Audit #12-01:

Fiscal Year-End 2011 Citywide Inventory

Detailed Audit Report

Office of the City Auditor and Clerk
Internal Audit

Prepared by:

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City Auditor and Clerk

Final Report Issued: April 10, 2012

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OFFICE OF THE CITY AUDITOR AND CLERK
Internal Audit Division

Date: April 10, 2012

To: Mayor Suzanne Atwell, Vice Mayor Terry Turner, Commissioner Paul Caragiulo, Commissioner Willie Shaw, and Commissioner Shannon Snyder

From: Pamela M. Nadalini, City Auditor and Clerk

Subject: Audit #12-01: Fiscal Year-End 2011 Citywide Inventory

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Attached for your information and review is a copy of the above-mentioned detailed report.

If you have any questions, please do not hesitate to contact me at (941) 954-4169.

Attachment(s):

Detailed Audit Report #12-01
Executive Summary Audit Report #12-01

c: Terry Lewis, Interim City Manager
Robert Fournier, City Attorney
Heather Essa, MPA, CIA, CGAP, Manager, Internal Audit
File

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Detailed Audit Report #12-01
Executive Summary Audit Report #12-01

c: Robert Fournier, City Attorney
Marlon Brown, Deputy City Manager
Christopher Lyons, Director, Financial Administration
Douglas Jeffcoat, Director, Public Works
Javier Vargas, Director, Public Utilities
Mary Bensel, Executive Director, Van Wezel Performing Arts Hall
Chief Mikel Holloway, Chief of Police, Sarasota Police Department
Heather Essa, MPA, CIA, CGAP, Manager, Internal Audit
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BACKGROUND AND INTRODUCTION

During fiscal year 2011, the following city departments or divisions maintained inventory: Sarasota Police Department, Van Wezel Performing Arts Hall, Public Works, Public Utilities, Bobby Jones Golf Club, the Municipal Auditorium and Payne Park.

A variety of items are held in inventory, some of which are used to service internal customers (such as equipment maintenance, infrastructure parts, police uniforms and supplies, etc), whereas other items are held for resale to the public (such as sporting equipment, souvenirs, and concession food and beverages).

At the end of each fiscal year, departments that maintain inventory assemble count teams to perform physical counts of inventory items. Results of the counts are used to update inventory quantities in departmental inventory computer systems as well as to make adjustments to each department's inventory valuation. Adjustments to inventory valuations are provided to the Financial Administration Department for inclusion in the general ledger.

Example: The Utilities Department maintains an organized stockroom where surplus fittings are stored for future use.

The following table summarizes inventory information by Department or Division:

Department or Location	Inventory Costing Method In Use	Inventory Count Method	Automated Inventory System In Use?	Ending Inventory Balance as of 9/30/11	Percent of 2011 Inventory Balance Tested by Internal Audit
Municipal Auditorium and Payne Park	Last Invoice[1]	Periodic	No	$863.25	36.0%
Public Utilities-Utility Stores	First-In-First-Out (FIFO)	Perpetual	Yes	$47,864.99	24.63%
Public Works-12th Street Equipment Maintenance and Fuel/Oil	First-In-First-Out (FIFO)	Perpetual	Yes	$207,590.20	19.24%
Bobby Jones Golf Club Pro Shop	Weighted Average	Perpetual	Yes	$47,829.61	41.8%
Van Wezel Performing Arts Hall	Last Invoice	Periodic	No	$1,616.19[2]	89.5%
Sarasota Police Department	Last Invoice	Perpetual	Yes	$108,565.49	9.3%
Grand Total Inventory Valuation/ Percent Tested by Internal Audit				**$414,329.73**	**20.2%**

[1] The use of last invoice costing is a non-standard costing method.

[2] Actual ending inventory amount was $1,707. Incorrect amount reported by department due to an item count misstatement; the department has expressed plans to correct the discrepancy in its next inventory adjustment.

