



# Memorandum

**TO:** HONORABLE MAYOR AND  
CITY COUNCIL

**FROM:** Toni J. Taber, CMC  
City Clerk

**SUBJECT:** SEE BELOW

**DATE:** October 22, 2024

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**SUBJECT: Encumbrances Audit Report**

**Recommendation**

As recommended by the Public Safety, Finance and Strategic Support Committee on September 19, 2024, accept the report on an audit of compliance with the City's Encumbrance Policy.

CEQA: Not a Project, File No. PP17-009, Staff Reports, Assessments, Annual Reports, and Informational Memos that involve no approvals of any City action. (City Auditor)

[Public Safety, Finance and Strategic Support Committee referral 9/19/24 - Item (d)1]



**Office of the City Auditor**

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**Report to the City Council  
City of San José**

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**ENCUMBRANCES:  
DEPARTMENTS SHOULD  
REGULARLY REVIEW ALL  
ENCUMBRANCES TO  
ENSURE TIMELY  
LIQUIDATION**

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**Report 24-04  
September 2024**

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September 12, 2024

Honorable Mayor and Members  
Of the City Council  
200 East Santa Clara Street  
San José, CA 95113

**Encumbrances: Departments Should Regularly Review All Encumbrances to Ensure Timely Liquidation**

In the FY 2024-25 Proposed Operating Budget, the General Fund had \$84.5 million reserved for encumbrances, or roughly 5 percent of total General Fund uses. An additional \$133 million was reserved across the special operating funds, and further reserves were budgeted in the City's capital funds.

An encumbrance is an amount of money set aside to pay the estimated expenses for contracted goods or services. Departments establish an encumbrance when they have a purchase order for goods or a contract for professional services. Departments are expected to liquidate the encumbrance when it is no longer necessary. Upon liquidation, any remaining balance on older encumbrances is recognized as excess fund balance and would be available for any eligible uses within the respective fund. Within the General Fund, eligible uses of one-time funds would include offsetting projected budget deficits on a one-time basis, increasing reserves, funding deferred infrastructure and maintenance needs, and meeting other one-time funding needs.

The City has an Encumbrance Policy (CPM 5.1.12) that requires encumbrances to be liquidated six months after the term of the agreement ends or when the encumbrance is no longer needed by the department. Timely liquidation ensures that funds are released promptly to pay for other City needs. The objective of the audit was to review encumbrances for compliance with the City's Encumbrance Policy.

**Finding 1: City Staff Should Review Expired and Unused Encumbrances.** Data from the City's primary reporting and tracking tool for encumbrances indicates that more than a third of the roughly 3,500 encumbrances in the City's operating funds were not used within the fiscal year or related to purchase orders or contracts that have expired. We found:

- An estimated 1,300 older encumbrances may not still be necessary or are inaccurately reported. These encumbrances total up to \$30 million (including about \$13.8 million in the General Fund) and should be reviewed.

- In some cases, these may need to be liquidated, which could lead to an increase in ending fund balance within each fund. In other cases, the reported amounts are erroneous and should be corrected so department staff can properly manage them in the future.
- In a limited sample of older encumbrances totaling \$1.38 million, department staff confirmed that \$950,000 across 21 encumbrances in the operating funds should be liquidated. Additionally, five encumbrances totaling \$325,000 in the reporting tool already showed full liquidation in the financial management system. Only two encumbrances, totaling \$109,000, were still valid and accurate.

**Recommendation:** To address outdated encumbrances in the City’s financial management system, the Administration should:

- Immediately require departments to review all encumbrances to liquidate or correct as needed.

**Finding 2: Consistent Monitoring and Accurate Reporting Tools Would Facilitate the Timely Liquidation of Encumbrances.** Though the City’s Encumbrance Policy requires timely liquidations of encumbrances, some department fiscal staff were not aware of the policy and not all departments have processes in place to ensure regular monitoring. We found:

- Further guidance for department staff and requiring regular reviews of encumbrances could help ensure timely liquidation and improve overall encumbrance management.
- The primary reporting tool on encumbrances from the financial management system has inaccuracies, which can make encumbrance monitoring difficult.
- Additionally, the primary reporting tool does not include the end date for a purchase order or a contract, which would be helpful to track the status of the encumbrance.

**Recommendations:** To improve encumbrance monitoring, the Finance Department should:

- Require regular year-end reviews of encumbrances that haven’t been used recently.
- Update training for department staff about monitoring encumbrances.
- Update reporting tools to allow for streamlined monitoring.

This report has 5 recommendations. We plan to present this report at the September 19, 2024, meeting of the Public Safety, Finance, and Strategic Support Committee of the City Council. We would like to thank the Finance Department, the Information Technology Department, and the City Manager’s Budget Office for their time and insight during the audit process. The Administration has reviewed the information in this report, and their response is shown on the yellow pages.

Respectfully submitted,



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City Auditor

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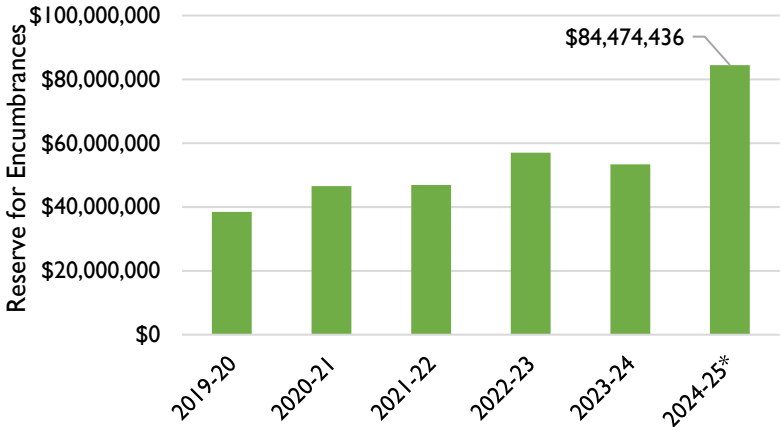
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# Background

The City’s operating budget includes reserves for encumbrances for the General Fund and for each special operating fund. In recent years, the amount budgeted for encumbrances in the General Fund has increased. Larger budgeted encumbrances highlight the need for review and monitoring by department staff.

