

OFFICE OF THE CITY CONTROLLER



**PUBLIC WORKS AND ENGINEERING DEPARTMENT
NORTHEAST REGIONAL STREET AND STORM SEWER
MAINTENANCE CENTER
UNANNOUNCED INVENTORY AUDIT OF MATERIALS,
SUPPLIES AND FIXED ASSETS**

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OFFICE OF THE CITY CONTROLLER
CITY OF HOUSTON
TEXAS

October 1, 2001

The Honorable Lee P. Brown, Mayor
City of Houston, Texas

SUBJECT: Public Works and Engineering Department
Northeast Regional Street and Storm Sewer Maintenance Center
Unannounced Inventory Audit of Materials, Supplies and Fixed Assets
(Report No. 01-03)

Dear Mayor Brown:

The City Controller's Office Audit Division has completed an unannounced inventory audit of materials, supplies and fixed assets located at the Public Works and Engineering Department's Northeast Regional Street and Storm Sewer Maintenance Center, 5500 McCarty Road, and the Storm Sewer Section of the Right of Way Division, located at 9003 North Main. The primary objective of the audit was to assist management with the assessment of the adequacy of internal controls related to recording, valuing, reporting and safeguarding the Department's inventory and fixed assets.

The report, attached for your review, concludes that controls over inventory and warehousing operations are inadequate, ineffective, and do not provide reasonable assurance that the Storm Sewer Section's materials and supplies are accurately recorded, valued, reported and adequately safeguarded. Draft copies of the matters contained in the report were provided to Department officials. The views of the responsible department officials as to action taken or being taken are appended to the report as Exhibit I.

We commend the Department for taking immediate action on the recommendations identified in the report. Also, we appreciate the cooperation extended to our auditors by Department personnel during the course of the audit.

Respectfully submitted,


Sylvia R. Garcia
City Controller

xc: City Council Members
Albert Haines, Chief Administrative Officer
Gerard Tollett, Chief of Staff, Mayor's Office
Thomas Rolen, Director, Public Works and Engineering Department
Philip Scheps, Director, Finance and Administration Department

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EXECUTIVE SUMMARY

INVENTORY

Controls over inventory and warehousing operations are inadequate, ineffective, and do not provide reasonable assurance that the Storm Sewer Section's (Section) materials and supplies are accurately recorded, valued, reported and adequately safeguarded.

- The Section was not aware of written policies and procedures for inventory and warehouse operations, although MMB's Standard Operating Procedures included limited procedures for non-automated warehouses.
- The Section's warehouse personnel lack proper training to perform inventory and warehousing duties. During our unannounced inventory count on February 20, 2001, a Senior Storekeeper was performing the Section's warehouse duties, however, for an extended period of time prior to our count, an equipment operator had temporarily performed the storekeeper's duties.
- The Section submits monthly inventory reports to PW&E's Materials Management Branch. These reports are not reliable. For January 2001, the Section reported an inventory valued at \$400,526, however our test counts indicated some items were not included in the report. For example, 205 drums of herbicide, valued at \$232,285, were not included in the report.
- The majority of our test counts, as confirmed by PW&E's Section Chief, did not match the Section's inventory records. Section personnel could not provide explanations for the differences between our test counts and their inventory records, other than Section personnel may not always document all receipts, issues, and transfers of inventory. Proper documentation is necessary to minimize errors in the inventory records and to make pilfering more easy to detect.
- The inventory valuation method used by the Section is not consistent with the City's average cost valuation policy. The Section used unit prices from purchase orders rather than average cost to value inventory. Further, many of the commodities were valued at zero cost.
- We analyzed commodities with quantities on hand included in the Section's December 2000 inventory report. Our analysis indicated possible excessive quantities of inventory for many commodities. The quantities on hand of 100 of the 210 commodities exceeded a one-year supply. The cost of acquiring, warehousing, and managing excessive quantities of inventory is an unnecessary commitment of City resources and exposes the inventory to obsolescence and misappropriation.
- During the last five years, the Internal Review Section repeatedly reported many of our current findings to Department management, however, only one of these reports was addressed to the Director. The Section reported issues such as lack of policy and procedures, inconsistent inventory valuation methods, slow moving inventory, excessive

inventory levels, and exclusion of inventory items from total inventory. The repeated reporting of these issues indicates the issues were not corrected.

