

STATE OF WEST VIRGINIA
SPECIAL REPORT
OF
WEST VIRGINIA DIVISION OF HIGHWAYS
ANNUAL INVENTORY OBSERVATIONS
AND
REVIEW OF INVENTORY PROCEDURES

JUNE 30, 2001



OFFICE OF THE LEGISLATIVE AUDITOR
CAPITOL BUILDING
CHARLESTON, WEST VIRGINIA 25305-0610

WEST VIRGINIA DIVISION OF HIGHWAYS
ANNUAL INVENTORY OBSERVATION
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WEST VIRGINIA DIVISION OF HIGHWAYS
ANNUAL INVENTORY OBSERVATION
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EXIT CONFERENCE

We held an exit conference on August 17, 2001 with the Business Manager of the West Virginia Division of Highways and other representatives of the West Virginia Division of Highways and all findings and recommendations contained in the Special Report on the Annual Inventory Observation and Review of Inventory Procedures were reviewed and discussed. The Division of Highways' responses are included in bold and italics in the Summary of Findings, Recommendations and Responses and after our recommendations in the General Remarks section of this Special Report.

WEST VIRGINIA LEGISLATURE
Joint Committee on Government and Finance



Theodore L. Shanklin, CPA, Director
Legislative Post Audit Division
Building 1, Room W-329
1900 Kanawha Blvd., E.

Area Code (304)
Phone: 347-4880
Fax: 347-4889

CHARLESTON, WEST VIRGINIA 25305-0610

To the Joint Committee on Government and Finance:

The objectives of the Special Report were to gain an understanding of the of West Virginia Division of Highways' Annual Inventory Observation and to review the adequacy of the inventory procedures used to conduct the Annual Inventory of Parts, Materials and Supplies. In order to achieve the objectives noted above, we performed the following:

Reviewed the West Virginia Code pertaining to the operations of the West Virginia Division of Highways (WVDOH); specifically the responsibilities of the WVDOH to account for its financial operations and safeguard its assets;

Reviewed and evaluated for adequacy the instructions dated June 1, 2001 provided to District Engineers outlining the procedures to be used to conduct the Annual Inventory of Parts, Materials and Supplies;

Reviewed and evaluated the adequacy of the audit program for the Annual Inventory of Parts, Materials and Supplies developed by the Internal Audit staff of the WVDOH ;

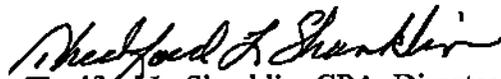
Determined the value of the Inventory of Parts, Materials and Supplies of the WVDOH as of June 19, 2001 for the purpose of assessing the number of locations where such inventories were located, as well as, the recorded value of such inventories as a means to select those locations where Post Audit Division staff would be assigned to observe the taking of the WVDOH Annual Inventory and conduct test counts to verify the degree of compliance with the instructions for taking the Annual Inventory;

Observed the Annual Inventory process at 19 different locations on Tuesday, June 26, 2001 and Wednesday, June 27, 2001. These 19 inventory locations accounted for \$8,287,331.84 of the \$32,931,530.10 in recorded inventories of the WVDOH as of June 19, 2001 and made up 25.2 % of the recorded value of the inventory of the WVDOH; and,

Conducted test counts of various inventory items observed during the taking of the WVDOH inventory and compared the results of those test counts with various inventory reports of the WVDOH designed to account for variances between the recorded number of individual inventory items and the actual physical counts of these items.

The results of our work are contained in the General Remarks Section of this Special Report.

Respectfully submitted,


Thedford L. Shanklin, CPA, Director
Legislative Post Audit Division

August 9, 2001

Auditors: Michael E. Sizemore, CPA, Supervisor
Neil M. McEachron, CPA
Stanley D. Lynch, CPA
David N. Harris, CPA
Peter J. Maruish, Jr., CPA
Thomas F. Ward, CPA
Lori A. Fischer
Erin S. Roark

WEST VIRGINIA DIVISION OF HIGHWAYS

ANNUAL INVENTORY OBSERVATION AND REVIEW OF INVENTORY PROCEDURES

INTRODUCTION

The West Virginia State Road Commission was created by the enactment of Chapter 112 during the 1921 Regular Session of the West Virginia Legislature and codified as Chapter 17, Article 2 of the West Virginia Code. The enactment of Chapter 169 during the 1995 Regular Session of the West Virginia Legislature repealed Chapter 17, Article 2 of the West Virginia Code and all references to the State Road Commission now refer to the West Virginia Division of Highways (WVDOH). The activities of the WVDOH are generally governed by the provisions of Chapter 17, Articles 1, 2A, 3, 4, and 26 of the West Virginia Code and the head of the spending unit is the Commissioner of Highways, who is appointed by the Governor with the advice and consent of the West Virginia State Senate.

