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Office of the City Auditor

Audit Report

**AUDIT OF CERTAIN COMPONENTS
OF FUND BALANCE**
(Report No. A09-011)

June 19, 2009

City Auditor

Craig D. Kinton

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Executive Summary

Controls over encumbrance processing, an important budgetary control, were not in place or operating effectively to ensure that all available funds were included in the beginning fund balance presented for the City Council's consideration during the Fiscal Year (FY) 2008-2009 budget deliberations.

The City does not have a formal policy for fund balance designations (General Fund). These designations establish risk reserves for emergencies, contingencies, and other future expenditures, and thereby reduce the fund balance that would otherwise be available to the City Council for appropriation. Implementation of a formal policy to outline the processes for establishing designations, including the basis for the designations, the estimation processes, and the timing, content, and frequency of the briefings to City Council would improve controls and oversight of these important management decisions.

Fiscal Year 2007 expenditures were processed and paid even though the departments did not initially establish encumbrances as required by City accounting practices. Instead, the departments established encumbrances in FY 2008 after the goods and services were received. This practice increases the risk that City management may not receive timely and accurate information needed to evaluate compliance with budgetary and legal restrictions on the use of funds.

Accounting and Reporting Definitions

Fund Balance – difference between assets and liabilities

Fund Balance Reservations – portions of fund balances that are: (a) legally segregated for a specific use; or, (b) not appropriable for expenditure because the underlying asset is not a financial resource available for current appropriation or expenditure

Fund Balance Designations – indicate tentative management plans for the future use of financial resources

Encumbrances – represent commitments related to unperformed contracts for services and undelivered goods

Source: *American Institute of Certified Public Accountants (AICPA) State and Local Governments Audit and Accounting Guide*

Recommendations Summary

We recommend the Department of Budget Management Services (BMS):

- Develop formal policies and procedures for encumbrances, including a requirement that department directors annually certify that encumbrances are still valid or otherwise ensure that the encumbrances are closed timely
- Develop a formal policy for fund balance designations that outlines the processes to establish designations, including the basis for the

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designations, the estimation processes, and the timing, content, and frequency of briefings to City Council

- Improve policies and procedures to ensure that departments cannot process and pay for goods and services without first establishing an encumbrance within the appropriate fiscal year

Management's Response Summary

Management agrees with all four of the recommendations contained within the report. These recommendations will document current practices and improve communications. Management strongly believes the City's current accounting practices and fund balance designations are sound, consistent with the City Council's Financial Management Performance Criteria, conform to Generally Accepted Accounting Principles (GAAP), and adhere to City Charter requirements. Additionally, the City's financial statements are audited each year by an independent external auditor.

For the complete management response see Appendix III.

Summary of Objectives, Scope and Methodology

The objectives of the audit were to: (1) Verify the accuracy of beginning Budget Fund Balances; and, (2) Test support for reservations and designations of fund balances.

The audit scope included certain fund balance line items as reported in the FY 2007 Comprehensive Annual Financial Report (CAFR). Specifically, we evaluated General Fund amounts reserved for encumbrances and amounts unreserved, but designated for future uses. In addition, we evaluated AMS Advantage System data for encumbrances established in or prior to FY 2007. However, certain other matters, procedures, and transactions occurring outside that period may have been reviewed to understand and verify information related to the audit period. We interviewed the Chief Financial Officer, the staff in BMS, and staff in nine other City departments. We reviewed portions of the City's budget and the CAFR for FY 2006 and 2007. We analyzed and sampled data from the AMS Advantage System for FY 2005, 2006, 2007, and 2008 as of August 2008 and as of November 2008.

AUDIT RESULTS

Overall Conclusion

Controls over encumbrance processing were not in place or operating effectively to ensure that all available funds were included in the beginning fund balance presented for the City Council's consideration during the Fiscal Year (FY) 2008-2009 budget deliberations. In addition, the City does not have a formal policy for fund balance designations (General Fund) which establish risk reserves for emergencies, contingencies, and other future expenditures. Furthermore, FY 2007 expenditures were processed and paid even though the departments did not initially establish encumbrances as required by City accounting practices. This increases the risk that City management may not receive timely and accurate information needed to evaluate compliance with budgetary and legal restrictions on the use of funds.

