



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

April 7, 2014

The Honorable City Council
Palo Alto, California

Finance Committee Recommendation to Accept the Inventory Management Audit

The Office of the City Auditor recommends acceptance of the Inventory Management Audit. At its meeting on February 18, 2014, the Finance Committee approved and unanimously recommended the City Council accept the report. The Finance Committee minutes are included in this packet.

Respectfully submitted,

Houman Boussina
Acting City Auditor

ATTACHMENTS:

- Attachment A: Inventory Management Audit (PDF)
- Attachment B: Finance Committee Meeting Minutes Excerpt (February 18, 2014) (PDF)

Department Head: Houman Boussina, Acting City Auditor



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

February 18, 2014

**The Honorable City Council
Attention: Finance Committee
Palo Alto, California**

Inventory Management Audit

In accordance with the Fiscal Year 2013 Annual Audit Work Plan, the Office of the City Auditor has completed the Inventory Management Audit. The audit report presents five findings with a total of fourteen recommendations. The Office of the City Auditor recommends the Finance Committee review and recommend to the City Council acceptance of the Inventory Management Audit.

We thank the staff of the Administrative Services Department, the Utilities Department, the Public Works Department, and the Information Technology Department for their time, information, and cooperation during the audit process.

ATTACHMENTS:

- Attachment A: Inventory Management Audit (PDF)

Department Head: Houman Boussina, Acting City Auditor



CITY OF
**PALO
ALTO**

INVENTORY MANAGEMENT AUDIT

December 2013



Office of the City Auditor

Houman Boussina, Acting City Auditor
Mimi Nguyen, Senior Performance Auditor



Office of the City Auditor

EXECUTIVE SUMMARY – INVENTORY MANAGEMENT AUDIT

CITY OF
**PALO
ALTO**

Audit Objective: To determine if the City has adequate controls to ensure accuracy and completeness of inventory records, accountability for inventory transactions, and safeguarding of inventory.

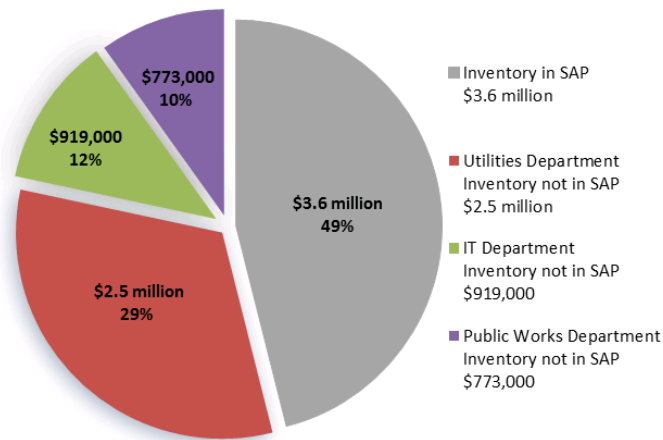
SUMMARY OF RESULTS

The Administrative Services Department (ASD) and other City departments with inventory management roles and responsibilities should improve controls and oversight. ASD should promote and enforce citywide inventory management standards and continually improve processes using the City’s SAP inventory system.

The audit report indicates:

- At least \$4.2 million in inventory was not managed using the City’s SAP inventory system, which if used could have provided transparency, accountability, and operational efficiencies.
- ASD should improve controls to ensure the accuracy of inventory records. We found an overall inventory record accuracy rate of 89 percent. About \$100,000 out of the \$3.6 million in recorded inventory sampled was inaccurate.
- More than 50 percent of the City’s stock materials, or about \$2.5 million in inventory, had not turned over in a one-year period as of May 12, 2013 indicating the City’s warehouses had significant quantities of unused or infrequently used inventory.
- The City should improve physical security over its inventory.

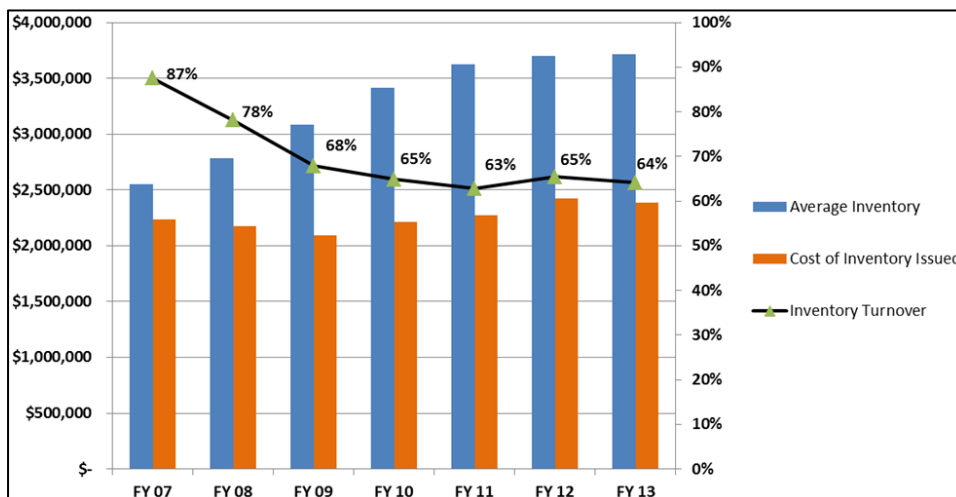
At least \$4.2 million in inventory was not managed using the City’s SAP Enterprise Resource Planning (SAP) inventory management system.



The City’s Comprehensive Annual Financial Report indicated \$3.6 million in inventory as of June 30, 2013.

In this report, the Office of the City Auditor (OCA) provides 14 recommendations to improve management of the City’s inventory. Page two of this executive summary presents highlights of findings and recommendations in this report.

Inventory turnover decreased from 87 percent in Fiscal Year 2007 to 64 percent in Fiscal Year 2013 (as of April 19, 2013), indicating decreased efficiency and effectiveness of inventory management practices. The City’s average inventory meanwhile increased from about \$2.5 million in FY 2007 to over \$3.6 million in FY 2013, a 46 percent increase.



Source: City of Palo Alto financial records

REPORT HIGHLIGHTS**Finding 1: ASD and City departments should implement inventory management policies and procedures citywide to achieve the City's inventory goals and objectives (Page 9)**

- We identified at least \$4.2 million in inventory that is not managed using the City's SAP inventory system. The inventory was managed by the following City departments:
 - Utilities Department - \$2.5 million
 - Public Works Department - \$773,000
 - Information Technology (IT) Department - \$919,000
- The Utilities Department disposed of at least \$30,000 in unused materials past their expiration dates.

Finding 2: ASD should improve controls to ensure the accuracy of recorded inventory (Page 15)

- Inventory records were inaccurate for 20 of 182 materials in our sample, indicating an 89 percent accuracy rate.

Finding 3: Inventory records do not evidence accountability for all inventory transactions (Page 19)

From January 1, 2007 through April 19, 2013:

- About \$1.0 million in inventory was issued without reservations evidencing the need and authorization.
- Individuals reserved and issued about \$1.1 million in RWQCP Warehouse inventory (72 percent of the total inventory issued) and about \$321,000 in MSC Warehouse inventory (2.1 percent of the total inventory issued).
- Staff used a generic user account that was accessible using a shared password to issue about \$8.5 million in inventory (58 percent of inventory issued).

Finding 4: The City's warehouses have significant quantities of unused or infrequently used inventory (Page 21)

- More than 50 percent of the City's 4,383 stock materials, or about \$2.5 million in inventory, had not turned over in a one-year period as of May 12, 2013.
- Inventory turnover decreased from 87 percent in Fiscal Year 2007 to 64 percent in Fiscal Year 2013 (as of April 19, 2013), indicating decreased efficiency and effectiveness of inventory management practices.

Finding 5: The City should improve physical security over its inventory (Page 25)

- A large number of cards granted access to the MSC and the MSC Warehouse, including cards without adequate identifying information needed to uniquely link activity with an individual.
- While only 6 City employees were assigned to work at the MSC Warehouse, 71 cards provided access to the facility.

Finding 1 Recommendations:

- ASD and City departments should implement the City's inventory management policies and procedures citywide to achieve inventory goals and objectives.
- ASD should review its inventory accounting policies and correct any misstatements in the City's accounting records.

Finding 2 Recommendation:

- ASD should update and enforce inventory count policies and procedures to help ensure consistent and accurate inventory records.

Finding 3 Recommendations:

- ASD should update and enforce inventory transaction policies and procedures to ensure there is proper authorization and accountability for all transactions.
- ASD should avoid use of generic user accounts. ASD should consult with the IT Department to determine an appropriate alternative to using a generic account to issue inventory.

Finding 4 Recommendations:

- ASD should identify, formalize, and communicate inventory management goals and objectives to City departments.
- ASD should update existing policies and develop new policies and procedures to address the following: a) roles and responsibilities for managing inventory levels, b) management of slow-moving or dead stock, and c) transitioning to new materials.

Finding 5 Recommendations:

The Public Works Department should:

- Perform a citywide physical access risk assessment.
- Develop policies and procedures to address the management of citywide physical security.
- Configure the fleet access control system to support the City's security goals and objectives or determine if the AMAG Technology, Inc. Symmetry Security Management System (SMS) should replace it.
- Review and update SMS access authorization records to ensure access card holders can be uniquely identified.
- Assess the adequacy of records of individuals assigned keys and take necessary corrective action to ensure the accuracy and completeness of the records.
- Improve physical security at the City Hall storage area.

This document represents a limited summary of the audit report and does not include all of the information available in the full report. The full report can be found on the Office of the City Auditor website at: <http://www.cityofpaloalto.org/gov/depts/aud/reports/performance.asp>

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In accordance with the Fiscal Year 2013 Annual Audit Work Plan, the Office of the City Auditor has completed this Inventory Management Audit. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.



We would like to thank the staff of the Administrative Services Department, the Utilities Department, the Public Works Department, and the Information Technology Department for their time, information, and cooperation during the audit process.

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INTRODUCTION

Audit Objective

The objective of the audit was to determine if the City has adequate controls to ensure accuracy and completeness of inventory records, accountability for inventory transactions, and safeguarding of inventory.

