



## REPORT TO COUNCIL City of Sacramento

915 I Street, Sacramento, CA 95814-2604  
www. CityofSacramento.org

Staff Report  
February 17, 2009

Honorable Mayor and  
Members of the City Council

**Title:** Presentation of the internal audit report, *Inventory Processes & Inventory Reports, Department of Utilities*

**Location/Council District:** City-wide

**Recommendation:** Receive and file the *Inventory Processes & Inventory Reports, Department of Utilities'* internal audit report

**Contact:** Marty Kolkin, City Auditor, 808-5704

**Presenters:** Marty Kolkin, City Auditor, 808-5704

**Department:** City Manager

**Division:** Internal Audit

**Organization No:** 02001011

### Description/Analysis

**Issue:** The attached internal audit report, *Inventory Processes & Inventory Reports, Department of Utilities*, highlighted systematic and material deficiencies existed in the Water, Sewer and Storm Drainage Funds' inventory processes and reports. However, Department of Utilities' representatives were supportive of recommended improvements and made substantial progress in resolving cited deficiencies.

The City Auditor recommends that the Director of Utilities or his representatives implement best practices for inventory as cited by the Government Accountability Office ("GAO"), dated March 2002, *Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property*.



Best practices cited by GAO include:

1. Establish Accountability;
2. Establish Written Policies;
3. Select an Approach;
4. Determine Frequency of Counts;
5. Maintain Segregation of Duties;
6. Enlist Knowledgeable Staff;
7. Provide Adequate Supervision;
8. Perform Blind Counts;
9. Ensure Completeness of Counts;
10. Execute Physical Counts;
11. Perform Research; and
12. Evaluate Count Results.

The City Auditor recommended corrections to all aspects of DOU's inventory processes and reports, including; 1) Beginning Inventory; 2) Receipts and Disbursements Inventory Reports, 3) Physical Counts and 4) Other Concerns.

**Policy Considerations:** The City Auditor's presentation of the *Inventory Processes & Inventory Reports, Department of Utilities'* internal audit is consistent with the City's core values of fiscal responsibility and accountability.

**Environmental Considerations:**

**California Environmental Quality Act (CEQA):**

Under the California Environmental Quality Act (CEQA) guidelines, this audit report does not constitute a project and is therefore exempt from review.

**Sustainability Considerations:** Provide catalyst for improvements of municipal operations.

**Other:** Not Applicable.

**Commission/Committee Action:** Receive and file.

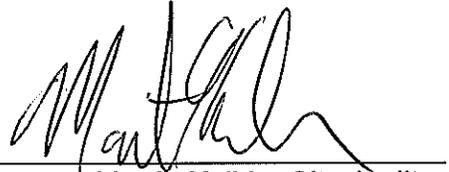
**Rationale for Recommendation:** This audit was requested by the Director of the Department of Utilities and recommended by the City Manager and City Council. The *Inventory Processes and Inventory Reports, Department of Utilities'* audit report highlighted systematic and material deficiencies that existed in the Water, Sewer, and Storm Drainage Funds' inventory processes and reports. This report was discussed in detail with the Director of the Department of Utilities and the City Manager's Office.

The Department of Utilities' representatives made substantial progress in resolving cited deficiencies and implementing recommended improvements.

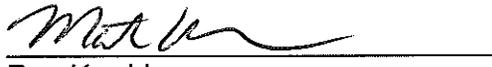
**Financial Considerations:** No additional financial considerations

**Emerging Small Business Development (ESBD):** No goods or services are being purchased as a result of this agreement.

Respectfully Submitted by:

  
\_\_\_\_\_  
Martin Kolkin, City Auditor

Recommendation Approved:

*for*   
\_\_\_\_\_  
Ray Kerridge  
City Manager

**Table of Contents:**

Staff Report pg. 1

**Attachments**

1 Background pg. 4

2 *Inventory Processes & Inventory Reports, Department of Utilities*  
Audit Report pg. 5

**Attachment 1****Background:**

The City Auditor completed a limited scope examination of the Department of Utilities' inventory processes and inventory reports. This audit was requested by the Director of Department of Utilities and recommended by the City Manager and City Council. This audit was conducted in accordance with the City Council's core values and guiding principles of fiscal responsibility and accountability, as well as applicable standards contained in Government Auditing Standards, issue by the Comptroller General of the United States, with the exception of a peer review.

