DEPARTMENT OF CORRECTIONS

VIRGINIA CORRECTIONAL ENTERPRISES

RICHMOND, VIRGINIA

AUDIT STATUS REPORT

As of

APRIL 21, 1999

AUDITOR OF PUBLIC ACCOUNTS

COMMONWEALTH OF VIRGINIA

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AUDIT SUMMARY

In fiscal year 1998, Virginia Correctional Enterprises (VCE) experienced record sales and earned a net income of $524,425. As a result, VCE significantly improved its financial condition by increasing its cash reserves, materially reducing accounts payable, and repaying its $1 million line of credit with the State Treasurer.

The primary purpose of our audit was to follow-up on the material weaknesses noted in the prior report. Overall, we found VCE had begun making progress, although limited in some areas, toward correcting the major weaknesses in its operations. Specifically, we found the following:

- The Secretary of Public Safety formed a task force to review VCE's operations and make recommendations for improving its efficiency and profitability. The Task Force submitted a formal report to the Secretary in September 1998 outlining its findings and recommendations. As a result of the Task Force recommendations, the Department of Corrections formed a committee to develop a new mission statement for VCE and created a Chief Operating Officer position at VCE. VCE is filling the position. The Secretary also sent a policy analyst to VCE to review its operations. However, at the time of this report, the policy analyst's recommendations have not been completed.

- VCE has two conflicting missions. The Secretary of Public Safety, the Department of Corrections, and VCE need to formally decide how VCE will operate in relation to the requirements to be self-sufficient and to maximize inmate training and work opportunities.

- VCE terminated all of its joint venture contracts during fiscal year 1999, which has helped VCE stabilize its financial condition. However, VCE has experienced difficulties collecting outstanding receivables from some of its terminated joint venture partnerships and Prison Industry Enhancement programs. Morton Marks and Sons, one of VCE's joint venture partners, filed for bankruptcy in September 1998. At that time, they owed VCE $1.6 million. Approximately $800,000 of the past due receivables have been collected through the Commonwealth's Debt Set-Off program. However, the Department of Corrections has yet to transfer these funds to VCE. In order to avoid similar problems with future private industry partnerships, VCE has developed procedures for approving and monitoring new partnerships.

- VCE's critical systems are not Year 2000 compliant. Despite assurance provided by the vendor that SYMIX was Year 2000 compliant, through testing of the system, VCE determined it was not compliant. VCE determined its operating system and relational database engine were not Year 2000 compliant, as well. VCE completed the upgrade of its operating system in April 1999. VCE is in the process of obtaining the upgrade tapes for SYMIX and its relational database engine. VCE risks the possibility of the disruption of operations due to system limitations if it does not upgrade its systems by fiscal year 2000.

- VCE prepared an initial strategic business plan. However, the plan lacks some of the necessary elements to ensure that VCE will maintain its financial position, take advantage of opportunities available as new correctional facilities open, and market its products in an increasingly competitive environment.

Commonwealth of Virginia

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

Walter J. Kucharski, Auditor

April 21 1999

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

The Honorable Richard J. Holland
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

AUDIT STATUS REPORT

We have audited **Virginia Correctional Enterprises** to determine the status of management's progress in implementing the recommendations in our prior year report dated May 11, 1998 and the VCE Task Force report dated September 1998.

Audit Approach

Audit Objectives:

Our audit's primary objectives were to:

- determine the status of management's implementation of the recommendations contained in our prior year report;
- determine the status of management's implementation of the recommendations contained in the VCE Task Force in its report to the Secretary of Public Safety;

Audit Scope:

This report covers the period beginning May 12, 1998 through April 21, 1999. Since there has been less than one year since the issuance of our prior year report and the Task Force report, VCE has had limited time to implement the recommendations. Therefore, we acknowledge that VCE has begun addressing the recommendations; however, we do not expect complete implementation due to the severity of the findings and the limited time in which they have had to implement change.

Audit Procedures:

We limited our audit procedures to those procedures we considered necessary to achieve our objectives. These procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of VCE and its industries' operations as they relate to prior year recommendations.

EXIT CONFERENCE

We discussed this report with management at an exit conference held on June 17, 1999.

Sincerely,

AUDITOR OF PUBLIC ACCOUNTS

DBC:jld
jld:50

INTRODUCTION AND FINANCIAL CONDITION

The purpose of this report is to provide the status of Virginia Correctional Enterprises' (VCE) progress in implementing the recommendations in our prior year report dated May 11, 1998, and the Task Force report dated September 1998. Due to the timing of this report, there has been limited time in which VCE could implement these recommendations. Therefore, we acknowledge that VCE has begun addressing each of these recommendations; however, we do not expect complete implementation due to the severity of the findings and the limited time in which they have had to implement changes.

Over the last few years, we have reported major deficiencies that adversely affect VCE's ability to operate efficiently and effectively. Below is a table that sets out our recommendations and VCE's progress over the past five years. This report will discuss the Task Force's recommendations and VCE's progress in implementing those findings in the section entitled "VCE Task Force Report." In the remaining sections of this report, we will discuss our prior year recommendations, VCE's implementation plan, and the status of implementation.

In our discussion of each recommendation, we have provided the following progress levels on VCE's implementation status:

■ **Limited Progress:** VCE is in the planning stage of addressing the issue.

● **Reasonable Progress:** VCE is implementing their plan to address the issue; however, we are unable to determine whether VCE's actions will have a positive and permanent effect on the issue.

Significant Progress: VCE has implemented the recommendation with positive results.

Recommendation	**FY 1994**	**FY 1995**	**FY 1996 thru 5/97**	**FY 1997 thru 5/98**	**FY 1998 thru 5/99**
POLICY:					
Update & Comply with Applicable Procurement Guidelines	X		X		
Work with the Department of Corrections to Develop an Appropriate Cost Recovery Method for Correctional Officers♦		X			
Work with Department of Accounts to Enforce Mandatory Source Requirement♦		X	X		
Immediately Discontinue Pass Through Sales				X	
PROCEDURAL:					
Improve Billing Procedures	X	X	X		
Improve Accounts Receivable Procedures	X	X	X	X	
Develop & Implement Procedures to Ensure Timely Deliveries to Customers	X	X	X		
Ensure Appropriateness of User Access and Access Permissions	X		X	X	X ●
Analyze Effectiveness of Joint Venture Contracts			X	X	
Develop Systems Policies and Procedures			X	X	X ■
Ensure Customer Validity				X	

Recommendation	**FY 1994**	**FY 1995**	**FY 1996 thru 5/97**	**FY 1997 thru 5/98**	**FY 1998 thru 5/99**
OPERATIONAL:					
Improve Financial Position	X			X	
Work with the Department of Corrections to Minimize Unproductive Inmate Hours		X			
Work with the Department of Corrections to Research & Review what Products can Meet the Needs of the Department of Corrections & Other State Agencies ♦		X			
Develop a Strategic Business Plan		X	X	X	X ■
Develop a Formal Sales & Marketing Plan		X	X	X	X ■
Develop Accurate Standard Costs & Pricing Methodologies		X	X	X	X ●
Communicate Goals and Strategies to All Organizational Levels			X	X	X ■
Expand and Use Accurate Merchandise Return Reason Codes			X	X	X ●
Year 2000 Compliance			X	X	X ■
Ensure Current System Operating Environment is Conducive to Business Operations				X	X ■

♦ We ceased making these recommendations because either VCE and the Department of Corrections decided not to implement the recommendation **OR** they could not obtain cooperation from the other parties involved in the issues to implement a change.

