

Village of Newberry

2017 Budget Analysis

Scope of Services Provided

As detailed in our engagement letter dated April 19, 2017, we have analyzed the Village's 2017 budget document as compared to actual results in 2015 and 2016. We established benchmarks for "normal" activity, identified line items that deviate from those benchmarks, and then concluded whether the deviations appeared to be normal in the course of business for a municipality such as the Village or require further follow up.

Further, we have analyzed the Village's cash position and concluded on its adequacy or inadequacy, as well as made suggestions for improvement.

Overview Comments on 2017 Budget

The budget document provided to us appears to be the same document provided to the Village Council for its December 19, 2016 Council meeting. This document is very simple, including just three columns of information: account number, account name, and the amount of revenue or expenditure/expense proposed for the 2017 budget. This document does not include all of the required elements for a budget document or General Appropriation Act (GAA) as stated in Michigan PA 2 of 1968. Information that is required to be included, but is excluded from Newberry's budget document is:

1. Prior year actual balances (FY2015 actual)
2. Current year estimated balances. This might be the current budget (FY2016) or a more thorough projection of where the Villages revenues and expenditures will end up by the end of the fiscal year.
3. Estimated fund balance at the end of the upcoming budget year

Additional information, although not required, that could be included for the benefit of the Council or any user of the budget document:

1. Detailed schedule of the adoption and amendment process
2. Legal level of control (is the budget adopted at the fund level? Department level? Line item?)
3. Prescribed consequences of violating the GAA
4. Written narrative explaining any changes from one year to the next – What happened last year that is not expected to repeat next year? What new activity is included in the upcoming budget?
5. Establishment of priorities, linking the detail to those priorities
6. Written goals by department – what do they hope to achieve in this upcoming fiscal year?
7. Communicate the economic and fiscal conditions that support the budget

Village of Newberry

2017 Budget Analysis

In addition to this letter, we have provided an Excel file with our analysis, additional questions, and conclusions. Our scope for selecting accounts to examine further was determined to be differences, positive or negative, of \$5,000 and 8%. We separately compared 2015 actual to 2016 actual, 2015 actual to 2017 budget, and 2016 actual to 2017 budget. If the difference in any of these 3 calculations exceeded the threshold, we looked into it further.

Significant Observations and Variances

The following are the significant variances we noted in our analysis that we believe warrant your attention. There are additional variances over our selected scope identified in the accompanying Excel file.

General Fund:

- Property Tax Revenue is the largest individual revenue source for General Fund. The 2017 budget appears reasonable compared to the prior two fiscal years.
- State Shared Revenue (101-4-101-574) is the second largest revenue source for the General Fund. The budgeted amount for 2017 is approximately \$25,000 greater than the amount provided by the Michigan Department of Treasury on its website.
 - Village follow up – Is there an additional transaction(s) included in this budgeted amount?
- Reimbursements from other funds (101-4-101-677, 101-4-101-678, 101-4-101-679, 101-4-101-681, 101-4-101-682) for expenditures incurred by General Fund that benefit other funds fluctuate from year to year based on activity in other funds. 2017 budgeted amounts are slightly elevated over 2016 actual amounts.
 - Village follow up – determine if it is reasonable that certain employees and equipment would be used more for the benefit of other funds in 2017 than in 2016.
- Contractual Services – Other (101-5-201-818, 101-5-270-818) fluctuates significantly from year to year
 - Village follow up – identify which services are included in these lines and determine if it is reasonable that 2017's budget would be significantly less than both 2015 and 2016 actual amounts incurred.
- The General Fund has the final scheduled debt payment on an installment loan due in the 2017 fiscal year per the 2016 audited financial statements, but the principal payment has not been included in the budget for account 101-5-284-991. In addition, the last payment on the 2002 GO bonds has not been budgeted for in 101-5-945-991.
 - Village follow up – Budget should be amended for these debt payments.