AUDIT PURPOSE

This audit was performed to assess the FYE 2011 physical inventory process, including compliance with inventory instructions and related controls over inventory. This audit was included on the 2011-2013 Audit Schedule.

AUDIT SCOPE

The scope of this audit included a review of departmental inventory activities, including physical inventory counts, compliance with inventory policies and procedures, and physical and information system security regarding City assets for the fiscal year ending September 30, 2011. The time period for the audit was October 1, 2010 - September 30, 2011.

AUDIT OBJECTIVES

The audit focused on determining whether:

1) Departmental inventory procedures were adhered to during counts of inventory;

2) Physical access to inventory was appropriately restricted to safeguard City assets;

3) Access to inventory information systems was appropriately restricted to necessary personnel;

4) Reported inventory included usable or saleable items;

5) Inventory cut-off procedures were adequate to ensure that inventory transactions are reported in the correct fiscal year;

6) Inventory amounts were properly recorded; and

7) Management oversight of the physical inventory count and reconciliation process was adequate to ensure adjustments were properly reviewed and authorized.

AUDIT STANDARDS

The auditor conducted this audit in accordance with generally accepted government auditing standards. Those standards require that the auditor plan and perform the audit to provide a reasonable basis for findings and conclusions based on audit objectives. The auditor believes that the evidence obtained provides a reasonable basis for findings and conclusions based on the audit objectives.

The Internal Audit Division strives to follow and adhere to the guidance included in the International Professional Practices Framework set forth by the Institute of Internal Auditors.

TESTING METHODOLOGY

In order to fulfill the audit objectives, Internal Audit:

- Interviewed appropriate personnel;
- Observed physical inventory counts of departments;
- Evaluated compliance with departmental inventory instructions;
- Performed sample test counts[3] and verified unit costs to assure accuracy and existence of items;
- Reviewed user access to inventory information systems;
- Evaluated segregation of duties concerning inventory activities;
- Reviewed inventory reconciliations and adjusting journal entries; and
- Evaluated management's oversight of the physical inventory reporting process.

AUDIT CRITERIA

Conditions noted by Internal Audit during testing and fieldwork were compared to audit criteria, which included:

- Departmental Inventory Instructions; and

- The United States General Accounting Office's Executive Guide on "Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property", dated March 2002

AUDIT CONCLUSIONS

Observations and recommendations in this report are offered as independent guidance to management for their consideration in strengthening controls.

A complete list of Internal Audit's observations and recommendations begins on page 10 of this report. For information on priority levels assigned to audit recommendations, please see **Exhibit A**.

Based on results from testing the auditor's sample, Internal Audit determined through fieldwork and testing that:

1) Physical inventory counts were generally performed in compliance with each department's respective inventory instructions. Further, all departments appropriately utilized a blind count[4] method, which encourages the most accurate and reliable count.

[3] A judgmental sample of inventory items was selected for audit testing based on either number of items in stock or price per unit.
[4] In a blind count situation, counters are provided part number(s)/ SKUs, description, location, and other information needed to perform the count, but they are not privy to the number of items recorded in the inventory system. This method reduces the risk of counters relying on a number they see on the inventory report and, instead, requires counters to physically perform the count and record the totals actually observed.

2) Adequate physical access controls were observed to be in place for the majority of the departments with regards to secure, lockable storage areas.

Example: The Van Wezel safeguards inventory in lockable storage cabinets.

The relevant exception was **Payne Park Auditorium**, for which keys have been given to various community groups allowing them to access the facility without the assistance of staff (due to various leases for groups to utilize the building). It should be noted that the majority of the concession inventory at the facility is appropriately secured in a separately-keyed storage room and the value of the inventory accessible in the open concession area is insignificant.

With regards to segregation of duties concerns, opportunities exist for all departments to realign job tasks to better reduce theft/ fraud risk as several employees were responsible for incompatible or excessive duties (ie, in one instance an employee was able to order, receive, initiate payment, modify inventory records, perform counts, and reconcile/ adjust inventory valuations).