VCE Task Force Report

Because of our prior report, the Secretary of Public Safety formed a task force to review the status of VCE and to make recommendations to improve the efficiency and profitability of VCE. The VCE Task Force submitted a formal report detailing their recommendations to the Secretary of Public Safety in September 1998. The Task Force did not dwell on areas already sited in our report. However, in cases where the Task Force made recommendations similar to those in our reports, we will discuss VCE's progress toward implementing the recommendations in the remaining sections of this report. VCE has taken the following actions because of the Task Force recommendations.

- The Department of Corrections formed a committee to develop a new mission statement for VCE. The committee includes the VCE Director, the VCE management team, and four wardens of facilities with VCE shops. The committee has developed the following draft statement.

  VCE works collaboratively with institutions in support of the Department of Corrections mission by providing meaningful work and job skill development for sentenced offenders through self-sufficient production of quality goods and services in a competitive manner.

- The Department of Corrections created a Chief Operating Officer position at VCE. The Department of Corrections has advertised for the position and talked to several candidates. The Department of Corrections anticipates it will take several months to decide which candidate to hire.

- VCE developed monthly operating budgets for each plant. The Operations Manager and Cost Accounting prepared the budgets based on fiscal year 1998 activity. The plant managers receive the budget-to-actual results monthly and quarterly. Cost Accounting is responsible for following up on variances identified in the quarterly reports. VCE's Programmer will make additional modifications to the system to allow more detailed reporting at the plant level. Further, the Task Force recommended that VCE should not allocate general, administrative, and warehouse overhead to each enterprise based on sales volume. VCE and the Department of Corrections management concur with this recommendation, but have not yet determined a viable alternative method.

- VCE is currently investigating opportunities for new industries in the non-durable sector including tire recycling and flat goods industries.

- VCE plans to hold statewide forums between wardens and plant managers at least annually. Further, the Department of Corrections Deputy Director expects the annual review process for host facility wardens to include evaluation factors relating to VCE.

- VCE has met with the Department of General Services' Division of Purchase and Supply to discuss implementing a process that will ensure raw materials are received by VCE in a timely manner to avoid production delays.

- The Task Force recommended that VCE conduct a formal analysis of the wood industry. Based on past experience, VCE has determined that losses in the wood industry are due to under utilization of capacity. In order to operate at full capacity, VCE would have to significantly improve the sales level of wood products. To improve sales, VCE increased the marketing of wood products, upgraded its Pine Line, and developed a new line, called the Nottoway Line. Due to the number of inmates employed in the wood industry, VCE has decided to continue manufacturing wood products. Approximately 20% of the inmates employed by VCE work in the wood industry. VCE plans to perform a formal break-even analysis in the future.

- The Task Force included several recommendations related to the Division of Purchase and Supply's enforcement of the mandatory source requirement. The Department of Corrections is working with the Department of General Services to improve the relationship between the two agencies and the enforcement efforts of Purchase and Supply. Further, the Task Force recommended that consideration should be given to amending the Virginia Public Procurement Act by adding provisions that would help to enforce the mandatory use of goods and services produced by VCE. VCE has not suggested any amendments to the current legislation concerning VCE products. Management does not believe any such amendments would pass.

- The Task Force recommended amending the Code of Virginia to clarify that the Correctional Enterprises Advisory Board should review ongoing activities from time to time, rather than prospectively. The Code of Virginia requires the Board to meet quarterly. However, with only two members attending the meeting in January 1999, there was no quorum, the acting Chair did not convene the meeting, and the Board has not met since then. Due to the lack of participation by the current board members, VCE has sent letters to all of them concerning their interest to remain on the board. Pending the responses from the board members, VCE has not requested amending the Code of Virginia.

The Director of VCE sends quarterly updates to the Department of Corrections Assistant Director concerning VCE's progress toward implementing the Task Force recommendations. In addition to the appointment of the VCE Task Force, the Secretary of Public Safety sent a Policy Analyst to VCE to review its operations and make recommendations for improvement. However, the Policy Analyst's Report was not complete at the time of this report, and therefore, we will not address those recommendations in our report.

General Operations

VCE is a division of the Department of Corrections, with VCE's Director reporting to the Department of Corrections Assistant Director. The Department of Corrections must approve any major decisions made by VCE personnel with regard to its operations. Currently, VCE manages 22 production facilities in 14 correctional institutions. From its industries, VCE provides a variety of products and services. Although the Department of Corrections recently opened several new institutions, VCE has no immediate plans to open new production facilities or expand existing operations.

VCE has two conflicting missions. Section 53.1-54 of the Code of Virginia mandates VCE to be self-sufficient by offsetting all operating costs through the sale of inmate manufactured goods and services. In addition, Section 53.1-41 of the Code of Virginia requires VCE to maximize job skill training and wage earning opportunities for the Department of Corrections inmates.

These two missions contradict each other because many of VCE's industries that provide a large number of inmate jobs operate in a deficit. VCE management interprets the self-sufficiency requirement to apply to VCE operations as a whole. Therefore, management does not believe it is in violation of the Code of Virginia by continuing to incur losses in certain industries. However, VCE realized an overall net income in only two of the last eight fiscal years of operation. In addition, VCE only employs approximately 5% of the total incarcerated population, which does not appear to maximize training and work opportunities.

The Secretary of Public Safety, the Department of Corrections, and VCE need to formally decide how VCE will operate in relation to the requirements to be self-sufficient and to maximize inmate training and work opportunities. As noted under the section entitled "VCE Task Force Report," a VCE committee is developing a new mission statement for VCE. The committee should clearly state VCE's position with regard to the requirements to be self-sufficient and to maximize inmate training and work opportunities in its new mission statement.

