



THE CITY OF SAN DIEGO

DATE: March 18, 2014

TO: Halla Razak, Director
Public Utilities Department

Dennis Gakunga, Director
Purchasing and Contracting Department

FROM: Eduardo Luna, CIA, CGFM, City Auditor
Office of the City Auditor

SUBJECT: Hotline Investigation Report of Public Utilities Warehouse Supply Purchases

The Office of the City Auditor received a Fraud Hotline complaint alleging that since 2011, Public Utilities Department's Wastewater Treatment and Disposal (WWTD) warehouse employees have been making excessive purchases of equipment and supplies. During the investigation of the Fraud Hotline complaint, WWTD management revealed two additional allegations. The first additional allegation involved irregularities with the purchase of batteries. WWTD management indicated that significant quantities of batteries were being purchased with City funds, but there were no inventory records of the batteries being received. The second allegation involved a vendor who stated that an employee had solicited cash and goods in exchange for receiving supply orders.

The investigation determined that certain allegations were substantiated. Supply items, including batteries, were purchased in excess of the inventory records of supply items being received. The investigation identified \$243,683 of supply item purchases for which no inventory records of the items being received were found. The investigation also verified the admissions of a vendor who stated that goods and cash were provided to a city employee to maintain a business relationship between the vendor and the City.

Background

WWTD has a central warehouse and four additional warehouses at its four major treatment and reclamation plants. These warehouse facilities support the four plants, eight pump stations, the Wastewater Collection Division, and general water operations.

During the period of 2008 through summer 2011, warehouse supplies that were purchased were paid for either by a Blanket/Open Purchase Requisition and Invoice (Form 2610), or by City procurement card (P-card). In July 2011, the City awarded cooperative procurement contracts for maintenance repair and operations supplies (MRO) to five vendors, and required City departments to purchase all MRO supplies through a MRO vendor.

The WWTD utilizes a commercial software program, EMPAC, to manage its inventory of supplies that support the plants, pump stations, and other facilities in the Public Utilities Department. EMPAC assigns a unique stock item number to each supply item. This EMPAC stock item number is different from the vendor's item number.

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Procedurally, WWTD employees who place supply orders are required to simultaneously create in EMPAC an “open purchase order” with the particular stock item number of the supply being purchased and estimated delivery date. The purchase order is “closed” by recording the entry into EMPAC when the goods are received at a warehouse. When an order is delivered to the warehouse, the receiving employee writes the EMPAC stock number on the box and places the item in a designated warehouse bin.

To place a supply item order, the WWTD facility generates an order form (Stock Issue Ticket) listing the EMPAC stock item number and quantity. When the warehouse fills an order, an invoice (Warehouse Issue Ticket) is generated listing the stock item number and quantity of a supply item shipped to the facility. EMPAC maintains a perpetual inventory of each stock item ordered, received, added to inventory, and distributed to an operating unit. EMPAC will generate a reorder report when the inventory of a stock item falls below a certain threshold.

Relevant Municipal Code and Regulations

The San Diego Municipal Code (SDMC) § 22.3203 requires the City to establish competitively awarded contracts with vendors when individual purchase transactions exceed \$5,000 and annual purchases exceed \$50,000.

The City of San Diego Administrative Regulation §95.60 (3.4) states:

Persons in the public service shall not accept money or other consideration or favors from anyone other than the City for the performance of an act which they would be required or expected to perform in the regular course of their duties. This prohibition would not normally include items such as plaques, souvenirs, or mementos of nominal value often associated with a given event. Persons shall not accept gifts, gratuities or favors of any kind which might reasonable be interpreted as an attempt to influence their actions with respect to City business.

The City’s Procurement Card Program Policies and Procedures Handbook (Revised January 2006, Chapter 7-- in force when questionable P-card transactions occurred) states:

Intentional misuse of a procurement card includes:

- Use of a card without required approval.
- Use of a card for any purpose other than official City of San Diego business.
- Use of a card by a person other than the Cardholder.
- Splitting orders into smaller portions to circumvent transaction limits.

