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May 19, 2006

Assignment 10117

To: Distribution List

Subject: Internal Audit Report - Year-End Expense Accruals and Encumbrance Rollovers

We have completed an audit of the Year-End Expense Accruals and Encumbrance Rollovers. We conducted the audit during September through October 2005 covering fiscal year 2005.

We thank all the County departments, particularly the Controller-Treasurer Department, Santa Clara Valley Health and Hospital System, and Social Services Agency for their cooperation. Their assistance contributed significantly to the successful completion of the audit.

Respectfully submitted,

(Signatures on file)

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# COUNTY OF SANTA CLARA

CONTROLLER-TREASURER DEPARTMENT - INTERNAL AUDIT DIVISION

## **Internal Audit Report Year-End Expense Accruals & Encumbrance Rollovers**



Assignment 10117  
May 19, 2006

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## Executive Summary

**Conclusion** Based upon the results of our testing, no findings were noted for the two-way match non-project type encumbrances. The Controller-Treasurer Department improved the Encumbrance Policy over the last two years to take advantage of the preventive controls that were configured into the original SAP implementation. The revised Encumbrance Policy includes built in controls in SAP to prevent or place limitations on rollovers of non-project type purchase orders. In addition, Internal Audit conducted encumbrance reviews in fiscal years 2003 and 2004. The new policy streamlined the encumbrance rollover process resulting in the substantial decrease of the encumbrance rollovers for two-way match non-project type from \$58,699,679 (5,395 line items) in FY 2004 to \$2,323,905 (41 line items) in FY 2005. See Attachment A.

The departments did not use FY 2005 year-end expense accruals to unilaterally move money from one fiscal year to the next without Board approval. The accruals were based on services provided in the prior year and were either partially or completely paid in the following fiscal year within 60 days. However, the audit revealed an excess of \$1,358,073 in expenses that were recorded through the year-end accrual process. See finding 1.

The Controller-Treasurer Department is in agreement with all our findings and recommendations contained in this report. The Santa Clara Valley Health and Hospital System (SCVHHS) states that FY 2005 expense accruals resulted in net under accruals, after over and under accruals were netted. The under accruals identified by SCVHHS, which Internal Audit verified, were not part of our audit scope; they were either not recorded in FY 2005 or were not fully paid by the completion of our fieldwork. With the exception of this issue, SCVHHS agrees with our findings and will work with the Controller-Treasurer Department to facilitate the analysis of year-end accruals.

Details are provided below.

**Audit Background** We conducted a countywide review of year-end expense accruals and encumbrance rollovers as part of our FY 2006 audit work plan. This audit is the result of Internal Audit's annual macro-risk assessment. We conducted our audit in accordance with the Professional Practices Framework established by the Institute of Internal Auditors.

**Audit Objective** The objectives of the audit were to determine whether year-end expense accruals and encumbrance rollovers were used to unilaterally move funds from one fiscal year to the next without Board approval.

**Audit Scope** The scope of the audit included:

- Determining whether two-way match non-project type encumbrances were rolled over in accordance with County policies.
- Testing whether two-way match and non-match expense accruals were paid

- within 60 days after year-end.
- Determining whether excess accrued expenses were properly resolved. The scope included only FY 2005 expense accruals that have been fully paid during our fieldwork period.

Since the audit objectives were to determine whether year-end expense accruals and encumbrance rollovers were used to unilaterally move funds from one fiscal year to the next without Board approval, the scope of our audit did not include determining the accuracy of the accruals. If the audit objective was to determine the accuracy of accruals, the audit program would have included testing to identify under accruals, accruals that were not recorded, and accruals not paid as of completion of fieldwork.

(Signatures on file)

David G. Elledge  
Controller-Treasurer

Bill Perrone, CIA  
Supervising Internal Auditor

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## Findings and Recommendations