Village of Newberry

2017 Budget Analysis

- There is nothing budgeted for the sidewalk program (101-5-442-818). Last year, expenditures were \$27,003.
 - Village follow up – If the sidewalk program continues into 2017, the budget should be amended accordingly.
- The cost of hospitalization insurance (101-5-850-716) is budgeted to be 15.5 percent more than in 2016 and 53.9 percent more than in 2015.
 - Village follow up - If budget is accurate, consider alternative insurance plan designs.
- The budgeted MERS pension contribution (101-5-850-718) for 2017 is \$90,000 less than the actual contribution in 2016.
 - Village follow up – As this seems highly unlikely, consider the need for a budget amendment.
- The 2017 budget includes an expenditure of \$183,385 for “Budget Stabilization”.
 - Village follow up
 - If the Village is considering establishing a Budget Stabilization Fund under Public Act 30 of 1978, please have a discussion with Plante Moran before continuing.
 - If this was meant to be like a “contingency” expenditure in order to balance the budget, it should be amended and reduced to offset the additional expenditures noted above that should be included in the budget.
- The 2017 budget contains four accounts with “Appropriation” in the name that appear to be Interfund Transfers Out to other funds to help subsidize the operations of those other funds; however, 3 of the 4 do not agree to the accounts in the other funds that are the “other side” of the interfund transfer.
 - Village follow up – amend the budget to make interfund transfers net to zero between funds.
- The Village currently budgets and accounts for motorpool activity within the General Fund, with other funds paying General Fund an equipment rental fee when the motorpool equipment is used to benefit those other funds. While this practice is acceptable, the Village isn’t really setting aside any funds for future capital replacement. Village leadership has informed us of their intention to move the motorpool activity to its own separate fund. This would be consistent with many other municipalities and is an acceptable accounting treatment. An alternative would be to assign or commit fund balance derived from the surplus cash generated by the equipment rental fee.

Conclusion:

The General Fund budget appears to be fairly accurate overall compared to the actual results for 2016. After potential budget amendments identified above, budgeted revenues and expenditures may still be

Village of Newberry

2017 Budget Analysis

approximately equal. The actual results for General Fund in 2016 was a reduction of fund balance of \$60,281, but that appears to be due to a late journal entry that increased Interfund Transfers Out to the two street funds. Those transfers are indicative of the Street Funds spending in excess of their means, not a problem with the General Fund budget.

Major Street Fund

- The Major Street Fund is primarily funded by revenue from the Michigan Department of Transportation via distributions of revenue through Public Act 51 of 1951. The Act 51 revenue is budgeted to be slightly less than the actual results for both 2015 and 2016; however, it is likely to be slightly more than in previous years.
 - Village follow up – The difference is unlikely to be significant enough to warrant a budget amendment.
- The fund spent \$31,971 last year on sidewalks, but nothing is budgeted for 2017 (202-5-451-850).
 - Village follow up – The spending on sidewalks appears to be the reason the Major Streets Fund needed an Operating Transfer In from General Fund to prevent a deficit of fund balance as of December 31, 2016. If the Village is concerned about preserving General Fund's fund balance, it may be best to postpone continuing the sidewalk program until a future year.
- On a line by line basis, the budgeted expenditures for 2017 are slightly less than 2016's actual expenditures. The budgeted expenditures may not be reasonable unless the Village makes a conscious effort to do less for the Major streets in 2017.
 - Village follow up – Monitor spending in this department carefully in order to prevent the need for another Operating Transfer In from the General Fund to prevent a deficit of fund balance.

Conclusion:

The Major Street Fund's budget appears to be reasonable overall; however, since the 2017 fiscal year began with only \$490 of fund balance, there is very little room for error if the Village's goal is to not negatively impact the General Fund.

Local Streets Fund:

- The Local Streets Fund has two primary funding sources: Act 51 revenue similar to the Major Streets Fund and a dedicated millage. The budgeted tax revenue for 2017 is slightly less than

Village of Newberry

2017 Budget Analysis

the 2016 actual property tax revenue. The budgeted Act 51 revenue is approximately \$20,000 or 32 percent more than the actual revenue received in 2016

- Village follow up – The Department of Transportation provides a tool to calculate a municipality’s Act 51 revenue based on the number of miles within the municipality. If the Village has not already done so, we recommend completing the tool to verify the budget is reasonable.
- The General Fund transferred \$47,500 from the General Fund to the Local Streets Fund to prevent a deficit of fund balance in 2016. The 2017 budget includes a transfer from General Fund of 17,500 and one from the Major Streets Fund of \$5,200.
- The budgeted expenditures for 2017 are \$27,000 less than the actual expenditures for 2016.
 - Village follow up - Monitor spending in this fund carefully in order to prevent the need for an additional Operating Transfer In from the General Fund over and above what has already been budgeted.

