

**OFFICE OF THE CITY CONTROLLER**



**FLEET MANAGEMENT DEPARTMENT (FMD)**

**PERFORMANCE AUDIT  
OF THE PROCESS TO  
SELL/TRANSFER VEHICLE REPAIR PARTS INVENTORY**

**Ronald C. Green, City Controller**

**David A. Schroeder, City Auditor**



OFFICE OF THE CITY CONTROLLER  
CITY OF HOUSTON  
TEXAS

RONALD C. GREEN

January 5, 2012

The Honorable Annise D. Parker, Mayor

**SUBJECT: REPORT #2012-06  
FLEET MANAGEMENT DEPARTMENT (FMD) – PERFORMANCE AUDIT OF THE PROCESS  
TO SELL/TRANSFER VEHICLE REPAIR PARTS INVENTORY**

Dear Mayor Parker:

The Controller's Office evaluated and tested the inventory processes involving vehicle repair parts as they pertained specifically to the valuation of the stock on hand to be sold to the Genuine Parts Company (NAPA). The sale/transfer of the existing inventory to NAPA was one component of implementing a contract that was signed and executed between the City of Houston and NAPA (Contract #4600010761)<sup>1</sup>. The inventory was *previously* held and managed by the Houston Fire Department (HFD), Solid Waste Management Department (SWM), and the Houston Police Department (HPD). The attached report represents the results of our testwork of which some key points are noted below.

- The City's inventory count and valuation process had adequate controls to reasonably ensure accuracy.
- The City received fair value for inventory items as agreed to in the contract.
- The inventory procedures yielded significant adjustments of \$1.2 Million (approximately 30% of the original book value) by recognizing errors previously undetected or not remediated. As a result of the overall process, we commend FMD for taking an assertive leadership role in effectively managing the physical count and transfer, along with developing and implementing stronger oversight controls.

FINANCIAL HIGHLIGHTS OF INVENTORY TRANSFER FROM HFD, SWM, AND HPD TO NAPA	
Book Value of Inventory (Prior to transfer)	\$3,934,340
Inventory Adjustments (write-offs, scrap, errors, shrinkage, etc.)	(\$1,203,669)
Net Inventory Activity (Purchases, issuances, usage, etc.)	(\$432,385)
Book Value of Inventory transferred to NAPA	\$2,298,286
Book Value of Inventory still owned by COH but managed by NAPA	(\$827,859) <sup>2</sup>
Payments received by COH from NAPA	\$1,470,427

<sup>1</sup> An evaluation and communication of contract risks and concerns associated with the component of outsourced inventory management functions are being provided in a separate memorandum.

<sup>2</sup> These items will be issued back to the City at zero cost for valid vehicle work orders.



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RONALD C. GREEN

We appreciate the cooperation and professionalism extended to the Audit Division during the course of the project by personnel from FMD, HFD, SWM, and HPD.

Respectfully submitted,

Ronald C. Green  
City Controller

cc: City Council Members  
Chris Brown, Chief Deputy City Controller, Office of the City Controller  
Waynette Chan, Chief of Staff, Mayor's Office  
Andy Icken, Chief Development Officer, Mayor's Office  
Scott Minnix, Director, Fleet Management Department  
Terry Garrison, Chief, Houston Fire Department  
Harry Hayes, Director, Solid Waste Management Department  
Charles McClelland, Chief, Houston Police Department  
David Schroeder, City Auditor, Office of the City Controller

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### TABLE 1

FINANCIAL HIGHLIGHTS OF INVENTORY FROM HFD, SWM AND HPD .....	1
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## EXECUTIVE SUMMARY

The Office of the City Controller; Audit Division has completed an audit of the inventory process for the sale of vehicle replacement parts inventory from Houston Fire Department (HFD), Solid Waste Management Department (SWM), and the Houston Police Department (HPD) to the Genuine Parts Company (NAPA).