Upon release of the draft audit report, Internal Audit met with each inventory unit to discuss how an appropriate separation of inventory duties could be achieved specific to them. As of the release date of the final report departments were either working on restructuring inventory duties for the future and implementing compensating controls, or had already established how they would achieve an appropriate separation going forward.

3) Inventory information systems were better restricted to necessary users when compared with the most recent inventory audit (Audit #10-01); however, there were some concerns specifically regarding the Cartegraph system where the number of users with capabilities to modify records was excessive, considering job responsibilities.

Further, for all departments to reduce the risk of loss, individuals responsible for maintaining inventory/ stock keeping should not be able to modify the inventory records; in the event this cannot be avoided, compensating controls should be put in place (such as periodic management review of modified records).

4) Reported inventory values appropriately included usable, or saleable, items. The auditor observed that departments properly identified obsolete items and segregated those items from other inventory.

5) Departments were in compliance with inventory cut-off procedures.

6) Generally, inventory amounts were accurately reported to the Financial Administration Department.

There were two relevant exceptions to this observation:

Sarasota Police Department- No inventory adjustment was recorded in either the inventory system or the City's financial system after the department's physical count in 2010. Because the last full inventory recorded in SPD's inventory system was in October 2009, there were numerous discrepancies between quantities reported by the inventory system and the actual count of items on-hand in 2011. Internal Audit noted that, after the 2011 physical inventory count, SPD appropriately submitted an updated inventory valuation to the Financial Administration Department to reflect the current inventory.

Utility Stores- The original inventory value submitted to Financial Administration was unintentionally understated by $22,139.90. The auditor was able to determine, as a result of sample testing, that the report generated by the inventory system was not appropriately reporting the values for all items in the stockroom. Department staff was notified of the observation during audit fieldwork and staff was able to work with the software vendor to correct the issue. A corrected inventory value was immediately submitted to Financial Administration to reflect the increased value after the reporting issues were remedied (inventory value was revised from $25,725.09 to the correct amount of $47,864.99). The issue was corrected prior to release of the audit report, so no recommendation is necessary at this time.

Additionally, the original inventory adjustment submitted to the Financial Administration Department was incorrectly posted in reverse to the City's financial system. To their credit, Financial Administration staff immediately corrected the journal entry upon learning of the error from the auditor. The issue was corrected prior to release of the audit report, so no recommendation is necessary at this time.

7) Management was appropriately present at several of the physical counts; however, evidence of management approvals (signatures) on final adjustments to inventory values was not noted for most departments (only the Municipal Auditorium/ Payne Park adjustment had evidence of a department director's signature).

   To ensure appropriate adjustments to final inventory values, someone with higher authority than the Inventory Custodian should review and physically sign the final adjustment paperwork (especially in instances in which the ideal segregation of duties cannot be achieved due to limited staff/resources).

