VIRGINIA CORRECTIONAL ENTERPRISES

DEPARTMENT OF CORRECTIONS

RICHMOND, VIRGINIA

REPORT ON AUDIT

FOR THE PERIOD

JULY 1, 1998

through

DECEMBER 31, 1999

AUDITOR OF PUBLIC ACCOUNTS

COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of Virginia Correctional Enterprises, a division of the Department of Corrections, for the period of July 1, 1998 through December 31, 1999, found:

- internal control matters that we consider reportable conditions; however, we do not consider these matters to be material weaknesses;

- no instances of non-compliance with applicable laws and regulations tested that are required to be reported;

- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System; and

- adequate implementation of corrective action with respect to audit findings reported in the prior year except as reported.

VCE should establish and maintain a strategic business plan. We discuss this finding in the section entitled “Financial Operations.”

VCE should enforce and perform job sampling to validate standard costs. We discuss this finding in the section entitled “Standard Costing.”

- T A B L E O F C O N T E N T S -

INTERNAL CONTROL BACKGROUND, FINDINGS, AND RECOMMENDATIONS AND FINANCIAL INFORMATION

In 1934, the Virginia Department of Corrections created a new division entitled Virginia Correctional Enterprises (VCE). That year VCE's sales totaled $147,154. Currently, VCE reported $33,987,011 in sales for fiscal 1999. VCE is one of many work programs operated by the Department of Corrections. VCE is the only work program that is mandated to be self-sufficient, not receiving any state appropriation or federal grants to operate, and to maximize inmate employment. VCE provides the Department of Corrections with approximately $1.5 million from program revenues to pay for security guards for inmates in the work program. From its industries, VCE offers a variety of products and services to not-for-profit organizations and government entities. All revenues go to operate and manage VCE's industries. VCE reinvests any excess revenues in production machinery and equipment, vehicles, technology upgrades, and expansions.

As of June 1999, VCE operated ten industries in 14 state correctional institutions as shown below. During fiscal 2000, VCE reopened the microfilm industry at the Virginia Correctional Center for Women on a small scale, employing approximately seven inmates.

Industry	Institutions	Items Manufactured
Wood	Greensville Lunenburg Nottoway	Dorm Furniture Office Furniture Tables Lounge Furniture Bookcases
Shoe	Augusta	Work Boots Military Boots Innersoles for Boots
Laundry	Virginia Correctional Center for Women Greensville	Laundry Services
Dental	Southampton	Dentures Partials Mouth Guards
License Tag	Powhatan	License Plates for Virginia Department of Motor Vehicles
Metal	Dillwyn Buckingham	File Cabinets Desks Shelves Cabinets Lockers Stools Tables Prison Beds

Industry	Institutions	Items Manufactured
Clothing	Coffeewood Halifax Haynesville Augusta Stanton	Scrubs DOC Coveralls DOC Jumpsuits DOC Pants Juvenile Justice Shirt Denim Jeans Chambray Shirts Jackets T-shirts Boxer Shorts Butcher Coat Laundry Bags Aprons Bed Sheets Pillowcases Blankets
Vinyl Binders	Powhatan	Vinyl Binders Silk Screening
Printing	Powhatan	Custom Printing Silk Screening
Office Systems	Brunswick	Desks Credenzas Seating Storage Tables

Employment Levels

As of December 1999, VCE employed 158 civilian staff around the Commonwealth to perform its administrative, financial, marketing, sales, and management operations. This number includes a new Chief Operating Officer and a Buyer Manager hired in response to audit and VCE Task Force recommendations from prior years.

VCE's goal is to increase employment opportunities for the Virginia inmate population. As of June 30, 1999, VCE employed approximately five percent or 1,392 of the 26,768 inmates housed in all of Virginia's state adult correctional institutions. In December 1999, the inmate employment rate dropped to 4.47 percent or 1,196 of 26,883 inmates due to the seasonal fluctuation in purchases by state agencies that are higher in June than in December. VCE has not substantially increased inmate employment opportunities due to the lack of a strategic business plan, discussed in the finding "Continue Developing a Strategic Business Plan," and other factors affecting inmate employment as discussed below.

Factors Affecting Correctional Industries

VCE works to employ the maximum number of inmates in its shops. However, VCE must balance this goal with the statutory requirement to remain self-sufficient. Therefore, VCE works to employ the most inmates possible while not incurring an overall loss in net income. Even though inmate wages are low, \$.55 to \$.80 per hour, VCE encounters other expenses and conditions that negatively affect production, cost, and employment.