The inventory processes and reports examined are the responsibility of the Department of Utilities' management. The City Auditor's responsibility is to express an opinion on the inventory processes and reports for the Department of Utilities, including the Water, Sewer, and Storm Drainage Funds. The Solid Waste did not reflect an inventory and resultantly was not included in the audit.

This report provides the Mayor, City Council, and the City Manager with an objective evaluation of the Department of Utilities' inventory processes and inventory reporting.

**Cost Benefit Ratio of this Audit**

The City Auditor benchmarks a cost efficiency standard of identifying \$2 of cost efficiencies for every \$1 spent on an internal audit.

The following cost efficiencies were identified for the *Inventory Processes & Inventory Reports, Department of Utilities'* audit:

**Identified Funds by the Audit:**

Correction of FY 2007 Beginning Inventory	\$482,706
Errors in FY 2008 Inventory Reports	<\$69,058>
FY 2008 Physical Count Understatement	\$457,433

**Total Identified Cost Efficiencies** **\$871,081**

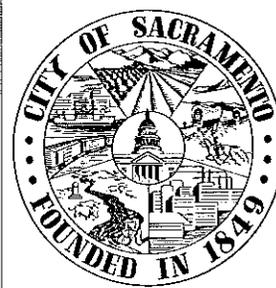
Fully loaded Auditor Costs (estimated at 135% of actual costs) \$ 56,000

**Cost Benefit Ratio of Identified Cost Efficiencies  
to Internal Auditor Costs** **\$15 to \$1**

**Attachment 2**

# **CITY OF SACRAMENTO INTERNAL AUDIT**

## **Inventory Processes & Inventory Reports, Department of Utilities Report Number 2008-01**





OFFICE OF THE  
CITY MANAGER

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CALIFORNIA

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February 17, 2009

Honorable Mayor, City Council Members, and City Manager:

The Sacramento City Auditor has completed a limited scope audit of the Department of Utilities' inventory processes and inventory reports. The processes and reports examined are the responsibility of the Department of Utilities' management. The City Auditor's responsibility is to express an opinion on the inventory processes and reports for the Utilities Department, including the Water, Sewer, and Storm Drainage Funds. The Solid Waste Fund did not reflect an inventory and resultantly was not included in the audit.

This audit was conducted in accordance with the City Council's core values and guiding principles of fiscal responsibility and accountability, as well as applicable standards contained in Government Auditing Standards, issue by the Comptroller General of the United States, with the exception of a peer review.

The audit report provides the Mayor, City Council, and the City Manager with an objective evaluation of the Department of Utilities' inventory processes and inventory reporting.

In my opinion, systematic and material deficiencies existed in the Water, Sewer, and Storm Drainage Funds inventory processes and reports. However, Department of Utilities' representatives were supportive of recommended improvements and made substantial progress in resolving cited deficiencies.

Audit conclusions were discussed in detail with the City Manager's Office and the Director of the Department of Utilities. The written responses to this report are included in the Appendix. I appreciate the cooperation and professionalism of Department of Utilities' representatives that resulted in significant improvements to inventory processes and inventory reports.

