

INTERNAL AUDIT REPORT

CITY OF MANCHESTER

NEW HAMPSHIRE



Highway Department Consumable Inventory June 30, 2001

Prepared by
City of Manchester, NH – Finance Department
Internal Audit Division

**INTERNAL AUDIT REPORT
CITY OF MANCHESTER, NEW HAMPSHIRE
HIGHWAY DEPARTMENT CONSUMABLE INVENTORY
JUNE 30, 2001**

TABLE OF CONTENTS

LETTER OF TRANSMITTAL	1
INTRODUCTION	2
FINDINGS AND RECOMMENDATIONS	
OBSERVATION 1 – INTERNAL CONTROLS OVER CONSUMABLE INVENTORIES	4
OBSERVATION 2 – INVENTORY ORGANIZATION	6
OBSERVATION 3 – CAPITALIZED ITEMS THAT SHOULD HAVE BEEN EXPENSED ..	7
APPENDIX	9

January 28, 2014

Committee on Accounts, Enrollment and Revenue Administration
City of Manchester, New Hampshire
Honorable Aldermen: Hirschmann, Thibault, Pinard, Lopez and Levasseur

Dear Honorable Committee Members:

At the July meeting, a request was made by Internal Audit (IA) to perform a test of the Highway Department's consumable inventory balance at June 30, 2001. This is an annual audit conducted by IA and was approved by the Committee at the July meeting.

The scope of the assignment was to perform an audit of the reported June 30, 2001 consumable inventory balance to express if the balance reported in the general ledger was fairly stated. As part of IA's audit the accounting controls in place during fiscal year 2001 were also evaluated.

The audit procedures began with documentation and evaluation of the internal accounting controls in place at the Highway Department during the audit period. No material problems in the existing control structure were noted and a standard sample size of 60 items was judgmentally selected for testing. All items were tested for completeness (the correct amounts were recorded) as well as valuation (the correct value was assigned to each item).

Conclusion

While IA discovered an immaterial amount of variances between the physical counts and recorded amounts and a few minor internal control problems as noted in our report the recorded balance was found to not be materially misstated and required an audit adjustment of \$22,912 which has been completed. The Highway Department was the first City agency to use the HTE system to track its consumable inventory and should be commended for the tremendous amount of work involved in this project. IA has been conducting audits of the consumable inventory balance for the last three years and has noted an improvement in internal controls and reporting in each year.

The draft audit report was sent to the management of the Highway Department for review and comment. The observations generated and the auditee written responses are included on pages four through eight. The auditee responses indicate general agreement with the reports recommendations and states that corrective action will be taken in the current fiscal year. We appreciate the courtesy and cooperation of the staff and administration of the Highway Department on this assignment.

Respectfully Submitted,

Kevin Buckley, CPA
Internal Audit Manager

INTRODUCTION

AUDIT BACKGROUND

At the July meeting of the Committee on Accounts, Enrollment & Revenue Administration it was requested that a financial audit of June 30, 2001 Highway Department consumable inventory balance be conducted. The Finance Officer of the City of Manchester (the City) has been designated by state law, city charter and local ordinance with the authority to conduct such examinations and audits.

Our audit was conducted in accordance with generally accepted auditing standards, as promulgated by the American Institute of Certified Public Accountants, as well as standards applicable to financial and compliance audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

AUDIT SCOPE AND OBJECTIVES

IA's audit was limited to determining if the HTE general ledger balance for the Highway Department consumable inventory account was fairly stated at June 30, 2001. As part of IA's audit the internal control structure in place during fiscal year 2001 was documented and evaluated.

The results of our testing are included in the recommendation and observation section of this report found on pages four through eight.

BACKGROUND OF AUDITEES

The City of Manchester Highway Department is charged with improving and maintaining the City's infrastructure and to provide general basic services such as construction and maintenance of all public roadways and bridges, the collection and treatment of wastewater, the control and collection of storm drainage and the collection and disposal of solid waste. In FY 1999 the department also took over the maintenance of City facilities and the aggregation and purchase of energy services.