Conclusion:

The Local Street Fund’s budget appears to be reasonable overall; however, since the 2017 fiscal year began with only \$338 of fund balance, there is very little room for error if the Village’s goal is to not negatively impact the General Fund any more than is already budgeted.

Fire Funds:

- The Village has 3 separate fire funds – one to receive the dedicated millage, one to pay for large capital items, and one for operational costs.
 - Village follow up – Consider combining these into a single fund. Any benefit to keeping 3 separate funds can be accomplished through utilizing the Village’s general ledger in a more efficient manner. Having 3 funds creates unnecessary work.
- The Fire Revolving Fund is primarily funded by contributions from neighboring communities. The budget for 2017 includes a substantial increase in those contributions.
 - Village follow up – Verify the increased contribution is contractually obligated.
- Both the Fire Capital Fund and Fire Revolving Fund includes an Operating Transfer In from General Fund (206-4-206-584, 207-4-207-584), but the budget balance does not agree to the amount budgeted to be transferred out of General Fund.
 - Village follow up - Amend the budget so that Transfers match on both sides.

Village of Newberry

2017 Budget Analysis

Conclusion:

The three Fire funds' budgets appear to be reasonable overall; however, the Fire Capital and Fire Revolving Funds receive contributions from General Fund. If General Fund's budget or fund balance is a concern, the three fire funds are stable financially and overall well-funded to the point that they could survive with less of a contribution from the General Fund.

Further, General Fund could be removed entirely as a revenue source for Fire if necessary. The Village does have other revenue options for Fire, including a Public Act 33 public safety assessment that could free up substantial savings to the General Fund.

Grant Funds:

- The Village operates two separate grant funds – Tahquamenon Outdoor Recreation Complex (TORC) Fund and the Atlas Park Fund. The TORC fund is budgeting a grant of \$228,000 which is substantially more than 2016, but less than 2015. The Atlas Park Fund budget includes a first time grant of over \$55,000.
 - Village follow up – Verify the existence and size of the grants. Ensure the Village is properly prepared to administer the grants, including making the necessary draw-down requests.

Conclusion:

As long as the budgeted amount of the grants is correct and the Village is prepared for all of the requirements of administering the grants, no further follow up necessary.

Electric Fund:

- The Electric Fund, an enterprise fund, is primarily funded through a user charge to its customers. Budgeted revenue for 2017 is consistent with actual revenue from 2016.
- Hospitalization expense (582-5-250-716) is budgeting a significant increase in cost for 2017 similar to what was noted above for the General Fund.
- Fuel Oil (582-5-584-735) has fluctuated wildly. In 2015, the Village spent \$46,000. In 2016, this dropped to \$8,000. The 2017 budget calls for \$25,000.
 - Village follow up – Is the budgeted amount based on anything other than being in the middle between the two extremes of the two previous years?
- As an enterprise fund, the Electric Fund is accounted for on the full-accrual basis of accounting. This means that the fund records Depreciation Expense instead of Capital Outlay and a

Village of Newberry

2017 Budget Analysis

reduction to the debt liabilities instead of Debt Service expense for principal payments. Therefore, the budget does not include significant cash outlays and it is not apparent from looking at the budget if the Electric Fund is planning for any kind of substantial capital improvements. For these and other reasons, a budget similar to that of a General Fund is not adequate for setting rates in an enterprise fund.

Conclusion:

With the exception of the items noted above, the budgeted activity of the Electric Fund is very consistent with 2016; however, that does not mean that rates have been set adequately to provide the necessary cashflow to operate and maintain the system and provide service to the Village's clients. The Village needs to take additional steps to analyze the existing rate structure to determine if rate increases are necessary.

