



A Report to the Galveston
City Council

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Audit Report
AU2016-2

Inventory Process Audit Report



Report Summary

The City Auditor Department constructed a list of internal controls for inventory processes within a local municipality and listed each internal control in a separate spreadsheet described and attached as Appendix 1 – Inventory Processes. This list is not intended for the use of management but rather to inform management of the specific internal controls analyzed in this audit for the City's Inventory Process. Each internal control listed in Appendix 1 was then evaluated to determine if the control design and operations of the control proved to be effective in an applicable reporting framework or a financial reporting framework for inventories at the City of Galveston. The City Auditor recommends that the City of Galveston develop a *comprehensive* policy that establishes government-wide requirements regarding inventory. This policy should include the types of items that should be considered inventory reportable to Finance for inclusion in the Comprehensive Annual Financial Report (CAFR) and establish annual reporting requirements for all departments. It should also include instructions regarding inventory security, inventory segregation of duties, the performance of annual physical counts by departments and requirements for reporting discrepancies between book and physical inventories to the Finance Department for proper resolution. The Policy should specify standards for the identification, documentation, reporting, and removal of surplus inventory and disposals, including the transfer of surplus inventory between departments and the sales thereof to outside vendors.



INVENTORY PROCESS AUDIT- FINANCE DEPARTMENT
CITY AUDITOR

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City of Galveston
Inventory Processes– Finance Department
City Auditor Executive Summary

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Background

The City of Galveston inventories vehicles, equipment, computers, supplies and furnishings in each department of the City. Items with a purchase price of less than \$5,000 are expensed within departments rather than inventoried. The Finance Department is charge with establishing the internal control policies and procedures for inventory processes within the City of Galveston. In turn, the City Auditor Department is responsible for evaluating the design and operating effectiveness of those internal controls.

Objective

The objective of this report is to evaluate the design and operating effectiveness of the Finance Department's internal control framework over inventory processes relating to (1) *an applicable reporting framework* and (2) *a financial reporting framework*. These objectives are further described below as:

(1)Applicable Reporting Framework - The objectives of internal controls over inventory processes for an applicable reporting network are to ensure a complete set of principles for the requirements, laws, and regulations that a municipal government is subject to.

(2)Financial Reporting Framework - The objectives of internal controls over inventory processes for a financial reporting network are to ensure a comprehensive set of standards for determining measurement, recognition, presentation, and disclosure.

Scope

To evaluate the design and operating effectiveness of the two objectives of internal controls over inventory processes identified and then to evaluate the basic components of each objective for the City of Galveston as described in the supplemental appendices and below:

(1)Applicable Reporting Network

- a) Control Environment - The City of Galveston's control environment establishes the tone of an organization that influences the control consciousness of its personnel.
- b) Risk Assessment - Risk assessment is the City of Galveston's identification and analysis of relevant risks to achieving the organization's objectives.
- c) Control Activities – The City of Galveston's control activities are the policies and procedures that are performed by personnel that help ensure that management's directives regarding compliance are carried out.
- d) Information and Communication - The information and communication component includes the City of Galveston's identification, capture, and exchange

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of information in a form and time frame that enable personnel to carry out their responsibilities.

- e) Monitoring Activities - Monitoring activities assess the City of Galveston's quality of internal control performance over time.
- f) Capturing and processing information for the City of Galveston.
- g) Defining the financial reporting process for the City of Galveston.

(2) Financial Reporting Network

- a) Rights and Obligations – All inventory balances properly reflect amounts collected or should have been collected by the City of Galveston.
- b) Valuation and Allocation – All inventory balances properly value and allocate amounts that individuals or agencies paid to the City of Galveston.
- c) Occurrence – All inventory balances represent amounts uncollected by the City of Galveston.
- d) Completeness – All inventories have been captured by the City of Galveston.
- e) Accuracy – All inventories have been accurately recorded by the City of Galveston.
- f) Cut-off – All inventory balances are recorded by the City of Galveston in the correct accounting period.
- g) Classification – All inventory balances are correctly classified by the City of Galveston.

Fieldwork Performed

The City Auditor Department constructed a list of internal controls for inventory processes within a local municipality and listed each internal control in a separate spreadsheet described and attached as Appendix 1 – Inventory Processes. This list is not intended for the use of management but rather to inform management of the specific internal controls analyzed in this audit for the City's Inventory Process. Each internal control listed in Appendix 1 was then evaluated to determine if the control design and operations of the control proved to be effective in an applicable reporting framework or a financial reporting framework for inventories written at the City of Galveston. The City Auditor Department also noted if opportunities exist for the improvement of those internal controls below in "Auditor Recommendations".

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Audit Findings

There are no findings for the City Auditor to report to The Mayor and City Council concerning the City's Inventory Process. The City Auditor Department will make itself available to consult with the Finance Department should management choose to act upon improving internal controls for accounts receivable compliance at the City of Galveston.

