

Laguna Honda Hospital Replacement Program

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BASELINE INFORMATION

Bond Scope: In November 1999 approximately 70 percent of the San Francisco voters approved the Laguna Honda Hospital Replacement Program (LHHRP) bond proposal see (Appendix A).

Although early LHHRP cost estimates totaled close to \$500 million, the City’s Capital Improvements Advisory Committee recommended a LHHRP general obligation bond amount of \$299 million to be combined with \$102 Million in Tobacco Settlement Revenues. The plan to close the gap between the early program estimates and bond amount included value engineering the project in order to reduce the construction cost.

Baseline Budget and Schedule: The program plan included construction of four new buildings totaling 1200 beds and remodel of the existing building, Wing H as well as all associated site and utility work necessary to complete the master plan.

Table 1. LHHRP Baseline Budget as of 2001

Sources & Uses of Funds	Estimated Budget 2001
SOURCES	
Bond Funds:	
1999 Prop A LHHRP GO Bonds	\$299,000,000
Total Bond Funds	\$299,000,000
Other Sources:	
Tobacco Settlement Revenues	\$102,600,000
Total Other Sources	\$102,600,000
Grand Total Sources:	\$401,600,000

KEY FACTORS AFFECTING LHHRP IMPLEMENTATION

In August 2000, the joint venture of architectural firms Anshen+Allen Architects and Gordon H Chong and Partners (A+A/GHCP) was selected to design the replacement facility. Both firms had extensive experience in design of hospitals and assisted living facilities. In September 2000, the design process began.

In January 2001, the Planning Department issued the Initial Study, which the scope of the environmental review and the recommendation to prepare a full Environmental Impact Report. As the design proceeded in 2001, work began on the Preliminary Draft Environmental Impact Report (PDEIR).

The PDEIR was issued in December 2001 and was approved by the Planning Commission in June 2002. A subsequent appeal was heard by the Board of Supervisors in August, not upheld and the final legislation allowing the project to proceed was issued in September 2002.

Construction of the first phase of the work, consisting of relocation of utilities began in November 2002.

Turner Construction Company/CPM was selected in 2002 as a consultant to the team, providing mainly logistics and cost estimating services. Turner is one of the largest general contractors in the healthcare sector.

In December 2002, the drawings for all the work associated with the new buildings and the Remodel of the Existing Building were submitted to the appropriate regulatory agencies at the State and Local jurisdictions. In doing so, the team had met a key legislative deadline. SB1953 and subsequently SB 1128 and 2046, require that the facility submit all drawings before January 1, 2003. By doing so, the Hospital qualified for reimbursement of capital costs once the new facilities are in operation.

At the end of 2002, the Board of Supervisors approved legislation to allow Public Works to utilize the Construction Manager-at-Risk (CM-at-Risk) approach for project delivery. The approach was supposed to position the City to better manage the risk associated with these inherently high-risk projects. However, the decision to use CM-at-Risk was made late and the project did not realize the benefit of having constructability review of the bid documents in a way that would allow the design team to make informed decisions based on input from the CM-at-Risk contractor.

In 2003, an independent firm, Redicheck Pacific was hired to perform a review of the drawings for inconsistencies, specifically coordination between disciplines. Review of the documents continued at the State level and construction work for the Access Improvement Project (new roadway), Utilities Modifications and the Site Work proceeded. In April 2003, the final cost estimate for the remaining construction work was performed by Turner Construction and Hanscomb.

In January 2004, the State issued the first of two building permits (Increment 1) for the new buildings. In April, Turner, in their new role as CM-at-Risk (General Contractor), reviewed and updated the 2003 cost estimate prepared by the Architect's cost estimating consultant. As a result of the market conditions at that time, Public Works was advised on June 1, 2004 of a possible \$25M overrun. Public Works advised the Health Care Commission and the project oversight committee of the projected cost increases.

In an effort to mitigate the anticipated cost overrun, Turner Construction recommended at the beginning of 2004 that the City expedite the bidding of the structural steel and concrete work before the prices continued to rise for these two trades. Because of the volatility in the market, at that time, no contractors were willing to commit to a lump sum price. Bidding was then delayed to July, and structural steel and concrete numbers were received significantly over budget. The remainder of the bids was scheduled to be received in August 2004. In late July, because of the California Superior Court's decision regarding State Proposition 209, the City's contracting process was put on hold while the City determined the impact to its Minority/Women Business Enterprise program (M/WBE).

In September, in anticipation of a worsening bid market, legislation was introduced to allow the City to accept sealed bids in an effort to better negotiate additional value engineering that the bidders may bring forward. This legislation would work in tandem with the earlier CM-at-Risk Legislation to allow the

City to leverage any additional savings through the bid process. It also allowed the City to identify and mitigate potential cost overruns in a competitive environment during the bidding process.

In October Public Works received for multiple trades, all of which were significantly over budget. Analyses of these bid results and the subsequent re-bid results are included later in this report see (Appendix B).

In February 2005, the State issued the building permit for Increment 2, completing the permitting process for the new buildings. Permits for the Remodel of the Existing Building and the future site work were still pending.

The second round of bidding has continued into March 2005. Key bid deadlines were extended to accommodate bidders and maintain the competition. Bids were valid 90 days from receipt. Current bidders were assuming to start construction in April. Turner Construction and their sub-contractors began to prepare the site by relocating site utilities in anticipation of construction of the new buildings.

Unprecedented Market Conditions

At the beginning of 2004, Turner Construction advised Public Works of volatility in the structural steel market. In March, Public Works attempted to bid the structural steel bid package but bidders were unwilling to commit to a lump sum price because of the unstable material market conditions.

This volatility soon spread to other construction materials. By mid-summer, significant cost increases were being predicted as a result of not only material cost increases but also because of labor costs increases.

When the Laguna Honda Hospital Replacement Program began design in 2000, the cost per square foot for conceptual estimating for a skilled nursing facility was under \$300. In 2003 Turner Construction, is was advising clients to use \$450. Refer to Turner’s letter excerpted below, see (

Appendix C).

The table below illustrates escalation rates for hospitals in California during the time in question:

Project	Date of Previous Estimate	Current Bid	Percent Escalation	Number of Months	Escalation per Month
Laguna Honda	Apr-03	Oct-04	52.2%	18	2.9%
Hospital A	Apr-04	Nov-04	28.1%	7	4.0%
Hospital B	Jan-03	Jan-04	22.9%	12	1.9%
Hospital C	Dec-03	Sep-04	25.7%	9	2.8%
Hospital D	Dec-03	Sep-04	32.6%	9	3.6%
Hospital E	Dec-03	Oct-04	22.7%	10	2.3%
Average monthly escalation					2.9%

The construction budget for the project had assumed a standard escalation rate of 5% per year based on historical data and best industry practices. However, due a booming local economy and the global demand for construction materials, the escalation rate was running at unprecedented rate of approximately 30% per year for certain trades, see (Appendix D) for excerpt from xxxx consulting.

As discussed above, Public Works sought to contain costs through value engineering and other efforts but the scope changes, delays, changing economy, and unforeseen site conditions forced an upward trend on LHHRP costs. The City chose to identify additional sources to cover the rising costs rather than further reduce the overall LHHRP deliverables for the public. Additional sources included: (1) general obligation bond interest earnings; (2) additional Tobacco Settlement Revenues and (3) Certificates of Participation (COPs).

As previously noted, the Public Health Commission approved major budget and funding changes, while smaller changes were approved by the Department Heads of Public Works and Public Health.

LHHRP Change Order Breakdown:

Construction fell behind schedule soon after steel frame erection was completed. Challenges with design details necessitated nearly constant revisions to the contract drawings, which required approvals from OSHPD, the State permitting agency with jurisdiction over all hospitals.

		Main Buildings		Remodel	
a.	Errors	\$ 10,443,538		\$ 851,453	
b.	Omissions	\$ 6,314,790		\$ 1,122,907	
c.	Site Conditions	\$ 21,271,324		\$ 10,307,708	
d.	(Interim) Global Settlements	\$ 30,789,398		\$ 201,827	
e.	Client Request/City Request	\$ 9,748,924		\$ 2,668,830	
f.	Code Changes/OSHPD	\$ 856,723		\$ 5,397	
		\$ 79,424,697		\$ 15,158,122	
		Main Bldgs		Remodel	
g.	CO's	\$ 48,635,299		\$ 14,956,295	
h.	Interim (Global) Settlements	\$ 30,789,398		\$ 201,827	
		\$ 79,424,697		\$ 15,158,122	
		Main Bldgs		Remodel	
i.	Base Contract	\$ 286,575,303		\$ 41,909,378	
j.	Additions	\$ 79,424,697	21.7%	\$ 15,158,122	26.6%
26.5%k.	Total Contract	\$ 366,000,000		\$ 57,067,500	

Examples of major change orders per category:

Errors

wedge anchors	\$ 400,000
various framing revisions	\$ 3,200,000
Vapor barrier	\$ 1,000,000
	\$ 4,600,000

Omissions

Loading Dock Canopy	\$ 300,000
Kitchen duct omissions	\$ 275,000
Flashing	\$ 700,000
	\$ 1,275,000

Site Conditions

Vapor Barrier	\$ 1,000,000
MEP Coordination	\$ 4,000,000
	\$ 5,000,000

Client Requests

Patient Laundry Rooms	\$ 1,200,000
security	\$ 1,100,000
radiology	\$ 500,000
bedpan	\$ 400,000
smartbeds	\$ 600,000
	\$ 3,800,000

FINAL LHHRP DELIVERABLES

Appendix E, LHHRP Comparative Matrix, compares the baseline and final LHHRP program schedule as well as the baseline, approved and estimated final budgets.

Original Vs Final

Original	Final
1200 Beds – 4 Buildings	780 beds – 3 buildings

LESSONS LEARNED

Some of the key lessons learned from LHHRP that will be beneficial to all major capital projects, but particularly to large, complex programs.

- Provide adequate initial funding to allow for conceptual engineering and environmental review to be completed prior to asking voters to approve funding for projects
- Fund and implement a comprehensive facility condition survey for remodel of existing facilities prior to setting a project budget to reduce the exposure due to unforeseen site conditions during construction
- Include community input on project scope prior to the development of the bond proposal to limit scope changes and associated schedule delays due to revisions to the design
- Carefully evaluate market trends based on project type. The LHHRP utilized the inflation rate which had been relatively steady during the previous decades. The value proved to be inadequate when market conditions changed unexpectedly. Major construction demands elsewhere in the world coupled with a response to the statewide directive to seismically upgrade hospitals created a demand for a limited supply of materials and contractors.

- Public Works has had great success with CM/GC as a delivery method when implemented from the start. LHHRP suffered from the decision to change the delivery method over three years after design had started.
- Set a program reserve allocation for extraordinary construction escalation due to market conditions such as economic peaks and strong international demand for construction materials. Public Works and the requesting department should consult industry escalation standards and the City's Chief Economist
- Identify pre-qualified contractors for construction services
- Increase contractor outreach to maximize competition
- Engage construction experts early in and during design phase for constructability review and accurate cost estimating



San Francisco County, CA November 2, 1999 Election



Proposition A

Laguna Honda Hospital Bond

City of San Francisco

2/3 Vote Required

137,123 / 73.10% Yes votes 50,351 / 26.80% No votes

See Also: [Index of all Measures](#)

Information shown below: [Summary](#) | [Fiscal Impact](#) | [Yes/No Meaning](#) | [Arguments](#) | [Full Text](#)

Shall the City and County incur bonded debt and/or other evidences of indebtedness and/or undertake lease financing, in an aggregate principal amount not exceeding \$299,000,000, for the acquisition, improvement, construction and/or reconstruction of a new health care, assisted living and/or other type of continuing care facility or facilities to replace Laguna Honda Hospital, and reduce the property tax impact by requiring the application of available tobacco settlement revenues received by the City and County, and any state and/or federal grants or funds received by the City and County that are required to be used to fund these facilities, (a) to finance the acquisition, improvement, construction and/or reconstruction costs of such facilities, and (b) to pay the principal and redemption price of, interest on, reserve fund deposits, if any, and/or financing costs for the obligations authorized thereby?

Summary Prepared by the Ballot Simplification Committee:

THE WAY IT IS NOW: The City owns and operates Laguna Honda Hospital, founded in 1866. Laguna Honda provides more than 1,000 residents with long-term care, regardless of ability to pay, including skilled nursing, AIDS and dementia services, hospice, rehabilitation, and acute care. The hospital also provides the community with adult day health care and senior nutrition programs.

Many of Laguna Honda Hospital's current facilities were built between 1926 and 1940. The hospital was damaged in the 1989 Loma Prieta earthquake. Many of its building systems, including fire safety and electrical, are in need of

Nonpartisan Information

League of Women Voters

- [Voters Guide on SF Measures](#)

News and Analysis

San Francisco Chronicle

- [Laguna Honda Outpaces Other Measures in Fund Raising 10/23/99](#)
- [ELECTION '99](#)

FAQVoter.com

- [Q&As on the Ballot Measures](#)

Suggest a link related to Proposition A

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repair or replacement. In addition, the hospital has large open wards that do not meet Federal and State regulations for patient privacy.

Because of legal settlements with tobacco companies to recover money spent on public health costs associated with smoking, the City expects to receive \$347 million over the next 25 years.

The principal and interest on general obligation bonds are paid out of property tax revenues.

THE PROPOSAL: Proposition A would authorize the City to borrow \$299 million by issuing general obligation bonds to acquire, construct or reconstruct a health care, assisted living, and/or other type of continuing care facility or facilities to replace Laguna Honda Hospital. Proposition A would require an increase in the property tax to pay for the bonds.

Proposition A also provides that all tobacco settlement monies received by the City, after \$1 million is set aside each year for smoking education and prevention programs, would be used to pay for some construction and to offset the cost to property owners of repaying the bonds.

A two-thirds majority vote is required for passage of Proposition A.

Fiscal Impact from the City Controller Edward Harrington:

Should the proposed bonds be authorized and issued, in my opinion the costs would be:

Bond Redemption	\$299,000,000
Bond Interest	\$230,526,000
Debt Service Requirement	\$529,526,000

Based on a single bond sale, the average annual debt requirement for twenty (20) years at the current six (6) percent interest rate would be approximately \$26,476,300 which is equivalent to four and eleven hundredths cents (\$0.0411) per \$100 of assessed valuation in the current tax rate. The increase in annual property taxes for the owner of a home with an assessed value of \$300,000 would amount to approximately \$120.36 if all bonds were sold at the same time. It should be noted, however, that the City does not plan to issue all authorized bonds at one time; if



these bonds are issued over several years, the actual effect on the tax rate would be less than the maximum amount shown above. Also, to the extent revenues that are expected to be available from a settlement with certain tobacco companies are used for debt service, the impact on future years' tax rates would be substantially less.

