REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

A REVIEW OF THE INDEPENDENT AUDITS PERFORMED ON THE SAN DIEGO UNIFIED PORT DISTRICT

F-916 **SEPTEMBER 1989**

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Acting Auditor General

September 5, 1989 F-916

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

Dear Mr. Chairman and Members:

In June 1987, the San Diego Unified Port District (port) discovered an alleged fraudulent purchasing scheme. We reviewed selected portions of audit work supporting the annual independent audits for the port to determine why the independent auditors hired by the port did not detect this alleged scheme. The auditors were required to conduct their audits of the port in accordance with generally accepted auditing standards. However, audits governed by these standards would not necessarily disclose all errors and irregularities. Although the auditors did not detect the alleged fraudulent purchasing scheme, we saw nothing in the audit workpapers supporting the financial audits indicating that the auditors did not comply with generally accepted auditing standards.

At the request of the Board of Commissioners, the independent auditors also made a special investigation of the port's purchasing activities in 1984. This investigation focused on expenditures related to the supplier later implicated in the fraudulent purchasing scheme. According to their report, the auditors found no irregularities during their special investigation. We were not able to review the related workpapers because the independent auditors had destroyed them in accordance with their firm's policy on retention of workpapers.

After the 1987 discovery of the alleged fraudulent purchasing scheme, the auditors made various recommendations, resulting from annual audits for fiscal years 1986-87 and 1987-88. The Attachment to this letter presents those recommendations that appear to be related to the alleged purchasing irregularities and also presents the port management's comments on those recommendations. The port's comments about these recommendations indicate that port management believes many of the actions had been taken before the recommendations were made.

Background

The San Diego Unified Port District Act of 1962 created the port to promote commerce, navigation, fisheries, and recreation within the area. This legislation authorized the port to acquire, construct, maintain, operate, develop, and regulate harbor works and improvements. The jurisdiction of the port includes rail, water, and air terminal facilities, as well as the tidelands and lands lying under the San Diego Bay.

The port is an autonomous public agency governed by the seven-member Board of Commissioners, which appoints an executive director as its chief administrator. The port prepares and controls its own budget and administers and controls its fiscal activities. It is also responsible for all port construction and operations under the policy direction of the Board of Commissioners.

At June 30, 1988, the port's assets exceeded $425 million, its annual revenues were nearly $84 million, and its annual expenses were approximately $40 million.

Alleged Purchasing Irregularities at the Port

In June 1987, following the port's discovery of the alleged fraudulent purchasing scheme, the Office of the District Attorney for the County of San Diego (district attorney's office) assigned staff to investigate the theft of money from the port. In December 1988, a former port employee pleaded "guilty" to grand theft from the port. The grand theft charge indicated that, with the help of one of the port employees later charged in the case, the former employee obtained materials and the installation of a residential patio at the port's expense. In January 1989, the district attorney's office filed criminal charges against four individuals: two employees of the port, including the director of purchasing, and two employees of a store that supplied goods to the port (supplier). Additionally, in February and June 1989, the district attorney's office filed criminal charges against two more individuals: an employee of the port and an individual who had previously provided computer consulting services to the port for a fee. In June 1989, the employee of the port charged in February 1989 pleaded "no contest" to the charges filed against him. As of July 1989, the remaining five cases were proceeding through the legal process. We do not know whether other individuals will be charged with related crimes.

According to the declarations of the district attorney's office that were issued to support the arrest warrants, the port discovered the fraudulent purchasing scheme in June 1987 when it noted that port records indicated certain individuals had illegally obtained goods and services paid for by the port during the previous two years. The fraudulent purchases were allegedly made through an open purchase order the port maintained with a supplier for normally ordered automotive-related items. The declarations of the district attorney's office stated that port employees investigating the matter identified various irregularities in documents related to purchases made through the supplier. These irregularities indicated that documents had been altered and forged.

