City and County of San Francisco

Office of the Controller – City Services Auditor

DEPARTMENT OF PUBLIC HEALTH:

Internal Controls at Laguna Honda Hospital's Central Supply Department Do Not Ensure That Assets Are Properly Accounted for and Safeguarded

March 27, 2014

OFFICE OF THE CONTROLLER
CITY SERVICES AUDITOR

The City Services Auditor Division (CSA) was created in the Office of the Controller through an amendment to the Charter of the City and County of San Francisco (City) that was approved by voters in November 2003. Charter Appendix F grants CSA broad authority to:

- Report on the level and effectiveness of San Francisco's public services and benchmark the City to other public agencies and jurisdictions.
- Conduct financial and performance audits of city departments, contractors, and functions to assess efficiency and effectiveness of processes and services.
- Operate a whistleblower hotline and website and investigate reports of waste, fraud, and abuse of city resources.
- Ensure the financial integrity and improve the overall performance and efficiency of city government.

CSA may conduct financial audits, attestation engagements, and performance audits. Financial audits address the financial integrity of both city departments and contractors and provide reasonable assurance about whether financial statements are presented fairly in all material aspects in conformity with generally accepted accounting principles. Attestation engagements examine, review, or perform procedures on a broad range of subjects such as internal controls; compliance with requirements of specified laws, regulations, rules, contracts, or grants; and the reliability of performance measures. Performance audits focus primarily on assessment of city services and processes, providing recommendations to improve department operations.

CSA conducts its audits in accordance with the Government Auditing Standards published by the U.S. Government Accountability Office. These standards require:

- Independence of audit staff and the audit organization.
- Objectivity of the auditors performing the work.
- Competent staff, including continuing professional education.
- Quality control procedures to provide reasonable assurance of compliance with the auditing standards.

For questions about the report, please contact Director of City Audits Tonia Lediju at Tonia.Lediju@sfgov.org or 415-554-5393 or CSA at 415-554-7469.

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City and County of San Francisco

Office of the Controller – City Services Auditor

Department of Public Health:
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Purpose of the Audit

The Office of the Controller's City Services Auditor Division (CSA) performed an inventory audit of the Central Supply Department (Central Supply) at Laguna Honda Hospital and Rehabilitation Center (Laguna Honda). The audit determined whether the department has adequate inventory processes and controls to ensure that materials, supplies, and tools are accurately accounted for, adequately organized, and properly secured.

Highlights

The inventory and materials management processes of Laguna Honda's Central Supply have multiple weaknesses. Although purchase orders are correctly recorded as part of the inventory process, the audit found numerous errors in the sampled inventory records, a lack of policies and procedures to guide physical inventory counts, dispensing of obsolete items, and manual inventory operations. Overall, Central Supply's internal controls are inadequate because they do not reasonably assure Laguna Honda that assets are properly accounted for and safeguarded. Specifically, the audit found that Central Supply:

- Has inventory on hand that does not match its system records.
- Performs inconsistent counts and does not track frequency of counts performed.
- Adjusts its inventory category thresholds without proper analysis or oversight.
- Has weak internal controls over reconciliation of quantity discrepancies in inventory cycle counts.
- Uses an inventory valuation method that is inconsistent with Laguna Honda's accounting policy.
- Does not record the value of the inventory transferred from the Pharmacy Room.
- Does not limit the distribution of its master keys, which increases risk and limits accountability if loss occurs.
- Lacks written policies and procedures for dispensing expired or obsolete items, and management does not sign to indicate its approval before the disposal of these items.
- Lacks written policies and procedures to perform physical inventory counts.
- Correctly records its purchases orders.

Recommendations

The report includes 21 recommendations for the department to strengthen its inventory and material management controls. Specifically, Central Supply should:

- Establish performance goals for the physical count.
- Implement procedures to ensure that periodic inventory counts are scheduled and performed.
- Periodically analyze usage to validate the inventory segments.
- Ensure that Central Supply values its inventory in accordance with its accounting policy.
- Record the cost of each inventory item on its inventory lists.
- Separate duties so that staff that counts inventory cannot adjust quantities in the Pathways system.
- Establish written policies and procedures.

Copies of the full report may be obtained at:
Office of the Controller ● City Hall, Room 316 ● 1 Dr. Carlton B. Goodlett Place ● San Francisco, CA 94102 ● 415.554.7500
or on the Internet at http://www.sfgov.org/controller

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CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ben Rosenfield
Controller

Monique Zmuda
Deputy Controller

March 27, 2014

Health Commission
101 Grove Street, Room 311
San Francisco, CA 94102

Ms. Barbara A. Garcia
Director of Health
Department of Public Health
101 Grove Street, Room 308
San Francisco, CA 94102

Dear commission president and members, and Ms. Garcia:

The Office of the Controller's City Services Auditor Division (CSA) presents its audit report of inventory processes of the Central Supply Department (Central Supply) at Laguna Honda Hospital and Rehabilitation Center (Laguna Honda). The audit objectives were to determine whether Central Supply has adequate inventory processes and controls to ensure that materials and supplies are accurately accounted for, adequately organized, and properly secured.

The audit concluded that Central Supply's internal controls are inadequate to ensure that assets are properly accounted for and safeguarded.