In 1997 the City converted its computerized financial system to HTE. The HTE system is a fully integrated system that links several subsidiary modules to the INFISYS general ledger. The Highway Department was the first department to use the Purchase and Inventory module (P&I) to track its consumable inventory. This involved doing a complete physical inventory then posting the beginning balance for more than 1,500 items. The Highway Department inventory is made up of fuel, auto parts and construction material. In FY 2001 the Department issued more than 1.4 million dollars worth of material from its inventory. Activity for the account in FY 2001 is shown in the chart Shown on the next page:

FY 2001 Inventory Activity

Beginning Balance	\$ 536,124
Issues	(1,045,416)
Fleet Charges	(373,302)
Adjustments	(13,850)
Purchases	1,342,984
Ending Balance	\$ 446,540

Inventory is located in three distinct areas. The garage area has a locked caged-in-area where the majority of vehicle parts are stored and another secured area where tires are kept. There are inventory personnel on hand at all times to control the flow of material. The highway yard has a fenced in area and a couple of sheds where construction material is kept. Access is limited and inventory personnel control the flow of material in and out of the area. The Manchester Transfer Station is used for large piles of fill and some larger sewer and storm drain parts. At the transfer station all trucks entering to pick up bulk objects are weighed empty and weighed again as they are leaving. Inventory slips used for entry by the business office into the inventory system are prepared at all locations.

The department appears to have adequate segregation of duties over inventory control and access to the HTE inventory module.

After an audit adjustment of \$22,912 was entered the 6/30/01 consumable inventory balance of \$446,540 appears to be fairly stated.

FINDINGS AND RECOMMENDATIONS

OBSERVATION 1 INTERNAL CONTROLS OVER CONSUMABLE INVENTORY:

From a sample of 60 items selected from the 6/30/01 Highway Department consumable inventory in the Purchase and Inventory module of HTE, Internal Audit (IA) detected errors with 12 of the items selected or a 20% error rate. IA's sample had a total recorded dollar amount of \$315,533 out of a total dollar population of \$474,674 or 66.47% of the recorded population. IA's sample revealed a net overstatement of \$9,547.44 or an overstatement of the sample of 3%. From IA's review of the internal control structure in place at the Highway Department during FY 2001 we noted the following weaknesses that IA believes contributed, at least in part, to the errors noted above.

- The City, and by extension the Highway Department, does not maintain a written policy and procedures manual over the handling of inventory transactions. A current manual would improve the Highway Department's ability to maintain continuity of operations during any absences or turnover of personnel responsible for accounting and financial administration of the inventory. It would also be useful in documenting the internal controls and identifying opportunities to enhance segregation of duties. The manual could encompass the following functions:
 - Requisitioning, purchasing and receiving inventory
 - disposal of obsolete, missing or damaged inventory
 - custody and accounting of inventory
 - Frequency and procedures of taking a physical inventory

This observation was also noted in IA's prior audit report on the 6/30/2000 Highway Department consumable inventory balance. A similar comment was included in the FY 2000 management letter to the audit of the general purpose financial statements of the City as of and for the year ended 6/30/2000.

- Physical inventory cycle counts are conducted four times a year but have failed to reveal or correct some significant errors in the inventory. IA has noted items with significant account balances that were no longer in the inventory and items that were being expensed and yet had large balances capitalized in the inventory as noted in observation 2 on page 6. Both of these conditions were present throughout the year and should have been picked up in the physical inventory conducted by the department.
- The Highway Department was one of the first departments to utilize the P&I module in the City. In order to enter the hundreds of balances in a timely manner they utilized several people who were not familiar with the inventory or with accounting procedures at the Highway Department. Due to this, several erroneous entries were made in the beginning balances in FY 1997. While many of these balances have been corrected there are several that have yet to be corrected. For example, as noted above and in observation 3 on page 7 an item that is normally expensed was put in the system as a capitalized item. This beginning balance has been carried forward since that time.

- As noted in observation 2 on page 6 some of the inventory was not well organized. This was particularly evident at the transfer station. This area is isolated from the rest of the Highway Department and does not appear to get the same scrutiny as other areas.

RECOMMENDATION:

1. Until the City develops a policy and procedure manual of its own the Highway Department should develop an agency specific manual to cover how inventory transactions are to be handled and how the physical inventory is to be controlled.
2. Procedures over the physical inventory counts should be reviewed to determine how the items noted above remained undetected.
3. When making changes such as entering beginning balances to a new computer system only qualified and well-supervised employees should be used. All beginning balances entered in the inventory module should be reviewed to ensure that the inventory is fairly stated.
4. Inventory should be better organized particularly at the transfer station area.

AUDITEE RESPONSE:

When the Highway Department instituted cycle counts the main emphasis was placed on duplicate items, items with high turnover and items which were capitalized that should have been expensed. With an inventory of thousands of different items this was a major undertaking. We have made significant progress and will continue to do so over the course of the next round of cycle counts. Many of the observations noted had been observed and no action was taken because the time constraint was too great to properly research all of these situations.

The discrepancies noted for high volume items are well within excepted guidelines

The authorization to enter beginning inventory has been restricted to a select group of individuals in the department. They are all within the accounting function; the Business Service Officer, the Account 2 and the Purchasing Agent. This change was made during the last fiscal year as a result of our normal auditing procedure and through cycle count audits. The stock personnel fill out forms for new inventory item request.