The WVDOH is organized into ten Districts headquartered at various locations around the State of West Virginia, as well as, an 11 District (District 00) known as the Equipment Division which is located at Buckhannon, West Virginia. The WVDOH is responsible for 37,370 miles of public roads which includes 34,610 miles of State highway, 88 miles of the West Virginia Turnpike, 549 miles of Interstate highway, 1,736 miles of the National Highway System, 6,343 bridges, two National Scenic Byways and eight State Scenic Byways. The duties of the WVDOH include: planning; engineering, right-of-way acquisition, construction, reconstruction, traffic regulation and overall maintenance of the State's roads. Some additional duties of the WVDOH include: highway

research, outdoor advertising contiguous to State roads, roadside development, safety and weight enforcement and dissemination of highway information.

The Equipment Division is responsible for providing direct and indirect major equipment maintenance, repair, rebuild, service support, parts support, technical advice and staff assistance to 11 intermediate service support and repair shop made up of the ten District Equipment Shops and the Materials Control, Soils and Testing Division Equipment Shop. In addition, the Equipment Division has a secondary mission of providing equipment maintenance service, repair and rebuild support to other State agencies by request, as well as, the responsibility for coordinating the purchase and delivery of all vehicle fuels and lubricants for all other State agencies.

WEST VIRGINIA DIVISION OF HIGHWAYS

**ANNUAL INVENTORY OBSERVATION
AND
REVIEW OF INVENTORY PROCEDURES**

ADMINISTRATIVE OFFICERS AND STAFF

JUNE 30, 2001

Mr. Fred Vankirk, P.E. Commissioner
Mr. Jack White. Assistant Commissioner
Mr. Danny Ellis Business Manager
Mr. Bill Feazelle Director - Finance Division
Mr. James R. Wade Acting Director - Internal Auditing Section
Mr. Bob Mullins Chief - Information Services Division
Mr. Bob Andrew Director - Equipment Division

WEST VIRGINIA DIVISION OF HIGHWAYS

**ANNUAL INVENTORY OBSERVATION
AND
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SUMMARY OF FINDINGS, RECOMMENDATIONS AND RESPONSES

**Instructions Governing the Annual Inventory
of Parts, Materials and Supplies**

1. During the observation of the Annual Inventory, we noted the pre-count cards which were used to document the inventory counts done by WVDOH staff responsible for inventories at the various locations around the State, and which become the basis for the recording of the Annual Inventory balances carried forward to the subsequent fiscal year were not adequately safeguarded after the Internal Audit staff of the WVDOH had performed audit procedures designed to verify the accuracy of inventory counts during the Annual Inventory.

Auditors' Recommendation

We recommend the WVDOH take steps to adequately safeguard the pre-count cards to provide for an effective cut-off for the Annual Inventory.

Agency's Response

We disagree with the audit recommendation. (See pages 10-14)

Timing of the Annual Inventory

2. The annual inventory procedures utilized by the WVDOH displayed weaknesses which could affect the achievement of an effective cut-off for inventories. We believe

the Annual Inventory process of the WVDOH would be more effective and the possibility for recording errors would be lessened if the Annual Inventory Observation was scheduled to commence not earlier than the close of business on the last regular business day of the fiscal year.

Auditors' Recommendation

We recommend the WVDOH consider scheduling the Annual Inventory to commence not earlier than the close of business on the last regular business day of the fiscal year.

Agency's Response

Given the historical accuracy of the inventory, it is our position that the economic benefit of scheduling the inventory to minimize the use of extended work hours is warranted over any increase accuracy that could be realized by a June 30 cut off.

(See pages 14-16)

Compliance with Annual Inventory Instructions

3. During our participation in the Annual Inventory Observation, we noted instances where the instructions provided to the District Engineers to be used during the Annual Inventory were not followed consistently. We observed some items in District 2 including the following: oil, antifreeze, guardrails, as well as, guardrail posts and blocks had not been subjected to pre-count as called for in the instructions and some items of inventory were not arranged in an orderly fashion to facilitate counting.