Background

According to the Palo Alto Municipal Code (Municipal Code), the Administrative Services Department (ASD) is responsible for all purchases required by various departments, offices, and units of the City, and for the operation and maintenance of the City's warehouse and storage facilities, which according to the City's financial records as of June 30, 2013, contained about \$3.6 million in General Fund inventory.

The City's Stores Warehouses (Stores), a division of ASD, is the warehousing and logistical arm of the City, housing over 3,500 items at two facilities located at the Municipal Services Center (MSC) and the Regional Water Quality Control Plant (RWQCP). Stores is responsible for all shipping, receiving, and delivery of materials in addition to daily deliveries to over 30 City locations, library book transfers, the delivery of City Council and special packets, and facilitation of all surplus sales. There are four storekeepers and one warehouse supervisor responsible for the City's warehouse operations. The Public Works Department is responsible for the maintenance, security, and safety of City structures where the City's inventory is stored.

The Government Accountability Office (GAO) provides an executive guide applicable to governmental and nongovernmental agencies holding inventory or property and equipment.¹ The guide indicates that the lack of reliable information impairs the government's ability to:

- Know the quantity, location, condition, and value of assets it owns.
- Safeguard its assets from physical deterioration, theft, loss, or mismanagement.
- Prevent unnecessary storage and maintenance costs or purchase of assets already on hand.
- Determine the full costs of government programs that use these assets.

ASD has adopted the City's SAP Enterprise Resource Planning (SAP) system and has developed inventory management policies and procedures to manage the City's inventory. SAP supports processes and functions that can help ensure efficient and effective management of inventory as summarized in Exhibit 1.

¹ GAO-02-447G: Executive Guide - Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property (March 2002)

Exhibit 1: Summary of SAP Inventory Functions

INVENTORY CONTROL	DESCRIPTION OF INVENTORY FUNCTION IN SAP
Goods Movement	Transaction resulting in change in stock.
Goods Receipt	Posting receipt of goods, increasing warehouse stock.
Goods Issue	Posting material withdrawal or issue, reducing warehouse stock.
Return Delivery	Returning delivered goods to the vendor.
Stock Transfer	Removal of material from one storage location to another.
Reservation	Request to the warehouse for withdrawal of material at a specified date.
Physical Inventory	Recording and posting actual stock levels based on counting, weighing, or measuring at a given storage location at a specific time through periodic inventory, continuous inventory, cycle counting, and inventory sampling methodology.
Batch Handling	Ability to manage stock by various levels of detail or if precise identification is required.
Print Function	Document printing for physical goods movement.
Material Master	Contains information on all the materials stored. It is the central source for retrieving material-specific data.
Archiving	Track the archiving of material documents and physical inventory documents.
Reporting	Range of functions and reports that provide extensive information on all materials and their stock data.

Audit Scope and Limitations

The City's policies and procedures do not define "inventory." The audit covered the City's inventory, defined as supplies and materials that have not been placed into operation, primarily at the MSC and the RWQCP.

The audit assessed the adequacy of inventory management and safeguarding controls. It did not address the following areas:

- Disposition and use of materials subsequent to issuance by the City's warehouses.
- Management of materials not in inventory that the department has already identified as surplus or obsolete.
- Staffing and inventory carrying costs, such as the cost to store, handle, and protect inventory or costs associated with obsolescence.
- Processes to determine if materials should be stocked and the appropriateness of stocking levels and the reorder point for materials.
- Organization and the condition of the City's inventory.
- Application of the City's 2 percent surcharge policy. Stores charges departments a 2 percent markup in addition to the average cost identified in SAP for supplies and materials.²

² This policy is also discussed in the Audit of Contract Oversight: Office Supplies issued in November 2012. ASD indicated it would review the practice of storing office supplies.

Audit Methodology

To conduct this audit, we performed the following:

- Reviewed inventory management guidelines set forth by the Government Accountability Office (GAO) and the Government Finance Officers Association (GFOA), the SAP Library (online guidance for the SAP system), and surveys and reports on inventory management practices and physical security.
- Reviewed the Municipal Code and the City's inventory management and physical security policies, procedures, and processes.
- Interviewed Administrative Services Department (ASD), Utilities Department, Public Works Department, and Information Technology (IT) Department staff responsible for managing and safeguarding the City's inventory and associated assets.
- Reviewed inventory reported in the City's financial records and analyzed inventory data in the City's SAP system. Assessed the accuracy and completeness of inventory records.
- Analyzed access authorization records for selected points of access at the MSC.
- Consulted with the City's external auditing firm, Macias Gini & O'Connell, LLP (MGO), regarding presentation of inventory in the City's financial statements.

City Auditor's Conclusion

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. These audit findings indicate that ASD and other City departments with inventory management roles and responsibilities should improve controls to ensure accuracy and completeness of inventory records, accountability for inventory transactions, and safeguarding of inventory. In addition, ASD should promote and enforce citywide inventory management standards and continually improve processes using the City's SAP inventory system.

In this report, the Office of the City Auditor provides 14 recommendations to improve inventory management at the City. We recommend that other City departments with inventory management roles and responsibilities review this report and implement the recommendations where applicable.

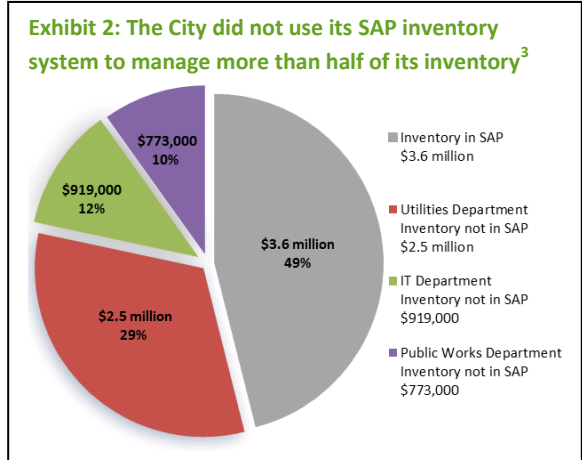
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Finding 1: ASD and City departments should implement inventory management policies and procedures citywide to achieve the City’s inventory goals and objectives

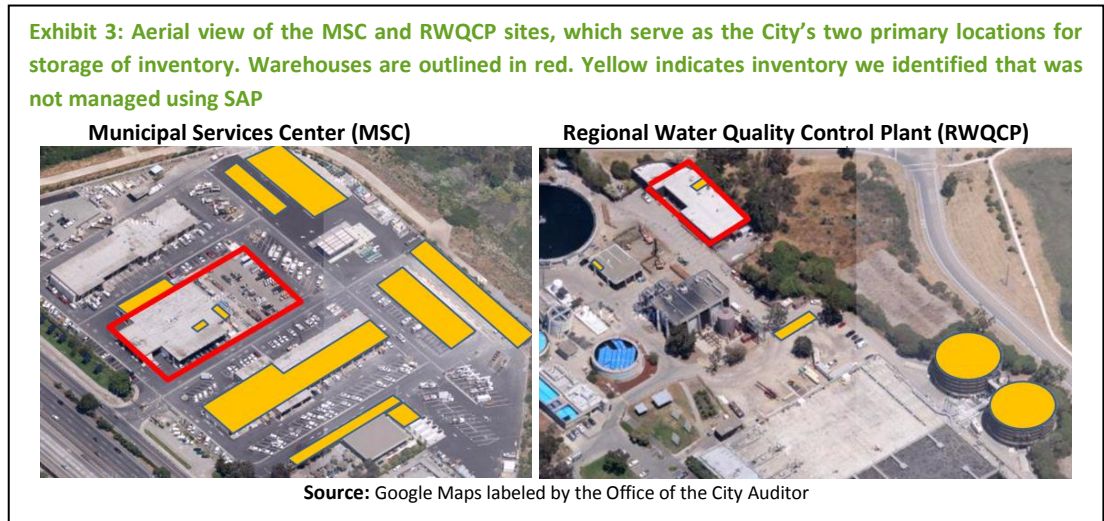
We identified at least \$4.2 million in City department inventory that was not managed using the City’s SAP inventory system, which if used could have provided transparency, accountability, and operational efficiencies. The Administrative Services Department (ASD) has not effectively enforced inventory policies and procedures citywide, and City departments have not implemented sufficient inventory management controls. Moreover, our audit scope was limited because more than half of the City’s inventory was not managed using the SAP inventory system.

The inventory we identified that was not included in the SAP inventory system was managed by the following City departments (Exhibit 2):³

- Utilities Department - \$2.5 million
- Public Works Department - \$773,000
- Information Technology Department - \$919,000



In order to assess completeness of the City’s inventory data in SAP and the adequacy of oversight, we surveyed selected locations at the City’s Municipal Services Center (MSC) and Regional Water Quality Control Plant (RWQCP). Exhibit 3 shows aerial views of these locations, with the City’s two main warehouses outlined in red. We identified at least \$4.2 million in inventory at these locations that was not managed using the City’s SAP inventory system (highlighted in yellow in Exhibit 3).



³ The City’s Comprehensive Annual Financial Report indicated \$3.6 million in inventory as of June 30, 2013. To the extent reasonable and practical, we valued the inventory we identified that was not managed using the SAP inventory system by referring to purchase orders, comparable items in inventory, and staff estimates.

The Municipal Code indicates that ASD is responsible for operating and maintaining the warehouse and storage facilities of the City. The City has adopted and implemented SAP, which supports inventory management processes and functions needed to ensure the efficient and effective management of inventory, as summarized in the Background section of this report. In addition, ASD has developed inventory management and accounting policies and procedures. However, ASD has not clearly defined, communicated, and enforced its inventory goals and objectives citywide resulting in inconsistencies in inventory processes, management, and controls. ASD should promote and enforce citywide inventory management standards and continually improve processes using the City's SAP inventory system.

While we noted varying degrees of oversight for the \$4.2 million in inventory that was not managed using the SAP inventory system, we found that City departments did not have adequate systems to manage and safeguard the inventory and to ensure the consistent and appropriate treatment of the inventory from a financial accounting perspective. The lack of reliable and complete inventory data may impair the City's ability to:⁴

- Know the quantity, location, condition, and value of its inventory.
- Safeguard its inventory from physical deterioration, including possible theft, loss, or mismanagement.
- Prevent unnecessary storage and maintenance costs or purchase of inventory already on hand.
- Determine the full costs of government programs that use these assets.