The Department has job duty and training manuals for some accounting personnel but not all. We will finalize a procedures manual this year.

OBSERVATION 2 **INVENTORY ORGANIZATION:**

In order to help maintain control over inventory the inventory items should be maintained in as orderly a manner as possible. Items should be properly labeled and organized to ensure ease in finding and counting the inventory. IA noticed several instances where inventory items were not well organized.

Many items that were very similar in appearance were not clearly labeled. This increases the risk that the part number from a similar item could be recorded in error thereby understating one part's balance and overstating another in the HTE module.

At the transfer station, where the City stores items such as catch basins and large pipes, the inventory was not clearly organized at all or clearly labeled. Items were scattered across a large area with no apparent methodology. This made it very difficult to obtain a good inventory count.

Department records also showed that 719 tons of crushed bank run and 1,140 tons of compost loam mix should have been on hand. IA could find none.

IA was informed by Highway personnel that the City no longer used crushed bank run gravel but instead used recycled asphalt. HTE records show that the last time crushed bank run was issued occurred on 10/02/00. The last receipt of crushed bank run was 53 tons received on 3/16/00. It was determined that the crushed bank run was physically combined with the recycled asphalt but the inventory records were not changed to reflect this.

HTE records show that the last issue of compost loam mix was on 06/14/01, the next previous transaction was an issue on 05/26/99. Except for an initial balance of 2000 tons on 07/23/97 records show no receipts of the compost loam mix into inventory. IA has determined that including the compost loam mix in the inventory overstates the June 30, 2001 balance by \$5,699.

RECOMMENDATION:

The Highway Department should work to better organize its inventory in a manner that will make it easier to perform a physical inventory. Labels should be attached to the item or bin that contains the item to help with conducting an inventory.

Items at the transfer station should be segregated by item number and the yard cleaned and organized. If it becomes obvious that a balance is incorrect the records should be adjusted. All items should be clearly labeled.

The recycled asphalt and crushed bank run records should be adjusted to reflect that they have been combined. And the records should be adjusted to eliminate the compost loam mix.

Cycle counts should be performed more frequently at the transfer station by a person who does not work there or have control over the inventory.

AUDITEE RESPONSE:

Inventory in the garage has been separated by item and item type. Bin locations are assigned in the stockroom and we have inputted most of these in the inventory module. The parts personnel are knowledgeable of their inventory and have been trained as to the organization of parts through their bin locations.

Many of the items observed at the Drop Off facility are obsolete and have been written off. They are left there in cases where old structures need to be repaired. I agree there needs to be more organization at the site. (The state of the site is a result of many, many years) This type of operation has been planned out, unfortunately with the size of the area and inventory; large equipment will be needed. This equipment is being used in our daily operations.

The compost loam mix was a byproduct of the city's yard waste collection. This material was available to citizens at no charge. The balance noted in inventory is what citizens removed from inventory. This does overstate the inventory but the cost associated was a tool to help track the cost of construction projects.

The recycling of asphalt is normally done on an annual basis. It is my assumption the crushed bank run gravel was mixed into the recycled pile being they are in close proximity to each other. That being the case the inventory is overstated but only by the difference between the price of the recycled asphalt and the crushed bank run gravel.

Cycle counts at the drop off facility are done on a quarterly basis and that schedule can be accelerated. Counts on the aggregate materials are more difficult because surveyors are needed to measure each pile.

OBSERVATION 3 **CAPITALIZED ITEMS THAT SHOULD HAVE BEEN EXPENSED:**

Our test work revealed two instances out of 60 items tested (3%) where items that are or should be expensed have been capitalized in the year-end inventory.

R6434D X tire chains and R6435D X tire chains were reported in the 6/30/01 inventory at 1570 units and 1600 units respectively. Per conversation with highway personnel these items are expensed during the year and not capitalized. From examining the activity in the accounts it is clear that the items are being expensed. The balances appear to have been entered in error when the HTE system was first set up and the balances carried forward. This results in an overstatement of the inventory balance at 6/30/01 of \$11,491.

RECOMMENDATION:

The computer records should be adjusted to eliminate the balances in the two tire chain accounts. A review of all items normally expensed should be conducted in order to determine if there are any other balances that are incorrectly in the system.

AUDITEE RESPONSE:

Over the past year the Highway Department has placed a large emphasis on our consumable inventory. Cycle counts have been instituted and many adjustments have been made to correct items incorrectly recorded as inventory, obsolete items and duplicate item entries. All these adjustments have had an impact on our budget and as a result reporting has increased in accuracy. Tire chains were incorrectly recorded in the initial phase. Those items are overstated and we are in the process of making corrections.