

Staff Report



Chief Administrator's Office

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REPORT TO: Audit Committee

DATE OF MEETING: December 11, 2023

SUBMITTED BY: Corina Tasker, Internal Auditor, 519-741-2200 ext. 7361

PREPARED BY: Corina Tasker, Internal Auditor, 519-741-2200 ext. 7361

WARD(S) INVOLVED: All

DATE OF REPORT: November 17, 2023

REPORT NO.: CAO-2023-509

SUBJECT: 4th Quarter 2023 Audit Status Report

RECOMMENDATION:

For information.

REPORT HIGHLIGHTS:

- The purpose of this report is to provide information regarding recent audits.
- There are two audits included in this report: 1) Physical Inventory Count; and 2) Market Alcohol Control status report.
- Results of the audits were positive, with no fraud detected.
- There are no financial implications.
- Community engagement included this report posted to the city's website with the agenda in advance of the council / committee meeting.
- This report supports the delivery of core services.

EXECUTIVE SUMMARY:

The following report provides a summary of the Internal Audit assurance and consulting services completed during the period of October to December 2023. The table below shows the audits contained in this report.

Division / Topic	Scope
Physical Inventory Count	Count Verification
Market – Alcohol Inventory	Status Update

Assurance work is in progress on the following topics:

Consulting work is in progress on the following reviews:

- Training Documentation - process review
- External billable work orders – Lean review
- Contractor Management – gap analysis review

*** This information is available in accessible formats upon request. ***
Please call 519-741-2345 or TTY 1-866-969-9994 for assistance.

The physical inventory count verification found three variances, which resulted in a \$2,029.90 write-up. Total adjustments for the year were \$143,147 write-down related mainly to salt and aggregate adjustments. Overall, the physical inventory process is in control and no concerns were identified.

The Market Alcohol status update found that 100% of audit recommendations to better protect alcohol inventory from theft have been implemented.

BACKGROUND:

The overarching goal of internal audit is **to protect the City's assets and interests**. This includes, but is not limited to, protecting the long-term health of the organization, its financial and physical assets, its reputation, its ability to perform critical services and the safety and well-being of employees and citizens.

Internal Audit provides assurance and consulting services in accordance with the International Standards for the Professional Practice of Internal Auditing (Standards), IIA 2012. These services are independent, objective activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

- **Assurance services** provide an objective assessment of evidence to provide an independent opinion or conclusions regarding an entity, operation, function, process, system, or other subject matter.
- **Consulting services** are advisory in nature and are generally performed at the specific request of an engagement client. When performing consulting services, the internal auditor should maintain objectivity and not assume management responsibility.

Audit topics are selected independently by the Internal Auditor and approved by Audit Committee on an annual basis. Audit results are brought back to Audit Committee in reports such as this on a quarterly basis as completed.

REPORT:

1. Physical Inventory – Count Verification

Completed: November 5, 2023

Overview

The Procurement-Stores section of the Financial Operations division is responsible for the receipt, storage, and disbursement of a variety of physical inventory used in City operations. This inventory is stored within the Stores warehouse within the Kitchener Operations Facility (KOF), as well as some larger items being stored outside in the yard. (e.g., large pipe, catch basins, aggregates, salt). Stores staff perform an annual inventory of all parts and materials to ensure that financial records match the amounts on hand. Internal audit then counts a sample of parts to provide assurance that staff counts are accurate. This is a standard audit activity. In addition, staff make adjustments to inventory balances within SAP throughout the year and during the physical inventory count to restore the financial balance to equal the quantity on hand. An analysis of the total adjustments for the year is also included below.

Definitions

Controllable stock - stock which the Stores staff have direct control over with regards to purchases and usage. Located within the warehouse.

Floor-to-sheet audit – randomly selecting parts in the warehouse, counting them, and comparing the quantity to what is in the financial system (SAP).

Sheet-to-floor audit – pre-selecting parts based on unit value or total value, counting them, and comparing the quantity to what is in SAP. This includes both warehouse and outdoor inventory.

Shrinkage rate – the percentage of total inventory purchases that are written-down or lost due to factors such as theft, error, fraud, or damage.

Uncontrollable stock - stock which is located in the KOF yard which are not under direct supervision by the Stores division.

Write-down - the quantity on hand was less than what was recorded in SAP and therefore the financial records were decreased to match the physical quantity. Usually occurs when inventory is used without updating SAP.

Write-up – the quantity on hand was more than what was recorded in SAP and therefore the financial records were increased to match the physical quantity. Usually occurs due to keying errors when setting up or relieving inventory, or when the wrong unit of measure was used (e.g., number of cartons counted instead of individual parts).

Audit Process and Findings

Standard floor-to-sheet and sheet-to-floor audits were done to confirm the physical quantity of parts on hand compared to what staff had counted. The audit covered 25% of the total value of inventory. The sheet-to-floor audits covered the top 10 unit values and top 10 total values. The floor-to-sheet audits consisted of twenty random shelf locations. Three variances, which equates to 8% of the sample, were found through this verification process which resulted in a \$2,029.90 write-up. This is considered a very low value of variances found through the audit process and is consistent with prior years. It represents 0.05% of total inventory on hand.

Total Adjustments

In addition to reporting on the variances found through the audit process during the physical inventory, the total adjustments for the year are also reported below. These numbers include the adjustments made by staff during the physical inventory and the \$2,030 write-up driven by the internal audit verification, as well as all other adjustments made throughout the year. The purpose of this analysis is to identify any material groups or part numbers that have large or unusual adjustments to ensure the root cause has been identified and actions put in place to eliminate or reduce adjustments in the future.