  
Martin J. Kolkin  
City Auditor

**Table of Contents**  
**Inventory Processes and Inventory Reports,**  
**Department of Utilities**  
**Report Number 2008-01**

<b><u>EXECUTIVE SUMMARY OF FINDINGS &amp; RECOMMENDATIONS</u></b> .....	iii
 <b><u>PRELIMINARY SECTION</u></b>	
Introduction.....	1
Objective & Scope.....	1
Citywide Ramifications.....	1
 <b><u>CONCLUSIONS FINDINGS</u></b>	
<b>Summary of Audit Findings</b>	
1. <b>Beginning Inventory – Correction of \$486,706 FY 2007 Errors</b> .....	<b>3</b>
1A. Reversal of an Incorrect, FY 2007, \$400,620 Inventory Write-off.....	3
1B. Correction of \$82,086 of FY 2007 Inventory Pricing Errors.....	3
 2. <b>Correction of \$69,058 of Net Errors in FY 2008 Receipts and Disbursements</b> <b>Inventory Reports</b> .....	 <b>3</b>
 3. <b>FY 2008 Physical Count of Ending Inventory Understated by \$457,433</b> .....	 <b>3</b>
 4. <b>Other Concerns</b> .....	 <b>4</b>
Approximately \$600 thousand of fixed assets not recorded on the fixed asset report	
Approximately \$200 thousand of inventory improperly expensed at purchase, instead of recording in inventory as required	
 <b><u>APPENDIX</u></b> .....	 <b>5</b>

**Executive Summary of  
Findings & Recommendations  
Inventory Processes and Inventory Reports,  
Department of Utilities  
Report Number 2008-01**

Material deficiencies in departmental inventory controls were cited in the City of Sacramento's internal audit report *Management Controls: Inventory & Debit Card Usage for the Department of Utilities*, dated May 16, 2008. Further internal audit review of the Department of Utilities ("DOU") was performed at the request of the new DOU Department Director and at the direction of the City Manager, the Mayor, and City Council.

Based upon the work performed, the City Auditor concluded that systematic and material deficiencies existed in the Water, Sewer, and Storm Drainage Funds' inventory processes and reports. However, Department of Utilities' representatives were supportive of recommended improvements and made substantial progress in resolving cited deficiencies.

The City Auditor recommended adjustments to DOU's inventory system and financial statement that resulted in approximately \$871 thousand of net increases for FY 2008. The Director of Utilities concurred and appropriate corrections were made to the City's financial system.

The City Auditor recommends that the Director of Utilities or his representatives implement industry best practices as cited in *Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property*, released by the Government Accountability Office ("GAO") in March 2002.

GAO Best Inventory Practices	Action Taken by Management	Estimated Completion Date
1. Establish Accountability	The Director of Utilities concurred with implementing all GAO's Best Inventory Practices.	Completed
2. Establish Written Policies		Completed
3. Select an Approach		Completed
4. Determine Frequency of Counts		Completed
5. Maintain Segregation of Duties		Completed
6. Enlist Knowledgeable Staff		Completed
7. Provide Adequate Supervision		Completed
8. Perform Blind Counts		Completed
9. Ensure Completeness of Counts		Completed
10. Execute Physical Counts		Completed
11. Perform Research		Completed
12. Evaluate Count Results		Completed

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**Preliminary Section**  
**Inventory Processes and Inventory Reports,**  
**Department of Utilities**  
**Report Number 2008-01**

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**INTRODUCTION**

The City Auditor completed a limited scope examination of the inventory processes and reports for the Water, Sewer, and Storm Drainage Funds. The Solid Waste Fund did not reflect an inventory and accordingly was not included in this audit.

**OBJECTIVE & SCOPE**

This report provides the Mayor, City Council, and the City Manager with an objective evaluation of the Department of Utilities' inventory processes and inventory reporting tools for the Water, Sewer, and Storm Drainage Funds. The objectives of this internal audit report also include providing recommendations for best practices in achieving accurate inventory counts and inventory reports.

**Records Examined**

The audit included, but was not limited to the following:

- Physical observations of internal controls, operations, and practices;
- Analytical examinations of financial data;
- Examination and verification of general ledger data;
- Review of inventory reports and programming;
- Interviews and discussions with personnel from the Department of Utilities, the Finance Department, the City Attorney's Office, and the City Manager's Office; and
- Review of best practices for inventory.

