

AGENDA ITEM 702 FEBRUARY 1 2016

DATE: February 1, 2016
TO: Members, Board of Trustees
FROM: Leah Wilson, Chief Operating Officer
Christine Wong, Finance Director
SUBJECT: Adoption of Reserve Policy

BACKGROUND

As part of its commitment to prudent financial practices, on November 14, 2013, the State Bar established a reserve policy regarding the use of unanticipated resources in the General Fund (145_NOV). This policy specified that an amount equal to two weeks', or 3.8 percent, of annual operating expenditures should be retained in the General Fund as a reserve. Amounts above this level are allocated two-thirds to the Building Fund to facilitate maintenance and capital improvement projects and one-third to the Technology Improvement Fund to facilitate technology projects. Staff followed this reserve policy and made appropriate allocations for 2013 and 2014 year-end close.

Although the 2013 reserve policy established a modest minimum fund balance requirement, the State Bar's actual reserves significantly exceed the 3.8 percent level. Current fund balances are provided as Attachment A.

Both the 2013 reserve policy, and fund balance levels, were at issue in the State Auditor's June 2015 report, with an observation that the current two week reserve level is too low:

*"Other than a policy its board adopted in November 2013 that instituted a general fund policy of two weeks' operating expenditures, which we believe is too low given the uncertainty of its membership fee revenue each year, the State Bar does not have policies or procedures that justify or govern its total fund balances...the Government Finance Officers Association (GFOA)...cited a general best practice related to fund balances that could benefit the State Bar. Specifically the GFOA noted that an appropriate fund balance in an entity's general fund should be no less than two months of operating revenues or expenditures."*¹ (page 56)

In addition to identifying problems with the 2013 policy, the State Audit observed that the Bar's fund balances were high, resulting in two reserve-oriented recommendations as follows:

¹ California State Auditor Report 2015-030, *State Bar of California, It Has Not Consistently Protected the Public Through its Attorney Discipline Process and Lacks Accountability*

To ensure that the State Bar's fund balances do not exceed reasonable thresholds, the Legislature should consider putting a restriction in place to limit its fund balances. For example, the Legislature could limit the State Bar's fund balances to the equivalent of two months of the State Bar's average annual expenditures. (page 59)

"...the first biennial spending plan should also include an analysis of the State Bar's plans to spend its current fund balances". (page 60)

In accordance with its fiscal oversight and management charge and in light of the State Auditor's report, the Planning and Budget Committee initiated an assessment of the State Bar's existing fund structure, reserve policy and use of fund accounting; for this effort the Bar engaged the services of Mr. William Statler, an independent consultant with expertise in governmental and municipal accounting.

The independent fund accounting review was completed in August 2015. On September 29, the Board adopted a new fund structure to consolidate the Bar's funds into one General Fund and reclassify the remaining funds into two Program Fund Groups – Restricted and Special Revenue.

Since that time, staff has worked with Mr. Statler and external auditor Moss Adams to complete a detailed analysis of State Bar reserves, reserve-related methodological issues under Generally Accepted Accounting Principles (GAAP), and key principles for effective reserve policies.

RECOMMENDATION

Staff recommends that the Board adopt a two-month reserve policy as outlined in Attachment B and summarized below:

Minimum Target Reserve Level

The State Bar will maintain unrestricted, uncommitted reserves in its General Fund, and each fund within its Restricted and Special Revenue Program Funds, net of reserves that are non-spendable, restricted and committed, that equate to 2 months of recurring annual operating expenses for the respective funds; this translates to a minimum reserve level of 17 percent.

Use of Minimum Target Level Reserves

Reserves may be reduced below minimum target levels under certain circumstances including one-time uses in meeting cash flow needs; closing a projected short term revenue-expenditure gap; responding to unexpected expenditure requirements or revenue shortfalls; and making investments in human resources, technology, liability reductions, revenue base improvements, productivity improvements and other strategies that will strengthen State Bar revenues or reduce future costs.

Any expenditure that would cause the reserve level of either the General Fund, or any fund within the Restricted or Special Revenue Program Funds, to fall below 10 percent must be approved by the Board of Trustees.

Spend-Down of Excess Reserves

Whenever reserve levels surpass 30 percent in either the General Fund, or any fund within the Restricted or Special Revenue Program Funds, for a consecutive six month period, they are considered to be materially above the target minimum level and subject to spend-down, with the exception of Sections Funds.

Spend-down shall occur in accordance with the following principles:

1. Fund balance spend-down should be utilized to offset member dues and other assessments and use charges, where possible.
2. Fund balance spend-down should be used to advance strategic efficiency investments that will result in short- or long-term reductions in operating costs.
3. Fund balance spend-down should be used to bolster the Client Security Fund, where possible.

All spend-down in excess of \$250,000 must be approved by the Board of Trustees.

Restoring Reserve Balances Below Minimum Target Level

Whenever reserve levels in the General Fund, or any fund within the Restricted or Special Revenue Program Funds, fall below the target minimum level of 17 percent, the State Bar will strive to restore reserves to this level within five years. As revenues versus expenditures improve, the State Bar will allocate at least half to reserve restoration, with the balance available to fund outstanding liabilities, asset replacements, service levels restoration, new operating programs or capital improvement projects.

Application of the reserve policy on General, Restricted, and Special Revenue funds is reflected in Attachment A.

As depicted in Attachment A, the General Fund has a fund balance of less than five percent, due to the impact of the implementation of Governmental Accounting Standard Board Statement (GASB) 68, which requires the Bar to recognize a General Fund pension liability of approximately \$14.5 million.² Each fund within the Restricted and Special Revenue Program Funds have balances at or above the minimum target level, other than the Admissions and Annual Meeting Funds, which have 7.58 and 0 percent fund balances respectively. The Board will be asked to discuss options for restoring the General, Admissions, and Annual Meeting Fund reserve balances, and spending down remaining Restricted and Special Revenue Program Fund balances, other than Section Funds, at its February 1, 2016, meeting, with Board action anticipated in March.

The Reserve Policy will be reviewed by the Planning and Budget Committee and/or the Board of Trustees at least every other year beginning in 2016, and will be updated to ensure that it

² The estimated total State Bar unfunded pension liability of \$19 million (as opposed to the General Fund liability of approximately \$14.5 million) is based on the CalPERS 2014 valuation report; figures will be revised when the 2015 report is issued later this month.

remains current with GAAP. Any material changes to the Reserve Policy will require approval from the Board of Trustees.

FISCAL / PERSONNEL IMPACT:

There are no personnel impacts associated with Reserve Policy adoption. Fiscal impacts include the need to develop strategies to restore the General Fund reserve balance, and spend down the Restricted and Special Revenue Program Fund balances; these impacts will be fully articulated once the Board takes action with respect to restoration and spend-down at its March meeting.

RULE AMENDMENTS:

None

BOARD BOOK IMPACT:

Revision to Tab 17, Article 1 of the Bar's Board Book

PROPOSED BOARD OF TRUSTEES RESOLUTION:

Should the Board concur with staff's recommendation, the following resolutions would be in order:

RESOLVED, that upon the recommendation of the staff, the Board hereby adopts the reserve policy as set forth in Attachment B.