City and County of San Francisco

Office of the Controller – City Services Auditor

PORT COMMISSION:

The Port Should Strengthen Internal Controls Over Its Inventory

August 5, 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 Web site 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 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 regarding 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

Port Commission:
The Port Should Strengthen Internal Controls Over Its Inventory

August 5, 2014

Purpose of the Audit

The Office of the Controller's City Services Auditor Division (CSA) performed an inventory audit of the Port Commission (Port). The audit determined whether the department has adequate inventory processes and controls to ensure that materials, supplies, and tools at the Port of San Francisco are accurately accounted for, adequately organized, and properly secured.

Highlights

Port management is addressing recommendations in CSA's 2008 audit report on the Port's inventory practices. In particular, the Port implemented a new inventory system and revised its purchasing, receiving, and inventory policy and procedures. However, the Port still has weaknesses in its inventory processes and controls, which it must remedy. Although the Port has formal policies and procedures for receiving, processing, and distributing inventory, Port staff does not always adhere to these policies. Further, to ensure successful implementation of their goals, some policies must be revised. Overall, the Port needs to strengthen its internal controls to ensure that its assets are properly accounted for and safeguarded.

Specifically, the audit found that the Port:

- Has inventory on hand that does not match its system records.
- Has not updated its inventory categorization model to reflect its current inventory usage.
- Does not consistently perform daily cycle counts at each of its inventory locations.
- Has weak internal controls over its monthly cycle counts.
- Must segregate the storekeeper duties at its main storeroom.
- Does not adhere to its minimum and maximum inventory policy.
- Has inventory items that have no value assigned.
- Does not adequately evaluate slow-moving or obsolete inventory.

Recommendations

The report includes 16 recommendations for the Port to strengthen its inventory and materials management controls. Specifically, the Port should:

- Periodically analyze usage to validate inventory codes.
- Establish a cycle count frequency based on the value and usage of inventory at each location.
- Ensure that each inventory item has a minimum and maximum level assigned.
- Determine how to appropriately value inventory items with no recorded value.
- Adhere to its policy requiring annual evaluation of slow-moving and obsolete inventory.

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

August 5, 2014

Port Commission
Pier 1, The Embarcadero
San Francisco, CA 94111

Ms. Monique Moyer
Executive Director
Port of San Francisco
Pier 1, The Embarcadero
San Francisco, CA 94111

Dear Commission President and Members and Ms. Moyer:

The Office of the Controller's City Services Auditor Division (CSA) presents its audit report of inventory controls of the Port Commission (Port). This is the first inventory audit of the Port since the one CSA conducted in 2008. The audit objectives were to determine whether there are adequate inventory processes and controls to ensure that materials and supplies at the Port of San Francisco are accurately accounted for, adequately organized, and properly secured.

Port management is addressing recommendations cited in CSA's 2008 audit report on inventory practices, including by implementing a new inventory system and by revising its purchasing, receiving, and inventory practices. However, the Port still has an inaccurate inventory list, a substantial amount of inventory that has no value assigned, and policies and procedures that have not been implemented fully.

The report includes 16 recommendations for the Port to improve controls and the safeguarding of inventory items at its storerooms. The Port's response to the report is attached as an appendix.

CSA appreciates the assistance and cooperation of Port 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: Board of Supervisors
Budget Analyst
Citizens Audit Review Board
City Attorney
Civil Grand Jury
Mayor
Public Library

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GLOSSARY OF TERMS

ABC	ABC is a set of codes used to rank stock items in terms of the annual usage dollars in relation to the whole inventory. This is a Pareto analysis process by dollars spent on each item. Pareto analysis is a decision-making technique that statistically separates a limited number of input factors as having the greatest impact on an outcome.
City	City and County of San Francisco
Controller	Office of the Controller
CSA	The Office of the Controller's City Services Auditor Division
GAO	United States Government Accountability Office
Oracle	Oracle Enterprise Asset Management System, the asset management system the Port uses to monitor inventory levels and order materials from contracted vendors.
Port Commission	The Port Commission, which is an enterprise department of the City and County of San Francisco and governs the Port of San Francisco. The Port Commission has the complete and exclusive authority to manage, regulate, and control the harbor of San Francisco and to do all things it deems necessary in connection with the use, conduct, operation, management, maintenance, regulation, improvement and control of Port property.

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 City Services Auditor Division (CSA) of the Office of the Controller (Controller) conduct periodic, comprehensive financial and performance audits of city departments, services, and activities. CSA conducted this audit under that authority and pursuant to its annual audit plan. This audit is the third in a series of inventory audits of various city departments planned by the Controller. CSA previously audited the inventory practices of the Port Commission in 2008.

Background

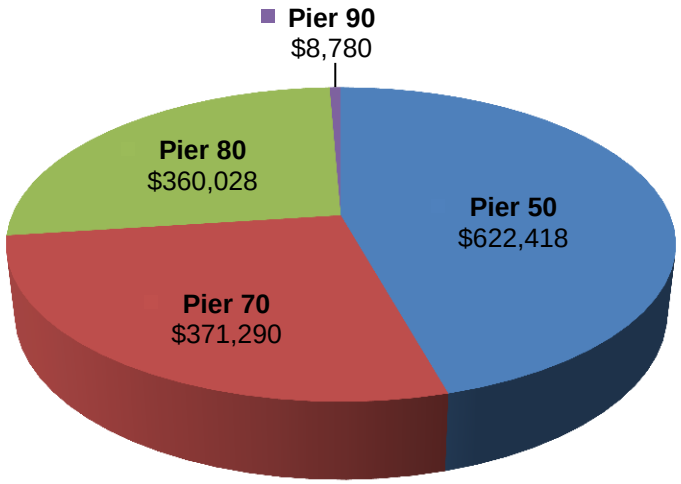
The City's Port Commission (Port) oversees the Port of San Francisco, which encompasses the 7.5 miles of San Francisco Bay shoreline stretching from Hyde Street Pier in the north to India Basin in the south. The Port's responsibilities include promoting maritime commerce, navigation, and fisheries; restoring the environment; and providing public recreation. More than 1,000 acres fall under its jurisdiction. The Port stores most of its inventory at four piers:

- Pier 50 (materials including plumbing, electrical, and painting supplies)
- Pier 70 (treated lumber)
- Pier 80 (crane materials)
- Pier 90 (materials lay down area[1])

On June 30, 2013, the Port's inventory was valued at nearly $1.4 million. Its audited financial statements indicate that the Port had $1.2 million in inventory, net of valuation reserves, on June 30, 2013. Exhibit 1 shows the Port's inventory values at each pier.

[1] The materials lay down area is a Pier 90 location where long wood piles are stored.

EXHIBIT 1 **Value of Port Inventory by Location on June 30, 2013**



Source: Oracle Inventory Report data provided by the Port.

Overview of Port divisions involved in inventory and materials management

Divisions and Services. The Port's Maintenance Division is responsible for maintaining the Port's waterfront as a positive connection to the other parts of the City. More than 100 skilled crafts persons are responsible for the preservation and improvement of the Port's fishing harbors, ferry landings, public parks, cargo terminals, and piers. The overall maintenance performed by the Maintenance Division includes the skilled work of carpenters, electricians, painters, gardeners, pile drivers, plumbers, roofers, and general laborers.

The Port's Finance and Administration Division is responsible for management of Port operations and support services, which include the work of the Business Services unit. Business Services' responsibilities include purchasing, materials management, administration of the Port's vehicles, and management of the Port's offices.

Inventory Management System. According to Port management, the Port implemented a new asset management system, Oracle Enterprise Asset Management system (Oracle), in June 2012. The Port is supposed to use Oracle to monitor inventory levels of its divisions' supplies and to reorder supplies when inventory levels fall to minimum levels. The Port also has

developed inventory management policies and procedures to manage its inventory.

Objectives

The audit's objectives were to determine whether the Port has:

1. Adequate inventory processes and controls to ensure that materials and supplies are accurately accounted for.
2. Adequately organized and properly secured all materials and supplies.
3. Approved and recorded inventory purchase orders accurately and in a timely manner.

Scope and Methodology

The audit included all items inventoried by the Port from July 1, 2013, through January 31, 2014. To perform the audit, the audit team:

- Interviewed staff and managers to gain an understanding of the Port's inventory processes.
- Inspected the Pier 50 and Pier 80 storerooms.
- Selected a purposeful sample of 24 inventory items from the inventory list and, using physical inspection, verified the number of units at Pier 50.
- Selected a purposeful sample of 24 inventory items at Pier 50 and verified that they were reported in the inventory list.
- Selected a purposeful sample of 10 inventory items from the inventory list and, using physical inspection, verified the number of units at Pier 80.
- Selected a purposeful sample of 12 inventory items at Pier 80 and verified that they were reported in the inventory list.
- Selected a random sample of 20 items from an inventory list and performed testing to determine if orders were properly approved and whether items were received and recorded in the inventory management system.

Internal Control Rating

CSA classifies locations with no control weaknesses as effective and those with few instances of control weaknesses as needing some improvement. If significant control weaknesses exist, CSA determines that major improvement is needed. If a department has severely inadequate controls and unmanaged risks, CSA deems the control environment as unsatisfactory.

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.

AUDIT RESULTS

Summary

The Port's inventory and materials management processes have multiple weaknesses. Numerous errors exist in sampled inventory records, daily cycle counts are not performed, incompatible job duties are not segregated, and slow-moving and obsolete items are inadequately monitored. Overall, the Port needs to improve its internal controls so it can be reasonably assured that its assets are properly received, recorded, accounted for, and maintained according to Port policies.

Finding 1

The Port's inventory on hand does not match its system records, indicating an inaccurate inventory list.

Inventory counts at the Pier 50 main storeroom show numerous discrepancies.

The Port's inventory record is inaccurate because it includes both shortages and overages.[2] The Port relies on its inventory management system, Oracle, to maintain an accurate list of its inventory, but the system produces inaccurate records due to its inclusion of overages and shortages. Inaccurate inventory records increase the risk of inefficiencies and reduce the Port's ability to monitor its materials.

CSA conducted counts by first independently counting inventory items, then notifying Port management and staff of discrepancies to allow them to conduct their own follow-up count. Port staff notified CSA of its follow-up count results and CSA conducted a final count with Port staff to verify any Port counts that did not agree with CSA's original inventory counts.

The audit's test counts of inventory found multiple discrepancies between system and floor counts. According to the Port's Inventory Item Detail Report (inventory list), 2,489 inventory items were located at the Pier 50 main storeroom on February 3, 2014. Of these, the audit selected 24 (1 percent) to determine the accuracy and existence of the counts in Oracle for Pier 50. Another 24 items from the inventory floor at Pier 50

[2] Shortages exist when Oracle Enterprise Asset Management system (Oracle) shows more items than are on hand. Overages are when Oracle shows fewer items than are on hand.

were selected to determine the completeness of the counts in Oracle.

System counts did not match actual counts for 38 percent of audited items.