Security Costs	VCE incurs approximately \$1.5 million in security costs annually.
Training Costs	VCE must train inmates, most with no prior work experience.
High Turnover	VCE experiences high turnover rates due to inmate transfers and inmate releases. VCE must then hire and train new employees.
Lockdowns	Unplanned lockdowns occur often and cause shops to lose manufacturing time.
Legal Restrictions on Selling	VCE is restricted to selling only to state and local government and not-for-profit organizations. As a result, VCE loses the ability to produce more and charge less for goods and services. This is in contrast to private industry that can take advantage of the economies of scale.
Barriers to the Private Industry Enhancement (PIE) Program (The PIE program is a Federal Bureau of Justice Assistance certification program in which prison industry goods are exempt from interstate commerce prohibitions. The program allows VCE to partner with private companies and help manufacture items that the company sells to the general public.)	♦ *Operating a business inside a secure facility* – Private sector organizations find it difficult to manage the operation. ♦ *Work interruptions due to security procedures.* - This causes missed deadlines and decreases in productivity. ♦ *Work interruptions due to court appointments.* - In a manufacturing environment, everyone is needed. Missing a key employee slows the manufacturing process down. ♦ *Restrictions on number of shifts.* – Private sector organizations can use 3rd and 4th shifts to meet required high production levels. VCE only runs 3rd and 4th shifts under extreme situations. The Department of Corrections prefers not to have these shifts due to the security risks and costs of moving inmates at night.

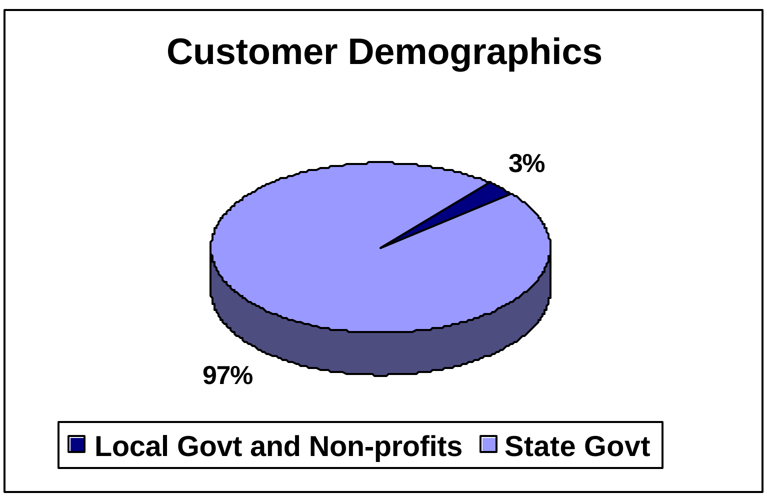
While Private Industry Enhancement partnerships can be difficult to procure, VCE continually works to market themselves to a variety of industries. These types of partnerships allow VCE to employ additional inmates in a new manufacturing process with lower start up costs since the private company usually provides all of the equipment and raw materials. By employing a larger percentage of the inmate population, VCE reduces the risk of violence against security personnel and inmates.

Another benefit of the Private Industry Enhancement program is it allows the Department of Corrections and VCE to satisfy the General Assembly's intent to have inmates pay their fines, court costs, and victim restitution, and contribute towards their cost of incarceration. In order to do this, inmates must earn a higher wage. Inmates' current average rate of pay is $.63 per hour, with a maximum rate of $.80 per hour when working in one of VCE's industries. Hourly rates are dependent on both skill and responsibility levels. Under the Prison Industry Enhancement Program, VCE can sell goods across state lines and inmates must earn at least minimum wage. Higher earnings allow for mandatory contributions for inmate room and board, payments for inmate legal defense, and allocations to inmate families and victim compensation funds. Inmates do not contribute to these liabilities when working in regular work programs at VCE and the Department of Corrections. Currently, VCE does not have a Private Industry Enhancement Program in place, but they do have a number of prospects.

Customer Base

Section 53.1–47 of the Code of Virginia requires all Commonwealth departments, institutions, and agencies to purchase goods manufactured by VCE. Agencies must obtain a waiver in order to purchase the same goods from another vendor. VCE will issue a waiver if their goods do not meet criteria set by the agency. Currently, state agencies account for approximately 97 percent of VCE's sales.

The Code of Virginia also allows counties, districts, cities, towns, nonprofit organizations, volunteer lifesaving first aide crews, rescue squads, fire departments, sheltered workshops, and community service organizations to purchase from VCE. During fiscal 1999, these customers account for approximately 3 percent of VCE's sales.



