

5-0400.00 ENCUMBRANCES

NOTE: OPI encourages, but does not require, the use of encumbrance accounting. Montana schools may choose to: (1) Not record encumbrances, (2) Record encumbrances only at June 30, or (3) Record encumbrances continually during the year (i.e. encumber each purchase order).

5-0410.00 PURPOSE OF ENCUMBRANCE ACCOUNTING

Since budgets are the legal authority to spend money, it is important for school administrators to have accurate, up-to-date information on the status of budget balances at any given time. To have an accurate idea of the situation, knowing the amount spent to date is not enough. Districts must also know the amount committed to avoid overspending budgeted funds.

5-0410.10 DEFINITIONS

“Encumbrances” are commitments related to unperformed, legally binding contracts for the purchase of goods or construction in progress. Used in budgeting, encumbrances are not GAAP expenditures or liabilities, but represent the estimated amount of expenditures ultimately to result if unperformed contracts/purchase orders in process are completed. See section 5-0410.40, “VALID OBLIGATION CRITERIA.”

“Encumbrance accounting” is used to set aside adequate spending authority to pay outstanding encumbrances. Encumbrance accounting is not complicated. In its simplest form, it means that when a purchase order is prepared, the budget balance in the appropriate account is checked to ensure that budget authority is available to spend. If the budget balance in the fund is adequate, the amount of the order is charged (“encumbered”), reducing the available budget balance. This entry reduces spending authority in the account to cover the order. When the invoice arrives and is paid, the encumbered amount is reversed and the amount of the invoice is recorded as an expenditure. At any point in time, the available budget balance in the account equals the appropriation (budgeted amount) less total expenditures and encumbrances.

Because encumbrance accounting is used to set aside spending authority for obligations when a budget will lapse on a certain date, **encumbrances are not needed in nonbudgeted funds, except to record obligations for grant funding on an award which lapses on a certain date.** If budget authority or grant spending authority carries into the next fiscal year, the district may chose not to record encumbrances. When the item is paid for in the next year, the expenditure would be recorded as a normal cash expenditure and charged to the budget of the current year.

Expenditure Budget vs. Actual Report
For the Accounting Period: 6/0X

Program-Function-Object	Committed Current Month	Encumbered YTD	Expended YTD	Current Appropriation	Available Appropriation	% Committed
101 Elementary General Fund						
100 Instructional Programs						
2213 Instructional Staff Development Services						
150 Stipends	100.00	0.00	3,544.02	5,800.00	2,255.98	61%
320 Prof-Ed. Ser	6,488.18	0.00	6,646.18	23,103.89	16,487.71	28%
340 Tech Serv	0.00	0.00	0.00	2,500.00	2,500.00	0%
582 Travel Out-Distr	5,013.49	2,214.00	13,951.15	14,592.00	-1,573.16	110%
610 Supplies	0.00	0.00	997.30	6,233.11	5,235.81	16%
640 Books	0.00	0.00	228.80	2,500.00	2,271.20	9%
810 Profess Dues	0.00	0.00	159.00	7,700.00	7,541.00	2%
Function Total:	11,601.67	2,214.00	25,526.45	62,429.00	34,688.55	16%

5-0410.20 REPORTING EXPENDITURES--BUDGETARY AND GAAP BASIS

Montana law allows school districts to report encumbrances for construction in progress and personal property as expenditures for budgetary purposes (20-9-209, MCA). As a result, expenditures may be reported on the "GAAP basis" and on the "Budgetary basis."

For "**GAAP basis**" reporting purposes, an encumbrance is not considered an expenditure or a liability until the goods or services are received. As a result, "GAAP basis" expenditures include only cash expenditures and accrued expenditures. "GAAP basis" reporting is usually done only in the audit report.

For "**Budgetary basis**" reporting purposes, encumbrances are reported as expenditures and as a fund balance Reserve for Encumbrances rather than a liability. As a result, "Budgetary basis" expenditures include cash expenditures, accrued expenditures, and encumbrances. The Trustees' Financial Summary (TFS) is prepared on the budgetary basis.

5-0410.30 LIST OF YEAR-END ENCUMBRANCES AND ACCRUALS

The district should develop a list showing the detail and amount of accrued expenditures and encumbrances by fund.