FIXED ASSETS

- On February 20, 2001, thirteen truck cab and chassis were stored at the Center. These vehicles were awaiting the installation of dump beds. Two of the vehicles were received in September 1999 and had City decals (shop number) and barcodes, and state license plates affixed to them. Of the remaining eleven vehicles received during January and February 2000, only two had barcodes affixed and none had decals or license plates. Barcodes and shop numbers are used to identify and track fixed assets and make the vehicles less vulnerable to theft.
- Two 5 yd cabs & chassis were classified as 3-4 yd cabs & chassis because Plant Account Numbers did not exist for five yard chassis, and the next best fit was used. Incorrect Plant Account Numbers diminish the integrity of the asset records and can result in assets being depreciated incorrectly, although in this case depreciation was not affected since the useful life of the assets is the same.
- The Department's Fixed Asset Detail Report and related Capitalization Forms indicated three of the thirteen vehicles that were received on January 27, 2000 were placed in service and depreciated beginning July 1, 1999 (over six months before the date the vehicles were received by the Department). The Financial Management Branch's review process detected the data entry error, however the noted correction was not made. Consequently, depreciation was overstated by approximately \$4,660 and the resulting net asset values were understated by the same amount.
- A forklift, valued at \$49,945, was received on December 5, 2000, barcoded, but was not recorded in the Department's Fixed Asset System as of February 21, 2001.

SCOPE AND PURPOSE

We have completed an unannounced audit of the materials, supplies and certain fixed assets at the Northeast Regional Street and Storm Sewer Maintenance Center (Center) located at 5500 McCarty Road and the Storm Sewer Section of the Right of Way Division located at 9003 North Main. The audit began on February 20, 2001 and consisted of test counting inventory and fixed assets, reviewing, analyzing and evaluating inventory and fixed asset processes, procedures and records. Our purpose was to assist management with the assessment of the adequacy of internal controls related to recording, valuing, reporting and safeguarding the Department's inventory and fixed assets.

The scope of our work did not constitute an evaluation of the overall internal control structure of the Department. Our examination was designed to evaluate and test the adequacy of the Department's controls over inventory and fixed assets. This was a financial related audit executed in accordance with Generally Accepted Government Auditing Standards (GAGAS).

Department management is responsible for establishing and maintaining a system of internal controls to ensure that the Division is accurately reporting inventory and fixed assets as an integral part of the Department's overall internal control structure. The objectives of internal control system are to provide management with reasonable, but not absolute, assurance that inventory and fixed assets are properly recorded, valued, reported and safeguarded.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with procedures may deteriorate.

CONCLUSION

Based on the results of the audit, we conclude that controls over inventory and warehousing operations are inadequate, ineffective, and do not provide reasonable assurance that the Section's materials and supplies are accurately recorded, valued, reported, and adequately safeguarded. Further, the Section's fixed assets should be properly monitored to ensure prompt and accurate recording into the Department's Fixed Assets Listing and Capitalization Schedules.

Kenneth Teer
Audit Manager

Joe Okigbo
Auditor-in-Charge

Steve Schoonover
City Auditor

INTRODUCTION

OVERVIEW

The Storm Sewer Section of the Right of Way Division of the Public Works and Engineering Department (PW&E) was designated to relocate to and manage the completed Northeast Regional Street and Storm Sewer Maintenance Center (Center). The design and construction of the Center began under the oversight of PW&E. PW&E issued the notice to proceed August 11, 1997, and the initial project completion date was August 11, 1998. Through change orders, 269 days were added to the project, extending the completion date to May 6, 1999. Oversight was transferred to the Building Services Department (BSD) in July 1999. Although the City issued the Certificate of Substantial Completion for the Center on October 11, 1999, the Center was not occupied until March 15, 2001, because of problems associated with the facility.

INVENTORY

In anticipation of the Center becoming available in May 1999, the Section began stocking the Center with materials and supplies. These materials and supplies were in addition to those kept at the Section's 9003 North Main location. At the time of our unannounced inventory count, the Section's inventory consisted of items stored at both the Center and North Main. Monthly, the Section sends inventory reports to PW&E's Materials Management Branch (MMB) for inclusion in PW&E's Monthly Inventory Summary.

FIXED ASSETS

The Right of Way Division has been storing newly acquired vehicles at the Center because of insufficient storage space at the Division's 812 Gillette location. Twenty-one vehicles were purchased over a year ago; however, thirteen of those vehicles have not been outfitted with dump beds. We were informed that the vendor responsible for outfitting the trucks defaulted on its contract. The Finance and Administration Department's Strategic Purchasing Division is currently working on securing a replacement contract.