The Utilities Department stored over \$82,000 in inventory at an unsecured location without oversight.

We identified at least \$82,000 in unsecured inventory stored along the north side of the City's MSC Warehouse

(Exhibit 4). Staff and non-employees could access these materials, which are not dispensed or accounted for using the City's SAP inventory system. The City also stocked these same materials at the adjacent MSC Warehouse structure. We identified 223 materials with unit values from 11 cents to \$162. The materials at this site were not subject to the

Exhibit 4: The Utilities Department stored materials at an unsecured location adjacent to the City's MSC Warehouse

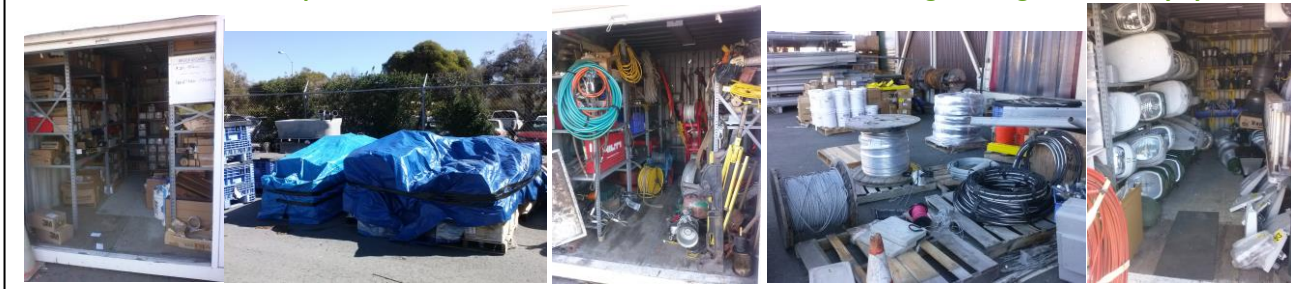


City's inventory management controls and were subject to potential misuse or theft. In addition, inconsistent with the City's accounting policy, these materials were prematurely recorded as expenditures when they were purchased.

⁴ GAO-02-447G: Executive Guide - Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property (March 2002).

The Utilities Department disposed of at least \$30,000 in unused materials past their expiration dates. The Utilities Department stores materials in numerous sheds and shelves located at the MSC (Exhibit 5). The Utilities Department does not maintain an inventory of these items. Due to the magnitude and nature of these materials, it was not practical to count or value them; however, in our opinion, the Utilities Department should establish and enforce appropriate inventory controls over these materials.

Exhibit 5: The Utilities Department stores materials at the MSC that are not managed using an inventory system



We observed Utilities Department staff purge at least 250 electrical items worth approximately \$30,000 from various storage sheds and bins subject to our audit. Staff stated these items had never been used but had expired (the shelf life for most of the electrical materials was printed on each item). In addition, during the purging process, Utilities Department staff returned to the MSC Warehouse 720 items valued at approximately \$35,000.

The Utilities Department has not managed its meters and transformers using an inventory management system with sufficient controls. We found 594 new electric, gas, and water meters not inventoried or managed using an inventory management system. The 594 meters, valued at approximately \$112,000, consisted of:

- 462 electric meters (\$85,000)
- 49 gas meters (\$14,000)
- 83 water meters (\$13,000)

The Utilities Department did not have adequate documentation to account for its meters. The meters were disorganized and managed using an undocumented manual process. Due to a lack of storage space within the meter shops, meters were stored in unsecured locations at the MSC.

Exhibit 6: New and used gas meters stored outside the meter shop



Exhibit 7: New electric meters stored inside and outside the meter shop



Transformer inventory, pending installation or use in emergencies, is not managed using the City's SAP inventory system. The available transformer inventory records indicate a lack of key inventory controls consistent with the City's SAP inventory system and inventory policies and procedures.

The Utilities Department provided two lists of transformer inventory; one was dated June 5, 2013 and the second September 3, 2013. The earlier list indicated 367 transformers while the second list indicated 421. We valued the 421 transformers at approximately \$2.3 million. These lists did not evidence basic inventory management controls,

and we could not independently reconcile these lists based on available SAP inventory data. In response to our concerns, staff investigated and provided an explanation for the variances. Staff indicated that the transformer inventory list was being updated as a result of a process change, a general clean-up of the data, and a verification/identification of transformers.

Exhibit 8: Transformers stored at the MSC



The Public Works Department did not use the City's SAP inventory system to manage at least \$773,000 in materials, including emergency replacement parts at the RWQCP. During our survey of the RWQCP, we identified 20 materials, including high value emergency replacement parts, which were not included in the City's SAP inventory system. The Public Works Department uses a manual tracking process that is inconsistent with inventory management goals and objectives to track these items. Moreover, these materials were prematurely recorded as expenditures when they were purchased, a practice that is inconsistent with the City's accounting policy for inventory.

Exhibit 9: High value emergency replacement parts and materials at the RWQCP



The Information Technology (IT) Department did not use the City's SAP inventory system to manage at least \$919,000 in materials. We found an estimated \$919,000 in IT Department inventory at the MSC Warehouse that was not managed using the City's SAP inventory system or any formal, defined process (Exhibit 10).⁵ The items included new computers, monitors, and accessories that may have a higher susceptibility to theft. These materials were prematurely recorded as expenditures when they were purchased, a practice that is inconsistent with the City's accounting policy for inventory. In addition, we noted the IT Department stores other inventory at an inadequately secured City Hall storage area without any formal inventory controls (Finding 5).

Finding 1 Recommendations to City Management:

1. ASD and City departments should implement the City's inventory management policies and procedures citywide to achieve inventory goals and objectives.
2. ASD should review its inventory accounting policies and correct any misstatements in the City's accounting records.

Exhibit 10: IT Department inventory at the MSC Warehouse not managed using the SAP inventory system



⁵ Our audit identified an estimated \$619,000 in IT Department inventory; however, Stores staff stated the department had subsequently increased its inventory at the warehouse. The IT Department estimated the additional inventory was worth \$300,000.

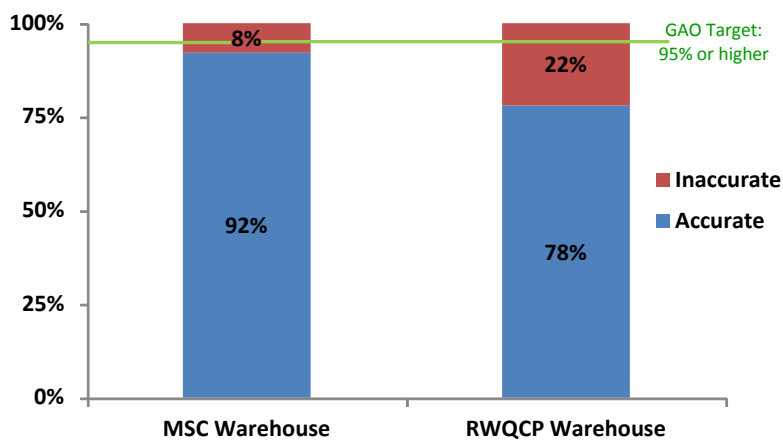
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Finding 2: ASD should improve controls to ensure the accuracy of recorded inventory

We found an overall inventory record accuracy rate of 89 percent based on a statistical sample of inventory records as of April 19, 2013. About \$100,000 out of the \$3.6 million in recorded inventory sampled was inaccurate, indicating a dollar-based error rate of about 2.7 percent.⁶ Inaccurate inventory records may cause financial misstatement and operational inefficiencies. The error rate we detected may not be indicative of the true error in the City's inventory records because the City did not use its SAP inventory system to manage all inventories and as a result, we could not include most of the city's inventory in our testing (Finding 1).

According to the Government Accountability Office (GAO), inventory record accuracy goals should be set at 95 percent or higher, and there should be other performance expectations and accountability and responsibility for the overall physical counts. We found variances between our counts and the City's inventory records for 20 of 182 materials in our sample, indicating an overall count accuracy rate of 89 percent.⁷ As shown in Exhibit 11, the 22 percent error rate for the RWQCP Warehouse was significantly greater than the 8 percent error rate for the MSC Warehouse.⁸

Exhibit 11: Inventory Record Accuracy Rates at the City's Warehouses⁹



Source: Office of the City Auditor counts and analysis of inventory records in SAP

The City's SAP system and staff rely on accurate inventory records to ensure stock materials are replenished at the appropriate time and to determine the quantity to order. In addition, inaccurate inventory records may result in inaccuracies in the City's financial statements. From a monetary perspective, we found about \$52,000 in error in a statistical sample of 182 materials, which indicates with 95 percent confidence that as of April 19, 2013, about 2.7 percent or approximately \$100,000 of the \$3.6 million in the City's recorded general fund inventory was in error and that the error could be as high as approximately \$181,000.⁹

⁶ We calculated inventory accuracy in terms of both dollars and the percent of materials with an accurate count indicated in the SAP system. The dollar-based error rate is important from a financial statement perspective. The record error rate is more important from an operational efficiency perspective.

⁷ The sample of 182 materials was selected out of a total population of 4,526 materials valued at about \$3.6 million.

⁸ Some materials associated with the warehouse locations were stored offsite.

⁹ The absolute value of the error was used as the basis for the projection. There is no lower bound on the error estimate because both overstatement and understatement pose operational risk and may indicate theft, mismanagement, and/or a poor control environment.

We also noted the following issues affecting the accuracy of the City's inventory records during our counts:

- \$4,373 in MSC Warehouse inventory was identified in SAP as "deleted/obsolete." According to staff, the inventory was not available to issue. Documentation of the authorization to remove these items from inventory was not available.
- Inventory records did not indicate the specific location for 10 RWQCP Warehouse materials valued at \$823. Some of these items were not found during the audit.
- 14 materials at the MSC and RWQCP Warehouses were identified in inventory records as "in stock" but without a recorded value. Some appeared obsolete, but others appeared valuable.