### **Finding 1                      The County overaccrued \$1,358,073 in expenses.**

The County records an accrual at year-end for expenses that have been incurred prior to June 30 but the invoice has not been received by the year-end cut off date. At the beginning of the next fiscal year, the prior year expense accrual is reversed leaving a negative expense amount to offset payments to be made for the prior year's expense. It is expected that the payment will be the same or very close to the amount accrued in the prior year so that there is no or very little negative expense amount that can be used for current fiscal year expenses. Overaccruing expenses at year-end creates additional funds to spend in the next fiscal year. The accrual should be a good faith estimate of costs incurred and should be promptly paid in the next fiscal year. Funds carried over to the next fiscal year, through an accrual, but no longer needed to pay for prior year expenses should be reversed or liquidated depending on when the over accrual is detected. Our review included only expenses that were recorded and have been fully paid during our testing period. For expenses that were not fully paid, we were unable to determine whether there were over or under accruals. In addition, our scope did not include determining the accuracy of the accruals, which would include identifying under accruals, unrecorded accruals, and accruals not paid as of completion of fieldwork. The objectives of the audit were to determine whether year-end expense accruals and encumbrance rollovers were used to unilaterally move funds from one fiscal year to the next without Board approval. The County's expense accruals totaled \$38,659,264 in FY 2005. For FY 2005, our testing indicated an excess of \$1,358,073 (Attachment B) of accrued expenses over actual expenses.

There are no formal monitoring activities performed by the Controller-Treasurer Department to ensure that over accruals of expenses are properly resolved. However, the department has established a report to identify two-way match year-end accruals and subsequent invoices posted against those accruals. Although payment information is available, there is currently no method to tie accruals recorded as non-match via journal entry to the payment since those accruals are not linked to a vendor. Internal control improvements are needed to prevent funds from the prior year to be carried over and used in the next year without Board approval.

Upon being notified of the \$1,358,073 in over accruals, the Controller-Treasurer Department immediately reversed \$516,898 of the excess accrued expenses from FY 2005 to prevent these funds from being spent in the next fiscal year without Board approval. However, it was unable to reverse the remaining \$841,175 of the over accruals since they were discovered after the completion of the County's Comprehensive Annual

Financial Report (CAFR). Thus the Controller-Treasurer removed the remaining amount from the FY 06 budget by returning \$401,255 to the General Fund and \$439,920 to the Enterprise Fund retained earnings.

In the case of the SCVHHS \$841,175 of over accruals were identified. One of the items was a \$347,952 Santa Clara Valley Medical Center three-way match accrual recorded in SAP, the County's financial system, as a journal entry. All items paid in SAP that interface from SCVHHS's Pathways Materials Management System (PMM) post to SAP as non-match items. It was included in the testing because it posted to SAP as a non-match. SCVHHS states that the FY 2005 expense accrual process resulted in net under accruals (after netting over and under accruals). The under accruals identified by SCVHHS, which Internal Audit verified, were not part of our audit scope; they were either not recorded in FY 2005 or were not fully paid by the completion of our fieldwork.

**Recommendation 1.1** The Controller-Treasurer Department should resolve any remaining issues resulting from the \$1,358,073 over accruals, including coordinating with SCVHHS changes to the year-end accrual process that facilitate accrual analysis. [Priority 1]

**Recommendation 1.2** The Controller-Treasurer Department should establish formal procedures and use the "Year-End Report of Activities for Two-Way Matched Accrued Invoices" it developed to monitor year-end accruals to ensure that subsequent payments are prompt and that over accruals are properly resolved. [Priority 1]

**Recommendation 1.3** To minimize the recording of accruals via journal entry, the Controller-Treasurer Department should develop a methodology and policy to have the departments accrue non-match invoices via estimated invoice. If journal entries must be used to accrue non-match invoices, then the Controller-Treasurer Department should work with the ASAP project team to develop a mechanism to efficiently track and monitor subsequent payments for non-match invoices accrued via journal entry. [Priority 1]

**Finding 2** **Timely Board approval was not obtained for the automatic rollover of project related encumbrances.**

Board approval is required for the rollover of budgetary appropriation balances for all encumbrances relating to capital projects, grant projects, or one-time funded multi-year projects. To avoid interruption of services, the budgetary appropriation balances for project related encumbrances were automatically rolled over from FY 2005 to the next fiscal year. However, the Encumbrance Policy states that the "Controller-Treasurer Department and the Office of Budget and

Analysis will subsequently seek the Board's approval for reappropriation of those encumbrances to the next fiscal year". This was done in January 2006 but should have been done as soon as possible after fiscal year-end. FY 2005 was the first year in which budgetary appropriation balances for project related encumbrances were automatically rolled over to the next fiscal year and procedures have not yet been established to seek subsequent Board approval. Seeking subsequent Board approval should be done to comply with the Encumbrance Policy and also to ensure that the Board is aware of changes to previously approved appropriations.