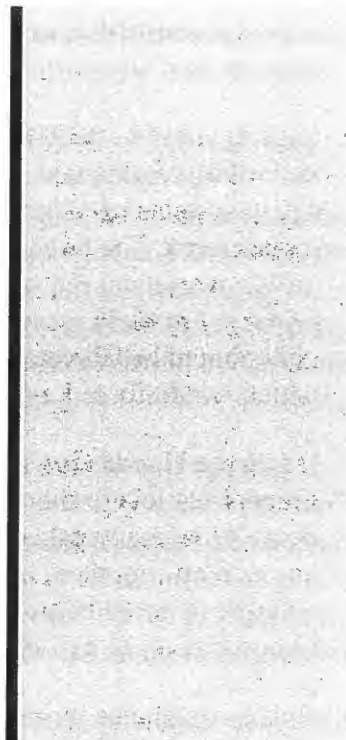
Meaning of Voting Yes/No

A YES vote of this measure means:

If you vote yes, you want the City to issue general obligation bonds in the amount of \$299 million to acquire, construct or reconstruct a health care, assisted living, and/or other type of continuing care facility or facilities to replace Laguna Honda Hospital.

A NO vote of this measure means:

If you vote no, you do not want the City to issue bonds for these purposes.



Arguments For Proposition A

Since 1866 San Francisco has cared for our elderly and disabled at Laguna Honda Hospital. Proposition A enables us to continue fulfilling this moral obligation into the next century. From both healthcare and financial standpoints, Proposition A prevents a catastrophe we cannot afford.

Thousands of San Francisco families have depended on Laguna Honda Hospital to provide compassionate medical care for elderly or disabled family members whose needs cannot be met at home. All San Franciscans are welcome at Laguna Honda, regardless of their ability to pay. As San Francisco's elderly population increases, the need for Laguna Honda will be even greater.

While the majority of Laguna Honda residents are elderly, many are people of all ages - born with disabilities, survivors of debilitating illnesses or severely injured in accidents. Any of us is just a car crash or accident away from needing the hospital's services. Laguna Honda has

Arguments Against Proposition A

Our indigent senior citizens deserve up-to-date skilled nursing care. Health experts agree that Laguna Honda is a wasteful, health care dinosaur, despite its dedicated staff and volunteers. Every other county in California has stopped warehousing senior citizens in boxes like Laguna Honda. The Laguna Honda proposal is outdated, expensive, and wasteful.

The total costs of rebuilding Laguna Honda, construction costs and interest, will be \$609,000,000. This amounts to about Half a Million Dollars per bed.

Over \$200,000,000 of the \$609,000,000 total cost of rebuilding Laguna Honda are slated to come from the Tobacco Settlement Funds. In May, the Mayor's Office stated San Francisco would receive \$585,000,000 in Tobacco settlement monies over the next 25 years.

In July, the Mayor's Office stated that figure had shrunk to \$347,000,000.

provided end-of-life care for more AIDS patients than any other hospital or hospice.

Laguna Honda's buildings were damaged in the 1989 earthquake. Most utility and safety systems need long-overdue repair or replacement. The large open wards do not meet government requirements for patient privacy. For these reasons, the federal government has threatened to end funding, which would force Laguna Honda to close.

If Laguna Honda closed, with San Francisco's severe shortage of nursing home beds, many patients would fail at home, requiring them to seek expensive emergency room treatment and acute care in hospitals such as San Francisco General.

Extensive studies by medical experts, architects, financial analysts and patient advocates show conclusively that rebuilding Laguna Honda at its current location is the most cost-effective and humane solution.

Proposition A combines compassion, state of the art healthcare and fiscal responsibility. Vote YES on A.

Board of Supervisors

Rebuttal to Arguments For

The Mayor and Board of Supervisors want to rebuild Laguna Honda with the same number of beds and types of services the current facility provides. But there are newer, more appropriate, more humane, cost effective ways to provide these services. Laguna Honda should be just one option in a range of choices in long term care.

San Francisco needs a new, much smaller Laguna Honda for those people with disabilities, including the elderly, who can be treated only in skilled nursing facilities.

Many current and future residents of Laguna Honda can obtain the services and

So, if there is not enough tobacco money to offset the cost of rebuilding Laguna Honda, the taxpayers will be forced to make up the difference.

There are more compassionate and less costly ways to address longterm care for seniors. First, we can utilize the excellent community-based long-term care providers that are available in San Francisco. Second, the City can partner with private providers to convert existing surplus acute care beds into longterm care beds. Third, we should use part of the tobacco settlement funds for the annual cost of caring for our elderly indigent population. The remainder of the tobacco funds should go to its intended purpose - to care for people with tobacco-related illnesses and educational programs to prevent teenage smoking.

The San Francisco Republican Party urges every San Franciscan to say "No" to City Hall's latest expensive and outdated plan. This will force the Mayor and the Board of Supervisors to consider contemporary, diversified, and compassionate care for our aging population.

Vote No on Proposition A.

Donald A. Casper, Chairman, San Francisco Republican Party.

Rebuttal to Arguments Against

Painstaking analysis by healthcare, finance and social service experts shows that rebuilding Laguna Honda Hospital is the least expensive way to provide quality healthcare to the greatest number of San Francisco's elderly and disabled.

Yes, rebuilding Laguna Honda is expensive, but other alternatives serving the same number of people would be far more costly. Talk of utilizing "community-based longterm care providers" is irresponsible, since San Francisco already faces a severe shortage of long-term care

care they need in places other than a large institution. They can receive that care in a friendly, humane environment at home or in home-like settings in their own neighborhoods, with more privacy and a better quality of life.

And their care can cost less than if they are 'warehoused' in a large institution. San Francisco currently has a variety of options for long term care services. We should expand this network of options and increase the number of people served. The resulting 'continuum of care' would stretch from one's own home to visiting nurses to adult day care centers to assisted living facilities to nursing homes like Laguna Honda.

Vote NO on this proposition. Tell the Mayor and Board of Supervisors not to waste our money on 'old' solutions. Tell them to work on new ways to provide the care San Franciscans deserve.

Abby Kovalsky
Board President
Independent Living Resource Center San Francisco

beds. The situation will only get worse as San Francisco's Baby Boomer population ages. Laguna Honda provides extensive 24 hour, 7 day a week care unavailable in community settings.

Dispersing Laguna Honda's population to smaller public facilities would require wasteful duplication of costly medical equipment. And where would these facilities be located?

Sadly, most efforts to establish healthcare facilities in residential neighborhoods generate opposition. Commercial areas are inappropriate as the home for frail elderly and disabled San Franciscans.

Rebuilding Laguna Honda can begin almost immediately. Developing alternatives would take years. Further delay would result in higher costs.

Meanwhile, people needing long-term care wouldn't receive it. Many Laguna Honda residents have smoking-related illnesses and cancer. Thus, Proposition A would use tobacco settlement funds exactly as Laguna Honda opponents say we should. Plus, \$1,000,000 a year of these funds would go toward preventing teenage smoking.

Let's stop playing politics with our most vulnerable citizens.

Vote YES on Proposition A.

Supervisors Tom Ammiano
Alicia Becerril
Sue Bierman
Amos Brown
Leslie Katz
Mark Leno
Mabel Teng
Michael Yaki
Leland Yee

Text for Proposition A

[Bond Special Election] CALLING AND PROVIDING FOR A SPECIAL ELECTION TO BE HELD IN THE CITY AND COUNTY OF SAN FRANCISCO ON TUESDAY, NOVEMBER 2, 1999, FOR THE PURPOSE OF SUBMITTING TO THE VOTERS A PROPOSITION TO INCUR BONDED DEBT AND/OR OTHER EVIDENCES OF INDEBTEDNESS AND/OR UNDERTAKE LEASE FINANCING BY OR FOR THE CITY AND COUNTY IN THE PRINCIPAL AMOUNT OF \$299,000,000 FOR THE ACQUISITION, IMPROVEMENT, CONSTRUCTION AND/OR RECONSTRUCTION OF A HEALTH CARE, ASSISTED LIVING AND/OR OTHER TYPE OF CONTINUING CARE FACILITY OR FACILITIES TO REPLACE LAGUNA HONDA HOSPITAL; PROVIDING FOR THE USE OF AVAILABLE TOBACCO SETTLEMENT REVENUES AND FOR THE USE OF STATE AND/OR FEDERAL GRANTS OR FUNDS RECEIVED BY THE CITY AND COUNTY THAT ARE REQUIRED TO FUND SUCH PROPOSED PROJECT; FINDING THAT THE ESTIMATED COST OF SUCH PROPOSED PROJECT IS AND WILL BE TOO GREAT TO BE PAID OUT OF THE ORDINARY ANNUAL INCOME AND REVENUE OF THE CITY AND COUNTY AND WILL REQUIRE EXPENDITURES GREATER THAN THE AMOUNT ALLOWED THEREFOR BY THE ANNUAL TAX LEVY; RECITING THE ESTIMATED COST OF SUCH PROPOSED PROJECT; FIXING THE DATE OF ELECTION AND THE MANNER OF HOLDING SUCH ELECTION AND THE PROCEDURE FOR VOTING FOR OR AGAINST THE PROPOSITION; FIXING THE MAXIMUM RATE OF INTEREST ON SUCH LEASE FINANCING, BONDED DEBT AND/OR OTHER EVIDENCES OF INDEBTEDNESS; PROVIDING FOR THE LEVY AND COLLECTION OF TAXES TO PAY BOTH PRINCIPAL AND INTEREST OF SUCH BONDED DEBT AND/OR OTHER EVIDENCES OF INDEBTEDNESS; PRESCRIBING NOTICE TO BE GIVEN OF SUCH ELECTION; ESTABLISHING THE ELECTION PRECINCTS, VOTING PLACES AND OFFICERS FOR THE ELECTION; WAIVING THE WORD LIMITATION ON BALLOT PROPOSITIONS IMPOSED BY SAN FRANCISCO MUNICIPAL ELECTIONS CODE SECTION 510; AND ACKNOWLEDGING RECEIPT OF FINDINGS BY THE CITY AND COUNTY PLANNING DEPARTMENT.

Be it ordained by the People of the City and County of San Francisco:

Section 1. A special election is hereby called and ordered to be held in the City and County of San Francisco on Tuesday, the 2nd day of November, 1999, for the purpose of submitting to the electors of the City and County a proposition to incur bonded debt and/or other evidences of indebtedness and/or undertake lease financing by or for the City and County of San Francisco for the Project hereinafter described in the amount and for the purposes stated in Section 7 hereof.

The special election hereby called and ordered shall be referred to herein as the "Bond Special Election."

Section 2. For purposes of this ordinance and the proposition to be voted upon set forth in Section 7 hereof, the following terms shall have the meanings set forth below:

"Available tobacco settlement revenues" is defined as the total payments the City and County receives under the 1998 Master Settlement Agreement (the "Agreement") over the term of any lease financing, bonded debt and/or other evidences of indebtedness

authorized hereby that the City and County may use for the Project under applicable law, less \$1,000,000 of the amount the City and County receives each year under the Agreement during the term of any obligations authorized hereby, which amount the City and County will use for tobacco education, prevention and control purposes.

"Project" is defined to include, without limitation, all works, property and structures necessary or convenient for the acquisition, improvement, construction and/or reconstruction of a new health care, assisted living and/or other type of continuing care facility or facilities to replace Laguna Honda Hospital, including, without limitation, infrastructure or other improvements in the areas appurtenant to, or which provide access to, such new facility or facilities.

Section 3. The first \$100,000,000 of available tobacco settlement revenues and/or any state and/or federal funds or grants received by the City and County that are required to be used to fund the Project shall first be applied to finance the costs of acquisition, construction and/or reconstruction of the Project. Any additional amounts from such sources received by the City and County shall be applied to reduce the amount of the outstanding obligations authorized hereby.

Section 4. The estimated costs of the Project to be financed with the obligations authorized hereby were fixed by the Board of Supervisors by the following resolution and in the principal amount specified below:

General Obligation Bonds, Resolution No. 57799, \$299,000,000.

Such resolution was passed by two-thirds or more of the Board of Supervisors and approved by the Mayor. In such resolution it was recited and found that the estimated cost of said Project is and will be too great to be paid out of the ordinary annual income and revenue of the City and County in addition to the other annual expenses of the City and County and will require expenditures greater than the amount allowed therefor by the annual tax levy and will require lease financing and/or the issuance or incurrence of bonded debt and/or other evidences of indebtedness by or for the City and County not exceeding the principal amount specified.

Such estimate of cost as set forth in such resolution is hereby adopted and determined to represent a portion of the estimated cost of such improvements and financing.

Section 5. The Bond Special Election shall be held and conducted and the votes thereat received and canvassed, and the returns thereof made and the results thereof ascertained, determined and declared as herein provided and in all particulars not herein recited such election shall be held according to the laws of the State of California, Municipal Elections Code, and the Charter of the City and County of San Francisco providing for and governing elections in the City and County of San Francisco, and the polls for such election shall be and remain open during the time required by such laws.

Section 6. The Bond Special Election is hereby consolidated with the Consolidated General Election scheduled to be held in the City and County of San Francisco on Tuesday, November 2, 1999. The voting precincts, polling places and officers of election for the November 2, 1999 Consolidated General Election are hereby adopted, established, designated and named, respectively, as the voting precincts, polling places and officers of

election for the Bond Special Election hereby called, and reference is hereby made to the notice of election setting forth the voting precincts, polling places and officers of election for the November 2, 1999 Consolidated General Election by the Director of Elections to be published in the official newspaper of the City and County on the date required under the laws of the State of California.

Section 7. The ballots to be used at the Bond Special Election shall be the ballots to be used at the November 2, 1999 Consolidated General Election. The word limit for the ballot proposition imposed by San Francisco Municipal Elections Code Section 510 is hereby waived. On the ballots to be used at the Bond Special Election, in addition to any other matter required by law to be printed thereon, shall appear the following proposition:

"LAGUNA HONDA HOSPITAL, 1999. Shall the City and County incur bonded debt and/or other evidences of indebtedness and/or undertake lease financing, in an aggregate principal amount not exceeding \$299,000,000, for the acquisition, improvement, construction and/or reconstruction of a new health care, assisted living and/or other type of continuing care facility or facilities to replace Laguna Honda Hospital, and reduce the property tax impact by requiring the application of available tobacco settlement revenues received by the City and County, and any state and/or federal grants or funds received by the City and County that are required to be used to fund these facilities, (a) to finance the acquisition, improvement, construction and/or reconstruction costs of such facilities, and (b) to pay the principal and redemption price of, interest on, reserve fund deposits, if any, and/or financing costs for the obligations authorized hereby?"

