

**Verona Borough  
Cash Flow Analysis and Budgetary Considerations**



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March 28, 2021**

## **The Project:**

Verona Borough seeks to establish a better understanding of its cash and budgetary position in light of its December 31, 2020 General Fund interfund liability to the Sewer Fund of approximately \$639,000.

## **Report:**

### **1. For several years the Borough General Fund has been carrying an increasing liability to the Sewer Fund.**

- a. Some background on the importance of funds:
  - i. Funds are the most critical feature of governmental accounting. Defined basically as separate self-balancing sets of accounts, funds are established by governments to facilitate simple bookkeeping and financial reporting.<sup>1</sup>
  - ii. Funds exist due to legal restrictions and obligations, and some exist for policy reasons in order to secure assets for specific purposes. Funds are categorized into types, and this report focuses on Governmental Fund Types which are comprised of the General Fund and the Special Revenue Funds.
  - iii. Governments should have as few a funds as possible but as many as necessary. Verona does not have excessive governmental funds. It has:
    1. the General Fund, which is the chief operating fund.
    2. Special Revenue Funds consisting of:
      - a. Liquid Fuels - a legally required fund for local governments to receive state liquid fuels taxes.
      - b. Sewer Fund - a fund established to report on operations of the sanitary sewer operation, including revenues from sewer fees and expenditures related to the operation of the sewer system, including treatment bills paid to ALCOSAN and line maintenance.
      - c. Police Seizure Fund
  - iv. It is important to note that a fund is not the same as a bank account. A fund may have multiple bank accounts (it will have at least one). In Verona, the General Fund has the following bank accounts (as of 12-31-2019, the date of the last completed audit at the time of this report):
    1. General Fund
    2. Parks and Rec

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<sup>1</sup> The Borough prepares its financial statements on a basis other than GAAP (generally accepted accounting principles); annual statements are prepared in accordance with the financial reporting provisions prescribed or permitted by Pennsylvania Department of Community and Economic Development (DCED). DCED recognizes fund segregations.

### 3. Recycling

## 2. Interfund Liability - As of December 31, 2019 the Interfund Liability between the General Fund and Sewer Fund was as follows:

	GOVERNMENTAL FUND TYPES				TOTAL GOV FUND TYPES
	General Fund	Special Revenue Funds			
	General Fund	Sewer	Total Other Spec Rev	Total all Spec Rev	
	12-31-2019	12-31-2019			
Assets					
Cash	329,787	100	212,868	212,968	542,755
Due from GF		661,279	10,928	672,207	672,207
TOTAL ASSETS	329,787	661,379	223,796	885,175	1,214,962
Liabilities					
Payrol taxes w/held	1,378				1,378
Due to Sewer	661,279				661,279
Due to Police Seizure	10,928				10,928
TOTAL LIABILITIES	673,585	0	0	0	673,585
FUND BALANCE	(343,798)	661,379	223,796	885,175	541,377
2019 Revenues	1,564,863	684,764	81,546	766,310	2,331,173
2019 Expenditures	1,763,847	570,897	0	570,897	2,334,744
	(198,984)	113,867	81,546	195,413	(3,571)
01-01-2019 FB	(144,814)	547,512	142,250	689,762	544,948
12-31-2019 FB	(343,798)	661,379	223,796	885,175	541,377

a. What this table shows:

- i. The December 31, 2019 General Fund liability to to the Sewer Fund is \$661,279
- ii. The December 31, 2019 General Fund fund balance as a result of this is \$(343,798).

b. As of March 28, 2021, the update to this information for 2020 per the published 2020 audit is not available.

