



Financial Distress: What it is, why it hurts and how to heal

Pennsylvania GFOA presentation
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April 28, 2025

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Getting to know you

The Group Consulting team at **Public Financial Management (PFM)** is a team of professionals whose mission is to help local, county and state government leaders manage their finances in the best way possible to advance their community's goals.

Our team has worked extensively to help Pennsylvania local governments overcome financial distress, both as its statutorily defined (Act 47) and as it practically manifests itself in government's finances and operations. We've worked on public safety, public works, and finance functions, in addition to cross-cutting challenges related to workforce management and revenue generation and collection.

Act 47 (Pennsylvania Municipal Oversight)

City of Pittsburgh, 2004 - 2018
City of New Castle, 2007 - 2023
City of Reading, 2009 - 2022
City of Chester (Receivership) (2020 - Present)
Borough of Newville (2023 - Present)

Federal Programs: NRN / DCTA

City of Johnstown (2024)
City of Monessen (2024)
Municipality of Norristown (2019-20)

EIP/Strategic Management Planning

Upper Darby Township, 2022 - Present
City of Lancaster, 2019 - Present
City of Erie, 2019 - 2020
Cheltenham Township, 2019 - 2020
City of McKeesport, 2019
City of Wilkes-Barre, 2016 – 2022

We've also worked with fiscally stressed counties and school districts across the Commonwealth.



Defining Financial Distress: Act 47

The Municipalities Financial Recovery Act (or Act 47 of 1987) creates a statutory definition for whether Pennsylvania municipalities are financially distressed. Communities are may be designated as financially distressed if one of the following criteria is present:

- A deficit over a three-year period, with a deficit of 1% or more in each of the previous fiscal years.
- Expenditures exceed revenues for a period of at least three years
- Deficits for two successive years equal to 5% or more of its revenues
- Default on debt payment or judgement payments
- Failure to make budgeted Minimum Municipal Obligation payments to employee pension plans
- Missed payroll; failure to remit income taxes withheld from employees; or failure to transfer payroll tax withholdings for more than 30 days
- Decrease in the “quantified level of municipal service” due to a community reaching the maximum real estate taxing level
- Filing for a plan of adjustment under federal bankruptcy

The Commonwealth does not proactively review if a municipality meets these criteria. There’s a statutory process where someone (usually the municipal leaders) must request a review that leads to official financial distress designation.

But if you’re headed toward the emergency room, you already know you’re sick. And if your community’s finances have reached the point where these events are occurring, then you are fiscally distressed from a practical standpoint. **Can we define fiscal distress in a way that helps us avoid it?**



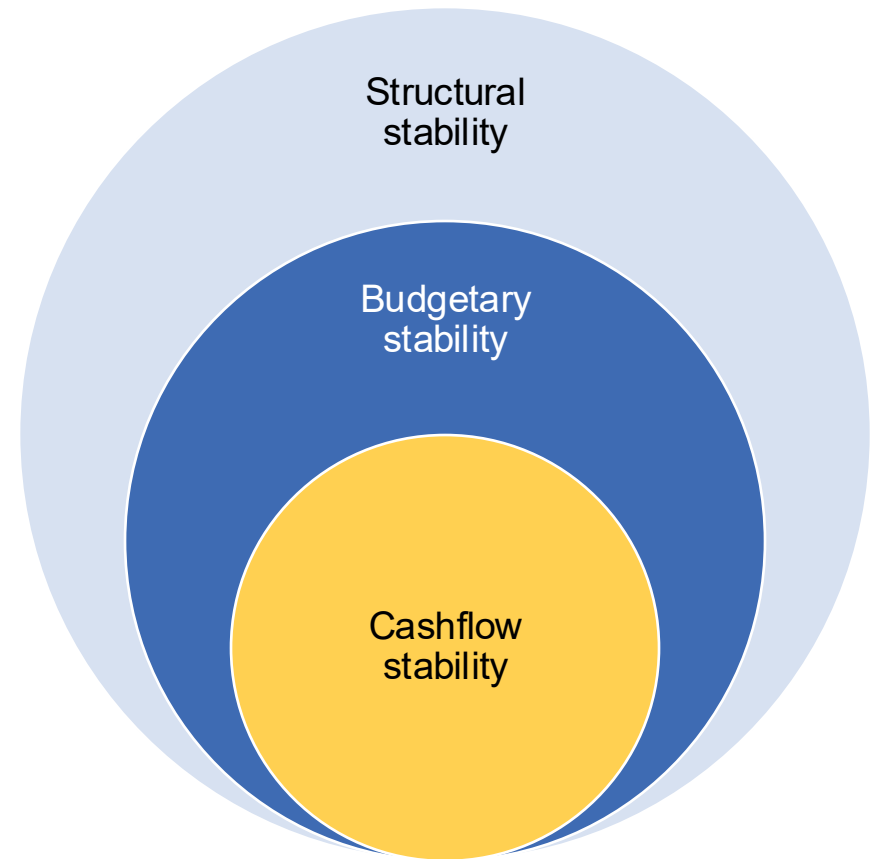
A working definition: Distress is the absence of stability