5-0410.40 VALID OBLIGATION CRITERIA

As provided by 20-6-209, MCA, the district may encumber current year appropriations (budget) for valid obligations at June 30 if the encumbrance meets one of the following criteria: (ARM 10.10.101)

- a. The costs of personal property, including materials, supplies, and equipment, ordered but not received may be encumbered if a valid purchase order was issued prior to June 30;
- b. The cost of commitments related to construction in progress may be encumbered if a legally binding contract was signed and effective or a valid purchase order was issued prior to June 30. If the contract is complete or virtually complete, the entire cost of the contract should be accrued.

NOTE: The criteria above **do not include contracts for services** other than construction. Districts which do not use a formal purchase order system during the year should use written purchase orders at year-end to properly document the validity of encumbrances for personal property items.

Purchase Orders

Purchase orders used to encumber the costs of goods at June 30 must be complete as to the items being purchased, show the price, be signed by the board-authorized purchasing officer and must be delivered or mailed to the vendor by June 30. OPI suggests that the board of trustees should set a reasonable purchase order cut-off date so that all orders may be processed in time to be encumbered by June 30. Copies of purchase orders must be retained as support documentation for encumbrances.

Clearing Prior Year Encumbrances

At year-end, a review should be made of all outstanding encumbrances to determine if they are still valid. Encumbrances for goods reported on the prior year's Trustees' Financial Summary must be liquidated (cleared) before June 30 of the current year. However, encumbrances related to construction contracts are not required to be cleared until the contract is completed or the contract is no longer valid. Journal entries for reversing encumbrances which are no longer valid are shown in section 5-0420.20, "LIQUIDATION OF OUTSTANDING ENCUMBRANCES."

5-0420.00 RECORDING ENCUMBRANCES

OPI recommends schools maintain their accounts on the budgetary basis during the year for budgetary control and annual budgetary reporting (i.e., Trustees' Financial Summary) purposes. Schools should adjust the amounts on the year-end closing workpapers to the GAAP basis to report GAAP basis expenditures on financial statements presented in accordance with GAAP for the audit report. Auditors may do this on behalf of the school district, but school districts should understand adjustments.

The following examples show journal entries to record encumbrances on a budgetary basis.

To record an encumbrance during the year or at fiscal year-end: For example, assume the district has issued a purchase order for \$1,500 of supplies but has not received the goods by June 30.

Debit: 803	Encumbrances	\$1,500
Credit: 953	Reserve for Encumbrances	\$1,500

(To record an encumbrance for a purchase order, contract, etc. The debit to Encumbrances above would be posted in the encumbrance field or column in the Expenditures Subsidiary Ledger to reduce the unencumbered budget balance.)

At fiscal year-end, to record outstanding encumbrances as expenditures: The encumbrances charged to expenditures must meet criteria 5-0410.40, "VALID OBLIGATION CRITERIA."

Debit: 802	Expenditures	\$1,500
Credit: 803	Encumbrances	\$1,500
Encumbrances Subsidiary Ledger		
XXX-XXX-XXXX-610	Supplies	\$1,500

(To charge unliquidated encumbrances as expenditures.)

The Reserve for Encumbrances account, which remains on the books after closing and shows the amount of unliquidated encumbrances, will be reported on the Balance Sheet as a fund balance reserve.

When the encumbrance is paid in the next fiscal year:

Debit: 953	Reserve for Encumbrances	\$1,500
Credit: 620 or 101	Warrants Payable or Cash	\$1,500

(To record a payment for an obligation which was encumbered for budgetary purposes in the prior year. The amount debited to the reserve must be the amount originally encumbered.)

5-0420.10 DIFFERENCES BETWEEN ENCUMBRANCE AND INVOICE AMOUNTS

Encumbrances are often recorded based on estimates of the cost of goods or services being purchased. Therefore, when an invoice is received in the current fiscal year for items encumbered in the prior year, it might be slightly greater or less than the amount originally encumbered. The accounting procedure for recording the payment of the encumbrance depends on the relative size of the difference between the amount encumbered and the amount paid.

Immaterial, or small, differences are to be charged to a current expenditure account or credited to the miscellaneous revenues account in the year of payment.

If differences are significant or material adjustments to expenditures or revenues, GAAP require special accounting treatment. As a general rule, the district should consider the difference between the amount encumbered and the invoice amount "material" if it is 5% or more of the anticipated ending fund balance of the affected fund. Consult your auditor or OPI for help in determining whether a difference should be considered material. **Material differences** are to be charged to expenditure object 892 Prior Period Expenditure Adjustments or credited to 6100 Prior Period Revenue Adjustments in the year of payment. Adjustments to these accounts are shown as adjustments to the beginning fund balance on the Trustees' Financial Summary and GAAP financial statements. They are not included in current revenues and expenditures. Adjustments recorded in object 892 must fall within the total budget of the affected fund.