FINDINGS AND RECOMMENDATIONS

INVENTORY

I. WRITTEN POLICIES AND PROCEDURES

BACKGROUND

The MMB has written policies and procedures for PW&E's automated warehouses (Advantage 2000 and GEMS 2000 systems), and procedures for performing physical (counting) inventory at all warehouses. The Section maintains a non-automated warehouse and

uses a computer spreadsheet to track its inventory and warehouse transactions.

FINDING

The Section was not aware of written policies and procedures for its inventory and warehouse operations, and since the Section's warehouse is non-automated, MMB exercises only limited oversight over the Section's inventory and warehousing operations. We found the Section's inventory accounting policies to be inconsistent with the City's accounting policies and the Section's inventory and warehousing procedures are not adequate to ensure effective internal control and inventory management.

RECOMMENDATION

The Section should seek, and MMB should provide, guidance on inventory and warehousing policy and procedures.

II. WAREHOUSING AND INVENTORY TRAINING

FINDING

During our unannounced inventory count on February 20, 2001, a Senior Storekeeper was performing the Section's warehouse duties, however, for an extended period of time prior to our count, an equipment operator had temporarily performed the storekeeper's duties. Discussions with the Section Manager, indicated that the only training warehouse personnel receive is on-the-job training. Unless employees are trained in the City's accounting policies and PW&E's inventory and warehousing procedures, the result will continue to be ineffective internal controls and a poor inventory management system.

RECOMMENDATION

The Section should provide inventory management and warehouse personnel proper training in the City's accounting policies and PW&E's inventory and warehousing procedures.

III. PERIODIC INVENTORY REPORTS

BACKGROUND

Monthly, the Section sends inventory reports to PW&E's MMB for inclusion in PW&E's Monthly Inventory Summary.

FINDING

The monthly reports are unreliable. For January 2001, the Section reported an inventory valued at \$400,526, however our test counts indicated some items were not included in the report. For example, 205 drums of herbicide, valued at \$232,285, were not included. Also, many commodities included in the report were not valued. Not

valuing and excluding commodities understates the value of reported inventory.

RECOMMENDATION

All appropriate inventory commodities should be included and valued in the Section's monthly inventory reports.

IV. CONTROLS OVER WAREHOUSING AND INVENTORY

BACKGROUND

The Section uses issue tickets to document materials and supplies issued from its warehouses and shipping documents, such as delivery tickets to document receipts. The Section tracks its inventory on a computerized spreadsheet, and the spreadsheet is updated monthly before preparing the monthly inventory reports.

FINDING

Controls over inventory and warehousing operations at the facility are inadequate, ineffective and do not provide reasonable assurance that materials and supplies are recorded and reported accurately. The majority of our test counts, as confirmed by PW&E's Section Chief, did not match the Section's inventory records.

Section personnel could not provide explanations for the differences between our test counts and their inventory records, other than not all receipts, issues, and transfers of inventory are documented. Inadequate documentation of receipts, issues and transfers and unexplained differences between inventory records and actual quantities on hand, indicate poor inventory management and possible misappropriation of City's assets.

RECOMMENDATION

The Section should establish procedures to promptly and accurately record its warehouse receipts, issues and transfers. Differences between inventory records and actual quantities on-hand should be adjusted only after review and approval by appropriate management.

V. INVENTORY VALUATION METHOD

BACKGROUND

The City's accounting policy is that inventory is valued at average cost. The Advantage 2000 system, which is used to maintain inventory at automated warehouses, values inventory at average cost.

FINDING

The inventory valuation method used by the Section is not consistent with the City's accounting policy. The Section uses unit prices from

purchase orders rather than average cost to value inventory. Further, many of the commodities were valued at zero cost.

RECOMMENDATION

The Section should value its inventory in accordance with the City's accounting policy.

VI. INVENTORY USAGE

BACKGROUND

Over the years, many organizations have used just-in-time procurement and other techniques, such as economic order methods, to minimize and manage inventory. The Section does not use the above techniques. Instead, Section management and warehouse personnel determine what, when, and how much to order on a case-by-case basis. Many commodities are purchased in large quantities and stored in the warehouses for future use.