Water Fund:

- Water is also an Enterprise Fund, meaning it is primarily funded by a user charge to its customers. The sale of water has been budgeted to be \$104,200 or 22.4% higher than 2016.
 - Village follow up – Were the water rates increased by 22.4% before January 2017? If not, is there reason to believe the volume of water sold will increase enough to generate this much more revenue than in 2016?
- The Water Fund includes "Bond Revenue" (583-4-00-524) of \$300,000 which is actually a drawdown of financing available. This is offset by \$300,000 of construction expense (583-5-592-811). Because of full accrual accounting, the outlay will be capitalized as an asset and the "bond revenue" will be reclassified as a liability. Budgeting the flow of cash, even though it is not proper accounting, is a very common method used by municipalities.
- Similarly to Electric, the principal payments on Water's debt has not been budgeted.

Conclusion:

Line by line, the operating expenses budgeted in 2017 are consistent with actual 2016 expenses. However, same as with Electric, that does not mean that the rates have been adequately set to generate enough cash for the system.

Village of Newberry

2017 Budget Analysis

Sewer Fund(s):

- The Village has historically had 2 sewer funds. As requested by the Village, our work on the proposed new chart of accounts merged the two funds into one. Similarly, we have combined the two sewer funds in this analysis.
- Like Water, Sewer includes Construction Expense that is offset by Bond Revenue.
- Like both Water and Electricity, bond principal payments have appropriately not been budgeted under full-accrual accounting.
- Hospitalization (495-5-850-716) in 2017 is budgeted to be 17% higher than 2016 actual. This is not quite as high as what we noted above for General Fund and Electric.
- Contractual Services – Other (590-5-590-818) was over \$92,000 in 2015, then \$66,000 in 2016, and now only budgeted for \$3,000 in 2017
 - Village follow up – what type of services were being used by Sewer and is it reasonable that they will not be used again in 2017?
- Conversely, the other Contractual Services – Other (495-5-527-818) has increased from \$1100 in 2015 to \$6400 in 2016 and is now budgeted for \$44,000 in 2017.
 - Village follow up – Is this increase related to the other Contractual Service decrease? If not, what is going to be paid for in 2017?
- Electricity (495-5-527-921) costs have fallen from \$51,000 in 2015 to \$42,000 in 2016, and now budgeted for \$38,000 in 2017.
 - Village follow up – Is this reasonable to drop this much?
- L&P Insurance (495-5-527-810) has also continued to decrease every year.
 - Village follow up – is this reasonable to keep dropping? Or, is it part of a cost allocation within the Village?
- There is an expense budgeted called “Equipment Reserve” (495-5-527-974) for \$56,000.
 - Village follow up – Is this actually buying equipment? Is the intention to save \$56,000 for future equipment purchases? Either way, this does not seem like a full-accrual expense.
- Similar to General Fund, the Sewer Fund has an account called “Budget Stabilization” (590-5-590-994). Same questions apply here as they did above in General Fund.

Conclusion:

With the exceptions noted above, line by line, the operating expenses budgeted in 2017 are consistent with actual 2016 expenses; however, that does not mean that the rates have been adequately set to generate enough cash for the system.

Village of Newberry

2017 Budget Analysis

Cash Position

Per our engagement letter, a component of this assignment is to evaluate the cash position for the funds.

Based on our analysis of the audited December 31, 2016 financial statements and the 2017 budget, we find the level of cash the Village is currently in possession of to be adequate **for now**. The Village is unlikely to run out of cash during fiscal year 2017; however, the Village’s cash position has been in a state of decline for several years.

Just looking at cash can be misleading. For example, if you have \$5,000,000 of cash, one might assume the Village is sitting pretty; however, if the Village has \$6,000,000 of accounts payable, that \$5,000,000 is nowhere near adequate. Instead, let’s look at *working capital*.

Working Capital is defined as the difference between current assets (cash and receivables) and current liabilities (accounts payable, accruals, and the next debt payment). It is a measurement of your ability to pay your bills as they come due. The following table shows working capital (excluding inventory, a current asset that cannot be converted to cash or used to pay bills) for the entire Village (Governmental and Enterprise Funds) over the last 5 years:

Year Ended December 31	Working Capital
2012	\$2,165,844
2013	\$1,794,280
2014	\$1,466,493
2015	\$ 775,439
2016	\$ 923,099

Overall, the 5 year trend is troubling as working capital has declined 57 percent, but 64 percent if we had stopped in 2015. One year is not a trend, so we cannot assume that the Village turned the corner in 2016 is back on its way to prosperity. This could very well be an aberration.