### BACKGROUND

In implementing one of the City's initiatives to create efficiencies and eliminate redundancies, a major portion of the fleet operations were centralized to a newly formed Fleet Management Department (FMD). One of the first areas addressed was the vehicle repair functions throughout several departments. As a result, on January 6, 2011, the City of Houston (City) entered into a contract with NAPA (Contract #4600010761) to assume the responsibilities for stocking and managing vehicle replacement parts storerooms at the City's vehicle maintenance facilities providing "just in time inventory". The contract includes repair facilities that are located in SWM, HFD, and HPD. NAPA had already been providing those services to Public Works and Engineering (PWE) and Parks and Recreation Department (PAR) under separate agreements.

The contract contains two primary components:

- Sale, disposition and transfer of existing vehicle/apparatus repair parts inventory to NAPA
- Change in business process to outsource the inventory ownership and management function from the City to NAPA

In September 2010 (under the management of FMD), HFD, SWM and HPD began preparing for the transition by determining whether the inventory stock items were usable or not. Part of identifying usable parts, was to analyze usage activity by part number. The book value of the Repair Parts Inventory as of September, 2010 was approximately \$3.9 Million. Between September and the time that the contract was executed, an internal analysis of the physical inventory was taken and, as a result, approximately \$390,000 was written-off (primarily by HFD and SWM).

As part of selling the existing inventory, a physical count was jointly performed by the City and NAPA during March through May 2011, which was valued at \$2.3 Million (original cost) and included an additional write-off of about \$500,000. One-third of this ending inventory (approximately \$800,000) represented items that had not been issued within 2 years. However HFD, SWM and HPD have active vehicles that would justify keeping them for their potential use. These items are being held by NAPA, but were not purchased, and therefore are available to be issued to the City without charge based upon valid City work orders.

<b>TABLE 1</b>	
<b>Financial Highlights of Inventory Transfer from HFD, SWM, and HPD</b>	
<b>Book Value of Inventory</b> (Prior to transfer)	<b>\$3,934,340</b>
<b>Inventory Adjustments</b> (write-offs, scrap, errors, shrinkage, etc.)	<b>(\$1,203,669)</b>
<b>Net Inventory Activity</b> (Purchases, issuances, usage, etc.)	<b>(\$432,385)</b>
<b>Book Value of Inventory transferred to NAPA</b>	<b>\$2,298,286</b>
<b>Book Value of Inventory still owned by COH but managed by NAPA</b>	<b>(\$827,859)</b>
<b>Payments received by COH from NAPA</b>	<b>\$1,470,427</b>

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## AUDIT SCOPE AND OBJECTIVES

The original scope of the engagement focused on the first component of the contract as mentioned above, in preparation for and performing the physical inventory between March and May of 2011 at HFD, SWM, and HPD facilities .<sup>1</sup>

As a result of our preliminary due diligence, we developed and refined audit objectives to determine whether:

1. There were sufficient internal controls to ensure an accurate count and valuation of physical inventory;
2. The City received compensation that complies with contract terms for inventory sold and transferred to NAPA; and
3. Items identified as scrap/obsolete repair parts were transferred to Property Disposal Management Office (PDMO) and accounted for properly.

## PROCEDURES PERFORMED

In order to obtain sufficient and appropriate evidence that provides reasonable assurance in supporting our conclusions related to the objectives identified above, we performed the following:

- Assessed the process by which the physical inventories were to be performed;
- Conducted interviews and inquiries with FMD, HFD, SWM, NAPA, and PDMO staff;
- Observed physical inventories at HFD and SWM facilities to determine if the process was functioning as intended;
- Performed inventory reconciliations (roll forward) at HFD, SWM, and HPD;
- Observed the transfer of obsolete/scrap parts to PDMO from HFD, SWM, and HPD;
- Reviewed NAPA purchase documentation for completeness; and
- Verified payments made to the City for accuracy.

## AUDIT METHODOLOGY

We conducted this engagement in accordance with Generally Accepted Government Auditing Standards and the International Standards for the Practice of Internal Auditing as promulgated by the Institute of Internal Auditors. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives.

