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July 5, 1990

F-958

Honorable Elihu M. Harris, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 2148
Sacramento, California 95814

Dear Mr. Chairman and Members:

Our audit of the Business Enterprise Program for the Blind (program), administered by the Department of Rehabilitation (department), disclosed that the department has weaknesses in its purchase and use of equipment for the program. For example, the department purchased equipment costing a total of $15,100 when similar equipment was available in warehouse storage. Also, we identified instances where the department's controls over the transfer and disposal of equipment are inadequate. For example, the department's equipment records do not accurately reflect transfers and disposals. As a result of these weaknesses, the department unnecessarily spent federal and vendor trust funds, and its ability to detect lost or stolen equipment is diminished. According to the department, it intends to correct some of these weaknesses by centralizing purchasing activities, closing certain warehouses and improving its coordinating of purchases with inventory on hand.

BACKGROUND

The program provides training and employment for legally blind persons in the management of food service and vending facilities on public and private properties throughout the State. In addition, the program's staff promote and develop new vending and food service locations in public and private buildings. The vendors retain profits from the facilities they manage except for a percentage fee prescribed by law. The fee, which varies depending on vendor operations and profits, can be up to 6 percent of gross sales. The fees are placed in a vendor trust fund account and are used to maintain vendor equipment. They are matched with federal funds to establish new facilities and to purchase new and replacement equipment. For fiscal year 1988-89, the program's expenditures totaled approximately $7.5 million.

In July 1987, the department's internal auditors reported on their review of the program's internal controls over equipment. Their review disclosed several weaknesses in the control over equipment. The following are examples of weaknesses that the auditors found:

- The department made additions and changes to the equipment records without providing supporting documents;

- Equipment was not promptly marked with department identification tags;

- Equipment disposals lacked required approvals and lacked adequate supporting documentation; and

- The department did not take inventories of all equipment annually, as required by program policy, and when the inventories were taken, the department did not reconcile and adjust the equipment records.

In August 1989, the internal auditors reported on another review of the program's internal controls over equipment. During their review, the internal auditors found that the department had not corrected some of the weaknesses identified in 1987, and the department had determined that $1.2 million in equipment was missing. As a result of the weaknesses identified, the internal auditors performed a physical inventory of equipment in September 1989. The internal auditors found over 1,000 discrepancies between their inventory and the department's inventory records. In addition, the internal auditors determined that approximately $1.6 million in equipment was missing.

In response to weaknesses cited by the internal auditors, the department placed five program employees on leave in September 1989; on March 30, 1990, the department ended the employment of four of the five employees, consisting of the program chief, assistant chief, supervising business enterprise consultant, and property manager. According to records from the department, the employees were terminated because of their failure to manage, supervise, or maintain accountability for the department's equipment.

SCOPE AND METHODOLOGY

The purpose of our audit was to independently evaluate the department's internal controls over equipment used within the program. We focused our audit on the department's procedures for the purchase and use of equipment. The audit is limited in that we did not select our samples randomly and did not make statistical projections to estimate the extent of the problems we identified.

To determine whether the department adequately controlled its purchase and use of equipment, we reviewed statutes, state and federal regulations, and state and departmental policies concerning the purchase and use of equipment. In addition, we reviewed the approvals for 15 equipment purchases received between October 1989 and March 1990 and paid for between December 1, 1989, and February 28, 1990. We also reviewed the evidence that the department received the goods and services for which it paid.

To determine whether the department promptly affixed identification tags and accurately recorded newly purchased equipment, we tested 20 items of equipment purchased between December 1, 1989, and February 28, 1990. Moreover, to determine whether the department correctly processes program equipment transferred within the department, we reviewed the department's policies and procedures concerning the transfer of such equipment, and we reviewed a sample of 23 transfers that the department made between December 1, 1989, and February 28, 1990.

To determine whether the department properly disposes of worn-out equipment, we reviewed a sample of 17 of the 43 equipment disposals that the department made between October 1, 1989, and March 7, 1990. In addition, we reviewed a certain type of transfer that the department appropriately treats as a disposal. We reviewed 7 of these disposals made during the same period.