- i. It has been reported verbally by the auditor that the estimated December 31, 2020 General Fund liability to the Sewer Fund is \$639,000.
  - ii. The year end 2020 General Fund fund balance is still being determined as part of the audit and preparation of the annual financial report (DCED Report). It will remain a significant deficit in the range of \$300,000 to \$400,000.
- c. Nature of the Interfund Liability - The interfund liability resulted from several factors:
- i. The Borough did not maintain fund segregation in its internal accounting system and only reported fund segregations as part of the annual financial statement.
  - ii. The Borough did not monitor the annual report for interfund liabilities.
  - iii. The Borough did not maintain separate bank accounts for the Sewer and General Funds.
  - iv. The Borough did not produce interim balance sheets or perform the appropriate "due to" and "due from" entries to properly record short term general fund borrowing from the sewer fund.
  - v. Because sewer fees were deposited into the General Fund checking account, as well as sewage treatment fees paid from it, the Borough was unable to see when the Sewer Fund covered the General Fund shortfalls with surpluses from the sewer operation.
  - vi. A historical trend for the Sewer Fund demonstrates the surpluses.<sup>2</sup>

	2016	2017	2018	2019
Sewer Fees	537,404	572,965	689,171	684,767
Sewage Treatment	496,992	391,983	855,439	570,897
Over (Under)	40,412	180,982	(166,268)	113,870
Accumulated Surplus		221,394	55,126	168,996

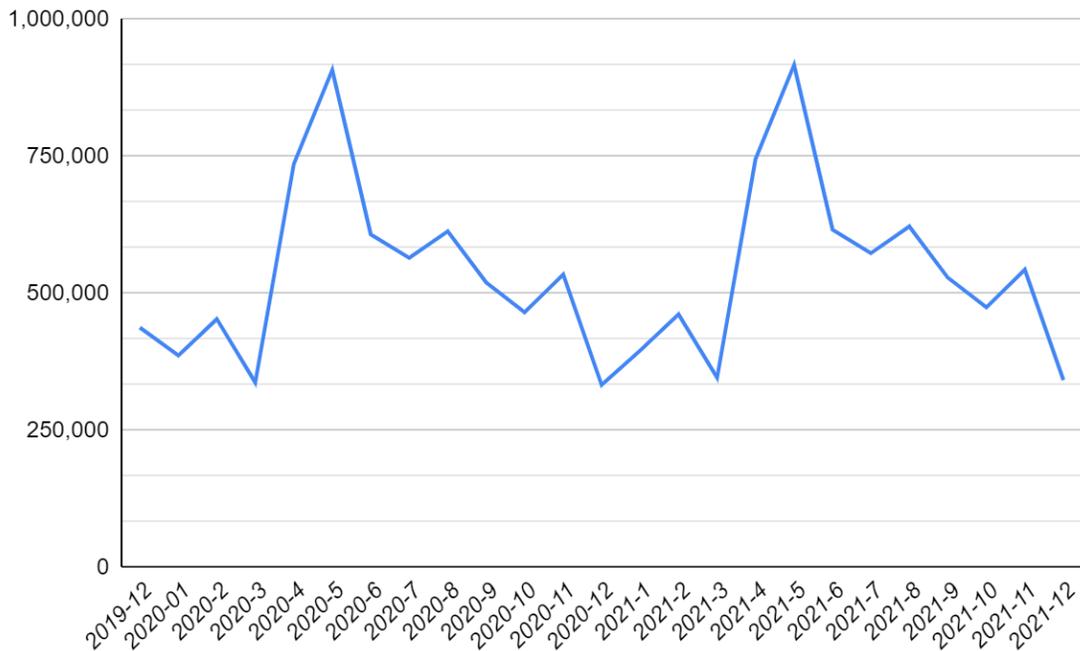
3. Cash Flow - Cash flow is the monitoring and managing of inflows and outflows of cash and the liquidity of investments for the purpose of meeting short term financial obligations.

- a. The cash flow trend for the borough since December 2019 indicates a steady depletion. Funds are being spent at a rate

<sup>2</sup> This analysis compares fee income to treatment costs. Additional revenues or expenditures reported in annual financial statements may have occurred. The Borough's auditor can provide combining statements for amounts reported in the Special Revenue Funds column of the DCED report for complete income and expense details on the Sewer Fund.

faster than they are being replenished.

