Review of Unique Supplies, A Working Capital Fund Activity (A-12-91-00010)

To
Kevin E. Moley
Assistant Secretary for Management and Budget

DEPARTMENT OF HEALTH & HUMAN SERVICES
Office of Inspector General

Memorandum

Richard P. Kusserow
Inspector General

Date
OCT 28 1991

Subject
Review of Unique Supplies, A Working Capital Fund Activity (A-12-91-00010)

The attached final report presents the results of our Review of Unique Supplies, A Working Capital Fund (WCF) Activity.

We found that Unique Supplies is having and will continue to have problems in recovering costs unless significant changes in operations are instituted. The activity has shown losses of $51,308, $205,428, and $94,744 in Fiscal Years (FY) 1989, 1990 and mid-year 1991 respectively.

Unique Supplies became a part of the WCF in FY 1989. The WCF charter mandates that each activity operate in a manner that all costs are recovered. Our review focused on the conditions that are causing the continuous losses in Unique Supplies operations. We determined the losses were caused by selling the majority of products at or below cost thereby failing to recover costs and overhead. We also found inventory control was inadequate because valuations of items were not current and internal controls should be strengthened.

In response to our draft report, the Assistant Secretary for Management and Budget (ASMB) agreed with the conclusions and recommendations. The ASMB has directed efforts to reduce Unique Supplies' costs and implement corrective actions in line with our recommendations. The response is attached to the report as Appendix A.

Please advise us regarding the status of corrective actions on our findings and recommendations within the next 60 days. If you have any questions, please call me or have your staff contact John A. Ferris, Assistant Inspector General for Human, Family and Departmental Services Audits, at (202) 619-1175.

Attachment
Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

REVIEW OF UNIQUE SUPPLIES, A WORKING CAPITAL FUND ACTIVITY

Richard P. Kusserow
INSPECTOR GENERAL

CIN: A-12-91-00010
This final report presents the results of our review of Unique Supplies, A Working Capital Fund (WCF) activity. We found that Unique Supplies is having and will continue to have problems in recovering costs unless significant changes in operations are instituted. The Unique Supplies operations for Fiscal Year (FY) 1990 showed a loss of $205,428; with total revenue of only $241,246. A loss of $51,308 was reported in FY 1989. The current mid-year operations as of March 31, 1991 reflect a $94,744 loss; a trend that could match the FY 1990 loss. In preparing WCF financial statements, losses of Unique Supplies are offset against profits of other activities.

Unique Supplies is selling approximately one-third of its inventory items at less than what it pays for them. The markup on the remaining products is not sufficient to recover operational expenses. We identified several factors that contributed to this situation. First, Unique Supplies lacked an adequate system to value and manage inventory. Further, due to the requirement that Unique Supplies staff obtain approval from the WCF Board of Governors before increasing prices, the staff is restricted from operating Unique Supplies in a business-like manner designed to break even. The WCF management has reviewed the Unique Supplies operations and proposed changes which could improve Unique Supplies financial position if adopted by the WCF Board of Governors. For example, the WCF management's price changes would significantly increase prices associated with some products.

The WCF staff was able to determine costs of items, overhead rates, and prices for many products sold by Unique Supplies through an extensive review effort; however, Unique Supplies lacks a real time financial...
management system that would provide necessary management data to enable it to operate on a continuous-basis, as a going concern. We believe the Department needs to: (1) allow Unique Supplies management to adjust prices to cover direct costs, and (2) strengthen internal controls and ensure that Unique Supplies has an adequate inventory control system.

INTRODUCTION

Background

Unique Supplies became part of the WCF in FY 1989. The WCF manager is responsible for fund management related to the activity; however, the Office of Management and Acquisition, Division of Administrative Services (DAS), Material Management Branch provides day-to-day operational management. Unique Supplies has the mission of purchasing, storing and distributing customized items for the Department including letterhead, envelopes, emblems, plaques, and nonstandard Government forms. Approximately one full-time equivalent position is devoted to Unique Supplies operations.

Our follow-up review of the WCF in FY 1990 disclosed that since Unique Supplies entered the WCF, it has not been able to provide routine financial data for development of timely WCF financial statements. During our follow-up, we noted that Unique Supplies was unable to accurately control the inventory on hand or provide timely valuation for that inventory. As a result, the WCF manager had difficulty determining Unique Supplies' cost of goods sold and the results of operations in order to prepare the WCF annual financial statements.

Objective, Scope, and Methodology

The objective of this review was to determine why Unique Supplies continues to lose money. We also assessed the causes for untimely development of financial management data. The review was conducted in accordance with generally accepted Government auditing standards.