The FY 2024-25 Proposed Operating Budget included \$84.5 million reserved for encumbrances in the General Fund, 5.2 percent of the total General Fund uses. This is higher than the reserves in FY 2023-24, which totaled \$53.4 million, or 2.5 percent of the total General Fund uses. It is more than double the reserves from FY 2019-20, which totaled \$38.5 million (also 2.5 percent of General Fund uses). A large portion of this growth is due to increased funding from the American Rescue Plan and Coronavirus Relief Fund and for homelessness-related services.<sup>1</sup>

**Exhibit I: General Fund Encumbrance Reserves Have More than Doubled Since 2019-20**



Source: Adopted Operating and Proposed Operating Budget

\*FY 2024-25 figures are proposed, not adopted. In prior years, reserves for encumbrances did not change between proposed and adopted operating budgets.

Many special funds in the operating budget also have encumbrance reserves. These range from a few thousand dollars to tens of millions of dollars. In total, the FY 2024-25 Proposed Operating Budget included \$133 million of encumbrance reserves across all the special funds. This was slightly lower than the total in FY 2023-24, which was \$138.6 million.

<sup>1</sup> Of the \$84.5 million, the City Manager’s Budget Office reports that \$20.8 million is related to funding from the American Rescue Plan (ARP) and Coronavirus Relief Fund (CRF), \$18.6 million of which was added to the General Fund at the end of FY 2022-23. Across all programs, \$26.2 million is appropriated for homelessness-related services, including Measure E and some of the ARP/CRF funding. The remaining funds are related to departmental appropriations (such as a department’s non-personal expenditures), capital funding, and other City-Wide Expenses.



Combining the special funds with the General Fund, the FY 2024-25 Proposed Operating Budget had a total of \$217.5 million in encumbrance reserves.

**What is an encumbrance?**

An encumbrance is an amount of money set aside to pay the estimated expenses for contracted goods or services. For example, a department would establish an encumbrance when they have a purchase order for goods or a contract for professional services. By establishing an encumbrance, departments ensure that they have money available to pay invoices for goods or services that they have contracted for.

An **encumbrance** is an amount of money set aside to pay the estimated expense for contracted goods or services.

Encumbrances are included in the City’s budgets and carry forward year-to-year until the money has been spent or the encumbrance is no longer needed. If there is still money in an encumbrance that the department no longer needs to pay more invoices, department staff should liquidate the encumbrance. The timely liquidation of encumbrances requires monitoring by department staff to ensure that funds are not unnecessarily tied up in future years.

Encumbrances require **monitoring** to ensure timely liquidation.

**City Encumbrance Policy**

City Policy Manual policy 5.1.12 is the Encumbrance Policy. The stated purpose of the Encumbrance Policy is “to ensure the timely liquidation of encumbrances.” It lays out several policies relating to encumbrances and then has a series of procedures. The policies state that departments and staff should:

1. *Encumber funds made available by an appropriation ordinance.*
2. *Enter all encumbrances into [the financial management system] with the term (start and end dates) of the executed contract.*
3. *Encumber the appropriate amount per the executed contract in [the financial management system].*
4. *Adjust encumbrances in accordance with executed amendments to the contract or change orders during fiscal periods one through twelve.*
5. *Liquidate an encumbrance that is no longer necessary to fulfill the purpose for which it was created or is more than six months past the contract end date except, including but not limited to, the following:*
  - a. *unpaid invoices; or*
  - b. *a request to reallocate encumbered funds to a different vendor for the same purpose or carry-over approval is under review or has been approved by the Budget Office.*

6. Liquidate current fiscal year encumbrances to the current year appropriation.
7. Liquidate prior fiscal year encumbrances to fund balance unless:
  - a. other uses for the funds consistent with the appropriation ordinance were approved by the Budget Office; or
  - b. the encumbrance is grant related with a value of \$10,000 or less and carry forward was requested by a Department Director.
8. Use a [financial management system] encumbrance account code for accrual entries.
9. Authorize the Director of Finance to liquidate encumbrances in accordance with this policy.

**Process for Handling Encumbrances**

The processes for creating, adjusting, and liquidating encumbrances are largely handled by department staff. None of these processes are automated. Department staff manually review and process the creation, adjustment, and liquidation of encumbrances. Though the Finance Department (Finance) has the authority to liquidate encumbrances without a department request, Finance reports that this does not happen in practice.

<b>Creation</b>	When a contract has been executed or a purchase order requisitioned, department staff identify whether an encumbrance should be created. Department staff may encumber all the money needed for an agreement as soon as it is executed, or only encumber part of the funds based on fiscal year spending or expected service orders. Finance staff in either Purchasing or Accounts Payable will approve the creation of the encumbrance.
<b>Adjustment</b>	After creation, an encumbrance amount may need to be adjusted. For example, a contract may have been amended, or a change order may have been issued. Adjusting an encumbrance is also the responsibility of department staff. Increases to purchase orders or changes to purchase order dates require further approval by Finance.
<b>Monitoring and Liquidation</b>	<p>Department staff are responsible for monitoring encumbrances to determine if there are remaining balances that need to be liquidated. Departments reported that this monitoring most frequently occurs at the end of the fiscal year but may happen on an ongoing basis or regularly during the fiscal year. Administrative staff may have to coordinate with program staff to understand whether an encumbrance can be liquidated.</p> <p>When an encumbrance is liquidated, the remaining money is released to be used for other purposes. If a liquidated encumbrance was created within the same fiscal year, the money returns to the appropriation that the encumbrance was in. If the encumbrance was created in a prior fiscal year, the money returns to the fund’s ending fund balance and is available in the following fiscal year for appropriation for any eligible use within the respective fund.</p>