Each voter to vote in favor of the issuance of the foregoing proposition shall punch the ballot card in the hole after the word "YES" to the right of the proposition, and to vote against the proposition shall punch the ballot card in the hole after the word "NO" to the right of the proposition. If a numerical or other system is used at such special election, each voter to vote in favor of the proposition shall mark the ballot card or equivalent device after the number or in the location corresponding to a "YES" vote for the proposition and to vote against the proposition shall mark the ballot card or equivalent device after the number or in the location corresponding to a "NO" vote for the proposition.

Section 8. If the Director of Elections shall certify to the Board of Supervisors that two-thirds of all the voters voting on such proposition voted in favor of and authorized the incurring of bonded debt and/or other evidences of indebtedness and/or lease financing for the purposes set forth in such proposition, then such proposition shall have been accepted by the electors, and bonded debt and/or other evidences of indebtedness and/or lease financing authorized thereby shall be issued or incurred upon the order of the Board of Supervisors. Such bonded debt and/or other evidences of indebtedness and/or lease financing shall bear interest at a rate not to exceed twelve percent (12%) per annum.

Section 9. In anticipation of the issuance or incurrence of bonded debt and/or other evidences of indebtedness and/or lease financing, the City and County may issue commercial paper notes, bond anticipation notes or other shortterm evidences of indebtedness to finance and refinance the costs of the Project, provided that the aggregate principal amount thereof outstanding at any time shall not exceed the authorized but unissued amount of obligations authorized hereby.

Section 10. For the purpose of paying the principal of and interest on any general obligation bonds or other evidences of indebtedness (excluding any lease financing), the Board of Supervisors shall, at the time of fixing the general tax levy and in the manner for such general tax levy provided, levy and collect annually each year until such bonded debt and/or other evidences of indebtedness are paid, or until there are sufficient sums set apart for that purpose to meet all sums coming due for the principal of and interest on such bonded debt and/or other evidences of indebtedness, a tax sufficient to pay the annual interest on such bonded debt and/or other evidences of indebtedness as the same becomes due and also such part of the principal thereof as shall become due before the proceeds of a tax levied at the time for making the next general tax levy can be made available for the payment of such principal.

Section 11. The Board of Supervisors hereby acknowledges receipt of findings by the City and County Planning Department that the Bond Special Election is in conformity with the priority policies of Section 101.1(b) of the City and County Planning Code and with the City and County's General Plan, as set forth in a letter dated April 27, 1999 on file with the Clerk of the Board of Supervisors in File No. 990921.

Section 12. This ordinance shall be published once a day for at least seven (7) days in the official newspaper of the City and County and such publication shall constitute notice of the election and no other notice of the election hereby called need be given.

Section 13. The appropriate officers, employees, representatives and agents of the City and County of San Francisco are hereby authorized and directed to do everything necessary or desirable to accomplish the calling and holding of the Bond Special Election, and to otherwise carry out the provisions of this ordinance.

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Laguna Honda Replacement Program

Where do we go from here?

Ed Harrington
Controller
May 19, 2005

As costs to replace Laguna Honda Hospital have increased, Mayor Gavin Newsom asked the Controller's Office to collect information and prepare an independent analysis of the options that are available to the City. To prepare this report we looked at a variety of possible options, but concluded there are only two options worth considering:

Option 1 – Use all reasonably available funds to complete a 1,200 bed skilled nursing facility at Laguna Honda.

Option 2 – Use most funds to complete three buildings at Laguna Honda with 780 skilled nursing beds and use the remaining funds plus operational savings to purchase other long-term care services in assisted living, supportive housing, home care or other community based settings. Total people served under this option would exceed 1,800.

Background – the Laguna Honda Replacement Project

In 1999 the voters of San Francisco approved a \$299 million general obligation bond measure to construct “a health care, assisted living and/or other type of continuing care facility or facilities to replace Laguna Honda Hospital.” While the project was planned to have 1,200 skilled nursing facility (SNF) beds--approximately the historic number of beds in the current Laguna Honda Hospital--**the number of beds to be built is not included in the bond ordinance.** In a recent Court order, Judge James Warren states: “Nothing in the Proposition A ‘bond contract’ limits the type of facility the City must construct to a ‘long-term care facility’. Moreover, nothing in the Proposition A ‘bond contract’ requires the City to construct a facility of a specific size.” Please note that the current census at Laguna Honda is under 1,050 patients.

The original project plan included constructing 1,200 beds in four buildings in the following order:

- 300 beds in the South building
 - 60 beds in the Link building
 - 420 beds in the North building
 - 420 beds in the West building
- 1,200 beds total

plus 140 assisted living beds on the LHH site (only partially funded at \$15 million).

The proposed Laguna Honda replacement facility was estimated to cost \$401 million made up of \$299 million in bonds, and \$102 million from proceeds of a tobacco settlement and interest earnings. In March 2005, bids for the first phases of the project indicated there was a shortfall of \$84 million for a new estimated cost of \$485 million. In May 2005, additional bid information increased the cost estimate by another \$12 million. The cost overruns are attributed to increased construction escalation. The project had budgeted a construction escalation rate of 3.8% per year. In the 18 months ending last October, construction escalation had increased by about 55%.

Current estimates for entire project:

If escalation continues at:	Total project cost:
• 2.9%/mo (18 month high) (Used for DPH 3/15/05 report)	\$747 million
• 2.4%/mo (last 23 months)	\$678 million
• 1%/mo (moderate case)	\$580-\$600 million
• 3.8%/year (future drops to original projection)	\$540-\$550 million
• Most probable	\$600-640 million

These escalated total costs can be viewed as a per bed cost of approximately:

- SNF Original estimate \$322,000
- SNF Current-first three buildings (heavily loaded with infrastructure) \$536,000
- SNF Current-last (West) building (no extra food, loading dock, etc.) \$350,000

Option 1 would use \$629 million in funding to cover the estimated \$600 million to \$640 million most probable cost estimate for a 1,200 bed skilled nursing facility.

This is possible because other funding streams are now available that were not envisioned when this project was first proposed.

<u>Currently Programmed funds</u>	<u>Original proposal</u>	<u>Current View</u>
General Obligation bonds	\$299 million	\$299 million
Tobacco Settlement before bonds are issued	\$80 million	\$92 million
Other—primarily interest	\$22 million	\$10 million
Sub-total	\$401 million	\$401 million

New Funding (see explanations on following page)

1. Issue Certificates of Participation (COPs) using the general fund as credit but to actually be repaid using federal revenue made available through SB1128 \$120 million
 2. Use NEXT \$100 million of Tobacco Settlement funds \$100 million
- Total funds that could be made available \$621 million

1. Issue COPs to be repaid using Federal revenue available through SB1128

This 1999 bill, by State Senator Jackie Speier, allows the City to receive additional Federal funds by billing for the cost of debt service once we build new SNF beds at Laguna Honda that are occupied by Medi-Care sponsored patients. This new stream of revenue can be leveraged through COPs to provide additional funds for the project. Legally, the COPs would be guaranteed by the City's General Fund, but the assumed source for repayment would be the additional Federal reimbursement.

2. Use NEXT \$100 million of Tobacco Settlement funds for construction

Proposition A requires that "the first \$100,000,000 of available tobacco settlement revenues...shall be applied to...construction [and additional receipts should be applied to debt service]. The proposition also defines available tobacco settlement revenues as tobacco settlement payments the City receives over the term of bonded debt. Since the City has not issued any debt, the tobacco settlement revenues received to date would fall outside this definition. While this interpretation has been challenged, it prevailed in the recent court litigation. Based on this interpretation, instead of spending a total of \$100 million in tobacco settlements revenues on Project costs, the City could choose to apply the approximately \$92 million of tobacco settlement revenues received before bond issuance **and** the next \$100 million received after bond issuance for a total of \$192 million from this source.

This would mean that property tax payers would be responsible for an additional \$100 million of debt service since the tobacco settlements funds wouldn't be available for this purpose. However, since 1999, tobacco settlement funds have amounted to significantly more than were originally projected and the total cost of borrowing has been reduced by more creative financing techniques. That means that property tax payers would still be projected to pay \$189 million less than was originally proposed even if they had to pay the additional \$100 million (see table below).

Property Tax effect:

	<u>Bond Repayment Sources</u>		
	<u>Property Tax</u>	<u>Tobacco Settlement</u>	<u>Total</u>
Original 1999 estimate	\$315 M	\$215 M	\$530 M
Current estimates	\$26 M	\$443 M	\$469 M
If \$100 million more tobacco settlement used for construction	\$126 M	\$333 M	\$469 M

Note: Original property tax payments of \$315 million would drop by \$189 million to \$126 million under this proposal.

Option 2 would provide a mix of long term care for over 1,800

individuals. The City would use all of the funds identified in Option 1 plus the General Fund share of the operational savings that would occur since fewer SNF beds would be maintained at their relatively high cost. These funds would provide for 1,015 beds on the Laguna Honda campus and pay for the annual cost of care for another 790 individuals in various community-based settings.

Construction costs:

- a. Use \$482 million--\$299 million of the general obligation bonds, plus the \$120 million COPs (SB 1128 monies), \$10 million in interest and \$53 million of tobacco settlement funds--to complete the first three buildings with 780 beds.
- b. Use \$59 million of tobacco settlement funds to build 235 assisted living and/or supportive housing beds at Laguna Honda (at approximately \$250,000 per bed). This could build 5 floors of the West Building with 47 units of assisted living per floor. This would be substantially more than the 140 assisted living beds that were only partially funded in the original plan. These beds added to the 780 SNF beds would provide 1,015 beds at the Laguna Honda campus.

Annual units of service: Attachment A is a paper prepared by the Mayor's Office of Disability that provides examples of how long term non-skilled nursing services might be provided and the number of people who could be served. It conservatively estimates that 100 people could receive long term care in a mix of settings for about \$2 million per year. Since the total saved under Option 2 c, d and e amounts to \$15.8 million dollars annually, approximately 790 people could be served per year.

- c. Use \$80 million of previously received tobacco settlement revenues that could be freed up when the general obligation bonds are issued. These funds could be invested in a trust fund and used for other long-term care needs for 25 years until the Laguna Honda bonds are paid off. We estimate this trust fund would generate about \$5.4 million per year that could fund the long-term care needs of **270 people** per year. Once the Proposition A bonds are paid off the City would no longer be constrained to use tobacco settlement revenues for any particular purpose; any further receipts could be used to maintain this trust fund or allocated to pay for similar long-term care programs.
- d. Use \$6.1 million annually of operating savings from the 185 SNF beds not built (West building drops from 420 to 235) to provide assistance to an additional **305 plus people** with long-term care needs. This calculation assumes that the General Fund cost per day of a SNF bed is approximately \$100. Most of these costs are staffing, food and similar costs that are not fixed; so we assume that the City would save about \$90 per day per bed for each SNF bed that we do not build.
- e. Use an additional \$4.3 million in savings by having 235 assisted living or supportive housing beds rather than SNF beds to provide assistance to another **215 people**. This calculation assumes that the City could contribute \$50 per day

with a Medi-Cal waiver for this lower level of care rather than the \$100 per day currently paid for SNF beds.

Using the various levels of institutional and community care offered in Option 2 would presumably be responsive to concerns of the Department of Justice that have been expressed over the past several years.

Terminology: This report uses terms like "beds", "people" or "individuals" somewhat interchangeably for the convenience of the reader. They do not refer to services only available over time to one person, rather they are meant to indicate the availability of services to a total number of people at any one time.

Attachment A

**Estimates for Housing, Medical and Supportive Care Costs for
People Discharged from LHH**

(Excerpts from a report by the Mayor's Office on Disability
Susan Mizner - April, 2005)

Background & Summary

The City is considering adding funding to long-term care needs other than skilled nursing beds. The question presented is what community care could be provided at what price? In short:

Q: How many people, eligible for services at LHH, could be served in the community at service levels similar to Laguna Honda?

A: For each \$2 million, 100 people could be served.

Assumptions and Analysis

Of the people able to leave a skilled nursing facility and return to the community, (currently 84% of the LHH residents according to data from TCM), Targeted Case Management staff estimate that 25% would want to live in a Board and Care facility, 50% would want supportive housing, and 25% would want to return to their own home or live in independent housing (with outside supports).¹

So, for every 100 people discharged from LHH, their preferred living situations would break down as follows:

- 25 Board and Care
- 50 Supported Housing
- 25 Own home or independent unit

Board & Care

For Board and Care residents, the cost to the city would be a straightforward "patch" for the providers, above what they receive from SSI or Social Security.² The best numbers available for that patch would be \$1600 / month per resident, or, \$19,200 per year.

Total cost to county for 25 people in Board and Care = \$480,000

¹ Data from national surveys support this. There is currently a large body of research regarding trends in long-term care use. Seniors are living healthier longer, and staying home longer. The data shows that few seniors want nursing home placement, and the availability of new models of service, such as PACE and assisted living, has helped seniors avoid nursing home placement longer or altogether. Nationally and in California, nursing home bed occupancy rates have steadily decreased, and are currently around 81%.

² Charlene Harrington, PhD, testifying at the Mayor's Disability Council, cited a study that found 315 available slots at residential and board and care facilities. Of these, half of the providers said they would be willing to take on more clients with substance abuse, cognitive impairment, or behavioral problems if the reimbursement rates were higher. This patch is the estimated need.

Supportive Housing

Supportive Housing comes in a range of forms. Some supportive housing is in Single Room Occupancy units, others include private units where services can be provided to many people at the same location. Models for seniors are available through HUD's 811 buildings or On Lok.

For people entering Supported Housing, there would be both housing and care costs. The care costs would vary according to need, but would primarily be covered by programs such as IHSS, PACE, Adult Day Health, and waiver programs. To be conservative, these numbers do not include the waiver programs (which are **no** cost to the county).

Population assumptions per 50 people

- 10% of people in supportive housing would need only IHSS services – 5
- 50% would benefit from, and be able to get into, a PACE program – 25
- The remainder, 40% would get services from both IHSS and Adult Day Health – 20
- About a third may also receive one or more home delivered meals per day – 15

The cost breakdown per person to the County for these assumptions would be as follows:

Supportive Housing costs - \$42/ day or 15,330 / year.