The scope of our work did not constitute an evaluation of the overall internal control structure of the departments. Department management is responsible for establishing and maintaining a system of internal controls to ensure: City assets are safeguarded; financial activity is accurately reported and is reliable; and management and their employees are in compliance with laws, regulations, and policies and procedures. The objectives are to provide management with reasonable, but not absolute assurance that the controls are in place and effective.

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<sup>1</sup> The results of our review pertaining to the second component of the contract are being distributed under separate cover.

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## CONCLUSIONS

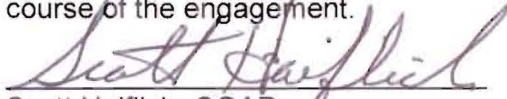
As a result of the evidence obtained in performing the procedures that were designed to meet the audit objectives, we believe we have a sound basis for our conclusions as presented below.

Because the responsibility of vehicle repair parts was moved under the control of FMD, they assumed pre-existing business processes that were under the design and control of other City departments. Therefore, part of realizing efficiencies in business process improvement is identifying the magnitude of issues that existed in tandem among several departments by bringing them into view as a support function to the core services that the City provides. So the management responses that are included in this report are from FMD to remediate issues as a part of the overall process improvement, not to correct deficiencies that resulted from their formation.


- The inventory procedures yielded significant adjustments of \$1.2 Million (approximately 30% of the original book value) by recognizing errors previously undetected or not remediated. As a result of the overall process, we commend FMD for taking an assertive leadership role in effectively managing the physical count and transfer, along with developing and implementing stronger oversight controls.<sup>2</sup>
- Based on our review of the physical inventory process design and observation during inventories at HFD and SWM, we concluded that the process was adequately controlled and functioned as intended. (Objective 1) NOTE: There are City owned inventory items that are under the physical control of NAPA and are issued back to the City at no cost when needed for maintenance/repairs. (See Finding 2, *Accountability for Category 2 Parts*.)
- NAPA used the City's ending inventory values as the basis for the items purchased. Therefore, we concluded that the method for determining the total purchase price was fair and equitable and NAPA paid a fair price for the repair parts and fluids accepted from the City of Houston. (Objective 2)
- HFD items transferred to PDMO for disposition/internet auction did not reconcile to the total items identified with the "SCRIP" code in M5. (Objective 3; See Finding 1, *Verification of Inventory Transfers to PDMO*.)

## ACKNOWLEDGEMENT AND SIGNATURES

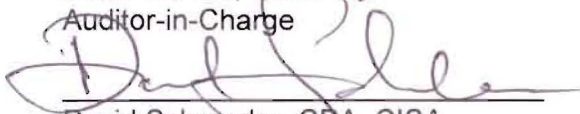
The Audit Team would like to thank FMD, HFD, SWM, and HPD for their efforts throughout the course of the engagement.



Scott Haiflich, CGAP  
Auditor-in-Charge



Arnie Adams, CFE, CIA  
Audit Manager



David Schroeder, CPA, CISA  
City Auditor

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<sup>2</sup> We would like to specifically recognize: Kim Burley, Lisa Young, Larry Hunter and Tom Hendrix for commitment to exceptional performance, continuous improvement, and successful completion of the inventory transfer.

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**FINDINGS, RECOMMENDATIONS, MANAGEMENT RESPONSES, AND  
ASSESSMENT OF RESPONSES**

**I. ACCOUNTABILITY FOR PARTS (CATEGORY 2)**

**BACKGROUND**

Prior to the physical inventories of repair parts at HFD, SWM, and HPD parts storerooms, both NAPA and the Fleet Management Department (FMD) reviewed repair parts inventory usage reports from the City's work order and vehicle repair parts inventory management system (M5). Per the agreement between the City and NAPA, the repair parts inventory were placed in three categories: (1) Parts that NAPA agreed to purchase, (2) *Slow moving parts not to be purchased that would remain in inventory under the physical control of NAPA and issued at zero cost*, and (3) Obsolete/scrap items that would be transferred for disposition.