Develop Formal Policies and Procedures for Encumbrances and Require Department Directors to Certify Encumbrance Validity Annually or Ensure Encumbrances Are Closed Timely

The City does not have formal policies and procedures for monitoring encumbrances. Encumbrances are accounting entries that are an important budgetary control used to ensure that departments have sufficient funds available before obligating the City to pay for goods or contracted services.

\$36 million Operating Funds

Operating Funds, or **single-year funds**, include the General Fund and Enterprise funds (Dallas Water Utilities, Convention and Event Services, Aviation, and non-major enterprise funds, including the Municipal Radio and Building Inspection).

\$20.7 million of \$36 million (or 58 percent) of the operating fund encumbrances established in or prior to FY 2007 had not been used as of August 8, 2008. Approximately \$16.2 million of these encumbrances were originally established in or prior to FY 2005 and 2006.

When such encumbrances are allowed to remain open for long periods of time, previously granted budget authority remains in effect. In addition, encumbrances that are not timely closed reduce the fund balance that would otherwise be available for future appropriation and also results in an overstatement of the reservation of fund balance reported in the City's Comprehensive Annual Financial Report (CAFR).

Budget Management Services (BMS) stated that department directors are periodically notified and asked to review outstanding encumbrances to ensure that encumbrances are still valid; however, there is no formal policy and department directors are not required to certify encumbrance validity annually. In

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contrast, the Texas State Comptroller of Public Accounts in Accounting Policy Statement, *Encumbrance Report and Lapsing of Appropriations* (APS 018) requires state agencies to report binding encumbrances within 60 days following fiscal year end and include a signed certification or the encumbrances are closed.

The audit results described below indicate that departments could improve the monitoring of encumbrances to ensure continued validity or that encumbrances are closed timely. The following is a summary of audit procedures performed for encumbrances, including confirmations, data analysis, sample tests, and the associated results:

Confirmations

The City Auditor's Office sent confirmation requests to 30 departments managing General Funds and five departments managing Enterprise Funds. Fifteen departments did not respond to the request. Only eight departments provided complete responses. Therefore, additional audit procedures were performed as discussed below.

Data Analysis

The City Auditor's Office obtained AMS Advantage System data for all General Fund and Enterprise Fund encumbrances reported in the FY 2007 Comprehensive Annual Financial Report (CAFR) that were still open as of August 8, 2008. During the audit, BMS instructed departments to review and close encumbrances that were no longer valid. We verified that within three months, \$15.3 million or 43 percent of the \$36 million in Operating Fund encumbrances, open as of August 8, 2008, were closed as follows:

- \$9.9 million General Fund (5,370 encumbrances)
- \$5.4 million Enterprise Fund (1,699 encumbrances)

Sample Testing

The City Auditor's Office tested a sample of 76 General Fund and Enterprise Fund encumbrances totaling approximately \$4 million which was selected from ten City departments. The sample population included encumbrances established in or prior to FY 2005 through FY 2007 that were still open as of September 30, 2007. Sample testing indicated that:

- Thirty-nine of the 76 encumbrances sampled (or approximately 51 percent) indicated no payment activity had occurred since the encumbrances were originally established; One administrative

encumbrance established in FY 2005 totaling \$2.5 million comprised the majority of the approximately \$4 million sampled

- Seventy-three of the 76 encumbrances (or approximately 96 percent) had been outstanding for a year or more

Recommendation

We recommend BMS:

- Develop formal policies and procedures for encumbrances. These policies and procedures should include, at a minimum, monitoring requirements, guidance on how to close encumbrances, and year-end procedures for both BMS and City departments.
- Require department directors to certify the validity of encumbrances annually or otherwise ensure that the encumbrances are closed timely.

Management's Response

Agree. Management agrees with the recommendation to commit to writing the current practice of an (at least) annual departmental review of encumbrances. For many years, BMS has led efforts to review encumbrances to ensure only valid encumbrances are reflected in the City's audited financial statements. Historically, the review was conducted efficiently with the assistance of a computer program that identified potential aged encumbrances and following review and, when appropriate, deleted them automatically. Following implementation of the new financial system in October 2005, the computer program did not interface with the new system. For two years, the review and deletion of encumbrances was accomplished through a very manual, labor-intensive effort. In 2008, a new computer program was completed and (once again) the review and deletion process is accomplished in a very efficient manner.