### *Prior Effort to Liquidate Encumbrances*

In spring 2020, the Budget Office and Finance led an effort to liquidate unnecessary encumbrances. They asked department staff to liquidate any purchase orders created prior to 2018 and cancel any encumbrances relating to contracts created prior to 2011. Any exceptions to these liquidations or cancelations were subject to review by Finance and the Budget Office. Budget Office staff report that this contributed to a total \$2.4 million of liquidations for that fiscal year, which increased the fund balance of the General Fund.<sup>2</sup>

### **Data and Reliability of Information**

Encumbrances are recorded in the City's financial management system. Users can access information about encumbrances by looking up a purchase order or contract, or a vendor, directly in the system. For the City's budgets, staff set aside reserves for encumbrances based on the most recent year-end data from when the budget is being compiled. Meaning, for the FY 2024-25 budget, the data on encumbrances is as of **June 2023**. Data for a fiscal year is not finalized until December. This audit relies on **June 2024** data, but not the formal close of the fiscal year (which had not yet occurred).

Once a month, a team in the Information Technology Department (ITD) runs a report on all outstanding encumbrances. This is called the Remaining Balance Report and is a key resource for department staff in understanding their encumbrances.

However, the Remaining Balance Report is not always accurate. It sometimes includes encumbrances that have been fully liquidated. Also, the balances shown in the Remaining Balance Report do not always match to what is in the financial management system. As a result, the information included in this audit report is provided to show the scope of what should be reviewed based on the best available information as reflected in the Remaining Balance Report. It does not necessarily represent amounts that are available to increase fund balance through liquidation.

The report on encumbrance balances is not always accurate; encumbrances **should be reviewed** to determine how much can be liquidated.

Finance and ITD have worked with the system's vendor on issues relating to this report, but the work is ongoing. Further information about the Remaining Balance Report is included in Finding 2 of this report.

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<sup>2</sup> The liquidation of carry-over encumbrances is assumed as a component of the fund balance estimate each year by the Budget Office. The FY 2024-25 Proposed Operating Budget assumes the liquidation of \$1.8 million in the General Fund at the end of FY 2023-24.

# **Finding I      City Staff Should Review Expired and Unused Encumbrances**

## **Summary**

Data from the City’s primary reporting and tracking tool for encumbrances indicates that more than a third of all encumbrances in the City’s operating funds were not used within the fiscal year or relate to purchase orders or contracts that have expired. In some instances, these should be liquidated and in other cases the encumbrances are erroneously reported. Overall, we estimate that about 1,300 older encumbrances should be reviewed by departments to determine whether they need to be liquidated or corrected. When old encumbrances are liquidated, the funds fall to ending fund balance and can be used for other purposes. These encumbrances total up to \$30 million across all operating funds (including \$13.8 million in the General Fund). In a limited sample of older encumbrances totaling \$1.38 million, department staff confirmed that \$950,000 of encumbrances in the operating funds should be liquidated and \$325,000 already showed full liquidation in the financial management system. Only two, totaling \$109,000, were still valid and accurate.

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## **Around 1,300 Operating Fund Encumbrances Should be Reviewed for Potential Liquidation or Correction**

Across the General Fund and special operating funds, departments are holding encumbrances that should be reviewed for potential liquidation, which could lead to an increase in ending fund balance for those funds. Others have incorrect balances in the City’s Remaining Balance Report; in reality, there is no money available to liquidate. (See Finding 2 for more information)

Factors such as whether an encumbrance is for an expired agreement or there has been no recent activity can give a sense of whether an encumbrance needs to be reviewed. To confirm whether an encumbrance can be liquidated, departments must review each encumbrance individually. Often, department administrative staff must discuss with program staff to verify that all invoices had been paid and that the encumbrance is no longer needed. However, not all encumbrances that appear to be outdated need liquidation. Some are still in use; others may be inaccurately included in the report.

## **More Than One-Third of the Open Encumbrances in the General Fund and Special Operating Funds Should Be Reviewed**

There were 3,500 encumbrances in the General Fund and special operating funds as of June 2024, of which about 1,300 likely need some review based on several

factors as described in Exhibit 2.<sup>3</sup> Per the Remaining Balance Report, these encumbrances that warrant departments’ review total up to \$30 million, of which about \$13.8 million is within the General Fund.<sup>4</sup>

**Exhibit 2: Up to \$30 Million in Encumbrances Should Be Reviewed for Potential Liquidation or Correction Across the City’s Operating Funds (June 2024)**

Reason to Review	Context	Should be Reviewed (June 2024)	
		General Fund Only	All Operating Funds
<b>Purchase order ended 6+ months ago.</b>	44 percent of encumbrances for purchase orders were at least six months expired as of June 2024. The Encumbrance Policy states encumbrances should be liquidated six months after the contract or purchase order term ends.	362 purchase orders, \$2.8 million	619 purchase orders, \$7.3 million
<b>No recent recorded activity for the encumbrance.</b>	Some encumbrances that were established years ago had: <ul style="list-style-type: none"> <li>No recorded activity in the most recent fiscal year.</li> <li>No last activity date recorded at all.</li> </ul> 450 encumbrances, totaling \$10.1 million, had their last activity recorded in 2021 or prior.	325 contracts, \$8.4 million	525 contracts, \$19.1 million
<b>No spending of the encumbrance.</b>	Some encumbrances that were established years ago had no recorded spending. For example, one department reported that two encumbrances dating back to 2017 totaling \$290,000 were for contracts that had never been signed and needed liquidation.	76 contracts, \$2.6 million	154 contracts, \$3.5 million
<b>Total</b>		763 encumbrances, \$13.8 million	1,298 encumbrances, \$30.0 million

Source: Auditor analysis of FY 2023-24 period I3 Remaining Balance Report and financial management system report on purchase order expiration dates.

