



THE CITY OF SAN DIEGO

DATE: November 21, 2012

TO: Honorable Members of the Audit Committee

FROM: Eduardo Luna, City Auditor

SUBJECT: **Additional Information Regarding Annual Central Stores**

The purpose of this memorandum is to address several informational questions regarding the City's Annual Central Stores Inventory Audit. Yearly, the Office of the City Auditor undertakes an agreed-upon procedures audit of Central Stores inventory. The agreed-upon procedures used for the FY12 audit included obtaining electronic records, selecting a sample for audit, and conducting a physical inventory count of the City sample for comparisons to stock records. The agreed-upon procedures also included statistical sample testing (99 percent confidence level) and included inventory counts involving opening boxes and ensuring that the boxes contained the listed items.

- Sealed boxes with a low item value may not be opened since it requires significant time to open each box. For instance, paper products may be stored on several pallets of boxes with reams of paper inside. The auditor generally examines seals and the condition of the boxes.
- High value items in boxes are verified on a random basis. In the past, the random checks have not identified discrepancies between box contents and the labels. Had this been the case, the agreed-upon procedures would be revised.

Central Stores conducts 100 percent annual counts of stock items

Central Stores also counts higher value items more frequently, as well as maintaining an internal process to limit the time inventory remains in stock. Central Stores generally finds their inventory counts are within one percent of inventory reflected with records. Additionally, Central Stores indicates that they have an internal obsolete stock process which targets inventory not processed in 12 months.

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In the third quarter of the fiscal year, Central Stores evaluates material not utilized over 12 months and determines the disposition of each item. While much of the inventory includes low value and high quantity items, Central Stores does not appear to assess valuation as part of their inventory counts.

In City's FY 2011 Comprehensive Annual Financial Report, Central Stores inventory represented about \$2.75 million of \$280 million (about 1 percent) in total assets reflected in the financial statements. The financial statements presented inventory within the Internal Service funds, which also included Fleet services, publishing services, and self-insurance.

Evolution of Audit Procedures

The San Diego Municipal Code requires the Auditor to cause an inventory to be taken of all items in the storerooms and warehouses of the City. This includes a comparison between stock records and inventory maintained. However, the Municipal Code does not set out the specific procedures outlined in the agreed-upon procedures used for the annual audit.

Prior to 2007, the Comptroller's Internal Audit Division conducted the inventory audit. In 2007, the City reorganized the audit function and placed audit responsibilities within what would in 2008 become the independent Office of the City Auditor. As a result, the City Auditor assumed performing the required audits using the same agree-upon procedures of the previous audit division.

Current audit procedures have evolved over the past decade as a result of the reduction in storeroom and warehouse facilities and purchasing practices allowing departments to procure needed materials in a just in time manner. Currently, the City maintains only two storeroom and warehouse sites. The current agreed-upon procedures do not entail matching 100 percent of the inventory on the floor to stock records maintained by Central Stores. However, the current procedures includes counting inventory on a sample basis and comparing the items to stock records, observing the storeroom facilities for unusual items during the inventory count; reviewing the sample data for reasonableness of pricing; and making inquiries with staff on any unusual items identified during the process.

Changes to Central Stores Inventory Audit

In reviewing the Municipal Code requirements and changes in audit procedures, the current audit procedures can be strengthened to include more specific verification testing that inventory on the floor is properly reflected in records. Also, more specific verification testing can increase assurance that Central Store's internal processes adequately address impact on valuation for little used inventory.

Given the reduction in storerooms and changes in procurement practices, there may be value in revisiting the audit requirements for Central Stores inventory, as the past several audits did not result in significant findings. According to the City's external auditor, the amount stored in inventory is not material for the purposes of the financial statements and may be better reviewed using a risk-based approach.

Respectfully submitted,

A handwritten signature in black ink, reading "Eduardo Luna". The signature is fluid and cursive, with the first name "Eduardo" and the last name "Luna" clearly distinguishable. It is positioned above a horizontal line.

Eduardo Luna
City Auditor