



INTERNAL AUDIT

Inventory Controls for Water and Sanitary Sewer Line Repairs Audit Follow-up

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**March 9, 2015
Report 201530**

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Authorization

The City Auditor has conducted follow-up audit of Inventory Controls for Water and Sanitary Sewer Line Repairs. This audit was conducted under the authority of Resolution #2013-51 and in accordance with the Annual Audit Plan approved by the League City, City Council in Resolution #2014-27.

Objective

This is a follow-up of the "Inventory Controls for Water and Sanitary Sewer Line Repairs" report issued on March 25, 2014. The objective was to determine if previous audit recommendations were implemented.

The objective of the original audit was to determine if accountability exists for the inventory assets.

Scope and Methodology

The City Auditor conducted this audit in accordance with Generally Accepted Government Auditing Standards except this audit function has not had an external peer review. Those standards require planning and performing the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. The City Auditor believes that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

In order to determine if previous recommendations were implemented, I:

- Visited the Line Repair department to observe their inventory
- Examined their book inventory
- Inquired with the superintendent about their current procedures
- Took test counts on items in their inventory

The scope of the audit follow-up was for the current time period.

To assess the reliability of the data elements needed to answer the engagement objective, I sampled 15 inventory items which I counted and compared to the book inventory.

Overall Conclusion

The implementation results are as follows:

Fully Implemented	Partially Implemented	Not Implemented	No Follow-up Needed
3	5	1	1

Audit Follow-up

This follow-up audit was not intended to be a detailed study of every relevant system, procedure, and transaction. Accordingly, the Follow-up section presented in this report may not be all-inclusive of areas where improvement might be needed.

The following results for each finding are as follows:

- 1) The audit found no one who is accountable for the Line Repair inventory. This is an important item in the entire internal control framework. None of these opportunities for improvement are possible without someone accountable.

Recommendation: Suggest that someone be designated as Inventory Control Coordinator.

Management Response: I agree.

Action Plan: A job description will need to be created and funding will need to be made available through the budget process.

Implementation: Possible implementation date is 10/14. A supervisor could be assigned these duties until the position is filled.

Deputy City Manager Response: Line Repair inventory is managed informally with a single point of inventory management over each sub-department: Line Repair, meter shop, and small tools and equipment.

Recommended action: Improve controls by adding fencing, shelving, cameras, key and access control to the various locations where inventory is stored. This will be a budgeted item in FY 2015.

Follow-up:

Line Repair has pulled one of the supervisors and works on inventory issues (Purchasing, Placing, Recording, and Counting) on a part-time basis. While this is an improvement, control issues still remain such as the following:

- Employees with custody of and access to inventory should not perform physical inventory counts, modify inventory records and reconcile the physical inventory counts to the book inventory records

Additionally, this supervisor cannot adequately cover his supervisory responsibilities along with his work on the inventory.

Implementation:

Partially Implemented. Compensating Controls need to be put in place such as the following:

- Have two employees count the inventory
- Have an employee who does not have day-to-day responsibility for maintaining the physical inventory or inventory record-keeping and reconciliation responsibilities count the inventory
- Have the superintendent review and approve all modifications of the inventory records or review a summary report of all modifications on a monthly basis

Staff Response February 15, 2015: We will adjust our procedures to have two employees count the inventory, one of those will be an employee not responsible for maintenance of the inventory. The Superintendent will review and approve all modifications of the inventory records or review a summary report of all modifications on a monthly basis.

- 2) Organizing the inventory is the first step. Currently, the inventory is located in different sections of the warehouse and outside the warehouse. While observing a sample inventory count the auditor observed some difficulty in staff finding the entire inventory for specific items. Additionally, in some cases there are no markings in the storage area notating where the specific inventory item is stored. Also, three other departments have storage and access to the warehouse and a couple telephone poles were found outside by the Line Repair area. Line repair inventory needs the whole warehouse. This also does not provide for safeguarding of assets particularly brass parts. (Reference Pictures 1,2,3,4)

Recommendation: Organize the inventory for efficiency of picking the inventory and knowing where the entire inventory is located.

Management Response: I agree.

Action Plan: A supervisor will be assigned to organize the inventory to prepare for counting.

Implementation: Estimated completion date is 04/01/14.

Deputy City Manager Response: Concur with above. May necessitate the segregation with fencing, shelving and the construction of a mezzanine at line repair to fully implement. If so, a portion of this will come forward as a budget request in FY 2015.