The report includes 21 recommendations for Laguna Honda to improve control and accountability over safeguarding of assets and inventory functions at Central Supply. The department's response to the report is attached as an appendix.

CSA appreciates the assistance and cooperation of Laguna Honda staff during the audit. For questions about the report, please contact me at Tonia.Lediju@sfgov.org or 415-554-5393 or CSA at 415-554-7469.

Respectfully,

Tonia Lediju
Director of City Audits

cc: Mayor
Board of Supervisors
Citizens Audit Review Board
City Attorney
Civil Grand Jury
Budget Analyst
Public Library

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GLOSSARY OF TERMS

ABC	ABC is not an acronym, but rather an inventory categorization technique often used in materials management.
Central Supply	The Central Supply Department at Laguna Honda Hospital and Rehabilitation Center
City	City and County of San Francisco
Controller	Office of the Controller
CSA	The Office of the Controller's City Services Auditor Division
First In, First Out	Under the first in, first out inventory valuation method, the cost of goods sold is based upon the cost of material bought earliest in the period, while the cost of inventory is based upon the cost of material bought later in the year. This results in inventory being valued close to current replacement cost.
GAO	U.S. Government Accountability Office
Laguna Honda	Laguna Honda Hospital and Rehabilitation Center
Pathways	Pathways Material Management™ (PMM) is the principal system used by the Central Supply Department to monitor inventory levels of medical supplies and order medical supplies from the contracted vendor. PMM is part of McKesson Corporation's enterprise resource utilization (ERP) hospital applications.

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INTRODUCTION

Audit Authority

This audit was conducted under the authority of the Charter of the City and County of San Francisco (City), Section 3.105 and Appendix F, which requires that the Office of the Controller's (Controller) City Services Auditor Division (CSA) conduct periodic, comprehensive financial and performance audits of city departments, services, and activities. CSA conducted this audit under that authority and in accordance with its annual audit plan. This audit is the first in a series of inventory audits of various city departments planned by the Controller.

Background

Laguna Honda Hospital and Rehabilitation Center (Laguna Honda) is a skilled nursing and rehabilitation center owned by the City and operated by the Department of Public Health. The hospital provides skilled nursing services, rehabilitation services, group living for people with developmental disabilities, and treatments and programs for a variety of other conditions. Laguna Honda stores most of its inventory in five departments of the hospital:

1. Pharmacy (pharmaceutical supplies)
2. Central Supply (medical supplies)
3. Food and Nutrition Services
4. Linen (linen used on patient beds)
5. Materials Management (janitorial supplies)

Laguna Honda reported fiscal year 2012-13 year-end inventory valued at $1.1 million. Exhibit 1 shows the areas where the hospital stores its inventory items and their values on June 30, 2013.

EXHIBIT 1 Inventory on June 30, 2013

Department	Inventory Balance
Pharmacy	$430,718
Linen	391,007
Central Supply	175,910
Food and Nutrition Services	106,130
Materials Management	26,994
Total	$1,130,759

Source: Laguna Honda Accounting/Finance Division

Based on a risk assessment of Laguna Honda's five inventory locations, CSA determined that the Central Supply Department (Central Supply) had the highest risk and selected it for audit.

Overview of Laguna Honda Hospital's Inventory

Mission and Services. Central Supply's mission is to stock Laguna Honda's nursing units with medical supplies and equipment needed for the care of residents. Central Supply's inventories are stored at the Central Supply Room and the Materials Management Department warehouse. Central Supply carried 657 inventory items on October 1, 2013. Central Supply is open from 6:30 a.m. to 8:30 p.m., seven days a week to accommodate the needs of the nursing units and to be responsive to peak demand periods.

Inventory Management System. Central Supply uses the Pathways Material Management System (Pathways) to monitor inventory levels of medical supplies on the nursing units and to order medical supplies from contracted vendors when inventory levels fall below the PAR level.[1] Central Supply, in collaboration with the Nursing Services Department, established and entered into Pathways the PAR levels of medical supplies for each nursing unit. PAR levels are established to provide three to four days of medical supplies.

Each day, Pathways calculates necessary inventory replenishments using the established minimum and maximum inventory levels and pending department order requests in the system. Central Supply reviews, approves, and processes the replenishment requisitions.

Objectives

The audit's objectives were to determine whether Central Supply:

1. Has inventory processes and controls adequate to ensure that materials and supplies are accurately accounted for.
2. Adequately organizes and properly secures all materials and supplies.
3. Approves and records inventory purchase orders accurately and in a timely manner.

[1] PAR levels are boundary markers in inventory levels that signal replenishment needs.

Scope and Methodology

The audit included all items inventoried by Laguna Honda's Central Supply from July 1, 2012, through June 30, 2013. To perform the audit, the audit team:

- Interviewed staff and managers to gain an understanding of Central Supply's inventory processes.
- Inspected the Central Supply Room.
- Judgmentally selected a sample of 25 inventory items from the inventory list and, using physical inspection, verified the number of units on hand.[2]
- Judgmentally selected a sample of 25 inventory items in the room and verified that they were on an inventory list.
- Selected a sample of 24 items from an inventory list and tested to determine if orders were properly approved and whether items were received and recorded in the inventory management system.