ASD policies and procedures do not ensure implementation of key control elements for maintaining an accurate inventory as set forth by the GAO. In addition, ASD has not implemented performance measures, such as inventory count accuracy rate, to help ensure the effectiveness and efficiency of warehouse operations are evaluated and appropriately communicated to management. Based on our observations and discussions with staff, we identified the following areas for improvement:

- **The issuance of materials at the RWQCP Warehouse is significantly less controlled than at the MSC Warehouse.** In contrast to the MSC Warehouse where most materials are issued to staff based on reservations previously entered in the SAP system that document the requisition, the RWQCP Warehouse operates as an "open warehouse" where departmental staff enter the warehouse, take materials, and record what they have taken on a manual sign-out sheet at the front counter.¹⁰ A single storekeeper is responsible for retrospectively entering the issuance of materials and accounting for any variances between physical counts and the inventory records in SAP.
- **Physical inventory counts conducted by warehouse staff were not "blind" or sufficiently documented.**¹¹ Staff was aware of the inventory records in SAP when performing physical counts. Because the record of on-hand quantity was provided to staff counting inventory, there was a risk that staff may not have actually performed the count or may have made incorrect assumptions. Physical inventory count records in SAP did not indicate the reason for any discrepancies and did not provide assurance that the person performing physical inventory counts did not enter the adjusting entries in SAP. Without adequate controls to ensure the person performing inventory counts does not enter adjusting entries and that there is a documented reason for discrepancies between counts and inventory records, there is a risk that the individual counting inventory could misappropriate items and make adjustments in SAP to hide the theft. In addition, ASD did not ensure all City inventory, including inventory held at off-site locations, was subject to physical counts.

¹⁰ Reservations in SAP represent requests to the warehouse to keep materials ready for withdrawal at a later date and for a certain purpose. SAP also uses reservation information to ensure required materials are available and procured in time. SAP allows goods to be issued without reservations.

¹¹ A "blind count" is a physical inventory taken by personnel who perform a hands-on count of inventory without access to the quantities currently shown in electronic or other inventory systems. Blind counts offer the greatest degree of assurance of accurate and reliable counts.

Finding 2 Recommendation to City Management:

3. ASD should update and enforce inventory count policies and procedures to help ensure consistent and accurate inventory records. The update should at minimum require blind inventory counts, sufficient documentation of counts and adjustments, and appropriate segregation of duties. ASD should consider implementing controls included in the GAO publication titled “Executive Guide Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property.”

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Finding 3: Inventory records do not evidence accountability for all inventory transactions

From January 1, 2007 through April 19, 2013, about \$1.0 million in inventory was issued without proper authorization and adequate documentation of the need. Other key control weaknesses, such as the use of generic user accounts in SAP and inadequate segregation of incompatible duties, increased the risk of fraud and abuse. In addition, the City has not used its SAP inventory system to appropriately manage and safeguard all inventories (Finding 1).

The City's SAP system provides opportunities to implement automated controls over inventory transactions. These controls, such as reservations to document the request and authorization for issuing materials and uniquely identifying user accounts to ensure activity in SAP can be linked to individuals, ensure accountability and transparency for inventory transactions, reducing the risk of fraud and abuse. Our audit indicates that from January 1, 2007 through April 19, 2013:

- **About \$1.0 million in inventory was issued without SAP reservations, which should be used to document and evidence the need and authorization for inventory transactions.**¹² The available reservation records in SAP did not appear to be consistently filled out, with some not indicating important information such as the "goods recipient" and "unloading point." According to the Warehouse Supervisor, all inventory issued should be supported by reservation records in SAP. We did not find sufficient policies and procedures addressing the use of reservations. Staff stated that the warehouse will issue inventory when requested regardless of who made the reservation and may also issue materials without reservations. Moreover, there is no process to restrict the amount of inventory staff issues based on the reservation or to reconcile differences between amounts issued and amounts reserved.
- **Segregation of duties had not been established.** An individual both reserved and issued about \$1.1 million in RWQCP Warehouse inventory (72 percent of the total inventory issued) while at least five individuals both reserved and issued about \$321,000 in MSC Warehouse inventory (2.1 percent of the total inventory issued). The lack of separation of these functions suggests inventory transactions were not appropriately authorized and raises the risk of misappropriation. Our review of staff functions further raises concerns for both locations:
 - At the RWQCP, there is only one storekeeper who has custody of the inventory, performs counts, and also makes adjustments retrospectively to inventory through issuance of goods. The warehouse is operated as an "open" warehouse where departmental staff can take inventory materials as needed without entering reservations in SAP. Staff signs out on a manual tracking sheet materials it removes from the warehouse, and the storekeeper enters reservations based on the sign-out sheets

¹² Reservations in SAP represent requests to the warehouse to keep materials ready for withdrawal at a later date and for a certain purpose. SAP also uses reservation information to ensure required materials are available and procured in time. SAP allows goods to be issued without reservations.

instead of requiring reservations ahead of time. The storekeeper indicated he also enters reservations to issue materials retrospectively to appropriately charge the departmental group he assumes removed the material(s) when there are discrepancies between his physical counts and inventory records in SAP.

- At the MSC, four of the six employees at the warehouse have responsibility for the custody of assets and inventory counts, which are incompatible duties. Three of the six employees also have authority to make adjustments to inventory records.
- **Staff used a generic user account in SAP known as “Stores1” that is accessible using a shared password to issue about \$8.5 million in inventory (net), which is about 58 percent of all inventory issued from January 1, 2007 through April 19, 2013.** The Stores1 account was also used to document receipt of some inventory and also to issue some reservations. Unique user IDs should be used to identify specific users responsible for inventory transactions. Staff cites convenience as the main factor for using the Stores1 account.
- **Individuals who made adjustments to inventory records also recorded the receipt of goods in SAP.** These duties should be separated to reduce the risk that an individual could misappropriate and write off inventory.

Finding 3 Recommendations to City Management:

ASD should:

4. Update and enforce inventory transaction policies and procedures to ensure there is proper authorization and accountability for all transactions. The update should, at minimum, require approved reservations prior to issuance of inventory and separation of the following incompatible roles: a) custody of inventory, b) counting of inventory, and c) making adjustments to inventory.
5. Avoid use of generic user accounts. ASD should consult with the IT Department to determine an appropriate alternative to using a generic account to issue inventory.

Finding 4: The City’s warehouses have significant quantities of unused or infrequently used inventory

More than 50 percent of the City’s 4,383 stock materials had not turned over in a one-year period as of May 12, 2013. In monetary terms, the City had approximately \$2.5 million in inventory, equivalent to about 71 percent of total recorded inventory, which had not been issued in a one-year period. In addition, while the City’s inventory levels have increased by over \$1.0 million since FY 2007, the turnover of inventory has steadily declined. Inventory efficiency measures, such as inventory turnover, indicate the ability of an organization to meet its needs with as little inventory as possible. Inventory that does not move may indicate a waste of resources including: 1) funds that are spent for inventory that is not needed, 2) materials that may become obsolete, and 3) space being used to store unneeded items.

The City has had low inventory turnover and excess dead stock, indicating inventory levels are not optimized. The City had approximately \$2.5 million in dead stock (about 71 percent of total recorded inventory) during the period from May 12, 2012, through May 12, 2013. Dead stock refers to inventory that has not been issued in a reasonable period of time, such as a one-year period. While some dead stock is expected, especially in the case of critical spare inventory, it generally indicates inefficient levels of inventory.

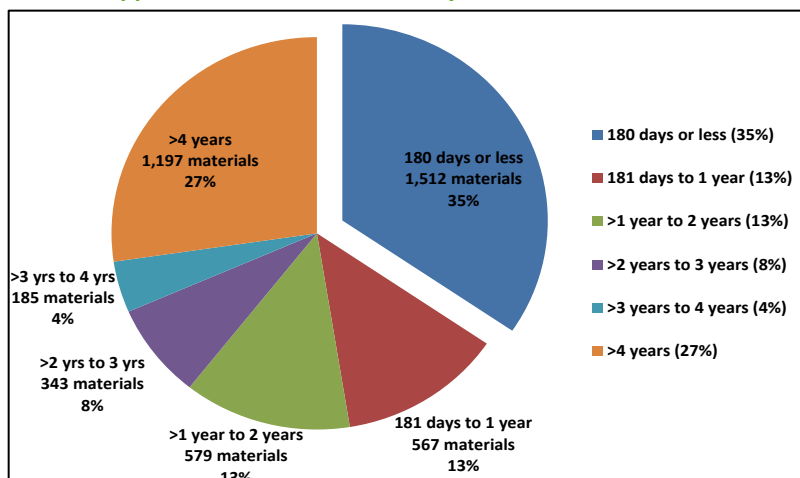
Our observations and interviews with staff indicate there is overcrowding at the RWQCP Warehouse. The City’s 2012 Long Range Facilities Plan for the RWQCP stated the existing warehouse facilities were inadequate and estimated \$3.0 million in costs for a space expansion project. Improved management of inventory levels may lower dead stock and result in an increase in available space.

The City also has a large number of materials in inventory that is not issued on a regular basis (slow-moving inventory). More than 50 percent of the City’s materials had not been issued in more than one year as of May 12, 2013.

Exhibit 12: Warehouse overcrowding at the RWQCP



Exhibit 13: Approximate time since the City’s 4,383 materials were last issued



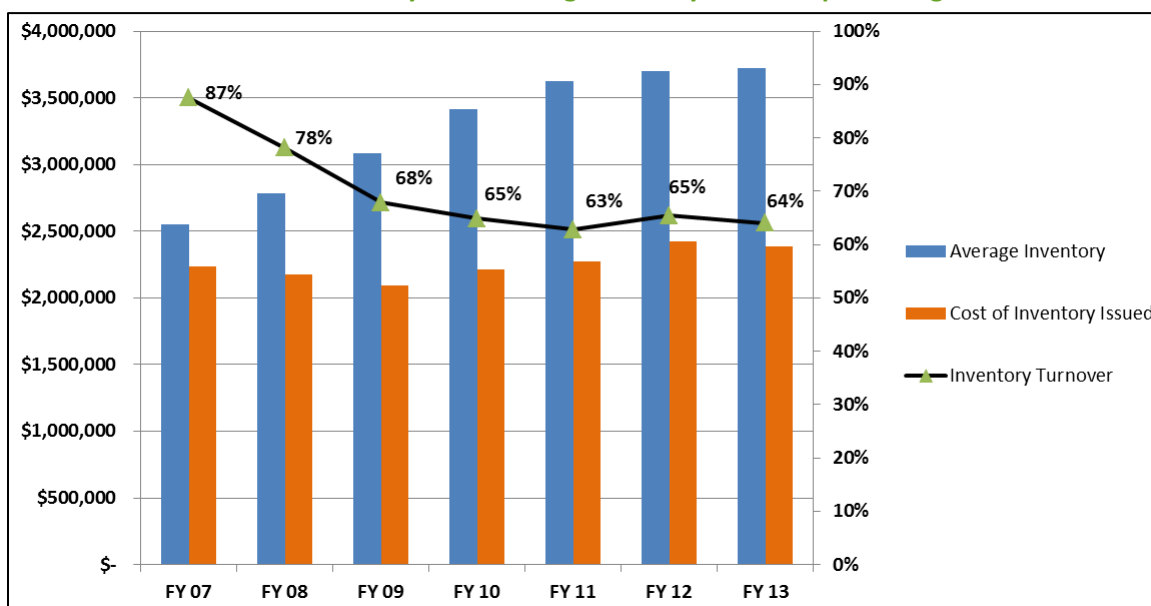
Source: City of Palo Alto SAP standard report as of May 12, 2013

The City’s SAP system indicated only about 35 percent of materials had been issued within a 180-day period. Exhibit 13 shows the approximate time since the City last issued materials it keeps in stock.