What if we looked at Governmental activities (General Fund, Fire, Streets, etc...) separately from the three Enterprise activities (Water, Sewer, and Electric)?

Village of Newberry

2017 Budget Analysis

Year Ended December 31	Working Capital		
	Governmental	Enterprise	Total
2012	\$ 790,364	\$ 1,375,480	\$ 2,165,844
2013	\$ 713,247	\$ 1,172,629	\$ 1,885,876
2014	\$ 646,478	\$ 876,331	\$ 1,522,809
2015	\$ 870,436	\$ (75,206)	\$ 795,230
2016	\$ 776,700	\$ 146,399	\$ 923,099

This provides more clarity. Governmental activities have been relatively stable, while the Enterprise Funds have been burning through cash at a rapid pace. Admittedly, the budget document could be better and the content of the budget could be more accurate; however, this demonstrates a different problem. The Enterprise Funds have the ability to charge whatever they need to in order to provide service and maintain their infrastructure; but the working capital balance has been in a free fall.

When looking at utilities, working capital can also be misleading. The problem is with receivables. Yes, receivables are converted to cash and used to pay bills; however, as quickly as receivables are collected, a new receivable is generated when the next round of invoices is prepared. So, a utility never really liquidates its receivables. They just hang around on the balance sheet with some light to moderate fluctuations month to month.

Let's take another look at the Enterprise working capital, but remove the accounts receivable.

Year Ended December 31	Enterprise WC	Accounts Receivable	Modified WC
2012	\$ 1,375,480	\$ 348,904	\$ 1,026,576
2013	\$ 1,172,629	\$ 253,801	\$ 918,828
2014	\$ 876,331	\$ 597,674	\$ 278,657
2015	\$ (75,206)	\$ 376,836	\$ (452,042)
2016	\$ 146,399	\$ 399,787	\$ (253,388)

This is even bleaker. It's obvious the Enterprise funds are not generating enough cash to pay their own bills and are relying on borrowing from each other or from the Governmental funds.

Let's look at the cash generated or used for the three Enterprise activities over the past 5 years:

Village of Newberry

2017 Budget Analysis

Use of Cash (per audited statement of cash flows)				
	Electric	Water	Sewer	Total
2012	\$ 473,395	\$ (274,882)	\$ (173,830)	\$ 24,683
2013	\$ (412,325)	\$ 253,774	\$ 127,416	\$ (31,135)
2014	\$ (86,101)	\$ 77,864	\$ (53,412)	\$ (61,649)
2015	\$ (411,537)	\$ 35,214	\$ 20,131	\$ (356,192)
2016	\$ 171,806	\$ (339,405)	\$ (55,639)	\$ (223,238)

As demonstrated by this table, the Enterprise funds have been hemorrhaging cash for several years.

How much cash should an enterprise fund have?

When assist communities with utility rate setting, we generally follow the guidelines set forth by the American Water Works Association (www.AWWA.org).

Basically, a utility should have enough cash on hand to pay its operating bills, pay its debt service payments, and have enough in reserve in the event equipment or infrastructure breaks and requires an immediate fix or replacement.

The following table calculates what we consider an appropriate amount of cash to have on hand for the Village’s activities and then a comparison to what the Village actually had at December 31, 2016:

Village of Newberry

2017 Budget Analysis

	Electric	Water	Sewer	Total
Target cash on hand				
60 days of operations (less depreciation)	\$ 386,180	\$ 35,638	\$ 168,955	
5% of the Net Book Value of Capital Assets	\$ 112,051	\$ 488,149	\$ 245,052	
1 year of debt service	\$ 274,100	\$ 361,900	\$ 253,114	
Target cash on hand (less interfund balances)	\$ 772,331	\$ 885,687	\$ 667,121	\$ 2,325,139
As of 12/31/16				
Cash	\$ 180,131	\$ 449,614	\$ 158,200	
Due from Other Funds	\$ 405,455	\$ 335,970	\$ 55,492	
Advance to Other Funds	\$ 52,363	\$ -	\$ 124,602	
Due To Other Funds	\$ (388,118)	\$ (96,036)	\$ -	
Advance From Other Funds	\$ -	\$ -	\$ (525,455)	
Actual net cash on hand	\$ 249,831	\$ 689,548	\$ (187,161)	\$ 752,218
Over/(short) of target	\$ (522,500)	\$ (196,139)	\$ (854,282)	\$ (1,572,921)
Percent short of target	68%	22%	128%	68%

