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Date: March 18, 2014

To: Audit, Finance and Enterprise Committee

From: Jennifer Ruttman, City Auditor

Subject: Audit of Surplus Property Disposal

cc: Alex Deshuk, Manager of Technology and Innovation
Ed Quedens, Business Services Dept. Director
Doug Fugate, Mail, Print, and Materials Administrator

Pursuant to the Council-approved Audit Plan, the City Auditor's office has completed an audit of the City's surplus property disposal processes. The final report is attached and will be presented at the next scheduled meeting of the Audit, Finance and Enterprise Committee. Please feel free to contact me with any questions or concerns.

AUDIT REPORT

CITY AUDITOR

Report Date: March 18, 2014
Department: Business Services / Materials & Supply Division
Subject: Audit of Surplus Property Disposal
Lead Auditor: Karen Newman

OBJECTIVES

The objectives of this audit were to determine whether City surplus property is managed and disposed of in accordance with applicable policies, procedures, and regulations; and to determine whether adequate internal controls are in place and operating effectively to minimize the risks associated with the various disposal methods and processes.

SCOPE & METHODOLOGY

To accomplish our objectives, we reviewed applicable citywide and departmental policies and procedures; interviewed staff responsible for the disposal process; observed operations at the East Warehouse Surplus Store; reviewed and tested inventory records, sales transactions, and deposit preparation; and evaluated the adequacy of the related internal controls.

BACKGROUND

The Materials and Supply Division of the Business Services Department is responsible for the disposal of City personal property (except for vehicles) meeting specific criteria, as established by the City Manager and set forth in Management Policy #205. Disposal of any City personal property with a cost exceeding \$100 requires the approval of the Business Services Department Director. Saleable items are tracked in an electronic inventory system and sold, either in the City Surplus Store or via EBay or Public Surplus auctions. Alternative methods of disposal are seldom used, but may include trade-in, sealed bid sale, negotiated sale, donation to a qualified organization, recycle/scrap, etc. Proceeds from the sale of asset forfeiture property are deposited into a special account for law enforcement use, as required by law. All other sale proceeds are deposited into the City's General Fund to help offset the cost of warehouse operations. Last fiscal year, the total surplus sales revenue was approximately \$295,000.

CONCLUSION

We found that the staff members responsible for the surplus property disposal process are very conscientious and they consistently provide excellent customer service to both internal and external customers. However, Surplus Store operations and practices do not always comply with City and departmental policies and procedures. In our opinion, internal controls over the disposal process need improvement, particularly in the areas of pricing, inventory records, and management oversight. A summary of our findings and recommendations is included below. For additional details, please see the attached Corrective Action Plans (CAPs).

SUMMARY OF FINDINGS & RECOMMENDATIONS

Finding	Recommendation
<p>1. Discounts and price reductions are applied without required authorization, supporting documentation, or management oversight.</p>	<p>1-1. All price reductions or negotiations outside of the established surplus sales labeling and discounting guidelines should be authorized in writing by the Materials & Supply Administrator. Documentation of this authorization should be maintained in accordance with applicable record retention policies.</p> <p>1-2. The Materials & Supply Administrator should periodically review reports showing discounts applied to inventory items, to ensure only authorized discounts are processed.</p>
<p>2. No effective inventory verification procedures are in place. Adjustments to inventory records are made without authorization, supporting documentation or management oversight.</p>	<p>2-1. Effective periodic or perpetual inventory verification procedures should be implemented.</p> <p>2-2. Inventory adjustments should always be authorized and documented.</p> <p>2-3. The Materials & Supply Administrator should periodically review reports showing inventory adjustments.</p>
<p>3. Recycled and other non-sellable items are not reviewed in aggregate or tracked in the system.</p>	<p>3-1. The Materials & Supply Administrator should periodically review a list of items that have been recycled or disposed of without being sold.</p>
<p>4. Surplus items are disposed of prior to receiving a signed Approval for Disposal form.</p>	<p>4-1. Materials and Supply should not dispose of surplus property until the authorization required to do so is received.</p> <p>4-2. Documents authorizing disposal of property should be maintained in a manner that allows them to be traced to the related property items and vice versa; or a different means of documenting and/or verifying disposal authorization should be developed.</p> <p>4-3. Management should consider revising Management Policy #205 to provide a more expedient/efficient means of authorizing the disposal process.</p>
<p>5. Invoices are voided without approval or oversight.</p>	<p>5-1. All voided invoices should be appropriately documented and approved.</p> <p>5-2. The Materials and Supply Administrator should periodically review system reports showing voided and missing invoices.</p>
<p>6. There are no written deposit preparation procedures.</p>	<p>6-1. Procedures for deposit preparation should be documented.</p>

CAP#1: Discounts and Other Price Adjustments Occur Without Authorization

Observations: Price reductions and percentage discounts are applied beyond those provided for within established procedures, without management authorization or oversight.