Auditor Follow-Up Comment

The City Auditor's Office commends management for the improvements made to provide an efficient process for departments to monitor encumbrance validity and release funds no longer required to meet obligations. In addition to documenting current practice, we continue to encourage management to include policy and procedure guidance for year-end review procedures that include BMS oversight of departments' decisions to retain spending authority.

Develop a Formal Policy for Fund Balance Designations

The City does not have a formal policy for fund balance designations (General Fund). These designations establish risk reserves for emergencies, contingencies, and other future expenditures. As such, designations have a direct impact on the amount of fund balance that is available to the Council for appropriation.

A formal policy would outline processes to demonstrate the:

- Basis for the designations
- Estimation processes
- Timing, content, and frequency of briefings to City Council

Designated Fund Balance

“Represents management’s intended future use of resources and generally should reflect actual plans approved by the Government’s senior management. “

“It is recommended that the appropriate policy-setting body within a government establish a formal policy on the level of unreserved fund balance to be maintained in the General Fund”.

Source: *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*

The annual budget document and the CAFR are presented and discussed with the City Council annually; however, the presentations do not necessarily provide City Council the opportunity to hear and discuss the fund balance designations.

According to management, the current designations were established at various times between 1990 and 2007 with City Council approval. Management also stated that the written policy and procedures governing the designations are Generally Accepted Accounting Principles (GAAP) and the City’s Financial Management Performance Criteria (FMPC). However, unlike a formal policy, GAAP and the FMPC do not outline processes to demonstrate the basis for the designations, the estimation processes, and the timing, content, and frequency of briefings to City Council.

GAAP provides guidance on how the City accounts for and reports designations of fund balance. The FMPC, an appendix in the City’s Annual Budget document, summarizes the purpose, performance criteria, and fund levels for the Emergency Reserves, Contingency Reserves, and the Risk Reserves which totaled \$23.3 million for FY 2007. The FMPC, however, did not include information for the Future Expenditures, Cultural Program, the 911 Program, and the TU Rate Case reserves which totaled \$22.5 million at the end of FY 2007.

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Table I shows the designations and amounts shown in the most recent audited CAFR for FY 2007.

Table I

General Fund Designations as of September 30, 2007

| Designations | Balance (in thousands) | Date Established | Authorization | Written Policy & Procedure (Per Management) |
|-----------------------------|-----------------------------------|-----------------------------|-----------------------------|--|
| Cultural Program | \$ 1,410 | 1984 | CR 84-3118 | GAAP |
| 9-1-1 Program | 4,850 | 1988 | Ordinance # 19860 | GAAP |
| TU Rate Case Reserve | 15,052 | 1993 | Ordinance # 21665 | GAAP |
| Future Expenditures | 1,162 | Each fiscal year-end | Management e-mail / memo | GAAP |
| Risk Reserve | 1,250 | Not Provided | Not Provided | FMPC / GAAP |
| Emergencies | 18,263 | Not Provided | Not Provided | FMPC / GAAP |
| Contingencies | 3,772 | Not Provided | Not Provided | FMPC / GAAP |
| Totals | \$ 45,759 | | | |

Source: FY 2007 CAFR, FY 2007 Financial Management Performance Criteria, and interviews with City Management.

Recommendation

We recommend BMS develop a formal policy for fund balance designations that outlines the processes to demonstrate the basis for the designations, the estimation processes, and the timing, content, and frequency of briefings to City Council.

Management’s Response

Agree. Management agrees with the recommendation to develop a formal policy regarding briefing fund balance designations to the Council’s Finance, Audit and Accountability Committee. The process to designate fund balances will remain in compliance with the Council-adopted Financial Management Performance Criteria (FMPC) and continue to be guided by Generally Accepted Accounting Principles (GAAP).

According to Generally Accepted Accounting Principles (GAAP), “Designations represent management’s intended future use of resources (e.g., contingencies, equipment replacement) and generally should reflect actual plans approved by the government’s senior management. Designations essentially reflect a government’s *self-imposed* limitations on the use of otherwise available current financial resources.” [Source: Chapter 3, *Classification and Terminology, 2005 Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*]. The designations established by the City and reflected in annual financial statements are in accordance with GAAP and subject to the annual review of the City’s external auditor.

Develop Policies and Procedures to Ensure That Departments Comply With City Accounting Practices Established for Budgetary Control

Approximately \$4.6 million in FY 2007 expenditures were processed and paid even though the departments did not initially establish encumbrances as required by City accounting practices. Instead, the departments established encumbrances in FY 2008 after the goods and services were received. Because of this control weakness, City management may not receive timely and accurate information needed to evaluate compliance with budgetary and legal restrictions on the use of funds.