In prior reports, we have stated that VCE should work with the Department of Corrections management to ensure VCE's goals also help achieve the Department of Corrections' goals. In response to this recommendation, the Director of VCE drafted a Department Operating Policy on how to manage VCE shops in conjunction with correctional facility operations. Some of the elements of the policy include establishing uniform work times for inmates, giving plant managers input into the hiring of inmates, and giving VCE plants preferential treatment during lockdown periods. In addition, the policy requires the host facility pay the salary of correctional officers assigned to its VCE plants.

The Department of Corrections management did not approve the first draft. VCE's Director is working on a second draft. Despite the lack of a formal operating policy, the Department of Corrections has been including VCE in some decisions impacting its operations. VCE and the Department of Corrections personnel are working together to develop new kitchen smocks for the facilities and new badges for personnel.

During fiscal year 1999, the Director of VCE began sending monthly reports to the Department of Corrections Assistant Director concerning the status of each division. In addition, they communicate throughout the month as issues arise impacting VCE operations. VCE personnel prepared a corrective action plan to the prior report and provided a copy to the Department of Corrections management. However, there is no formal mechanism in place for periodic updates on VCE's status toward implementing the corrective actions. To ensure both parties receive adequate information when making decisions, the Department of Corrections should include a representative of VCE on the Department of Corrections Executive Team.

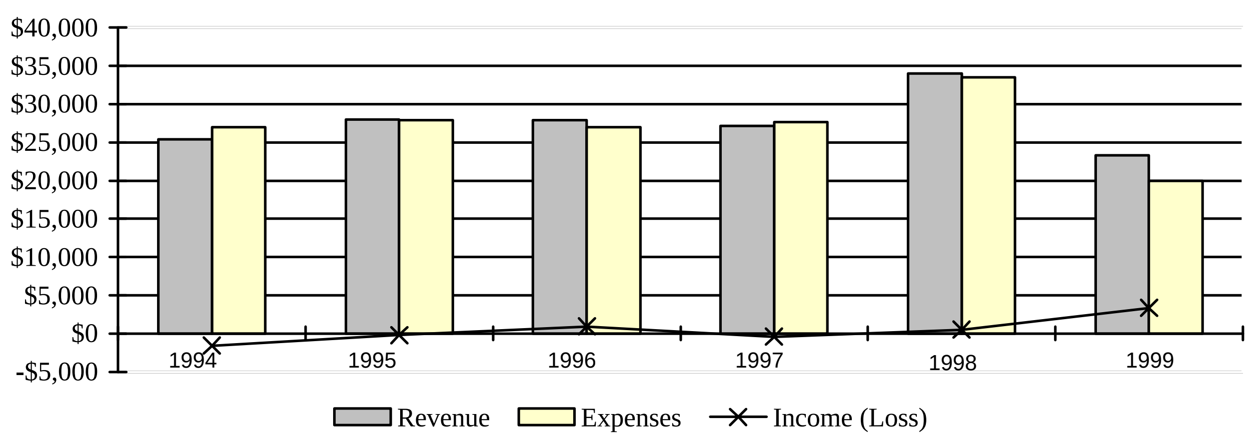
Overall Recommendation

The Secretary of Public Safety, the Department of Corrections, and VCE need to formally decide how VCE will operate in relation to the requirements to be self-sufficient and to maximize inmate training and work opportunities. VCE needs to incorporate this decision into the new mission statement that they are currently developing. This decision can presumably affect all other decisions VCE will make.

Sales And Expenses

In fiscal year 1998, VCE experienced record sales, anchored by approximately $4.7 million in June 1998. This volume of sales more than covered VCE's fixed costs and resulted in a net income of $524,425 for the fiscal year. The Clothing and License Tag industries' sales accounted for 42.7 percent of total sales for the fiscal year. These industries continue to subsidize VCE's unprofitable industries. Operating revenues increased 25.1 percent from $27.1 million in 1997 to $33.9 million in 1998, while operating expenses increased only 21.4 percent from $27.5 million in 1997 to $33.4 million in 1998. As of March 31, 1999, business operations resulted in a net income of $3.4 million as compared to $1.2 million at March 31, 1998. The following chart and table illustrate VCE's operating performance for fiscal years 1994-1998 and through March 1999.

Operating Revenues, Expenses, and Income
through March 31, 1999
(Dollars in Thousands)



Source: VCE financial statements for the fiscal years 1994 - 1998 and through March 31, 1999

Overall, VCE shows significant improvements in profit over previous fiscal years primarily because of increased sales volume from the opening of new prison facilities. VCE must recognize that these events are nonrecurring, which may not enable them to maintain or increase current sales levels, and will affect VCE's continued profitability. Fiscal year 1998 was the first full year under the new pricing structure in the License Tag industry, which contributed to the increase in profit as well. As noted in the prior report, VCE consolidated its Indian Creek office systems operations with Brunswick in March 1998. This should allow VCE to decrease overhead costs, thereby decreasing its overall loss in that industry.

Net Income (Loss) by Industry
Through June 30, 1998

Industry	Net Income (Loss) June 30, 1996	Net Income (Loss) June 30, 1997	Net Income (Loss) June 30, 1998
Clothing	$ 374,580	$ 312,134	$ 1,215,482
Data Services *	188,837	(56,626)	n/a
Dental Lab	31,101	30,741	29,445
Janitorial Products *	(114,068)	(78,205)	(58,113)
Laundry	200,575	112,829	321,667
License Tag	1,963,867	1,468,989	1,793,448
Metal Furniture	(108,273)	(238,577)	(339,785)
Microfilm *	(56,184)	(62,311)	(81,635)
Office Systems	(382,707)	(513,147)	(1,170,039)
Printing	12,583	114,855	261,266
Shoes	(6,760)	(17,218)	32,023
Vinyl Binders	(157,970)	(100,865)	(48,557)
Wood	(1,003,097)	(1,385,060)	(1,430,777)
Total	$ 942,484	$ (412,461)	$ 524,425

Source: VCE financial statements for fiscal years 1996 - 1998.

*VCE closed its Data Processing facility in June 1997, its Janitorial facility in March 1998, and its Microfilm facility in April 1998.

While VCE has made some business changes, it has not significantly changed the fundamentals of its business approach to improve the controls over prices, fixed or overhead costs, sales and marketing techniques, or expansion of its customer base. One of the changes VCE has made since the last report that has contributed to the improvement of its financial condition is the termination of all of its joint venture partnerships. By terminating the joint venture contracts, VCE eliminated the middleman enabling them to sell directly to customers at the market price. Further, VCE has recently revived its road show program, which is mainly used to promote its furniture lines. In addition to giving customers the opportunity to view and ask questions about products, the agency representatives can purchase products while at the shows.