Follow-up:

The inventory inside the warehouse is very well organized. (Reference Follow-up Picture Number 1 and 2)

The external inventory still needs work. A labeling system is needed to quickly identify the inventory items. (Reference Follow-up Picture Number 3)

During the sample count it was found that the Meter Technician inventory was commingled with the Line Repair department's inventory. The Meter Technician inventory belongs to the Utility Billing Department.

Implementation:

Partially Implemented. The Utility Billing Department manager has been notified of the commingling and will be taking corrective action.

Staff Response February 15, 2015: Signs are being added to the exterior inventory. The meter technicians use to be a part of the line repair department. Since the last Audit, they have been separated to be a part of Utility Billing and there inventory is being relocated to a separated secured area.

- 3) In order to detect Fraud, Waste and Abuse it is necessary to know what your inventory amount (both in numbers and dollars are). This consists of having both a book inventory and physical inventory for comparisons.

Recommendation: After the organization (Step 1 above) is completed, a complete physical count of all items should be made. This will constitute the beginning balance.

Management Response: I agree.

Action Plan: The supervisor assigned to organize will oversee the counting of inventory.

Implementation: Estimated completion date is 06/01/14.

Deputy City Manager Response: In addition to the book inventory it will take an integrated inventory/work order control process to implement. While we have a general understanding of the inventory, we will complete an inventory of the various assets and assess what level of controls are appropriate for the level of risk. If we desire to move forward with a formal inventory control/work order system, I recommend starting with vehicle maintenance.

Follow-up:

A complete physical inventory was taken at end of fiscal year. The department uses the bid tabulation sheet as a facilitator for the book inventory. They show the beginning inventory, used and ending inventory for each item in inventory. However, there is no evidence of investigating discrepancies that may occur.

During the follow-up a 15 item inventory sample was taken. Four of those items were Meter Technician inventory and Line Repair is no longer handling the management of those items. Of the remaining 11 items, six items did not reconcile with the book inventory. Four of those items the book inventory showed more than the physical count and the other two items the physical inventory was greater than the book inventory.

An Excel spreadsheet is used as a tabulation of all inventory activity. Before it makes it to the Excel spreadsheet a manual binder is used for all issuances of inventory. A supervisor may forget to log an issuance.

Implementation:

Fully Implemented for the Recommendation. However, there is room for improvement to provide a more accurate inventory count. A work order system is needed.

Staff Response February 15, 2015. This is the completion of the first year of maintaining the inventory count. There is clearly room for improvement. Both Line Repair and the Meter Technicians are working to improve the accuracy of the inventory. A work order system will help. Line Repair is going to try using the Street Department work order system to help improve accuracy.

- 4) As stated previously, recordkeeping for inventory is very important. It must consist of beginning balance, purchases, issuances and ending balances. To facilitate the tracking of these numbers efficiency could be made with a computer information system. It has been ascertained that the current accounting system (AS400) has the capability to account for inventory. Training could be received by staff. It also has been found that the new accounting system will also have an inventory module. Since timing of the purchase

becomes an issue; perhaps in the interim, a simple Excel spreadsheet could be used until the more sophisticated system can be used.

Recommendation: Once the physical inventory balances are input, recordkeeping for the inventories should commence. Suggest an Excel spreadsheet be used until the new accounting system is in place.

Management Response: I agree.

Action Plan: The spreadsheet that was used during the bid process has been modified to allow for keeping count and to determine the value of inventory items.

Implementation: Completed

Deputy City Manager Response: Concur with above. However, to close the loop we will need to develop work order reporting to account for inventory consumed from the inventory.

Follow-up:

A complete physical inventory was taken at end of fiscal year. The department uses the bid tabulation sheet as a facilitator for the book inventory. They show the beginning inventory, used and ending inventory for each item in inventory. What are missing are the dates, amounts purchased and used or issued in layered form for each accounting period. Without this information it would be difficult to determine the origin of any irregularity or fraud or analysis of the inventory. Large variances should be investigated.

Implementation:

Partially Implemented. *Expand the book inventory to include the beginning inventory add purchases subtract issues to get ending (current) inventory. Dates are also an important piece of information to log.*

Staff Response February 15, 2015: *Staff will adjust the inventory records to include the above recommendations.*

- 5) The audit found no entries in the Comprehensive Annual Financial Statements regarding the inventory in Line Repair. The full disclosure principle of accounting is violated because inventory is a current asset and must be reflected in the books and records of the city.

Recommendation: Once the above first steps are completed, Line Repair communicates to the Finance department the value of the inventory.

Management Response: I agree.

Action Plan: Once the inventory items have been counted and entered into the spreadsheet, the value of the inventory will be communicated to the Finance Dept.