Statement of Auditing Standards

This performance audit was conducted in accordance with generally accepted government auditing standards. These 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. CSA believes that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

[2] Auditors counted the individual units on hand for the selected inventory items. Auditors did not use blank inventory count sheets but used the full inventory list containing items and quantities on the day of the count.

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AUDIT RESULTS

Summary

The inventory and materials management processes of Laguna Honda's Central Supply have multiple weaknesses. CSA found numerous errors in the sampled inventory records, ineffective internal controls, a lack of policies and procedures to guide physical inventory counts, and dispensing of obsolete items. Overall, Central Supply's internal controls are inadequate because they do not reasonably assure Laguna Honda that assets are properly accounted for and safeguarded.

Finding 1

Central Supply's inventory on hand does not match its system records.

Central Supply's inventory record is inaccurate.

Central Supply's inventory record is inaccurate because it includes both shortages and overages.[3] Central Supply relies on its inventory management system, Pathways, to maintain an accurate list of its inventory. On the day of a count, Central supply staff generates from the Pathways system a list of items to be counted.

System counts did not match actual counts for 12 of 25 selected items.

Test counts of the inventory found multiple discrepancies between system and floor counts. Of the 657 items on Central Supply's inventory list on October 1, 2013, 25 (4 percent) were judgmentally selected for audit to determine the accuracy and existence of the counts in Pathways. Another judgmentally selected 25 items were counted from the inventory floor to determine the completeness of the counts in Pathways.

As shown in Exhibit 2, the system-to-floor test found that the physical inventory amounts did not match for 12 (48 percent) of the 25 items in the sample. For 6 items there were greater quantities than shown on the inventory records (an overage in Pathways of $332 of inventory) and for 6 other items, there were fewer on hand than listed (a shortage in Pathways of $590). The net variance was 3 percent of the value of the inventory sampled.

[3] Shortages exist when Pathways Material Management System (PMM) shows more items than are on hand. Overages are when PPM shows fewer items than are on hand.

EXHIBIT 2 Discrepancies in Inventory Records Based on System-to-Floor Physical Count

Item Number	Quantity in System	Number of Items Counted	Difference	Discrepancy Amount
4048	9	10	1	$165.95
4057	28	26	(2)	(112.04)
1001199	10	13	3	35.58
1126	205	183	(22)	(44.40)
1152	88	112	24	78.96
1191	23	17	(6)	(6.46)
1270	14	15	1	22.90
1287	25	19	(6)	(358.80)
1324*	25	80	55	0.00
1573	2	3	1	28.70
1574	3	2	(1)	(35.56)
1585	7	5	(2)	(32.75)
Total	**439**	**485**	**46**	**($257.92)**

* This part was transferred from the Pharmacy Department and has no value assigned. Please refer to finding 6 for further details.

Source: Auditor's analysis of sample of 25 items.

On the floor-to-system test, the physical inventory amounts did not match for 7 (28 percent) of the 25 items sampled (see Exhibit 3). For three items, there were more items on hand than shown in the inventory records (overage in Pathways of $279) and for four items there were fewer (shortage in Pathways of $956). The net variance was 9 percent of the value of the inventory sampled.

EXHIBIT 3 Discrepancies in Inventory List Based on Floor-to-System Physical Count

Item Number	Number of Items Counted	Quantity in System	Difference	Discrepancy Amount
1596	584	252	332	$262.28
1417	328	224	104	14.56
7049505	31	32	(1)	(0.24)
4264	95	96	(1)	(9.67)
5788656	60	78	(18)	(945.91)
4066	208	209	(1)	(0.22)
1499	15	14	1	1.67
Total	**1321**	**905**	**416**	**($677.53)**

Source: Auditor's analysis of sample of 25 items.

Floor counts did not match inventory records for 7 of 25 selected items.

Both overages and shortages may indicate potential loss or theft or, at a minimum, issuance issues. A shortage indicates that items were removed from inventory without updating records. An overage indicates that items were not recorded in inventory when stocked or that issued items were returned to the shelf. An overage can also occur when withdrawals from inventory are not recorded. These inaccuracies increase the risk of undetected theft and lost or missing assets.

Central Supply needs to establish accountability and set performance goals.

Central Supply personnel could not adequately explain the reasons for these discrepancies. Inaccurate records of the inventory items on hand make it more difficult to detect loss or theft. Inaccurate records also make it more difficult to monitor the inventory levels and reorder points to ensure that items are available when needed. Proper inventory accountability requires that detailed records of acquired inventory be maintained and that inventory is properly reported.

According to the U.S. Government Accountability Office (GAO) *Executive Guide: Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property* (GAO Guide),[4] one of the key factors in developing and implementing an accurate physical count process is to establish accountability. Establishing accountability for the inventory physical count process requires setting performance goals and holding the appropriate level of personnel responsible for the overall process. Performance goals for the physical count process can be set by establishing inventory record accuracy goals or other measurable, results-oriented performance expectations, such as adjustments and the number of accurate counts. Primary responsibility for the overall physical inventory counts should be specifically designated and assigned. The designated individual should be held responsible for achieving an established inventory record accuracy goal.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

1. Direct Central Supply Department staff to conduct

[4] GAO-02-447G, United States General Accountability Office, 2002, http://www.gao.gov

a 100 percent physical count of the inventory and reconcile discrepancies to establish a new inventory baseline.