According to the declarations, an investigator in the district attorney's office also talked to a number of port employees. These employees told him that one of the port employees being prosecuted gave them goods for personal use or explained how to obtain goods for personal use free of cost to them from other vendors. The goods included computers, videocassette recorders, tires, and furniture. According to an employee of the supplier, the supplier paid other vendors for goods and services not normally handled by the supplier and billed the cost of those items to the port on the supplier's invoices. The supplier's employee indicated that the supplier billed the port for these transactions by splitting invoices so that no invoice exceeded $250. This was apparently done to circumvent review by the port's director of finance before payment. The port had procedures requiring the port's director of finance to approve items that cost more than $250. The declarations further stated that a review of the supplier's documents showed that, on goods obtained from other vendors, the supplier added a 67 percent markup, approximately, to each vendor's invoices before billing the port.

The investigator also reported that a port employee provided information to one of the supplier's employees on the low bid responses to the port's requests for bids. This allowed the supplier to submit the lowest bid to the port. The supplier would then purchase the item sought by the port from the legitimate lowest bidder and resell it to the port for at or even below the cost the supplier had paid the lowest bidder. The supplier would then recover from the port, through split invoices of less than $250, the price the supplier had paid for the item, plus a 67 percent markup.

The declarations indicate that the port was fraudulently billed for "hundreds of thousands of dollars." According to a footnote in the port's audited financial statements for 1987-88, the port spent approximately $1.4 million with the supplier on open purchase orders over the two-year period during which the fraudulent purchasing scheme was believed to have occurred.

Scope and Methodology

The purpose of our review was to study the independent audits of the port to determine why the alleged purchasing irregularities were not detected by the independent auditors hired by the port. We also reviewed declarations that the district attorney's office issued in support of various arrest warrants. Additionally, we interviewed various employees of the port. Further, we met with the independent auditors and considered their comments.

Although we did not review the port's records, we reviewed audit work related to the port's purchasing activities. We first reviewed the audit work for fiscal years 1984-85 and 1985-86. We then reviewed the audit work for 1986-87 and 1987-88 to determine how the scope of the audit work may have changed after the port discovered the purchasing irregularities. We were unable to review the workpapers related to a special investigation of the port's purchasing activities conducted by the auditors in 1984. The auditors informed us that they had previously destroyed the workpapers in accordance with their firm's requirements relating to workpapers.

To summarize recommendations for corrective action at the port, we reviewed the management letters issued by the independent auditors for the port for fiscal years 1985-86, 1986-87, and 1987-88. (The auditors informed us that they did not issue a management letter for 1984-85.) We also requested that the management of the port indicate actions the port has taken in response to the recommendations.

Financial Audits of the Port

Section 52 of the San Diego Unified Port District Act requires that the port be audited annually in accordance with generally accepted auditing standards by independent certified public accountants. The purpose of the audit is to express an opinion on the port's financial statements. As part of the audit, the auditors are required to study and evaluate the port's system of internal accounting control. Although the auditors review internal accounting controls, such as controls over

purchasing, the study and evaluation is more limited than would be necessary if the auditors were expressing an opinion on the system of internal accounting control. The purpose of the study and evaluation as part of an audit of the financial statements is only to determine the nature, timing, and extent of auditing procedures. Because the study and evaluation is limited, the auditors would not necessarily identify all material weaknesses in the system.

Of the four years of audit work that we reviewed, only the audit work for fiscal years 1984-85 and 1985-86 audits were performed before the port discovered the alleged purchasing irregularities. As part of those audits, the auditors reviewed internal controls over the port's purchasing and tested 20 payments for each fiscal year to determine whether the controls were in place. Although the auditors' random selection process allowed all payments an equal opportunity to be selected, none of the payments tested were transactions with the supplier who was subsequently implicated in the alleged fraudulent purchasing scheme. The auditors did not make recommendations in the management letter for fiscal year 1985-86 that related to purchasing.