Intentional misuse of a procurement card is considered fraud and results in immediate corrective action, including cancellation of the employee's card. Further disciplinary action can include termination from City employment and prosecution. An employee who engages in intentional misuse of a procurement card is liable for the total dollar amount of unauthorized purchases.

Investigation Results

The investigation with the assistance of WWTD staff determined that goods that are not used by any WWTD facility were ordered by warehouse staff and paid for with City funds. The investigation determined that purchases of 1,844 batteries costing \$182,201 during the period March 2008 through November 2012 were made but that these batteries were not used, requested, or received by any facility supported by the WWTD warehouse. In addition, purchases totaling \$17,448 of hydraulic hoses, valves, and other automotive-related parts were made that were not requested or received by any facility supported by the WWTD warehouse. The investigation, therefore, identified \$199,649 in purchases of goods not requested or received by any facility supported by the WWTD warehouse.

The investigation noted material internal control weaknesses in the purchasing procedures that contributed to the purchase of supply items that were not used, requested, or accounted for.

- The inventory management system (EMPAC) does not have a bridge to accounts payable records and there is no normal procedure to reconcile the EMPAC inventory with accounts payable records. Invoices and forms completed by the purchasing employee provided to the supervisor for approval did not include EMPAC stock item numbers. The supervisor had no verification that the item being purchased was entered into EMPAC.
- A lack of separation of duties existed with the ordering, receiving, and paying for supply items. The same warehouse employee could place an order with a vendor, receive the order and sign the proof of delivery document, and pay or authorize payment of the vendor invoice.
- Approvals to exceed single-transaction dollar limits, set by the Procurement Specialist, on Citywide Blanket Purchase Orders were routinely granted by the Purchasing and Contracting Department for WWTD warehouse supply item purchases without justification from WWTD as to why it was necessary to exceed the dollar limit.

The investigation, with assistance from WWTD staff, also determined that purchases of supply items that were requested and used by the facilities supported by the WWTD warehouse were only partially or never delivered to WWTD. The investigation identified \$44,034 of invoices paid with no corresponding EMPAC entry to put these items into supply inventory. The investigation noted material internal control weaknesses in the purchasing procedures that contributed to the purchase of supply items utilized, but unaccounted for, by the facilities supported by the WWTD warehouse.

- Violations of San Diego Municipal Code (SDMC) §22.3203 were found with FY2011 and FY2012 P-card purchases. In FY2011, purchases from three vendors and in FY2012 purchases from two vendors exceeded the \$50,000 limit without a competitively awarded contract.
- P-card transactions of likely supply items were split to stay under the \$5,000 transaction limit set by San Diego Municipal Code (SDMC) §22.3203 without being competitively awarded.

- EMPAC open purchase orders were not simultaneously created in EMPAC when an order was placed with a vendor. Instead, when the supply items were delivered, the employee who received the supplies created an EMPAC purchase order based on the quantity of goods received, and not the quantity of goods ordered and invoiced by the vendor.
- General adjustments or physical count adjustments were made in EMPAC without any reconciliation procedures to attempt to identify the reason for the inventory imbalance.
- For supply purchases made by the WWTD warehouse through the MRO contract, the vendor would send the invoice to Public Utilities Business & Support Services (BSS). BSS would then send the invoice to WWTD to verify the supplies were received. WWTD staff would make the goods received entries without verifying that the supplies were, in fact, received.

Purchases of \$682,877 were made from a vendor (Vendor #1) by Citywide Blanket Purchase Order (CBPO), P-card, and MRO contract transactions during fiscal years 2009 through 2013. P-card purchases from Vendor #1 in FY 2011 (\$180,533) and 2012 (\$65,641) exceeded the \$50,000 threshold that the Municipal Code requires for competitive awards.

Vendor Issues

The investigation determined that a WWTD employee received cash and goods from a vendor (Vendor #2). This vendor was one of the two vendors who in FY2011 and FY2012 did more business with WWTD than is allowed by the Municipal Code. The vendor admitted that two generators and cash were provided to a City employee following the employee's solicitation to "take care of him/her" in order to keep WWTD warehouse business.

Also, Vendor #1 referenced above refused to cooperate in the investigation and did not provide documentation supporting deliveries of supply items purchased to a WWTD warehouse.