Implementation: Estimated completion date is 07/01/14

Deputy City Manager Response: Concur with the response. We will need to develop a process to account for inventory consumed through maintenance activities.

Follow-up:

According to the Chief Financial Officer the FY2014 Comprehensive Annual Financial Report will include the Line Repair Inventory of \$190,364.53.

Implementation:

Fully Implemented

- 6) Access to the inventory should be controlled access only. It was observed that a fenced in area could be climbed and access gained. Additionally, other departments have access to the building. In one section of the warehouse that housed brass parts access was unimpeded. (Reference Picture 5)

Recommendation: To enhance the safeguarding of the inventory assets, all access points should be card controlled. This eliminates the accounting for all employees that might have keys. It is much more efficient and effective to simply deactivate a card than to collect keys from an employee. Ensure that fences completely protect the inventory assets.

Management Response: I agree.

Action Plan: This will need to be a group effort between the Facilities, IT, and Line Repair Departments. Funding will need to be available prior to implementation. Brass items stored in this area have been relocated to the chain link cage which is kept locked.

Implementation: Unknown completion date.

Deputy City Manager response: We need to segregate and secure inventory for each department or sub department. Depending on the level of risk, we will improve the controls by adding fencing, shelving, cameras, card readers and access control to the various locations where inventory is stored. We will limit access to crew leader and above and provide additional levels of access to

inventory to respond to emergencies. Each department needs to evaluate their areas and develop a budget and action plan to add fencing, card readers, and cameras as necessary in the coming year.

Follow-up:

Interior Inventory area is card controlled. (Reference Follow-up Picture Number 4) Additionally, an exterior door that several other departments use to gain access to the building is card controlled. (Reference Follow-up Picture Number 5)

Additionally, only four supervisors and the superintendent have access to the inventory area. The warehouse inventory is all fenced in.

Implementation:

Fully Implemented

- 7) Segregation of duties is not present in the Line Repair department. Segregation of duties means no one person is in complete control of a transaction from beginning to end. It typically means that the authorization, recordkeeping, custody and reconciliation be done by different individuals. If this is not possible then mitigating controls must be in place such as supervisory reviews. Particularly concerning was the fact that supervisors and crews can pick their own inventory for their jobs. Consequently, excess inventory could be picked and sold to a third party.

Recommendation: Suggest that someone be designated as Inventory Control Coordinator to provide for segregation of duties over the picking of inventory.

Management Response: I agree.

Action Plan: See response #1

Deputy City Manager response: If we determine we want to fully segregate activities it is recommend we move towards a central warehouse concept where inventory is maintained by purchasing. This may necessitate an evaluation of work space to determine how to warehouse in the existing facilities.

Follow-up:

Department now has a part-time inventory coordinator and only the four supervisors and superintendent have access picking the inventory. See finding#1 for additional comments.

Implementation:

Partially Implemented.

Staff Response February 15, 2015: We will adjust our procedures to have two employees count the inventory, one of those will be an employee not responsible for maintenance of the inventory. The Superintendent will review and approve all modifications of the inventory records or review a summary report of all modifications on a monthly basis.

- 8) What applies to the material inventory also should apply to the small tools inventory. The small tools inventory is kept in a separate room in the front part of the warehouse. The door can remain open at times to allow crews to pick up their radios. Towards the back of this room various small tools are visible such as shovels. The remaining small tools such as reflective vests, goggles, and bug spray are kept in locked closets. One closet was unlocked upon the auditor's visit. Some of these small tools can be used at the home. Therefore, it is important to track this inventory. (Reference Picture 6 and 7)

Recommendation: Suggest that someone be designated as Inventory Control Coordinator to be accountable for the small tools inventory.

Management Response: I agree.

Action Plan: See response #1

Deputy City Manager response: Concur. We need to improve the controls associated with small tools and supplies.

Follow-up:

Small tools are now behind a locked door and in locked cabinets. (Reference Follow-up Picture Number 7) Some of the tools are housed behind the card controlled inventory area. (Reference Follow-up Picture Number 6) No inventory is kept on the small tools.

Implementation:

Partially Implemented.

Staff Response February 15, 2015 Staff will add small tools to the inventory.

- 9) The department had video cameras to monitor the movement of personnel and parts; however, they were not all functional. Poor lighting and dirty lenses

contributed to this situation. Additionally, the manager did not have access to view the camera video in real-time.

The IT director corrected this situation during the audit.

Deputy City Manager response: We need to add cameras and access control/card readers to selected locations.

Follow-up:

Not Needed.

10) There were no policies and procedures found regarding the ordering, picking, recording, and storage of inventory.