Note: As noted in the Background and further explained later in this finding, the Remaining Balance Report has some inaccuracies. All data presented are based on this report but require verification by department staff upon review of each encumbrance. In the categories of no recent usage and no spending, only encumbrances created two or more years prior were included. The data includes those encumbrances already reviewed with departments as part of this audit, including \$3 million in COVID-19 funding that had errors due to inconsistencies in tracking.

<sup>3</sup> In addition, around 150 encumbrances in the General Fund and special operating funds had negative balances in the Remaining Balance Report. This indicates an error, and those should also be reviewed for accuracy.

<sup>4</sup> The \$30 million needing review includes those encumbrances already reviewed with departments as part of this audit.

**In a Limited Sample Review of Encumbrances in the City’s Operating Funds, the Majority Needed Liquidation or Were in Error**

In a limited sample of 28 operating fund encumbrances in the Remaining Balance Report that met the criteria in Exhibit 2, only two were still valid. These totaled \$109,000, or less than 10 percent of the value of all the sampled operating encumbrances, which totaled \$1.38 million. Department staff determined that 21 of the encumbrances, totaling \$950,000, should be liquidated. In addition, five of the reported encumbrances, totaling \$325,000, had already been liquidated and had \$0 balances in the financial management system (see Finding 2 for a discussion of reporting errors).

*In a limited sample of older encumbrances, departments determined that only \$109,000 of the \$1.38 million encumbered was still valid.*

**Exhibit 3: Three Quarters of Sampled Encumbrances Needed to be Liquidated**

Result	By Fund Type		All Operating Funds
	General Fund	Special Operating Funds	
Should be Liquidated	18 encumbrances, totaling \$910,000	3 encumbrances, totaling \$40,000	21 encumbrances, totaling \$950,000
Valid	1 encumbrance, totaling \$73,000	1 encumbrance, totaling \$36,000	2 encumbrances, totaling \$109,000
Already Fully Liquidated (Reporting Error)	4 encumbrances, totaling \$211,000	1 encumbrance, totaling \$114,000	5 encumbrances, totaling \$325,000
Total	23 encumbrances, totaling \$1,194,000	5 encumbrances, totaling \$190,000	28 encumbrances, totaling \$1,384,000

Source: Auditor analysis of FY 2023-24 period II Remaining Balance Report, financial management system data, and feedback from department administrative staff. The sample only included encumbrances that were at least two years old and had not had spending within the fiscal year. Encumbrance amounts were rounded to the nearest thousand.

Notes:

- “Already Fully Liquidated (Reporting Error)” notes encumbrances that showed \$0 balances in the financial management system but still showed a balance greater than \$0 in the Remaining Balance Report. Zero balances indicate that there were actually no funds available in this encumbrance. The amounts shown for each fund are the erroneous balances included in the Remaining Balance Report.

- Two encumbrances totaling \$3 million relating to COVID-19 funding were excluded due to inconsistencies in tracking. Department staff reported that the encumbrances had been used but due to changes in accounting, that usage was not accurately reflected. The encumbrances still showed balances totaling \$3 million in the financial management system as of the time of the audit review. The appropriation balance indicates that most of the encumbrance balance was spent, but some portion may remain. Additional research is needed by department staff to understand the actual balances of these encumbrances.

Department staff reported several reasons why encumbrances were still recorded long after they were no longer necessary. In some cases, staff responsible for reviewing encumbrances had left. Staff also reported that the appropriate processes to review encumbrances had not been established, or that encumbrances were shared across departments so the ultimate responsibility to liquidate was unclear. In many cases, the amount of the encumbrance is not significant in the context of a department's overall budget. However, in the aggregate, the encumbrances can be significant. Lastly, the volume of encumbrances (more than 3,500 in the operating funds) can add to the challenge of regular monitoring.

### Liquidating Encumbrances Makes Funds Available for Other Purposes

When an encumbrance is liquidated, the money is no longer reserved to spend on that particular agreement.

If a liquidated encumbrance was created within the same fiscal year, the money returns to the appropriation that the encumbrance was in. If the encumbrance was created in a prior fiscal year, the money returns to the fund's ending fund balance.<sup>5</sup> Once it is in ending fund balance, it can then be used for any eligible use within the fund.

When an encumbrance is **liquidated**, any unneeded money returns to the original appropriation or fund to be spent on other needs.

For the General Fund, Council Policy I-18 dictates how fund balance can be used.

- a) The first increment of any General Fund "Ending Fund Balance" identified in the City Manager's Annual Report shall be allocated to offset any projected deficit for the following fiscal year, after necessary appropriation adjustment actions to re-budget funds, correct errors, or reflect updated cost information have been accounted for in the fund balance reconciliation.*
- b) After setting aside funding to address the projected deficit for the following year, the remaining funds shall be allocated for the following uses:*
  - 1. Budget Stabilization Reserve and/or Contingency Reserve.*
  - 2. Unmet/deferred infrastructure and maintenance needs.*

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<sup>5</sup> Per the City's Encumbrance Policy, two exceptions to this would be if other uses for the funds consistent with the appropriation ordinance were approved by the Budget Office or the encumbrance is grant related with a value of \$10,000 or less and carry forward was requested by a Department Director.

### 3. *Other one-time urgent funding needs.*

Particularly when faced with budget deficits, timely liquidation of encumbrances is important to ensure money is available to spend on critical one-time needs.