AUDIT OBSERVATIONS AND RECOMMENDATIONS

Issue #	Subject	Observation	Recommendation	Concur	Do not concur	Management Responses
1	Segregation of Duties & Inventory System User Rights All Departments	***All Departments:*** Segregation of duties concerns exist for all departments with regards to various employees performing inventory tasks that are incompatible. Having excessive duties within the inventory control process is a fraud/ theft risk. ***Bobby Jones Golf Club, Public Utilities, Public Works, SPD:*** The individual considered to be the "Custodian" of inventory was able to modify the perpetual inventory system and (in some cases) reconcile the inventory records, which is a fraud/ theft risk. ***Public Utilities, Public Works:*** The number of users with rights to modify/ delete records within the inventory systems is excessive. Segregating duties in the inventory management process assists in better control over physical inventory through reduced risk of loss and misstatements in counts and value. If it is not practical to achieve the ideal segregation of duties due to limited resources/ staff, compensating controls should be implemented to reduce risk.	***All Departments:*** **Separate inventory duties**, or implement compensating controls for duties, so that: 1) The person who receives/ signs off on inventory is not involved in the purchasing process (particularly, cash disbursement), 2) The person who has custody of the merchandise (Custodian) does not modify the inventory system or reconcile inventory counts to the inventory system/ general ledger, 3) The person who modifies the inventory system (adds/ edits/ deletes items) does not reconcile inventory counts to the inventory system/ general ledger. *(See **Exhibit B** for additional information on Segregation of Duties and Potential Compensating Controls.)* ***Bobby Jones Golf Club, Public Utilities, Public Works, SPD:*** **Modify access rights in departmental inventory systems** so that they are commensurate with job responsibilities and reflect an appropriate segregation of duties (ie, Custodian should not be able to modify records). ***Public Utilities, Public Works:*** **Review user groups in Cartegraph** and explore the possibility of reducing the number of users with the capability to modify/ delete records. **Priority: High**	X		***Bobby Jones Golf Club:*** Continue to review and implement compensating controls with consideration to staff and system limitations. POS system provider was contacted about modifying access rights, however, with the current version this is not possible but they will consider for future version. ***Public Works:*** Continue to review and implement compensating controls with consideration to staff and system limitations. Staff is currently reviewing the potential of outsourcing the fleet stock room function. Staff has reviewed user group assignments and IT has been contacted to adjust Cartegraph permissions to comply. ***Public Utilities- Utility Stores:*** 1. Accounting Specialist will process invoice after goods are received by the Supervisor of Utility Stores. 2. Supervisor of Utility Stores would modify inventory system but only with an Inventory Adjustment Form which is signed by Department Finance & Administration Manager or Director. Cycle counts will also be instituted. 3.The Department Finance & Administration Manager is now responsible for the reconciliation of inventory counts to the inventory system/general ledger. ***SPD:*** Since audit recommendations in December of 2009, SPD Maintenance Staff (Terry Ruthruff and Paul Shumway) have been receiving stock for the Stockroom. This can be verified independently by Internal Audit by going into FMS (the City's Financial System), searching by SPD Stockroom vendor, Design Lab, for instance, and looking for the receiving initials on the invoice. Police Fiscal Office or Lisa Shay, in City Accounting, could provide those documents. See attached example with "PS" in upper left-hand comer for Paul Shumway, indicating that Paul signed and received the goods, from March of 2010. No modifications have been made to the inventory taken at 9/28/11. A separate employee, with a separate desk and logon from our Custodian (Miguel Gomez) will be posting the incoming invoices. See the Stockroom Inventory Flow-chart (attached). It is a first draft (created by our Custodian, Miguel) to fit the Stockroom's Inventory system to Audit recommendations. Once approved, our MIS Unit will restrict access in the System and the Custodian will be unable to modify inventory. Support Services Manager will be working with a volunteer to perform cycle counts and reconciliations of the inventory monthly, therefore eliminating cumbersome year-end inventory, and at the same time providing better control and a more timely reconciliation process. ***Van Wezel Performing Arts Hall:*** We agree with this statement and are in the process of looking within our department to see who can take on these tasks. **Committed Action Item Due Date: Varies by Department; All should be implemented by 9/30/12**

Issue #	Subject	Observation	Recommendation	Concur	Do not concur	Management Responses
2	Management Approval of Final Adjustment Bobby Jones Golf Club, Public Utilities-Utility Stores, Public Works-12th St. Garage, Sarasota Police Department Van Wezel Performing Arts Hall	The final inventory valuation and adjustment report submitted to the Financial Administration Department did not have the signature of the Department Director. A supervisory individual with responsibilities independent of the inventory process should review and approve final adjustments to inventory.	Ensure inventory final report and adjustment is reviewed and approved by someone with higher authority than the Custodian (ie, Department Director). **Priority: Medium**	X		***Bobby Jones Golf Club:*** Approval by Department Director ***Public Works 12th Street Garage:*** Approval by Department Director ***Public Utilities- Utility Stores:*** Department Director will sign off on inventory final report at Fiscal Year End. ***SPD:*** Support Services Manager will send adjustment to Inventory via memo with Chiefs approval to City Accounting for processing, rather than communicate via email with Accounting Manager, going forward. ***Van Wezel Performing Arts Hall:*** We agree and will make this happen. **Committed Action Item Due Date: 9/30/12**