IHSS costs – Not all clients would need the maximum number of hours of care each month (approximately 9 hours of care a day). However, that maximum is assumed for these cost estimates. County costs for clients range from \$21 to \$35 / day, or \$7665 to \$12,775 / year, depending on whether this is the Independent Provider mode or Consortium services. Ave = \$10,220/yr

Those who receive only IHSS tend to be relatively stable medically, but have functional limitations that interfere with their ability to dress themselves, cook, clean, etc. Any medical care that they needed would be covered by MediCal, through visits to community clinics, etc.

PACE costs – to county are ZERO (This is an all-inclusive program with medical care, support services and meals provided.) This is also a program with 300 slots *currently* available.

Adult Day Health costs – to county are currently zero, MediCal covers all but an average of \$15 / day. If the county were to cover that cost, it would amount to \$5470 / yr. This is another program with slots *currently* available and with room for expansion.

Cost Totals

$$\text{SH} + \text{IHSS} = \$15,330 + 10,220 = \$25,550 / \text{yr} \times 5 = \$ 127,750$$

$$\text{SH} + \text{PACE} = \$15,330 + 0 = \$15,330 / \text{yr} \times 25 = \$ 383,250$$

$$\begin{aligned} \text{SH} + \text{IHSS} + \text{ADH} &= \$15,330 + 10,220 + \$5470 = \$31,020 / \text{yr} \times 20 = \$ 620,400 \\ &+ \text{HDM} = \$2190 \times 15 = \$32,850 \end{aligned}$$

Total to county for 50 People living in Supportive Housing = \$1,164,250

Independent Housing

Like supportive housing, this is a combination of housing costs and service/medical costs. This is the most difficult category to average. Many people would require a one-time expenditure to enable the person to modify or keep their housing. Some would require housing subsidies.

The assumptions are:

- 20%, or 5 of the 25 could return to a home that they own or could live with family. If funds were needed to rehab the home to make it accessible, CHRP funds could be accessed. (This is a little used fund available for a range of home rehabilitation, including access.) Cost to county = 0

- 50%, or 12 of the 25, could return to housing they were previously in, usually government subsidized (e.g. Housing Authority) or section 8 housing. Costs here would include both bridge rent payments, until released from the hospital or rehab, and possible renovations to make accessible, with one-time home modifications ranging from \$12K to \$42K.

Cost to county = \$30K (average cost) x 12 = \$360,000 one-time cost.

- 30% , or 8 of the 24, would want to be placed in independent, affordable housing, or provided a rent subsidy. The rent subsidy could range from \$500 to \$1500 per month, averaging \$1000/ month or \$12K / yr.
Cost to county = \$12K x 8 = \$96,000 on-going

The medical and support costs would be similar to costs in supportive housing.

Cost Totals for Independent Housing

IHSS = \$10,220 / yr x 2 =	\$ 20,440
PACE = \$0 x 13 =	\$ 0
IHSS + ADH = \$10,220 + \$5470 = \$15,690 / yr x 10 =	\$ 156,900
+ HDM = \$2190 x 10 =	\$21,900
Total medical and service, and rent subsidy costs =	\$295,240
One-time cost of \$360,000 for access changes, amortized over average life expectancy 5 years =	\$72,000 / year.
Total cost to county for 25 people living in independent housing	= \$367,240
<u>Grand total for 100 people leaving LHH and living in the community:</u>	
Board & Care =	\$480,000
Supportive Housing =	\$1,164,250
Independent Housing =	\$367,240
Grand total	\$2,011,490

Note re: Specific Populations: These calculations do not always factor in the varying needs of the population of LHH. About 40% of the LHH population has a primary psychiatric diagnosis or substance abuse issue and will need some form of community mental health services (including day treatment, counseling, mental health board and care, etc.)

It is important to note that, **the services to meet these unique and different needs can be secured primarily through programs that will cost the county nothing.** Specifically, Home and Community based Waivers can provide additional attendant/home nursing care (Nursing Facility Waiver), case management (Nursing Facility Waiver, MSSP, AIDS Waiver), as well as other incidental services for LHH residents. Waivers are 100% state and federal Medi-Cal funds, and are at no cost to San Francisco. In addition, Proposition 63 will provide \$50 million to SF for first year (planning year) and more thereafter to provide community mental health services and supports, including housing options. Proposition 63 funds can be used to drawn down federal matching funds, again, at no increased cost to San Francisco.



CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ben Rosenfield
Controller

Monique Zmuda
Deputy Controller

AUDIT FOLLOW-UP MEMORANDUM

DATE: February 25, 2010

TO: Mivic Hirose, Executive Administrator, Laguna Honda Hospital

FROM: Tonia Lediju, Director of Audits, City Services Auditor

SUBJECT: Results of Follow-up Review for Audit of Laguna Honda Hospital

EXECUTIVE SUMMARY

The Controller's City Services Auditor (CSA) Division issued an audit report in December 2006 entitled *The Hospital Improperly Purchased Linen and Other Supplies, and Needs to Improve Its Purchasing Procedures*. CSA has completed a follow-up review of the status of the recommendations in the 2006 report. Laguna Honda Hospital (LHH) indicated that it fully implemented all 11 recommendations in the audit report. Based on the follow-up work performed, CSA agrees with this assessment. LHH's actions to implement the recommendations are summarized on pages 2 through 4; the recommendations themselves and the implementation status of each are presented in Attachment A.

BACKGROUND & METHODOLOGY

The San Francisco Administrative Code (Administrative Code), Section 15.104, authorizes the Department of Public Health to become a member of the University Health Systems Consortium (consortium), and to use all services provided by the consortium, including the purchasing program. The consortium's supply company is called Novation. LHH's ability to make purchases in this way is known as its "Novation authority." This code section also authorizes LHH to enter written agreements and execute purchase orders with suppliers of goods and materials selected through Novation's competitive bid process. The Administrative Code further provides that these agreements and purchase orders will be governed by Novation's standard terms and conditions.

In accordance with Government Auditing Standards, Section 8.05, promulgated by the United States Government Accountability Office (GAO), CSA conducted a follow-up review of the agreed-upon recommendations in the 2006 audit report. Section 8.05 states that the purposes of audit reports include facilitating follow-up to determine whether appropriate corrective actions have been taken. This follow-up determined whether LHH has taken the corrective actions needed to implement the audit report's recommendations, with the goal of improving LHH's business practices. For recommendations calling for new procedures, CSA verified that the procedures were created and, in some cases, considered evidence of

the department's compliance with them. Future audits of LHH may incorporate review of its compliance with the new procedures.

To conduct the follow-up review, CSA met with key LHH personnel to discuss the status of the corrective actions taken to date, verified the existence of the procedures and processes that have been established, and documented the results of the fieldwork.

RESULTS

In response to this follow-up review, LHH in December 2009 reported that it had fully implemented all of the report's 11 recommendations, giving specific information for each recommendation (see Attachment A). CSA considered the information LHH provided, reviewed documentation, and verified that all 11 recommendations have been implemented. The results are presented below by subject area.

Recommendation 1: Re-examine LHH's policies and procedures for purchasing goods and services and the terms of its contract with Novation.

Consistent with the recommendation, LHH has revised its procedures for purchasing. According to LHH's Materials Management director, LHH analyzes Novation's prices on a case-by-case basis and compares them to the prices available through the standard contract of the City and County of San Francisco (City). If the price in the City contract is lower than Novation's price, then LHH will submit a purchase order through the City purchasing process. The Materials Management director reports that he has met with a Novation representative regularly in recent years to discuss ways of lowering prices and to receive updates on newly available programs and discounts.

Conclusion: Recommendation 1 has been implemented.

Recommendations 2, 3, 8, and 10: Establish in a manual various procedures for LHH's purchasing function.

Consistent with recommendation 2:

- LHH has prepared a policies and procedures manual for the Materials Management unit.
- CSA, on behalf of LHH, asked the Office of Contract Administration (OCA) to review LHH's purchasing policies and procedures but OCA did not respond to this request.

Consistent with recommendations 3, 8, and 10, LHH's policies and procedures manual includes:

- How to select a vendor when Novation has contracted with more than one vendor for certain products, and how to enter purchasing agreements under the Novation authority.
- A manual section on ethical business practices that says employees who make purchases must avoid any situation that impairs the exercise of independent judgment.

- A reminder that staff must encumber funds through creating a purchase order before ordering goods or services from a vendor.

Conclusion: Recommendations 2, 3, 8, and 10 have been implemented.

Recommendation 4: Purchase only products that Novation has competitively bid.

According to the Materials Management director, LHH's contract with Novation always states whether or not an item is competitively bid. If the item is not competitively bid, LHH can purchase the item through delegated departmental (or "Proposition Q") authority or place a purchase order through OCA. The recommendation suggests that LHH use only local business enterprise vendors through Novation. According to the Materials Management director, doing so would be impractical because very few of the Novation vendors are located in San Francisco.

Conclusion: Recommendation 4 has been implemented.

Recommendation 5: Purchase linen directly from the vendor to avoid Broadline's 10 percent mark-up.

LHH no longer does business with Broadline. LHH now buys linen products through the Novation authority via a dual-source agreement with Medline and Standard Textile.

Conclusion: Recommendation 5 has been implemented

Recommendation 6: Develop and implement procedures to verify that the product types and prices match the products ordered; verify that vendors charge Novation's prices.

According to the Materials Management director, LHH began using the Pathways Materials Management (PMM) system on September 30, 2008. PMM consists of computer hardware and software that allows for inventory control for hospital supplies and a three-way match to ensure quantities and prices agree on the purchase order, receiving document, and invoice. Item prices in PMM are locked so only authorized parties can change the price of an item. Prices are updated weekly based on an electronic price book issued by the items' distributors. If a price on an invoice is higher than the price calculated by PMM when LHH placed the order, then LHH would reject the invoice and seek an adjustment.

Conclusion: Recommendation 6 has been implemented.

Recommendation 7: Inform employees of the San Francisco Campaign and Government Code, Section 3.214, which can require them to avoid contracting decisions where they may have a conflict of interest.

In 2006 and 2009, LHH provided training on the City's delegated departmental purchasing authority. The training covered this code section. In addition, the training included:

- Best procurement practices.
- Principles and standards of ethical purchasing.
- How to ensure that all the City's legal requirements are met.

Conclusion: Recommendation 7 has been implemented.

Recommendation 9: Seek \$20,500 refund from Broadline for its excessive mark-up.

In 2007, the Materials Management director sent a memorandum to Broadline requesting a \$20,500 credit for excessive markup but never received a response.

Conclusion: Recommendation 9 has been implemented.

Recommendation 11: Require all managers to attend mandatory purchasing training.

LHH reports that it provided the required mandatory purchasing training. In March 2006, before the audit report was issued, LHH provided purchasing training to at least 55 employees. This exceeds the number of LHH employees who order goods, according to the Materials Management director.

Conclusion: Recommendation 11 has been implemented.

CSA extends its appreciation to you and your staff who assisted with this follow-up. If you have any questions or concerns, please call or e-mail Audit Manager Mark Tipton at (415) 554-7660 or ***Mark.Tipton@sfgov.org***.

cc: Tess Navarro, Deputy Financial Officer, LHH
Russell Nakai, Director, Materials Management, LHH
Ben Rosenfield, Controller
Robert Tarsia, Deputy Audit Director
Mark Tipton, Audit Manager
Vivian Chu, Associate Auditor

ATTACHMENT A: FINDINGS AND RECOMMENDATIONS

Audit Report Rec. #	Recommendation	December 2009 Status per LHH	Auditor's Follow-up Work	Results
1	<p>Re-examine its policies and procedures for purchasing goods and services, and its contract terms with Novation, to determine whether Laguna Honda is always making the most cost-effective purchasing decisions. To this end, Laguna Honda should perform periodic analysis of the Novation contract to determine if its prices are favorable. Also, when making purchases, Laguna Honda should periodically determine if purchasing goods and services under the City processes would be more favorable. Finally, Laguna Honda should work with Novation to identify if there are better ways for Laguna Honda to receive lower prices.</p>	Completed.	<p>Interviewed LHH Materials Management director to determine:</p> <ul style="list-style-type: none"> • How LHH re-examined its purchasing policies and procedures and the Novation contract to determine if it always gets the best possible prices. • How often LHH determines if Novation's prices are favorable. • How often LHH determines if using the City's processes would be more favorable than using Novation. • How LHH works with Novation (e.g., via periodic meetings) to identify ways to get lower prices. <p>Obtained documentation of LHH Materials Management director's frequent meetings with Novation representative.</p>	Implemented.

Audit Report Rec. #	Recommendation	December 2009 Status per LHH	Auditor's Follow-up Work	Results
2	Prepare a procedures manual for Laguna Honda's purchasing function, including purchases made using the Novation authority or the City's purchasing process. Consult with the City's Office of Contract Administration to ensure that the hospital has established adequate procedures.	Completed.	<p>Obtained Materials Management unit's policies and procedures manual. Found that procedures do cover purchases made under the Novation authority.</p> <p>Asked whether LHH consulted with OCA to ensure that the hospital has established adequate procedures. According to the Materials Management director, LHH attempted to ask OCA to review its purchasing policies and procedures manual but OCA declined to do so. This was confirmed with the CSA audit manager who contacted OCA at the time.</p>	Implemented.
3	Establish in the procedures manual specific procedures for selecting a vendor when Novation has contracted with more than one vendor for certain products, and procedures that specify how staff is to enter purchasing agreements under the Novation authority.	Completed. See Materials Management unit's policies and procedures manual, Section 3.14.	<p>Obtained manual and found that Section 3.14 does establish relevant policies or procedures:</p> <ul style="list-style-type: none"> • For selecting a vendor when Novation has contracted with more than one vendor for certain products. • That specify how staff is to enter purchasing agreements under the Novation authority. 	Implemented.

Audit Report Rec. #	Recommendation	December 2009 Status per LHH	Auditor's Follow-up Work	Results
4	Ensure that staff uses the Novation authority to purchase only those products that Novation has competitively bid. Further, when using disadvantaged or local business enterprise vendors through Novation, ensure that Novation has used a competitive bidding process or [Laguna Honda itself should] use a competitive bidding process to select the vendor.	Completed.	<p>Obtained document/invoices to show how LHH used the Novation authority. Reviewed sample documents showing Novation's prices.</p> <p>Interviewed personnel to determine how LHH knows it purchases only those products that Novation has competitively bid. According to the Materials Management director, LHH's contract with Novation always states whether or not an item has been competitively bid. If the item is not competitively bid, LHH can purchase the item through delegated departmental (Proposition Q) authority or place a purchase order through OCA.</p>	Implemented.
5	Purchase linen directly from Standard Textile and avoid Broadline's 10 percent mark-up. In addition, Laguna Honda should evaluate whether it has other agreements with suppliers or distributors in which it can save additional money by using only Novation's standard terms and conditions as a basis for selection.	Completed. LHH is currently utilizing Novation contract with Medline.	Interviewed personnel to determine how LHH uses the Novation contract with Medline. According to the Materials Management director, Novation now has a linen contract with Medline. Broadline is no longer used.	Implemented.