FINDING

We analyzed commodities with quantities on hand included in the Section's December 2000 inventory report to see how long it would take the Department to use the inventory on hand. The quantities on hand of 100 of the 210 commodities exceeded a one-year supply.

The cost of acquiring, warehousing, and managing excessive quantities of inventory is an unnecessary commitment of City resources and exposes the inventory to obsolescence and misappropriation.

RECOMMENDATION

We recommend that the Section maintain its inventory at levels that can be consumed within a more reasonable period of time.

VII. INTERNAL REVIEW SECTION

BACKGROUND

The Public Works and Engineering Department's Internal Review Section periodically performs inventory observations to assist management in evaluating the adequacy of internal controls and compliance with inventory counting procedures. A report is issued to management at the completion the review.

In May 1999, Deloitte & Touche recommended in its Comprehensive Performance Audit Report that "the Internal Review Section should be realigned to report directly to the Director of PW&E. This will help to ensure integrity and impartiality as well as uncover issues within the department which may have otherwise remained hidden". For various

reasons, the Director of PW&E disagreed with realigning the Internal Review Section, and the Department is not currently planning to implement the recommendation.

FINDING

During the last five years, the Internal Review Section repeatedly reported many of our current findings to Department management, however, only one of these reports was addressed to the Director. The Section reported issues such as lack of policy and procedures, inconsistent inventory valuation methods, slow moving inventory, excessive inventory levels, and exclusion of inventory items from total inventory. The repeated reporting of these issues indicates the issues were not corrected.

RECOMMENDATION

We recommend that management take corrective actions to address the issues noted in the Internal Review Section reports. To ensure management acts on future reports promptly, the Internal Review Section should address its reports to the Director and send copies to affected management.

FIXED ASSETS - VEHICLES

I. BARCODES

BACKGROUND

On February 20, 2001, thirteen truck cab and chassis were stored at the Center. These vehicles were awaiting the installation of dump beds.

FINDING

Two of the vehicles were received in September 1999 and had City decals (shop number) and barcodes, and state license plates affixed to them. Of the remaining eleven vehicles received during January and February 2000, only two had barcodes affixed and none had decals or license plates. Barcodes and shop numbers are used to identify and track fixed assets and make the vehicles less vulnerable to theft.

RECOMMENDATION

To facilitate identifying and tracking fixed assets, barcodes should be affixed to assets upon receipt.

II. CLASSIFICATIONS

BACKGROUND

The Financial Management Branch is responsible for assigning barcodes and asset description numbers (Plant Account Numbers) to the Department's vehicles.

FINDING

Two 5 yd cabs & chassis were classified as 3-4 yd cabs & chassis because Plant Account Numbers did not exist for five yard chassis, and the next best fit was used. Incorrect Plant Account Numbers diminish the integrity of the asset records and can result in assets being depreciated incorrectly, although in this case depreciation was not affected since the useful life of the assets is the same.

RECOMMENDATION

We recommend that Financial Management Branch establish Plant Account Numbers when necessary to record asset acquisitions.

III. CAPITALIZATION AND DEPRECIATION

BACKGROUND

The Department's Fixed Assets Section is responsible for recording and depreciating assets that meet the City's capitalization policy. The Section uses a Capitalization Form to capture asset information such as description, acquisition date, purchase price, and depreciation period. The Form is used to input the asset information into the Department's automated fixed asset system. The system calculates periodic depreciation amounts and the current values of the assets.

FINDING

The Department's Fixed Asset Detail Report and related Capitalization Forms indicated three of the thirteen vehicles that were received on January 27, 2000 were placed in service and depreciated beginning July 1, 1999 (over six months before the date the vehicles were received by the Department). The Financial Management Branch's review process detected the data entry error, however the noted correction was not made. Consequently, depreciation was overstated by approximately \$4,660 and the resulting net asset values were understated by the same amount.

RECOMMENDATION

Management should establish adequate controls to ensure that corrections to the fixed asset records are made properly and timely.

IV. FIXED ASSETS LISTING

FINDING

PW&E's Fixed Assets Section maintains records of assets owned by the various divisions. A forklift, valued at \$49,945, was received on

December 5, 2000, barcoded, but was not recorded in the Department's Fixed Asset System as of February 21, 2001.

RECOMMENDATION

We recommend that the Department's Fixed Assets Section implement procedures to effectively capture and promptly record in the Fixed Assets Listing, assets that have been assigned barcodes.