The audit report is intended for the information and use of the Mayor, City Council, City Manager, and City Management.

**CITYWIDE RAMIFICATIONS**

This report focused solely upon the inventory for DOU. Conclusions regarding other City Departments are beyond the scope of this audit. However, audit recommendations have relevance for numerous City Departments that maintain inventory.

**Conclusions and Findings  
Inventory Processes and Inventory Reports,  
Department of Utilities  
Report Number 2008-01**

The City Auditor determined that systematic and material deficiencies existed in the Water, Sewer, and Storm Drainage Funds' inventory processes and reports. Deficiencies located included flawed and inadequately designed inventory reports, insufficient internal controls, pricing input errors, quantity input errors, inadequate separation of duties, inaccurate physical inventory counts, and the absence of internal process to report deficiencies to management.

**Summary of Audit Findings**

Finding	Findings	Dollar Value
1	Correction of FY 2007 Beginning Inventory	\$482,706
2	Errors in FY 2008 Inventory Reports	< 69,058 >
3	FY 2008 Physical Count Understatement	457,433
	<b>Total Findings</b>	<b>\$871,081</b>

Additionally, \$161,381 of tools was misclassified as DOU's inventory within the City's financial system.

**DEPARTMENT DIRECTOR'S ACTION**

Department Director Marty Hanneman immediately committed resources to resolve located deficiencies. The status of the corrective actions is noted throughout this report.

**FINDINGS**

DOU's inventory processes and reports required corrections to all aspects of the inventory process; 1) Beginning Inventory; 2) Receipts and Disbursements Inventory Reports, 3) Physical Counts and 4) Other Concerns.

**Table of Inventory Adjustments**

	Per Inventory Reports	Adjustment Needed	Per Audit
Beginning Inventory, 7/1/07	\$1,884,518*	\$ 482,706	\$2,367,224
Net Receipts & Disbursements	916,621	<69,058>	847,563
Ending Inventory, 6/30/08	\$2,801,139*	\$ 413,648	\$3,214,787
Short and Over	<56,873>	43,785	<13,088>
Physical Count	\$2,744,266	\$ 457,433	\$3,201,699

\* - Beginning and Ending Inventory were decreased by \$161,381 for the reclassification of tools incorrectly included in inventory.

**1. Beginning Inventory – Correction of \$482,706 FY 2007 Errors**

The City of Sacramento's internal audit report *Management Controls: Inventory & Debit Card Usage for the Department of Utilities* dated May 16, 2008, cited material errors in the FY 2007 inventory report used as the basis for a \$400,620 inventory write-off. The Audit Report recommended taking steps to accurately compute the value of the ending inventory.

**1A. Reversal of an Incorrect, FY 2007, \$400,620 Inventory Write-off**

The City Auditor recommends that the \$400,620 inventory write-off entry for FY 2007 be reversed in FY 2008 and the correct beginning inventory value determined.

**The Director of Utilities concurred and this entry was reversed in FY 2008.**

**1B. Correction of \$82,086 of FY 2007 Inventory Pricing Errors**

The City Auditor recommends that the beginning inventory of FY 2008 be increased by \$82,086 to correct for pricing errors, incomplete data, and computational errors.

**The Director of Utilities concurred and this entry was made in FY 2008.**

**2. Correction of \$69,058 of Net Errors in FY 2008 Receipts and Disbursement Inventory Reports**

DOU representatives acknowledged during the audit that pricing errors in their receipts and disbursement reports were so prevalent that no reliance could be placed on unit costs information within that system. Additionally, employees were permitted unrestricted access, without training, to "correct" pricing per unit and number of units purchased. Lastly, no internal procedures existed for reporting deficiencies to DOU management.