Auditors' Recommendation

We recommend the WVDOH review the reports of their Internal Audit staff to ascertain the degree of compliance with the Annual Inventory instructions as a means

of determining those Districts and Organization Numbers which have a pattern of not complying with the Annual Inventory instructions and take steps to improve future compliance with the instructions.

Agency's Response

We believe current DOT audit follow-up procedures address this recommendation.

(See pages 17 and 18)

WEST VIRGINIA DIVISION OF HIGHWAYS

**ANNUAL INVENTORY OBSERVATION
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GENERAL REMARKS

INTRODUCTION

We have completed a Special Report of the Annual Inventory Observation and Review of Inventory Procedures of the West Virginia Division of Highways (WVDOH) as of June 30, 2001.

COMPLIANCE MATTERS

We reviewed and evaluated the adequacy of the instructions provided to District Engineers of the WVDOH outlining the procedures to be used to conduct the Annual Inventory of Parts, Materials and Supplies (Annual Inventory). We also reviewed and evaluated the adequacy of the audit program for the Annual Inventory of Parts, Materials and Supplies developed by the Internal Audit staff of the WVDOH. In addition, we reviewed applicable sections of the West Virginia Code which governed the accounting of the financial operations of the WVDOH and its responsibility to safeguard assets. Our findings are discussed below.

**Instructions Governing the Annual Inventory
of Parts, Materials and Supplies**

During our observation of the Annual Inventory, we noted the pre-count cards which were used to document the inventory counts done by WVDOH staff responsible for inventories at the various locations around the State, and which become the basis for the recording of the Annual Inventory balances carried forward to the subsequent fiscal year were not adequately safeguarded after

the Internal Audit staff of the WVDOH had performed audit procedures designed to verify the accuracy of inventory counts during the Annual Inventory. As a part of our work, we reviewed the adequacy of the instructions provided to the District Engineers of the WVDOH concerning how the Annual Inventory should be conducted and the documentation which should be retained regarding the Annual Inventory. As set forth in Section II of these instructions, the official cut-off for the Annual Inventory of the WVDOH was 4:00 p.m. on Wednesday, June 27, 2001. In addition, Section V of these instructions stated in part,

- “A. Each organization will be provided pre-count cards to develop an early count of all items listed on their respective June 19 inventory masters. The cards will be distributed by the Comptroller no earlier than June 19, 2001....

- C. The pre-count cards provide a space for the early physical count as well as spaces for the posting of receipts, transfers and usages prior to the June 27th cut-off. **Make sure entries are legible, as these cards will be used in loading of inventory into the system.**” (Emphasis added)

The actual conduct of the Annual Inventory and the observation of the inventory by the Internal Audit Staff of the WVDOH commenced at approximately 7:30 a.m. on Tuesday, June 26, 2001 which is earlier than the official cut-off date for the Annual Inventory and continued through Thursday, June 28, 2001. During this three-day period, WVDOH internal auditors were visiting locations, referred to within the WVDOH as Organization Numbers. At each location, the internal auditors would perform required procedures which included, among other things, performing test counts of inventory items and comparing those test counts to the number of items shown on the pre-count cards.

However, Post Audit Division staff assigned to observe the Annual Inventory noted the pre-count cards were not safeguarded after the internal auditors completed their work. We believe the pre-count cards are one of the most important mechanisms within the inventory system of the WVDOH for establishing proper cut-off with regard to the WVDOH Annual Inventory. As such, we believe the Internal Audit staff should have taken possession of the pre-count cards once they had completed their Annual Inventory observation procedures at a particular location and retained possession of the pre-count cards until such time as the visitations were completed within that particular district and the process of closing the inventory process through the Preliminary Variance and Final Variance analysis was ready to be performed.

Because the pre-count cards are not adequately safeguarded, the possibility exists for erroneous or improper entries to be made on the pre-count cards with respect to the receipt or usage of inventory items, after the Internal Audit staff has completed their observation procedures, but before the information from the pre-count cards is recorded in the WVDOH's inventory system known as REMIS (Remote Entry Management Information System). Any such erroneous or improper entries would negatively impact the accuracy of the Annual Inventory and impede the WVDOH from achieving an effective cut-off with regard to the Annual Inventory.

