

EXECUTIVE SUMMARY
AUDIT OF INVENTORY ITEMS WITH POTENTIAL EXTERNAL USES

INTRODUCTION

At the request of the director of service delivery (DSD) at Harmar operating location, Internal Audit reviewed inventory items to identify those items that have the most common potential uses outside of Port Authority such as paper towels, leather gloves and spray cans of cleaner and analyzed the inventory adjustments and usage of inventory items to determine if enhanced internal controls are needed to control the usage of inventory items. The DSD's request was made in the interest of improving business processes. In fiscal year 2010, material and supply expenditures were approximately \$ 16.2 million or 4.5% of total expenses of \$361 million.

STATEMENT OF OPINION

We were able to identify only 105 inventory items out of 28,000 (0.4%) that had inventory shortages over \$1,000 and common potential uses outside of Port Authority. Although the process used to record inventory shortages in PeopleSoft and account for supplies prevented us from accurately identifying all items with shortages greater than \$1,000 during the audit period, Port Authority's maintenance staff assisted us in identifying inventory items with common potential external uses. While the current system has inherent weaknesses in internal control, management's decision to accept the risks is reasonable especially considering the limited number of items identified as having common potential external uses and a significant inventory shortage and the cost of many of the options that could be taken to improve internal controls, such as staffing parts rooms at all times, would be exorbitant. In addition, after the most recent upgrade of PeopleSoft, management gained the ability to track reasons for adjustments to inventory in PeopleSoft and has changed business processes to allow a more accurate analysis going forward.

We made recommendations which can be implemented with minimal cost to improve business processes and internal controls for inventory items.

OBSERVATION 1 – Improving Internal Controls for Parts Rooms on 2nd & 3rd Shifts

Parts rooms are not staffed on any shift during weekends and on the third shift at most locations because the cost would be exorbitant. The cost to hire the additional staff that would be required at all operating locations to staff parts rooms at all times has been estimated at approximately \$1.2 million annually. Management has attempted to mitigate the associated risks by storing expensive/sought-after items in locked cabinets/cages. Although the practice of not staffing the parts rooms full-time is cost effective, it makes managing materials through the materials management system difficult for the following reasons:

- Storage cabinets are sometimes left unlocked due to operational necessity,
- Maintenance employees do not always log inventory items removed from the inventory, and
- Inventory shortages identified through cycle counts are processed as requisitions rather than adjustments to inventory so complete data for analysis is not available.

We recommend that:

- All cycle count adjustments should be recorded as adjustments to inventory rather than being processed as requisitions to improve management's ability to estimate inventory shortages. Management concurs and has implemented this change. In addition, management has begun tracking inventory adjustments made as a result of cycle counts to create better data for future analysis.
- After each annual physical inventory, management produces reports showing the number and value of inventory adjustments identified during the annual physical inventory. We

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recommend that the inventory adjustments made during the entire year, including those made during cycle counts, should be included on these reports to give a more complete measure of the inventory adjustments made for the year. Management has implemented this recommendation.

OBSERVATION 2 – Budget Variances for Supplies and Comparison of Supply Usage

We reviewed material and supply usage at each operating location during the period January 1, 2006 through June 3, 2008 for all 105 stock items identified as having common potential external uses and inventory usage greater than \$2,000 during the audit period. We identified several significant differences in usage between the operating locations. In many instances, valid reasons exist for differences in use of supply items between operating locations. Different levels of usage of supply items at similarly-sized operating locations can indicate differences in operational needs and/or operating procedures, or that these items are not adequately controlled.

Supplies are expensed to the bus operating locations' budgets upon shipment from the Manchester central storeroom because management determined that expensing supplies individually at the time they are used would not be cost effective due to their high volume of usage and relatively low unit dollar value. At the South Hills Village Rail Center and South Hills Junctions locations, some supplies are maintained in inventory and requisitioned from inventory on an as-needed basis and some are expensed upon shipment from the Manchester central storeroom. Examples of supplies include paper products, cleaners, gloves, trash can liners, air fresheners, batteries, sand paper, masking tape, tie wire, and soap

We recommend that:

- All 105 stock items identified as having common potential external uses should be kept in locked areas. Some of the items are stored in locked areas but not all of them. In addition, all other stock items considered by supervisory personnel to have a common external use should also be maintained in locked areas. If a working supply of these items is required to be readily accessible, only one box of each item should be maintained outside of the locked area at a time where possible.
- Management should perform a periodic trend analysis to review supply usage between operating locations and share the results with operations management to identify increases in supply use.

Management agrees with Internal Audit's recommendations and has provided a supply analysis that will be completed bi-annually within Port Authority's fiscal year.

OBSERVATION 3 – Recording Parts Used in Planned Asset Management System

Port Authority does not record materials used while performing maintenance on work orders. Recording all materials used on work orders will eliminate the need for employees to complete the manual log for parts removed from parts rooms when they are unstaffed and enable Port Authority to estimate inventory shortages more accurately. It will also improve accountability in the maintenance function because management will be able to identify maintenance costs for each asset and asset class.

We recommend that, as part of the implementation of the planned asset management system, the inventory items used should be recorded on work orders to improve management's ability to analyze operations and to strengthen internal controls over inventory. The work order system or

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the planned asset management system should be interfaced with the PeopleSoft Financial system to the extent possible to eliminate duplication of data entry.

Management responded that the Bus Operations Officer, Rail/Engineering Operations Officer and Director of Purchasing and Materials Management will attempt to have the planned work order system capture material requisition(s) with a link to PeopleSoft.

OBSERVATION 4 – Stock Items With \$0.00 Unit Price

We noted that the inventory file in PeopleSoft contained 3,383 items out of a total of approximately 28,000 items (12%) with a unit price of \$0.00. Several reasons exist for carrying items at a \$0.00 value. Port Authority shop employees make some stock items such as connectors and hoses. The materials for these items are expensed at the time they are used to build the item so the item is carried in inventory at \$0.00 so that it will not be expensed again when it is requisitioned. Also, some parts are provided as spare parts when a major item is purchased. For example, when new rail cars are purchased, a significant number of spare parts are typically included in the contract. These items are paid for out of the capital money for the purchase and they are carried in inventory at \$0.00 so that they will not be expensed when they are requisitioned.

When inventory items are valued at \$0.00, they become difficult to manage because there is no value associated with them. These items might not be included on the variance report at the annual physical inventory because this report only includes items with a dollar variance of at least \$250.00 or a quantity variance of 10%. Also, if the item is reported on a variance report, it might not be given management attention due to its minimal value. In addition, valuing inventory items at \$0.00 causes inventory to be undervalued.

We recommend that management should review all inventory items with a unit value of \$0.00 annually to ascertain whether the item should be carried in inventory at no value. This review should be documented.

Management concurs with the recommendation and will review these items at least annually.

OBSERVATION 5 – Improving Documentation of Scrap Process

We observed that, while the process used to identify inventory items that are obsolete and dispose of them is adequate, the documentation requires improvement. The documentation of the items identified as obsolete exists in emails, which are stored in the electronic inboxes of two employees. This documentation may not be retrievable if it does not exist in a manner that is easily accessible in the event that employees retire or otherwise terminate their employment with Port Authority.

We recommend that the manager of inventory and purchasing should formally authorize the inventory items to be reclassified as obsolete with his signature. Also, the manner of final disposition of each item on the obsolete inventory list should be documented on the list along with relevant details.

Management concurs and has developed a written procedure for documenting the process for managing obsolete inventory.

Other minor observations are included in the full report including recommendations for written procedures for completing cycle counts, parts room duties and processing obsolete inventory.