- b. The chart below shows the closing general fund bank account balance for each month from December 31, 2019 through February 28, 2021 and estimates bank balances for March - December 2021 based upon the net changes in bank balance for the same period in 2020.
- c. At December 31, 2020, cash was down from the December 31, 2019 balance by \$104,562. Were the past trend to continue, the cash position of the borough at December 31, 2021 would be reduced \$95,716 since December 2019. The cash flow history and future projection for Verona is as follows:



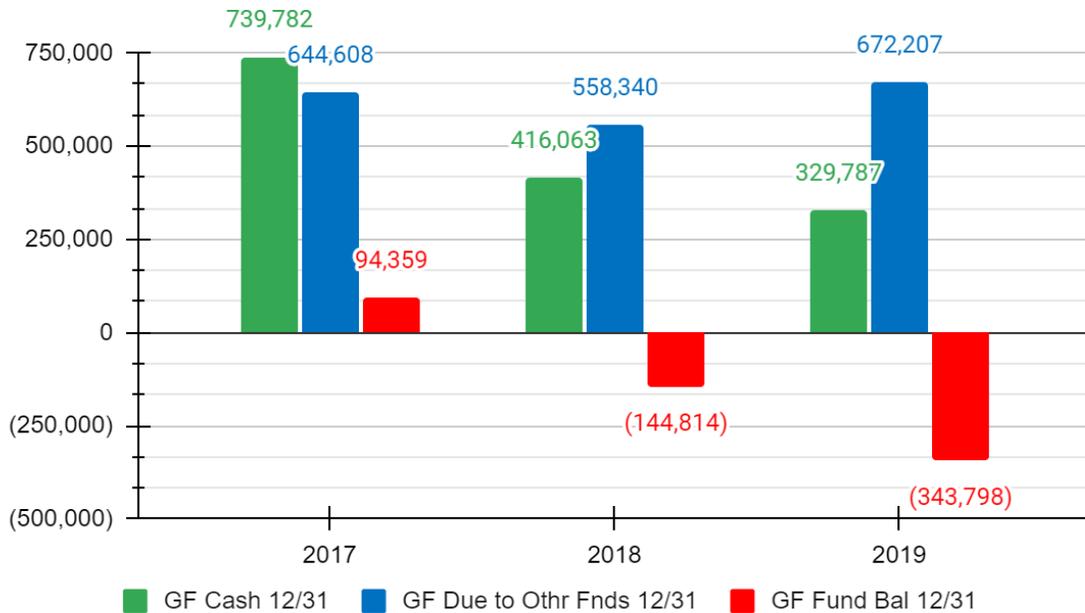
#### 4. Significance and Consequence of the Interfund Liability

- a. Historical Problem - The interfund liability problem for the General Fund starts in 2015. The December 31, 2014 Annual Financial Report shows the General Fund with only \$506 as due to other funds.<sup>3</sup>
- b. The significance and consequence of this interfund liability is to reduce the Borough's General Fund fund balance.<sup>4</sup>

<sup>3</sup> Special Revenue funds are combined on the DCED report and show a receivable of the same amount. As part of this report, this 2014 amount is assumed to be with the Sewer Fund.

<sup>4</sup> Fund Balance is defined as the difference between assets and liabilities reported in a governmental fund.

- c. Starting in 2018 the Borough has posted a negative General Fund fund balance. That deficit mirrors the difference between the December 31 amount in Cash and the December 31 Due to Other Funds.<sup>5</sup> The following graph depicts this situation:



- d. Due to weaknesses in the interim financial reporting and a failure to properly interpret and respond to the Annual Report, the Borough has unknowingly and continuously borrowed from the Sewer Fund.<sup>6</sup>
- e. Since the General Fund is the primary operating fund of the borough, a negative fund balance means the Borough has a structural deficit.
- f. Effectively immediately, sewer fees should to be deposited into the Sewer Fund bank account. A separate Sewer Fund should be established the financial system and reported on a monthly basis. Sewer expenses should be paid from the Sewer Fund bank account. In all situations where deposits are received or payments made on behalf of another fund, the required "due to" and "due from" journal entries should be made and the corresponding transfer should happen on a timely basis.<sup>7</sup>

<sup>5</sup> Cash on the Annual Report includes the General Fund checking account as well as investments. Due to Other Funds is all Special Revenue Funds. Combining schedules for 2019 were reviewed to document the liability is with the Sewer Fund.

<sup>6</sup> The Management Letter from the Borough auditors has identified this weakness since the 2016 Audit.