Comments: Management has established procedures for price labeling and progressive discounting of surplus inventory items at scheduled intervals. The longer an item remains on hand, the greater the discount. However, we found that actual practices are not always in accordance with those procedures. Discounts on actual sales varied both higher and lower than provided for by the established pricing schedule. This was sometimes done as an across the board discount, i.e. all bikes sold at 50% off on a given day. In other cases, variances were found only on individual transactions.

In addition to percentage discounts applied at the time of sale, the list price of an item is sometimes changed with no documented authorization or reason.

According to the City of Mesa Surplus Sales Store Procedures, *"Each sale item will be given a price at its inception and will only be discounted within the parameters of the colored dot system- no other price reductions or price negotiations will be made unless authorized by the Materials & Supply Administrator."*

Unauthorized discounts or price reductions outside of the parameters established by management increase the risk of loss due to fraud.

Recommendations:

- 1-1. All price reductions or negotiations outside of the established surplus sales labeling and discounting guidelines should be authorized in writing by the Materials & Supply Administrator. Documentation of this authorization should be maintained in accordance with applicable record retention policies.
- 1-2. The Materials & Supply Administrator should periodically review reports showing discounts applied to inventory items, to ensure only authorized discounts are processed.

Management Response:

- 1-1. The Surplus Store has written procedures to manage price reductions in the Surplus Store: "A store item will be in the store at full price for its first 90 days. After 90 days, it will then be discounted 25%. After the item has been in the store for a full 180 days, it will be removed and placed in an auction type venue."

Any store items that are to be sold outside of these parameters will be prior approved in writing by the Mail, Print & Materials Administrator.

- 1-2. The Surplus Store system has created a report (Surplus Items not Sold at Discount) that shows all store items that have sold outside of the established parameters. The Mail, Print & Materials Administrator will review this report at least monthly to ensure compliance with established procedures.

CAP#2: Effective Inventory Verification Procedures Have Not Been Implemented

Observations: Effective inventory verification procedures have not been implemented. In addition, adjustments to inventory records are made without authorization, supporting documentation, or management oversight.

Comments: Although some form of inventory counts were reportedly conducted, no structured procedures were followed, segregation of duties was not maintained, and the results were not adequately documented. Best practices in inventory management include either periodic or perpetual inventory counting procedures. These procedures serve to verify that all recorded inventory is physically present and accounted for, and that all physical inventory is accurately recorded in the system. They also serve as a compensating control in the absence of other internal controls.

When performing inventory counts, segregation of duties is critical to the integrity of the process. This is especially true when staffing levels are insufficient to allow for adequate segregation of duties in day to day operations. While it may be unavoidable to have the same individual maintain the inventory records, manage the physical inventory, and process sales transactions, it is essential that this individual not be responsible for the periodic inventory verification procedures. This includes any post-inventory adjustments made to the system.

When an inventory record is adjusted, such as when a price is changed, or an item is marked as "stolen", it is important that the change is authorized and that the reason for the change is documented. This is true whether the change results from inventory verification procedures or for any other reason.

Recommendations:

- 2-1. Effective periodic or perpetual inventory verification procedures should be implemented.
- 2-2. Inventory adjustments should always be authorized and documented.
- 2-3. The Materials & Supply Administrator should periodically review reports showing inventory adjustments.

Management Response:

- 2-1 The Warehouse Supervisor will perform weekly, random counts of surplus inventory. The Warehouse Supervisor will pull a report from the Surplus Sales System using the Surplus Inventory Catalog, choosing several categories to count each week.
- 2-2 Any discrepancies and adjustments will be reported on a

"Surplus Program Item Discrepancy/Adjustment Documentation"
form.

- 2-3 Any discrepancies found and adjustments completed will be reviewed by the Mail, Print and Materials Administrator.

CAP#3: Oversight Over Disposal of Non-Sellable Items Needs Improvement

Observations: Recycled and other non-sellable items are not reviewed in aggregate or tracked in the inventory system.

Comments: When items are transferred to Materials and Supply for disposal, but are deemed unfit for sale, they may be recycled, disposed of in a Solid Waste bin, or otherwise scrapped. However, when this occurs, the items are not entered into the inventory system, no documentation is maintained, and there is no review or oversight of the process.

With no oversight and no documentation, there is an increased risk that misappropriation of assets could occur without being detected.

Recommendations: 3-1. The Materials & Supply Administrator should periodically review a list of items that have been recycled or disposed of without being sold.