We recommend the WVDOH take steps to adequately safeguard the pre-count cards to provide for an effective cut-off for the Annual Inventory.

Agency's Response:

The Department of Transportation disagrees with this recommendation. The content of the report suggests that in order to adequately safeguard the count cards, the Internal Audit staff of the DOT should physically take possession of the count cards after sample verification.

We believe that the integrity and accuracy of the inventory is protected under the current procedure. We further believe that the opportunity for a material misstatement of the inventory on the financial statements is minimal given current audit testing, and controls inherent in the inventory process.

The inventory instructions detail procedures to be followed for usages and receipts that are incurred after the pre-counts are performed. The Internal Audit Section performs adequate testing to reasonably ensure the accuracy of this recorded information prior to accepting the final inventory of the organization.

The inventory instructions address the proper handling of the pre-count cards by the organizations involved in the inventory. During the inventory review process, the auditor verifies a statistically valid Probability Proportional to Size (PPS) sample and numerous random sample counts. The pre-count cards remain in the possession and control of the organization owning the inventory. At the completion of the data entry, the auditor compares the amount entered with the amount that had been counted by the auditor. Any differences are noted and immediately resolved. In the event of receipt or usage, the documentation supporting that receipt or usage is submitted to the auditor.

While we recognize that the possibility that erroneous or incorrect transactions could be recorded exists in any inventory system. The additional testing performed by the internal audit staff after data entry will ensure the validity of transactions that effect sampled items. The usage document required by DOT Procedures (DOT 6) provides adequate internal control over the usage of inventory and further serves to protect and support any transactions that could be entered on the pre-count cards. The DOT 6 documents are subject to review by Internal Audit during the inventory process.

Additionally, if the auditor controls the pre-count cards, any receipts or usages would be recorded with the assistance of the auditor. By not having the pre-count cards readily available, WV DOT staff may be remiss in ensuring that the balance on the card is adjusted for unanticipated receipts or usages. Therefore, control of the pre-count cards by the auditor may effectively increase the number of unrecorded transactions. Further, the independence of the auditor may be compromised by his possession of this inventory document as the auditor may be compelled to adjust the cards for receipts or usages.

Logistically this inventory is conducted in at least 86 locations (55 counties, Equipment Division, 10 District Storerooms, 10 District Equipment Shops, 10 District Sign Shops, etc.) all over the State of West Virginia. As was noted in the report, the process consumed three days. It is impractical for the auditors to control the inventory or have possession of the pre-count cards for that period.

It is our opinion that by proper compliance with the inventory instructions, verification of counts and transactions by the auditor, and the documentation of receipts and usages after auditor counts, there is sufficient control of the inventory process.

Timing of the Annual Inventory

As was noted in the prior finding entitled "Instructions Governing the Annual Inventory of Parts, Materials, and Supplies", the Annual Inventory procedures utilized by the WVDOH displayed weaknesses which could affect the achievement of an effective cut-off for inventories. Any instances where receipts or usages of inventory items are not properly recorded as having occurred in the correct fiscal year would tend to reduce the effectiveness of the WVDOH's

system of internal control and the accuracy of the WVDOH's financial reporting. The instructions provided to District Engineers indicate the importance of achieving an effective cut-off and state in Section VI:

“B. There will be no transfers, issues or receipts during the physical inventory unless an emergency need or an unexpected delivery arrives. The storerooms and any other issuing or receiving locations are to be shut down until the counting and verification have been completed....”

Although, Post Audit Division staff did not observe any requisitioning of items from inventory during the field observations which we conducted, the possibility for inventory items to be removed did exist because the Storerooms were not closed for business during the taking of the Annual Inventory. We believe the Annual Inventory process of the WVDOH would be more effective and the possibility for recording errors would be lessened if the Annual Inventory Observation was scheduled to commence not earlier than the close of business on the last regular business day of the fiscal year.

For example, using this method, the official cut-off of the Annual Inventory would have been 4:00 p.m. on Friday, June 29, 2001 rather than 4:00 p.m. on Wednesday, June 27, 2001 and the Internal Audit staff would have commenced their Annual Inventory observation procedures at that time. Effectively, any unexpected deliveries of inventory or emergency usages of inventory occurring after the close of business on the last regular business day of the fiscal year would be treated as having occurred in the subsequent fiscal year. By conducting the Annual Inventory and observation at the end of the fiscal year, rather than at an interim date close to year-end, the management of the WVDOH can eliminate many of the circumstances which can contribute to cut-off problems.