Our original engagement was to consider the adequacy of the budget. Based on the first half of this report, the budget, while not great, is fairly accurate in relation to the expenses expected and incurred. For the Enterprise funds, the problem is not a bad budget. The problem is inadequate rate development.

Additional Comments on Enterprise Funds

1. Public Act 2 of 1968, the Uniform Budgeting and Accounting Act, only requires a General Appropriation Act for General Fund and Special Revenue Funds, but not for Enterprise Funds or several other fund-types. While it is not required, primarily due to the precarious financial position the enterprise funds are in, we recommend that the Village continue to develop and pass a budget for all of the enterprise funds. This will provide a benchmark to compare your spending to; however, a budget by itself is not enough to effectively set rates as the Village should also be concerned about accumulating enough cash to satisfy its bond covenants also.
2. Should the Enterprise Funds' cash position continue to deteriorate, the General Fund will need to subsidize these funds with cash support. While it is allowable for General Fund to subsidize

Village of Newberry

2017 Budget Analysis

an enterprise fund, it makes little sense to do so as an enterprise fund can set its user fee to whatever level is necessary to fund operations and long-term plans. We recommend enterprise funds stand on their own financially.

3. While it is allowable for the General Fund to subsidize the enterprise funds, the enterprise funds cannot subsidize General Fund (example: Revenue raised by your Sewer rate cannot be used to pay for Fire Department operations.). This would be a violation of the Bolt vs. City of Lansing legal decision. The Village is not doing this.
4. It is allowable for the enterprise funds to reimburse General Fund for expenses paid for by General Fund that are for the benefit of the enterprise fund. This is how the Village is operating.

Overall Conclusions

1. Overall, the budget document itself is inadequate from both a compliance with PA 2 perspective, as well as in terms of overall usefulness to the reader.
2. The Governmental funds have been relatively stable over the past 5 years; however, that does not mean the budget document is providing Village management with enough useful information for making operational decisions.
3. General Fund is currently subsidizing the Fire and Street funds. If these funds are not monitored closely, expenditures over budget will have a significant negative impact to General Fund.
4. The Enterprise funds are using cash at an accelerated rate as a result of poor utility rate development. If not addressed soon, this will begin to affect the General Fund which will be forced to step in and provide financial support.

Suggestions

1. Revise the budget document to provide the required elements per PA 2 of 1968.
2. In addition to the required elements, add additional "best practices" that will help the leadership of the Village of Newberry make operational decisions and that will help educate and inform other users of the document.
3. Develop a five-year financial forecast for the major Governmental funds. This will help the Village understand the current state of the Village's finances as well as help chart the course for the next several years.
4. Combine the 3 separate fire funds into a single fire fund. This will eliminate some unnecessary accounting work and will provide a more complete picture of the operations of the Fire department.
5. Consider a Public Act 33 of 1951 public safety special assessment to generate new revenue for Fire to eliminate the dependency on General Fund.

Village of Newberry

2017 Budget Analysis

6. Address the utility rates and implement an increase to the rates before the next fiscal year. Best practices would include a long-term rate model that will assist the Village with annual rate setting while also keeping an eye on the future improvements necessary to the utility infrastructure and provide the necessary funding to pay for those improvements.
7. Change the way the Village budgets for the enterprise, from full-accrual to cash-basis. Currently, the Village budgets for depreciation expense, but not for debt principal payments (because in full-accrual accounting this is a reduction of a liability, not an expense) or capital assets (because in full-accrual accounting this is trading one asset, cash, for another asset, capital asset, not an expense). Switching to a cash-basis will provide a clearer picture of how much revenue must be generated in order to pay the bills and put enough into reserve.