We were unable to determine the accuracy or completeness of the department's reconciliation of its equipment records to the physical inventory performed by the internal auditors in September 1989 because, as of May 24, 1990, the department had not completed the reconciliation.

Finally, to determine the extent we could rely on the work completed by the department's internal auditors, we examined, on a test basis, the documentary evidence of their work. In addition, we conducted tests of the inventory performed by the internal auditors in September 1989. Based on our tests, we were satisfied with the inventory performed by the internal auditors.

INADEQUATE CONTROL OVER THE
PURCHASE AND USE OF EQUIPMENT

Section 74.140 of Title 34 of the Code of Federal Regulations requires state agencies to have procedures (including a periodic review of the use of and need for equipment) for managing equipment until transfer, replacement, or disposal. In addition, we believe that prudent management of equipment requires that the department purchase equipment when a direct need exists and when such equipment can be placed into service within a reasonable time. According to the acting regional commissioner for the U.S. Department of Education's Rehabilitative Services Agency, a reasonable storage time should not exceed six months. Acceptable reasons for equipment storage include temporary holding awaiting final completion of a new vending facility, recovery and transfer of equipment from a closed facility to another facility, or when purchase discounts justify short-term storage costs for needed equipment.

During our review of 15 equipment purchases, representing some of the equipment received by the program between October 1, 1989, and February 28, 1990, we noted two examples where the department purchased equipment that was already available in department warehouses. In one case, the department purchased an ice cream vending machine, costing $3,900, even though the Sacramento warehouse has had the same model, still in the factory carton, in storage since July 1984. As of March 31, 1990, the ice cream vending machine was still in storage. In another case, the department purchased three refrigerators, costing a total of approximately $11,200, for use at a Los Angeles vending site. However, the department had 17 identical refrigerators, purchased in May and June 1989, in its Los Angeles warehouse. As of March 31, 1990, the 17 refrigerators were still in the warehouse. According to the department, these weaknesses occurred because the department's administrative staff were not required to coordinate purchases with the inventory on hand. In addition, the department stated that beginning in December 1989, all purchases were centralized in Sacramento. Finally, the department stated that once its equipment records are reconciled with the inventory taken by its internal auditors in September 1989, it will maintain a list of equipment that will be utilized before new equipment is purchased.

In addition, the department has stored new equipment in its warehouses for extended periods. During our review, we observed equipment stored in the Sacramento and San Diego warehouses. Some of the equipment was in original factory packaging and had been in storage for more than four years. For example, the Sacramento warehouse had four electric ovens, purchased in November 1985 for a total of $13,000, and three vending machines, purchased in July 1984 for a total of approximately $6,800. In another case, we observed five new ice makers at the San Diego warehouse, purchased in June 1989 for approximately $17,900.

As a result of these weaknesses in the purchase and use of equipment, the department unnecessarily spent at least $15,100 in federal and vendor trust funds. Furthermore, unnecessarily long storage of equipment diminishes the department's opportunity to use the equipment's warranty and delays the productive use of the equipment.

INADEQUATE CONTROL OVER THE TRANSFER AND DISPOSAL OF EQUIPMENT

Section 74.140, Title 34 of the Code of Federal Regulations requires state agencies to maintain accurate records for each item of equipment, including the location of the equipment, the date that the information was recorded, and pertinent information concerning the final disposition of equipment. In addition, the program's policies and procedures require documentation of the transfer of equipment between vending locations. These policies and procedures also require prior approval of the transfer. Finally, Section 8640 of the State Administrative Manual requires approval before disposal and requires that the equipment be disposed of without delay. Section 8640 further requires agency officials to determine why planned disposals are not completed within 30 days.