Audit Report Rec. #	Recommendation	December 2009 Status per LHH	Auditor's Follow-up Work	Results
6	<p>Develop and implement procedures that enable staff to verify that the product types and prices match the products ordered. Importantly, staff should be able to verify that prices charged by vendors conform to Novation's prices. If there are differences, Laguna Honda should work with Novation and the vendor to ensure Laguna Honda pays the correct prices.</p>	<p>Completed, utilizing Pathways Materials Management (PMM) software. PMM provides three-way match: purchase order, receiving document, and invoice matching.</p>	<p>Interviewed LHH personnel. The Materials Management director demonstrated for the auditors a few screens that are part of the system and stated that PMM:</p> <ul style="list-style-type: none"> • Was first used by LHH on 9/30/2008. • Is an automatic system that ensures that LHH verifies if prices charged by vendors conform to Novation's prices. • Restricts who can change the price of an item. • Allows prices to be changed via weekly updates based on price books issued by the product distributors. If a price on an invoice is higher than the price when the order was placed, PMM will cause LHH to reject the invoice and seek adjustments. 	<p>Implemented.</p>

Audit Report Rec. #	Recommendation	December 2009 Status per LHH	Auditor's Follow-up Work	Results
7	<p>Inform its employees of the San Francisco Campaign and Governmental Code, Section 3.214, which requires employees to recuse themselves from making contracting decisions that may benefit anyone with whom they have a personal relationship, unless an exception is necessary. In this case, as specified in the Code, Laguna Honda should ensure that such employees disclose personal relationships before signing such contracts.</p>	<p>Completed. Two trainings on Proposition Q authority were presented, one in 2006 and one in 2009.</p>	<p>Obtained documentation of the two trainings in the form of training handouts, which included the dates of the training sessions.</p> <p>Obtained a handout from the trainings that addresses San Francisco Campaign and Government Code, Section 3.214.</p> <p>By requiring its employees to attend one of these trainings every three years, LHH helps to ensure that employees recuse themselves from making contracting decisions that may benefit anyone with whom they have a personal relationship, or disclose such a relationship before signing a contract.</p>	<p>Implemented.</p>
8	<p>Establish in the procedures manual a section on ethical business practices that, among other requirements, specifies that employees that make purchases are to avoid any situation that impairs the exercise of independent judgment, as is established in the Office of Contract Administration's Purchasing Manual.</p>	<p>Completed. See Materials Management unit's policies and procedures manual, Section 3.12.</p>	<p>Obtained manual and found that Section 3.12 does point out that LHH employees, like all City employees, must adhere to San Francisco Campaign and Government Code, Section 3.214. The manual states that employees (involved in purchasing decisions) will be required annually to read and sign that they accept the provisions of San Francisco Campaign and Government Code, Section 3.214, and annually complete and sign State of California Form 700 (a statement of economic interests).</p>	<p>Implemented.</p>

Audit Report Rec. #	Recommendation	December 2009 Status per LHH	Auditor's Follow-up Work	Results
9	Seek a refund from Broadline for the excessive mark-up it charged from the start of the contract on August 15, 2002, through December 31, 2004. We estimate the refund should be approximately \$20,500.	Completed.	Verified that the Materials Management director issued a memo to Broadline on 3/30/2007 to request a credit of \$20,500 for excessive mark-up charged by Broadline during the period from 8/15/2002 to 12/31/2004. However, according to the Materials Management director, LHH never received this credit from Broadline.	Implemented.
10	When using the city process for making purchases, establish procedures that require staff to encumber purchases before ordering goods or services from a vendor.	Completed, using ADPICS.	Reviewed Materials Management unit's policies and procedures manual. Found that Section 3.1 does require staff to encumber funds before ordering goods or services from a vendor. A purchase order creates such an encumbrance.	Implemented.
11	Require that all of its managers attend mandatory purchasing training to ensure they are aware of the City's purchasing requirements.	Completed.	Obtained and reviewed content of the Proposition Q purchasing authority training for managers, evidence that the training was considered mandatory, and a list of all current LHH managers. Obtained from post-training tests the signature pages of 55 employees who attended the March 2006 training. Did not verify that all 55 employees were managers, however, according to the Materials Management director, this number exceeds the number of LHH employees who place orders for goods.	Implemented.

ATTACHMENT B: LAGUNA HONDA HOSPITAL'S RESPONSE

City and County of San Francisco



Gavin Newsom
Mayor

Department of Public Health

Laguna Honda Hospital &
Rehabilitation Center

Russell Nakai,
Director, Materials Management

Date: February 22, 2010
To: Tonia Lediju, Controller's Office Director of Audits
From: Russell Nakai *Russell Nakai*
Subject: Results of Follow-up Review for Audit of Laguna Honda Hospital

This memo is to confirm that I am in agreement with the audit findings with the follow-up audit conducted in December 2009 by Mark Tipton and Vivian Chu.

(415) 759-2326

375 Laguna Honda Blvd.

San Francisco, CA 94116-1499



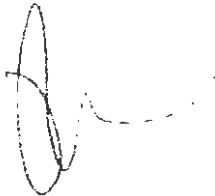
MEMORANDUM

TO: Mohammed Nuru, Director
Department of Public Works

FROM: Tonia Lediju, Director of City Audits
City Services Auditor Division

DATE: July 30, 2013

SUBJECT: The Department of Public Works Generally Complied With Close-out
Procedures for the Laguna Honda Hospital Replacement Program
Contract but Must Better Document Its Compliance



EXECUTIVE SUMMARY

The Department of Public Works (Public Works) generally complied with most of the close-out procedures for its construction contract with Turner Construction Company, the contractor for the Laguna Honda Hospital Replacement Program (LHH replacement program). However, Public Works was unable to provide the assessment team with documentation to verify its compliance with eight of 34 applicable close-out procedures. Public Works concurs with this finding, and agrees to implement the related recommendations.

BACKGROUND, OBJECTIVES & METHODOLOGY

Background

Basis for Assessment. In accordance with the Office of the Controller's City Services Auditor Division (CSA) work plan for fiscal year 2012-13, CSA assessed Public Works' compliance with close-out procedures for portions of the LHH replacement program construction contract as part of CSA's ongoing program of assessing compliance with contract close-out procedures in various departments of the City and County of San Francisco (City) each quarter.

Laguna Honda. Laguna Honda Hospital and Rehabilitation Center (Laguna Honda) is a skilled nursing and rehabilitation center owned and operated by the City's Department of Public Health (Public Health). Located on a 62-acre campus, Laguna Honda is one of the largest skilled nursing facilities in the United States. Laguna Honda's mission is to provide high-quality,

culturally competent, long-term care and rehabilitation services to the diverse communities of San Francisco.

Public Works. Public Works designs, builds, operates, maintains, cleans, greens, and improves city infrastructure, public rights-of-way, and facilities. Public Works is organized into several bureaus and divisions. The Building Design and Construction Division, the subject of this assessment, is a project management, architecture, and engineering organization, which delivers major capital building projects to city departments. Although Laguna Honda is owned and operated by Public Health, Public Works staff managed the LHH replacement program and all construction contract close-out activities.

Laguna Honda Hospital Replacement Program. The LHH replacement program comprises demolition, construction, and renovation of Laguna Honda, including renovations to existing facilities and the construction of three new buildings (South, Link, and East). The general contractor for the project (under contract number 8550A) is Turner Construction Company. The project began on November 18, 2002, and construction of the Link, South, and East buildings was completed in December 2010. The contract was closed out and final payment was made on December 24, 2012. The renovations to existing facilities, expected to be completed by Fall 2013, are now being performed under a separate contract. Upon completion, the program will result in 765 skilled nursing facility beds and 15 acute care beds, for a total of 780 beds.

On November 2, 1999, San Francisco voters approved Proposition A, a ballot measure authorizing the City to issue up to \$299,000,000 in general obligation bonds to finance the LHH replacement program. The program also received funding from other sources. The final program cost was \$582,672,054. The following exhibit lists the sources of funds used for the LHH replacement program.

EXHIBIT Sources of Funding for the Laguna Honda Hospital Replacement Program	
Source	Amount
General Obligation Bonds	\$296,083,671
Interest Earned from General Obligation Bonds	26,771,514
Tobacco Settlement Revenues	133,554,943
Interest Earned from Tobacco Settlement Revenues	7,437,788
Certificates of Participation	120,000,000
Various Grants	1,098,686
Total	\$584,946,602

Note: The project budget was subsequently reduced by \$2,274,548, for a final cost of \$582,672,054.

Source: Laguna Honda Hospital Replacement Program Quarterly Status Report (December 2012) presented to the City's Citizens' General Obligation Bond Oversight Committee.

Close-out Defined. Contract close-out formally ends the construction phase of a capital project and ensures that all contractual and legal obligations have been fulfilled before final payment is released to the contractor. Ensuring compliance with all close-out procedures assures the City that the contractor used city resources appropriately and completed the work in accordance with contract terms.

Objectives and Methodology

The objectives of the assessment were to determine whether:

- Public Works adequately oversaw compliance with all the close-out procedures in the contract for the new South, Link, and East buildings, which were completed in December 2010.
- The contractor complied with the contract's close-out procedures.

To achieve the objectives, CSA:

- Reviewed close-out procedures for the LHH replacement program contract.
- Developed a checklist of requirements for all phases of close-out based on Public Works' required procedures for substantial completion¹ and final completion² of the project.
- Reviewed close-out documentation provided by Public Works.
- Determined whether each requirement was met or did not apply to the project based on documentation provided by Public Works.
- Reviewed a relevant best practices document.

CSA judgmentally selected the LHH replacement program for assessment as part of a more comprehensive review of close-out procedures on city general obligation bond-funded projects.

RESULTS

Public Works could not provide adequate documentation to verify that it had properly completed eight of 34 applicable close-out procedures.

The assessment found that Public Works complied with most close-out procedures for the LHH replacement program. However, the Public Works project team was unable to provide the

¹ Substantial completion is the stage at which the progress of work is deemed to be sufficiently complete, in compliance with the contract, to allow for the issuance of a temporary certificate of occupancy, so that the facility being built may be used for its intended purpose.

² Final completion is the date of written acceptance of the work by the City when the contract has been fully performed, including all punch list items, and when all contractual and administrative items have been fulfilled.

assessment team with documentation verifying that it ensured compliance with the following eight items required for project close-out. Specifically, Public Works has no documentation that the:

- a) Construction manager submitted three copies of the punch list (a list of tasks to be completed before the contract can be closed-out), including the value of the items on the list and the reason the work was not complete.
- b) City representative and construction manager conducted an inspection within two working days from receipt of written request, or that the City representative notified the construction manager of unfulfilled requirements.
- c) Contractor requested re-inspection when it completed work identified as still incomplete in previous inspections.
- d) Contractor delivered City-owned tools, spare parts, extra materials, and similar items to a location designated by the City.
- e) Contractor submitted a certified, endorsed copy of the punch list indicating that each item had been completed or otherwise resolved to the city representative for acceptance.
- f) Contractor complied with final cleaning requirements, including touch-up painting.
- g) Contractor removed temporary facilities, services, materials, and rubbish.
- h) Contractor touched up and otherwise repaired and restored marred exposed finishes to eliminate visual defects.

Public Works does not use a close-out checklist to ensure that all procedures have been completed. Procedural steps are a tool to assist Public Works staff in ensuring that the department and contractor meet contract requirements and ensure successful completion of the project. Failure to follow all required steps could cause an important requirement to be overlooked. Creating a checklist of required procedures and documentation is a best practice for contract close-out and would assist Public Works staff in ensuring that all applicable close-out procedures in the contract are completed and documented. Also, Public Works staff noted that some of the contract's close-out procedures are outdated and need to be revised to reflect current practices.

Recommendations

The Department of Public Works should:

1. Establish a close-out checklist for all current and future construction projects and ensure that it has ready access to the documentation needed to verify that the close-out requirements have been met.
2. Keep a complete record of all aspects of its construction close-out procedures.

3. Review contract requirements pertaining to close-out procedures and revise outdated procedures to reflect current practices.

Public Works' response is attached. CSA will work with the department to follow up on the status of the recommendations made in this memorandum. CSA extends its appreciation to you and your staff who assisted with this project. If you have any questions or concerns, please contact me at (415) 554-5393 or tonia.lediju@sfgov.org.

cc: Public Works

Edgar Lopez

John Thomas

Nelson Ng

Jocelyn Quintos

Lourdes Nicomedes

Controller

Ben Rosenfield

Monique Zmuda

Mark de la Rosa

Deric Licko

Edvida Moore

ATTACHMENT: DEPARTMENT RESPONSE

City and County of San Francisco



Edwin M. Lee, Mayor
Mohammed Nuru, Director

San Francisco Department of Public Works

1 Dr. Carlton B. Goodlett Place, City Hall, Room 348
San Francisco, CA 94102
(415) 554-6900 ■ www.sfdpw.org



MEMORANDUM

Date: July 22, 2013
To: Tonia Lediju, Director of City Audits
From: Mohammed Nuru, Director, Department of Public Works
Subject: Laguna Honda Close Out Assessment

Thank you for your memo of June 13, 2013 regarding the results of your audit of the close-out procedures for the Laguna Honda Hospital Replacement Program. We appreciate your team's insights into our construction contract closeout procedures. As discussed with your staff, we will update our checklist and procedures where practicable and as the current state of the law allows.

We will customize our closeout policies and procedures to the specific nature and scope of the project requiring the project manager/project architect/project engineer to work closely with contract preparation group to develop a contract appropriate to the project. Specifically, we will develop and implement a closeout checklist of required procedures and documentation that is suitable and practical to the specific project.

DPW strives for continuous improvement of our business practices. Please see the attached document for our detailed response to the recommendations contained in the draft audit report. Should you have any other questions, please contact Jocelyn Quintos at (415) 554-6935.