The audit's system-to-floor test at Pier 50 found that the physical inventory amounts did not match for 9 (38 percent) of the 24 items tested. Five items had more inventory in their respective locations than shown on the inventory list (an overage in Oracle of inventory valued at $5,444). Also, 4 items had fewer units on hand than listed (a shortage in Oracle of $4,419). Some items tested were stored in two locations. In instances where CSA sampled both item locations, inventory totals were counted separately by location. For instances where CSA sampled one location, CSA verified the item's total count in both locations. Exhibit 2 shows items found to have discrepancies.

EXHIBIT 2 Pier 50 Storeroom: Discrepancies in Inventory Records Based on System-to-Floor Physical Counts

Sample Number	Quantity in System	Number of Items Counted	Difference	Discrepancy Amount
3	14	20	6	$79.92
4 [a,d]	800	0	(800)	(40.00)
5 [a,d]	700	1,293	593	29.65
10 [a,c]	6	5	(1)	(52.06)
11	7	4	(3)	(3,050.58)
20	3	29	26	5,121.48
21 [a]	38	29	(9)	(1,276.47)
23	3	7	4	213.00
24	21	22	1	0.00[b]
Total				**$1,204.94**

Note:
[a] Some of the Port's inventory items are stored in two locations, which are tracked in Oracle.
[b] This inventory item incorrectly has no value associated with it in Oracle. According to Port management, the item was erroneously loaded in the new Oracle system without a value.
[c] Some items were located on the floor and not in a designated location. For documentation purposes, CSA attributed them to the closest location and, therefore, did not include the additional location as a discrepancy.
[d] The Port originally tracked these items by box rather that by individual unit. The amounts listed are the correct unit value.

Source: Auditor's analysis of a sample of 24 items.

Floor counts did not match inventory records for 21 percent of audited items.

Of the 24 items counted from the storeroom floor, the physical inventory amounts did not match for 5 (21 percent) of the items sampled (see Exhibit 3). For 4 items (17 percent) there were fewer units on hand than units shown on the inventory list, resulting in $402 in

shortages. Also, for 1 item (4 percent), there were more units on hand than shown on the inventory list, resulting in $369 in overages. Of the 48 items CSA counted at Pier 50, the accuracy rate was 71 percent.

EXHIBIT 3 Pier 50 Storeroom: Discrepancies in Inventory Records Based on Floor-to-System Physical Counts

Sample Number	Quantity in System	Number of Items Counted	Difference	Discrepancy Amount
4	16	14	(2)	($0.94)
7	23	20	(3)	0.00*
13	102	41	(61)	(383.69)
14	1,700	1,100	(600)	(18.00)
16	0	7	7	369.39
Total				**($33.24)**

Note:

* According to Port accounting staff, this was among the first items transferred from the trade shops to the Pier 50 storeroom. See Finding 7 for more details

Source: Auditor's analysis of a sample of 24 items.

Inventory counts at Pier 80 showed some discrepancies.

Of the 1,443 inventory items on the Port's inventory list at Pier 80, 10 (1 percent) were selected to determine the accuracy and existence of the counts in Oracle. Further, 12 additional items at Pier 80 (1 percent) were selected for audit to perform inventory floor counts to verify the completeness of the counts in Oracle.

Although CSA's Pier 80 system-to-floor counts found no discrepancies, floor-to-system counts noted three exceptions (see Exhibit 4). Two items had on-hand quantities greater than reported on the inventory list, resulting in an overage of nine units and $2,896. The remaining item had an on-hand quantity that was less than what was reported on the inventory list, resulting in a shortage of three units and $108. Of the 22 items CSA counted at Pier 80, the accuracy rate was 86 percent.

EXHIBIT 4 **Pier 80 Crane Shop: Discrepancies in Inventory Records Based on Floor-to-System Physical Counts**

Sample Number	Quantity in System	Number of Items Counted	Difference	Discrepancy Amount
8	1	2	1	$2,500.00
9	3	0	(3)	(108.00)
10	0	8	8	396.00
Total				**$2,788.00**

Source: Auditor's analysis of sample of 12 items.

The Port needs to establish accountability and set performance goals.

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. Both of these types of discrepancies can result from staff inaccurately updating system records. Regardless of the cause, these inaccuracies increase the risk of undetected theft and assets going lost or missing.

While Port personnel could not always explain the reasons for discrepancies, according to Pier 50 staff, some inventory items were stored in locations not indicated on the inventory list. 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 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 a guide published by the U.S. Government Accountability Office (GAO Guide),[3] 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

[3] GAO-02-447G, Executive Guide Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property, United States General Accountability Office, 2002, http://www.gao.gov.

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.

Establishing performance goals will help the Port manage and evaluate the effectiveness and efficiency of its storeroom operations and continually assess the department's progress in achieving and maintaining those goals. According to the GAO Guide, inventory record accuracy goals should be set at 95 percent or higher. In contrast, as stated above, the audit found overall inventory record accuracy rates of 71 percent at Pier 50 and 86 percent at Pier 80.

Recommendations

The Port Commission should:

1. Ensure that its system records accurately reflect inventory on hand.

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

The Port must revise its inventory categorization model (ABC policy) to improve inventory counts and categorization.

The Port's ABC Code Policy needs revision.

The Port has not updated its ABC Code Policy to correctly reflect its current inventory usage. Low usage rates have caused the Port's inventory to have percentage breakdowns among the A, B, and C item categories that do not match those stated in the policy. Failure to update the inventory categorization model could result in an incorrect number of cycle counts occurring and items being included in the wrong inventory category.