2. Establish performance goals for the physical count and develop employee/supervisor performance measurement systems to hold appropriate personnel accountable for accomplishing a consistent, accurate physical count of inventory.

Finding 2

Central Supply staff performs inconsistent counts and does not track the frequency of counts performed.

Inventory counts are not performed at regularly scheduled intervals.

The Central Supply employees do not regularly perform inventory cycle counts. Without regular cycle counts of its entire inventory, Central Supply cannot ensure that its inventory is being adequately protected against loss and theft, that there are no shortages or unnecessary purchases, or that the inventory is properly reported in Laguna Honda's financial records.

Inventory items are segmented in three categories.

According to the director of materials management, who oversees both the Materials Management and Central Supply departments, inventory items have been segmented into three categories based on their usage level. Category A represents inventory items in the top 20 percent in terms of usage rate, in category B are items in the next 20 percent, and in category C are items in the remaining 60 percent. Each category is counted with greater or lesser frequency to achieve more coverage of the most frequently used inventory items and less coverage of the inventory items with little or no movement. According to management, Category A items are scheduled to be counted weekly, Category B items every other week, and category C items monthly.

Only seven counts occurred in fiscal year 2012-13.

Central Supply's cycle count transactions summary report for fiscal year 2012-13 shows that only seven cycle counts were performed in the year, of which three were in June 2013. Before June 2013 Central Supply staff performed its last physical inventory count on April 10, 2013, which illustrates the irregular frequency of the inventory counts performed. The materials management director acknowledged that cycle counts are not

conducted routinely. He also explained that Central Supply does not have enough personnel to perform the planned inventory counts.

A log of records of physical counts performed is not maintained.

Central Supply does not use a tracking log of cycle counts performed for each category of inventory. The lack of a tracking log indicates that Central Supply staff does not monitor the cycle counts of items to achieve the desired frequency of counts or assure an accurate count. A tracking log of the physical counts for each category would ensure that all items in each category are adequately counted.

According to the GAO Guide, counting an appropriate amount of the total inventory at a point in time or over a period of time with regular frequency helps to provide accurate inventory records for operational decisions and financial reporting. Without periodically scheduled physical inventory counts, inventory shortages and overages could occur and remain undetected.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

3. Implement procedures to ensure that periodic inventory counts are scheduled, performed regularly, and reconciled to the perpetual inventory and accounting records.

4. Create a manual or electronic tracking log to record category counted and the dates of the cycle counts.

Finding 3

Central Supply's ABC inventory category thresholds are adjusted without proper analysis or oversight.

No usage analysis was performed to validate the inventory segments.

Central Supply staff can adjust the category thresholds of the items listed in the inventory management system without management's preapproval. As noted in Finding 2, inventory items were categorized into A, B, and C categories to help management identify items with significant impact on overall inventory cost and requiring different management and controls. However, according to Central Supply staff during a walkthrough of the Central Supply Room by the audit team, the thresholds of

the items that fall under categories A, B, and C had been adjusted in the prior quarter. The staff stated that the thresholds for categories A and B were updated the prior quarter to each cover the top 40 percent of items in terms of usage rate. According to the interim lead Central Supply Technician, the higher thresholds were used to help increase the physical counts coverage. This change to the categories' thresholds was implemented without prior approval from the materials management director or the assistant materials manager.

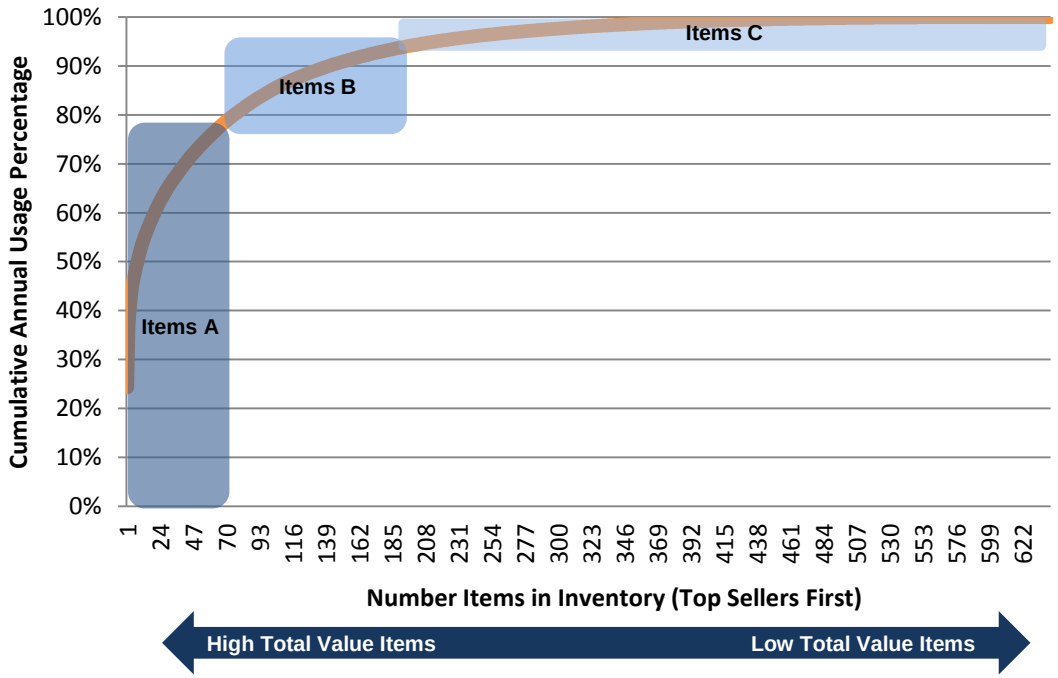
The materials management director confirmed that the three inventory segmentations were initially determined based on industry practices. He also stated that since the implementation of the inventory management system, the department has not analyzed its inventory usage to validate the thresholds of the segments due to staff shortages.