Our work was performed in Washington, D.C. and observations were made at warehouse facilities in Landover, Maryland, between February and May 1991.
To accomplish our objective we assessed relevant internal controls, collected and analyzed documents related to the inventory control process, inventory valuation procedures, and item pricing techniques. Additionally, we assessed the effectiveness of Unique Supplies management systems to develop information needed by management within the organization and the WCF. In addition, we interviewed WCF, Unique Supplies, and DAS staff. For the items we tested, we found no instances of noncompliance with applicable laws and regulations. With respect to those items not tested, nothing came to our attention to cause us to believe that untested items were not in compliance with applicable laws and regulations.

RESULTS OF THE REVIEW

Unique Supplies should break even over time or be on a schedule to recover costs as they are incurred. Since joining the WCF, it has consistently lost money each year. We determined the losses were caused by selling the majority of products at or below cost, thereby failing to recover costs and overhead. Inventory control was inadequate because valuations of items were not current and internal controls needed strengthening.

Item Pricing

Many of Unique Supplies' products are being sold at less than cost. For example, we identified 59 of 163 (36 percent) items from a listing of forms that were priced below their purchased cost. Unique Supplies is currently using pre-FY 1989 prices. These prices are outdated and do not reflect costs of the items in the inventory.

In a memorandum dated August 24, 1990, Unique Supplies requested the WCF Board of Governors' approval of a 20 percent across-the-board price increase. Price changes need to be approved by the WCF Board of Governors in accordance with the WCF charter. The Board directed Unique Supplies to better justify the individual price increases. At the close of our field work, Unique Supplies had not presented an improved request with an analysis of the costs. We determined several areas that hampered Unique Supplies' analysis: 1) the staff was unable to extract necessary data as a direct result of late billings from vendors (contracted printers, Government Printing Office (GPO) and Reprographics), 2) no physical inventories had been taken at the
warehouse facility, 3) cost of goods sold was unknown and 4) there was no basis for costing inventory.

Our analysis of new price proposals shows that the 20 percent increase requested by Unique Supplies would have fallen far short of recovering costs based on FY 1990 operations. Revenue generated totaled $241,246 while operating costs totaled $446,675 for a loss of $205,429. Had the 20 percent across-the-board increase been in effect, revenues would have totaled $289,495 and the resulting loss would have been reduced to $157,180 for the year. These annual losses are absorbed by the retained earnings account of the WCF which is set aside for accrued annual leave, replacement costs of equipment and other designated items.

Additionally, the prices do not recover the total costs of operations of Unique Supplies as mandated in the WCF charter because the current price list does not include administrative or indirect operating costs. We traced an order for Form 564s (Administrative Time and Leave Record). These forms are routinely used by the Operating Divisions (illustrated in the graph on Page 5). The GPO recently produced and sold this form to the Department for $7.03 per hundred. Additional Reprographics (REPRO) costs before Unique Supplies received the forms amounted to $2.58 per hundred; for a total cost of $9.61 per hundred. We noted that Unique Supplies was selling Form 564s in accordance with the FY 1989 price list for $3.60 per hundred.

We found the WCF staff performed an extensive analysis in 1990 that determined the actual cost of resale items and developed a price change proposal that would reflect both administrative and indirect costs. For example, the WCF staff estimated that to recover direct administrative, and indirect operating costs related to Form 564, they should be sold for $14.60 per hundred. Based on the WCF staff analysis, Unique Supplies is losing $11.00 on every hundred Form 564s it sells. The WCF price change proposals, however, had not at the time of our field work been accepted by Unique Supplies or DAS and forwarded for presentation to the WCF Board of Governors for approval.
Inventory Valuation

Unique Supplies had not included the value of inventory items received from vendors but not yet billed. We found Unique Supplies routinely received vendor invoices from GPO 6 months to a year after receipt of merchandise, while the quantity received was added into the inventory, the cost of the merchandise was not added to the inventory valuation at that time. As a result, the value of inventory on hand was understated and, accordingly, the per unit cost was understated.

The WCF staff went through the process of assembling the cost of inventory data for Unique Supplies; however, the task should actually have been performed by the activity operational management group. The same data that WCF management used for analysis is also available to DAS and this data should have been assembled by DAS.
**Internal Controls**

We found controls over authorization of purchase orders were sufficient and safeguarding of assets was adequate. However, little attention was being paid to the separation of duties in receiving, recording and distributing stock. Although we found no instances of material weaknesses, any employee assigned to Unique Supplies can routinely pull from stock items, distribute items to the customer and record the transaction. Separation of duties is needed to provide a better check and balance system over daily operations. Additionally, Unique Supplies has been using a Department of Agriculture (USDA) controlled warehouse in Maryland to store inventory. The USDA generated distribution or sales data from the warehouse, and receipt of new inventory data was invariably late. We found that the sales data for the months of August and September 1990 were not received by the Unique Supplies staff until February 1991. This is a problem beyond the control of the Unique Supplies or DAS. Accordingly, accurate sales data for FY 1990 financial statement purposes was not available for inclusion in the income statement.