Encumbrance Accounting

City accounting practices require departments to establish an encumbrance when a purchase order, Master Agreement purchase, Service contract, or contract are executed to reserve appropriations for commitments for the expenditure of funds. This accounting practice, known as encumbrance accounting, is designed as a budgetary control.

Encumbrance accounting is a budgetary control used to demonstrate management's compliance with budgetary and legal restrictions on the use of funds; however, this budgetary control is not effective when City departments order goods and services without first establishing an encumbrance.

The AMS Advantage System includes a control that prevents a department from establishing an encumbrance for a prior fiscal year. In addition, the AMS Advantage System automatically records expenditures for the previous fiscal year when invoices which are dated prior to fiscal year end are processed. If a department failed to appropriately establish an encumbrance in the prior fiscal year, however, the AMS Advantage System allows the department to set up and process payments against current year encumbrances. As a result, BMS and the departments need policies and procedures to improve controls over encumbrances to ensure that departments establish an encumbrance before or within a reasonable timeframe after ordering goods or contracting for services.

Recommendation

We recommend BMS work with the departments to develop policies and procedures that help ensure that departments cannot process and pay for goods or services without first establishing an encumbrance within the appropriate fiscal year.

Management's Response

Agree. Management agrees and Business Development and Procurement

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Services will revise Administrative Directive 4-5 to clarify and include a requirement that departments establish an encumbrance of funds in the financial system when orders are placed.

It should be noted there are practices and procedures in place to ensure the expenses related to purchases are recorded within the appropriate fiscal year. Accounts Payable staff ensures payments are made to the correct fiscal year by reviewing invoices. A second review of all invoices over \$50,000 is performed in the Financial Reporting Division of the City Controller's Office to further ensure accuracy of the City's financial statements.

Background, Objectives, Scope and Methodology

Background

City of Dallas Budget

The City's budget is a financial tool that establishes the Dallas City Council's spending priorities. The budget establishes appropriation authority and sets limits on annual expenditures. The annual budget covers a fiscal year from October 1 to September 30 of the subsequent year.

Fund Balance¹

Governmental funds report the difference between their assets and liabilities as fund balance, which is divided into reserved and unreserved portions. The function of reserved fund balance is to isolate the portion of fund balance that is not available for the following period's budget, so that unreserved fund balance can serve as a measure of current available financial resources.

- Reserved fund balance – Reservation of fund balance is necessary to specify:
 - Resources not available for spending
 - Legal restrictions on spending
- Unreserved fund balance – Unreserved fund balance may be subdivided into designated and undesignated portions as follows:
 - Designated Fund Balance – reflects a government's self-imposed limitation on the use of otherwise available current financial resources
 - Undesignated Fund Balance – represents amounts available for appropriations

Encumbrance accounting

Encumbrance accounting, under which purchase orders, contracts, and other commitments for the expenditure of monies are recorded in order to reserve that

¹ Source: Chapter 3, Classification and Terminology, 2005 Governmental Accounting, Auditing, and Financial Reporting (GAAFR)

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portion of the applicable appropriation, is utilized as an extension of formal budgetary integration in the governmental funds. For budgetary purposes, appropriations lapse at fiscal year end except that portion related to encumbered amounts. For Governmental Funds, outstanding encumbrances are reported as reservations of fund balances and do not constitute expenditures or liabilities for Generally Accepted Accounting Principles (GAAP) purposes since the goods and services have not been received and the commitments will be honored during the subsequent year.

Objectives, Scope and Methodology

The objectives of the audit were to: (1) Verify the accuracy of beginning Budget Fund Balances; and, (2) Test support for reservations and designations of fund balances.

The audit scope included certain fund balance line items as reported in the Fiscal Year (FY) 2007 Comprehensive Annual Financial Report (CAFR). Specifically, we evaluated General Fund amounts reserved for encumbrances and amounts unreserved, but designated for future uses. In addition, we evaluated AMS Advantage System data for encumbrances established in or prior to FY 2007. However, certain other matters, procedures, and transactions occurring outside that period may have been reviewed to understand and verify information related to the audit period. We also interviewed the Chief Financial Officer, staff in the Department of Budget Management Services, and staff in nine other City departments. We reviewed portions of the City's budget and the CAFR for FY 2006 and 2007. We analyzed and sampled data from the AMS Advantage System for FY 2005, 2006, 2007 and 2008 as of August 2008 and as of November 2008.