Fiscal distress is the absence of fiscal stability at any of these levels:

- **Cashflow stability:** The ability to pay bills in full and on time when they are due
- **Budgetary stability:** The ability to balance annual revenues against annual expenditures in all funds
- **Structural stability:** The ability to balance recurring revenues against recurring expenditures over a multi-year period

Each level of stability builds of the prior level, so there needs to be a base level of cash stability to achieve budgetary and structural stability; and a base level of budgetary stability to achieve structural stability.

But it is possible to have a degree of structural stability without completing eliminating all warning signs of budgetary or cash flow distress.





Cash flow stability



Cash flow stability

We will know we have basic cash flow stability if...

- We have enough cash to pay all our bills in full and on time, when we receive them, from the fund that carries the obligation
- We have enough cash on hand that we can absorb the impact of an unexpected short-term event (major snowstorm, delay in tax/grant receipts) and still be able to answer the prior question in the affirmative

We will know we have even stronger cash flow stability if...

- We do not rely on interfund **loans** to pay our bills during the year (different from interfund **transfers**)
- We do not use a Tax Anticipation Note or other cash flow borrowing mechanism to cover our expenses early in the year
- We have enough cash on hand that we can absorb a more substantial negative event (loss of a major employer, sudden increase in demand for service) and still answer the previous questions in the affirmative

Your turn: Is there a minimum cash balance that target that you use?



You might have cash flow distress if...

You miss a payroll, a debt payment, an IRS tax remittance, etc (Act 47 triggers)

You can't pay all your bills, so you carry some of them into the next year

You're selling assets to cover your cash flow needs

You can't pay all your bills without interrupting operations, just to make it through the year (hiring freeze, cancelling capital projects)

You carry a lot of old bills (+60 or +90 days) on your AP aging report

You use a Tax Anticipation Note (TAN) to pay your bills early in the year

You put off paying your pension obligation until the end of the year for cash flow reasons.

You use interfund loans to pay your bills during the year

You're one bad stretch away from having to use any of the prior measures to avoid running out of cash

If you have enough cash on hand to pay your bills, but still have difficulty doing so, you may have a different, related problem. Communities that just emerged from a cash flow crisis may still struggle to pay bills on time because they need to build the processes, habits and culture that lead to timely bill payment.