**Recommendation 2** The Controller-Treasurer Department should ensure that future requests for Board approval of the automatic rollover of project related encumbrances occur as soon as possible after the fiscal year-end. [Priority 2]

**Finding 3** **Year-end accruals are not always recorded in accordance with the written year-end training instructions.**

In FY 2005, approximately \$11.7 million was accrued as two-way match and approximately \$27 million as non-match. During the FY 2005 year-end training, departments were instructed to accrue two-way match invoices (i.e. Board Contracts and Service Agreements) via estimated invoice and non-match invoices (i.e. direct pay, petty cash, and employee reimbursements) via a journal entry. Approximately 53% of the non-matched items tested were two-way match invoices that should have been accrued via estimated invoice but were recorded via journal entry by the SCVHHS. SCVHHS states that its volume, completion of its year-end accrual analysis, and calculation of amounts due to subcontractors do not permit entry of all accruals via estimated invoice by the Controller-Treasurer Department cut-off date. SCVHHS states that it processes 12,000 invoices for the month of June. In addition, according to SCVHHS many contracts are based on patient care and units of service and vary from month to month, and require analysis and calculation by Finance and other SCVHHS staff before accruals can be entered. SCVHHS's practice has been to end its estimated invoice process before the Controller-Treasurer Department's deadline and use journal entry accruals to complete its process after additional analysis. SCVHHS states that this results in more accurate accruals and fewer journal entries and audit adjustments after the Controller-Treasurer Department's deadline.

The monitoring of year-end accruals by the Controller-Treasurer Department can be conducted significantly more efficiently if two-way match items are accrued via estimated invoice, as subsequent payments can be tracked back to the accrual. Currently, there is no efficient method in place to track subsequent payment for accruals recorded via

journal entry. In addition, there are no formal written policies and procedures requiring that all two-way matches be accrued via estimated invoice.

**Recommendation 3.1** The Controller-Treasurer Department should develop comprehensive written policies and procedures over expense accruals to clearly communicate the department's expectations regarding the recording and subsequent payment of expense accruals. The written policies and procedures should be in the established Controller-Treasurer Department format and placed on the intranet. These policies and procedures should address, at a minimum, the following [Priority 2]:

- Require that all two-way match and non-match invoices be accrued via estimated invoice. Departments that are unable to comply should notify and provide justification to the Controller-Treasurer Department for resolution.
- Require payment of year-end accruals within 45 days. Departments unable to meet this payment timeline should notify and provide justification to the Controller-Treasurer Department for resolution. Payment of invoices within this timeframe will allow the Controller-Treasurer Department adequate time to monitor overaccrued expenses and take appropriate actions in an efficient manner. If the excess accrued expense was discovered prior to the completion of the CAFR, the Controller-Treasurer Department can simply process a journal entry to reverse the accrual; otherwise, it will have to work with OBA to reduce the budget by the excess accrued amount from the next fiscal year.

**Recommendation 3.2** The Controller-Treasurer Department should work with SCVHHS to facilitate accruing all non-match and two-way match items as estimated invoice. [Priority 2].

**Exhibit A**  
**Encumbrance Rollover Comparison For Two-Way Match**

<b><u>Fiscal Year</u></b>	<b><u>Amount</u></b>	<b><u>Line Items</u></b>
2003	\$56,978,051	1,559
2004	\$58,699,679	5,395
2005	\$2,323,905	41

**Attachment B**  
**FY 2005 Overaccrued Expenses**

Department/Agency	Overaccrued Expenses	Vendor Name	Status of Overaccrued Expenses
Health & Hospital System	\$145,654.64	SJ Care & Guidance Center	Recommend reduction of FY 06 budget
Health & Hospital System	\$151,666.73	7th Avenue Center	Recommend reduction of FY 06 budget
Health & Hospital System	347,952.27	Medtronic	Recommend reduction of FY 06 budget
Health & Hospital System	91,967.91	Various [1]	Recommend reduction of FY 06 budget
Health & Hospital System	74,652.00	Various [2]	Recommend reduction of FY 06 budget
Health & Hospital System	29,281.40	Various [3]	Recommend reduction of FY 06 budget
Agri Resource Mgmt	29,072.49	Longs	Resolved by Controller-Treasurer Department
Social Services Agency	\$59,483.00	City of San Jose	Resolved by Controller-Treasurer Department
Social Services Agency	\$328,342.09	State of California	Resolved by Controller-Treasurer Department
Social Services Agency	<u>100,000.00</u>	State of California	Resolved by Controller-Treasurer Department
<b>TOTAL</b>	<b><u>\$1,358,072.53</u></b>		