According to the GAO Guide, to count an appropriate amount of the total inventory, management must decide which inventory items to count and how frequently those items should be counted. Ideally, all inventory items would be counted at least yearly. However, maintaining accurate inventory records by counting items takes time and costs money. Because there are limits on these resources, the best way to balance control of the inventory and the cost of the count is to focus on the items determined to be more important or at higher risk of loss or theft. Management should consider items' value, criticality to operations, and susceptibility to theft or fraud when segmenting the inventory and determining the frequency of counts for each segment.

Measuring the significance of each type of inventory item in terms of usage or value will help management divide the inventory into identifiable segments and determine the frequency of counts based on the assessed risk of each segment. Management has adopted the ABC classification as its inventory categorization technique and segmented its inventory items based on usage to help focus on items that cost the department most in terms of total consumption value. The higher the usage, the more activity an item is likely to have, hence the greater likelihood that transaction issues will result in inventory errors.

To make the most effective use of the ABC classification, periodic review should be completed to validate the categories. The audit identified three categories based on an analysis of Central Supply's inventory usage during fiscal year 2012-13, as shown in Exhibit 4.

EXHIBIT 4 **Central Supply Usage Analysis**
Fiscal Year 2012-13



Source: Auditor's analysis of data from Pathways Material Management System.

Based on the usage rate of inventory items, the top 10 percent of the items account for 78 percent of the annual inventory consumption value, the next 20 percent of the items account for 16 percent of the annual consumption value, and the bottom 70 percent of the items account for only 6 percent of the annual consumption value. Because 78 percent of the annual inventory consumption is covered by only 10 percent of the items in inventory, these items warrant the most attention. The next segment covers 16 percent of the items in inventory and should also have sufficient coverage.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

5. Periodically analyze usage to validate the inventory segments, determine the desired frequency of counts, and reassess the risk of each segment.

6. Require proper signoff by the director of materials management before any update to the inventory segments.

Finding 4

Central Supply needs to strengthen internal controls over reconciliation of quantity discrepancies in inventory cycle counts.

Inventory count and recording duties are not segregated.

Central Supply's processes to reconcile inventory discrepancies are inadequate. The employees responsible for performing inventory cycle counts are also permitted to adjust the inventory list. This lack of separation of duties is an internal control weakness that increases the risk of fraud. If the duties are not separated, the control weakness can result in improper transactions being recorded in the inventory records to cover improper or unauthorized transactions. Also, errors can easily be hidden at the time of cycle counts without further investigation.

In fiscal year 2012-13 568 inventory cycle count adjustments were made to Central supply's inventory, of which 97 percent were processed by the same four employees who performed the inventory cycle counts. Further, according to Central Supply staff no specific guidance was provided to staff on inventory shortage or overage thresholds requiring management's review and approval. Central Supply management also could not provide evidence of any reconciliation having been performed between cycle count sheet quantities and inventory item transactions to identify causes of the quantity discrepancies.

According to staff, Central Supply's process is to discard count sheets after inputting the physical count results in the inventory system. Thus, it could not provide any supporting documents for the inventory cycle count adjustments or copies of completed count sheets, except

for the June 28, 2013, physical inventory count.

Segregation of duties is a widely accepted internal control and business practice. It entails segregating key duties among different people, and reduces the risk of error and fraud so that no single individual can adversely affect the accuracy and integrity of the count. The key areas of segregation are physical custody of assets, processing and recording of transactions, and approval of transactions. Ideally, personnel performing any one of the above functions would not also have responsibilities in either of the other two functions.

Without proper reconciliations, accounting records could be inaccurate

According to the GAO Guide, even with a strong control environment and sound physical count procedures, it is not unusual for there to be differences in quantities between the physical count and the record. Research about the cause—sometimes referred to as root cause analysis—and reconciliation of differences are essential elements of an effective physical count process. The process of research includes performing the required analysis, promptly completing research, and referring variances to management for approval and/or security for investigation. Research, when properly conducted, supports adjustment to the inventory records, identifies the causes of variances between the physical count and the inventory records, and provides management with information with which to implement corrective actions.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

7. Separate Central Supply Room duties so that staff responsible for counting inventory cannot adjust quantities in the Pathways system. Differences between inventory records and actual quantities on hand should be adjusted only after review and approval by management.

8. Establish policies and procedures that guide staff on how to formally report inventory discrepancies to management.

9. Develop a record retention policy for files supporting the inventory physical counts.

Finding 5

Central Supply's inventory valuation method is inconsistent with Laguna Honda's accounting policy.