Assessing your cash position

We use the following process to project, monitor and improve cash flow position:

- **Historical analysis:** Collect information on monthly spending and revenue collection on a **cash basis** across **all** accounts that roll up to the General Fund. Keep enterprise funds, special revenue funds, capital funds, fiduciary funds separate, but account for their interaction with the General Fund. We can do separate projections for those as needed.
- **Build your report structure:** We need to communicate our performance and needs to people who do not work in finance. Pick the 5-8 most important accounts/categories for revenues and 5-8 most important for expenditures. Use detail where it helps you manage and communicate.
- **Make your monthly projections:** We use a mix of math and management insight to do monthly projections (see next page)
- **Check your results each month and identify variances from projections:** Were did I spend/collect more/less than projected? Why did that happen? Am I likely to spend/collect more/less than I projected overall? Or am I just likely to spend/collect it faster/slower?
- **Identify (and act upon) your options:** If you're likely to spend more than projected overall, how can you change that? If you're likely to collect less than projected overall, how can you change that?
- **Now do it again, and again, and again...**



Start with a percentage-based projection...

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Real estate tax	1%	0%	15%	54%	20%	1%	4%	0%	2%	1%	0%	1%	100%
Earned Income Tax	5%	15%	5%	5%	15%	5%	5%	15%	5%	5%	15%	5%	100%
Other Taxes	6%	21%	9%	4%	19%	15%	9%	1%	5%	3%	1%	7%	100%
Departmental earnings	7%	22%	3%	4%	10%	5%	5%	17%	2%	4%	18%	3%	100%
Intergovernmental	0%	93%	0%	0%	0%	0%	0%	0%	7%	0%	0%	0%	100%
Other	100%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	100%
Total Revenues	11%	10%	9%	24%	16%	3%	4%	7%	3%	3%	7%	3%	100%
Salaries and FICA	8%	8%	8%	12%	8%	8%	8%	8%	12%	8%	8%	8%	100%
Health Insurance	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	8%	100%
Pension	0%	0%	0%	0%	0%	0%	0%	0%	100%	0%	0%	0%	100%
Other personnel	15%	15%	3%	8%	0%	14%	0%	0%	9%	9%	9%	18%	100%
Contracted Services	27%	0%	12%	0%	13%	8%	1%	2%	13%	2%	5%	18%	100%
Other op exp	8%	0%	27%	8%	8%	8%	7%	7%	7%	7%	6%	7%	100%
Debt service	0%	0%	0%	0%	0%	0%	50%	0%	0%	0%	0%	50%	100%
Total Expenditures	7%	4%	10%	7%	6%	6%	14%	5%	12%	6%	6%	15%	100%



...then translate to dollars...

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Real estate tax	\$5	\$0	\$77	\$268	\$101	\$5	\$22	\$1	\$11	\$4	\$2	\$6	\$500
Earned Income Tax	\$25	\$75	\$25	\$25	\$75	\$25	\$25	\$75	\$25	\$25	\$75	\$25	\$500
Other Taxes	\$3	\$10	\$4	\$2	\$9	\$8	\$5	\$1	\$2	\$1	\$1	\$4	\$50
Departmental earnings	\$4	\$13	\$2	\$3	\$6	\$3	\$3	\$10	\$1	\$2	\$11	\$2	\$60
Intergovernmental	\$0	\$19	\$0	\$0	\$0	\$0	\$0	\$0	\$1	\$0	\$0	\$0	\$20
Other	\$100	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$100
Total Revenues	\$137	\$117	\$108	\$298	\$191	\$41	\$54	\$86	\$41	\$33	\$88	\$36	\$1,230
Salaries and FICA	\$35	\$35	\$35	\$52	\$35	\$35	\$35	\$35	\$52	\$35	\$35	\$35	\$450
Health Insurance	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$175
Pension	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$50	\$0	\$0	\$0	\$50
Other personnel	\$5	\$5	\$1	\$3	\$0	\$5	\$0	\$0	\$3	\$3	\$3	\$6	\$35
Contracted Services	\$19	\$0	\$8	\$0	\$9	\$6	\$1	\$1	\$9	\$1	\$3	\$12	\$70
Other op exp	\$18	\$0	\$66	\$20	\$20	\$19	\$17	\$16	\$16	\$16	\$15	\$16	\$240
Debt service	\$0	\$0	\$0	\$0	\$0	\$0	\$105	\$0	\$0	\$0	\$0	\$105	\$210
Total Expenditures	\$91	\$55	\$124	\$90	\$79	\$79	\$172	\$66	\$145	\$70	\$71	\$189	\$1,230
Beginning Balance	\$200	\$246	\$308	\$292	\$500	\$612	\$574	\$456	\$476	\$372	\$336	\$353	
Ending Balance	\$246	\$308	\$292	\$500	\$612	\$574	\$456	\$476	\$372	\$336	\$353	\$200	