We conducted this audit under the authority of the City Charter, Chapter IX, Section 3 and 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.

Major Contributors to This Report

Carol Smith, CPA, CIA, CFE, Assistant City Auditor
Theresa Hampden, CPA, Assistant City Auditor
Reisha Hall
Kevin Hannigan, CIA
Kimeca Jackson
Thandee Kywe
Tony Sivasothy, CPA
Jing Xiao, CPA

Management's Response

RECEIVED

Memorandum

JUN 15 2009

CITY AUDITOR'S OFFICE



DATE: June 13, 2009
TO: Craig D. Kinton, City Auditor
SUBJECT: Response to Audit Report: Audit of Certain Components of Fund Balance

Management appreciates the opportunity to respond to the draft audit report and certain assertions contained within the subject report and respectfully requests the following be included as "Management's Response Summary" in the final audit report:

Management's Response Summary

Management agrees with all four of the recommendations contained within the report. These recommendations will document current practices and improve communications. Management strongly believes the City's current accounting practices and fund balance designations are sound, consistent with the City Council's Financial Management Performance Criteria, conform to Generally Accepted Accounting Principles (GAAP), and adhere to City Charter requirements. Additionally, the City's financial statements are audited each year by an independent external auditor.

Responses to the individual audit report recommendations are as follows:

Recommendation:

We recommend BMS:

- Develop formal policies and procedures for encumbrances. These policies and procedures should include, at a minimum, monitoring requirements, guidance on how to close encumbrances, and year-end procedures for both BMS and City departments.
- Require department directors to certify the validity of encumbrances annually or otherwise ensure that the encumbrances are closed timely.

Management Response

Management agrees with the recommendation to commit to writing the current practice of an (at least) annual departmental review of encumbrances. For many years, BMS has led efforts to review encumbrances to ensure only valid

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encumbrances are reflected in the City's audited financial statements. Historically, the review was conducted efficiently with the assistance of a computer program that identified potential aged encumbrances and following review and when appropriate, deleted them automatically. Following implementation of the new financial system in October 2005, the computer program didn't interface with the new system. For two years, the review and deletion of encumbrances was accomplished through a very manual, labor-intensive effort. In 2008, a new computer program was completed and (once again) the review and deletion process is accomplished in a very efficient manner.

Recommendation:

We recommend BMS develop a formal policy for fund balance designations that outlines the processes to demonstrate the basis for the designations, the estimation processes, and the timing, content, and frequency of briefings to the City Council.

Management Response

Management agrees with the recommendation to develop a formal policy regarding briefing fund balance designations to the Council's Finance, Audit and Accountability Committee. The process to designate fund balances will remain in compliance with the Council-adopted Financial Management Performance Criteria (FMPC) and continue to be guided by Generally Accepted Accounting Principles (GAAP).

According to Generally Accepted Accounting Principles (GAAP), "Designations represent management's intended future use of resources (e.g., contingencies, equipment replacement) and generally should reflect actual plans approved by the government's senior management. Designations essentially reflect a government's *self-imposed* limitations on the use of otherwise available current financial resources." [Source: Chapter 3, *Classification and Terminology*, 2005 *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*]. The designations established by the City and reflected in annual financial statements are in accordance with GAAP and subject to the annual review of the City's external auditor.

Recommendation:

We recommend BMS work with the departments to develop policies and procedures that help ensure that departments cannot process and pay for goods and services without first establishing an encumbrance within the appropriate fiscal year.

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Management Response

Management agrees and Business Development and Procurement Services will revise Administrative Directive 4-5 to clarify and include a requirement that departments establish an encumbrance of funds in the financial system when orders are placed.

It should be noted; there are practices and procedures in place to ensure the expenses related to purchases are recorded within the appropriate fiscal year. Accounts Payable staff ensures payments are made to the correct fiscal year by reviewing invoices. A second review of all invoices over \$50,000 is performed in the Financial Reporting Division of the City Controllers Office to further ensure accuracy of the City's financial statements.



David Cook
Chief Financial Officer

C: Mary K. Suhm, City Manager
Ade Williams, Director of Business Development and Procurement Services
Edward Scott, City Controller
Jeanne Chipperfield, Director of Budget and Management Services

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