at anytime to rebalance the two funds which make up TAF's net worth (NAV): the Operating Fund and the Stabilization Fund.

2015 was another banner year for TAF's securities portfolio, driven primarily by its global equities where total earnings (realized and unrealized) were significantly above the budgeted returns. Adhering to the current Stabilization Fund policy, would add another \$2.8 million to the Stabilization Fund, thereby resulting in the Stabilization Fund approaching nearly \$10 million or 35% of TAF's Net Asset Value (NAV) at the end of fiscal 2015. It is proposed that the Stabilization Fund be capped at 25% maximum of the NAV. This will have the effect of freezing further contributions to the Stabilization Fund, which already (as of 2014 year-end) represented approximately 3 years of TAF annual operating budget.

**Contingent External Revenues** -- As outlined in TAF's September 14, 2015 budget submission to the Board, TAF is a project-driven incubator of leading-edge climate solutions with a portfolio of internally funded programs (including grant making) and externally-funded projects. The Stabilization Fund helps TAF to buffer its program expenditures against fluctuations in the financial market performance, including currency rate shifts between CAD\$ and USD\$.

Since much of TAF's budgeted spending is for programs based on presumptive external revenues (ie: fundraising), this process has to be managed on a contingency basis. In general TAF operates on the basis that program expenditures are not incurred unless external funding is secured. This fiscally-prudent approach can have the effect of creating large budget variances due to: (1) "under-spending" in the operating budget if fundraising was less successful and; (2) "over-spending" if fundraising exceeded expectations. Finally, TAF recognizes external funding revenues in the year they are used, rather than when they are awarded, which can also contribute to "budgeted" versus "actual" variances. However this contingency approach to external revenue management is fundamentally prudent.

**Contingent Grant Spending** – Since grants depend on cultivating quality applicants who can meet TAF's objectives, this part of TAF's expenditures is always uncertain. In addition, grants can be rescinded by TAF at any time when the original granting conditions have not been met, or cannot be met, or when the recipient no longer needs the grant. Both of these elements related to TAF's granting budget can also create budget variances.

## CONTACT

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