...then add actuals to find the variances...

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Actual	Orig	Var
Real estate tax	\$10	\$5	\$55	\$268	\$101	\$5	\$22	\$1	\$11	\$4	\$2	\$6	\$488	\$500	-\$12
Earned Income Tax	\$25	\$90	\$20	\$25	\$75	\$25	\$25	\$75	\$25	\$25	\$75	\$25	\$510	\$500	\$10
Other Taxes	\$3	\$10	\$0	\$2	\$9	\$8	\$5	\$1	\$2	\$1	\$1	\$4	\$46	\$50	-\$4
Departmental earnings	\$4	\$10	\$5	\$3	\$6	\$3	\$3	\$10	\$1	\$2	\$11	\$2	\$60	\$60	\$0
Intergovernmental	\$0	\$19	\$0	\$0	\$0	\$0	\$0	\$0	\$1	\$0	\$0	\$0	\$20	\$20	\$0
Other	\$100	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$100	\$100	\$0
Total Revenues	\$142	\$134	\$80	\$298	\$191	\$41	\$54	\$86	\$41	\$33	\$88	\$36	\$1,224	\$1,230	-\$6
Salaries and FICA	\$35	\$35	\$35	\$52	\$35	\$35	\$35	\$35	\$52	\$35	\$35	\$35	\$450	\$450	\$0
Health Insurance	\$12	\$20	\$20	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$183	\$175	-\$8
Pension	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$50	\$0	\$0	\$0	\$50	\$50	\$0
Other personnel	\$5	\$5	\$1	\$3	\$0	\$5	\$0	\$0	\$3	\$3	\$3	\$6	\$35	\$35	\$0
Contracted Services	\$15	\$15	\$8	\$0	\$9	\$6	\$1	\$1	\$9	\$1	\$3	\$12	\$81	\$70	-\$11
Other op exp	\$18	\$0	\$66	\$19	\$19	\$17	\$17	\$17	\$16	\$16	\$15	\$16	\$236	\$240	\$4
Debt service	\$0	\$0	\$0	\$0	\$0	\$0	\$105	\$0	\$0	\$0	\$0	\$105	\$210	\$210	\$0
Total Expenditures	\$85	\$75	\$130	\$88	\$77	\$77	\$172	\$67	\$145	\$70	\$71	\$189	\$1,246	\$1,230	-\$16
Beginning Balance	\$200	\$257	\$316	\$266	\$476	\$589	\$553	\$435	\$454	\$350	\$314	\$331			
Ending Balance	\$257	\$316	\$266	\$476	\$589	\$553	\$435	\$454	\$350	\$314	\$331	\$178			