In addition, VCE is trying to improve its customer service, which has been lacking in the past. VCE's salesmen have increased their customer contact activity. In particular, the salesmen targeted those customers who had been purchasing products from the joint venture dealers in order to keep their business. Further, VCE representatives have been meeting with the major higher education institutions in an effort to improve their relationship. These meetings reviewed the needs of the higher education institutions, in terms of products and timing. By improving communications between the two, VCE hopes to reduce mandatory source violations and level out the cyclical nature of their purchases. Finally, VCE enacted a new Quick Ship Program in fiscal year 1999, which guarantees delivery of its core products within 7 days.

Previous Recommendation:

Improve Financial Position

Management should attempt to increase its line of credit with Treasury. As part of obtaining this increase, management should prepare a business plan which both the State Comptroller and State Treasurer should review and approve.

The plan should address how management will collect its delinquent accounts receivable and reduce what it owes to private vendors. The plan should also consider the following issues.

- VCE should reduce its raw materials and finished goods inventory on hand. Management must develop policies and procedures for authorizing purchase orders and requisitions to reduce unnecessary purchases.

- VCE should negotiate agreements with its suppliers for longer payment terms; for example 90 days instead of 30 days. This may enable VCE to produce and sell the finished goods before paying the original supplier.

- VCE should consider working with the Departments of Corrections and Planning and Budget to acquire contributed or working capital sufficient to fund its raw materials and finished goods inventory.

VCE cannot rely on sales volume continually increasing or remaining the same to ensure self-sufficiency. VCE needs to review its unprofitable industries and product lines to justify their continuation. VCE must continually find ways to reduce overhead.

These recommendations provide the basis for a sound business plan. In the long-term, this plan should help VCE better manage its cash flow, pay vendors timely, and have cash available to purchase raw materials or make necessary capital purchases.

Status: **Significant Progress**

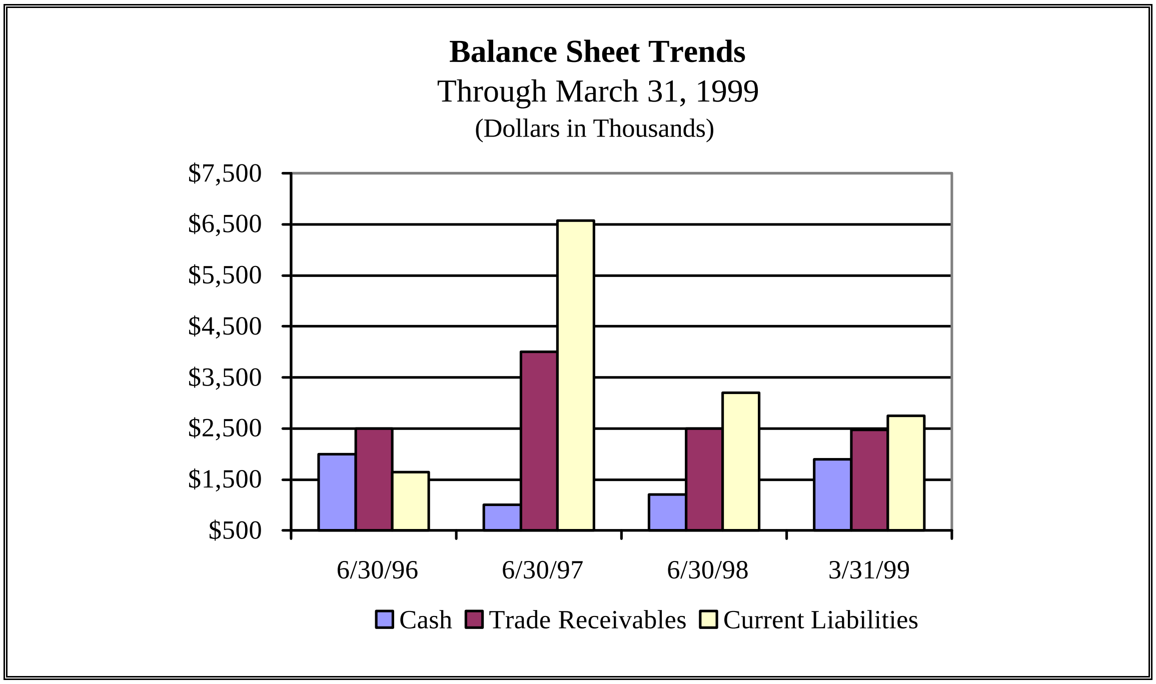
Follow-up Audit Result:

Financial Position Has Improved

VCE's financial position has improved since the issuance of our prior report. VCE's cash flow substantially improved from the increase in sales volume and net income. Further, in June 1998, VCE collected approximately $3.9 million from sales or outstanding accounts receivable, compared to $3.2 million in June 1997. Therefore, VCE increased its cash reserves, materially reducing accounts payable, and repaying $500,000 of the line of credit with the State Treasurer. VCE paid the remaining $500,000 due to the State Treasurer in January 1999. In addition, VCE paid the Department of Motor Vehicles $550,000 during 1998 toward the license tag warehouse transfer liability.

In April 1998, the Department of Corrections paid the remaining $1,518,252 on VCE's behalf to fully reimburse the Department of Motor Vehicles for the transfer liability. VCE must now pay the Department of Corrections for this reimbursement; however, the Department of Corrections has not established a fixed due date or terms for interest on the balance. The increase in cash reserves permitted VCE to improve its compliance with the Prompt Payment provisions of the Virginia Procurement Act. VCE maintained compliance during fiscal year 1999, as well.

The following graph illustrates the position of selected balance sheet accounts over the past 3 years and through March 1999. The reduction in the trade receivables outstanding at June 30, 1998, reflects the reservation of a $1.5 million receivable from Morton Marks & Sons, a former joint venture partner of VCE. We discuss the potential disposition of the Morton Marks & Sons contract further in the section entitled "Private Industry Partnerships."