The auditors used a similar approach to testing the port's controls over purchasing for fiscal years 1986-87 and 1987-88, after the discovery of the alleged purchasing irregularities. However, in fiscal year 1986-87, the auditors tested 30 payments instead of 20 payments. In fiscal year 1987-88, the auditors further increased their sample size to 40 payments. The auditors increased this sample size because they tested controls over payments before the end of the fiscal year. (Under the auditors' methodology for selecting sample size, the auditors assigned a higher risk factor for tests conducted before the end of the fiscal year. An increase in risk factor results in an increase in sample size because the auditors would need to review more items to satisfy themselves that they have compensated for the increased risk.) Although the auditors increased the sample size, no payments happened to be selected that related to the supplier implicated in the fraudulent purchasing scheme. The auditors made recommendations to strengthen controls over purchasing in 1986-87 and 1987-88. These recommendations are included in the Attachment to this letter.

The Workpapers Supporting Recent Financial Audits Indicate That the Auditors Complied With Generally Accepted Auditing Standards

Generally accepted auditing standards require auditors to search for errors or irregularities that would have a material effect on the financial statements and to exercise due skill and care in the conduct of that examination. The standards further provide that the search for material errors and irregularities ordinarily is accomplished by the performance of those auditing procedures that, in the auditor's judgment, are appropriate to form an opinion on the financial statements; extended auditing procedures are required only if the auditor's examination indicates that material errors or irregularities may exist.

Generally accepted accounting principles define materiality as a misstatement of a magnitude that would affect the judgment of a reasonable person relying on the information. The footnotes to the port's audited financial statements for 1986-87 and 1987-88 reported that the port's management believed the ultimate disposition of the investigation by the district attorney's office would not have a material adverse effect on the business or financial position of the port. Clearly, the independent auditors agreed since they did not qualify their opinions on the financial statements for these years because of the alleged purchasing irregularities. A qualified opinion states that "except for" the effects of the matter to which the qualification relates, the financial statements are presented fairly in conformity with generally accepted accounting principles.

Further, generally accepted auditing standards state that the risk that material errors or irregularities will not be detected is increased by the possibility of collusion or forgery. Certain acts, such as collusion between personnel and third parties or among management or employees, may result in misrepresentations being made to the auditor or in the presentation to the auditor of falsified records or documents that appear truthful and genuine. Unless the auditor's examination reveals evidential matter to the contrary, the auditor's reliance on the truthfulness of certain representations and on the genuineness of records and documents obtained during the examination is reasonable. The auditing standards caution that the auditor is not an insurer or guarantor. The subsequent discovery that errors or irregularities existed during the period covered by an independent auditor's examination does not, in itself, indicate inadequate performance on the auditor's part.

Although the auditors did not detect the alleged fraudulent purchasing scheme, we saw nothing in the audit work we reviewed indicating that the auditors did not comply with generally accepted auditing standards.

Workpapers Supporting an Earlier Special Investigation Were Not Available To Review

During September 1984, the Board of Commissioners engaged the independent auditors to conduct a special investigation of the port's purchasing activities. According to the port director, the Board of Commissioners engaged the auditors because a former finance department employee, who resigned in August 1984, reported that the supplier later implicated in the fraudulent purchasing scheme was awarded purchase orders although the supplier was not the lowest bidder.

According to the 1984 auditors' report, the investigation consisted of the following: The auditors obtained an understanding of the purchasing procedures by interviewing port employees in the finance department including the general accounting section and purchasing and stores section. Additionally, the auditors reviewed the controls at the stores purchasing facility located at the maintenance department shop. Further, the auditors examined all expenditures from July 1, 1983, through June 30, 1984, related to the supplier. As part of the examination, the auditors traced the expenditures to supporting documentation and noted the description of the item purchased and the signature of the individual receiving the goods. Finally, the auditors examined 50 purchase requisitions, selected randomly, noting documentation of the vendor bids and the description of the inventory item and noting that the purchase was properly recorded.

In their report dated October 1984 to the Board of Commissioners, the auditors stated that no matters came to their attention causing them to believe that the expenditures related to the supplier were not proper port purchases or that the purchase requisitions examined were not prepared in accordance with port policies.

We were unable to review the workpapers supporting the October 1984 report. The auditors informed us that they had previously destroyed the workpapers resulting from the special investigation in accordance with their firm's requirements relating to workpapers.