...then adjust projections or performance as needed

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Actual	Org.	Var
Real estate tax	\$10	\$5	\$55	\$280	\$100	\$5	\$22	\$1	\$11	\$4	\$2	\$6	\$500	\$500	\$0
Earned Income Tax	\$25	\$90	\$20	\$25	\$75	\$25	\$25	\$75	\$25	\$25	\$75	\$25	\$510	\$500	\$10
Other Taxes	\$3	\$10	\$0	\$2	\$9	\$8	\$5	\$1	\$2	\$1	\$1	\$4	\$46	\$50	-\$4
Departmental earnings	\$4	\$10	\$5	\$3	\$6	\$3	\$3	\$10	\$1	\$2	\$11	\$2	\$60	\$60	\$0
Intergovernmental	\$0	\$19	\$0	\$0	\$0	\$0	\$0	\$0	\$1	\$0	\$0	\$0	\$20	\$20	\$0
Other	\$100	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$100	\$100	\$0
Total Revenues	\$142	\$134	\$80	\$310	\$190	\$41	\$54	\$86	\$41	\$33	\$88	\$36	\$1,235	\$1,230	\$6
Salaries and FICA	\$35	\$35	\$35	\$52	\$35	\$35	\$35	\$35	\$52	\$35	\$35	\$35	\$450	\$450	\$0
Health Insurance	\$12	\$20	\$20	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$15	\$183	\$175	-\$8
Pension	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$50	\$0	\$0	\$0	\$50	\$50	\$0
Other personnel	\$5	\$5	\$1	\$3	\$0	\$5	\$0	\$0	\$3	\$3	\$3	\$6	\$35	\$35	\$0
Contracted Services	\$15	\$15	\$8	\$0	\$6	\$3	\$1	\$1	\$9	\$1	\$3	\$12	\$75	\$70	-\$5
Other op exp	\$18	\$0	\$66	\$19	\$19	\$12	\$17	\$17	\$16	\$16	\$15	\$16	\$231	\$240	\$9
Debt service	\$0	\$0	\$0	\$0	\$0	\$0	\$105	\$0	\$0	\$0	\$0	\$105	\$210	\$210	\$0
Total Expenditures	\$85	\$75	\$130	\$88	\$74	\$69	\$172	\$67	\$145	\$70	\$71	\$189	\$1,235	\$1,230	-\$5
Beginning Balance	\$200	\$257	\$316	\$266	\$488	\$604	\$575	\$458	\$477	\$372	\$336	\$354			
Ending Balance	\$257	\$316	\$266	\$488	\$604	\$575	\$458	\$477	\$372	\$336	\$354	\$200			



Three ideas to improve your cash stability

- **Minimum fund ~~fund~~ cash balance policy**

You probably have a minimum fund balance/reserve policy (and, if not, you should). But cash is different from fund balance. Should you also have a minimum cash balance target and, if so, what is it? Is it an annual or quarterly target? What are the requirements around replenishing your balance back up to that level if you fall below it?

- **Interfund loan and transfer policy**

Consider a policy that governs your use of interfund loans (repaid within the same year) and transfers (not repaid). Your policy should address the size (individual and cumulative), reporting/approval requirements, and repayment requirements.

- **Use your TAN as a scoreboard**

Lots of Pennsylvania municipalities use Tax Anticipation Notes (TANs) or cash flow borrowings early in the year, and they use them responsibly. While it would be ideal financially to avoid using them entirely, you may need to weigh that goal against others.

If you do use a TAN, can you make it smaller? Can you repay it earlier? This was one of our strategies for measuring and driving progress for Act 47 communities because we needed a threshold for success other than “Am I still worried I’m going to run out of money this year?”



Dealing with a cash flow crisis

What if I'm already in a cashflow crisis, or I'm worried that I may be soon?

You miss a payroll, a debt payment, an IRS tax remittance, etc (Act 47 triggers)

You can't pay all your bills, so you carry some of them over into the next year

You're selling assets to cover cash flow needs

You can't pay all your bills without interrupting operations, just to make it through the year (hiring freeze, discretionary spending freeze, cancelling capital projects)

The first thing you should do is tell someone – your senior Administrator, your elected officials and the Department of Community and Economic Development – so that you get the support you need.

It is very tempting to try to solve a cash crisis on your own but that can lead to bad decisions that make the problem worse and undermine your credibility to lead later. This is a very common story for Act 47 communities.

Your municipality should prioritize achieving **basic cash flow stability** over other worthy goals – tax rate stability, funding capital projects, hiring to fill budgeted vacancies, launching new projects.

The key question is not whether these goals are good or important, but whether they are more important than sustaining vital and necessary services. Dead men can't fix problems.