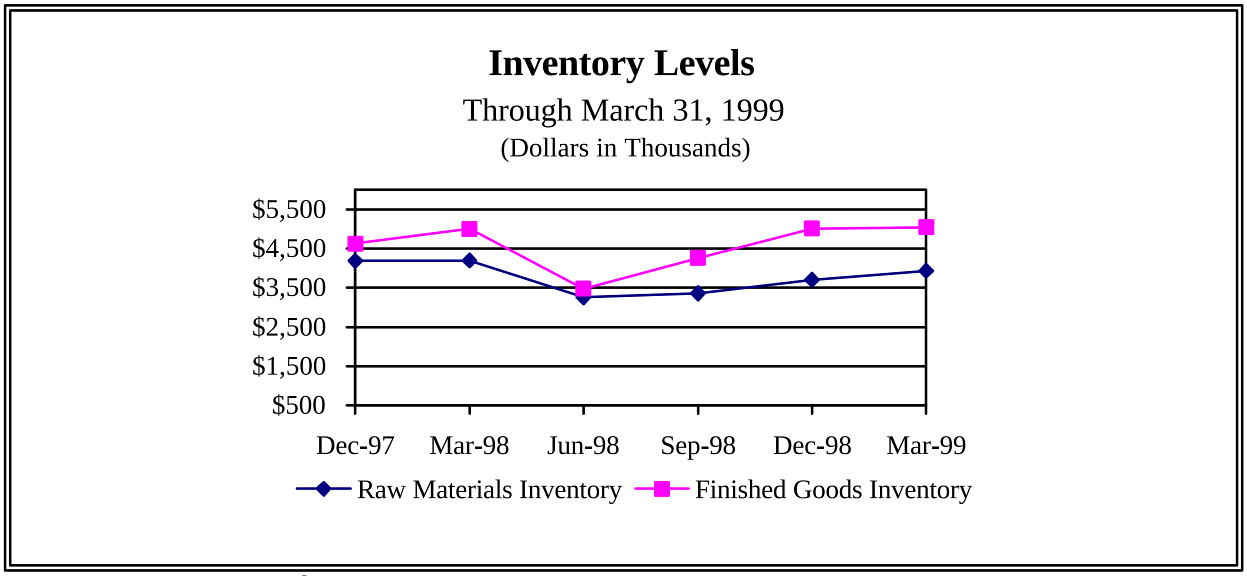


Source: VCE Financial Statements

Because of its improved financial condition, VCE management does not believe in the short term that it needs to implement the recommendations made in our previous report. Therefore, VCE did not attempt to increase its line of credit with Treasury or acquire contributed or working capital to fund inventory or future expansion. VCE has not drawn on its line of credit since repaying it, making it available to use if VCE needs additional working capital.

Further, VCE has not significantly reduced its inventory levels as recommended in the prior audit report due to their inventory analysis, increased sales, and the new Quick Ship Program. In order to determine the optimal level of raw materials and finished goods inventory, VCE management considered the average time it takes to receive raw materials from vendors, the time it takes to manufacture a product, anticipated turnover in finished goods based on informal sales forecasts, and the desired level of its safety stock. Based on these factors, VCE determined it should maintain a three-month supply of its raw materials inventories and a two-month supply of its finished goods inventories. Throughout the year, the Sales Manager monitors the safety stock levels and sales demand at the plant level to determine if inventory levels should be increased or decreased.

Raw materials and finished goods inventories have fluctuated as a result of this new inventory monitoring process. Historically, VCE's fourth quarter sales volume is greater than other quarters due to state agencies' year-end buying philosophy. Therefore, VCE builds inventory levels in the third quarter in anticipation of fourth quarter sales. This explains inventory fluctuations in the third and fourth quarters. In fiscal year 1999, VCE's inventory level increased during the second quarter as well, due to the implementation of VCE's new Quick Ship Program. The graph below reflects quarterly inventory levels from December 1997 to March 1999.



Source: VCE Financial Statements

While VCE does consider the current inventory level when purchasing raw materials, it has not developed formal policies and procedures for authorizing purchase orders and requisitions. Currently, VCE follows the Department of Corrections procurement procedures. According to the Department of Corrections procedures, the Buyer Manager authorizes purchases.

Since VCE's Buyer Manager Position is currently vacant, the Operations Manager has the responsibility for authorizing all purchase requisitions. Before approving a requisition for the purchase of raw materials, the Operations Manager reviews the current inventory level for that material to determine whether the purchase is necessary to maintain the optimal level. For all other purchases, he considers the necessity of the item. When in doubt, he questions the employee who ordered the item. Another task assigned to the Buyer Manager is the negotiation of extended payment terms with VCE's suppliers. VCE has not implemented this recommendation either. Once VCE fills the Buyer Manager position, they will develop formal authorization procedures and negotiate with VCE's suppliers for extended payment terms.

Follow-up Audit Recommendation

Although VCE's financial condition has improved, the development of a viable strategic business plan remains a necessity for VCE. A strategic business plan will provide VCE the basis for making business decisions that will ensure continued profitability in the absence of nonrecurring events that VCE has relied on to increase sales in the past. VCE should reevaluate the need for implementing the recommendations suggested in the prior audit report once it has determined its plans for the future. If VCE decides to expand into new industries, it may require additional working capital to fund the expansion and start-up costs. VCE must continue efforts to fill the vacant Buyer Manager position. Given the difficulty it has had filling the position, VCE should consider assigning the tasks of developing formal authorization procedures and negotiating extended payment terms with its suppliers to another employee.

BUSINESS STRATEGY

Previous Recommendation:

Develop a Strategic Business Plan

VCE must immediately develop a strategic business plan. The plan must include short and long-term organizational goals, performance measures, and sales and marketing strategies. When developing the plan, management must examine and evaluate current business practices. Management must immediately analyze the product lines, product pricing, and sales and marketing methodologies. VCE should work with Department of Corrections management to ensure VCE goals also help achieve the Department of Corrections' goals. Finally, when developing the plan, VCE management must continue to examine private partnerships that will help promote the mission statement and provide additional partnerships in other industries.

Status: **Limited Progress**

Follow-up Audit Result:

An Initial Business Plan Was Developed

The Director of VCE prepared an initial business plan. However, it is primarily a historical record of VCE's operations and does not contain some of the necessary elements of a business plan. The document includes a review of all the products manufactured and services provided by VCE. VCE examined its existing industries to determine whether to continue or discontinue operations. Factors considered in this evaluation were the industries gross margin, the potential for stable and consistent growth, and the number of inmates employed by the industry. Although the document contains some goals, listed in the table below, it does not outline how VCE will achieve these goals. Further, VCE has listed numerous projects, but either does not set timetables for the completion of these projects or does not give support for how VCE will meet established completion dates when present.

Business Plan Goals

Goal	Target Date	Performance Measure	New Programs Developed	Monitoring Process Disclosed
Timely Delivery	2001	96 % on-time	Quick Ship Program	None
Inmate Employment	2002	14% of the total incarcerated Population	None	None
Inmate Recidivism	None	None	None	Secure legislative funding to track released inmates.
Product Quality - Returns	2002	0.5% of shipments	QC inspection process at plants	None
Product Engineering	2000	100% review of product's components	Sampling Project	None
Cost Structure	1999	100% review of product pricing	Pricing and Cost Analysis Form	None
Net Profit Range	None	2.5% to 5%	None	None
Gross Margin	None	At least 20%	Business Categorization	None

Source: VCE Business Plan

In the preparation of the document, VCE failed to explore potential new industries that it should enter. It is important for VCE to determine which new industries it should enter in order to increase its customer base, and thereby increase its sales and inmate workforce. Further, the document lacks forecasting and budgeting information that is necessary to form the basis of good business decisions. Finally, as noted above, the document is solely the work of the Director of VCE. The Department of Corrections management was provided a draft of the document but had no significant modifications. Since numerous parties, including VCE and the Department of Corrections personnel, play an integral role in the success of VCE's operations, they should work together in the development of the business plan.