According to Laguna Honda's accounting policy, inventory unit cost is based on the value of the units placed into inventory last. However, Central Supply does not follow this policy, instead using unit prices from the pricing agreement with its prime distributor to update the unit cost of inventory on hand. As a result, Central Supply cannot be assured that it reports the value of its inventory correctly in Laguna Honda's financial records.

According to management, Central Supply switched to a new prime distributor in June 2013. Due to the lower markup fees in the new pricing agreement, management reevaluated its inventory items and updated the unit costs on both open purchase orders and inventory on hand supplied by the prime distributor.

Of the 24 items the audit selected from the inventory list to verify per-unit cost, 13 (54 percent) were correctly valued based on the last replenishment receipts, while the other 11 (46 percent) were valued based on pricing information provided by the prime distributor rather than the value of the units placed into inventory last. As a result, Central Supply undervalued this inventory by $361 (6 percent of the value of the inventory sampled).

Recommendation

10. Laguna Honda Hospital and Rehabilitation Center should ensure that the Central Supply Department values its inventory in accordance with its accounting policy.

Finding 6

Central Supply does not record the value of inventory items transferred from the Pharmacy Department.

2 percent of the inventory items on hand have no recorded value.

Its inventory list shows that Central Supply holds inventory items with no value assigned. Of the 654 items listed on Central Supply's inventory list on June 28, 2013, 11 items (2 percent) have no dollar value shown.

According to management, the inventory items with no recorded value were requested from the Pharmacy Department. Central Supply does not incur the related

costs of these transferred items and, therefore, does not assign value to them; the Pharmacy Department absorbs the full cost of these items. However, by not tracking the value of the items obtained from the Pharmacy or retaining records supporting their value, the value of Central Supply's inventory is not correctly reported in financial statements.

According to Laguna Honda's inventory valuation policy, unit cost used for inventory on hand is the value of the units placed into inventory last and the units distributed on a first in, first out basis. Central Supply must record the cost of the items in its inventory to support this financial statement practice and the total value of its inventory on Laguna Honda's financial statements.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

11. Record the cost of each inventory item on its inventory lists.

12. Ensure that inventory items transferred between departments are expensed when consumed.

Finding 7

Wide distribution of Central Supply master keys increases risk and limits accountability if loss of inventory items occurs.

Multiple departments have master keys to access to the Central Supply Room after regular business hours.

Although the Central Supply Room is properly locked and off-limits to the public during regular business hours, its keys have been widely distributed. This is a problem, especially because the inventory area lacks both security cameras and an electronic key card system.

Master keys to the room have been issued to other Laguna Honda departments, including Facility Services and Nursing Services Department. According to Central Supply staff, Nursing Services Department staff occasionally accesses the Central Supply Room to take medical supplies and equipment in case of emergency needs after regular business hours. Nurses will usually leave written notes for Central Supply staff detailing the items and quantity taken. However, Central Supply could not provide any support to show how a note left by

nursing staff for items taken from the storeroom after business hours resulted in a subsequent adjustment in the inventory system to update the inventory list.

There is no list of the employees who have been given keys to the Central Supply storeroom. Therefore, no assurance exists that only authorized users are accessing the inventory areas. According to Materials Management and Central Supply policy and procedures, when Central Supply is not open and staffed, medical supplies and equipment can be obtained by contacting the nursing supervisor who has access to the storeroom. However, the procedures manual does not address any required form to document items withdrawn from Central Supply or who is responsible for entering requisitions into the inventory system.

According to guidance from the Auditing Standards Board,[5] access to a storage area should be limited to those employees whose duties require it, and the custody of keys should be controlled. This guidance specifically addresses controls for a public warehouse and management's responsibility for the safeguarding of its assets. CSA is applying this guidance to Central Supply given the similarities in management practices and processes.

The risk of internal theft or loss at Central Supply is increased due to the number of employees and different hospital departments that can access the storeroom, especially after regular business hours. Central Supply staff would be unaware of missing inventory or inventory taken after regular business hours if nursing employees choose not to or, due to time constraints, are unable to leave a note listing the items taken. Also, Central Supply has no process to track who entered and exited the storeroom during hours when it is closed.

Access to the storeroom should be reduced to limit opportunities for anyone to remove inventory items without recording having done so. Discrepancies noted during the audit's physical count may have originated

[5] Auditing Standards Board's Statement of Auditing Standards, AU 901, *Public Warehouses – Controls and Auditing Procedures for Goods Held*, Section 901.15. The Auditing Standards Board is the American Institute of Certified Public Accountants' senior committee for auditing, attestation, and quality control applicable to the performance and issuance of audit and attestation reports for nonissuers.

from staff accessing or returning inventory items after regular business hours without recording the transactions in the inventory system.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

13. Document and implement inventory security policies and communicate these policies to employees of the departments accessing the Central Supply storeroom.

14. Develop a log or pre-numbered form to keep track of items taken after business hours.

15. Require employees accessing the Central Supply storeroom after business hours to document on the log or form all necessary information, including but not limited to employee ID, item number, date and time, and quantity taken.

16. Require nursing supervisors to authorize in writing the withdrawal of materials from the Central Supply storeroom after regular business hours and require Central Supply personnel to input the information in the inventory system and file supporting documents.