Management Response: 3-1. Currently, the disposal method should be indicated on the Internal Property Report/Transfer Forms though the audit did reveal a lack of consistency. Until an automated system is in place, the Mail, Print and Materials Administrator will ensure these documents indicate a disposal method for each item transferred from departments on the transfer form which is attached to the Approval for Disposal form.

There is a report that has been developed in the Surplus Store System that will show items not sold due to being disposed in another manner (recycled, trashed or cannibalization). These are items that were initially going to be sold, but were determined to be nonworking/saleable. This report will be reviewed by Mail, Print & Materials Administrator monthly.

To manually input all items sent to the warehouse into the Store System simply to show they were disposed of would be a tremendous task. An integrated Property Transfer and Disposal Approval system is being developed that would make this possible. All surplus items would then be easily tracked from the initiation of a transfer from a department to the Store or to another disposal method will be traceable. The system is in queue with IT and is targeted for completion mid-2014.

CAP#4: Disposal Authorization Process Needs Improvement

Observations: Materials & Supply often disposes of surplus items prior to receiving a signed Approval for Disposal (AFD) form. In addition, AFD forms are not maintained in a manner that allows them to be traced to the related property items or vice versa.

Comments: Staff members reported that surplus items are often sold prior to receipt of the signed AFD forms, as the process of obtaining the form is lengthy and it is not cost efficient or practical to store the items until the forms are received. They also noted that there is currently no way to tie the forms back to the respective items; therefore, we were unable to test whether any specific item sold or for sale had been properly approved for disposal.

Management Policy #205 Section IV states: *"... Except as exempted above, no City personal property shall be disposed of unless an Approval for Disposal Form has been approved by the department head and City Manager Designee, including property that is recommended to be scrapped via recycling or disposal."*

The AFD form is used to document not only the authority to dispose of an item, but also the approved method of disposal. Without the form, there is currently no means to verify this information. Thus, any property item to be disposed of should be traceable to a corresponding AFD form, unless an alternative method is developed to verify that each item has been authorized for disposal. At the time of this writing, management was in the process of developing an automated/online version of the AFD form, with the hope that this will help speed up the process. While we support this approach, it may not completely resolve the issue of compliance.

Recommendations:

- 4-1. Materials and Supply should not dispose of surplus property until the authorization required to do so is received.
- 4-2. Documents authorizing disposal of property should be maintained in a manner that allows them to be traced to the related property items and vice versa. Alternatively, a different means of documenting and/or verifying disposal authorization should be developed.
- 4-3. Management should consider revising Management Policy #205 to provide a more expedient/efficient means of authorizing the disposal process.

Management Response: 4-1 Authorization of the Approval for Disposal form now happens earlier in the process. No surplus items will be sold until necessary authorization is received.

- 4-2 Under current paper-based process this is difficult. The intended outcome is now noted for each item attached to an Approval for Disposal form.

An integrated Property Transfer and Disposal Approval system is being developed that would make this possible. All surplus items would then be easily tracked from the initiation of a transfer from a department to the Store or to another disposal method will be traceable. The system is in queue with IT and is targeted for completion mid-2014.

- 4-3 Management Policy 205 is being rewritten and changes to the authorization process are being proposed.

CAP#5: Documentation and Oversight of Voided Invoices Needs Improvement

Observations: Invoices generated by the Surplus Store inventory system were voided without authorization, supporting documentation, or management oversight. We also found that numerous invoices were missing from the sequence of invoices in the inventory system.

Comments: Management Policy #210, Cash Handling, states that: "*VOIDS and refunds should be appropriately documented and approved.*"

Since voiding or deleting invoices are known ways of concealing fraud, requiring management approval or providing another means of oversight serves as a fraud deterrent.

While IT support staff assured us that invoices cannot be deleted from the system, we noted that no process was in place to detect or resolve this issue.

Recommendations: 5-1. All voided invoices should be appropriately documented and approved.

5-2. The Materials and Supply Administrator should periodically review system reports showing voided and missing invoices.

Management Response: 5-1. All voided invoices and a reason for void will be documented and kept on file for review.

5-2. The "Store Daily Sales Tally" report will be reviewed monthly by Mail, Print & Materials Administrator. Voids and missing invoices on the report will be verified against the documentation and the reason for the void will be validated.

CAP#6: Procedures Needed for Deposit Preparation Process

- Observations:** There are no written procedures for deposit preparation at the Surplus Store.
- Comments:** Written procedures provide the guidance necessary for consistently and accurately performing key processes. These documents aid in setting clear expectations, reducing errors and ensuring continuity of operations during employee absences, particularly when such a small staff is responsible for the entire operation.
- Recommendations:** 6-1. Procedures for deposit preparation should be documented.
- Management Response:** 6-1. Documented procedures for Surplus deposit preparation have been completed.