LEGEND

[1] The overaccrued expense consists of the following:

PO #	Vendor #	Amount
4300001676	Cross Country	\$17,692.00
4300001680	GE Medical Sys	\$12,861.24
4300001923	Medstaff Inc.	\$21,916.19
4300002200	Stanford	\$13,561.48
4400000042	Vine Hill Media	\$25,937.00
Total		<u>\$91,967.91</u>

[2] The overaccrued expense consists of the following:

PO #	Vendor #	Amount
4300002292	Ocadian Care	\$59,152.00
4400001533-20	Aimee Reedy	\$15,500.00
Total		<u>\$74,652.00</u>

[3] The overaccrued expense consist of the following:

PO #	Vendor #	Amount
4300001976	Braswell	\$11,384.40
4400001288	Seneca Center	\$17,897.00
Total		<u>\$29,281.40</u>

# County of Santa Clara

Finance Agency

Controller-Treasurer Department



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April 19, 2006

TO: David G. Elledge, Controller-Treasurer

FROM: Vinod Sharma, Accounting Division Manager  
Leshia Luu, Disbursement Division Manager  
Irene Lui, Property Tax Manager  
David Indra, ASAP Production Support Manager

SUBJECT: Response to Internal Audit's Report—Review of Year-End Expense Accruals and Encumbrance Rollovers

This memo outlines the Controller-Treasurer Department's response to recommendations included in the Internal Audit Division's report on the review of the County's process for the year-end expense accrual and encumbrance rollover for the fiscal year 2005. It also provides our work plan for implementing those recommendations.

### Management Action 1.1

We have already implemented the recommendation by removing the FY2006 budget of the General Fund departments identified in the report. The budget for the Santa Clara Valley Health and Hospital System (SCVHHS) Enterprise Fund was not adjusted, as any adjustment to its budget will revert the funds back to its retained earnings only. The funds will remain with the Enterprise and not benefit the General Fund. We have also developed a report to help monitor the status of year-end accruals more effectively.

### Management Action 1.2

The Controller-Treasurer Department's ASAP Project Team has developed a report that will allow us to monitor Countywide year-end accruals more effectively. We will start utilizing this report to review the year-end accruals for FY2006. This will include routine monitoring of all year-end accruals, subsequent payments posted against those accruals, and review and resolution of any over accruals noted.

### Management Action 1.3

We agree with the recommendation, and have already developed a methodology with the ASAP Project Team. We have incorporated this methodology in the FY2006 year-end training materials to have the departments accrue non-match invoices via estimated invoice rather than journal entry. The policy on the new method was communicated to the department fiscal officers in March 2006. We have also included this policy in our fiscal year-end training material to be provided to departments in June 2006. The ASAP

Project Team is developing a report which will allow us to track accruals and monitor subsequent payments for any expense accruals via journal entry. The report will be available for use when the fiscal year-end approaches.

Management Action 2

We concur with the recommendation, and have included this task in our fiscal year-end calendar of events. We implemented a new encumbrance policy in FY2005, which has effectively streamlined the encumbrance rollover process and reduced the number of rollover line items from 5,395 in FY2004 to only 41 lines in FY2005. However, the rollover request was inadvertently not included in the year-end cleanup transmittal sent to the Board in September 2005. We have updated our year-end calendar of events to ensure that we will seek the Board's approval for encumbrance rollover as part of the year-end cleanup transmittal submitted to the Board in August/September annually.

Management Action 3.1

We agree with the recommendation. We have already communicated the requirements to the department fiscal officers in March 2005. Further, the fiscal year-end training to departments also includes information on the new requirements. The fiscal year-end training will be provided to departments in June 2006.

Management Action 3.2

We agree with the recommendation, and the ASAP Project team has already developed an automated method that will allow SCVHHS to accrue all items as estimated invoice for the FY 2006 year-end expense accrual process.