Conclusions and Recommendations

The investigation determined the allegations that excessive purchases of equipment and supplies were being made was substantiated.

The investigation identified \$243,683 of supply item purchases for which no inventory records of the items being received were found. The investigation also identified issues related to two City vendors. Therefore, based on the observations made during the investigation of this complaint, we make the following recommendations:

1. The Public Utilities Department should conduct and complete the on-going formal Fact-finding investigations to provide the documentation and support for disciplinary action, if warranted, for the "unaccounted for" inventory and payments received by a City employee.
2. The Public Utilities Department should revise WWTD warehouse inventory management procedures to ensure:

- EMPAC stock item numbers appear on every vendor invoice and invoices are reconciled to EMPAC records.
 - EMPAC Open Purchase Orders (POs) are immediately created when an order is placed with a vendor.

 - Accounts Payable transactions are periodically reconciled to EMPAC inventory records and discrepancies are researched.

 - Proper segregation of duties between ordering, receiving, and authorizing payment for supplies is maintained.

 - The receiving of supply orders are properly verified.

 - Transactions that require competitive awards are in compliance with the San Diego Municipal Code and Procurement Card Handbook.
3. The Public Utilities Department should refer the vendor issues regarding Vendor #1 and Vendor #2 to the Purchasing and Contracting Department to determine if debarment is appropriate.
4. The Purchasing and Contracting Department should:
- Act on the referral from the Public Utilities Department for debarment of Vendor #1 and Vendor #2.

 - Complete a thorough review of Citywide transactions conducted by Vendor #1 and Vendor #2 to determine if there are any additional transaction irregularities with other City Departments.

Referral to San Diego Police Department

The results of the Fraud Hotline investigation were referred to the San Diego Police Department for their evaluation and appropriate action.

Fraud Hotline Confidentiality Requirements

This investigation was conducted under the authority of California Government Code §53087.6 which states, beginning at §(e)(2):

Any investigative audit conducted pursuant to this subdivision shall be kept confidential, except to issue any report of an investigation that has been substantiated, or to release any findings resulting from a completed investigation that are deemed necessary to serve the interests of the public. In any event, the identity of the individual or individuals reporting the improper government activity, and the subject employee or employees shall be kept confidential.

(3) Notwithstanding paragraph (2), the auditor or controller may provide a copy of a substantiated audit report that includes the identities of the subject employee or employees and other pertinent information concerning the

investigation to the appropriate appointing authority for disciplinary purposes. The substantiated audit report, any subsequent investigatory materials or information, and the disposition of any resulting disciplinary proceedings are subject to the confidentiality provisions of applicable local, state, and federal statutes, rules, and regulations.

Public Utilities Department Response

The Public Utilities Department (Department) accepts the recommendations set forth within this report with some clarifications noted below. The Department's responses to the specific recommendations are as follows:

Clarification of WWTD Warehouse Staff Involvement

The Department initiated an independent investigation in July 2012 upon warehouse management's discovery of questionable warehouse purchases made or orchestrated by a single warehouse employee of a certain type of automotive battery not used in the Department. Upon further investigation, the Department received information from a vendor that this same warehouse employee asked the vendor for goods and cash in order to maintain a business relationship with the warehouse.

Recommendation #1

The Public Utilities Department should conduct and complete the on-going formal Fact-finding investigations to provide the documentation and support for disciplinary action, if warranted, for the "unaccounted for" inventory and payments received by a City employee.

The Department agrees with the Recommendation and convened a Fact-Finding Investigation panel on February 1, 2013.