According to the Port's ABC Code Policy, the ABC

Codes are used to rank stock items in terms of the annual usage dollars in relationship to the whole inventory. The policy states that inventory codes are to be based on inventory usage reports and that inventory should be divided according to the following model:

- Class A items are 5 percent of the total item count and 80 percent of the annual dollars.
- Class B items are 15 percent of the total item count and 15 percent of the annual dollars.
- Class C items are 80 percent of the total item count and 5 percent of the annual dollars.

The Port's policy states that the percentage breakdown is a guideline and may be adjusted based on management's judgment. It also says that the codes shall be reviewed and updated at a minimum of once per calendar year. As shown in exhibits 5 and 6, the Port's current ABC assignments are not entirely compliant with the ABC model outlined in its departmental policy. Although the Port's current ABC assignments reflect the required percentages of usage value (annual dollars), the total item counts do not.

EXHIBIT 5 Port ABC Assignments at Pier 50 Storeroom

Class	Item Count	Sum of Usage Value	Actual Quantity %	Usage Value Percent
A	130	$784,036	5%	80%
B	401	146,291	17%	15%
C	1,896	48,923	78%	5%
Total	**2,427**	**$979,250**	**100%**	**100%**

Source: Port's ABC Assignment Report

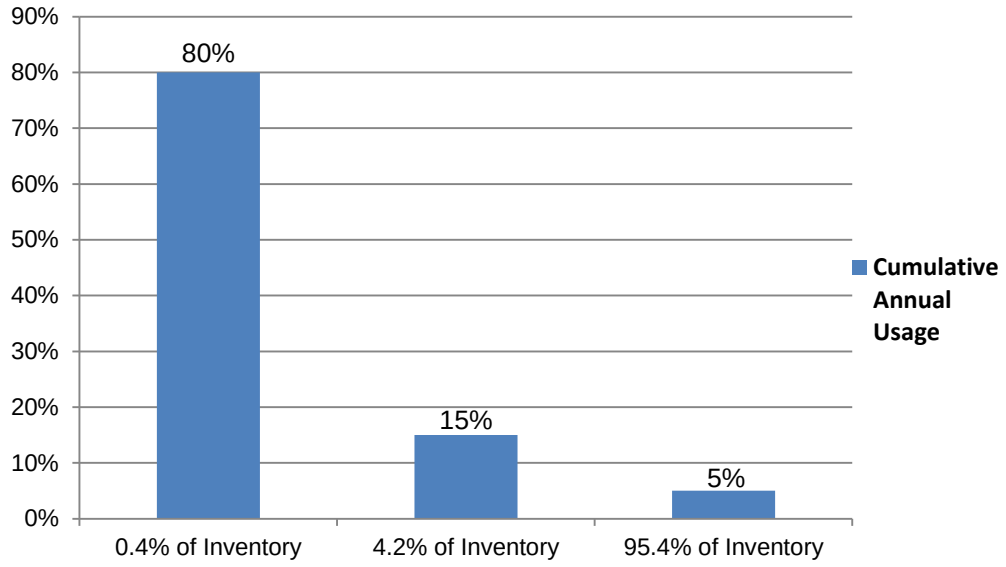
EXHIBIT 6 Port ABC Assignments at Pier 80 Crane Shop

Class	Item Count	Sum of Usage Value	Actual Quantity %	Usage Value Percent
A	2,250	$288,205	36%	80%
B	2,013	53,869	32%	15%
C	1,962	17,955	32%	5%
Total	**6,225**	**$360,029**	**100%**	**100%**

Source: Port's ABC Assignment Report

According to Port management, the ABC codes have not been updated since the implementation of Oracle. During the transition period, management allowed staff to purchase inventory items directly to complete ongoing projects, resulting in the low inventory utilization rate. To make the most effective use of the ABC classification scheme, it must be validated with periodic reviews. As shown in Exhibit 7, the audit identified the Port's cumulative annual usage based on an analysis of 12 months of inventory usage at Pier 50.

EXHIBIT 7 **Inventory Usage at Pier 50 Storeroom**
February 2013 Through January 2014



Source: Auditor's analysis of Port's ABC Assignments Report.

Current usage indicates that less than 1 percent of the Port's highest value inventory items accounts for 80 percent of all annual usage.

Based on the Port's current usage rate of inventory items, the top 0.4 percent of items account for 80 percent of annual usage dollars and the top 4.2 percent of items account for 95 percent of annual usage dollars. The Port will not always be able to meet its current ABC guideline percentages, as indicated by this analysis. The model that the Port's policy provides is unrealistic because inventory usage values fluctuate over time. As a result, the Port frequently will be out of compliance with this policy and will need to update its models following each review of the percentage breakdown by class of item.

Recommendations

The Port Commission should:

3. Update its ABC Code Policy to distribute its codes based either on percentages of the total item count or annual usage dollars, not both.

4. Periodically analyze usage to validate the inventory codes.

Finding 3

The Port does not conduct daily inventory cycle counts as required by its policy, increasing the risk of losses due to theft.

Port staff does not perform daily cycle counts of inventory.

According to Port staff, the Port does not perform daily inventory cycle counts at each of its inventory locations.[4] Without regular cycle counts of its entire inventory, the Port cannot ensure that its inventory is being adequately protected against loss and theft, that there are no shortages or unnecessary purchases, or that inventory is properly recorded in the Port's inventory system.

According to the Port's Inventory Cycle Counting Policy, cycle counts are to be performed daily, as generated by Oracle, and cycle count results are to be posted daily, also. According to Port management, staff has not regularly conducted cycle counts because of staffing issues.

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 typically 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. Accordingly, it is not always practical to give the same treatment to each item. Instead, it may be desirable to segment the inventory into identifiable classes and assess the risk for each segment or class to

[4] According to Port management, Port staff last performed a count of class A and B items in February 2013 at Pier 50 and Pier 80.

determine the frequency of counts.