The Unique Supplies' inability to accurately value inventory, coupled with delayed reporting by the warehouse, and outdated price lists are symptoms of weak internal controls. A lack of strong controls could subject Unique Supplies resources to waste or abuse. We believe this area requires continued management oversight to minimize the potential for loss or abuse.

Unique Supplies' management is presently undertaking a feasibility study regarding switching to distribution of bulk forms from the GPO or printing contractors directly to customers. Under the proposed system the customer would be charged when placing the order or shipment. This method would also eliminate the need for a $25,000 annual warehousing rental fee and may create major changes in the operations of Unique Supplies. Unique Supplies notified the USDA by memorandum dated March 29, 1991 of their intention to discontinue using the warehouse facilities as of September 30, 1991.

**CONCLUSIONS AND RECOMMENDATIONS**

Unique Supplies is not operating as an effective going concern because it is not employing adequate inventory
valuation techniques and is selling approximately one-third of its inventory below cost. The use of pre-FY 1989 prices and the lack of an adequate process for appropriately valuing inventory contribute to the losses Unique Supplies is encountering. In order to perform routine analysis necessary to assess economic alternatives, financial management data must be sound; and Unique Supplies' inventory valuation methods should be current. The management of Unique Supplies has not applied sufficient effort to provide for recording the value of supplies received, controlling and handling of inventory and recording of shipments and sales for timely inclusion into the financial statements.

We recommend that the Assistant Secretary for Management and Budget (ASMB) direct the management of Unique Supplies in coordination with the WCF manager to:

- Implement a price list which will cover operational costs and result in Unique Supplies breaking even in FY 1992.

- Operate an inventory system which provides timely recording of the valuation of all items. Unique Supplies should contact vendors to determine costs. If obtaining accurate cost data is impractical, then the inventory received by Unique Supplies without an invoice should be entered at estimated cost.

We recommend that ASMB have DAS:

- Strengthen internal controls and include Unique Supplies as a part of its internal control reviews under the Federal Managers' Financial Integrity Act (FMFIA) program.

We further recommend that the ASMB as Chairman of the Board of Governors:

- Authorize Unique Supplies to adjust prices based on costs to purchase inventory items, but retain control of the percentage of overhead Unique Supplies can add to prices.
ASMB RESPONSES AND OIG COMMENTS

The ASMB concurred with the findings in our draft report and initiated corrective measures. These included having Unique Supplies submit a new price list to the WCF Board. The new price list has been approved. Presently, Unique Supplies is making changes in its method of handling inventory. The new system will track stock on hand, prepare computerized reorder notices, show the current value of the inventory and provide other inventory control and financial information. The ASMB believes these changes should make a more economical and effective operation. The ASMB staff are also planning for Unique Supplies to implement in FY 1992 organizational and procedural changes to strengthen internal controls. The ASMB is considering our recommendation to include Unique Supplies under the FMFIA program and perform necessary reviews.

Please advise us of the status of corrective actions on our findings and recommendations within the next 60 days. If you have any questions, please call me or have your staff contact John A. Ferris, Assistant Inspector General for Human, Family and Departmental Services Audits, at (202) 619-1175.
DATE : SEP 27 1991

MEMORANDUM- TO: Richard P. Kusserow
                        Inspector General
                        General

FROM: Kevin E. Moley
       Assistant Secretary for Management and Budget


We have reviewed your draft report on Unique Supplies and agree with its conclusions and recommendations. In fact, we have already taken measures to respond to your recommendations.

Regarding cost concerns, on July 18, 1991, the Working Capital Fund (WCF) Board of Governors approved a new price list for Unique Supplies. We are confident these revised prices, based upon an earlier analysis by the WCF Manager's staff, will make Unique Supplies more self sustaining and we will continue to monitor our prices to ensure that they are sufficient to recover costs.

In addition, we are taking steps to reduce costs. We notified the Department of Agriculture that we intend to terminate our participation in the Consolidated Forms and Publication Warehouse in Landover, Maryland, effective September 30, 1991. We are currently inventorying the forms which were returned from the Landover warehouse and entering the data into a microcomputer based inventory system. This new system will provide stock on hand, computerized reorder notices, the current value of the inventory and other inventory control and financial information; all of these factors should permit us to operate in a more cost effective manner. Implementation of this new inventory system is receiving top priority.

Early in FY 1992, we plan to implement organizational and procedural changes to strengthen internal controls, and we are currently reviewing your recommendation to include Unique Supplies under the Federal Manager's Financial Integrity Act program. We are also analyzing new alternative service delivery methods, and pricing policies to determine the most efficient and effective method of delivering and pricing the products of Unique Supplies. We will present to the WCF Board of Governors, for approval, any changes which result from this analysis.
We believe that progress has been made to alleviate problem areas detailed in your draft report and we will continue to strive to provide efficient and cost effective service to our customers.