Because of errors in the financial management system's reporting tools used by departments, it is not clear how much will be fall to fund balance after departments review the 1,300 encumbrances identified in this audit.<sup>6</sup> Even if the amounts are in error, they still need correction so that department staff can easily identify active encumbrances to manage.

#### **Capital Funds Also Have Encumbrances That May Need to be Reviewed**

Across the City's capital funds, financial records show that over \$300 million was reserved for encumbrances for FY 2024-25. Capital projects can have long timelines and large encumbrances. Some departments, such as the Environmental Services Department, reported encumbering all the funds for a construction contract upon contract execution. This could mean that encumbrances are kept for years but are still related to ongoing work. As a result, capital funds were not included in our estimates of potentially outdated encumbrances in this finding. Encumbrances in capital funds, however, may still need to be reviewed. In our sample of six capital encumbrances, two were already fully liquidated in the financial management system (\$2.3 million total was erroneously reported) and four were still valid (\$2.1 million total).

#### **Recommendation:**

- I: To address outdated encumbrances currently held by departments, the City Administration should immediately require all departments to liquidate any encumbrances that are no longer necessary and close any fully liquidated purchase orders and contracts.**

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<sup>6</sup> The City's Proposed Operating Budget assumed that \$1.8 million of General Fund encumbrances would be liquidated for FY 2023-24. As of early August 2024, Finance reports showed that \$3.6 million of General Fund encumbrances would be liquidated. Of this, around \$336,000 was liquidated by a department shortly after being alerted to old encumbrances by our office.



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## **Finding 2      Consistent Monitoring and Accurate Reporting Tools Would Facilitate the Timely Liquidation of Encumbrances**

### **Summary**

Though the City has an Encumbrance Policy to require timely liquidations of encumbrances, some department fiscal staff were not aware of the policy and not all departments have processes in place to ensure regular monitoring. The Remaining Balance Report (the primary report on encumbrances) has inaccuracies, which makes monitoring encumbrances difficult. In some cases, the Remaining Balance Report shows balances for encumbrances that have already been fully liquidated. Additionally, the report does not have the end date for a purchase order or a contract, which would be helpful to track the status of the encumbrance.

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### **Clearer Guidance for Liquidation Processes Would Clarify Requirements for City Staff**

The City has an Encumbrance Policy, but not all department fiscal staff that process encumbrances were aware of it. Two staff in separate departments reported that they did not know the City had a policy; two other staff only reported that they had read the policy but did not report having processes to review encumbrances to liquidate balances within six months of the contract or purchase order expiration. Further guidance and a requirement for regular reviews of encumbrances could help ensure timely liquidation.

### **City Trainings Should Remind Staff of the Encumbrance Policy**

Finance discusses encumbrances at trainings provided to department fiscal and administrative staff at the end of the fiscal year. Though the training notes the requirement to liquidate encumbrances when necessary or six months after expiration, the training slides available for staff do not note that this is a policy requirement or that there exists an Encumbrance Policy. The training does include a reminder to only liquidate encumbrances once all invoices have been paid.

Because staff who process encumbrances are invited to these annual trainings, they are a good opportunity to remind staff about the Encumbrance Policy and to emphasize that timely liquidation is a policy requirement. The trainings can also remind staff that not liquidating old encumbrances can have budgetary implications of which they may not be aware.

### **The Encumbrance Policy Should Include Further Direction to Review Encumbrances**

The current City Encumbrance Policy states that it is the City policy to:

5. *Liquidate an encumbrance that is no longer necessary to fulfill the purpose for which it was created or is more than six months past the contract end date except, including but not limited to, the following:*
  - a. *unpaid invoices; or*
  - b. *a request to reallocate encumbered funds to a different vendor for the same purpose or carry-over approval is under review or has been approved by the Budget Office.*

In practice, surveyed departments most frequently reported that their primary monitoring of encumbrances took place at the end of the fiscal year.

The City of Los Angeles more clearly ties the timing of encumbrance liquidation to the fiscal year. The city's financial policy states:

*As a rule, any encumbered funds that remain unspent for a period longer than one fiscal year shall be reverted. An exception to this policy applies to encumbrances for commodities procurements, which include supplies or equipment. These encumbered funds shall revert if they remain unspent for a period longer than three years.*

The City of San Diego also has requirements tied to a fiscal year timeline. The city's council budget policy states:

*Operating departments shall only encumber funds that will be spent in the current fiscal year. Departments shall review encumbrances throughout the year and request to close all operating encumbrances prior to the end of the fiscal year.*

Like San Diego, some other jurisdictions require that staff only encumber what they expect to spend in the current fiscal year as a way to limit carryover encumbrances. The cities of Oakland and Long Beach have such policies. The County of Santa Clara Encumbrance Policy states that for non-project related purchase orders, encumbrances do not automatically roll over to the next fiscal year. Departments must work with budget staff to re-appropriate funds if needed for the new fiscal year.

By adopting a requirement that departments review all encumbrances at the end of the fiscal year with the goal to liquidate any unnecessary funds, the City would further encourage timely liquidation. This requirement would align with common department practices as well as other jurisdictions' procedures. It would also make it clear that liquidation of these encumbrances is a financial priority.

**Recommendations:**

- 2: **To further encourage regular review of encumbrances going forward, the Finance Department should update the City's Encumbrance Policy to require that, at the end of each fiscal year, departments review any encumbrance that has not had activity recorded in the fiscal year. The stated goal should be to liquidate any unneeded encumbrances and correct any inaccuracies.**
- 3: **To ensure staff have sufficient guidance in the liquidation of encumbrances, the Finance Department should:**
  - a. **Remind fiscal staff of the City's Encumbrance Policy in year-end trainings, including any new requirements regarding year-end review of encumbrances; and**
  - b. **Provide a Finance staff point of contact or general email address for department staff to ask questions about liquidations of encumbrances for purchase orders and awards of contracts.**

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**Better Reports on Encumbrances Would Allow for More Effective Monitoring**

The Remaining Balance Report from the financial management system is the tool that the City uses to understand encumbrances. However, the report has inaccuracies and lacks helpful information about term end dates.