Because the City reports inventory at cost (asset) using the consumption method on the financial statements and Category 2 parts were not purchased by NAPA, they remain the property of the City and therefore need to be accounted for properly.

**FINDING**

FMD does not have processes in place to:

- Monitor the issuance and remaining balances of inventory items maintained by NAPA that are still owned by the City and
- To verify that part substitution is not occurring for the issuance of category 2 parts.

**RECOMMENDATION**

FMD should participate in NAPA's periodic physical inventories of Category 2 parts to verify that these are being safeguarded and to assure that accountability is maintained. Further, there should be routine analysis of NAPA parts billed to the City as compared to Category 2 parts on hand.

**MANAGEMENT RESPONSE**

*"FMD will monitor the issuance and remaining balances of inventory items maintained by NAPA by utilizing its beginning inventory spreadsheet of all non-sales justified items (COH line items), which shows the value of the zero-cost parts still owned by the City, subtracting the quantity of parts issued between the date of the beginning inventory until the current date, to find the value of the actual inventory in NAPA's system TAMS.*

*Since the value of the non-sales justified items stored in TAMS is zero (\$0.00), FMD will calculate the value of the parts issued by running a sales history report in M5 to find quantities, and cross-referencing the part number to an M5 storeroom listing report of all COH line items. The M5 storeroom listing report shows the part's original cost. FMD will research any variances between the ending value in its non-sales justified items spreadsheet and the value of what is in TAMS. FMD will repeat this process monthly.*

*FMD will verify that part substitution is not occurring for the issuance of category 2 parts by reinforcing the training NAPA personnel have had on the importance of issuing COH line items first before a standard line item. NAPA has an incentive to eliminate the zero-cost parts still owned by the City, because these parts are taking up valuable shelf space where NAPA could alternatively stock parts that carry a 7% markup."*

**ASSESSMENT OF RESPONSE:**

Management's response effectively remediates the issues identified.

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## II. VERIFICATION OF HFD INVENTORY TRANSFERS TO PDMO

### BACKGROUND

Historically, management routinely identified repair parts that were obsolete or no longer usable. They moved them in M5 using the code "SCRP". As a basis for transfer to the Property Disposal Management Office (PDMO), a listing was printed detailing all "SCRP" coded repair parts. They were identified by location and physically removed, tagged, and segregated. The departments then prepared FA97 forms identifying each repair part with the SCRCP designation. HFD, SWM, and HPD transferred the SCRCP parts to PDMO for disposition. (*PDMO sells scrap items through various methods which provide revenue recovery back to the City*).

### FINDING

Prior to the NAPA inventory, \$258,794 of repair parts owned by HFD and identified as "SCRCP" could not be verified by either HFD or PDMO. NOTE: While the \$258,794 variance was written-off as part of the physical inventory taken during the NAPA transfer, there is no way to verify that it was received by PDMO and sold for value.

### RECOMMENDATION

While FMD took over operations previously managed by HFD, SWM, and HPD, FMD should ensure that the supporting documentation (FA97's) are completed, signed and retained.

### MANAGEMENT RESPONSE:

*"FMD is building a legacy of transparency and accountability. It has the combined expertise of parts inventory management employees from Solid Waste, Fire, Police, and Parks & Recreation. FMD will use an FA97 form whenever it salvages parts, including the remaining zero-cost parts, and follow a verification process when parts are palletized and delivered to PDMO."*

### ASSESSMENT OF RESPONSE:

Management's response effectively remediates the issues identified.



# CITY OF HOUSTON

Fleet Management Department

## Interoffice

Correspondence

**To:** Ronald Green  
City Controller

**From:** Scott Minnix *SM*  
Acting Director

**Date:** December 19, 2011

**Subject:** Performance Audit of the Vehicle  
Repair Parts Inventory Process  
(Transfer to NAPA)

FMD appreciates the audit of the vehicle repair parts inventory transfer to NAPA. The department responses are found in the report, and are in accordance with each of the findings identified by the audit team.

The department would like to thank your team for their detailed work and recommendations on this audit. It was a pleasure working with them during this process.