Recommendation #2

The Public Utilities Department should revise WWTD warehouse inventory management procedures to ensure:

- a) EMPAC stock item numbers appear on every vendor invoice and invoices are reconciled to EMPAC records.*
- b) EMPAC Open Purchase Orders (POs) are immediately created when an order is placed with a vendor.*
- c) Accounts Payable transactions are periodically reconciled to EMPAC inventory records and discrepancies are researched.*
- d) Proper segregation of duties between ordering, receiving, and authorizing payment for supplies is maintained.*
- e) The receiving of supply orders are properly verified.*
- f) Transactions that require competitive bids are in compliance with the San Diego Municipal Code and Procurement Card Handbook.*

The Department agrees with the recommendations, as detailed below:

- a) *We have requested that all vendors provide EMPAC stock item numbers on their invoices as of October 2012. A new procedure and filing system was created to track all purchases made by warehouse staff. The system and procedures require reconciling all invoices to EMPAC records.*
- b) *The Warehouse Policies and Procedures Manual was updated July 2012 to reinforce the existing expected practice of creating EMPAC Purchase Orders immediately when orders for stock items are placed. Senior Warehouse Supervision is randomly verifying compliance.*
- c) *The Department has an internal Vendor Invoice Tracking System (VITS). In FY 14, the Senior Warehouse Supervisor became the alternative VITS approver and is therefore notified of all warehouse invoices that are ready for approval. The Senior Warehouse Supervisor periodically compares invoices to EMPAC records after receiving this notice and especially focuses on high dollar and high volume purchases. Any discrepancies discovered by the Senior Warehouse Supervisor are researched and resolved. Questionable purchases are brought to the attention of the Division Director.*
- d) *The proper segregation of duties between ordering, receiving, and authorizing payment for supplies is being accomplished wherever possible. At facilities where a single person is responsible for ordering, receiving, and authoring payment, we have controls in place as described in c) above to detect if improper purchases are being made. Additionally, warehouse personnel are rotated on an unscheduled basis to assist or operate another warehouse which provides opportunities for separation of ordering, receiving, and authorizing payment.*

It should be noted that a new procedure was implemented that all credit card purchases require approval from supervision prior to staff making the purchase.

- e) *The procedure of properly verifying received supply orders is in the Warehouse Policies and Procedures Manual. Emphasis has been placed on this requirement with warehouse employees at scheduled group meetings.*

Internal procedures described in a) and c) above also verify receipt of supply orders.

- f) *Detailed and frequent training on existing and new procedures for the procurement of materials, whether using the procurement card or through a purchase order, was initiated January 2013 and has continued on a regular basis. To ensure procedures and information is easily accessible to all warehouse staff, a specific community file has been created in the Department's computer files.*
3. *The Public Utilities Department should refer the vendor issues regarding Vendor #1 and Vendor #2 to the Purchasing and Contracting Department to determine if debarment is appropriate.*

The Department agrees with this finding and will turn over all files accordingly.

Purchasing and Contracting Response

Recommendation 4: (bullet #1)

Act on the referral from the Public Utilities Department for debarment of Vendor #1 and Vendor #2.

Purchasing & Contracting Response:

Purchasing and Contracting (P&C) will work with the Public Utilities Department, and the Office of the City Attorney to determine if consideration should be given to pursue debarment action for Vendor #1 and Vendor #2 based on evidence presented and reviewed by the Hotline Investigation Internal Audit and Administrative Fact Finding team.

Recommendation 4: (bullet #2)

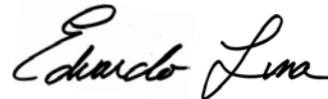
Complete a thorough review of Citywide transactions conducted by Vendor #1 and Vendor #2 to determine if there are any additional transaction irregularities with other City Departments.

Purchasing & Contracting Response:

Purchasing and Contracting (P&C) will complete a thorough review of Citywide transactions conducted by Vendor #1 and Vendor #2 to determine if there are any additional transaction irregularities with other City Departments. P&C will work with related City Departments and the Office of the City Attorney where appropriate to immediately address any irregularities.

We appreciate all of the assistance we received from Public Utilities and Purchasing and Contracting staff during our investigation. Thank you.

Respectfully submitted,



Eduardo Luna
City Auditor

cc: Honorable Mayor Kevin Faulconer
Honorable Members of the City Council
Honorable Members of the Audit Committee
Scott Chadwick, Chief Operating Officer
Stacey LoMedico, Assistant Chief Operating Officer
Rolando Charvel, Interim City Comptroller
Jan Goldsmith, City Attorney
Andrea Tevlin, Independent Budget Analyst