**The Remaining Balance Report Has Inaccuracies**

The Remaining Balance Report is the only report the City has to monitor every encumbrance. The report pulls data on encumbrance balances from the financial management system. Per the system's vendor, this report does not just take a purchase order or contract outstanding balance but rather calculates the amount of funds remaining by looking at all transactions relating to the encumbrance. According to the Information Technology Department, running this report is a massive undertaking and requires 20 hours of processing to complete. One reason for this is that the report begins pulling data on open encumbrances created after January 1, 2000.

Despite all this, the report does not accurately reflect what appears in the financial management system. In some cases, this is due to staff using incorrect processes to adjust or liquidate encumbrances. In other cases, the errors appear to be due to how the Remaining Balance Report pulls information from the financial management system.

<p><b>Inaccurate balances</b></p>	<p>The encumbrance balances in the Remaining Balance Report do not always match what is in the financial management system. Per Finance and ITD staff, this can happen when department staff adjust an encumbrance through a non-standard process, or when data is entered into the wrong fiscal year. In our limited sample, about a quarter of encumbrances had inaccurate balances. Additionally, about 150 operating fund encumbrances have negative balances in the Remaining Balance Report, which are also errors.</p>
<p><b>Inclusion of cancelled encumbrances</b></p>	<p>The Remaining Balance Report should only show encumbrances that are still open. However, some encumbrances that appear cancelled in the financial management system still appear on the report. Often, these encumbrances have a \$0 balance in the financial management system but show a different balance in the report.</p>
<p><b>Missing dates</b></p>	<p>The Remaining Balance Report has a column for “Last Activity Date.” This can indicate how recently an encumbrance has been used. However, this field is sometimes blank even though an encumbrance shows activity (such as adjustments or some invoice payments).</p>

Despite its flaws, departments report that the Remaining Balance Report is a key tool and the primary source they have to understand all the encumbrances in their department. As such, it is important to ensure that the Remaining Balance Report is as accurate as possible to allow for effective monitoring.

**Budgeted Encumbrance Reserves Differ from the Remaining Balance Report**

The Remaining Balance Report provides line-item detail on encumbrances, but it is not used in the creation of the City’s budgets. Instead, the budgeted figures rely on a different report, the Appropriation Balance Report. This report shows aggregate figures for encumbrances for an appropriation rather than the line-item encumbrance detail. However, the totals from the Remaining Balance Report do not align with the Appropriation Balance Report. For June 2023, the Remaining Balance Report showed an additional \$7 million in net encumbrance balances as compared to the Appropriation Balance Report.

**The Remaining Balance Report Does Not Contain End Dates to Enable Effective Monitoring**

When a purchase order or contract expires is a key indicator of when an encumbrance may need to be liquidated. Per the Encumbrance Policy, encumbrances should be liquidated within six months of the term ending date. However, departments do not have an easy way to see the end date relating to a particular encumbrance.

In the financial management system, there is a field for an end date. This field is not used consistently for contracts. Instead, staff enter contract end date information as text into description fields, making the data hard to extract. There are reports from the financial management system that can produce end dates for each contract or purchase order if data was entered into the end date field.

No end date field appears in the Remaining Balance Report, but ITD staff report that the end date is an available field to add from the raw data. To make this field more useful, however, department staff should be instructed to enter the term end date for contracts.

Department staff reported that having a better way to monitor contract status and end dates would make monitoring encumbrances easier. Adding a date field to the Remaining Balance Report would consolidate this monitoring into one place.

**Recommendations:**

- 4: To ensure City staff are processing activity on encumbrances appropriately, the Finance Department should:**
- a. Update year-end trainings to remind staff that all encumbrance adjustments, whether for purchase orders or contracts, should follow standard procedures through use of the purchasing module; and**
  - b. Require department staff to enter contract end dates into the appropriate field in the financial management system for use in monitoring reports.**
- 5: To improve the accuracy and usefulness of reporting on encumbrances, the Finance Department should work with the City's outside vendor and the Information Technology Department to:**
- a. Develop a separate report from the financial management system that more accurately reflects encumbrance balances, or**
  - b. Update the current Remaining Balance Report by:**
    - i. Reviewing and correcting encumbrances that have inaccurate balances,**
    - ii. Resolving errors in how the report is pulling information on encumbrance balances,**
    - iii. Updating the report to include term ending dates of contracts and purchase orders, and**
    - iv. Determining an appropriate date range for the report to minimize unnecessary data processing.**



# Conclusion

The City has an Encumbrance Policy to require the timely liquidation of encumbrances. However, inconsistent monitoring has resulted in encumbrances remaining open for longer than needed. Overall, department staff should review 1,300 older operating fund encumbrances included in the primary reporting and tracking tool to determine if they need liquidation or correction. Some encumbrances relate to expired purchase orders or have not had any recent activity (or in some cases, any spending whatsoever). These encumbrances total up to \$30 million. In a limited sample, department staff confirmed that \$950,000 in older encumbrances should be liquidated and an additional \$325,000 had already been liquidated and were reported in error. Only two encumbrances, totaling \$109,000, were valid and accurate. The City Administration should require departments to review all encumbrances and liquidate as needed. Going forward, regular reviews at year-end, improved training, and more helpful reporting can facilitate departments' monitoring of encumbrances.

## RECOMMENDATIONS

### **Finding 1: City Staff Should Review Expired and Unused Encumbrances**

Recommendation #1: To address outdated encumbrances currently held by departments, the City Administration should immediately require all departments to liquidate any encumbrances that are no longer necessary and close any fully liquidated purchase orders and contracts.