Overall inventory turnover at the City decreased from 87 percent in fiscal year 2007 to 64 percent in fiscal year 2013 (as of April 19, 2013), indicating decreased efficiency in the City’s management of inventory.¹³

Inventory turnover levels for warehouses may vary. A 2011 ScottMadden, Inc. report on materials management indicates that while inventory turnover ranged from 600 to 900 percent for commercial warehouses, turnover ranged from 60 to 140 percent for utility warehouses.¹⁴ According to staff, the majority (about 85 percent) of the City’s inventory is associated with its utilities.¹⁵ The City’s overall turnover of 64 percent is at the lower end of these ranges. Exhibit 14 shows average inventory has increased from about \$2.5 million in FY 2007 to over \$3.6 million in FY 2013, a 46 percent increase, while inventory turnover has decreased 23 percent, from 87 percent to 64 percent. The City issued about 64 percent of its average inventory during FY 2013 which may indicate the City may not be meeting the needs of departments with as little inventory as possible and/or that City departments have not sufficiently used and leveraged the City’s inventory.

Exhibit 14: The City’s decreasing inventory turnover percentage¹⁶



Source: City of Palo Alto financial records

¹³ Inventory turnover indicates how often inventory is consumed. It is the cost of inventory issued divided by average inventory during a specified period.

¹⁴ ScottMadden, Inc. is an energy consulting firm that publishes benchmarking reports on inventory management practices including inventory optimization practices and performance within the electric and gas utility industry. Utility warehouses include transmission and distribution warehouses.

¹⁵ Our analysis indicates that as of April 19, 2013, the City had approximately \$1.4 million (about 38 percent of its \$3.6 million in recorded inventory) in materials such as electric cables and wires associated with its electric utility. Other categories with large dollar amounts also appeared associated with the City’s utilities.

¹⁶ Cost of Inventory Issued indicates the total average cost of inventory issued to City departments each fiscal year. FY 13 data is as of April 19, 2013.

Based on our observations and discussions with staff, we identified the following areas for improvement to ensure the City maintains optimum levels of inventory:

- **The Utilities Department and ASD did not ensure that about \$130,000 in cable was used prior to transitioning to a new type of cable, resulting in dead stock and potential waste.** A standard SAP report identified about \$130,000 in dead stock for a type of cable, ranking the material as the highest dead-stock value item (Exhibit 15). The report stated 100 percent of the material was dead stock, indicating there had been no issuance of the cable in at least one year. Staff stated the Engineering Division directed the transition to a new type of cable, and neither Engineering nor Operations were aware there was a significant amount of existing cable remaining. Staff stated the remaining cable was usable; however, staff did not appear to know how to appropriately resolve the concern raised by our audit and suggested the cable could be discarded. Engineering, Operations, and Stores staff should ensure, when possible, stock is consumed before a replacement material is introduced to avoid potential waste.

**Exhibit 15: Dead stock of \$130,000
(cable #35372)**



- **Obsolete reservations in the City's SAP system may result in overstocking and could have resulted in over \$200,000 in unnecessary purchases.** During the audit, staff was preparing to purchase \$357,015 in two types of cable identified in a standard SAP report as having a combined \$150,000 in dead stock. These items were ranked as the second and third highest dead stock value items. In response to our concerns that obsolete SAP reservations may have resulted in unnecessary system-generated orders, staff reviewed and cleared outstanding reservations, resulting in a reduction of the total purchase order amount for these two materials from \$357,015 to \$128,370. Staff stated there is no process to ensure old reservations are reviewed and deleted. Also, staff has not configured SAP to expire outstanding reservations.

**Exhibit 16: Dead stock of \$150,000
(cables #35374 and #35361)**



- **ASD should use standard SAP inventory reports to help improve management of inventory levels.** Staff has relied on an annual informal process of soliciting departmental feedback to determine and monitor the appropriateness of stocking levels. During the audit, we identified SAP standard reports that staff should strongly consider incorporating into the City's inventory management processes. These include reports that identify slow-moving inventory and dead stock.
- **ASD should review and update SAP settings that prompt material orders.** Our review of selected SAP settings for materials suggests staff has not adequately customized or adjusted the settings to ensure the City purchases needed quantities of materials at the appropriate time. The City's SAP system is generally configured to plan material orders when stock levels fall below the designated reorder point, with the goal of replenishing inventory to the maximum level, in addition to any external requirements (e.g., reservations) that may exist

within the planned delivery time. According to staff, SAP parameters are based on information in manual forms submitted by City departments. Our review of current SAP settings suggests generic and/or unrealistic values have been entered. A detailed review of the City's implementation of SAP for inventory management, the appropriateness of parameters submitted by departments, and the accuracy of parameters entered into SAP is beyond the audit scope. According to a ScottMadden, Inc. report, survey results indicate utilities organizations are using a mix of system-based calculations and employee judgment to set inventory levels, and this approach yields the best performance results. The report indicates using manual calculations alone yielded the poorest performance results.

- **Roles and responsibilities for monitoring and correcting inventory levels have not been formalized.** Our discussions with ASD and Utilities Department staff suggest roles and responsibilities for maintaining appropriate inventory levels have not been adequately defined and communicated. ASD should ensure policies and procedures address roles and responsibilities for warehouse staff and client City departments.

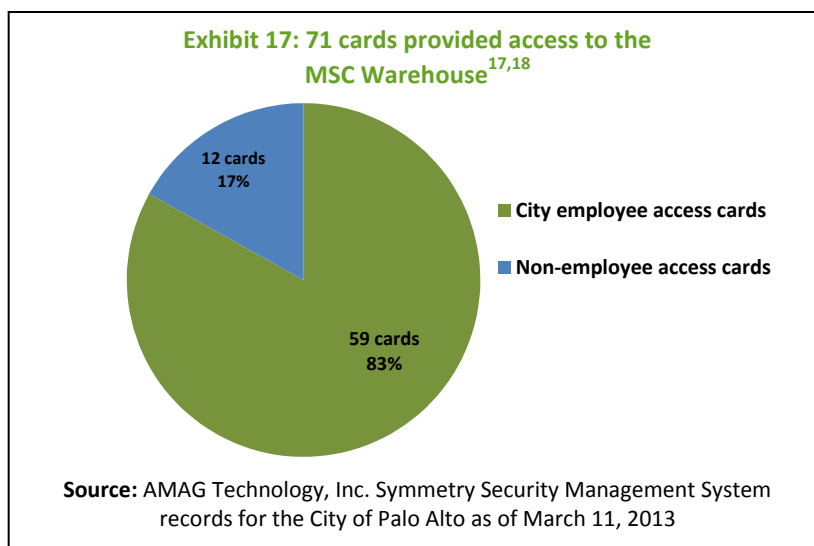
Finding 4 Recommendations to City Management:

6. ASD should identify, formalize, and communicate inventory management goals and objectives to City departments.
7. ASD should update existing policies and develop new policies and procedures to address the following:
 - Roles and responsibilities for managing inventory levels
 - Management of slow-moving or dead stock
 - Transitioning to new materials
8. ASD should consult with the IT Department and other City departments to ensure staff:
 - Identifies and uses key SAP inventory management reports.
 - Appropriately configures and updates SAP parameters affecting inventory levels.

Finding 5: The City should improve physical security over its inventory

We found a large number of cards granted access to the MSC and the MSC Warehouse facility, including cards without adequate identifying information needed to uniquely link activity with an individual. We also noted other security concerns, including an inadequate process to update and restrict access levels using the City's card access system, inadequate record keeping for the City's physical keys, an ineffective camera monitoring system, and the use of a fleet access control system at the MSC that has had key functionality disabled. The City uses the MSC as a secured location to safeguard not only inventory, but other sensitive and strategic areas and key assets such as transformers and cable needed to maintain the City's electric infrastructure. The Public Works Department should collaborate with the Utilities Department, IT Department, the Office of Emergency Services, and the Police Department to perform a comprehensive physical security risk assessment for the MSC in order to prioritize and remedy access control weaknesses. The security concerns raised in this audit also apply to other City facilities.

While only 6 City employees were assigned to work at the MSC Warehouse, 71 cards provided access to the facility. The City uses an AMAG Technology, Inc. Symmetry Security Management System (SMS) to secure 84 points of entry citywide. We selected for review three access points, including the MSC Warehouse. While 6 City employees were assigned to work at the MSC Warehouse, 71 cards provided access to the site of which 59 were associated with City employees.¹⁷ We could not associate 12 of the cards with any City employee.¹⁸ In response to our audit, staff reported that the number of people with access to the warehouse has been reduced to 38 City employees, all of which are uniquely identified.



¹⁷ In some instances more than one card was assigned to an individual. We estimate approximately 55 employees had access to the MSC Warehouse.