We recommend the WVDOH consider scheduling the Annual Inventory to commence not earlier than the close of business on the last regular business day of the fiscal year.

Agency's Response

The inventory instructions provide for minimal usages and receipts in the time between inventory cut-off and fiscal year end. The balance of the annual inventory that is verified is used for the financial statements. It is our opinion that the controls provided by the instructions and the historical accuracy of the perpetual inventory balances ensure that the balances represented on the financial statement are reasonably accurate and reliable at fiscal year end.

The WVDOT perpetual inventory system has been verified annually for more than 15 years. The current inventory indicated that the percentage difference between the counted balance and the book balance (variance), prior to inventory was 0.091%. The WVDOT has enjoyed variances of less than 1% for many years. This level of accuracy verifies the validity of the perpetual balances maintained by WVDOT organizations. Our Internal Audit Section has historically issued positive opinions on the perpetual inventory system.

There is a significant economic benefit realized by performing inventory verification prior to the close of business on the last day of the fiscal year. The WVDOT is saving a significant amount in overtime payments for not only the auditors, but also the other personnel involved in the inventory processes. Given, the historical accuracy of the inventory, it is our position that the economic benefit of scheduling the inventory to minimize the use of extended work hours is warranted over any increased accuracy that could be realized by a June 30 cut-off.

Compliance with Annual Inventory Instructions

Post Audit Division staff was assigned to observe the Annual Inventory in 19 different locations in Districts 00, 02, 04, 07 and 08. As a part of the observation, we noted instances where the instructions provided to the District Engineers to be followed during the Annual Inventory were not followed consistently. Specifically, Section 1 of the instructions states in part,

- “A. District/Division Comptrollers and Storekeepers will be responsible for administrating the following instructions and methods to insure uniformity and accuracy statewide.
- B. All stock must be reviewed prior to inventory to insure that it is arranged in a neat and orderly manner. Be sure that all inventory items of the same type are in the same area or bin....”

In addition, Section V of the instructions states in part,

- “A. Each organization will be provided pre-count cards to develop an early count of **all items** listed on their respective June 19 inventory masters....” (Emphasis added)

Specifically, we noted where some items in District 2 had not been subjected to the pre-count as called for in the Annual Inventory instructions. Among the items which had not been subjected to pre-count were oil, antifreeze, guardrails, and guardrail posts/blocks. In addition, some items of inventory were not arranged in an orderly manner to facilitate counting. We believe the failure to follow the portion of the Annual Inventory instructions calling for pre-counts of all items and an orderly arrangement of inventory items could lead to errors in arriving at accurate inventory counts and frustrate the effort to conduct an effective Annual Inventory.

We recommend the WVDOH review the reports of their Internal Audit staff to ascertain the degree of compliance with the Annual Inventory instructions as a means of determining

those Districts and Organization Numbers which have a pattern of not complying with the Annual Inventory instructions and take steps to improve future compliance with the instructions.

Agency's Response

We believe that the intent of this recommendation is addressed within current DOT Audit follow-up procedures. DOT Internal Auditors have historically reported that organizations with the agency have complied with the inventory instructions. The Internal Auditors would report any non-compliance that materially effects the results of the inventory. These reports are subject to the DOT's audit follow-up procedures that require that the effected organizations respond to, and document corrective action. Internal Audit would also follow-up to ensure that corrective action has taken place. There has been no pattern of non-compliance with the inventory instructions noted with any particular organization.

STATE OF WEST VIRGINIA

OFFICE OF THE LEGISLATIVE AUDITOR, TO WIT:

I, Thedford L. Shanklin, CPA, Director of the Legislative Post Audit Division, do hereby certify that the report appended hereto was made under my direction and supervision, under the provisions of the West Virginia Code, Chapter 4, Article 2, as amended, and that the same is a true and correct copy of said report.

Given under my hand this 20th day of August 2001.



Thedford L. Shanklin, CPA, Director
Legislative Post Audit Division

Copy forwarded to the Secretary of the Department of Administration to be filed as a public record. Copies forwarded to the Secretary of the Department of Transportation; Division of Highways; Governor; Attorney General; and, State Auditor.