(Note that positive numbers represent write-ups and negative numbers represent write-downs.)

Year	2021	2022	2023
Controllable stock write-up	\$15,701	\$82,029	\$84,936
Uncontrollable stock write-up (down)	(\$185,017)	(\$222,268)	(\$228,043)
Total write-up (down)	(\$185,316)	(\$140,239)	(\$143,107)

In 2023 the total adjustments for the year (Nov.10/22 to Nov.9/23) were \$143,107 write-down. Usually, the total adjustments are a write-down between \$50,000 - \$200,000 related to adjustments to aggregates and salt in the yard and therefore this figure is within normal expectations. The 2023 total write-down represents 1.1% of the total inventory purchases for the year of \$12 million. Industry standards indicate that up to 2.5% is an acceptable shrinkage rate. The ending inventory balance was \$3,940,387.

Controllable Stock Adjustments

Of the 2023 adjustments, \$84,936 write-up was from controllable stock. In 2023 the write-up was attributable to multiple material groups and there was not a large write-up in any specific part number. However, the material groups which saw the largest total write-ups included gas utility parts and vehicle maintenance parts. Write-ups are most often due to errors in issuing out stock, such as using the wrong unit of measure causing too much inventory to be relieved.

Stores implemented regular cycle counts in January 2023 which see each high moving part number counted at least three times per year, including the full physical inventory. This will allow variances to be identified earlier and investigated to determine root cause of the error, allowing real-time corrections to be made and eliminating the need to write parts up or down. Currently they are counting approximately 170 parts per week and finding an accuracy rate of about 80-90%. If they can determine the root cause and the user of the part, they will charge it out to that job or cost centre. If they are unable to ascertain ownership, then they will use the write-up or write-down function which then charges the amounts on a prorated basis to all user groups.

Over time, as more root causes of variances are determined and rectified, it is anticipated that the total amount of adjustments will decrease.

Uncontrollable Stock Adjustments

The remaining \$228,043 of write-down is related to stock which is outside in the KOF yard which are not under direct supervision by Stores staff. It is impractical to have dedicated staff monitoring the outdoor inventory on a 24/7 basis and therefore there is a reliance on staff to inform Stores when they take inventory from the yard. However, this often does not happen, leading to the many smaller write-downs in products such as pipe or aggregates. This year \$75K of the write-down is related to salt purchased by the Region that was invoiced to the City in error. The City is working to recover the funds from the Region which will offset this adjustment.

Conclusion

Overall, the physical inventory process is in control and no concerns were identified. The adjustments to controllable stock are generally small write-ups. Uncontrollable stock adjustments are typical and are expected given the current uncontrolled environment. Improvements to measurement techniques and ongoing cycle counts will help reduce the amount of inventory adjustments.

2. Market - Alcohol Inventory – Status Update

Completed: October 27, 2023

Overview:

In 2013 an audit of the Kitchener Market's inventory control for alcohol was done. At that time, it was found that there were no controls in place to ensure that all alcohol purchased on behalf of the Market, for programs such as cooking classes and events, were accounted for. There was no oversight of expenses or physical control of product, making the process vulnerable to theft from both the public and staff. Recommendations were made at the time to implement a tracking sheet and reconciliation process. Market alcohol control is now part of the list of rotating controls and compliance audits, and a repeat audit was done in September 2022. The overall goal of the audit was to review and confirm adequate controls are in place to ensure that alcohol purchases for the Market are used for their intended purpose and not taken by staff or customers.

Audit Objective:

All services which have undergone a service review in the past are subject to a status update, not sooner than one year following the original audit. The purpose of status updates is to hold staff accountable for addressing the audit findings and to identify any areas that have not seen significant progress. In addition, if applicable, further testing or review may also be done to test whether improvements have had the intended effect.

Status Definitions:

- **Complete** = the recommendation has been fully implemented.
- **In progress** = implementation has begun.
- **Not started** = no work has begun yet but will in the future.
- **Not required** = the recommendation either does not require any action, or it is no longer relevant, and no work will be done to implement it.

Number of original recommendations:	7
Number of recommendations complete:	7
Number of recommendations in progress:	0
Number of recommendations not started:	0
Number of recommendations not required:	0

The Market management and staff are commended for being the first division to implement 100% of the audit recommendations by the status update. Physical controls were put in place to protect the alcohol from theft in addition to processes to:

- Confirm, track, and reconcile incoming purchases of alcohol.
- Event day tracking and reconciliation of opening balances, uses during the event, closing balance, and sales/deposits.
- Periodic inventory counts

All of these improvements will provide better controls around alcohol inventory.

Conclusion / Next Steps:

This topic will remain on the list of rotating assurance audits.

STRATEGIC PLAN ALIGNMENT:

This report supports the delivery of core services.

FINANCIAL IMPLICATIONS:

Capital Budget – The recommendation has no impact on the Capital Budget.

Operating Budget – The recommendation has no impact on the Operating Budget.

COMMUNITY ENGAGEMENT:

INFORM – This report has been posted to the City’s website with the agenda in advance of the council / committee meeting.

PREVIOUS REPORTS/AUTHORITIES:

- CAO-2022-494 2023 Internal Audit Work Plan
- CAO-2022-500 4th Quarter Audit Status Report

APPROVED BY: Dan Chapman, CAO

ATTACHMENTS: None