Follow-up Audit Recommendation

We recommend that VCE continue developing its strategic business plan. The plan must include all of the elements included above as well as those outlined in prior reports. In addition, both VCE and Department of Corrections personnel must be involved in the development of the plan. As discussed in the section entitled "General Operations," VCE management should work with the Department of Corrections management to ensure the goals outlined in the plan also help achieve the Department of Corrections' goals. Further, in developing the business plan, VCE should ensure it is compatible with its new mission statement. Finally, management should consider enlisting the aid of a professional business planner to assist in the process.

PRIVATE INDUSTRY PARTNERSHIPS

Previous Recommendation:

Analyze Effectiveness of Joint Venture Contracts

The VCE management team should immediately conduct a cost/benefit analysis, determine opportunity costs gained or lost, and determine whether VCE and the Commonwealth benefited from participating in the joint venture contracts. If the Department of Corrections management approves termination, VCE must formalize its plan to address collecting accounts receivable balances, product warranties, and orders in current production. In addition, VCE management must ensure it can logistically resume operations. Specifically, VCE management should reevaluate its customer service functions, plant manufacturing operations, sales and marketing functions, product pricing, the warehouse distribution center, and its transportation and fleet size. Business practices prior to entering the joint venture contracts were not successful and resulted in significant losses, dissatisfied customers, smaller product lines, and slow delivery times. Therefore, VCE management must act to avoid these problems in the future.

If termination is not approved, VCE management must take immediate and stronger actions to enforce the current contract specifications and assume its fiduciary responsibility. In addition, if VCE negotiates additional joint venture contracts, management must properly procure the contracts and ensure they represent the Commonwealth's best interests.

Follow-up Audit Result:

Existing Joint Venture Contracts Were Terminated

Status: **Significant Progress**

VCE management terminated all of its existing joint venture contracts without conducting a formal cost/benefit analysis, determining opportunity costs gained or lost, or determining whether VCE and the Commonwealth benefited from participating in them. Further, VCE did not formalize its plan to address collecting accounts receivable balances, product warranties, and orders in current production related to the joint venture contracts. Despite this lack of planning, as discussed above under the section entitled "Sales and Expenses," the termination of the joint venture contracts appears to have helped VCE stabilize its financial condition. However, VCE has experienced difficulties collecting outstanding receivables from some of its terminated joint venture partnerships and Prison Industry Enhancement (PIE) Programs.

In September 1998, Morton Marks and Sons, one of the Herman Miller joint venture dealers, filed for Chapter 11 Bankruptcy Protection. At that time, they owed VCE $1.6 million. Therefore, the Office of the Attorney General filed a lawsuit on behalf of VCE to recover the past due receivables. Approximately $800,000 of the past due receivables have been collected through the Commonwealth's Debt Set-Off Program.

The Department of Corrections is holding the collected debt set-off funds. The Department of Corrections is monitoring VCE's financial position to determine whether they need the funds. The Department of Corrections may retain the funds to reduce the receivable due from VCE for the license tag warehouse transfer payment. After filing bankruptcy, Morton Marks and Sons could not resume operations and consequently liquidated. VCE did not receive any additional funds because of the liquidation. Neither VCE nor the Office of the Attorney General anticipates that they will collect additional funds.

As noted in the prior report, VCE was in litigation with Zig Zag Embroidery, a discontinued PIE Program vendor, for unpaid invoices of $215,000. The Office of the Attorney General determined the amount was uncollectible and dropped the suit. VCE reduced accounts receivable for the amount deemed uncollectible. Ariens, Inc., another PIE Program partner, still owes VCE for excess costs incurred when manufacturing camp stoves for the vendor. On April 21, 1999, VCE and Ariens negotiated and agreed upon repayment of $13,900 of the receivable. In August 1998, VCE entered another partnership with Ariens to manufacture 5,000 additional camp stoves at $11.01 each. A formal contract was prepared to document the conditions of the partnership. In addition, the Office of the Attorney General reviewed the contract. VCE has substantially completed manufacturing the stoves.

Approximately $260,000 is due to VCE from the remainder of the terminated joint venture partners. Chasen's Business Interiors owes $150,000 of this amount. VCE has not collected these receivables due to billing and product disputes. Accounts Receivable and Customer Service personnel are maintaining weekly communications with the vendors to resolve the problems. VCE management expects to collect these outstanding receivables.

In order to avoid similar problems with future private industry partnerships, VCE has developed procedures for approving and monitoring new partnerships. The approval process includes reviews by the Department of Corrections personnel, VCE personnel, the Board of Corrections, the VCE Advisory Committee, and the Office of the Attorney General. VCE has developed a checklist to document its review. As part of its research, VCE will consider the following factors:

- the size and scope of the operation,
- the financial position of the potential partner,
- the impact of the partnership on the state's non-inmate workforce,
- the potential return on investment, and
- the cost/benefit of entering the partnership.

If, after performing this review, VCE determines it should enter the partnership, they will draft a formal contract. Finally, VCE has developed draft policies for the legal review of contracts and agreements.

To ensure it adequately monitors future partnerships, VCE has formalized its contract administration policy. Under the new policy, VCE assigns a contract officer and contract monitor to each contract. VCE has documented the officer and monitor for each contract along with their responsibilities. The contract officer is responsible for the procurement process surrounding the contract. The contract monitor is responsible for ensuring the parties involved follow all the provisions of the contract. The contract monitor is required to sign a document, which lists the responsibilities for a specific contract, indicating acceptance of the responsibilities. The new policy also details the notification process when a contract violation has occurred.

VCE has not entered any new joint venture or PIE program partnerships. At this time, VCE does not intend to enter any more joint venture partnerships. Instead, it will use the PIE program to form private industry partnerships. Both VCE and the Department of Corrections have advertised for potential partners; however, there has been limited response. VCE is in the process of researching several potential partners.

Follow-up Audit Recommendation

VCE should continue to look for viable private industry partners to permit expansion of its operations. When VCE identifies potential partners, it should follow its processes for reviewing potential partnerships and monitoring provisions of partnership contracts.

CUSTOMER BASE

Previous Recommendation:

Ensure Validity of Customers

VCE should not provide services or sales to customers outside its authority as established by the Code of Virginia. VCE management should ensure the validity of all customers before transacting a sale. VCE should develop procedures and policies to obtain and retain support for the sale including not-for-profit verifications, letters of understanding, and contracts. VCE's failure to validate its customers and subsequently conduct business with unallowable customers exposes the Commonwealth to unnecessary potential legal liabilities and contradicts public policies.