Budgetary stability



Budgetary stability

We will know we have basic budgetary stability if...

- We balance expenditures against our revenues without using fund balance, carry forward or any other term for prior year reserves
- We balance our budget without large tax increases or large spending cuts (recognizing “large” is subjective)
- We balance our budget without relying on questionable assumptions, over projecting revenues, or ignoring expenditures to “make the numbers work”
- We have a balanced budget that funds operations, makes scheduled debt payments, funds our pension obligations...

We will know we have even stronger budget stability if...

- ...**and** we are investing in our capital assets or making other strategic investments (OPEB trust fund, tax stabilization fund)
- We adopt a balanced budget that funds the services our residents need and want at the price they are willing to pay through taxes and service charges, and then we execute that spending plan in a way where we finish the year with an acceptable (but not excessive) operating surplus



You might have budgetary distress if...

You're running large or repeated deficits (Act 47 triggers)

Your budget is “balanced” because you're drawing down your reserves at an unsustainable level or creating new long-term liabilities (e.g. debt refinancing to fund current operations in exchange for higher/longer debt payments, poorly constructed early retirement incentive programs)

You balanced the budget on paper by omitting or understating expenditures; inflating revenues; or making other very optimistic assumptions (big increases in collection rates; flawless execution of difficult efficiency initiatives; unrealistic pension assumptions)

You balanced the budget by doing a very large tax increase or service cuts

You balanced the operating budget but have insufficient investment in your capital assets (roads and bridges; municipal facilities, parks, vehicles, information technology)

A stressful budget does not mean it's a bad budget. A stress-free budget does not mean it's a good budget

You might need to make large, painful course corrections to address structural problems or respond to external circumstances beyond your control. There are cases where a large tax increase or service cuts is a sign of good, responsible financial management. To determine whether those actions are really “tough love,” budgetary stability should be evaluated from a structural perspective (will these actions help us balance recurring revenues against recurring expenditures).



Assessing your budgetary position

Budgets are adopted publicly on a predictable timetable, so there is likely more scrutiny and discussion of your budgetary position than your cash position. The annual audit shows year-end budgetary performance at a summary level. We recommend quarterly financial report to evaluate your performance between budget adoption and the year-end review. Financial reporting is a powerful management tool when reports are...

- **Accurate:** The data presented provides a complete, correct, and true picture of financial activity
- **Meaningful:** The right data is presented at the right level of detail with useful points of comparison to inform management decisions
- **Timely:** The data is presented soon enough that it is relevant for management to make decisions based on it.

Sample Table: Budget-to-Actual Performance

	A	B	A / B	C	A – C	(A – C) / C
	QX 2021	2021 Budget	% Collected	QX 2021	Difference (\$)	Difference (%)
Revenues	\$XXX	\$XXX	XX.X%	\$XXX	\$XXX	XX.X%
Expenditures	\$XXX	\$XXX	XX.X%	\$XXX	\$XXX	XX.X%
Difference	\$XXX	\$XXX	N/A	\$XXX	\$XXX	N/A



Budget balancing tactics: Addressing crisis...

- **Improving data quality:** There is a strong correlation between bad financial data and bad financial performance
- **Better budgeting:** Data-driven revenue projections, position-based personnel budgets
- **Purchasing controls** for operating expenditures
- **Position control** in the budgeting and hiring processes
- Wage freezes, step freezes or other measures to **moderate growth in cash compensation**
- **Reduce growth in employee benefit costs:** Health plan changes, plan redesign, employee cost sharing
- **Pension savings:** Eliminate provisions that disproportionately escalate costs (pension spiking, “ghost time”)
- **OPEB initiatives:** Change cost sharing arrangement for current employees, eliminate benefits for future employees
- **Service evaluation:** What can we stop doing? What should we stop doing?
- **Debt diet:** Prohibition on swaps and scoop-and-toss transactions; limited new issuance
- **Cost recovery:** Increasing service fees to meet or approach cost of associated services
- **Tax increases**