EXHIBIT A: INTERNAL AUDIT RECOMMENDATION PRIORITIES

Internal Audit utilizes the following classification scheme applicable to internal audit recommendations and the appropriate corrective actions:

Priority Level[1]	Description	Implementation Action[3]
High	Fraud or serious violations are being committed or have the potential to occur, security issues, significant financial or non-financial losses are occurring or have the potential to occur.[2]	Immediate
Medium	A potential for incurring moderate financial or equivalent non-financial losses exists.[2]	Within 60 days
Routine	Operation or administrative process will be improved.	60 days to 6 months

1 The City Auditor and Clerk is responsible for assigning internal audit recommendation priority level categories. A recommendation that clearly fits the description for more than one priority level will be assigned the higher level.

2 For an audit recommendation to be considered related to a significant financial loss, it will usually be necessary for an actual loss of $25,000 or more to be involved, or for a potential loss (including unrealized revenue increases) of $50,000 to be involved. Equivalent non-financial losses would include, but not be limited to, omission or commission of acts on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its citizens.

3 The implementation time frame indicated for each priority level is intended as a guideline for establishing target dates. Determining proposed action dates is the responsibility of the Charter Official(s) over the area(s) or function(s) audited.

NOTE: Please note that this exhibit is a standard form which appears in every audit and is meant to be utilized to aid management in understanding the seriousness or potential seriousness of an audit observation. A "High" or "Medium" priority rating assigned to an audit observation should not be construed to mean that fraud or wrongdoing is, in fact, occurring but rather fraud or wrongdoing has the potential to occur in the absence of adequate internal controls.

EXHIBIT B: SEGREGATION OF DUTIES CONSIDERATIONS

Process/ Role	Control Considerations	If the Answer to Control Consideration is "Yes", Recommend:	Examples of Compensating Controls if Recommendation Cannot be Achieved
Purchasing/ Receiving	Do employees involved in receiving goods from vendor also perform any of the following? . Purchase goods (ordering/ cash disbursement) . Record invoices in FMS	Employees who receive and sign off on goods received should not be involved in the purchasing or cash disbursement process.	Employees who are Custodians and perform receiving duties might order goods if a) order form is sent to Accounts Payable individual, b) signed packing slip is sent to Accounts Payable individual after receipt, and c) invoice is sent directly from vendor to Accounts Payable Clerk. In this structure, Accounts Payable Clerk would perform 3-way match and could follow-up on any merchandise "not received" but invoiced.
Custody/ Access to Inventory	Do employees with custody of and access to inventory have responsibility to perform any of the following? . Modify perpetual inventory records . Reconcile physical inventory counts to perpetual inventory records . Reconcile perpetual inventory records to the general ledger inventory balance . Record manual adjustments in the perpetual inventory system	Employees with access to physical inventory should not be responsible for modifying/ updating/ deleting in the perpetual inventory system or the general ledger.	Modifications to inventory records should be reviewed and approved by a supervisory-level employee on a periodic basis.
Inventory Counts	Are physical inventory counts performed by someone with no responsibility over inventory?	Employees with access to physical inventory (Custodian) should not be responsible for performing inventory counts. Employees with responsibilities associated with the inventory system and reconciliation responsibilities should not be involved in performing physical inventory counts.	If the Custodian/ Reconciler must be involved in the count: • 2-person count teams should be utilized. • Spot checks should be completed by supervisory personnel. • Surprise counts should be performed by individuals independent of inventory responsibilities periodically (ie, quarterly) to verify the accuracy of the inventory records.
Reconciliation	Is the employee responsible for modifying the inventory system also able to reconcile physical inventory counts with the perpetual inventory and/ or the general ledger?	Employees who can modify the inventory system should not reconcile physical inventory counts to the perpetual inventory and/or the general ledger.	The reconciliation should be reviewed/ approved by a supervisory- level employee.