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"CPAs for NGOs" social responsibility programme

Lump Sum Grant, Reserve Fund and Financial Projection



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

OUTLINE

1. What are Lump Sum Grant and Reserve Fund?
2. Lump Sum Grant, Reserve Fund and Financial Management
3. Process of Financial Projection

PART 1

What are Lump Sum Grant and Reserve Fund?

What is Lump Sum Grant?

- LSG is a social welfare subvention system through which the Government provides subvention to agencies for providing social welfare services.
- Under the LSG system, the Government provides subvention to agencies in the form of an agency-based lump sum grant; and agencies may freely deploy the grant as long as the required objectives, outputs, results and standards of social welfare services provided are met.
- In other words, this subvention model focuses on output control.
- The policy intends to encourage:
 - ✓ Effective use of public resources
 - ✓ Innovation
 - ✓ Responsiveness
 - ✓ Performance management



What is Lump Sum Grant?

- This social welfare subvention model requires agency heads to perform as a social entrepreneur:
 - ✓ Market-driven management style
 - ✓ Proactive human resources management (e.g. staffing and pay structure, manpower deployment, and etc.)
 - ✓ Active financial management practice
 - ✓ Proactive fund-raising effort
 - ✓ Service re-engineering and innovation
 - ✓ Corporate governance and transparency

- Among the above elements of social entrepreneurialism, agency heads are required to be financially-minded:
 - ✓ Financial projection
 - ✓ Cost control
 - ✓ Investment decision-making



What is Reserve Fund?

- NGOs under LSG subvention system maintain two types of reserve:
 - ✓ Lump Sum Grant Reserve
 - ✓ Provident Fund Reserve

- *“Generally speaking, the Lump Sum Grant reserves of NGOs are generated from staff turnover, service streamlining and re-engineering, organizational restructuring, and successful bidding of new services, etc.”*
 - Secretary for Labour and Welfare in a written reply to Hon Cheung Kwok-che on 10 June 2009



What is Reserve Fund?

Lump Sum Grant Reserve

- LSG Reserve is generated from underspending of LSG provided by the Government against actual spending in providing subvented services (including personal emolument and other charges).

Provident Fund Reserve

- PFR is generated from the excess of the provident fund subvention provided by the Government (calculated at 6.8% of the mid-point salary of the recognized staff rank) over the actual provident fund expense for non-snapshot staff.

The Regulatory Framework for Reserve Fund

General principles

- ✓ “The reserves can be used at the discretion of NGOs subject to the following:-
 - (a) PF reserves can only be used for PF commitments in the future;
 - (b) the Reserve Fund must be used on FSA activities and the related support services; and
 - (c) the NGO will absorb all financial consequences arising from the use of the reserves.”

(para. 2.39 of LSG Manual)

The Regulatory Framework for Reserve Fund

General principles

- ✓ “When a NGO considers using its reserves, it must:-
 - (a) ensure that it will not encounter financial difficulties;
 - (b) if the NGO subsequently encounters financial difficulties, resolve the problem(s) on its own without any financial assistance from the Government;
 - (c) ensure that the problem(s) and resolution(s) do not have adverse effects on the NGO achieving the requirements of FSAs and the interests of its service users; and
 - (d) take into account their snapshot staff commitments, as well as the need for service enhancement and staff development.”

(para. 2.40 of LSG Manual)



The Regulatory Framework for Reserve Fund

General principles:

- ✓ “NGOs may use LSG or LSG Reserve for marginal capital items where justified either on resource or timing grounds. Also, in the course of delivering or improving their services, NGOs may come across situations in which procurement of capital items may be essential both in terms of expediency and operational needs. ”

(para. 2.37 of LSG Manual)

- ✓ “NGOs should therefore put in place a proper mechanism for deployment of LSG Reserve and any decisions relating to the deployment of LSG Reserve to meet special or major expenditure items, such decisions should be thoroughly discussed in the NGO Board/Management Committee, well justified and documented.”

(para. 2.38 of LSG Manual)

The Regulatory Framework for Reserve Fund

General principles:

- ✓ NGOs Board/Management Committee should consider measures to optimally use the PF surplus from the 6.8% posts on staff who are not protected under the snapshot arrangement.