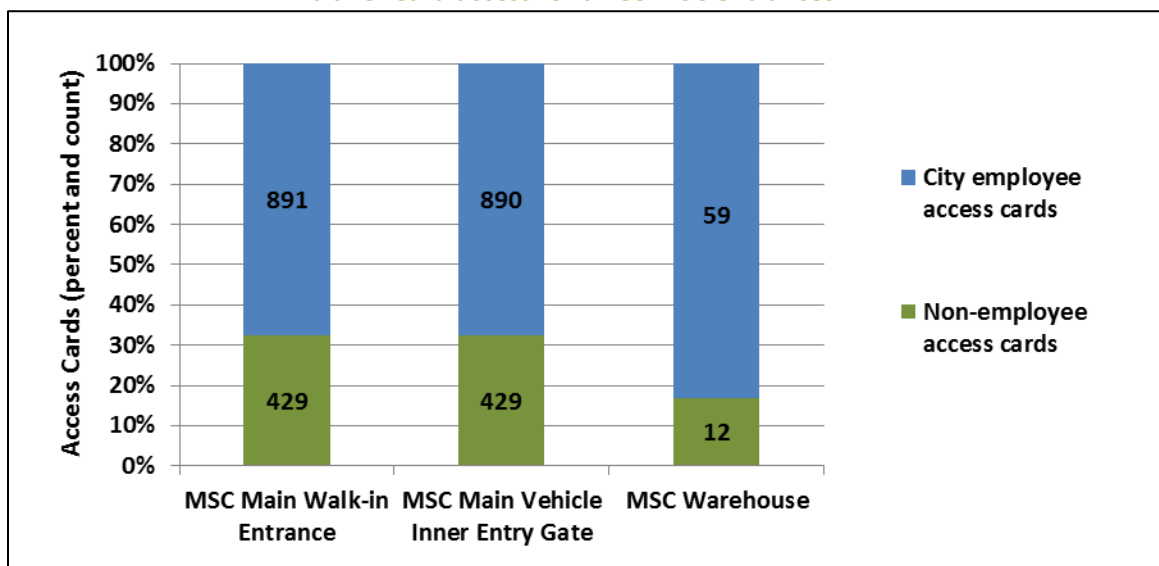
¹⁸ "Non-employee access cards" include some cards that do not uniquely identify an individual and include shared and group cards.

A large number of cards provided access to the MSC. We found about 61 percent of the 1,417 City employees as of March 12, 2013, or 858 employees, had card access to the MSC Main Walk-in Entrance. We could not associate 429 cards providing access to the MSC Main Walk-in Entrance with City employees. We also noted the following in our limited review of access cards:

- Some cards are assigned without sufficient identifying information. Some cards indicated generic first and last names such as "Roto Rooter," "Contractor Greenwaste," "3732R facilities," and "School Distr Palo Alto."
- Some cards appeared to be assigned to more than one person (shared or group cards).

Standards on security emphasize that access privileges should be limited to those that the user genuinely needs to complete job responsibilities. Security standards also indicate that users should be uniquely identifiable, so that they can be linked to their actions. Exhibit 18 summarizes the number of City employee and non-employee access cards for three selected MSC entrances.

Exhibit 18: Card access for three MSC entrances^{19,20}



Source: AMAG Technology, Inc. Symmetry Security Management System records for the City of Palo Alto as of March 11, 2013

We found the City does not have policies and procedures addressing access controls and security at the MSC. Specifically, procedures do not exist to ensure proper operation and management of SMS or the City’s fleet access control system. Access to City facilities is initially granted based on an access authorization form City departments submit to the Public Works Department. There are no further proactive measures to monitor or appropriately restrict access levels unless either a departmental supervisor submits a new form or Public Works

¹⁹ In some instances more than one card was assigned to an individual. We estimate approximately 858 employees had access to the “MSC Main Walk-in Entrance,” 857 employees had access to the “MSC Main Vehicle Inner Entry Gate,” and 55 employees had access to the “MSC Warehouse.”

²⁰ “Non-employee access cards” include some cards that do not uniquely identify an individual and include shared and group cards.

Department staff receives an automated email from the IT Department indicating an employee departure. Moreover, the Public Works Department has not required City departments to specify a business need when access is requested for employees or other individuals and entities.

The Municipal Code indicates that each department head and council-appointed officer is responsible for securing city-owned property. It also indicates the Public Works Department is responsible to maintain all public structures owned or operated by the City, including the security and safety of these structures. SMS provides a full range of capabilities to control access at a detailed level and to generate reports to assess and monitor access levels and activity. We found no evidence of formalized processes that leverage these SMS capabilities.

We also noted the following access control weaknesses during our limited review:

- The City uses a fleet access control system (a Fleet Data Systems, LLC solution) that provides remote (hands-free) access to the MSC for approximately 350 vehicles according to staff. The system is informally managed and does not have the capability to generate reports on card holders and/or activity. The vendor stated City staff has disabled the ability of the system to run reports. Staff stated the City is transferring all vehicle access control to SMS.
- The City has not effectively secured IT inventory and other departmental items at a City Hall storage area. Staff did not have a record of individuals assigned keys for this location. Inside the storage area, we noted inadequate fencing (height is too low) used to secure highly desirable IT inventory (Exhibit 19). Moreover, the IT Department did not have a process or formal records to track movement of inventory from this storage location.

In response to audit, staff reported and we verified that card access control has been added for the storage area and the "IT cage" and that the fence has been extended to the ceiling.

- According to staff, the City has an ineffective camera surveillance system it plans to replace at the MSC. Staff stated the current system does not have adequate coverage and does not record in poorly lit areas.

Exhibit 19: Inadequate fencing allows access to IT assets



Finding 5 Recommendations to City Management:

The Public Works Department should:

9. Perform a citywide physical access risk assessment in collaboration with the Utilities Department, Office of Emergency Services, IT Department, and the Police Department in order to effectively identify, prioritize, and address access control weaknesses.
10. Develop policies and procedures to address the management of citywide physical security. Policies and procedures should address:
 - a. Designation of roles and responsibilities to ensure physical security controls appropriately restrict and monitor access.
 - b. Management (administration) and proper use of the City's access control systems.
 - c. Processing departmental requests to grant or modify employees' physical access.
 - d. Granting restricted access to non-employees.
 - e. Ensuring access is timely modified or revoked when roles and responsibilities change.
11. Configure the fleet access control system to support the City's security goals and objectives or determine if the AMAG Technology, Inc. Symmetry Security Management System should replace it.
12. Review and update AMAG Technology, Inc. Symmetry Security Management System access authorization records to ensure access card holders can be uniquely identified. Access cards (especially generic or group cards) should only be assigned with a documented and approved business need.
13. Assess the adequacy of records of individuals assigned keys and take necessary corrective action to ensure the accuracy and completeness of the records. The Public Works Department should identify and prioritize replacement or rekeying of locks for high risk areas if records do not identify who is in possession of the keys or if the keys issued were of the type that can be duplicated.
14. Improve physical security at the City Hall storage area. Appropriate actions include, but are not limited to, enforcing appropriate key or card access controls and securing areas that have inadequate fencing.

ATTACHMENT 1: City Manager's Action Summary

In response to the Audit Recommendations in this report, the City Manager has agreed to take the following actions. We will review and report progress on implementation of these recommendations during our audit recommendation follow-up process.

Finding #	Recommendation	City Manager's Action Plan	Target Date
1	1. ASD and City departments should implement the City's inventory management policies and procedures citywide to achieve inventory goals and objectives.	<ul style="list-style-type: none"> Citywide policies and procedures will be reviewed, updated, and shared with all departments cited in this Audit. Inventory goals and objectives will be stressed and implemented where it is cost-effective to do so. 	June 30, 2014
1	2. ASD should review its inventory accounting policies and correct any misstatements in the City's accounting records.	<ul style="list-style-type: none"> ASD has reviewed issues raised by the Auditor and has found no material misstatements in its FY 2013 financial records and CAFR. ASD believes its accounting policies are reasonable. Accounting policies and records, however, will be reviewed as staff responds to Recommendation 1. 	May 31, 2014
2	3. ASD should update and enforce inventory count policies and procedures to help ensure consistent and accurate inventory records. The update should at minimum require blind inventory counts, sufficient documentation of counts and adjustments, and appropriate segregation of duties. ASD should consider implementing controls included in the GAO publication titled "Executive Guide Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property."	<ul style="list-style-type: none"> ASD has implemented blind inventory counts and appropriate segregation of duties at the MSC warehouse and will continue to improve. Limited staffing at the MSC does make segregation of duties challenging. To achieve greater accuracy in counts at the RWQCP warehouse as well as segregation of duties, additional staffing is necessary. Staff from Public Works and ASD propose to evaluate the costs and benefits of the recommendation and report back to Council. Staff will strive to implement controls cited in GAO publication and inform Council of its progress. 	June 30, 2014

Finding #	Recommendation	City Manager's Action Plan	Target Date
3	4. ASD should update and enforce inventory transaction policies and procedures to ensure there is proper authorization and accountability for all transactions. The update should, at minimum, require approved reservations prior to issuance of inventory and separation of the following incompatible roles: a) custody of inventory, b) counting of inventory, and c) making adjustments to inventory.	<ul style="list-style-type: none"> ASD will reassess its transaction policies and procedures to ensure proper authorization and accountability within its warehouses and whether additional FTE will be needed to achieve the separation of the "incompatible" roles. Systems, current and new, will be assessed to maximize use of the reservation system. There may be situations, like an emergency, where goods may be withdrawn without a reservation. Staff will work to reconcile this situation. 	June 30, 2014
3	5. ASD should avoid use of generic user accounts. ASD should consult with the IT Department to determine an appropriate alternative to using a generic account to issue inventory.	<ul style="list-style-type: none"> ASD is working with IT and SAP personnel to change user accounts from generic to specific, identifiable staff. 	January 31, 2014
4	6. ASD should identify, formalize, and communicate inventory management goals and objectives to City departments.	<ul style="list-style-type: none"> Once current policies and procedures are reviewed and updated and inventory management goals and objectives are reaffirmed, they will be discussed and left with departments. 	June 30, 2014
4	7. ASD should update existing policies and develop new policies and procedures to address the following: <ul style="list-style-type: none"> Roles and responsibilities for managing inventory levels Management of slow-moving or dead stock Transitioning to new materials 	<ul style="list-style-type: none"> ASD will update its policies & procedures, to include a review of Muni Code requirements, and work with departments to: a) clearly define responsibilities for managing inventory levels; b) periodic reports will be sent to departments to identify dead stock; c) departments will coordinate with ASD when new materials are ordered and replace old inventory. 	June 30, 2014
4	8. ASD should consult with the IT Department and other City departments to ensure staff: <ul style="list-style-type: none"> Identifies and uses key SAP inventory management reports. 	<ul style="list-style-type: none"> ASD has worked and will continue to work with SAP staff to use and develop SAP inventory management reports. A list of these reports will be included by Target Date. 	March 31, 2014