Cc: Public Works
Edgar Lopez, Deputy Dir. for Buildings & City Architect, Department of Public Works
John Thomas, Project Manager, Department of Public Works
Jocelyn Quintos, Business Services Division Manager, Department of Public Works
Lourdes Nicomedes, Accounting Manager, Department of Public Works

Controller's Office

Ben Rosenfield, Controller, City and County of San Francisco
Monique Zmuda, Deputy Controller, City and County of San Francisco
Mark de la Rosa, City Services Auditor
Deric Licko, City Services Auditor
Edvida Moore, City Services Auditor



San Francisco Department of Public Works
Making San Francisco a beautiful, livable, vibrant, and sustainable city.

For each recommendation, the responsible agency should indicate whether it concurs, does not concur, or partially concurs. If it concurs with the recommendation, it should indicate the expected implementation date and implementation plan. If the responsible agency does not concur or partially concurs, it should provide an explanation and an alternate plan of action to address the identified issue.

RECOMMENDATIONS AND RESPONSES

Recommendation	Response
The Department of Public Works should:	
1. Establish a close-out checklist for all current and future construction projects and ensure that it has ready access to the documentation needed to verify that the close-out requirements have been met.	The Department concurs. We will develop a close-out checklist that accounts for the specific nature and timeline of projects. We will update our close-out policies and procedures by the end of July and implement fiscal year 2013-2014.
2. Keep a completed record of all aspects of its construction close-out procedures.	The Department concurs. The Department maintains procedures, including Project Closeout. These are available at the department's intranet site.
3. Review contract requirements pertaining to close-out procedures and revise outdated procedures to reflect current practices.	The Department concurs. As noted in our response to Recommendation #1, we will review and update our close-out procedures as appropriate. This includes taking into consideration the continuous nature of the punch list process and the specific nature of the projects.

City and County of San Francisco

Office of the Controller – City Services Auditor

DEPARTMENT OF PUBLIC HEALTH:

**Internal Controls at Laguna Honda
Hospital's Central Supply
Department Do Not Ensure That
Assets Are Properly Accounted for
and Safeguarded**



March 27, 2014

**OFFICE OF THE CONTROLLER
CITY SERVICES AUDITOR**

The City Services Auditor Division (CSA) was created in the Office of the Controller through an amendment to the Charter of the City and County of San Francisco (City) that was approved by voters in November 2003. Charter Appendix F grants CSA broad authority to:

- Report on the level and effectiveness of San Francisco's public services and benchmark the City to other public agencies and jurisdictions.
- Conduct financial and performance audits of city departments, contractors, and functions to assess efficiency and effectiveness of processes and services.
- Operate a whistleblower hotline and website and investigate reports of waste, fraud, and abuse of city resources.
- Ensure the financial integrity and improve the overall performance and efficiency of city government.

CSA may conduct financial audits, attestation engagements, and performance audits. Financial audits address the financial integrity of both city departments and contractors and provide reasonable assurance about whether financial statements are presented fairly in all material aspects in conformity with generally accepted accounting principles. Attestation engagements examine, review, or perform procedures on a broad range of subjects such as internal controls; compliance with requirements of specified laws, regulations, rules, contracts, or grants; and the reliability of performance measures. Performance audits focus primarily on assessment of city services and processes, providing recommendations to improve department operations.

CSA conducts its audits in accordance with the Government Auditing Standards published by the U.S. Government Accountability Office. These standards require:

- Independence of audit staff and the audit organization.
- Objectivity of the auditors performing the work.
- Competent staff, including continuing professional education.
- Quality control procedures to provide reasonable assurance of compliance with the auditing standards.

For questions about the report, please contact Director of City Audits Tonia Lediju at Tonia.Lediju@sfgov.org or 415-554-5393 or CSA at 415-554-7469.

Audit Team: Irella Blackwood, Audit Manager
Mamadou M. Gning, Audit Manager
Sandeep Rajbhandari, Staff Auditor



City and County of San Francisco

Office of the Controller - City Services Auditor

Department of Public Health:

March 27, 2014

**Internal Controls at Laguna Honda Hospital's Central Supply Department
Do Not Ensure That Assets Are Properly Accounted for and Safeguarded**

Purpose of the Audit

The Office of the Controller's City Services Auditor Division (CSA) performed an inventory audit of the Central Supply Department (Central Supply) at Laguna Honda Hospital and Rehabilitation Center (Laguna Honda). The audit determined whether the department has adequate inventory processes and controls to ensure that materials, supplies, and tools are accurately accounted for, adequately organized, and properly secured.

Highlights

The inventory and materials management processes of Laguna Honda's Central Supply have multiple weaknesses. Although purchase orders are correctly recorded as part of the inventory process, the audit found numerous errors in the sampled inventory records, a lack of policies and procedures to guide physical inventory counts, dispensing of obsolete items, and manual inventory operations. Overall, Central Supply's internal controls are inadequate because they do not reasonably assure Laguna Honda that assets are properly accounted for and safeguarded.

Specifically, the audit found that Central Supply:

- Has inventory on hand that does not match its system records.
- Performs inconsistent counts and does not track frequency of counts performed.
- Adjusts its inventory category thresholds without proper analysis or oversight.
- Has weak internal controls over reconciliation of quantity discrepancies in inventory cycle counts.
- Uses an inventory valuation method that is inconsistent with Laguna Honda's accounting policy.
- Does not record the value of the inventory transferred from the Pharmacy Room.
- Does not limit the distribution of its master keys, which increases risk and limits accountability if loss occurs.
- Lacks written policies and procedures for dispensing expired or obsolete items, and management does not sign to indicate its approval before the disposal of these items.
- Lacks written policies and procedures to perform physical inventory counts.
- Correctly records its purchases orders.

Recommendations

The report includes 21 recommendations for the department to strengthen its inventory and material management controls. Specifically, Central Supply should:

- Establish performance goals for the physical count.
- Implement procedures to ensure that periodic inventory counts are scheduled and performed.
- Periodically analyze usage to validate the inventory segments.
- Ensure that Central Supply values its inventory in accordance with its accounting policy.
- Record the cost of each inventory item on its inventory lists.
- Separate duties so that staff that counts inventory cannot adjust quantities in the Pathways system.
- Establish written policies and procedures.

Copies of the full report may be obtained at:

Office of the Controller • City Hall, Room 316 • 1 Dr. Carlton B. Goodlett Place • San Francisco, CA 94102 • 415.554.7500
or on the Internet at <http://www.sfgov.org/controller>

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CITY AND COUNTY OF SAN FRANCISCO
OFFICE OF THE CONTROLLER

Ben Rosenfield
Controller

Monique Zmuda
Deputy Controller

March 27, 2014

Health Commission
101 Grove Street, Room 311
San Francisco, CA 94102

Ms. Barbara A. Garcia
Director of Health
Department of Public Health
101 Grove Street, Room 308
San Francisco, CA 94102

Dear commission president and members, and Ms. Garcia:

The Office of the Controller's City Services Auditor Division (CSA) presents its audit report of inventory processes of the Central Supply Department (Central Supply) at Laguna Honda Hospital and Rehabilitation Center (Laguna Honda). The audit objectives were to determine whether Central Supply has adequate inventory processes and controls to ensure that materials and supplies are accurately accounted for, adequately organized, and properly secured.

The audit concluded that Central Supply's internal controls are inadequate to ensure that assets are properly accounted for and safeguarded.

The report includes 21 recommendations for Laguna Honda to improve control and accountability over safeguarding of assets and inventory functions at Central Supply. The department's response to the report is attached as an appendix.

CSA appreciates the assistance and cooperation of Laguna Honda staff during the audit. For questions about the report, please contact me at Tonia.Lediju@sfgov.org or 415-554-5393 or CSA at 415-554-7469.

Respectfully,

Tonia Lediju
Director of City Audits

cc: Mayor
Board of Supervisors
Citizens Audit Review Board
City Attorney
Civil Grand Jury
Budget Analyst
Public Library

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GLOSSARY OF TERMS

ABC	ABC is not an acronym, but rather an inventory categorization technique often used in materials management.
Central Supply	The Central Supply Department at Laguna Honda Hospital and Rehabilitation Center
City	City and County of San Francisco
Controller	Office of the Controller
CSA	The Office of the Controller's City Services Auditor Division
First In, First Out	Under the first in, first out inventory valuation method, the cost of goods sold is based upon the cost of material bought earliest in the period, while the cost of inventory is based upon the cost of material bought later in the year. This results in inventory being valued close to current replacement cost.
GAO	U.S. Government Accountability Office
Laguna Honda	Laguna Honda Hospital and Rehabilitation Center
Pathways	Pathways Material Management™ (PMM) is the principal system used by the Central Supply Department to monitor inventory levels of medical supplies and order medical supplies from the contracted vendor. PMM is part of McKesson Corporation's enterprise resource utilization (ERP) hospital applications.

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INTRODUCTION

Audit Authority

This audit was conducted under the authority of the Charter of the City and County of San Francisco (City), Section 3.105 and Appendix F, which requires that the Office of the Controller's (Controller) City Services Auditor Division (CSA) conduct periodic, comprehensive financial and performance audits of city departments, services, and activities. CSA conducted this audit under that authority and in accordance with its annual audit plan. This audit is the first in a series of inventory audits of various city departments planned by the Controller.

Background

Laguna Honda Hospital and Rehabilitation Center (Laguna Honda) is a skilled nursing and rehabilitation center owned by the City and operated by the Department of Public Health. The hospital provides skilled nursing services, rehabilitation services, group living for people with developmental disabilities, and treatments and programs for a variety of other conditions. Laguna Honda stores most of its inventory in five departments of the hospital:

1. Pharmacy (pharmaceutical supplies)
2. Central Supply (medical supplies)
3. Food and Nutrition Services
4. Linen (linen used on patient beds)
5. Materials Management (janitorial supplies)

Laguna Honda reported fiscal year 2012-13 year-end inventory valued at \$1.1 million. Exhibit 1 shows the areas where the hospital stores its inventory items and their values on June 30, 2013.

EXHIBIT 1 Inventory on June 30, 2013	
Department	Inventory Balance
Pharmacy	\$430,718
Linen	391,007
Central Supply	175,910
Food and Nutrition Services	106,130
Materials Management	26,994
Total	\$1,130,759

Source: Laguna Honda Accounting/Finance Division

**Office of the Controller, City Services Auditor
Internal Controls at Laguna Honda Hospital's Central Supply Department Do Not Ensure
That Assets Are Properly Accounted for and Safeguarded**

Based on a risk assessment of Laguna Honda's five inventory locations, CSA determined that the Central Supply Department (Central Supply) had the highest risk and selected it for audit.

*Overview of Laguna
Honda Hospital's
Inventory*

Mission and Services. Central Supply's mission is to stock Laguna Honda's nursing units with medical supplies and equipment needed for the care of residents. Central Supply's inventories are stored at the Central Supply Room and the Materials Management Department warehouse. Central Supply carried 657 inventory items on October 1, 2013. Central Supply is open from 6:30 a.m. to 8:30 p.m., seven days a week to accommodate the needs of the nursing units and to be responsive to peak demand periods.

Inventory Management System. Central Supply uses the Pathways Material Management System (Pathways) to monitor inventory levels of medical supplies on the nursing units and to order medical supplies from contracted vendors when inventory levels fall below the PAR level.¹ Central Supply, in collaboration with the Nursing Services Department, established and entered into Pathways the PAR levels of medical supplies for each nursing unit. PAR levels are established to provide three to four days of medical supplies.

Each day, Pathways calculates necessary inventory replenishments using the established minimum and maximum inventory levels and pending department order requests in the system. Central Supply reviews, approves, and processes the replenishment requisitions.

Objectives

The audit's objectives were to determine whether Central Supply:

1. Has inventory processes and controls adequate to ensure that materials and supplies are accurately accounted for.
2. Adequately organizes and properly secures all materials and supplies.
3. Approves and records inventory purchase orders accurately and in a timely manner.

¹ PAR levels are boundary markers in inventory levels that signal replenishment needs

Scope and Methodology

The audit included all items inventoried by Laguna Honda's Central Supply from July 1, 2012, through June 30, 2013. To perform the audit, the audit team:

- Interviewed staff and managers to gain an understanding of Central Supply's inventory processes.
- Inspected the Central Supply Room.
- Judgmentally selected a sample of 25 inventory items from the inventory list and, using physical inspection, verified the number of units on hand.²
- Judgmentally selected a sample of 25 inventory items in the room and verified that they were on an inventory list.
- Selected a sample of 24 items from an inventory list and tested to determine if orders were properly approved and whether items were received and recorded in the inventory management system.

Statement of Auditing Standards

This performance audit was conducted in accordance with generally accepted government auditing standards. These standards require planning and performing the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. CSA believes that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

² Auditors counted the individual units on hand for the selected inventory items. Auditors did not use blank inventory count sheets but used the full inventory list containing items and quantities on the day of the count.

**Office of the Controller, City Services Auditor
Internal Controls at Laguna Honda Hospital's Central Supply Department Do Not Ensure
That Assets Are Properly Accounted for and Safeguarded**

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AUDIT RESULTS

Summary

The inventory and materials management processes of Laguna Honda's Central Supply have multiple weaknesses. CSA found numerous errors in the sampled inventory records, ineffective internal controls, a lack of policies and procedures to guide physical inventory counts, and dispensing of obsolete items. Overall, Central Supply's internal controls are inadequate because they do not reasonably assure Laguna Honda that assets are properly accounted for and safeguarded.

Finding 1

Central Supply's inventory on hand does not match its system records.

Central Supply's inventory record is inaccurate.

Central Supply's inventory record is inaccurate because it includes both shortages and overages.³ Central Supply relies on its inventory management system, Pathways, to maintain an accurate list of its inventory. On the day of a count, Central supply staff generates from the Pathways system a list of items to be counted.

System counts did not match actual counts for 12 of 25 selected items.

Test counts of the inventory found multiple discrepancies between system and floor counts. Of the 657 items on Central Supply's inventory list on October 1, 2013, 25 (4 percent) were judgmentally selected for audit to determine the accuracy and existence of the counts in Pathways. Another judgmentally selected 25 items were counted from the inventory floor to determine the completeness of the counts in Pathways.

As shown in Exhibit 2, the system-to-floor test found that the physical inventory amounts did not match for 12 (48 percent) of the 25 items in the sample. For 6 items there were greater quantities than shown on the inventory records (an overage in Pathways of \$332 of inventory) and for 6 other items, there were fewer on hand than listed (a shortage in Pathways of \$590). The net variance was 3 percent of the value of the inventory sampled.

³ Shortages exist when Pathways Material Management System (PMM) shows more items than are on hand. Overages are when PPM shows fewer items than are on hand.