Status: **Significant Progress**

Follow-up Audit Result:

Policies And Procedures Have Been Developed

VCE implemented new procedures in February 1999 for verifying and maintaining documentation supporting the validity of customers. The verification procedures include obtaining a tax identification number and tax status form for not-for-profit customers before transacting a sale. The Accounts Receivable Department maintains sufficient documentation concerning the validity of customers.

In addition to developing new procedures, VCE reviewed its current customer master file and flagged those customers lacking adequate support as invalid in the system. Based on review of the Customer Analysis Report, there were no sales made to the invalid customers noted in the prior audit report. VCE flagged many of these customers as invalid in the system. In addition, we noted no additional customers that appeared invalid. VCE cannot delete invalid customers from the system until they have been inactive for at least three years because the system maintains a three-year history file of all activity. Therefore, VCE must flag invalid customers in its systems to prevent use of these customer accounts. When VCE personnel receive an order from a customer flagged as invalid, they must request and receive the missing documentation proving the validity of the customer, prior to transacting a sale.

Follow-up Audit Recommendation

VCE should flag **all** invalid customers in its system to prevent violations of the Code of Virginia. Further, after the customer accounts have been inactive for the required three-year period, VCE should delete them from its customer master file. Finally, VCE should consider maintaining a log documenting periodic reviews of its customer master files and communications with customers concerning validity.

PASS THROUGH SALES

Previous Recommendation:

Immediately Discontinue Pass Through Sales

VCE must immediately discontinue further initiation of pass through sale transactions. This business practice, whereby VCE knowingly purchases finished goods and resells them to customers at a profit, does not help VCE achieve its goals and objectives.

Follow-up Audit Result:

Pass Through Sales Have Been Discontinued

Status: **Significant Progress**

VCE has not purchased finished goods for resale from the vendors noted in the prior audit report. However, VCE has not deleted these vendors from its system or flagged them as invalid to prevent inadvertent use of the accounts. No additional vendors appear to be selling finished goods to VCE.

Follow-up Audit Recommendation

VCE should flag invalid vendors in its system to prevent violations of the Code of Virginia. Further, after the vendor accounts have been inactive for the required three-year period, VCE should delete them from its vendor master file.

AUTOMATED SYSTEMS

Previous Recommendation:

Ensure Current System Operating Environment is Conducive to Business Operations

As VCE develops its strategic business plan, it must evaluate its current automated system to ensure it is functioning as intended and meeting organizational needs. Management must consider supporting continued hardware and software upgrades to ensure sound and appropriate business decisions. For example, the current version cannot support an automated logistical function, does not provide data collection service, and does not allow VCE to operate in a client server environment. In addition, the current network does not support user access to outside networks, including the Internet or other state agencies. If management does not commit to continuous upgrades, VCE must ensure it fully uses all available information when making its operating decisions. VCE must strongly consider filling its vacant programmer position to help management and users continue to improve their use of the system. Presently, VCE users must rely on standard system reports and do not have the ability to create new report parameters or customize existing reports. This inability to get all the information it needs restricts management's ability to make sound business decisions.

Follow-up Audit Result:
The Automation Plan Is Being Updated

Status: **Limited Progress**

VCE is currently in the process of updating its automation plan. As part of this process, management is determining what their needs are in terms of features. Major areas identified for further investigation include those cited in the prior report. Further, VCE is researching upgrading its current system to Syteline, which is a newer version of SYMIX.

This is a logical first step since a conversion package is available and it will be more cost efficient. As part of this research, they are determining whether Syteline offers the features identified as necessary in VCE's automation plan. In addition, VCE plans to review other software packages to determine whether they can better meet their needs than their current system. VCE is working with the Department of Corrections information technology personnel to ensure its system is compatible with the new system the Department of Corrections is implementing. VCE filled the programmer position in February 1999.

Follow-up Audit Recommendation

VCE should finalize its automation plan based on organizational goals outlined in a strategic business plan. Once VCE finalizes the plan, they should make the necessary hardware and software upgrades to its system to ensure sound and appropriate business decisions.

Year 2000 Readiness

Follow-up Audit Result:
Critical Systems Are Not Year 2000 Compliant

Status: **Limited Progress**

Despite assurance provided by the vendor that SYMIX was Year 2000 compliant, VCE determined it was not compliant through testing of its version of SYMIX. Further, VCE determined its operating system and relational database engine were not Year 2000 compliant. Tapes are available from all of the vendors to upgrade the systems to year 2000 compliant versions. VCE has received verbal certification from the vendors indicating the upgraded versions are compatible. VCE completed the upgrade of its operating system on April 19, 1999. However, VCE has not completed testing the upgrade. VCE has requested the vendor to provide the upgrade tapes for SYMIX and its relational database engine by the middle of June. Further, VCE has requested a quote from the SYMIX vendor for the installation of the required CARS interfaces along with the upgrade. VCE will upgrade the relational database engine and SYMIX simultaneously because the current version of SYMIX is not compatible with the relational database engine upgrade. VCE has not completed the testing of its embedded chip technology. VCE plans to complete the upgrade and testing of all critical systems by June 30, 1999.

Follow-up Audit Recommendation

VCE should take all steps necessary to ensure its critical systems are year 2000 compliant prior to the beginning of fiscal year 2000 to prevent the disruption of operations due to system limitations.

Previous Recommendation:
Develop Systems Policies and Procedures

VCE should document policies and procedures for all phases of its automated systems as required by the standards developed by the Council on Information Management. VCE should perform a risk analysis on the information systems. The results of this analysis should be used to develop a clear, complete, and detailed Information Security Plan. This plan should address system development, information security, operational controls, security awareness training, physical security, and business continuation planning.

We understand VCE is working with the Department of Corrections to develop a business continuation plan. In doing so, VCE management should ensure the corporate plan fully addresses their business environment, the need for continued business operations, and individual business requirements.

When developing its plan, VCE should also ensure the vendor continues to support the software. Currently, the vendor will only support VCE's software through the year 2002. VCE should develop policies and procedures to verify that systems are properly maintained and adequate controls exist to prevent system failure.

Follow-up Audit Result:
Metro Information Services Has Been Hired

Status: **Limited Progress**

VCE contracted with Metro Information Services in February 1999 to conduct a Risk and Business Impact Analysis Study and to develop a Business Recovery Plan. VCE anticipates it will take approximately one year to complete the entire project. However, the Risk and Business Impact Analysis Study is scheduled to be complete by June 1, 1999. VCE will develop an Information Security Plan based on the risks identified and recommendations made by Metro. Metro is also developing the Business Recovery Plan for the Department of Corrections. Therefore, this facilitates the coordination between VCE and the Department of Corrections regarding business continuation planning.