### **Finding 2: Consistent Monitoring and Accurate Reporting Tools Would Facilitate the Timely Liquidation of Encumbrances**

Recommendation #2: To further encourage regular review of encumbrances going forward, the Finance Department should update the City's Encumbrance Policy to require that, at the end of each fiscal year, departments review any encumbrance that has not had activity recorded in the fiscal year. The stated goal should be to liquidate any unneeded encumbrances and correct any inaccuracies.

Recommendation #3: To ensure staff have sufficient guidance in the liquidation of encumbrances, the Finance Department should:

- a. Remind fiscal staff of the City's Encumbrance Policy in year-end trainings, including any new requirements regarding year-end review of encumbrances; and
- b. Provide a Finance staff point of contact or general email address for department staff to ask questions about liquidations of encumbrances for purchase orders and awards of contracts.



## Audit of Encumbrances

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Recommendation #4: To ensure City staff are processing activity on encumbrances appropriately, the Finance Department should:

- a. Update year-end trainings to remind staff that all encumbrance adjustments, whether for purchase orders or contracts, should follow standard procedures through use of the purchasing module; and
- b. Require department staff to enter contract end dates into the appropriate field in the financial management system for use in monitoring reports.

Recommendation #5: To improve the accuracy and usefulness of reporting on encumbrances, the Finance Department should work with the City's outside vendor and the Information Technology Department to:

- a. Develop a separate report from the financial management system that more accurately reflects encumbrance balances, or
- b. Update the current Remaining Balance Report by:
  - i. Reviewing and correcting encumbrances that have inaccurate balances,
  - ii. Resolving errors in how the report is pulling information on encumbrance balances,
  - iii. Updating the report to include term ending dates of contracts and purchase orders, and
  - iv. Determining an appropriate date range for the report to minimize unnecessary data processing

# APPENDIX A

## Audit Objective, Scope, and Methodology

The mission of the City Auditor's Office is to independently assess and report on City operations and services. The audit function is an essential element of San José's public accountability, and our audits provide the City Council, City management, and the general public with independent and objective information regarding the economy, efficiency, effectiveness, and equity of City operations and services. In accordance with the City Auditor's Fiscal Year (FY) 2024-25 Audit Work Plan, we have completed an audit of encumbrances. The audit was conducted in response to an increase in the reserves for encumbrances in the General Fund in recent years, and a request from a resident.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objective of this audit was to review encumbrances for compliance with the City's Encumbrance Policy (CPM 5.1.12). We sought to understand the relevant internal controls over encumbrance processing, and have performed the following to achieve the audit objective:

- Reviewed the City's Encumbrance Policy (City Policy Manual 5.1.12) to understand the requirements around encumbrance creation, adjustment, and liquidation.
- Analyzed the June 2023, May 2024, and June 2024 Remaining Balance Reports to assess how many encumbrances may be candidates for liquidation based on age, expiration date, and usage in alignment with the City's Encumbrance Policy.
- Compared information from the June 2023, May 2024, and June 2024 Remaining Balance Reports to the financial management system, including available reports on purchase order end dates, to assess accuracy of the information and potential for liquidation.
- Reviewed information on encumbrances from adopted operating budgets, the FY 2024-25 Proposed Operating Budget, and the June 2023 Appropriation Balance Report to understand budgets for encumbrance reserves.
- Selected a judgmental sample of 36 encumbrances across five departments to review with department staff to confirm whether the encumbrance should be liquidated and understand the history of the encumbrance and related agreement. This sample included encumbrances recorded as of May 2024 that were at least two years old and did not have recorded activity within the year. The results of this sample review cannot be extrapolated to all other encumbrances.
- Selected a separate judgmental sample of 20 encumbrances relating to contracts to research information in the City Clerk's GILES database and in the financial management system to determine contract end dates.
- Interviewed Finance and Information Technology Department staff regarding information in the Remaining Balance Report and the financial management system, as well as Finance responsibilities regarding encumbrance processing.

- Interviewed department staff on their encumbrance-related processes and their knowledge of the City's Encumbrance Policy.
- Reviewed encumbrance-related policies from other jurisdictions to determine any common practices.

We would like to thank the Finance Department, the Information Technology Department, and the City Manager's Budget Office for their time and insight during the audit process.

**TO:** JOE ROIS  
CITY AUDITOR

**FROM:** Drew Corbett

**SUBJECT:** SEE BELOW

**DATE:** September 9, 2024

Approved



Date

9/10/2024

**SUBJECT:     **RESPONSE TO THE CITY AUDITOR ON AUDIT OF  
ENCUMBRANCE: DEPARTMENTS SHOULD REGULARLY REVIEW  
ALL ENCUMBRANCES TO ENSURE TIMELY LIQUIDATION****

The Administration has reviewed the City Auditor's report titled "Encumbrance Management Audit" and agrees with the two findings and five recommendations identified in the Audit Report. The Administration's specific response to each of the City Auditor's recommendations is provided below, along with target dates for implementation.

## **BACKGROUND**

The objective of the audit was to review encumbrances for compliance with the City's Encumbrance Policy to ensure that funds no longer needed for their originally intended purpose are released and made available for future use. The Administration takes very seriously the need to carefully track spending and ensure appropriate use of public funds, and City Council policy and practice include numerous check-ins throughout the fiscal year to assess spending, including the City Manager's Annual Report, the Mid-Year Budget Review, and Bi-Monthly Financial Reports to the Public Safety, Finance and Strategic Support Committee.

From an internal control standpoint, the Finance Department oversees a wide range of complex financial transactions and administrative procedures, with total City budgeted expenditures in excess of \$6 billion. In the Annual Comprehensive Financial Report for Fiscal Year 2022-2023, the City's external financial auditors expressed an opinion that the City's financial statements for Fiscal Year 2022-2023 were fairly stated in conformity with generally accepted accounting principles in the United States. This is the most favorable conclusion and is commonly known as an "unmodified" or "clean" opinion.