The department makes many of its transfers of equipment when it moves newly acquired equipment from a warehouse to a vending location or when it moves worn-out equipment to a warehouse before disposal. In both 1987 and 1989, the department's internal auditors cited weaknesses in the department's controls over disposals of program equipment, and in 1989, the internal auditors cited weaknesses in the controls over transfers. During our review, we also noted weaknesses in the department's controls over the transfer and disposal of program equipment. Specifically, we were unable to determine whether the department properly recorded all transfers of equipment because the department does not maintain a system, such as a numerical listing, to account for all transfers of equipment between vending locations. Also, in most cases, we could not determine whether the department approved transfers before they occurred, as required by department policy, because we found that the form used by the department to document the transfer of equipment within the program does not contain dates for the approval and transfer of the equipment.

We also found that the department's transfers of equipment were not correctly recorded. For example, for two of four vending locations and one warehouse that we reviewed, we found the following examples of incorrect recording of equipment transfers:

- A refrigerated sandwich unit was transferred between two locations on March 8, 1990; however, instead of recording the transfer, the item was deleted from the equipment records;

- A metal table was transferred to a location on March 28, 1990; however, according to the equipment records, the table was disposed of as junk in June 1987; and

- At one location, 14 (15 percent) of 95 items of equipment were not listed in the department's equipment records or were listed at another location in the records. Some of the equipment, which included commercial refrigerators and freezers with an initial total cost of more than $32,000, had been in the location for as long as three months.

We also reviewed 17 disposals, consisting of 89 items of equipment, that the department made between October 1, 1989, and March 31, 1990, and noted several errors. We found equipment that was disposed of without proper approval and that was incorrectly identified. For example, the department did not approve two disposals, representing nine items of equipment, before the disposals occurred. In addition, the department did not promptly record a February 2, 1990, disposal of six items. As of May 2, 1990, or 62 working days after disposal, the equipment was still listed in the equipment records at the vending location. In another example, the department disposed of two items that, according to the equipment records, had either been previously disposed of or were not listed in the equipment records.

As a result of these weaknesses in the controls over the transfer and disposal of equipment, the department's ability to prevent or detect lost or stolen equipment is diminished.

As noted in the background section of this report, the department terminated the program chief, assistant chief, supervising business enterprise consultant, and property manager for their inadequate management and supervision over equipment. In addition, although the reconciliation is not complete, the department is currently adjusting its equipment records to reconcile them with the equipment inventory taken by the department's internal auditors in September 1989.

CONCLUSION

The Department of Rehabilitation is not adequately managing the purchase and use of equipment used in the Business Enterprise Program. Specifically, the department purchased equipment when similar or identical equipment was available in its warehouses. In addition, equipment is not always placed into service promptly. For example, some equipment costing at least $19,700 has remained unused, in warehouse storage, for at least four years. As a result of these weaknesses, the department unnecessarily spent federal and vendor trust funds, and the department has lost the opportunity to use valuable warranty coverage.

In addition, the department does not adequately control the transfer and disposal of program equipment. Specifically, the department does not have adequate controls over the documentation and approval of transfers of equipment to vending locations within the program. In addition, the department does not always approve disposals before the disposals occur, does not always promptly record disposals or dispose of equipment, and maintains disposal records that are inaccurate. These weaknesses may prevent the detection of lost or stolen equipment.

RECOMMENDATIONS

To improve its management of the purchase and use of equipment for the Business Enterprise Program, the Department of Rehabilitation should take the following actions:

- Before purchasing needed equipment, verify that similar equipment is not available in its warehouses; and

- Reduce the equipment stored in its warehouses by putting usable equipment into service.

To improve the transfer and disposal of equipment used in the program, the department should take the following actions:

- Develop a system to identify all transfers of equipment between vending locations;

- Document the dates of approval and transfer of equipment to ensure prior approval of transfers;

- Within three days, submit documentation of the transfer of equipment between vending locations, as required by department procedures;

- Obtain prior approval for the disposal of equipment;

- Ensure that equipment records are accurate by reviewing the transfer and disposal documents for equipment and reconciling the equipment records with annual physical inventories; and

- Ensure that equipment records contain timely information by promptly recording transfer and disposal activity.