Financial Operations

Virginia Correctional Enterprises experienced a record year in 1999 with reported sales of $33,997,534 and net income of $6,127,006. While sales remained static between 1998 and 1999, net income increased by $5,602,581. The increase in net income is due to a $5,447,494 decrease in operating expenses. This decrease is the result of VCE's new "Quick Ship" program and the receipt of state debt set-off funds.

Virginia Correctional Enterprises
Income Statement
For the Fiscal Years Ended June 30, 1998 and 1999

	June 30, 1998	June 30, 1999
Operating Revenues		
Charges for Sales and Services	$33,987,012	$33,997,534
Operating expenses:		
Cost of Sales and Services	26,932,714	23,531,332
Overhead and Other Costs:		
Inmate Labor	14,025	14,715
Personal Services	2,226,742	2,304,337
Contractual Services	1,473,292	1,227,750
Provision for Doubtful Accounts	1,514,520	99,331
Supplies and Materials	192,536	295,057
Adult Security Cost	56,128	27,900
Expendable Equipment	88,093	264,857
Depreciation	207,521	227,774
Rent, Insurance, and Other Related Charges	470,072	485,287
Employee Benefits	562,573	621,774
Transfers to Other Agencies	(6,678)	(6,550)
Total Overhead and Other Costs	6,798,824	5,562,232
Total Expenses	33,731,538	29,093,564
Operating Income	255,474	4,903,970
Non-operating Revenue (Expenses):		
Recovery of bad debt expense	-	809,520
Gain (Loss) on the Sale of Fixed Assets	13,678	(3,576)
Other	255,273	417,092
Total Non-Operating Revenues (Expenses)	268,951	1,223,036
Net Income	524,425	6,127,006
Retained Earnings/Fund Balance July 1	2,859,557	3,383,982
Retained Earnings/Fund Balance June 30	$ 3,383,982	$ 9,510,988

Source: VCE financial reports and accounting system, while not audited, we have reviewed the controls over the system.

During fiscal 1999, VCE initiated a Quick Ship program on select core products to improve delivery time and increase customer satisfaction. VCE designed the program to incorporate a "just-in-time" manufacturing philosophy. VCE selected items with higher sales volumes for the program and guarantees delivery of these items within seven days. To make this guarantee, the program requires maintenance of safety stock levels at approximately 15 units per item in raw materials and finished goods, a substantial increase in inventory levels. VCE's normal policy is to dictate when, where, and if they will sell and ship an item based on their ability to produce the ordered items. Now, VCE gives the customers more control over their orders through the Quick Ship program. VCE found that this program has increased customer satisfaction since its implementation.

In order to implement the Quick Ship program successfully, VCE increased its raw material and finished goods inventory. This program primarily affected the wood, office systems, and metal industries. This would normally require a large monetary commitment, but management has worked to find solutions to reduce the cost of raw materials. Purchasing individual parts instead of kits decreased the cost of production, ultimately increasing net income. VCE used the increased net income to fund the increases in inventory.

Net Income (Loss) by Industry
For the Fiscal Years Ended June 30, 1998 and 1999

Industry	Net Income (Loss) at June 30, 1998	Net Income (Loss) at June 30, 1999
Clothing	$1,215,481	$2,006,791
Dental Lab	29,446	43,206
Janitorial Products	(58,113)	(17,398)
Laundry	321,668	615,471
License Tag	1,793,447	1,909,465
Metal Furniture	(339,785)	158,428
Microfilm	(81,635)	(605)
Office Systems	(1,170,039)	1,278,322
Printing	261,266	436,343
Shoes	32,024	134,865
Vinyl Binders	(48,557)	(56,873)
Wood	(1,430,778)	(381,009)
Total	$ 524,425	$6,127,006

VCE received over $800,000 in fiscal 1999 through the Commonwealth's Debt Set-Off Program for the Morton Marks receivables that VCE wrote off in fiscal 1998. Morton Marks and Sons, one of the Herman Miller joint venture dealers, filed for Chapter 11 Bankruptcy Protection in September 1998, at which time they owed VCE approximately $1.6 million. Since VCE had already written off the receivable, they had to re-establish the receivable to record the receipt of funds. This inflow of cash inflated net income by increasing current year revenues for the recovery of the bad debt incurred in the previous year.

The Quick Ship program was one element of the initial strategic business plan developed in the prior year by VCE's Chief Executive Officer. This program increased VCE's sales, reduced costs, and improved customer relations. VCE needs a complete strategic business plan with goals and ways to achieve the goals, so it can continue to improve its operations.