Conclusion

In June 1987, the port discovered a fraudulent purchasing scheme, which is believed to have involved many small purchases made through one vendor over a two-year period. Of the seven individuals charged with criminal activity, as of July 1989, one former employee of the port pleaded "guilty" and another pleaded "no contest" to charges against them. The remaining five cases are proceeding through the legal process. Management of the port does not believe that the ultimate disposition of the investigation by the district attorney's office will have a material adverse effect on the business or financial position of the port.

The independent auditors were required to conduct their audits of the port in accordance with generally accepted auditing standards. However, audits governed by these standards would not necessarily disclose all errors and irregularities. Although the auditors did not detect the alleged fraudulent purchasing scheme, we saw nothing in the workpapers we examined supporting the financial audits for fiscal years 1984-85, 1985-86, 1986-87, and 1987-88 that indicated that the auditors did not comply with generally accepted auditing standards.

In addition to the annual audits of the four years we reviewed, the Board of Commissioners requested that the auditors perform a special investigation of the port's purchasing activities in 1984. This investigation focused on expenditures related to the supplier later implicated in the fraudulent purchasing scheme. However, according to their report, the auditors found no irregularities during their special investigation. We were not able to review the related workpapers because they had previously been destroyed.

After the discovery of the alleged fraudulent purchasing scheme, the auditors made various recommendations resulting from annual audits for fiscal years 1986-87 and 1987-88. Some of these recommendations appear to be related to the alleged purchasing irregularities. Port management informed us of the actions they had taken in response to the recommendations. The port management's comments indicate that the port believes many of the actions had been taken before the recommendations were made.

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 the letter.

Respectfully submitted,

KURT R. SJOBERG
Acting Auditor General

Attachment

The San Diego Unified Port District's response to this letter

ATTACHMENT

SUMMARY OF SELECTED RECOMMENDATIONS MADE BY INDEPENDENT AUDITORS HIRED BY THE SAN DIEGO UNIFIED PORT DISTRICT FISCAL YEARS 1986-87 AND 1987-88

After the June 1987 discovery of the alleged purchasing irregularities, the independent auditors hired by the port made various recommendations resulting from annual audits for fiscal years 1986-87 and 1987-88. Some of these recommendations appear to be related to the alleged purchasing irregularities. Seven of the recommendations made for fiscal year 1986-87 were made as part of a special review of controls over the purchasing cycle. The auditors reviewed these controls at the request of the port's audit committee. We requested that port management comment on the corrective action the port has taken in response to the recommendations. The comments indicate that port management believes many of the actions were taken before the recommendations were made. The following is a summary of the recommendations and of the related comments made by port management.

Recommendations	Port Comments
Management Letter to the Board of Commissioners dated November 6, 1987	
Special Purchasing Review:	
The person initiating a purchase should not receive the item. It was the auditors' understanding that the port had already taken corrective action.	This separation of duties between procurement and receipt of goods substantially took place in the fall of 1986 when the purchasers and purchasing agent were physically moved to the port administration building and receiving was conducted in the maintenance department storeroom located three miles away.
Whenever possible, all items should be delivered to a purchasing department storeroom facility rather than to a job site.	This practice has been in effect since the creation of the port. While on occasion, certain commodities, such as hot asphalt or concrete, must be delivered at sites other than the storeroom, supervisory personnel verify that goods are received before payment.
The storeroom should periodically check on the status of purchase orders if items have not been received.	Since the formation of the port, purchasing personnel and storeroom personnel have done this.
After placing an order, the purchasing department should forward copies of the purchase order or requisition form to the requesting department, finance department, and appropriate storeroom facility. After obtaining the receiving report and invoice, the finance department should review all documents for propriety.	This was a policy of the finance department when it assumed all purchasing and storeroom activities in July 1982, and it remains the policy of the purchasing department now that it is independent of finance. Finance has always followed the practice of obtaining the receiving report and invoice and of reviewing all documents for propriety.