The purpose of classifying items into segments is to establish an appropriate degree of control over each item.

Management has adopted the ABC classification as its inventory categorization technique and segmented its inventory items based on dollar usage. The results of the ABC analysis can be used to focus on items that cost the department most in terms of total consumption value and to determine the frequency of counts. Management can use different frequencies for the various segments of its inventory. According to the GAO Guide, leading-edge locations that segmented their inventory by value counted more valuable items more frequently than less valuable items. In other instances, locations used a combination of value and activity or turnover of items to segment their inventory, in which the higher value items by activity were counted more frequently, usually four times per year, than those of lower value by activity, which were counted once a year.

The Port's inventory transactions report for February 2013 to January 2014 indicates that there were no inventory items issued from Pier 80. This lack of activity indicates that daily counts are not necessary at Pier 80. Locations that have little or no inventory movement and do not represent a significant portion of the inventory can be considered low-risk and can be counted less frequently.

Recommendation

5. The Port Commission should establish a cycle count frequency that considers the value and dollar usage of inventory at each location and revise its current cycle count policy accordingly.

Finding 4

The Port needs to strengthen its controls over the monthly cycle counts at Pier 70 to ensure inventory accuracy.

The Port has weak internal controls over the monthly inventory cycle counts at Pier 70 and must strengthen them so the Port can use the results to update its inventory list. The Port does perform monthly counts at Pier 70 as part of the accounting group's monthly close process. Two Port employees (one from accounting and one from maintenance) perform these counts separately and record the results on their own count sheets. The

accounting group then compares the count results to the Port inventory list in Oracle. According to the Port, the primary purpose of the monthly count at Pier 70 is to assess the accuracy and completeness of the accounting records for the preparation of the Port's financial statements.

Port staff does not always update the inventory list when count discrepancies are identified.

However, this count process is not indicated in the Port's cycle count policy. Further, accounting staff does not always reconcile the variances noted during the monthly counts or communicate the count results to the maintenance division. According to Port accounting personnel, discrepancies noted during these counts are not always updated into Oracle. They stated that Pier 50 staff is only informed about discrepancies when accounting sees an unusually large discrepancy.

January 2014 inventory count results at Pier 70 indicated that of the 21 inventory items counted, 11 were not on the Oracle inventory list. According to Port accounting personnel, some items were not accounted for in Oracle because they were used lumber returned from projects to be stored at Pier 70. Of the 10 inventory items listed in Oracle, 8 had count discrepancies. For 3 items there were fewer on hand than listed (a shortage in Oracle of $19,912) and for 5 other items, there were greater quantities than shown on the inventory records (an overage in Oracle of $6,868). The net variance of the count was 4 percent.

Further, although Port accounting personnel stated which two employees performed the January counts at Pier 70, CSA review of the two Pier 70 count sheets found that one of them had no name or identifying information of who actually performed the count. Additionally, the two count sheets failed to display if any items had been recounted. This is especially important due to the two count sheets having some differences in item counts. According to Port accounting, recounts are usually performed on the count sheet belonging to the accounting representative. They also stated that when a specific Port storekeeper is not available to perform the count with the accounting respresentative, counts are still performed but their results are not used to adjust the inventory system.

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

The Port Commission should:

6. Formalize the monthly cycle count procedure at Pier 70 in its inventory cycle counting policy, including policies on how to formally report inventory discrepancies to management.

7. Ensure discrepancies noted during the monthly cycle counts are properly updated in Oracle after review and approval of management.

Finding 5

Storekeeper duties need to be segregated at the Port's main storeroom to mitigate the risk of error and fraud.

Storekeeper duties overlap allowing one storekeeper to perform duties that should be segregated.

Key inventory duties are not properly segregated at the Pier 50 main storeroom because it is staffed by only two employees: a senior storekeeper and storekeeper. Although the senior storekeeper notified CSA that he is primarily responsible for creating purchase requisitions, both employees have access to the inventory records and master files and also can receive, issue, and record inventory quantities in Oracle, as well as perform daily cycle counts. This lack of segregation of duties is an internal control weakness that increases the risk of fraud[5]. If duties are not separated the weakness could result in improper transactions being recorded in the

[5] According to the GAO, Fraud involves obtaining something of value through willful misrepresentation.

inventory records to cover improper or unauthorized transactions.

Of the 15 packing slips reviewed by CSA that had signatures, the audit found the senior storekeeper's signature on five packing slips (33 percent of packing slips reviewed). This indicates that he frequently receives inventory items that he is also responsible for initiating the requisition process, inputting into Oracle, and distributing.

Further, storekeepers have user access to Oracle Inventory Stores which allows them to manage the master items file. This violates the control principle that the personnel that processes and records transactions should not have responsibility for modifying or updating the inventory master items. When an employee maintains both the assets and the records, that employee has the opportunity to remove items and manipulate the records so that any theft would go undetected. Personnel responsible for the custody of inventory should have read-only access to inventory records.

Employees that maintain both the assets and records have the opportunity to remove items without them being detected.

According to the GAO Guide, personnel who are responsible for approving transactions that affect on-hand inventory balances should not be responsible for the physical custody of the inventory or recording transactions. When an employee maintains both the assets and the records, that employee has the opportunity to remove items and manipulate the records so that any theft would go undetected. Personnel responsible for the custody of inventory should have read-only access to inventory records.

Segregation of duties is a widely accepted internal control and business practice. It entails dividing key duties among different people and reduces the risk of error and fraud so that no individual can adversely affect the accuracy and integrity of an inventory count. The key areas of segregation are:

- Physical custody of assets
- Processing and recording of transactions
- Approval of transactions

Ideally, personnel performing any one of the above functions would not also have responsibilities in either of the other two functions.