Continue Developing a Strategic Business Plan

VCE is operating without a complete strategic business plan. We have recommended that VCE develop a business plan in our last four audit reports. During fiscal 1998, VCE had a plan that detailed the history and present condition of VCE operations along with some goals. However, the plan lacked the objectives and tasks needed to achieve those goals. In addition, the plan was solely the work of VCE's Chief Executive Officer with no input from staff or the Department of Corrections management.

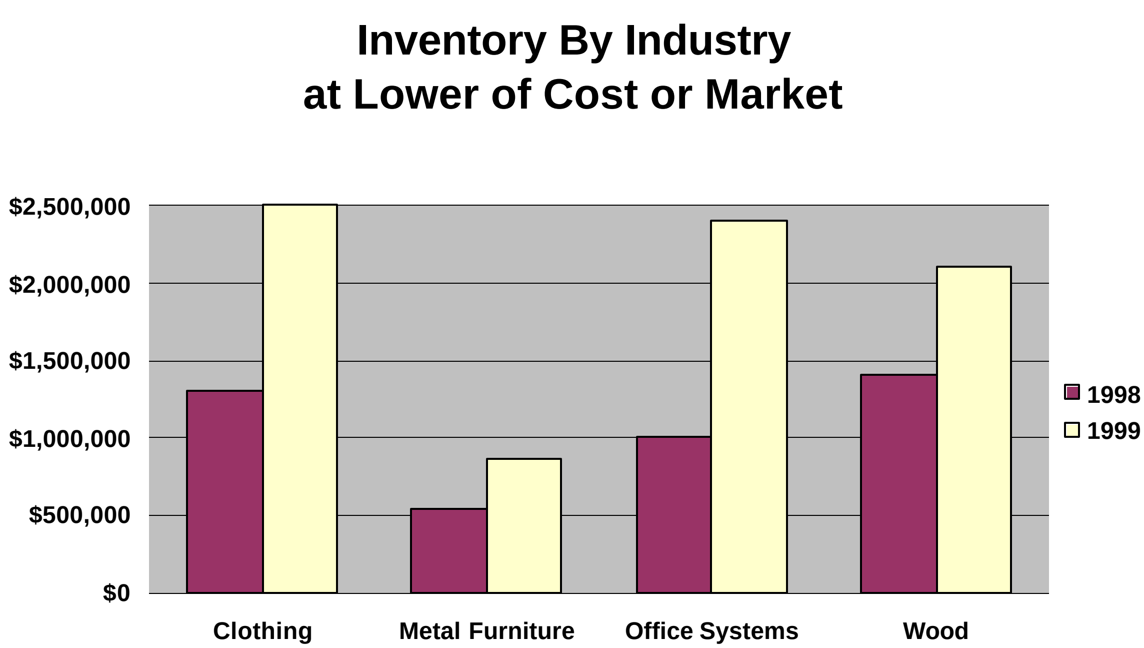
During the 1999 fiscal year, VCE began a strategic management process to develop a new strategic business plan. This process allows VCE employees and management and Department of Corrections management to participate. From this process, VCE has developed goals for the agency. They are using cash flow projections for 2000-2001 to determine whether they have the monetary resources needed to meet the established goals. While these steps demonstrate effort and intent, the plan is not near completion.

Recommendation:

We recommend that VCE make completion of its strategic business plan a top priority. VCE should strive to begin fiscal 2001 with a plan that includes its established goals. The plan must also detail the objectives and tasks needed to accomplish the goals. A complete strategic business plan should drive all business decisions and foster teamwork within VCE.

Inventory

Inventory increased by $3,436,489 during fiscal 1999. The overall increase reflects the levels needed to support the new Quick Ship program. The chart below illustrates the industries most affected by the Quick Ship program with details explaining the changes in inventory:



- *Clothing* - Inventory levels are higher in 1999 due to both the implementation of the Quick Ship program and the timing of sales. The Department of Corrections, the primary vendor for clothing, made a large purchase of inmate clothing in June 1998 that greatly reduced inventory levels. During fiscal 1999, VCE maintained a higher level of production, keeping up with sales to the Department of Corrections, and resulting in a higher inventory level.

- *Metal* - Inventory levels are higher in 1999 solely due to the implementation of the Quick Ship Program.

- *Office Systems* - Inventory levels are higher in 1999 due to the Quick Ship program and an overall decrease in sales. Sales during the first two quarters of fiscal 1999 decreased due to the dissolution of the Boling Company joint venture. However, once implemented the Quick Ship Program allowed VCE to respond faster to customers and rebuild its customer base. Based on the finished goods inventory levels for the last two quarters of 1999, sales for this industry have steadily increased with the Quick Ship Program.