We conducted this review under the authority vested in the auditor general by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this letter.

Respectfully submitted,

Kurt Sjoberg

KURT R. SJOBERG
Acting Auditor General

The Department of Rehabilitation's response to this letter

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June 21, 1990

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Dear Mr. Sjoberg:

Secretary Allenby has asked me to respond to your recent letter (F-958) regarding your audit of the Department of Rehabilitation's control and management of equipment used for the Business Enterprise Program.

We appreciate your review of our Business Enterprise Program, although it must be recognized that the timing of the audit occurred just after the Department had itself initiated significant employee disciplinary actions and program investigations. While the Department has initiated an aggressive corrective action plan, we anticipate that it will be late 1990 before all of the necessary program controls and improvements are implemented. Indeed, as outlined below, many of the examples cited in your letter were the result of purchases and decisions made prior to Departmental improvements in the program which were subsequently made.

The following are our responses to your specific recommendations:

Control Over The Use/Purchase Of Equipment

- Before purchasing needed equipment, verify that similar equipment is not available in its warehouses.

  Response: We agree with this recommendation. As explained below, the Department intends to cease the operation of all warehouses for the BEP. In addition, all equipment purchases have been centralized into one position in Sacramento. This is a new position which was permanently established in April 1990. Once the current inventory reconciliation is completed, we will maintain a list of existing equipment which will be utilized before new equipment is purchased.

- Reduce the equipment stored in its warehouses by putting usable equipment into service.

  Response: We agree with this recommendation. The Department has already taken steps to close all BEP warehouses because this practice led to duplicate purchases. The warehouse in Oakland has already been closed. The Los Angeles warehouse will be closed in July. The Sacramento warehouse will be phased out over the next several months. The small San Diego storage room will be closed in August. Also, the Department has recently eliminated the past practice of "bulk purchasing" which often resulted in unused items being stored for long periods in warehouses.

Control Over The Transfer/Disposal Of Equipment

- Develop a system to identify all transfers of equipment between vending locations.

  Response: We agree with this recommendation. The control, recording and management of equipment has been centralized into one position in Sacramento. This person has supervised the reconciliation of the physical inventory of all of the BEP equipment completed by our internal auditors as of September 30, 1989. This reconciliation will be completed in 60 days. In addition, the disposal of BEP equipment is also being reviewed by the Business Services Section a separate division of the Department.

- Document the dates of approval and transfer of equipment to ensure prior approval of transfers.

  Response: We agree with this recommendation and will implement it. The Department has amended the existing transfer system to include numbered forms and a control log.

- Within three days, submit documentation of the transfer of equipment between vending locations, as required by Department procedures.

  Response: This procedure was instituted by the new BEP management team in September 1989. The Department estimates that approximately 10,000 property surveys, transfers, and acquisition transactions are made annually. Given the number of transactions and the newness of this system, errors will occur. However, the Department has developed a system wherein the BEP vendors will assist the Department in ensuring that transfers are documented in a timely manner.

- Obtain prior approval for the disposal of equipment.

  Response: We agree with this recommendation. We are currently getting prior approval from Property Reutilization, Department of General Services for the disposal of equipment. In addition, the Business Services Section will be on the Survey Board and approve all equipment disposals by BEP.

- Ensure that equipment records are accurate by reviewing the transfer and disposal documents for equipment and reconciling the equipment records to annual physical inventories.

  Response: We concur with this recommendation which is consistent with the new BEP management plan. Once the initial inventory reconciliation has been completed, the Department will conduct physical inventories annually.

- Ensure that equipment records contain timely information by promptly recording transfer and disposal activity.

  Response: This recommendation is in line with current written Department procedures and will be implemented.

As always, we appreciate the efforts and professionalism of your audit team. If you have any questions or require additional information, please feel free to call me at 445-3971.

Sincerely,

P. Cecie Fontanoza

P. CECIE FONTANOZA
Director

cc: Clifford L. Allenby, Secretary
Health and Welfare Agency