Budget balancing tactics: Managing toward sustainable recovery

- **Public, periodic financial reporting**
- **Consensus revenue estimating process**
- **Purchasing efficiencies:** Cooperative purchasing, centralized purchasing, competitive purchasing (using RFPs or multiple quotes)
- **Stable, predictable growth** in employee wages and benefit costs
- Targeted investments to **improve recruitment and retention** for strategic priorities
- **Funding pensions:** Fix actuarial assumptions regarding interest earnings, mortality, etc. This often leads to higher contributions in the near term in exchange for stabilizing long-term costs
- **Building a capital budget:** Inventorying and prioritizing needs, creating a balanced funding plan (pay-as-you-go and debt supported)
- **Cost recovery:** Periodic review and adjustments to service fees
- **Home rule** if not already in place to gain local control over resident earned income tax rates
- **Tax increases:** Often still necessary but they are less frequent and more incremental



Structural stability



Structural stability

We will know we have basic structural stability if...

- We are balancing our recurring expenditures with our recurring revenues
- We're consistently on the right side of this simple diagram

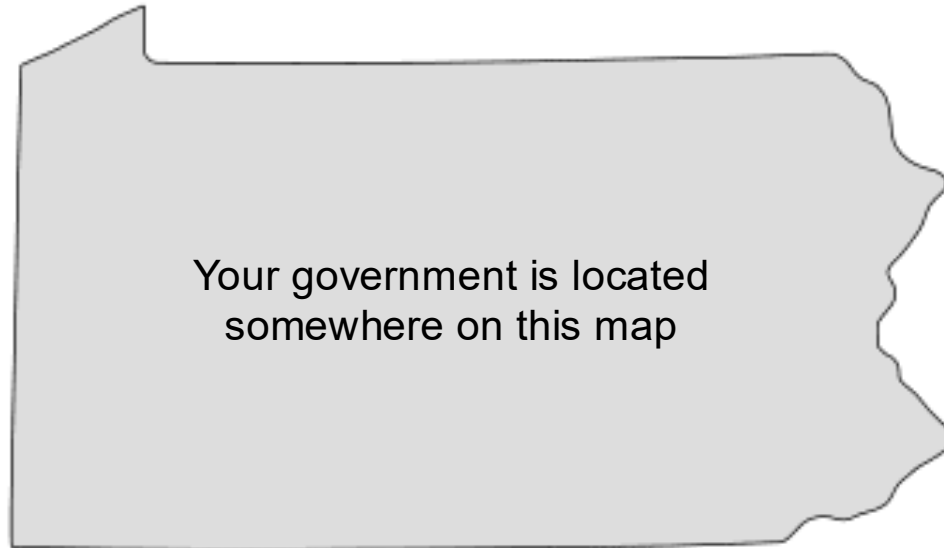
	I will use...	
	One-time revenues for...	Recurring revenues for...
One-time expenses	That makes sense.	Impressive!
Recurring expenses	Uh oh	That makes sense.

We will know we have even stronger structural stability if...

- We are responsibly funding our infrastructure, our retiree benefit obligations and our daily operations
- We (local government) play our part (whatever that is) in helping to address the community's biggest challenges, instead of focusing on our own survival



You might have structural challenges if...



Some Pennsylvania governments are doing well in this area. We have some AAA rated municipalities with well-funded pensions, capital budgets, and reserves. But most Pennsylvania local governments (and school districts and counties) have structural financial stress. They face the fundamental problem of relying to some degree on a flat revenue source (real estate tax) to fund consistently rising expenditures (e.g. wages, benefits). If you feel that structural stress, you are not alone!

You also don't have to fix that problem on your own. The GFOA has resources and DCED's Strategic Management Planning (STMP) program can help you design a well-rounded plan to deal with these challenges.



Thank you!

For more information:

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