**Office of the Controller, City Services Auditor
Internal Controls at Laguna Honda Hospital's Central Supply Department Do Not Ensure
That Assets Are Properly Accounted for and Safeguarded**

EXHIBIT 2 Discrepancies in Inventory Records Based on System-to-Floor Physical Count

Item Number	Quantity in System	Number of Items Counted	Difference	Discrepancy Amount
4048	9	10	1	\$165.95
4057	28	26	(2)	(112.04)
1001199	10	13	3	35.58
1126	205	183	(22)	(44.40)
1152	88	112	24	78.96
1191	23	17	(6)	(6.46)
1270	14	15	1	22.90
1287	25	19	(6)	(358.80)
1324*	25	80	55	0.00
1573	2	3	1	28.70
1574	3	2	(1)	(35.56)
1585	7	5	(2)	(32.75)
Total	439	485	46	(\$257.92)

* This part was transferred from the Pharmacy Department and has no value assigned. Please refer to finding 6 for further details.

Source: Auditor's analysis of sample of 25 items.

On the floor-to-system test, the physical inventory amounts did not match for 7 (28 percent) of the 25 items sampled (see Exhibit 3). For three items, there were more items on hand than shown in the inventory records (overage in Pathways of \$279) and for four items there were fewer (shortage in Pathways of \$956). The net variance was 9 percent of the value of the inventory sampled.

EXHIBIT 3 Discrepancies in Inventory List Based on Floor-to-System Physical Count

Item Number	Number of Items Counted	Quantity in System	Difference	Discrepancy Amount
1596	584	252	332	\$262.28
1417	328	224	104	14.56
7049505	31	32	(1)	(0.24)
4264	95	96	(1)	(9.67)
5788656	60	78	(18)	(945.91)
4066	208	209	(1)	(0.22)
1499	15	14	1	1.67
Total	1321	905	416	(\$677.53)

Source: Auditor's analysis of sample of 25 items.

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Floor counts did not match inventory records for 7 of 25 selected items.

Both overages and shortages may indicate potential loss or theft or, at a minimum, issuance issues. A shortage indicates that items were removed from inventory without updating records. An overage indicates that items were not recorded in inventory when stocked or that issued items were returned to the shelf. An overage can also occur when withdrawals from inventory are not recorded. These inaccuracies increase the risk of undetected theft and lost or missing assets.

Central Supply needs to establish accountability and set performance goals.

Central Supply personnel could not adequately explain the reasons for these discrepancies. Inaccurate records of the inventory items on hand make it more difficult to detect loss or theft. Inaccurate records also make it more difficult to monitor the inventory levels and reorder points to ensure that items are available when needed. Proper inventory accountability requires that detailed records of acquired inventory be maintained and that inventory is properly reported.

According to the U.S. Government Accountability Office (GAO) *Executive Guide: Best Practices in Achieving Consistent, Accurate Physical Counts of Inventory and Related Property* (GAO Guide),⁴ one of the key factors in developing and implementing an accurate physical count process is to establish accountability. Establishing accountability for the inventory physical count process requires setting performance goals and holding the appropriate level of personnel responsible for the overall process. Performance goals for the physical count process can be set by establishing inventory record accuracy goals or other measurable, results-oriented performance expectations, such as adjustments and the number of accurate counts. Primary responsibility for the overall physical inventory counts should be specifically designated and assigned. The designated individual should be held responsible for achieving an established inventory record accuracy goal.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

1. Direct Central Supply Department staff to conduct

⁴GAO-02-447G, United States General Accountability Office, 2002, <http://www.gao.gov>

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a 100 percent physical count of the inventory and reconcile discrepancies to establish a new inventory baseline.

2. Establish performance goals for the physical count and develop employee/supervisor performance measurement systems to hold appropriate personnel accountable for accomplishing a consistent, accurate physical count of inventory.

Finding 2

Central Supply staff performs inconsistent counts and does not track the frequency of counts performed.

Inventory counts are not performed at regularly scheduled intervals.

The Central Supply employees do not regularly perform inventory cycle counts. Without regular cycle counts of its entire inventory, Central Supply cannot ensure that its inventory is being adequately protected against loss and theft, that there are no shortages or unnecessary purchases, or that the inventory is properly reported in Laguna Honda's financial records.

Inventory items are segmented in three categories.

According to the director of materials management, who oversees both the Materials Management and Central Supply departments, inventory items have been segmented into three categories based on their usage level. Category A represents inventory items in the top 20 percent in terms of usage rate, in category B are items in the next 20 percent, and in category C are items in the remaining 60 percent. Each category is counted with greater or lesser frequency to achieve more coverage of the most frequently used inventory items and less coverage of the inventory items with little or no movement. According to management, Category A items are scheduled to be counted weekly, Category B items every other week, and category C items monthly.

Only seven counts occurred in fiscal year 2012-13.

Central Supply's cycle count transactions summary report for fiscal year 2012-13 shows that only seven cycle counts were performed in the year, of which three were in June 2013. Before June 2013 Central Supply staff performed its last physical inventory count on April 10, 2013, which illustrates the irregular frequency of the inventory counts performed. The materials management director acknowledged that cycle counts are not

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conducted routinely. He also explained that Central Supply does not have enough personnel to perform the planned inventory counts.

A log of records of physical counts performed is not maintained.

Central Supply does not use a tracking log of cycle counts performed for each category of inventory. The lack of a tracking log indicates that Central Supply staff does not monitor the cycle counts of items to achieve the desired frequency of counts or assure an accurate count. A tracking log of the physical counts for each category would ensure that all items in each category are adequately counted.

According to the GAO Guide, counting an appropriate amount of the total inventory at a point in time or over a period of time with regular frequency helps to provide accurate inventory records for operational decisions and financial reporting. Without periodically scheduled physical inventory counts, inventory shortages and overages could occur and remain undetected.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

3. Implement procedures to ensure that periodic inventory counts are scheduled, performed regularly, and reconciled to the perpetual inventory and accounting records.
4. Create a manual or electronic tracking log to record category counted and the dates of the cycle counts.

Finding 3

Central Supply's ABC inventory category thresholds are adjusted without proper analysis or oversight.

No usage analysis was performed to validate the inventory segments.

Central Supply staff can adjust the category thresholds of the items listed in the inventory management system without management's preapproval. As noted in Finding 2, inventory items were categorized into A, B, and C categories to help management identify items with significant impact on overall inventory cost and requiring different management and controls. However, according to Central Supply staff during a walkthrough of the Central Supply Room by the audit team, the thresholds of

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the items that fall under categories A, B, and C had been adjusted in the prior quarter. The staff stated that the thresholds for categories A and B were updated the prior quarter to each cover the top 40 percent of items in terms of usage rate. According to the interim lead Central Supply Technician, the higher thresholds were used to help increase the physical counts coverage. This change to the categories' thresholds was implemented without prior approval from the materials management director or the assistant materials manager.

The materials management director confirmed that the three inventory segmentations were initially determined based on industry practices. He also stated that since the implementation of the inventory management system, the department has not analyzed its inventory usage to validate the thresholds of the segments due to staff shortages.

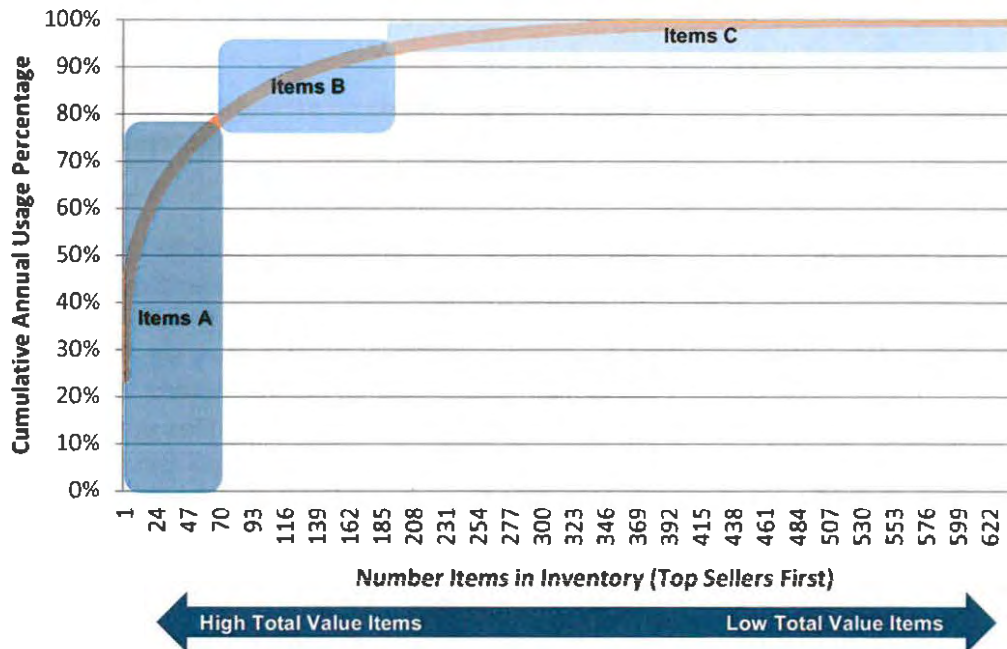
According to the GAO Guide, to count an appropriate amount of the total inventory, management must decide which inventory items to count and how frequently those items should be counted. Ideally, all inventory items would be counted at least yearly. However, maintaining accurate inventory records by counting items takes time and costs money. Because there are limits on these resources, the best way to balance control of the inventory and the cost of the count is to focus on the items determined to be more important or at higher risk of loss or theft. Management should consider items' value, criticality to operations, and susceptibility to theft or fraud when segmenting the inventory and determining the frequency of counts for each segment.

Measuring the significance of each type of inventory item in terms of usage or value will help management divide the inventory into identifiable segments and determine the frequency of counts based on the assessed risk of each segment. Management has adopted the ABC classification as its inventory categorization technique and segmented its inventory items based on usage to help focus on items that cost the department most in terms of total consumption value. The higher the usage, the more activity an item is likely to have, hence the greater likelihood that transaction issues will result in inventory errors.

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To make the most effective use of the ABC classification, periodic review should be completed to validate the categories. The audit identified three categories based on an analysis of Central Supply's inventory usage during fiscal year 2012-13, as shown in Exhibit 4.

**EXHIBIT 4 Central Supply Usage Analysis
Fiscal Year 2012-13**



Source: Auditor's analysis of data from Pathways Material Management System.

Based on the usage rate of inventory items, the top 10 percent of the items account for 78 percent of the annual inventory consumption value, the next 20 percent of the items account for 16 percent of the annual consumption value, and the bottom 70 percent of the items account for only 6 percent of the annual consumption value. Because 78 percent of the annual inventory consumption is covered by only 10 percent of the items in inventory, these items warrant the most attention. The next segment covers 16 percent of the items in inventory and should also have sufficient coverage.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

5. Periodically analyze usage to validate the inventory segments, determine the desired frequency of counts, and reassess the risk of each segment.
6. Require proper signoff by the director of materials management before any update to the inventory segments.

Finding 4

Central Supply needs to strengthen internal controls over reconciliation of quantity discrepancies in inventory cycle counts.

Inventory count and recording duties are not segregated.

Central Supply's processes to reconcile inventory discrepancies are inadequate. The employees responsible for performing inventory cycle counts are also permitted to adjust the inventory list. This lack of separation of duties is an internal control weakness that increases the risk of fraud. If the duties are not separated, the control weakness can result in improper transactions being recorded in the inventory records to cover improper or unauthorized transactions. Also, errors can easily be hidden at the time of cycle counts without further investigation.

In fiscal year 2012-13 568 inventory cycle count adjustments were made to Central supply's inventory, of which 97 percent were processed by the same four employees who performed the inventory cycle counts. Further, according to Central Supply staff no specific guidance was provided to staff on inventory shortage or overage thresholds requiring management's review and approval. Central Supply management also could not provide evidence of any reconciliation having been performed between cycle count sheet quantities and inventory item transactions to identify causes of the quantity discrepancies.

According to staff, Central Supply's process is to discard count sheets after inputting the physical count results in the inventory system. Thus, it could not provide any supporting documents for the inventory cycle count adjustments or copies of completed count sheets, except

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for the June 28, 2013, physical inventory count.

Segregation of duties is a widely accepted internal control and business practice. It entails segregating key duties among different people, and reduces the risk of error and fraud so that no single individual can adversely affect the accuracy and integrity of the count. The key areas of segregation are physical custody of assets, processing and recording of transactions, and approval of transactions. Ideally, personnel performing any one of the above functions would not also have responsibilities in either of the other two functions.

Without proper reconciliations, accounting records could be inaccurate

According to the GAO Guide, even with a strong control environment and sound physical count procedures, it is not unusual for there to be differences in quantities between the physical count and the record. Research about the cause—sometimes referred to as root cause analysis—and reconciliation of differences are essential elements of an effective physical count process. The process of research includes performing the required analysis, promptly completing research, and referring variances to management for approval and/or security for investigation. Research, when properly conducted, supports adjustment to the inventory records, identifies the causes of variances between the physical count and the inventory records, and provides management with information with which to implement corrective actions.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

7. Separate Central Supply Room duties so that staff responsible for counting inventory cannot adjust quantities in the Pathways system. Differences between inventory records and actual quantities on hand should be adjusted only after review and approval by management.
8. Establish policies and procedures that guide staff on how to formally report inventory discrepancies to management.
9. Develop a record retention policy for files supporting the inventory physical counts.

Finding 5

Central Supply's inventory valuation method is inconsistent with Laguna Honda's accounting policy.

According to Laguna Honda's accounting policy, inventory unit cost is based on the value of the units placed into inventory last. However, Central Supply does not follow this policy, instead using unit prices from the pricing agreement with its prime distributor to update the unit cost of inventory on hand. As a result, Central Supply cannot be assured that it reports the value of its inventory correctly in Laguna Honda's financial records.

According to management, Central Supply switched to a new prime distributor in June 2013. Due to the lower markup fees in the new pricing agreement, management reevaluated its inventory items and updated the unit costs on both open purchase orders and inventory on hand supplied by the prime distributor.

Of the 24 items the audit selected from the inventory list to verify per-unit cost, 13 (54 percent) were correctly valued based on the last replenishment receipts, while the other 11 (46 percent) were valued based on pricing information provided by the prime distributor rather than the value of the units placed into inventory last. As a result, Central Supply undervalued this inventory by \$361 (6 percent of the value of the inventory sampled).