(para. 2.25 of LSG Manual)

- ✓ NGOs should fully deploy the PF provisions and reserves for non-snapshot staff on PF contributions, including possibly special contributions to award non-Snapshot Staff for their good performance.

(para. 2.26 of LSG Manual)

PART 2

Lump Sum Grant, Reserve Fund and Financial Management

Agency Heads and Financial Management

- LSG system poses intertwining challenges to agency heads:
 - ✓ Sufficient resources are deployed to maintain service standard and quality.
 - ✓ Service provision can meet the changing need of the society.
 - ✓ Agency's financial sustainability.
- In light of the above challenges, agency heads are required to be both service-oriented and financially-minded in operating their agencies and planning for its medium- and long-term development.



Agency Heads and Financial Management

Financial Management Tools for Agency Heads

- Reserve Fund is indeed a financial management tool embedded in the LSG system because the excess fund accumulated over the years can help agencies to stand against financial difficulty.
- Another important financial management tool is financial projection **as** it can help agencies to forecast:
 - ✓ Agency's financial sustainability
 - ✓ Agency's financial vulnerability
 - ✓ Room for service expansion and innovation
 - ✓ Need for service re-engineering and contraction

Financial Projection from an Agency Head's Perspective

PART 3

Process of Financial Projection

Process of Financial Projection

Step 1: Preliminaries

Step 1a: Define the objectives

Step 1b: Collect data and information

Step 1c: Communicate with internal parties

Step 2: Expense Projection

Step 2a: Personal Emolument

Step 2b: Provident Fund

Step 2c: Other Charges



Process of Financial Projection

Step 3: Income Projection

Step 3a: Lump Sum Grant

Step 3b: Other income

Step 4: Consolidation

Step 4a: Prepare financial projection statement

Step 4b: Prepare reserve fund movement statement

Step 5: Making Managerial Decision

Step 5a: Determine necessary managerial actions

Step 5b: Assess the possible outcomes



Step 1a: Define the Objectives

- Financial projection is not ceremonial.
- The objectives of financial projection vary from agency to agency:
 - ✓ Exercising management stewardship
 - ✓ Determining the need for utilizing reserve funds
 - ✓ Determining the sustainability of reserve funds utilization
 - ✓ Determining fundraising requirements
 - ✓ Monitoring the use of financial resources
 - ✓ Planning for efficient use of financial resources
 - ✓ Planning for service enhancement, expansion or contraction
 - ✓ Fulfilling legal and regulatory requirements
- The objectives should be well-documented because:
 - ✓ Agencies are accountable to a wide audience.
 - ✓ Agencies are expected to be transparent.
 - ✓ Agencies are expected to use resources effectively and efficiently.



Step 1b: Collect Data and Information

- The next step is to determine what data and information are required.
- In the context of LSG, the following data is relevant:
 - ✓ Income
 - LSG: Disbursement records in the past three years
 - Investment Income: Investment document
 - ✓ Expense
 - Personal Emolument: Payroll and prevailing human resources policy
 - Provident Fund: Payroll and prevailing human resources policy
 - Other Charges
 - ✓ Other information
 - Annual financial report submitted to SWD for the immediate past year
 - Relevant correspondence with SWD
 - Master pay scale
 - Composite Consumer Price Index
 - News articles and other relevant information (e.g. expected civil servant pay adjustment)



Step 1b: Collect Data and Information

- The data and information utilized should be well-documented because:
 - ✓ Well-documented financial projection can shed light on future financial projection exercise.
 - ✓ Financial projection may be updated during interim period when needs arise.
 - ✓ Well-documented data and information can help the financial projection stand against enquiry and challenge.
 - ✓ Staff responsible for financial projection may be on leave or may have resigned.

- If more than one source of data and information is available, judgment needs to be made in choosing one on the following bases:
 - ✓ Reliability
 - ✓ Timeliness
 - ✓ Reasonableness

- Reasons for your choice should be documented and the non-chosen data should be kept on file for reference.