- *Wood* - In the Wood industry, inventory levels are higher in 1999 due to the implementation of the Quick Ship Program. Inventory levels are the highest at June 30, 1999, pending delivery of multiple, large orders for college dormitory furniture after year-end.

Standard Costing

VCE values inventory at standard cost for financial reporting purposes on a monthly basis and uses the standard cost to determine product pricing. For year-end financial reporting, VCE uses standard cost to value inventory at the lower of cost or market. VCE develops standard costs for materials, labor, and manufacturing overhead. In previous years, we have identified inaccuracies in VCE's standard costs.

In response to these findings, VCE is in the process of sampling all standard costs to determine whether they are correct. VCE requires each plant to sample one unit per week. VCE documents the type of materials used, amount of time per operation, and the number of labor hours during the manufacturing process. VCE adjusts the system for variances between the sample and what the system reports. This process ensures that the standard costs used to value inventory are correct.

Enforce and Perform Job Sampling to Validate Standard Costs

VCE plants do not sample production jobs as required to determine the actual production cost of items. VCE policy requires plants to sample at least one job per week. We found that the Vinyl Binder plant at Powhatan only performed four counts and the Metal plant at Dillwyn only performed six counts over a six-month period. Other shops varied from performing as few as eight sample jobs to as many as 28 jobs over a six-month period. Although there are reasons that a plant may not perform a sample job, for example lockdowns, the plants should make every effort possible to complete these sample jobs. The sampling process is VCE's control to monitor the differences between standard and actual costs. If VCE plants continue not to sample production jobs, variances between standard and actual costs could occur and go undetected by Cost Accounting. This in turn can affect inventory valuation and the establishment of sales prices.

Recommendation:

VCE should clarify its policy on performing sample jobs to include instances that preclude a plant from performing the sample counts. Centrally, VCE should monitor and enforce compliance with this sampling requirement. The individual plants should sample at least one job per week whenever possible.

Commonwealth of Virginia

Auditor of Public Accounts
P.O. Box 1295
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Walter J. Kucharski, Auditor

June 1, 2000

The Honorable James S. Gilmore, III
Governor of Virginia
State Capitol
Richmond, Virginia

The Honorable Vincent F. Callahan, Jr.
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

INDEPENDENT AUDITOR'S REPORT

We have audited the financial records and operations of **Virginia Correctional Enterprises,** a division of the **Department of Corrections,** for the period July 1, 1998 through December 31, 1999. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

Audit Objective, Scope, and Methodology

Our audit's primary objectives were to evaluate the accuracy of recording financial transactions on the Commonwealth Accounting and Reporting System and in VCE's accounting records, review the adequacy of internal control, and test compliance with applicable laws and regulations. We also reviewed VCE's corrective actions of audit findings from prior year reports.

Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of VCE's operations. We also tested transactions and performed such other auditing procedures as we considered necessary to achieve our objectives. We reviewed the overall internal accounting controls, including controls for administering compliance with applicable laws and regulations. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances:

Inventory
Expenditures
Revenues

We obtained an understanding of the relevant internal control components sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. We performed audit tests to determine whether VCE's controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws and regulations.

VCE's management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Our audit was more limited than would be necessary to provide assurance on internal control or to provide an opinion on overall compliance with laws and regulations. Because of inherent limitations in internal control, errors, irregularities, or noncompliance may nevertheless occur and not be detected. Also, projecting the evaluation of internal control to future periods is subject to the risk that the controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

Audit Conclusions

We found that VCE properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System and in its accounting records. VCE records its financial transactions on CARS on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles. VCE records its financial transactions in its accounting records on the accrual basis of accounting. The financial information presented in this report came directly from VCE's accounting records and financial reports.

We noted certain matters involving internal control and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect VCE's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial records. Reportable conditions, entitled "Enforce and Perform Job Sampling to Validate Standard Costs" is described in the subsection entitled "Standard Costing" and "Continue Developing a Strategic Business Plan" is described in the subsection titled "Financial Operations." We believe that none of the reportable conditions are material weaknesses.

The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

VCE has not taken adequate corrective action with respect to the previously reported finding "Develop a Strategic Business Plan." Accordingly, we included this issue in the finding entitled "Continue Developing a Strategic Business Plan" in the subsection entitled "Financial Operations." VCE has taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this report.

This report is intended for the information of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

EXIT CONFERENCE

We discussed this report with management at an exit conference held on July 6, 2000.

AUDITOR OF PUBLIC ACCOUNTS

DBC:jld
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