17. Re-key the Central Supply storeroom immediately, and track the issuance of master keys. After Central Supply completes its move to its new location, it should limit key distribution or install electronic keys to track employees' entry into the facilities.

Finding 8

Central Supply lacks written policies and procedures to perform physical inventory counts.

Central Supply lacks written policies and procedures to perform physical inventory counts.

Central Supply does not have documented policies and procedures that would provide employees clear and comprehensive instructions and guidelines on how and when to perform inventory counts. The absence of clearly written policies and procedures that define limits of authority can give staff excessive discretion that may provide opportunities for undetected thefts and other

fraudulent activities. Lack of procedures makes it difficult to hold individuals accountable for their actions.

According to the GAO Guide, establishing and documenting policies and procedures are essential to an effective and reliable physical count. Policies and procedures demonstrate management's commitment to the inventory physical count process and provide to all personnel clear communication and comprehensive instructions and guidelines for the count. Establishing written policies and procedures helps ensure consistent and accurate compliance and application needed to achieve high levels of integrity and accuracy in the physical count process. Policies and procedures also become the basis for training and informing employees and the reference when there is turnover in personnel.

Once policies and procedures have been established and documented, they must be regularly reviewed and updated to reflect changes in the process and tasks of the physical count. According to the director of materials management, Central Supply is relocating to a new building in the next fiscal year. Hence, written policies will be created after the move is completed to match the new processes that management will put in place.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

18. Establish written policies and procedures for the physical count process at the Central Supply storeroom. The written procedures should provide formal instructions for all aspects of the physical count processes, including:

    - The objective of the physical inventory count.
    - The period in which the inventory count should be conducted.
    - The employees that should be involved and their roles and responsibilities.
    - The inventory to be included in and excluded from the physical count.
    - Provisions for achieving proper cutoff, including control of receiving and issuance during the inventory-taking period and, if the storeroom is not shut down, provisions for handling inventory

movements.

- Instructions for use of inventory count sheets (including their distribution, collection, and control), including segregation of duties between persons responsible for count sheet control, counting inventory, and inputting completed count sheets to inventory records.
- Instructions for researching and adjusting variances.

19. Regularly review and revise policies and procedures for changes in the process and individual tasks.

Finding 9

Central Supply lacks written policies and procedures for identifying and dispensing expired or obsolete items.

Central Supply does not have established policies and procedures for addressing inventory obsolescence. According to Central Supply, a Central Supply employee occasionally inspects all inventory items in the storeroom and collects items that are due to expire within three months. Once the items with these expiration dates are collected, they are segregated in a separate area for disposal. Staff then updates the inventory count in the inventory system. Supervisory review and approval of the expired item is not required before disposal.

Proper approval methods and disposal of expired or obsolete items reduce the possibility of errors, theft, and mishandling.

According to the director of materials management, due to the low value of the disposed items, management does not review or signoff on the disposal of expired items. This is confirmed by Central Supply's report on past-expiration-date adjustments for fiscal year 2012-13, which shows the expired items had a value of $3,306. However, the lack of policies and procedures for identifying and disposing of obsolete inventory may cause Laguna Honda to incur unnecessary costs to store expired items that could be liquidated.

According to the GAO Guide, establishing and documenting policies and procedures are essential to an effective and reliable physical count. Physical controls and accountability reduce the risk of undetected theft and loss, unexpected shortage of critical items, and

unnecessary purchases of items already on hand. These controls improve accountability over inventory, which help ensure continuation of operations and improved storage and control of excess or obsolete stock.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

20. Establish written policies and procedures for the identification, segregation, and disposal of expired and obsolete items from the inventory. At a minimum the policies and procedures should define obsolescence and establish clear responsibilities for the enforcement of the policies and the ultimate disposition of the obsolete items.

21. Ensure that Central Supply Department management reviews and signs the list of obsolete/expired items before disposal.

Finding 10

Central Supply correctly records its purchases orders.

No exceptions were found in a randomly selected sample of 24 items for which invoices and other supporting documents verified the timely approval and recording of inventory purchases orders. Purchase orders were properly approved by the director of materials management or the assistant materials manager. Items were found to have been received by storekeepers and recorded in the inventory management system.

APPENDIX: DEPARTMENT RESPONSE

City and County of San Francisco
Edwin M. Lee, Mayor

Department of Public Health
Barbara A. Garcia, MPA
Director of Health

MEMORANDUM

To: Tonia Lediju, Director of City Audits
City Services Auditor Division

From: Barbara Garcia, Health Director
Department of Public Health

Date: March 11, 2014

Subject: Response to Findings from the Central Supply Inventory Control Audit at Laguna Honda Hospital

Enclosed for your review are the Department of Public Health's responses to the recent audit of the inventory control procedures at the Laguna Honda Hospital Central Supply. We appreciate the time and effort of your staff in conducting this audit.

We have carefully reviewed your team's draft report and findings and concur with each of the recommendations provided. Attached is the completed *Audit Recommendation and Response Form*. We are confident having been through this audit that our operation will run with much tighter controls.

If you have any questions or require further information, please do not hesitate to contact me at 415.554.2600 or Greg Wagner at 415.554.2610.