Step 1c: Communicate with Internal Parties

- Financial projection is not only the task of accounting team
- Instead, it is a top-level managerial activity which should be:
 - ✓ Led by top management
 - ✓ Participated by service heads and administration head
 - ✓ Executed by accounting department
- Because financial projection is a process involving:
 - ✓ Provision of up-to-date data and information from service sections
 - ✓ Assessment of the financial viability of service innovation
 - ✓ Determination of resource allocation
 - ✓ Identification of opportunity for service enhancement or expansion
 - ✓ Determination of resource re-allocation or service contraction
- It also provides a platform for internal communication

Step 2a & 2b: Personal Emoluments and Provident Fund

- Projections for personal emolument and provident fund should be rather straightforward.

- Data and information needed:
 - ✓ Staff strength (number of staff) as at the latest financial year-end date (e.g. 31 March 2014)
 - ✓ Salary level of each staff and planned pay rise/reduction
 - ✓ Planned number of new recruit and budgeted salary level
 - ✓ Planned number of staff under non-renewable contract
 - ✓ Planned number of retired staff
 - ✓ Estimated staff turnover
 - ✓ Contribution level of staff provident fund scheme



Step 2a & 2b: Personal Emoluments and Provident Fund

| Name | Rank | MPS | PF contribution ratio | Annual Salary | Annual PF contribution | Snapshot Staff |
|------|------|-----|-----------------------|---------------|------------------------|----------------|
| A | SSWO | 44 | 15% | \$1,037,280 | \$155,592 | ✓ |
| B | SWO | 39 | 15% | \$845,880 | \$126,882 | ✓ |
| C | SWO | 37 | 5% | \$772,920 | \$18,000 | ✗ |
| D | ASWO | 27 | 5% | \$517,440 | \$18,000 | ✗ |
| E | SWA | 22 | 15% | \$411,780 | \$61,767 | ✓ |
| F | EOII | 22 | 5% | \$411,780 | \$18,000 | ✗ |
| G | AOII | 22 | 5% | \$411,780 | \$18,000 | ✗ |
| H | CA | 10 | 10% | \$222,420 | \$22,242 | ✓ |

Total **\$4,631,280** **\$438,483**

PF (Snapshot Staff) \$366,483

PF (6.8% Post) \$72,000



Step 2c: Other Charges

- Other charges include:
 - ✓ Utilities
 - ✓ Food
 - ✓ Cleaning charges
 - ✓ Postage
 - ✓ Telephone
 - ✓ Advertisement
 - ✓ Bank charges
 - ✓ Audit fee
 - ✓ Repair and maintenance
 - ✓ Printing and stationery
 - ✓ Program expenses
 - ✓ Transportation and travelling
 - ✓ Insurance
 - ⋮
 - ⋮



Step 2c: Other Charges

- "Other charge" items can be projected by using the following formula:

| | | | | | | |
|-----------------------|---|-----------|---|----------------------------|---|-------------------|
| Controlling Factor | X | Unit Rate | X | Price Adjustment Factor | = | Projected Expense |
|-----------------------|---|-----------|---|----------------------------|---|-------------------|

Example:

| | | | | | | |
|-------------------------|---|------------------|---|-----------------------------|---|----------------------------------|
| No. of Advertisement | X | Rate per Adv. | X | Estimated Inflation Rate | = | Projected Advertising Expense |
|-------------------------|---|------------------|---|-----------------------------|---|----------------------------------|

| | | | | | | |
|------------------------------|---|----------|---|----------|---|-----------|
| 4 Full-Page Advertisement | X | \$40,000 | X | (1 + 4%) | = | \$166,400 |
|------------------------------|---|----------|---|----------|---|-----------|