Auditor Recommendations

The City Auditor recommends that the City of Galveston develop a *comprehensive* policy that establishes government-wide requirements regarding inventory. This policy should include the types of items that should be considered inventory reportable to Finance for inclusion in the Comprehensive Annual Financial Report (CAFR) and establish annual reporting requirements for all departments. It should also include instructions regarding inventory security, inventory segregation of duties, the performance of annual physical counts by departments and requirements for reporting discrepancies between book and physical inventories to the Finance Department for proper resolution. The policy should establish inventory tagging requirements to augment the effective identification of the inventory within the various departments. The Policy should specify standards for the identification, documentation, reporting, and removal of surplus inventory and disposals, including the transfer of surplus inventory between departments and the sales thereof to outside vendors.

Consideration should also be given by senior management to lowering the current \$5,000 limit to a lower dollar amount in order to increase the City of Galveston's ability to account for small inventory. Currently the City has one department tagging purchased items. The City Auditor department recommends all items purchased should have a tag with a computer generated number and the City of Galveston logo (if possible).

Staff Conduct

All staff acted in a professional and timely manner.

City Manager's Response

At present, the City of Galveston conducts an annual inventory count in September of each fiscal year. Accounting staff members visit each of five city locations where inventory is maintained and physically count from a selected sample. Amounts in the balance sheet inventory accounts are adjusted to reflect the total inventory remaining at fiscal year-end. Variances are reviewed by staff and the external auditors and significant variances are noted for further investigation.

GFOA recommends that every state and local government periodically inventory its tangible assets so that all such assets are accounted for, at least on a test basis, no less often than once every five years. While well-designed and properly maintained perpetual inventory systems can

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eliminate the need for an annual inventory of a government's tangible assets, no inventory system is so reliable as to eliminate completely the need for a periodic physical inventory.

Going forward, the Finance department will develop an inventory policy as a portion of an overall Asset Management policy. This policy will also include sections for capitalizable (over \$5,000) and non-capitalizable fixed assets (under \$5,000) that are being developed currently.

The Asset Management policy is to be developed using best practice guidelines provided by GFOA and similar professional and industry groups. Also, Finance is forming a citywide committee that will serve as a clearinghouse for specific policy provisions, and a project team to implement the policy and electronic systems selected to implement the policy. It is anticipated that the control provisions of the Assets Management policy will be implemented immediately upon approval of the policy.

Finance and the Asset Management committee will establish as a permanent goal the effective control, tracking and reporting of inventoried items. The committee will identify the types of assets under \$5,000 (non-capitalizable assets) that require tracking and tagging and provide location information of those items.

The Finance Department and its citywide team will also review existing software owned by the City to serve as the automated platform necessary to achieve control and reporting capability. This will include modules available as a part of the city's financial system as well as operating system currently in use by City departments. This includes an inventory module that is a part of the City's current financial system and a fleet management software system both of which have inventory capability.

The fleet management system (FASTER) barcode add-on module provides the ability to scan and print labels and perform handheld physical inventory. This module allows for data entry as well as inventory control. It can also be used when an in-house numbering system is in use, scanning either the in-house label or the OEM label.

The financial management system's stores module has the capability to manage consumable storeroom(s)/warehouse(s). The module issues equipment, materials, and/or supplies to departmental users. This module includes returns, cost adjustments and reporting capabilities. It is also integrated with the financial systems' purchasing and receiving functions.

Phase one of the assets management improvement project is currently in its final stages. The financial systems' fixed assets module has been populated with electronic assets records provide from the city's previous spreadsheet based system. The results are being reconciled and finalized.

As an extension of the automation of the fixed asset module, phase two will consist of tagging movable assets under \$5,000. Beginning in FY 2017, the City intends to implement another component of the current financial system's fixed asset module. The module includes transfer,

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history, and reporting capabilities to maintain an inventory of the custody and location of fixed and moveable assets.

Finally, phase three of the project will consist of implementing the stores module. This phase may require simultaneous implementation of the receiving function in the financial system to ensure success. Additional discovery and work will be required to make this determination.

| Appendix 1: Control Activities Form for Inventory Processes | Internal Control is Implemented and Effective | Documentation Could be Improved |
|---|---|---------------------------------|
| Recording Purchases | | |
| 1. Management reviews the entity's financial statements on a periodic basis and investigates significant variances from budgets and expected results. | X | |
| 2. Management or governing body approval of purchase orders is required for purchases that exceed established limits according to entity policy. | X | |
| 3. Purchase order, receiving report, and invoice are matched and cancelled prior to payment. | X | |
| 4. There is adequate segregation of duties among those who: | | |
| a. Initiate purchase orders. | X | |
| b. Maintain the purchase journal. | X | |
| c. Initiate checks for expenditures | X | |
| d. Review, authorize, or sign checks. | X | |
| e. Prepare or issue debit memos. | X | |
| g. Edit the vendor master file. | X | |
| h. Input purchase orders. | X | |
| i. Verify or process receipt of inventory. | X | |
| j. Receive goods from or transfer goods to inventory. | X | |
| k. Investigate discrepancies or issues related to expenditures, inventory, capital assets, revenue, debt, or cash. | X | |
| l. Maintain access to or custody of inventory. | X | |
| m. Process sales orders. | X | |
| n. Maintain the chart of accounts. | X | |