Recommendation: Develop policies and procedures regarding inventory and have all employees read them and certify they have read them.

Management Response: I agree.

Action Plan: Once the previous items are addressed, written policies and procedure will be developed and employees will be required to read and sign off on them.

Implementation: 10/01/14

Deputy City Manager response: Inventories need to be maintained at levels appropriate to respond the variety of situations that arise. Sometimes that necessitates keeping limited use parts to address emergencies. A designated employee should be assigned to maintaining the inventories in assigned areas. Material should be kept in areas appropriate to protect them from environmental and storage damage.

Follow-up:

No policies or procedures were found

Implementation:

Not Implemented

Staff Response February 15, 2015 Line Repair Staff is committed to putting policies and procedures into a written form. A draft will be completed for review by March 15, 2015

Deputy City Manager Response to the Line Repair Audit April 21, 2014

There are a number of findings in the Line Repair audit that are reflective throughout the operating departments (line repair, water production, sewer treatment, streets and drainage, vehicle maintenance, traffic operations and parks operations) within the League City organization and should be addressed systematically in lieu of department by department.

It is important that the levels of controls are consistent with the level of risk. As part of the City's executive team we want to be sure there are no unintended consequences moving forward. Today the inventories are loosely managed by the various operating departments and inventories are resupplied on an as needed basis. There is limited, if any, formalized detailed inventory maintained. Many of the inventories are stored in various city facilities with limited security or oversight.

We are in agreement that the systems and controls need to be enhanced, but recommend a measured approach in moving forward that could include, but not be limited to, the following:

1. Formalize the people that are responsible for maintaining the various inventories in each department and/or sub department. Completion date May 15, 2014
2. Segregate and secure inventory for each department or sub department. i.e. provide a secured area for line repair, meter shop, and small tools and equipment. Where possible, Limit formal access to controlled inventory to crew leaders and above and provide access to inventory for emergency needs (after hours and weekend responders). Enhance the control of scrap materials (metals) by keeping the materials secured. Completion date: May 31, 2014
3. Evaluate the level of risk by quantifying the investment in the various inventories. Completion date: May 31, 2014.
4. Depending on the risk, improve the controls by adding fencing, shelving, cameras, card readers and access control to the various locations where inventory is stored. This item will have a budgetary impact that will need to be addressed. Based upon the measures determined to be necessary, some controls may need to be addressed after October 1; however, those control measures that can be addressed within current resources will.
5. If there is a determination that League City needs to move toward an inventory control system where all (or most) materials incorporated into a project are accounted for on a work order by work order (project by project) basis, accounting will work with public works to accomplish this task.
6. Evaluate upgrading of trucks to maintain a minimum inventory of tools and parts that the crew leader is accountable for on a weekly basis. Completion date: This will be a migration as we schedule replacement of existing vehicles.
7. For vehicle maintenance look at inventory control/work order software that integrates into the financial software to begin to formalize inventory control/central stores where it makes sense. This will likely require additional resources for the software and people (parts manager) to segregate the parts supply. Completion date: This will be part of the FY 2015 budget and should be completed by March 2015.

It is important that the Council is comfortable that the levels of controls are appropriate for the level of risk. If we desire to move forward with an integrated inventory control/work order system we need to do some additional research to determine the options available both for an inventory system and options for an enhanced work order system to better track the consumption of the inventory.

EXHIBIT A

Sampling Methodology and Reliability of Computer Generated Data

The items to be counted were taken from the Bid Tabulation Sheet and judgmentally selected based on the unit price or total dollar amount. A total of 15 items were selected. The purpose of the count was for the auditor to gain a greater understanding of management's implementation of the Opportunities for Improvement. See Opportunity for Improvement #3 on page 4.

Picture 1



Line Repair Inventory in the yard

Picture 2



Clamp Inventory inside the warehouse

Picture 3



Line Repair Inventory in the yard

Picture 4



Poles intermingled with Line Repair Inventory

Picture 5



Unlocked gate leading to three other departments

Picture 6



Small tools – This portion was unlocked at time of visual

Picture 7



Small Tools Inventory – This was in a locked closet

Follow-up Picture 1



Inside of Warehouse showing Product Labels

Follow-up Picture Number 2



Inside of Warehouse – Brass Parts with Product Labels

Follow-up Picture Number 3



Outside Inventory with no labels

Follow-up Picture Number 4



Card Controlled Access to Inside Warehouse

Follow-up Picture Number 5



Outside Door to Warehouse Card Controlled

Follow-up Picture Number 6



Small Tools now in Card Controlled Warehouse

Follow-up Picture Number 7



Small Tools in Locked Cabinet