| Year | Month | Composite Consumer Price Index | | Consumer Price Index (A) | | Consumer Price Index (B) | | Consumer Price Index (C) | |
|------|-------|--------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|-----------------------|--------------------------|-----------------------|
| | | Index | Year-on-year % change | Index | Year-on-year % change | Index | Year-on-year % change | Index | Year-on-year % change |
| 2011 | | 108.0 | +5.3 | 106.4 | +5.6 | 105.8 | +5.2 | 105.8 | +5.1 |
| 2012 | | 110.3 | +4.1 | 110.3 | +3.6 | 110.4 | +4.3 | 110.1 | +4.1 |
| 2013 | | 115.1 | +4.3 | 115.9 | +5.1 | 114.9 | +4.1 | 114.3 | +3.8 |
| 2013 | May | 115.0 | +3.9 | 116.7 | +4.4 | 114.5 | +3.7 | 113.7 | +3.6 |
| | Jun | 115.2 | +4.1 | 116.9 | +4.6 | 114.7 | +3.9 | 113.8 | +3.7 |
| | Jul | 115.8 | +6.9 | 117.4 | +12.0 | 115.4 | +5.0 | 114.5 | +4.0 |
| | Aug | 113.2 | +4.5 | 109.9 | +4.9 | 114.6 | +4.4 | 114.9 | +4.3 |
| | Sep | 113.7 | +4.6 | 110.7 | +5.1 | 115.1 | +4.5 | 115.1 | +4.2 |
| | Oct | 118.8 | +4.3 | 118.5 | +4.5 | 116.4 | +4.4 | 115.6 | +4.1 |
| | Nov | 117.1 | +4.3 | 118.7 | +4.4 | 116.7 | +4.4 | 115.9 | +4.2 |
| | Dec | 117.7 | +4.3 | 119.2 | +4.3 | 117.3 | +4.4 | 116.4 | +4.1 |
| 2014 | Jan | 118.3 | +4.6 | 119.9 | +4.5 | 118.0 | +4.8 | 116.9 | +4.5 |
| | Feb | 118.8 | +3.9 | 120.8 | +4.2 | 118.4 | +4.0 | 117.1 | +3.5 |
| | Mar | 118.5 | +3.9 | 120.6 | +4.3 | 118.1 | +3.9 | 116.8 | +3.5 |
| | Apr | 119.3 | +3.7 | 121.3 | +3.9 | 118.9 | +3.8 | 117.8 | +3.5 |
| | May | 119.2 | +3.7 | 121.2 | +3.9 | 118.8 | +3.7 | 117.7 | +3.5 |
| | Jun | 119.3 | +3.6 | 121.2 | +3.7 | 118.9 | +3.6 | 117.8 | +3.5 |
| | Jul | 120.5 | +4.0 | 122.8 | +4.6 | 119.9 | +4.0 | 118.6 | +3.5 |

Step 2c: Other Charges

- We need to identify controlling factors affecting each of these other charge items.
 - Utilities: operation level and area of premises
 - Cleaning charges: area of premises
 - Postage: operation level
 - Phone and telecommunication: operation level and headcount
 - Advertisement: number and type of advertisement
 - Audit fee: audit scope and operation scale
 - Repair and maintenance: regular and one-off repair and maintenance
 - Printing and stationery: operation level and staff number
 - Transportation and travelling: operation level
 - Insurance: standard and non-routine insurance policy



Step 3a: Lump Sum Grant

| | |
|---------------------|---|
| Personal Emoluments | Civil Service Pay Adjustment |
| OC | Government-wide Price Adjustment Factor (namely the Composite Consumer Price Index) |
| Fee Income | As Advised by Social Welfare Department (SWD) |

Source: para. 2.12 of LSG Manual

Step 3a: Lump Sum Grant

Government bureaus must cut growth in spending by 1pc for two years

Two-year scheme beginning in 2016 will save HK\$6 billion and avert fiscal crisis, advisers say

"For departments and bureaus that are spending mostly on manpower and giving out subsidises to others, like education and social welfare departments, there will be room for further discussion on how they can attain the financial target," one source said.