Recommendations

The Port Commission should:

8. Ensure that purchasing, receiving, distribution, and inventory recording responsibilities are segregated to mitigate the risk of error and fraud.

9. Periodically review user access to Oracle to ensure that incompatible duties are separated.

Finding 6

The Port does not always adhere to its policy on minimum and maximum inventory levels, so it cannot be assured that correct amounts of inventory are always purchased.

Minimum and maximum levels are not assigned to many of the Port's inventory items.

The Port does not have minimum or maximum levels[6] assigned to each of its inventory items in Oracle. According to Port policy, minimum levels are to be assigned to each inventory item in Oracle, but the policy does not specify how minimum levels are to be determined. The policy also states that maximum inventory levels are to be assigned based on the Port's ABC inventory management system:

- Class A items require maximum inventory levels equal to two months' historical average usage.
- Class B items require maximum inventory levels equal to four months' historical average usage.
- Class C items require maximum inventory levels equal to nine months' historical average usage.

Of the 4,937 items on the Port's Min Max Report, generated on February 6, 2014, 3,221 (65 percent) did not have minimum levels assigned to them and 2,458 (50 percent) did not have maximum levels assigned to them. Failure to assign items proper minimum levels in Oracle could cause the Port to exhaust critical inventory items, which could stall maintenance work. Also, failure to

[6] Minimum and maximum inventory levels specify the point at which an item should be reordered (minimum level) and a reorder quantity ceiling (maximum level).

assign proper maximum levels could result in Port staff overpurchasing materials, which could result in wasted storage costs incurred to house unnecessary items.

Of the 20 inventory items selected for review of payments, CSA found one instance where an order was processed and received before the approval of the purchase order. Port management acknowledged that the absence of urgently needed material may have been the reason the Port did not follow its purchasing process. This situation could have been avoided if minimum levels were assigned.

According to the Port, all inventory items were not assigned a minimum or maximum level during the transition from the old inventory system to Oracle. Main storeroom staff also acknowledged that they rely on personal judgment to assess inventory levels and determine replenishment needs.

Minimum and maximum inventory levels are generally used to maintain inventory item quantities so that a minimum quantity is always on hand and that the maximum quantity is set to ensure that items are not overstocked. However, the Port's annual inventory turnover[7] in February 2013 through January 2014 was only 22 percent, indicating that it would take the Port 4.6 years to deplete its inventory on hand. According to the Port's policy regarding slow-moving and obsolete items, materials are considered slow-moving when the item turns over less than two times per year. Such a turnover rate may indicate that the Port holds many slow-moving and obsolete items.

Recommendations

The Port Commission should:

10. Ensure that each inventory item has a minimum and maximum level assigned to it.

11. Evaluate inventory items' turnover and establish more reasonable minimum and maximum inventory levels.

[7]Turnover rate measures how often inventory items are used. It is calculated by dividing the sum of inventory transactions by the total value of inventory over a specified period.

Finding 7

The Port's inventory list contains items that have incorrect values, which understates the total value of the Port's inventory.

Of the 4,948 items the Port had on its inventory list of February 3, 2014, 1,263[8] (26 percent) have no dollar value shown.[9] Failure to appropriately value inventory items will cause the Port's inventory value to remain understated.

The Port has 14 maintenance craft units known as trade shops. According to Port staff, in the past the Port allowed some of its inventory items to be stored in trade shops, and the inventory items were also expensed. Since the implementation of its new inventory system, Oracle, Port management has been consolidating at the main (Pier 50) storeroom the inventory items formerly held at the trade shops. However, only the item quantities are entered in Oracle because the historical costs information is unavailable.

Inventory has been recovered from 2 of the Port's 14 trade shops thus far.

According to Port management, the Port has recovered inventory from 2 of its 14 trade shops and expects to recover inventory from the remaining trade shops by September 2014. Port management also stated that the recovery of items from the trade shops has been slower than planned due to resource constraints and limitations in available data. According to the Port's finance staff, it is difficult to determine the unit cost of each item that has been put back on the inventory list. Because of this, the Port now plans to continue issuing zero-value items until they are depleted from inventory rather than determining their actual values.

Recommendation

12. The Port Commission should determine how to appropriately value recovered inventory.

[8] Of the 1,263 items with no dollar value on the Port's inventory list, 330 items had no on-hand quantity.

[9] The report states that each item's unit cost is zero.

Finding 8

The Port needs to strengthen its internal controls over receipt of inventory items to ensure timely payments and accurate inventory records.

Main storeroom staff stated that materials are not always received, reviewed, and entered into Oracle on the same day.

Port staff does not always record inventory items received at Pier 50 in Oracle in the required amount of time. Failure to update these records in a timely manner could result in payments being delayed and inaccurate inventory records. Delayed payments could result in vendor discounts being missed.

According to the Port's Receiving and Distribution Policy, materials are supposed to be entered in the Oracle system within 48 hours of receipt. Of the Port's 116 inventory receipt transactions from July 1, 2013, to January 31, 2014, the audit tested a random sample of 20 transactions (17 percent), all of which were inventory purchases (Purchase Order receipts). According to Port staff, the storekeeper signs and dates packing slips for inventory purchases sent to the storeroom on the day they are received. Of the 20 sampled transactions, 15 packing slips dated by storekeepers were found. Further, of these 15 dated packing slips, storekeepers did not record materials received into Oracle within the required 48 hours in 3 instances (20 percent). In these three instances, it took Port staff an average of six days to enter item information into Oracle. According to a Port storekeeper, materials are not always received, opened, and signed on the same day because of the timing of deliveries and staff availability.