Recommendations	Port Comments
As goods are received in the storeroom, they should be counted, inspected, and receipted. The storeroom clerk should then inform the finance department of the quantities received by sending a signed and dated packing slip to the finance department.	Storeroom personnel have always been required by policy to count and inspect goods when received and to sign a receiving report. The receiving report is then submitted to the finance department as part of the supporting documentation for the payment of goods and services.
Quarterly, the purchasing department should obtain bids from various vendors for volume purchases. Once the lowest acceptable bidder has been established for each supply or group of supplies, an open purchase order can be issued. The auditors commented that the port has reviewed its policies for granting open purchase orders and has shortened the lengthy list to those vendors most frequently used. They further recommended that the current practice of establishing dollar limitations on open purchase orders be continued.	Since August 1987, the purchasing department no longer issues open purchase orders of any form. Every purchase is done on an individual purchase order. Before that time, an established policy had always limited the dollar amount of open purchase orders.
Each department should keep and compare a copy of the requisition form with a copy of the material issues form received from the receiving department and with the monthly appropriation report received from the finance department. Further, each department should compare its monthly expenses with the budget and actual amounts reported by the finance department and should investigate significant variances.	Since 1982, when finance took over purchasing storeroom operations, copies of all requisitions, by policy of the director of finance, were to be submitted to each respective department so they could reconcile their monthly expenses to the monthly appropriation report they received from the finance department. Most departments, when discovering variances between budgeted actual expenses reported by finance and their requisition amount, would contact the finance department, which would make the reconciliation.

Recommendations	Port Comments
Other Pertinent Recommendations:	
An individual in the finance department should be responsible for formally reviewing the budget-to-actual reports on a departmental basis. Each department should be responsible for explaining any large variances.	On or about December 1986, an organizational change was made in the finance department when the assistant director of finance was given primary responsibility for reviewing the budget-to-actual report of each department.
The port should consider expanding the internal audit resources so that, in addition to internal auditors' efforts on tenant lease review, the auditors can determine compliance with port policy for each department of the district, including purchasing and finance.	In the budget for fiscal year 1988-89, the office of controller, under the port director, was established. The audit section, previously under the finance department, was transferred to the controller. Its primary function is to perform those tasks mentioned in the recommendation.
The port should require every person involved in the receipt of money or other assets and in the expenditure of money or the commitment to expend funds to take a vacation every year.	While certain legal prohibitions restrict the port from requiring employees to take entitled rights, such as vacation time, every effort is made to encourage all port employees to take vacations. All employees involved with fund expenditure do so.

Recommendations	Port Comments
Letter to the Director of Finance dated September 22, 1988	
Supporting documents for all invoices should be cancelled to avoid duplicate payments.	According to port management, this was more critical when the port used open purchase orders; however, while it continues to mark paid invoices and purchase orders as they are paid, the port no longer uses open purchase orders. A purchase order is issued for each purchase, and a copy of the stub check payment is attached indicating date paid, along with all supporting documentation also marked paid.
A computer program change should be made so that, no matter when a duplicate invoice is entered into the accounts payable system, the system will reject the invoice for payment.	This was already programmed in the software for the accounts payable system when the recommendation was made, and it is still in effect.
Before an invoice is processed for payment, it should be checked for mathematical accuracy. This review should be documented on the invoice itself.	Since the port was formed, this has been the policy of the past and present directors of finance and, the port hopes, the practice of supervisory and accounting clerical personnel.

BOARD OF PORT COMMISSIONERS
CHAIRMAN OF THE BOARD

August 23, 1989

Mr. Kurt R. Sjoberg
Acting Auditor General
Office of the Auditor General
State of California
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

Thank you very much for the opportunity to review and comment on your report on the independent audits performed for the San Diego Unified Port District. The report is very readable and deals with the subject which has been of concern to us since the Port discovered the diversion of funds and requested the District Attorney's assistance in June of 1987.

It is unfortunate that the government must spend extra time and money on problems of this sort, but we certainly agree that there are times when additional scrutiny may be in order.

The Port has recently changed auditors after a period of 25 years, and we have taken this occasion to request the new auditors to give particular emphasis to purchasing procedures as they proceed with our annual audits.

We appreciate your attention and the opportunity to comment on your report.

Sincerely,

Louis M. Wolfsheimer

LOUIS M. WOLFSHEIMER
Chairman

LMW:mrs