Source: South China Morning Post, 2 August 2014



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Step 3a: Lump Sum Grant

| Fiscal Year | Lump Sum Grant | Increment |
|------------------|----------------|---|
| 2013/14 (actual) | \$11,538,461 | Base year |
| 2014/15 | \$12,000,000 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +4% |
| 2015/16 | \$12,480,000 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +4% |
| 2016/17 | \$12,854,400 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +4% Across-the-board saving: -1% |
| 2017/18 | \$13,240,032 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +4% Across-the-board saving: -1% |
| 2018/19 | \$13,769,633 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +4% |



Step 3a: Lump Sum Grant

| Fiscal Year | Lump Sum Grant | Estimated PE/OC spits | Increment |
|---------------------|----------------|-------------------------|---|
| 2013/14 (actual) | \$11,538,461 | PE portion: \$8,076,922 | Base year |
| | | OC portion: \$3,461,539 | |
| 2014/15 | \$12,035,000 | PE portion: \$8,400,000 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +5% |
| | | OC portion: \$3,635,000 | |
| 2015/16 | \$12,553,000 | PE portion: \$8,736,000 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +5% |
| | | OC portion: \$3,817,000 | |
| 2016/17 | \$12,963,000 | PE portion: \$8,995,000 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +5% Across-the-board saving: -1% |
| | | OC portion: \$3,968,000 | |
| 2017/18 | \$13,386,000 | PE portion: \$9,261,000 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +5% Across-the-board saving: -1% |
| | | OC portion: \$4,125,000 | |
| 2018/19 | \$13,962,000 | PE portion: \$9,631,000 | Civil Servant Pay Adjustment: +4% Composite Consume Price Index: +5% |
| | | OC portion: \$4,331,000 | |

Step 3b: Other Income

- Bank interest income and investment income can be projected by the following formula:

| | | | | |
|--------------------------------|---|--|---|-----------------------------------|
| Average Annual Bank Balance | x | Projected Prevailing Interest Rate | = | Projected Bank Interest Income |
|--------------------------------|---|--|---|-----------------------------------|

| | | | | |
|--------------------------------|---|-----------------------------------|---|--------------------------------|
| Average Annual Invested Sum | x | Estimated Investment Return | = | Projected Investment Income |
|--------------------------------|---|-----------------------------------|---|--------------------------------|

Step 4a: Prepare Financial Projection Statement

| | <u>2014/15</u> | <u>2015/16</u> | <u>2016/17</u> | <u>2017/18</u> | <u>2018/19</u> |
|---------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| <u>INCOME</u> | | | | | |
| Lump Sum Grant | \$12,000,000 | \$12,480,000 | \$12,854,400 | \$13,240,032 | \$13,769,633 |
| Other income | \$10,000 | \$10,000 | \$10,000 | \$10,000 | \$10,000 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| | \$12,010,000 | \$12,490,000 | \$12,864,400 | \$13,250,032 | \$13,779,633 |
| <u>EXPENDITURE</u> | | | | | |
| Personal Emolument | (\$11,200,000) | (\$11,704,000) | (\$12,289,200) | (\$12,780,768) | (\$13,164,191) |
| Other Charges | (\$2,800,000) | (\$2,940,000) | (\$3,087,000) | (\$3,241,350) | (\$3,403,400) |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Surplus / (Deficit) | (\$1,990,000) | (\$2,154,000) | (\$2,511,800) | (\$2,772,086) | (\$2,787,958) |



Step 4b: Prepare Reserve Fund Movement Statement

| | <u>2014/15</u> | <u>2015/16</u> | <u>2016/17</u> | <u>2017/18</u> | <u>2018/19</u> |
|----------------------------|----------------|----------------|----------------|----------------|----------------|
| Surplus / (Deficit) | (\$1,990,000) | (\$2,154,000) | (\$2,511,800) | (\$2,772,086) | (\$2,787,958) |
| <u>Reserve Utilization</u> | | | | | |
| LSG Reserve b/f. | \$5,500,000 | \$3,510,000 | \$1,356,000 | (\$1,155,800) | (\$3,927,886) |
| LSG Reserve c/f | \$3,510,000 | \$1,356,000 | (\$1,155,800) | (\$3,927,886) | (\$6,715,844) |



