

**EXECUTIVE SUMMARY**  
**Audit of Internal Controls for the 2011 Annual Physical Inventory**

**INTRODUCTION**

Internal Audit observed the fiscal year 2011 annual physical inventory (Inventory). The Inventory is coordinated by the Purchasing and Materials Management Department. Its purpose is to ensure that the on-hand quantity for each inventory item is accurately recorded in the PeopleSoft financial system so that transit operations are supported by having parts and supplies available when needed and to value inventory accurately for financial reporting purposes. This Inventory was performed February 25, through February 27, 2011. As of February 2011, fiscal year 2010 material and supply expenditures were approximately \$16.2 million or 4.2% of total expenses of \$389 million.

**OBJECTIVES, SCOPE AND METHODOLOGY**

The audit objectives were to determine the adequacy of internal controls for the Inventory and to determine if inventory items were counted accurately. The scope of this audit was the fiscal year 2011 Inventory.

**STATEMENT OF OPINION**

In our opinion, in general, the FY 2011 inventory was conducted in a manner that provides reasonable assurance that the value of inventory is appropriately stated in the financial statements and, from an operational standpoint, materials are available when needed. We noted that, in some instances, cut-off procedures were not followed; however, the associated risks were mitigated because the effect of the deviation was determined to be insignificant. We made recommendations to improve internal controls and business processes going forward as summarized below.

**STRENGTHS NOTED DURING THE AUDIT**

**Follow Up On Prior Audit Recommendations**

We noted that management made significant progress on improving business processes over the past year. In the audit report for the annual physical inventory for fiscal year 2010, we made eight recommendations for improvements in business processes and management was able to address six of them. The other two recommendations are being considered by management. These improvements include processing cycle count shortages as inventory adjustments, a more organized storeroom at the Manchester location, improved labeling for batteries at the Auto Shop and greater clarity on the report used to recap the results of the Inventory.

**Results of Test Counts**

We selected a statistically valid sample of 185 inventory items for testing. We noted 15 errors (an overall accuracy rate of 92%). Based on the actual sample error rate of 8.11%, we are 90% confident that the true accuracy rate in the population is between 85.5% and 93.4%. In addition to the test counts from our sample, 655 judgmentally selected test counts were performed by Internal Audit during the Inventory. Of these 655 counts, 607 counts were determined to be correct and 48 counts were incorrect (an overall accuracy rate of 93%).

**OBSERVATIONS AND RECOMMENDATION**

**OBSERVATION 1 - Inventory Cutoff Processes**

Some Put-Away and Depletion processes were not completed prior to Inventory; however, the impact of this omission was insignificant compared to the total inventory value of \$11.1 million. On February 28, 2011, the first day that the business units were reopened for processing receivers and materials stock requisitions subsequent to the inventory cutoff, 65 items valued at \$41,016.09 were processed via Put-Away and 257 items valued at \$53,885.89 were processed via Depletion. These values represent Port Authority's maximum exposure due to the omission because some of the items were correctly processed via Put-Away and Depletion.

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**RECOMMENDATION 1**

The cutoff processes can be improved by either suspending the receiving function at the time of the cutoff or ensuring that all processes related to receiving, staging, and Complete Put-Away are run prior to the Inventory, ensuring that all material stock requisitions in PeopleSoft have been fulfilled and the Feedback and Depletion processes have been completed and/or using queries at the time of the Inventory to identify cutoff processes that need to be run before proceeding with the Inventory.

**MANAGEMENT RESPONSE 1**

The Purchasing and Materials Department has developed several queries to ensure that the put-away process has been completed for all inventory items that have been received and all items that have a Material Stock Requisition entered against them have been fully depleted prior to the Annual Inventory shut down. These queries will allow the Inventory Operations Group to periodically "spot check" and confirm that all inventory items are put-away or depleted in a timely manner. By reviewing each query on a periodic basis, this will ensure that on-hand quantities are correct and current. A copy of each report will be included in the post-inventory report that is distributed to all departments included in the annual inventory process.

**OBSERVATION 2 – Inventory Locations in PeopleSoft and Inactive Stock Items**

We noted that five stock items which were on-hand at the Auto Shop at the time of Inventory were not included on the Physical Count Data Sheets because no inventory location was established for these stock items in PeopleSoft. In addition, we noted that 12 inactive inventory items at the Auto Shop appeared on the Physical Count Data Sheets because they were not moved to the "None" bin in PeopleSoft after they were made inactive. The Auto Shop inventory location, which is not staffed by a full-time receiver, includes a supply of automobile and truck tires and batteries which are used in the maintenance of Port Authority vehicles.

**RECOMMENDATION 2**

Procedures should be developed for the Auto Shop to help ensure that bin locations are established for all inventory items, inactive items are moved to the "None" bin in PeopleSoft and the Put-Away process is run in a timely manner. The implementation of these procedures should be monitored. Management in the materials management function has indicated that it is considering reducing inventory quantities stocked at the Auto Shop or reclassifying all inventory items at the Auto Shop from inventory items to nonstock (supply) items. We concur that reducing inventory quantities stocked would be beneficial to controlling inventory, however, reclassifying them as nonstock (inventory) items will reduce internal controls because Port Authority will not be able to identify shortages in quantities which is a concern for items such as tires and batteries which have personal uses.

**MANAGEMENT RESPONSE 2**

The Purchasing and Materials Department will develop a procedure that ensures all items that have been deemed obsolete and made inactive in the PeopleSoft system, are moved to the "None Bin" to make certain that inactive inventory items are not listed on annual inventory count sheets. Purchasing and Materials Department is discussing the possibility of changing all inventory stock items located at the Auto Shop to non-stock items. This would eliminate the issues of inactive items, put-away, and depletion. All items purchased on a Port Authority purchase order will continue to be received in the PeopleSoft system. Purchasing will provide all updates regarding any changes.

Additional detail on these recommendations is included in the full report.