Table of Total Receipts & Disbursements

	Per Inventory Reports	Adjustment Needed	Per Audit
Total Receipts	\$5,515,573	\$<2,411,067>	\$3,104,507
Total Disbursements	4,598,952	<2,342,009>	2,256,944
Net Receipts and Disbursements	\$ 916,621	<\$69,058>	\$847,563

**The Director of Utilities concurred. DOU representatives corrected design flaws in inventory reports, developed sufficient internal controls, provided controls for adequate separation of duties, provided ongoing training, and developed internal procedures for reporting deficiencies to DOU management.**

**3. FY 2008 Physical Count of Ending Inventory Understated by \$457,433**

As previously noted, DOU representatives acknowledged during the audit that pricing errors in their inventory system were so prevalent that no reliance could be placed on unit costs information within that system. **As a result, DOU's FY 2008 inventory valuations for the City's financial statements were recalculated based upon replacement costs<sup>1</sup> and the physical count of the ending inventory, conducted by DOU, was understated by \$457,433.**

<sup>1</sup> The City Auditor noted that this inventory methodology was not in accordance with Generally Accepted Account Principles ("GAAP"). However, if fully disclosed, it is the City Auditor's opinion that this inventory valuation was one of the more practical methodologies available to DOU representatives.

According to DOU representatives, unit cost corrections within DOU's inventory system are scheduled to be completed in January 2009.

**The Director of Utilities concurred and this entry was posted in FY 2008.**

**4. OTHER CONCERNS**

According to Plant Services Division representatives no fixed asset listing existed and inventory on hand was immediately expensed. Plant Services Division representatives estimated the dollar value of these items as approximately:

- A. \$600 thousand of fixed assets not on the fixed asset report; and
- B. \$200 thousand of inventory improperly expensed at purchase, instead of recording in inventory as required.

DOU representatives noted that fixed assets had been inventoried, as recommended by the City Auditor. DOU representatives also stated that new procedures were implemented to ensure that inventory is recorded in a consistent and well documented manner.

**APPENDIX**  
**Management Response**



Department of Utilities  
Office of the Director

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CALIFORNIA

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January 29, 2009

**MEMORANDUM**

**TO:** Martin Kolkin, City Auditor

**FROM:** Marty Hanneman, Director of the Department of Utilities 

**SUBJECT:** Response to the Internal Audit of the Inventory Processes and Inventory Reports of the Department of Utilities

The Department of Utilities (DOU) acknowledges the findings contained in the internal audit report of its Inventory Processes and Inventory Reports. DOU is in agreement with the audit findings and supports the report's recommendation to implement best practices for inventory as cited by the Government Accountability Office (GAO), dated March 2002, *Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property*.

The Department of Utilities has undertaken a wide range of improvements designed to elevate its inventory practices and to increase management oversight of procurement practices and full compliance with City Policies.

Management Action

As noted in the Internal Auditor's Report Number 2008-01 Inventory Processes & Inventory Reports, Department of Utilities, the DOU implemented the *Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property* as cited by the GAO providing transparency and accountability. Below is a summary of DOU's actions related to the twelve (12) best practices.



CITY OF SACRAMENTO  
DEPARTMENT  
OF UTILITIES

*Making a Difference in Your Neighborhood*

Staff Report 14

GAO Best Inventory Practices	Action Taken by Management	Estimated Completion Date
1. Establish Accountability	The Director of Utilities concurred with implementing all GAO's Best Inventory Practices.	Completed
2. Establish Written Policies		Completed
3. Select an Approach		Completed
4. Determine Frequency of Counts		Completed
5. Maintain Segregation of Duties		Completed
6. Enlist Knowledgeable Staff		Completed
7. Provide Adequate Supervision		Completed
8. Perform Blind Counts		Completed
9. Ensure Completeness of Counts		Completed
10. Execute Physical Counts		Completed
11. Perform Research		Completed
12. Evaluate Count Results		Completed

DOU is committed to monitoring these business processes for continued application ensuring inventory is managed efficiently and in accordance with GAO's best practices.