Sincerely,

Barbara Garcia
Director of Health

Attachment: Audit Recommendation and Response Form

Cc: Roland Pickens
Greg Wagner
Mivic Hirose
Mike Llewellyn

101 Grove Street, Room 308, San Francisco, CA 94102
Phone (415) 554-2600 Fax (415) 554-2710

For each recommendation, the responsible agency should indicate whether it concurs, does not concur, or partially concurs. If it concurs with the recommendation, it should indicate the expected implementation date and implementation plan. If the responsible agency does not concur or partially concurs, it should provide an explanation and an alternate plan of action to address the identified issue.

RECOMMENDATIONS AND RESPONSES

Recommendation	Response
Laguna Honda Hospital and Rehabilitation Center should:	
1. Direct Central Supply Department staff to conduct a 100 percent physical count of the inventory and reconcile discrepancies to establish a new inventory baseline.	Concur. Central Supply (CSR) will conduct a 100% Physical Inventory by July 1, 2014.
2. Establish performance goals for the physical count and develop employee/supervisor performance measurement systems to hold appropriate personnel accountable for accomplishing a consistent, accurate physical count of inventory.	Concur. We will work on adding performance measurements and goals to be added to the annual performance evaluations by November 1, 2014.
3. Implement procedures to ensure that periodic inventory counts are scheduled, performed regularly, and reconciled to the perpetual inventory and accounting records.	Concur. We will re-implement the ABC (20, 20, 60%) analysis program by June 1, 2014.
4. Create a manual or electronic tracking log to record category counted and the dates of the cycle counts.	Concur. Manual tracking log will be utilized by May 1, 2014.

Recommendation	Response
5. Periodically analyze usage to validate the inventory segments, determine the desired frequency of counts, and reassess the risk of each segment.	Concur. Will run a quarterly report to review ABC usage. Implementation by August 1, 2014.
6. Require proper signoff by the director of materials management before any update to the inventory segments.	Concur. Implementation by May 1, 2014.
7. Separate Central Supply Room duties so that staff responsible for counting inventory cannot adjust quantities in the Pathways system. Differences between inventory records and actual quantities on hand should be adjusted only after review and approval by management.	Concur. Access to inventory adjustments will limited to management staff. Implementation by May 1, 2014.
8. Establish policies and procedures that guide staff on how to formally report inventory discrepancies to management.	Concur. Implementation by May 1, 2014.
9. Develop a record retention policy for files supporting the inventory physical counts.	Concur. Will maintain 1 year plus current FY. Implementation by May 1, 2014.
10. Ensure that Central Supply Department values its inventory in accordance with its accounting policy.	Concur. Update Accounting P&P to reflect current process. Implementation by July 1, 2014.
11. Record the cost of each inventory item on its inventory lists.	Concur. Implementation by May 1, 2014.

Recommendation	Response
12. Ensure that inventory items transferred between departments are expensed when consumed.	Concur. Implementation by May 1, 2014.
13. Document and implement inventory security policies and communicate these policies to employees of the departments accessing the Central Supply storeroom.	Concur. Will implement Key Watcher system to allow authorized users access only. Implementation by July 1, 2014.
14. Develop a log or pre-numbered form to keep track of items taken from the Central Supply storeroom after business hours.	Concur. Implementation by May 1, 2014.
15. Require employees accessing the Central Supply storeroom after business hours to document on the log or form all necessary information, including but not limited to employee ID, item number, date and time, and quantity taken.	Concur. Security Access policy to be created for authorized employees to read and sign prior to access. Implementation by July 1, 2014.
16. Require nursing supervisors to authorize in writing the withdrawal of materials from the Central Supply storeroom after regular business hours and require Central Supply personnel to input the information in the inventory system and file supporting documents.	Concur. Implementation by July 1, 2014.
17. Re-key the Central Supply storeroom immediately, and track the issuance of master keys. After Central Supply completes its move to its new location, it should limit key distribution or install electronic keys to track employees' entry into the facilities.	Concur. Implementation by March 3, 2014.

Recommendation	Response
18. Establish written policies and procedures for the physical count process at the Central Supply Room. The written procedures should provide formal instructions for all aspects of the physical count processes, including: • The objective of the physical inventory count. • The period in which the inventory count should be conducted. • The employees that should be involved and their roles and responsibilities. • The inventory to be included in and excluded from the physical count. • Provisions for achieving proper cutoff, including control of receiving and issuance during the inventory-taking period and, if the storeroom is not shut down, provisions for handling inventory movements. • Instructions for use of inventory count sheets (including their distribution, collection, and control), including segregation of duties between persons responsible for count sheet control, counting inventory, and inputting completed count sheets to inventory records. • Instructions for researching and adjusting variances.	Concur. Implementation by June 1, 2014.
19. Regularly review and revise policies and procedures for changes in the process and individual tasks.	Concur. Implementation by April 1, 2014.

Recommendation	Response
20. Establish written policies and procedures for the identification, segregation, and disposal of expired and obsolete items from the inventory. At a minimum the policies and procedures should define obsolescence and establish clear responsibilities for the enforcement of the policies and the ultimate disposition of the obsolete items.	Concur. Implementation by May 1, 2014.
21. Ensure that Central Supply Department management reviews and signs the list of obsolete/expired items before disposal.	Concur. Implementation by May 1, 2014.