Finding #	Recommendation	City Manager's Action Plan	Target Date
	<ul style="list-style-type: none"> Appropriately configures and updates SAP parameters affecting inventory levels. 	<ul style="list-style-type: none"> Parameters affecting inventory levels will be explored and updated as needed. 	
5	<p>9. The Public Works Department should perform a citywide physical access risk assessment in collaboration with the Utilities Department, Office of Emergency Services, IT Department, and the Police Department in order to effectively identify, prioritize, and address access control weaknesses.</p>	<ul style="list-style-type: none"> Public Works has and is interacting with departments to address access control weaknesses. Hard keys are being transitioned to a card entry system. A thorough review of those with access cards to the MSC warehouse has been conducted and the number of people with access has been reduced. A cage extension and a card access system have been added to a City Hall storage facility for IT equipment. Public Works will be working with other departments to identify further improvements such as an improved camera system at the MSC. 	December 31, 2014
5	<p>10. The Public Works Department should develop policies and procedures to address the management of citywide physical security. Policies and procedures should address:</p> <ol style="list-style-type: none"> Designation of roles and responsibilities to ensure physical security controls appropriately restrict and monitor access. Management (administration) and proper use of the City's access control systems. Processing departmental requests to grant or modify employees' physical access. Granting restricted access to non- 	<ul style="list-style-type: none"> Public Works staff will make improvements to existing policies and procedures to address citywide physical security. The department is in the process of working with IT, OES, and Police to address items a-e. PW is, for example, evaluating non-employee access to CNG filling equipment. 	December 31, 2014

Finding #	Recommendation	City Manager's Action Plan	Target Date
	<p>employees.</p> <p>e. Ensuring access is timely modified or revoked when roles and responsibilities change.</p>		
5	11. The Public Works Department should configure the fleet access control system to support the City's security goals and objectives or determine if the AMAG Technology, Inc. Symmetry Security Management System should replace it.	<ul style="list-style-type: none"> Prior to audit, PW staff was in the process of converting the Fleet access control system to the AMAG system. The AMAG technology access control system is expected to be implemented by FY end. 	June 30, 2014
5	12. The Public Works Department should review and update AMAG Technology, Inc. Symmetry Security Management System access authorization records to ensure access card holders can be uniquely identified. Access cards (especially generic or group cards) should only be assigned with a documented and approved business need.	<ul style="list-style-type: none"> Public Works will evaluate the current access control data base and remove any access cards that are not uniquely identified. Only uniquely identified access cards will be issued in the future. 	June 30, 2014
5	13. The Public Works Department should assess the adequacy of records of individuals assigned keys and take necessary corrective action to ensure the accuracy and completeness of the records. The Public Works Department should identify and prioritize replacement or rekeying of locks for high risk areas if records do not identify who is in possession of the keys or if the keys issued were of the type that can be duplicated.	<ul style="list-style-type: none"> PW will review physical key records and update them to reflect the current issuance of keys. The current key system is in process of being replaced, card readers will be added to key locations, and cameras will be installed in specific locations. The latter will be done in concert with Police, OES, and IT. 	December 31, 2014

Finding #	Recommendation	City Manager's Action Plan	Target Date
5	14. The Public Works Department should improve physical security at the City Hall storage area. Appropriate actions include, but are not limited to, enforcing appropriate key or card access controls and securing areas that have inadequate fencing.	<ul style="list-style-type: none">A review of City storage areas is underway. As stated above IT equipment at City Hall is now caged and will be caged at MSC warehouse as well. Public Works is evaluating new access controls.	December 31, 2014



FINANCE COMMITTEE MINUTES EXCERPT

Regular Meeting
Tuesday, February 18, 2014

Roll Call

Chairperson Berman called the meeting to order at 7:17 P.M. in the Council Chambers, 250 Hamilton Avenue, Palo Alto, California.

Present: Berman (Chair), Burt, Holman, Kniss

Absent:

Oral Communications

None

Agenda Items

2. Inventory Management Audit
3. Staff Response to Inventory Management Audit

Houman Boussina, Acting City Auditor, reported that management requested the City Auditor consider the audit. The audit was conducted in accordance with the annual Work Plan. The objective of the inventory management audit was to determine if the City had adequate controls to ensure accuracy and completeness of inventory records, accountability for inventory transactions, and safeguarding of inventory. The City included inventory primarily at the Municipal Services Center (MSC) and the Regional Water Quality Control Plant. It was important to consider the areas outside the scope of the audit. Those areas included disposition and use of materials after leaving the City's warehouses; management of surplus or obsolete materials; staffing; inventory carrying costs; the appropriateness of stocking levels and reorder points; organization and condition of inventory; and a 2 percent surcharge policy. The audit risk assessment process identified the other areas of risk. Although the areas were excluded from the audit, they could be addressed in future special advisory memoranda and/or audit reports.

MINUTES EXCERPT

Mimi Nguyen, Senior Performance Auditor, indicated Finding 1 found that at least \$4.2 million in inventory, more than half of total inventory, was not subject to consistent or adequate inventory management controls. The lack of reliable and complete inventory data could impair the City's ability to know the quantity, location, condition and value of inventory. Finding 2 found that inventory records were inaccurate for 20 of 182 materials in the sample, indicating an 89 percent accuracy rate overall for the \$3.6 million in recorded inventory. Inaccurate inventory records could result in financial misstatements and operational inefficiencies. Finding 3 found from January 1, 2007 through April 19, 2013 about \$1 million in inventory was issued without reservations evidencing the need and authorization. Also about \$8.5 million in inventory, about 58 percent of total inventory issued, was processed using a generic user account accessed with a shared password. In addition, Staff performed incompatible duties in managing and processing inventory. Controls ensuring accountability and transparency of inventory transactions reduced the risk of fraud and abuse and helped ensure materials were appropriately and timely procured and made available. Finding 4 found that more than 50 percent of the City's 4,383 stock materials, \$2.5 million in inventory, had not turned over in a one-year period. Inventory turnover decreased from 87 percent in FY 2007 to 64 percent in FY 2013. Inventory that did not move could indicate a waste of resources. Finding 5 found that there were a large number of cards granting access to the MSC and the MSC warehouse, including cards without adequate identifying information. Other security concerns were noted. Physical security controls were required to safeguard and protect the City's inventory and sensitive and strategic sites. As a result of the audit, the City Auditor made 14 recommendations addressed to the Administrative Services Department (ASD), Utility Department, Public Works Department, and Information Technology (IT) Department.

James Keene, City Manager, believed Staff's response could answer Finance Committee (Committee) questions.

Joe Saccio, Assistant Director of Administrative Services, acknowledged that management requested the audit and requested the Auditor review controls, policies and procedures. Staff could not find any material misstatements in financial statements. Staff implemented locked doors and gates and security cards to protect Utility, IT and Public Works goods. New containers and new storage units were provided at the Regional Water Quality Control Plant for storage of items outside the warehouse. Warehouse management and department users were in the process of clearing aged and unused inventory for return or surplus sales.

MINUTES EXCERPT

Vice Mayor Kniss asked Mr. Saccio to include in his responses the systems Staff utilized.

Mr. Saccio reported that Staff did not utilize SAP for all items of inventory. Staff would utilize SAP for IT equipment stored at the warehouse. Other databases and systems were used to track transformers and meters. Staff would review SAP's current uses and review the costs and benefits of continuing use of SAP, enhancing SAP or using other software. The City had a decentralizing system for tracking and managing goods. He inquired whether he provided the information Vice Mayor Kniss sought.

Vice Mayor Kniss responded no.

Mr. Saccio reported that Staff accounted for the \$919,000 of IT equipment. At the time of the audit, the goods were not being tracked in SAP. That was an omission; however, goods were manually tracked. One solution was to incorporate identification of IT goods in SAP. The Auditor recommended blind counts, and that was implemented. Public Works would institute a card reader system and replace a hard key system. Staff purged users originally identified for entry into the warehouse to active users and only people who needed access to the warehouse. Staff needed to review all procedures and policies and to document all roles and responsibilities of everyone in the departments. Staff needed enhanced communication and procedures among all departments. Staff needed system modifications and enhancements, whether in SAP or other systems, to address issues raised in the audit. Staff would generate periodic reports for users of inventory, so they could have accurate information regarding inventory. The Public Works Department would implement physical security measures and coordinate with the Emergency Response Department. Staff worked to safeguard City assets within existing budgetary and organizational constraints. Staff acknowledged that improvements could and would be made. The Auditor noted that \$4.2 million in inventory was not recorded in SAP. That did not mean that the City lost \$4.2 million in inventory. More than \$900,000 in IT goods were stored at the warehouse, but were not recorded in the inventory system. Remaining items were accounted for in a different system.

Lalo Perez, Director of Administrative Services Department and Chief Finance Officer, explained that the City's practice for many years was to expense out some inventory items. When items were expensed out, they were not tracked in inventory. Staff wanted to track inventory in SAP if possible; however, SAP might not be the most practical method for some areas of the City.

MINUTES EXCERPT

Mr. Keene noted that SAP was implemented in 2003 to integrate many different systems. The City underfunded the investment in SAP and training, such that former, parallel practices remained in use. Some problems would be simple to remedy. He suggested the various departments explain their reasons for doing things in certain ways and whether the additional cost to implement every level of control was worthwhile.

Council Member Holman did not find a Staff response to the disposition and use of materials after leaving warehouses. She inquired whether the levels of inventory were appropriate, given the dollar amount of inventory.

Mr. Perez requested the Auditor clarify disposition and use of materials.

Council Member Holman clarified that she wanted to know whether an item was utilized for a City project once it was checked out of inventory.

Vice Mayor Kniss asked if Council Member Holman wanted to know if Staff implemented a system to track each item.

Council Member Holman replied yes.

Mr. Boussina recognized this as an important element of safeguarding and appropriately using inventory. The audit stopped at inventory management. This was one reason Staff needed solid controls over the movement of inventory. Once transactions were recorded, Staff should know inventory was going out for an approved and authorized purpose and cause.