The Administration appreciates the thoughtful and competent work of the City Auditor's Office. The findings from this audit provide opportunities to further improve financial accountability and help ensure that the City continues to maximize the use of its limited budgetary resources in any given fiscal year.

## **RECOMMENDATIONS AND ADMINISTRATION'S RESPONSE**

**Recommendation #1:** To address outdated encumbrances currently held by departments, the City Administration should immediately require all departments to liquidate any encumbrances that are no longer necessary and close any fully liquidated purchase orders and contracts.

**Administration Response 1:** The Administration agrees with this recommendation.

**Green** - The Finance Department has already initiated action by sending an email to each department's Administrative Officer on August 29, 2024, highlighting the urgent outstanding encumbrance items that need to be reviewed, assessed, and liquidated. Departments are required to utilize the FY2025 Period 1 close Remaining Balance Report (RBR) to identify items that are expired or unused. All departments must liquidate any unnecessary encumbrances and close out fully liquidated purchase orders and contracts accordingly.

The first batch of cleanup is targeted to be completed by September 30, 2024. However, recognizing that some departments may have a larger volume of encumbrances to address, a second round of cleanup may be required. The due date for this second round will be determined based on the results of the initial cleanup and resource capacity of each department, likely by January 2025. The result of this work effort will be included in the 2024-2025 Mid-Year Budget Review, which will be heard for City Council review and approval in mid-February 2025.

**Target Date for Completion:** February 28, 2025

**Recommendation #2:** To further encourage regular review of encumbrances going forward, the Finance Department should update the City's Encumbrance Policy to require that, at the end of each fiscal year, departments review any encumbrance that has not had activity recorded in the fiscal year. The stated goal should be to liquidate any unneeded encumbrances and correct any inaccuracies.

**Administration Response 2:** The Administration agrees with this recommendation.

**Green** - The Encumbrance Policy (CPM 5.1.12) will be updated to include a requirement for departments to review encumbrances with no recorded activity by the end of each fiscal year and liquidate or correct them as needed.

**Target Date for Completion:** May 31, 2025

**Recommendation #3:** To ensure staff have sufficient guidance in the liquidation of encumbrances, the Finance Department should:

- a. Remind fiscal staff of the City's Encumbrance Policy in year-end trainings, including any new requirements regarding year-end review of encumbrances; and
- b. Provide a Finance staff point of contact or general email address for department staff to ask questions about liquidations of encumbrances for purchase orders and awards of contracts.

**Administration Response 3a/3b:** The Administration agrees with this recommendation.

**Green - 3a:** The Finance Department will incorporate reminders about the City's Encumbrance Policy and new requirements in year-end training sessions for fiscal staff.

**Target Date for Completion 3a:** June 30, 2025

**Green - 3b.** The Finance Department will identify and communicate points of contact, along with email addresses, for staff inquiries regarding encumbrance liquidations.

**Target Date for Completion 3b:** September 30, 2024

**Recommendation #4:** To ensure City staff are processing activity on encumbrances appropriately, the Finance Department should:

- a. Update year-end trainings to remind staff that all encumbrance adjustments, whether for purchase orders or contracts, should follow standard procedures through use of the purchasing module; and
- b. Require department staff to enter contract end dates into the appropriate field in the financial management system for use in monitoring reports.

**Administration Response 4a/4b:** The Administration agrees with this recommendation.

**Green - 4a:** The Finance Department will update year-end training materials to emphasize that all encumbrance adjustments should be processed through the purchasing module following standard procedures.

**Target Date for Completion 4a:** June 30, 2025

**Green - 4b.** Finance is considering mandating the entry of an encumbrance expiration date as a required field. However, a comprehensive study involving the Information Technology Department, the City's outside vendor, and department users will be necessary before reaching a conclusion.

**Target Date for Completion 4b:** June 30, 2025

**Recommendation #5:** To improve the accuracy and usefulness of reporting on encumbrances, the Finance Department should work with the City's outside vendor and the Information Technology Department to:

- a. Develop a separate report from the financial management system that more accurately reflects encumbrance balances, or
- b. Update the current Remaining Balance Report by:
  - i. Reviewing and correcting encumbrances that have inaccurate balances,
  - ii. Resolving errors in how the report is pulling information on encumbrance balances,
  - iii. Updating the report to include term ending dates of contracts and purchase orders, and
  - iv. Determining an appropriate date range for the report to minimize unnecessary data processing.

**Administration Response 5a/5b:** The Administration agrees with this recommendation.

**Green - 5a/5b:** The Finance Department will collaborate with the Information Technology Department and the City's outside vendor to either develop a new report or enhance the current Remaining Balance Report (RBR) to ensure it accurately reflects encumbrance balances and includes necessary updates.

**Target Date for Completion 5a:** June 30, 2025

**Target Date for Completion 5b:** January 31, 2025

JOE ROIS, CITY AUDITOR

September 9, 2024

**Subject: Response to the City Auditor Report: Encumbrances**

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## CONCLUSION

The Administration appreciates the City Auditor's thorough review of the encumbrance management processes. The Administration is committed to addressing these recommendations promptly to improve financial oversight, enhance policy compliance, and ensure effective management of City funds. Progress updates will be provided to the City Auditor's Office on a semi-annual basis.

A handwritten signature in blue ink, appearing to read "Drew Corbett", is displayed within a white rectangular box.

DREW CORBETT

Interim Director of Finance

For questions, please contact Victor Lo, Deputy Director of Finance, at (408) 535-8315 or [victor.lo@sanjoseca.gov](mailto:victor.lo@sanjoseca.gov).