To record the payment for an encumbrance for which the invoice price is slightly higher than the amount encumbered: Charge the current expenditure account for the difference. For example, assume the district encumbered \$100 for equipment and the invoice received in the next year totalled \$105 including freight.

Debit: 953	Reserve for Encumbrances	\$100
Debit: 802	Expenditures	\$5
Credit: 620 or 101	Warrants Payable or Cash	\$105
Expenditures Subsidiary Ledger		
XXX-XXX-XXXX-XXX	Any appropriate object	\$5

(To record payment for equipment encumbered in the previous year for which the invoice slightly exceeds the original encumbrance amount.)

To record the payment for an encumbrance for which the invoice price is slightly less than the amount encumbered: Credit the current Revenue account for the difference. For example, assume the \$100 encumbrance was invoiced at \$95.

Debit: 953	Reserve for Encumbrances	\$100
Credit: 402	Revenues	\$5
Credit: 620 or 101	Warrants Payable or Cash	\$95
Revenues Subsidiary Ledger		
XXX-1900	Other/Miscellaneous Revenue	\$5

(To record payment for equipment encumbered in the previous year for which the invoice was lower than the original encumbrance amount.)

5-0420.10 DIFFERENCES BETWEEN ENCUMBRANCE AND INVOICE AMOUNTS (Cont'd)

To record the payment for an encumbrance for which the invoice cost is materially greater than the amount encumbered: For example, assume the district encumbered a purchase order for \$400 for textbooks. The invoice cost is actually \$40,000. The obligation was under encumbered in error. The excess expenditure must be charged to the current year's budget.

Debit: 802	Expenditures	\$39,600
Debit: 953	Reserve for Encumbrances	\$ 400
Credit: 620 or 101	Warrants Payable or Cash	\$40,000
Expenditures Subsidiary Ledger		
XXX-XXX-XXXX-640	Textbooks	\$39,600

(To record the payment for an encumbrance for which the invoice significantly exceeds the encumbered amount. The debit to the reserve is the amount originally encumbered. The credit to warrants payable or cash is the invoice amount.)

To record the payment for an encumbrance for which the invoice cost is materially less than the amount encumbered: For example, assume the district encumbered a \$30,000 purchase order for desks which have not been received by June 30. The vendor can only supply part of the order. The invoice is for \$300.

Debit: 953	Reserve for Encumbrances	\$30,000
Credit: 402	Revenue	\$29,700
Credit: 620 or 101	Warrants Payable or Cash	\$ 300
Revenue Subsidiary Ledger		
XXX-6100	Material Prior Period Revenue Adjustments	\$29,700

(To record the payment of an encumbrance for which the invoice cost is materially lower than the encumbered amount.)

5-0420.20 LIQUIDATION OF OUTSTANDING ENCUMBRANCES

Prior year encumbrances must be liquidated by June 30 of the following year.

To reverse immaterial prior year encumbrances which are outstanding but are no longer valid:

For example, assume the district encumbered a purchase order for \$1,500 at the previous fiscal year-end. The vendor went out of business and the order will not be filled. The amount is not considered material to the fund's balance.

Debit: 953	Reserve for Encumbrances	\$1,500
Credit: 402	Revenues	\$1,500
Revenue Subsidiary Ledger		
XXX-1900	Other/Miscellaneous Revenue	\$1,500

(To reverse an immaterial prior year encumbrance which is no longer considered valid.)

To reverse material prior year encumbrances which are outstanding but are no longer valid:

Assume the district encumbered \$200,000 at the previous fiscal year-end for a construction contract to repair the roof. The repair is accomplished for only \$150,000. The unliquidated encumbrance must be removed from the books.

Debit: 953	Reserve for Encumbrances	\$200,000
Credit: 620 or 101	Warrants Payable or Cash	\$150,000
Credit: 402	Revenues	\$ 50,000
Revenue Subsidiary Ledger		
XXX-6100	Material Prior Period Revenue Adjustments	\$ 50,000

(To reverse a material prior year encumbrance which is no longer considered valid. The entire amount encumbered is removed from the books, the cash payment is recorded, and the excess is recorded as a prior period revenue adjustment. The balance of the 6100 account is shown on the Trustees' Financial Summary as an adjustment to beginning fund balance and is not included in current revenue.)