Mr. Perez reported some items could be found in a tracking system. For transformers, the Utility Department was required by regulatory mandate to track them. One of the challenges of using SAP was the checking in and out of inventory during repairs to equipment. Some items were not tracked and Staff did not know where those items would eventually be used.

Council Member Holman expressed concern over the lack of inventory tracking and control. She asked if levels of inventory were appropriate and if there was a definition of surplus.

Mr. Perez indicated there was a policy and procedure regarding surplus inventory. Surplus was an item no longer needed for City operations. Staff had to determine whether an item had a value or not. Based on thresholds for value, the determination of whether an item was surplus was made by the warehouse supervisor or Mr. Perez. In terms of inventory, Staff worked with departments to identify inventory. As a result of the audit process, Staff was receiving better cooperation.

MINUTES EXCERPT

Mr. Boussina identified what appeared to be inventory, essentially materials that were stored but not placed into operation, along the side of the building. The inventory was open to the MSC yard and accessible. He understood the items were expensed and were accessible to trucks for reloading and restocking. The items were not subject to inventory management control. The audit team physically counted and valued the items. It was not practical to audit them in the same way as the areas in Findings 2-5.

James Allen, Water Quality Control Plant Manager, reported stock items in SAP were assigned to a specific work order when taken from stock. Staff could track the specific stock item to a specific corrective repair. Certain stock items, such as latex gloves and housekeeping supplies, were not tracked.

Council Member Holman agreed consumables were a different category.

Mr. Allen added that consumables were taken from City stock.

Council Member Holman reiterated her question regarding the level of inventory.

Mr. Allen stated that much of the wastewater treatment equipment was kept on hand in case of a corrective repair. That equipment may not be needed for 10-30 years. Recently dead stock valued at approximately \$21,000 was identified because of obsolete equipment. He did not believe that amount was excessive in terms of the entire Wastewater Treatment Fund. He believed the amount of inventory was appropriate.

Tom Marshall, Assistant Director for Utilities Engineering, noted the largest and most expensive item the department was holding was transformers. Transformers were needed to replace failures in the field and for new customer connections. A typical lead time to obtain a transformer was six to nine months, resulting in the need for a large inventory.

Council Member Holman was not sure that transformers and items for emergency repairs approached the amount of inventory in terms of dollar investment. An incorrect amount of inventory was a systemic issue. She was shocked by the number of access cards issued and the use of a generic account accessible by a shared password to issue \$8.5 million in inventory. She requested more information regarding warehouse expansion at the Regional Water Quality Control Plant prior to any money being spent. Her overarching concern was the culture of the system; that Staff did not raise concerns before the audit was performed.

MINUTES EXCERPT

Mr. Saccio did not deny that the list of people with access was too great. During business hours, no one accessed the warehouse unless accompanied by a warehouse person responsible for inventory. Only a bona fide supervisor in charge of a specific project could enter the warehouse at night during an emergency. Some protections were in place to safeguard inventory. Staff did not believe many goods were being removed through theft.

Mr. Keene suggested department heads address practices that evolved within departments and became ingrained. The Chief Financial Officer (CFO) was frustrated by the pace of the integration effort and requested an audit. The audit was transparency on a management issue. There was not a systematic way to verify risks with the use of old systems.

Vice Mayor Kniss felt Staff provided more of a problem than an answer. If SAP was not sufficient or not operating correctly, it was the City Manager's problem. Clearly there were many problems and few, if any, answers. She was attempting to understand who was responsible for the outcome. Within six months, the Committee should hear Staff's detailed responses and solutions.

Council Member Burt heard a number of responses, but no answers. In 2007 the City had an annual inventory turnover of 87 percent, which dropped to 64 percent in 2013. Staff's responses did not explain what changed between 2007 and 2013. He inquired about changes in the respective departments that would account for a lower turnover rate.

Dean Batchelor, Assistant Director for Utilities Operations, reiterated that \$82,000 in inventory was unsecure and unaccounted for. The items were mostly truck stock pieces, nuts, bolts, washers, connectors. The highest limit item in there was \$165.

Council Member Burt noted approximately \$8 million in total inventory between Utilities and General Fund. He inquired about the amount of inventory carried by Utilities.

Mr. Batchelor answered approximately \$5-\$6 million. He reported \$2.1 million of inventory was transformers. Transformers were tracked on a monthly basis through Access programs, because of the testing aspects of it.

Council Member Burt asked if those were in place in 2007.

Mr. Batchelor indicated Utilities did not have as much stock and did not perform as many rebuilds in 2007.

MINUTES EXCERPT

Council Member Burt remarked that a lower turnover of inventory resulted in more stock. If there were sound operational reasons for deliberately higher stock, he would have put that in the report. He did not hear any reasons for needing more stock.

Mr. Marshall did not have an explanation for having more stock and less turnover in the warehouse. Utilities Staff could request ASD assistance to determine what was in the warehouse and why it was there. Typically Utilities Staff told ASD Staff which materials to stock and the number of items to be stocked.

Council Member Burt asked when Staff received the audit report.

Mr. Marshall responded December 2013.

Council Member Burt inquired about progress in understanding the reasons for a lower rate of turnover.

Mr. Marshall reported Staff was reviewing inventory in the warehouse to determine the items that needed to be stocked.

Mr. Allen noted the Water Quality Control Plant identified \$21,000 in dead stock. Those items were needed to repair the wastewater treatment plant and might be kept for 50 years or the life of the equipment.

Council Member Burt remarked that Staff was turning over inventory at a significantly slower rate and carrying more inventory today. Either some fundamental change in operational needs occurred or the City was carrying too much inventory because Staff was sloppy.

Mr. Allen reported Staff performed a complete review of all stock items and evaluated the number of items needed for each stock item.

Council Member Burt agreed that possibly the Water Quality Control Plant did not have a decrease in turnover. He inquired whether its turnover rate decreased.

Mr. Allen did not know. Some of the equipment did have a use, even if the resale value was low, and should not be discarded. That could contribute to the decreased turnover rate. If Staff included non-stock inventory, items that were expensed out, then the Water Quality Control Plant would have an even lower turnover rate. Turnover may not be a good method to benchmark the efficiency of the warehouse.

MINUTES EXCERPT

Council Member Burt inquired whether the methodology for determining turnover rate remained the same from 2007 to 2013. He did not find any information indicating changes in the methodology between 2007 and 2013.

Mr. Perez needed to provide better analytics. Staff could present that information when they returned to the Committee.

Council Member Burt inquired whether Staff analyzed inventory turnover by department.

Mr. Boussina indicated that inventory turnover was reported at a higher level in the report; however, he could break it out by department.

Council Member Burt believed that was a necessary first step in order to figure out where to focus.

Mr. Perez would identify the big ticket items versus general inventory ordered by all departments. Staff could provide specific details and factual numbers.

Mr. Keene commented that updating and reporting regarding the audit would continue. Staff was not in a position to work out all issues before presenting the audit. Working through recommendations, responses and solutions would take focus, time and effort. Staff's responses at the current time would not satisfy the Committee. Staff wanted the themes of Committee questions in order to respond to them at a later time.

Council Member Burt related his experience with inventory management issues in other organizations.

Mr. Keene noted a number of different solutions would be needed.

Council Member Burt felt metrics could be beneficial. One department could require a lower rate of turnover of materials by the nature of its work. Compiling a department-by-department baseline was one important measurement to establish the goal. He did not hear a Staff response regarding the use of technology beyond using or not using SAP. In industrial operations, technology had improved greatly. Once set up, new technology was easier to use than old methods.

MOTION: Vice Mayor Kniss moved, seconded by Chair Berman to recommend that Staff return to the Finance Committee within six months with the answers on how to correct the audit findings, incorporating measurements, detailing in an easy to understand way how the audit findings will be fixed.

MINUTES EXCERPT

Vice Mayor Kniss believed Staff's responses and solutions should return to the Committee. Clearly Staff had an idea of what they could do, but no clear idea of what they would do.

Mr. Saccio noted Staff provided an action plan to the auditor on each recommendation and timeline. Staff viewed responses to the audit as a work in progress.

Vice Mayor Kniss stated at some point solutions were needed.

Chair Berman inquired about a timeframe for providing the audit to the Council.

Mr. Perez recalled that in past actions the Committee accepted the report but conditioned it upon Staff returning with an update. The report would go to the Council and Staff would return within six months to provide a status update.

Chair Berman asked Vice Mayor Kniss if that action coincided with her intentions in the Motion.

Vice Mayor Kniss agreed with the plan. The audit may not be resolved in six months. Council Member Burt discussed the report aptly. Staff ought to be able to utilize technology for tracking inventory.

MOTION RESTATED: Vice Mayor Kniss moved, seconded by Chair Berman to direct Staff to return to the Finance Committee within six months with an indication of how the audit findings will be tracked or systematized so Staff will know what is in inventory; 2) to accept the Audit; and 3) forward the Audit to the full Council.

Mr. Keene asked if the audit would be forwarded to the Council.

Mr. Perez answered yes. It would be placed on the Consent Calendar.

Mr. Keene inquired about the Council's action with respect to the audit.

Mr. Perez reported the Council could accept the audit.

Mr. Keene did not wish to have a Council discussion if the Committee had a good direction for Staff.

Vice Mayor Kniss indicated the goal was for Staff to return to the Committee.

Mr. Keene reiterated that Staff knew the problem, but not the detailed steps to resolve it.

MINUTES EXCERPT

Chair Berman remarked that the City purchased SAP in order to integrate all departments. All departments should utilize the same solution. Obviously Staff did not know what inventory was on the shelves.

INCORPORATED INTO THE MOTION WITH THE CONSENT OF THE MAKER AND SECONDER 1) to have this Item go to Council under the Consent Calendar; 2) to include these Minutes when the Item goes before Council; 3) to have Staff respond within six months to the Finance Committee; and 4) to have Staff account for the level of inventory, the culture of responsibility and accountability, and the tracking and disposition of the materials posted at the warehouse.

Mr. Keene reported that technology could be utilized to implement the redesign of systems. The City could have some software capacity that was not being used. Staff was assessing the future of SAP and methods to support change efforts.

MOTION AS AMENDED PASSED: 4-0