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|--|---|---------------------------------|
| 5. Purchase orders, receiving reports, debit/credit memos, and shipping orders for returned goods (including unused forms) are prenumbered and the sequence is accounted for. | X | |
| Receiving and Storing Inventory | | |
| 6. Management or governing body approval of purchase orders is required for purchases that exceed established limits according to entity policy. | X | |
| 7. Purchase orders, receiving reports, and invoice entries that do not match are investigated promptly. | X | |
| 8. After each period end, management creates a log of all invoices received above the limit dictated by entity policy and checks to ensure that they were recorded in the proper period. | X | |
| 9. The inventory subledger (detail listing or perpetual record) is reviewed and reconciled to the general ledger. | X | |
| 10. Physical inventory counts are reconciled to the perpetual record - (subledger). | X | |
| 11. Physical inventory counts to verify quantities on hand are performed. | | |
| There is adequate segregation of duties among those who: | | |
| a. Initiate inventory purchases. | X | |
| b. Input purchase orders. | X | |
| c. Authorize inventory purchases. | X | |
| d. Verify and process receipt of inventory. | X | |
| e. Authorize transfer requests. | X | |
| f. Initiate checks for inventory purchases. | X | |

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|--|---|---------------------------------|
| g. Ship inventory. | X | |
| h. Record inventory transactions. | X | |
| i. Have responsibility for inventory counts. | X | |
| j. Investigate inventory count discrepancies. | X | |
| k. Investigate discrepancies or issues related to inventory. | X | |
| l. Approve changes to inventory cost/quantity (including disposal). | X | |
| m. Maintain inventory records. | X | |
| n. Edit the inventory master file. | X | |
| o. Maintain access to and custody of inventory. | X | |
| p. Process sales orders. | X | |
| q. Investigate discrepancies or issues related to revenue, investments, borrowings, derivatives, or cash. | X | |
| r. Post journal entries to the general ledger. | X | |
| s. Maintain the chart of accounts. | X | |
| Costing Inventory | | |
| 12. Management reviews the entity's financial statements on a periodic basis and investigates significant variances from budgets and expected results. | X | |
| 13. Only authorized individuals have access to make changes to the inventory master file. | X | |
| 14. Inventory pricing procedures are in accordance with the costing method used by the entity (FIFO, average cost, etc.). | X | |
| 15. Management reviews and approves the final priced inventory listing. | X | |

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| Managing Inventory | | |
| 16. Management reviews the entity's financial statements on a periodic basis and investigates significant variances from budgets and expected results. | X | |
| 17. The inventory subledger (detail listing or perpetual record) is reviewed and reconciled to the general ledger. | X | |
| 18. Only authorized individuals have access to and make changes to the inventory master file. | X | |
| 19. Physical inventory counts are reconciled to the perpetual record (subledger). | X | |
| 20. Physical inventory counts to verify quantities on hand are performed. | X | |
| 21. Book-to-physical adjustments are reviewed at period end. Inventory is stored in properly secured locations. Access is restricted to authorized personnel. | X | |
| 22. There is adequate segregation of duties among those who: | | |
| a. Initiate inventory purchases. | X | |
| b. Input purchase orders. | X | |
| c. Authorize inventory purchases. | X | |
| d. Verify and process receipt of inventory. | X | |
| e. Authorize transfer requests. | X | |
| f. Initiate checks for inventory purchases. | X | |
| g. Ship inventory. | X | |
| h. Record inventory transactions. | X | |
| i. Have responsibility for inventory counts. | X | |

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|---|---|---------------------------------|
| j. Investigate inventory count discrepancies. | X | |
| k. Investigate discrepancies or issues related to inventory. | X | |
| l. Approve changes to inventory cost/quantity (including disposal). | X | |
| m. Maintain inventory records. | X | |
| n. Edit the inventory master file. | X | |
| o. Maintain access to and custody of inventory. | X | |
| p. Process sales orders. | X | |
| q. Investigate discrepancies or issues related to revenue, investments, borrowings, derivatives, or cash. | X | |
| r. Post journal entries to the general ledger | X | |
| s. Maintain the chart of accounts. | X | |
| 23. Management reviews and approves adjustments to inventory control accounts and/or perpetual records. | X | |
| Estimating Excess and Obsolete Inventory Reserves | | |
| 24. Management reviews the entity's financial statements on a periodic basis and investigates significant variances from budgets and expected results. | X | |
| 25. Accounting policies and procedures specify correct treatment for estimating excess and obsolete inventory reserves, including those requiring management's estimates and judgments. | X | |
| 26. A supporting analysis is prepared for estimating excess and obsolete inventory reserves. The analysis documents compliance with relevant GAAP or an OCBOA (including relevant regulatory rules) and the entity's accounting policies. | X | |

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| 27. Management periodically assesses whether excess, slow-moving, obsolete, and defective inventories are identified and accounted for on a timely basis. | | X |