Of the 20 invoices tested, 4 (20 percent) offered cash discounts for early payments. In fact, the Port missed one of the discounts offered because it did not pay the invoice within the required timeframe. This resulted in the Port overpaying $35.80.

Further, storeroom management could not provide one packing slip to show that the Port received the quantity ordered. Failure to maintain packing slips violates the City's record retention policy, which is issued by the Controller. According to this policy, invoices and associated documents to support payment are to be maintained at least five years. Without a packing slip, the Port cannot be assured that materials were properly inspected upon receipt and cannot verify that the

inventory was received or by whom it was received.

Recommendations

The Port Commission should:

13. Ensure that storekeepers review, sign, and date packing slips immediately upon receipt of materials.

14. Ensure that material received is recorded in the Oracle system within 48 hours of receipt to comply with its policy.

15. Ensure that it retains all purchasing documents for a minimum of five years to comply with the City's record retention policy.

Finding 9

The Port does not adequately evaluate slow-moving or obsolete inventory, increasing the risk of purchasing unneeded items.

Port staff stated that it did not follow departmental policies on slow-moving and obsolete inventory.

The Port does not adhere to its slow-moving and obsolete inventory policy. The Port's policy regarding slow-moving and obsolete inventory states that the senior storekeeper is to generate inventory usage reports for the main storeroom and all subinventory locations annually. These reports are to be used to determine which inventory items have had no usage in the last 12 months or are slow-moving (less than 50 percent of the total on hand during the period has been used). Further, these items are supposed to be highlighted on the report and submitted to the deputy director for review. The deputy director or a designee is to evaluate the annual report and recommend dispositions for all reported items.

The Port's failure to adhere to its slow-moving and obsolete inventory policy and assess the usability of its inventory annually increases the risk that the Port will purchase too much inventory or inventory that is no longer needed. Also, excess inventory can cause the Port to store more inventory than necessary. Storing excess or obsolete inventory wastes space and, potentially, Port staff time to count the items.

According to one of the Port's storekeepers, although he has not provided the annual usage reports to the deputy director, he does informally evaluate the slow-moving inventory items. Whenever he notices an inventory item that has not been used in about a year, he deems it obsolete and reports it to the deputy director.

Port management confirmed that the next steps in this process will be to list all of the items that have had no usage in the past five years or more and dispose of them using the City's surplus declaration. However, this process does not entirely comply with Port policy, which outlines that usage reports are to be generated and reviewed for decision making purposes. Further, a supervisor at the Pier 80 crane shop, where crane materials are stored, acknowledged that the crane shop houses some very old items as spare parts, some of which may be obsolete. A Port manager stated that he was aware that the Port did not adhere to its policy regarding slow-moving and obsolete inventory, but other priorities have prevented management from pursuing this task. Specifically, the Port's focus has been to ensure a successful migration of inventory items from the trade shops to inventory.

Guidance in the field of inventory management allows organizations to keep on hand working parts for obsolete equipment or infrastructure that is still in use so that it can be serviced and repaired.[10] However, because the Port is now centralizing its trade shop inventory items at the Pier 50 main storeroom, it would benefit from assessing whether all items need to be retained.

Recommendation

16. The Port Commission should adhere to its slow-moving and obsolete inventory policy by appropriately evaluating inventory usage yearly.

[10] Steven M. Bragg, Inventory Best Practices, John Wiley & Sons, Inc., Hoboken, New Jersey, 2004.

APPENDIX: DEPARTMENT RESPONSE

July 29, 2014

Tonia Lediju
Director of CityAudits
City Hall, Room 476
1 Dr. Carlton B. Goodlett Place
San Francisco, CA 94102

Re: Response to Inventory Audit

Dear Ms. Lediju:

Thank you for the opportunity to review the draft report, *The Port Should Strengthen Internal Controls Over Its Inventory*. We appreciate the work the City Services Auditor (CSA) Division has done over the years to assist the Port to improve its purchasing and inventory practices. In response to a request from the Port and an audit recommendation from the Board of Supervisors Budget Analyst, CSA conducted an audit in 2008 of purchasing and inventory controls at the Port Maintenance Division. Thank you also for acknowledging some of the improvement and changes the Port has implemented since 2008.

As noted in the current inventory audit report, the Port has established a solid framework through its post-2008 operating policies and procedures but still has some more work to do to ensure their effective implementation. Port management substantially concurs with the audit recommendations. Please find attached the City's standard Recommendations and Responses form for inclusion with the final published report. It is likely that complete implementation of all the improvement changes that we plan will take more than a year.

Following the 2008 audit, we implemented stronger budget and other management controls over maintenance material purchasing. Previously, the shops were allowed to routinely order excess material and use money left over in their budgets at the end of year to purchase materials and supplies for future operating needs. Such excess and surplus material remained in the custody of the shops until a 2011 policy decision to transfer control and custody to the storekeepers at Pier 50. The Maintenance Division storekeepers have been in an on-going process of pulling the accumulated excess material from the trade shops and expect to complete this project in 2014. The next steps are to assess the condition and usability of recovered materials, determine appropriate shelf and surplus quantities of this material and determine appropriate current pricing or valuation

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of retained materials. The completion of these tasks requires time and is expected to extend into 2015.

Thank you and your staff for the thoroughness of the audit work in this important area and for considering the Port's feedback and implementation measures.