VCE has not contracted with the vendor to continue software support after the year 2002 due to its plans to upgrade its current system.

Follow-up Audit Recommendation

When developing its Information Security Plan, VCE should consider developing a Security Agreement that its employees must sign indicating their understanding and acceptance of VCE's system policies and procedures. Further, when VCE finalizes its system upgrade plans, management should reevaluate whether it is necessary to contract with the vendor of its current software for additional support based on the anticipated time frame for the upgrade.

Previous Recommendation:
Ensure Appropriateness of User Access and Access Permissions

VCE should develop and document adequate policies and procedures over system access. Such policies should address establishing, authorizing, monitoring, and deleting user access and permissions. VCE should also evaluate its use of a blanket access modeling structure to establish system privileges. In addition, VCE should require user passwords be changed throughout the year.

Follow-up Audit Result:
Policies and Procedures Have Been Documented

Status: **Reasonable Progress**

VCE documented policies and procedures for logical and physical systems access in January 1999. While these procedures do address establishing, authorizing, monitoring, and deleting user access permissions, they do not address user passwords. Further, VCE management did not distribute the policies and procedures to VCE personnel. Therefore, despite the documentation of procedures, VCE personnel are still unaware of them. VCE has corrected or justified inappropriate access noted in the prior audit report. As a result of current year testwork, we found one employee with system access 5 months after termination. Further, we found the controls surrounding the revocation of temporary access were inadequate.

Though not formally documented, VCE requires users to change their passwords quarterly. The system does not allow users to change their own passwords. Therefore, the Information System Section e-mails employees quarterly requiring them to submit a new password to the Information Systems Section for update. VCE continues to use blanket access models for positions; however, they can modify the blankets based on individual needs. Further, VCE management evaluates the models annually to determine whether changes are necessary.

Follow-up Audit Recommendation

When updating its automation plan, VCE should consider including enhanced user access controls as a required feature. These controls should include the ability to assign expiration dates for temporary access and user passwords. Further, VCE should upgrade the system to allow VCE personnel to change their own passwords. VCE should ensure its personnel are aware of and understand the policies and procedures surrounding logical and physical systems access. A good mechanism for ensuring employee awareness of system access policies and procedures is a Security Agreement, which we recommended above under "Develop System Policies and Procedures."

PRODUCT PRICING AND COSTING

Previous Recommendation:
Develop Accurate Standard Costs

VCE should evaluate and adjust standard costs annually to ensure accuracy and identify inefficiencies in operations. Furthermore, VCE should attempt to directly charge all costs to the originating industry whenever possible. Without accurate standards, it is difficult to identify products that are losing money, establish fair and adequate prices, or develop plans to increase, reduce, or discontinue products. This also distorts inventory and cost reporting throughout the year, making it difficult to evaluate industry and product profitability.

In addition, VCE management should ensure the prices of products are adequate to recover costs before starting production. If VCE is unable to recover actual costs at the established price, management should determine whether to adjust the price accordingly or discontinue production. In addition, VCE should implement more effective procedures to ensure selling prices in the system are current and reflect the agency's most recent catalog prices.

Follow-up Audit Result:
VCE Does Not Have Accurate Standard Costs

Status: **Reasonable Progress**

The Codes and Standards Section is in the process of sampling all product routings and bills of materials to determine whether they are correct. They have sampled approximately 50 percent of the product codes. Because of this project, VCE has modified, deleted, or added many codes. VCE will sample product codes on a periodic basis once they have completed the initial sampling process. VCE will plan these reviews based on when the code was last sampled, and known problems communicated by management. One individual still carries the bulk of the product engineering responsibilities.

Until VCE completes the review of all products, they cannot measure the impact of this project; however, significant variances remain between actual and applied labor and overhead costs. Therefore, it appears that incorrect routings and bills of materials are only part of the problem. VCE determines overhead and labor rates based on anticipated expenditures and inmate work levels, respectively. However, since VCE does not have a formal budgeting or forecasting process they must rely on prior year actual activity when arriving at the rates. By preparing formal budgets and sales forecasts, VCE could better anticipate expenditures and inmate work levels, which would lead to the development of more accurate overhead and labor rates.

VCE performs a profitability analysis before starting production of a new product. However, profitability is not the only factor considered by VCE when deciding whether to make a product. VCE also considers whether the product is part of a product line offered by VCE and the inmate employment potential. If the product is part of a group of products VCE offers, VCE may produce it even if they cannot fully recover the costs. We noted 320 items in the system priced below cost, which based upon quantities on hand, could result in a potential loss of $88,171. The majority of the items were in the wood and metal industries. Further, some of the products on the report were discontinued, or products that VCE had consciously priced below cost in order to match the market price. Also, there were numerous products in SYMIX at a zero dollar value. The majority of these items were in the KOS industry, which is specialized in nature, and where the selling price is often determined based on the customer's specifications.

VCE performs and documents a product cost and pricing analysis when new products are developed and when there is a change to the standard cost of a product. In addition, VCE personnel review the prices of all products annually with the issuance of its catalog. VCE compares catalog prices to the prices listed in the system to ensure there are no differences. In the new catalog issued by VCE in December 1998, the prices were included in a separate section in the back of the catalog. This will allow VCE to distribute new price lists to the customers during the year to reflect changes without having to print new catalogs.

Follow-up Audit Recommendation

Once the initial sampling process is complete, VCE should develop a formal monitoring system to ensure they evaluate all standard costs periodically. In addition, VCE should prepare formal budgets and sales forecasts to better anticipate expenditures and inmate work levels when developing standard overhead and labor rates.

MERCHANDISE RETURNS

Previous Recommendations**:**

Expand and Use Accurate Merchandise Return Reason Codes

VCE should expand its return reason codes within SYMIX to gain a better understanding of which production areas cause returns and need improvement. VCE management should communicate with warehouse and customer service personnel accepting returns to identify the various types of reason codes needed. In addition, VCE must update its catalog to reflect the new merchandise return policy to ensure consistent treatment of all customer returns.

In addition, VCE should enforce all contracts as written. VCE should take appropriate action to collect payment on those returns that are not its responsibility.

Status: **Reasonable Progress**

Follow-up Audit Result:

Return Reason Code Activity Is Not Monitored

VCE developed new return reason codes in its system in October 1998, but is unable to monitor the activity in these codes because the report logic in the system does not recognize them.

VCE updated its product catalog to notify customers that return shipments are subject to a minimum restocking charge of 25 percent and that VCE must issue a written authorization before any merchandise is returned.

Follow-up Audit Recommendation

VCE should modify the programming logic of its reason code report so it can monitor activity under the new return reason codes.