Step 4b: Prepare Reserve Fund Movement Statement

| | <u>2014/15</u> | <u>2015/16</u> | <u>2016/17</u> | <u>2017/18</u> | <u>2018/19</u> |
|---|----------------|----------------|----------------|----------------|----------------|
| Subvention Received | \$235,000 | \$244,400 | \$254,176 | \$264,343 | \$274,920 |
| Provident Fund Contribution Paid during the year | \$172,800 | \$185,000 | \$189,000 | \$195,000 | \$230,000 |
| Surplus/(Deficit) for the Year | \$62,200 | \$59,400 | \$65,176 | \$69,343 | \$44,920 |
| Add: Surplus/(Deficit) b/f. | \$500,000 | \$562,200 | \$621,600 | \$686,776 | \$756,119 |
| Surplus/(Deficit) c/f. | \$562,200 | \$621,600 | \$686,776 | \$756,119 | \$801,039 |



Step 5a: Determine Necessary Managerial Actions

- ✓ Based on the financial projection, the agency shall experience operating deficit from fiscal year 2014/15.
- ✓ Worse still, the trend shall not improve in the next 5 years which affect the agency's financial sustainability.
- ✓ The agency needs to utilize its LSG reserve from fiscal year 2014/15 to supplement the operating deficit.
- ✓ However, the LSG reserve shall dry up in fiscal year 2016/17.
- ✓ The management has an urgent need to devise measures to reverse this trend.

Step 5b: Assess the Possible Outcomes

| | <u>2014/15</u> | <u>2015/16</u> | <u>2016/17</u> | <u>2017/18</u> | <u>2018/19</u> |
|---------------------------|----------------|----------------|----------------|----------------|----------------|
| <u>INCOME</u> | | | | | |
| Lump Sum Grant | \$12,000,000 | \$12,480,000 | \$12,854,400 | \$13,240,032 | \$13,769,633 |
| Other income | \$10,000 | \$10,000 | \$10,000 | \$10,000 | \$10,000 |
| | \$12,010,000 | \$12,490,000 | \$12,864,400 | \$13,250,032 | \$13,779,633 |
| <u>EXPENDITURE</u> | | | | | |
| Personal Emolument | (\$10,000,000) | (\$10,200,000) | (\$10,404,000) | (\$10,612,080) | (\$10,824,321) |
| Other Charges | (\$2,000,000) | (\$2,100,000) | (\$2,205,000) | (\$2,315,250) | (\$2,431,012) |
| Surplus / (Deficit) | \$10,000 | \$190,000 | \$255,400 | \$322,702 | \$524,300 |

De-linking agency's pay scale and pay adjustment with that of civil servants

Outsourcing of services previously provided by full-time staff



Step 5b: Assess the Possible Outcomes

| | <u>2014/15</u> | <u>2015/16</u> | <u>2016/17</u> | <u>2017/18</u> | <u>2018/19</u> |
|----------------------------|----------------|----------------|----------------|----------------|----------------|
| Surplus / (Deficit) | \$10,000 | \$190,000 | \$255,400 | \$322,702 | \$524,300 |
| <u>Reserve Utilization</u> | | | | | |
| LSG Reserve b/f. | \$5,500,000 | \$5,510,000 | \$5,700,000 | \$5,955,400 | \$6,278,102 |
| LSG Reserve c/f | \$5,510,000 | \$5,700,000 | \$5,955,400 | \$6,278,102 | \$6,802,402 |



Final Step

- ✓ As mentioned at the outset, financial projection is not ceremonial. Instead, it serves a set of pre-determined, documented purposes:
 - Exercising management stewardship
 - Determining fundraising requirements
 - Monitoring the use of financial resources
 - Planning for efficient use of financial resources
 - Planning for service enhancement, expansion or contraction
 - Fulfilling legal and regulatory requirements

Final Step

- ✓ After completion by the accounting department, the financial projection needs to be discussed among top management, service heads, administer and accountant-in-charge; and the following matters need to be documented:
 - Decisions (with reasons and opposite views) made based on the financial projection
 - Matters to be drawn to the attention of management board or other governance bodies
- ✓ The financial projection together with all supporting documents should be well-documented.
- ✓ Before performance of the next round of financial projection, the existing financial projection may be revised if needs arise.

Thank You