Recommendation

10. Laguna Honda Hospital and Rehabilitation Center should ensure that the Central Supply Department values its inventory in accordance with its accounting policy.

Finding 6

Central Supply does not record the value of inventory items transferred from the Pharmacy Department.

2 percent of the inventory items on hand have no recorded value.

Its inventory list shows that Central Supply holds inventory items with no value assigned. Of the 654 items listed on Central Supply's inventory list on June 28, 2013, 11 items (2 percent) have no dollar value shown.

According to management, the inventory items with no recorded value were requested from the Pharmacy Department. Central Supply does not incur the related

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costs of these transferred items and, therefore, does not assign value to them; the Pharmacy Department absorbs the full cost of these items. However, by not tracking the value of the items obtained from the Pharmacy or retaining records supporting their value, the value of Central Supply's inventory is not correctly reported in financial statements.

According to Laguna Honda's inventory valuation policy, unit cost used for inventory on hand is the value of the units placed into inventory last and the units distributed on a first in, first out basis. Central Supply must record the cost of the items in its inventory to support this financial statement practice and the total value of its inventory on Laguna Honda's financial statements.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

11. Record the cost of each inventory item on its inventory lists.
12. Ensure that inventory items transferred between departments are expensed when consumed.

Finding 7

Wide distribution of Central Supply master keys increases risk and limits accountability if loss of inventory items occurs.

Multiple departments have master keys to access to the Central Supply Room after regular business hours.

Although the Central Supply Room is properly locked and off-limits to the public during regular business hours, its keys have been widely distributed. This is a problem, especially because the inventory area lacks both security cameras and an electronic key card system.

Master keys to the room have been issued to other Laguna Honda departments, including Facility Services and Nursing Services Department. According to Central Supply staff, Nursing Services Department staff occasionally accesses the Central Supply Room to take medical supplies and equipment in case of emergency needs after regular business hours. Nurses will usually leave written notes for Central Supply staff detailing the items and quantity taken. However, Central Supply could not provide any support to show how a note left by

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nursing staff for items taken from the storeroom after business hours resulted in a subsequent adjustment in the inventory system to update the inventory list.

There is no list of the employees who have been given keys to the Central Supply storeroom. Therefore, no assurance exists that only authorized users are accessing the inventory areas. According to Materials Management and Central Supply policy and procedures, when Central Supply is not open and staffed, medical supplies and equipment can be obtained by contacting the nursing supervisor who has access to the storeroom. However, the procedures manual does not address any required form to document items withdrawn from Central Supply or who is responsible for entering requisitions into the inventory system.

According to guidance from the Auditing Standards Board,⁵ access to a storage area should be limited to those employees whose duties require it, and the custody of keys should be controlled. This guidance specifically addresses controls for a public warehouse and management's responsibility for the safeguarding of its assets. CSA is applying this guidance to Central Supply given the similarities in management practices and processes.

The risk of internal theft or loss at Central Supply is increased due to the number of employees and different hospital departments that can access the storeroom, especially after regular business hours. Central Supply staff would be unaware of missing inventory or inventory taken after regular business hours if nursing employees choose not to or, due to time constraints, are unable to leave a note listing the items taken. Also, Central Supply has no process to track who entered and exited the storeroom during hours when it is closed.

Access to the storeroom should be reduced to limit opportunities for anyone to remove inventory items without recording having done so. Discrepancies noted during the audit's physical count may have originated

⁵ Auditing Standards Board's Statement of Auditing Standards, AU 901, *Public Warehouses – Controls and Auditing Procedures for Goods Held*, Section 901.15. The Auditing Standards Board is the American Institute of Certified Public Accountants' senior committee for auditing, attestation, and quality control applicable to the performance and issuance of audit and attestation reports for nonissuers.

from staff accessing or returning inventory items after regular business hours without recording the transactions in the inventory system.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

13. Document and implement inventory security policies and communicate these policies to employees of the departments accessing the Central Supply storeroom.
14. Develop a log or pre-numbered form to keep track of items taken after business hours.
15. Require employees accessing the Central Supply storeroom after business hours to document on the log or form all necessary information, including but not limited to employee ID, item number, date and time, and quantity taken.
16. Require nursing supervisors to authorize in writing the withdrawal of materials from the Central Supply storeroom after regular business hours and require Central Supply personnel to input the information in the inventory system and file supporting documents.
17. Re-key the Central Supply storeroom immediately, and track the issuance of master keys. After Central Supply completes its move to its new location, it should limit key distribution or install electronic keys to track employees' entry into the facilities.

Finding 8

Central Supply lacks written policies and procedures to perform physical inventory counts.

Central Supply lacks written policies and procedures to perform physical inventory counts.

Central Supply does not have documented policies and procedures that would provide employees clear and comprehensive instructions and guidelines on how and when to perform inventory counts. The absence of clearly written policies and procedures that define limits of authority can give staff excessive discretion that may provide opportunities for undetected thefts and other

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fraudulent activities. Lack of procedures makes it difficult to hold individuals accountable for their actions.

According to the GAO Guide, establishing and documenting policies and procedures are essential to an effective and reliable physical count. Policies and procedures demonstrate management's commitment to the inventory physical count process and provide to all personnel clear communication and comprehensive instructions and guidelines for the count. Establishing written policies and procedures helps ensure consistent and accurate compliance and application needed to achieve high levels of integrity and accuracy in the physical count process. Policies and procedures also become the basis for training and informing employees and the reference when there is turnover in personnel.

Once policies and procedures have been established and documented, they must be regularly reviewed and updated to reflect changes in the process and tasks of the physical count. According to the director of materials management, Central Supply is relocating to a new building in the next fiscal year. Hence, written policies will be created after the move is completed to match the new processes that management will put in place.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

18. Establish written policies and procedures for the physical count process at the Central Supply storeroom. The written procedures should provide formal instructions for all aspects of the physical count processes, including:
 - The objective of the physical inventory count.
 - The period in which the inventory count should be conducted.
 - The employees that should be involved and their roles and responsibilities.
 - The inventory to be included in and excluded from the physical count.
 - Provisions for achieving proper cutoff, including control of receiving and issuance during the inventory-taking period and, if the storeroom is not shut down, provisions for handling inventory

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movements.

- Instructions for use of inventory count sheets (including their distribution, collection, and control), including segregation of duties between persons responsible for count sheet control, counting inventory, and inputting completed count sheets to inventory records.
- Instructions for researching and adjusting variances.

19. Regularly review and revise policies and procedures for changes in the process and individual tasks.

Finding 9

Central Supply lacks written policies and procedures for identifying and dispensing expired or obsolete items.

Central Supply does not have established policies and procedures for addressing inventory obsolescence. According to Central Supply, a Central Supply employee occasionally inspects all inventory items in the storeroom and collects items that are due to expire within three months. Once the items with these expiration dates are collected, they are segregated in a separate area for disposal. Staff then updates the inventory count in the inventory system. Supervisory review and approval of the expired item is not required before disposal.

Proper approval methods and disposal of expired or obsolete items reduce the possibility of errors, theft, and mishandling.

According to the director of materials management, due to the low value of the disposed items, management does not review or signoff on the disposal of expired items. This is confirmed by Central Supply's report on past-expiration-date adjustments for fiscal year 2012-13, which shows the expired items had a value of \$3,306. However, the lack of policies and procedures for identifying and disposing of obsolete inventory may cause Laguna Honda to incur unnecessary costs to store expired items that could be liquidated.

According to the GAO Guide, establishing and documenting policies and procedures are essential to an effective and reliable physical count. Physical controls and accountability reduce the risk of undetected theft and loss, unexpected shortage of critical items, and

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unnecessary purchases of items already on hand. These controls improve accountability over inventory, which help ensure continuation of operations and improved storage and control of excess or obsolete stock.

Recommendations

Laguna Honda Hospital and Rehabilitation Center should:

20. Establish written policies and procedures for the identification, segregation, and disposal of expired and obsolete items from the inventory. At a minimum the policies and procedures should define obsolescence and establish clear responsibilities for the enforcement of the policies and the ultimate disposition of the obsolete items.
21. Ensure that Central Supply Department management reviews and signs the list of obsolete/expired items before disposal.

Finding 10

Central Supply correctly records its purchases orders.

No exceptions were found in a randomly selected sample of 24 items for which invoices and other supporting documents verified the timely approval and recording of inventory purchases orders. Purchase orders were properly approved by the director of materials management or the assistant materials manager. Items were found to have been received by storekeepers and recorded in the inventory management system.

APPENDIX: DEPARTMENT RESPONSE



City and County of San Francisco
Edwin M. Lee, Mayor

Department of Public Health
Barbara A. Garcia, MPA
Director of Health

MEMORANDUM

To: Tonia Lediju, Director of City Audits
City Services Auditor Division

From: Barbara Garcia, ~~Health Director~~
Department of Public Health

Date: March 11, 2014

Subject: Response to Findings from the Central Supply Inventory Control Audit
at Laguna Honda Hospital

Enclosed for your review are the Department of Public Health's responses to the recent audit of the inventory control procedures at the Laguna Honda Hospital Central Supply. We appreciate the time and effort of your staff in conducting this audit.

We have carefully reviewed your team's draft report and findings and concur with each of the recommendations provided. Attached is the completed *Audit Recommendation and Response Form*. We are confident having been through this audit that our operation will run with much tighter controls.

If you have any questions or require further information, please do not hesitate to contact me at 415.554.2600 or Greg Wagner at 415.554.2610.

Sincerely,

Barbara Garcia
Director of Health

Attachment: Audit Recommendation and Response Form

Cc: Roland Pickens
Greg Wagner
Mivie Hirose
Mike Lewellyn

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For each recommendation, the responsible agency should indicate whether it concurs, does not concur, or partially concurs. If it concurs with the recommendation, it should indicate the expected implementation date and implementation plan. If the responsible agency does not concur or partially concurs, it should provide an explanation and an alternate plan of action to address the identified issue.

RECOMMENDATIONS AND RESPONSES

Recommendation	Response
Laguna Honda Hospital and Rehabilitation Center should:	
1. Direct Central Supply Department staff to conduct a 100 percent physical count of the inventory and reconcile discrepancies to establish a new inventory baseline.	Concur. Central Supply (CSR) will conduct a 100% Physical Inventory by July 1, 2014.
2. Establish performance goals for the physical count and develop employee/supervisor performance measurement systems to hold appropriate personnel accountable for accomplishing a consistent, accurate physical count of inventory.	Concur. We will work on adding performance measurements and goals to be added to the annual performance evaluations by November 1, 2014.
3. Implement procedures to ensure that periodic inventory counts are scheduled, performed regularly, and reconciled to the perpetual inventory and accounting records.	Concur. We will re-implement the ABC (20, 20, 60%) analysis program by June 1, 2014.
4. Create a manual or electronic tracking log to record category counted and the dates of the cycle counts.	Concur. Manual tracking log will be utilized by May 1, 2014.

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Recommendation	Response
5. Periodically analyze usage to validate the inventory segments, determine the desired frequency of counts, and reassess the risk of each segment.	Concur. Will run a quarterly report to review ABC usage. Implementation by August 1, 2014.
6. Require proper signoff by the director of materials management before any update to the inventory segments.	Concur. Implementation by May 1, 2014.
7. Separate Central Supply Room duties so that staff responsible for counting inventory cannot adjust quantities in the Pathways system. Differences between inventory records and actual quantities on hand should be adjusted only after review and approval by management.	Concur. Access to inventory adjustments will limited to management staff. Implementation by May 1, 2014.
8. Establish policies and procedures that guide staff on how to formally report inventory discrepancies to management.	Concur. Implementation by May 1, 2014.
9. Develop a record retention policy for files supporting the inventory physical counts.	Concur. Will maintain 1 year plus current FY. Implementation by May 1, 2014.
10. Ensure that Central Supply Department values its inventory in accordance with its accounting policy.	Concur. Update Accounting P&P to reflect current process. Implementation by July 1, 2014.
11. Record the cost of each inventory item on its inventory lists.	Concur. Implementation by May 1, 2014.

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Recommendation	Response
12. Ensure that inventory items transferred between departments are expensed when consumed.	Concur. Implementation by May 1, 2014.
13. Document and implement inventory security policies and communicate these policies to employees of the departments accessing the Central Supply storeroom.	Concur. Will implement Key Watcher system to allow authorized users access only. Implementation by July 1, 2014.
14. Develop a log or pre-numbered form to keep track of items taken from the Central Supply storeroom after business hours.	Concur. Implementation by May 1, 2014.
15. Require employees accessing the Central Supply storeroom after business hours to document on the log or form all necessary information, including but not limited to employee ID, item number, date and time, and quantity taken.	Concur. Security Access policy to be created for authorized employees to read and sign prior to access. Implementation by July 1, 2014.
16. Require nursing supervisors to authorize in writing the withdrawal of materials from the Central Supply storeroom after regular business hours and require Central Supply personnel to input the information in the inventory system and file supporting documents.	Concur. Implementation by July 1, 2014.
17. Re-key the Central Supply storeroom immediately, and track the issuance of master keys. After Central Supply completes its move to its new location, it should limit key distribution or install electronic keys to track employees' entry into the facilities.	Concur. Implementation by March 3, 2014.

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Recommendation	Response
<p>18. Establish written policies and procedures for the physical count process at the Central Supply Room. The written procedures should provide formal instructions for all aspects of the physical count processes, including:</p> <ul style="list-style-type: none"> • The objective of the physical inventory count. • The period in which the inventory count should be conducted. • The employees that should be involved and their roles and responsibilities. • The inventory to be included in and excluded from the physical count. • Provisions for achieving proper cutoff, including control of receiving and issuance during the inventory-taking period and, if the storeroom is not shut down, provisions for handling inventory movements. • Instructions for use of inventory count sheets (including their distribution, collection, and control), including segregation of duties between persons responsible for count sheet control, counting inventory, and inputting completed count sheets to inventory records. • Instructions for researching and adjusting variances. 	<p>Concur.</p> <p>Implementation by June 1, 2014.</p>
<p>19. Regularly review and revise policies and procedures for changes in the process and individual tasks.</p>	<p>Concur.</p> <p>Implementation by April 1, 2014.</p>

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Recommendation	Response
20. Establish written policies and procedures for the identification, segregation, and disposal of expired and obsolete items from the inventory. At a minimum the policies and procedures should define obsolescence and establish clear responsibilities for the enforcement of the policies and the ultimate disposition of the obsolete items.	Concur. Implementation by May 1, 2014.
21. Ensure that Central Supply Department management reviews and signs the list of obsolete/expired items before disposal.	Concur. Implementation by May 1, 2014.