Sincerely,

Elaine Forbes
Deputy Director, Finance & Administration

Enclosure

cc: Monique Moyer, Executive Director
Tom Carter, Deputy Director, Maintenance Division
John J. J. Woo, Fiscal Officer
George Onyemem, Business Services Manager
Irella Blackwood, CSA Audit Manager
Mamadou M. Gning, CSA Audit Manager
Joseph Towner, Staff Auditor

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
The Port Commission should:	
1. Ensure that its system records accurately reflect inventory on hand.	Concur. The Port will conduct a full physical count to establish accurate records by June of 2015. Prior to this physical count, the Port will identify and dispose of obsolete items (December 2014) and enter usable items from the trade shops into the storeroom and inventory system. Port staff added a step to its year-end closing procedures and completed a partial physical inventory count at June 30, 2014. The count scope covered 109 items representing approximately 70% of the on-hand value recorded for the main storeroom account. This procedure identified discrepancies and resulted in net adjustments to reduce inventory value by approximately $15,000. Within 90 days, all storeroom personnel will be re-trained on the inventory system to ensure that staff accurately and timely updates system records. June 2015

Recommendation	Response
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. Performance plans for storeroom personnel and the storeroom supervisors will include performance measures and goals for record accuracy of 95 percent, accurate and timely inventory record updates, and accurate and timely inventory counts. Personnel involved in inventory management will be held accountable to accomplish the desired and agreed upon goals stated in performance plans commencing with fiscal year 2014-2015. August 2014
3. Update its ABC Code Policy to distribute its codes based either on percentages of the total item count or annual usage dollars, not both.	Concur. The Port will update our categorization model (ABC Policy) to reflect the nature of port business to be based on percentage of total line item count. Once the Port has reasonable utilization data for a one-year period, the Port will move to ABC categorization by consumption value. February 2015
4. Periodically analyze usage to validate the inventory codes.	Concur. The Port will analyze usage to validate ABC categorization to ensure that A reflects items of greatest importance that should be reviewed more frequently, B reflects items of midrange importance, and C reflects items of lowest importance. The Port must transition from direct purchasing by the shops to utilization of material from a functioning storeroom. Completing this analysis requires utilization data from a functioning storeroom. January 2015

Recommendation	Response
5. Establish a cycle count frequency that considers the value and dollar usage of inventory at each location and revise its current cycle count policy accordingly.	Concur. The Port will develop a monthly cycle count for A category items, and quarterly cycle count for B category items and an annual cycle count of C category items. Before initiating these counts, the Port must first dispose of obsolete items and enter into the inventory system items into the inventory storeroom returned from the trade shops. January 2015
6. Formalize the monthly cycle count procedure at Pier 70 in its inventory cycle counting policy, including policies on how to formally report inventory discrepancies to management.	Disagree. The Port will consolidate its lumber stock which is currently at Pier 70 into the main storeroom inventory at Pier 50 in order to better manage these materials. The monthly cycle counts which the accounting group performs are an ad hoc process to gauge certain risks for financial accounting and reporting. Once the inventory is managed through the inventory system, categorized correctly (ABC), and counted accordingly, the accounting group's test counts will not be necessary. June 2015
7. Ensure discrepancies noted during the monthly cycle counts are properly updated in Oracle after review and approval of management.	Disagree. As noted above, the accounting group's ad hoc process will be discontinued and replaced with timely cycle counts. The Port agrees all discrepancies noted during cycle counts must be corrected in the inventory system following management review and approval. Ongoing

Recommendation	Response
8. Ensure that purchasing, receiving, distribution, and inventory recording responsibilities are segregated to mitigate the risk of error and fraud.	Partially concur. Due to limited staffing, the Port is unable to provide for an ideal separation of functions. The Port believes, in most cases, there are sufficient compensating controls, principally other reviews and approval procedures. Port management will review roles and responsibilities and consider carefully the risks identified in the report. We have already identified that Miscellaneous inventory adjustments require more formalized approval and review. The Port will mitigate the risk of staffing levels through the supervisors' approval of all system corrections. Further, the CFO will review an exception report whereby the storeroom supervisor explains the reason for approval of each exception. September 2014
9. Periodically review user access to Oracle to ensure that incompatible duties are separated.	Concur. The Port will annually review user access to ensure that roles and responsibilities are appropriately maintained. August 2014
10. Ensure that each inventory item has a minimum and maximum level assigned to it.	Concur. The Port will review usage data and reset min/max levels. January 2015

Recommendation	Response
11. Evaluate inventory items' turnover and establish more reasonable minimum and maximum inventory levels.	Concur. The Port will evaluate inventory turnover periodically to determine proper min/max inventory levels as we build usage history in the new system. June 2015 then annually thereafter
12. Determine how to appropriately value recovered inventory.	Concur. The Port intends to value all usable recovered inventory material at current value. Recovered items will be sufficiently delineated in the stock numbering scheme for accounting assessment and control. On-going
13. Ensure that storekeepers review, sign, and date packing slips immediately upon receipt of materials.	Concur. The Port will enforce the process to have all materials received in the storeroom properly and that packing slips are dated and signed immediately upon receipt. August 2014
14. Ensure that material received is recorded in the Oracle system within 48 hours of receipt to comply with its policy.	Concur. Same as item #13. The Port will enforce standing policy requirement to record all receipts within 48 hours. August 2014

Recommendation	Response
15. Ensure that it retains all purchasing documents for a minimum of five years to comply with the City's record retention policy.	Concur. Port staff will be reminded that all purchasing documents must be retained for a minimum of five years which is the City's and the Port's policy. July 2014
16. Adhere to its slow-moving and obsolete inventory policy by appropriately evaluating inventory usage yearly.	Concur. This issue will be mitigated when the inventory review and cleanup of our current inventory listing is accomplished and obsolete materials removed and salvaged. December 2014