<sup>7</sup> These action steps are already underway with the appointment of a new bookkeeping firm effective April 1, 2021.

## 5. Implications and Next Steps

- a. Implications - The 2021 budget was adopted without recognizing fund restrictions. It is dependant on the Sewer Fund filling a gap between current revenues and current expenditures.<sup>8</sup> Since this was an error and is not an option for the Borough, the following next steps should be made:
- i. 2021 tax rates may not be reset, and so other adjustments, will need to be made to reduce the \$303,195 deficit.

2021 Adopted Budget: Total Revenue	3,149,689
Less 2021 Sewer Rental Fees	(853,259)
2021 Revenues Net of Sewer Fees	2,296,430
2021 Adopted Budget: Total Expenditures	3,149,625
Less 2021 Sewage Treatment Costs	(550,000)
2021 Adopted Budget: Expenditures Net of Sewage Treatment Costs	2,599,625
2021 General Fund Revenue Over (Under) Expenditures	(303,195)

- ii. In addition to adjusting the 2021 spending plan, a plan to build the General Fund balance must be developed.
1. Establish a fund balance policy - The Borough Council must establish a fund balance policy.
    - a. Minimum level of fund balance to be attained by December 31, 2021
    - b. Purpose of fund balance
  2. Recommended minimum fund balance-
    - a. Typically, a minimum fund balance is no less than 5% of annual *operating* expenditures. The annual operating expenditures for the Borough need to be ascertained.
      - i. To do so, a definition of capital expenditure in Verona should be determined.
      - ii. Recommended definition of capital -
        1. Cost of \$5,000 or more
        2. Useful life of 5 years or more
      - iii. It is difficult to ascertain the amount of operating versus capital expenditures in the 2021 budget because capital is presented as "Major

<sup>8</sup> This is true for the Liquid Fuels Fund as well. At the time of the report the intended expenditures for the \$79,000 in anticipated Liquid Fuels intergovernmental revenue was unknown. This separate fund also needs to be established and further budgetary adjustments may be needed.

Expenses” in the Public Works and Parks, and there are other large purchases throughout, such as building construction for the police department in the the General Government Repairs and Maintenance account. Council should formulate a clear list of what is capital in order to determine operating expenditures and calculate a minimum fund balance.

3. Identify potential projects for elimination or deferral due to financial constraints.
  - a. Based upon most recent discussion with Borough Engineer, the following schedule is known:

Description	Project Total	Grant	Grant Source	Local Share	Local Source
Storm Sewer CCTV and Condition Ratings (some point repairs and lining of areas with immediate need)	155,000	125,000	DCED CFA	30,000	General Fund
First Street Improvements	327,000	228,000	CFA Multimodal	99,000	Liquid Fuels
Cribbs Pavillion	201,750	200,000	DCED Greenways	30,000	General Fund
Drainage/Stormsewer Extension - Athletic Ave	60,000			60,000	General Fund
Wildwood Culvert Repairs	36,000	21,000	CDBG	15,000	General Fund
<b>TOTAL</b>	<b>779,750</b>	<b>574,000</b>		<b>234,000</b>	

- b. This list should be expanded to include all projects that meet the Borough definition of capital.
    - c. After any cuts of expenses are further applied, the total operating expenses for 2021 can be estimated. That expenditure amount that the of fund balance calculation should be based upon (x\*5%).
  4. Purpose of fund balance-
    - a. Rainy Day fund
    - b. Accumulate assets for future planned projects
    - c. Provide flexibility and resiliency to take advantage of unexpected opportunities such as new grants
- iii. A plan to make the Sewer Fund whole must be established.

1. An annual contribution to the Sewer Fund is recommended as the approach to take towards eliminating the interfund liability.
2. Considering that the deficit accumulated over 4 years, four annual contributions from the General Fund to the Sewer Fund totalling the 2020 liability may be a reasonable approach ( $639,000/4=159,750$ ).
3. This amount should be budgeted each year as an interfund transfer/other use of cash, which is akin to an expenditure.
- iv. A commitment to first designate any one-time revenues to shoring up the General Fund fund balance by utilizing it for existing priorities before initiating new spending. This refers specifically to any funding received from the federal American Rescue Plan signed on March 11, 2021, to the extent eligibility allows.

b. Summary of adjustments needed to the 2021 Budget:

- i. Address the \$303,000 General Fund shortfall resulting from properly segregating sewer revenues and expenditures from the General Fund and accruing any surplus of sewer fees over sewer treatment and operation costs to the Sewer Fund.
- ii. Establish target year end fund balance number and adjust expenses accordingly to achieve appropriate savings.  
Estimate: \$100,000
- iii. Establish "payment plan" and pay amounts due to Sewer Fund. Annual recommended payment \$159,750. The total liability must be reported on the new financial system balance sheet, however it is possible that the first payment to the first payment to the Sewer Fund could be deferred until 2022, so long as the current year revenue and expenditures are segregated and no further liability is accrued.
- iv. Earmark any one-time revenues first and foremost to restoring the General Fund fund balance.

6. Comments on the Future: a Capital Improvement Plan, Taxes and Policies on Borrowing and Other Financial Matters

- a. The Borough should develop a 5 year capital improvements plan, with capital being defined as \$5,000 or more in cost and a useful life of 5 years.
  - i. This includes programming sewer system improvements from any surpluses established by the sewer fund.

- b. Taxes - The Borough should anticipate tax increases that will be necessary for future budgets. In Verona, one mill generates approximately \$98,000 and a 2 mill increase will be necessary to address the average structural deficit of \$200,000.
- c. Borrowing -
  - i. Commercial loans or bonded debt should not be considered an option to eliminate the interfund liability. Further, the cost of issuance for bonded debt makes it prohibitive for borrowings of less than two million dollars.<sup>9</sup>
  - ii. Borrowing should be aligned with the useful life of a project. Asking future taxpayers to pay for current spending gaps without providing a future public benefit such as a capital improvement is discouraged. Borrowing to resolve the interfund liability accrued over the last four years is not recommended in consideration of intergenerational equity.
  - iii. A Tax Anticipation Note (TAN) may be an option given the current allowable 2 year vs. 1 year time frame for payback as a result of the COVID-19 pandemic. A TAN must be paid back in full; it is not installment payments such as a commercial loan or bond issue. However, to consider that option the Borough must:
    - 1. Commit to raising taxes sufficient to pay the TAN back as well as fund current operations in 2022.
    - 2. Understand the cost of the borrowing is an expense it will also need to cover in 2022.
    - 3. Consult with a financial advisor/lender and DCED prior to making a decision about a TAN.
  - iv. Other financial matters - the Borough is short on policies and performance standards. The current elected officials have taken a proactive approach by retaining new financial administration, acknowledging the need for professional management, serving as responsible stewards of the employees' pension and correcting the MMO payment arrears, and seeking an intergovernmental solution in regards to Building Inspection and Code Enforcement services. The borough should continue this momentum. It should:
    - 1. Establish policies and procedures for prudent accounting, budgeting, and cash management.
    - 2. Assure proper employee timesheet reporting to properly record the full cost of operations to the Sewer Fund.
    - 3. Revise and improve financial operations to

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<sup>9</sup> Some bonded debt may be appropriate once the Borough has established a capital improvement plan. Advice on capital financing is outside the scope of this project.

- a. properly be aware of the Borough's financial condition,
- b. understand rules for government accounting and financial reporting,
- c. practice more responsible individual fund budgeting.<sup>10</sup>

## Conclusion

Verona Borough is on the right track to address its challenges. Taking the necessary steps of establishing funds segregation, better monthly reporting, and a fund balance policy are fundamental. The borough's next step is to make some important decisions about what its work program and spending plan will be in 2021 and beyond. While the Borough cannot do that without having first done the fundamentals, likewise, the Borough cannot do it if it only does the fundamentals. It must build on foundation by having a constructive dialog between Council, staff, and the community about the next best moves in service to the people of Verona. First to resolve current problems and build a better financial management system; then to use that system to build a better Verona.

Respectfully Submitted,



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<sup>10</sup> Additional recommendations submitted in my report of February 28, 2021.