

**VIRGINIA CORRECTIONAL ENTERPRISES
DEPARTMENT OF CORRECTIONS
RICHMOND, VIRGINIA**

**REPORT ON AUDIT
FOR THE PERIOD
JANUARY 1, 2000 THROUGH DECEMBER 31, 2000**



AUDIT SUMMARY

Our audit of Virginia Correctional Enterprises, a division of the Department of Corrections, for the period of January 1, 2000 through December 31, 2000, found:

- internal control matters that we consider reportable conditions; however, we do not consider these 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 improve inventory management for the License Tag Industry and should enforce and perform job sampling to validate standard costs.

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INTERNAL CONTROL BACKGROUND, FINDINGS, AND RECOMMENDATIONS
AND FINANCIAL INFORMATION

The Virginia Department of Corrections has operated Virginia Correctional Enterprises (VCE) since 1934. VCE is one of many work programs that the Virginia Department of Corrections operates. VCE is the only work program that is entirely self-sufficient, not receiving any state or federal funds to operate. VCE also provides Corrections with approximately \$1.7 million in security for inmates in the work program. VCE pays this expense out of revenues. VCE offers products and services to government and not-for-profit entities. All revenues go to operate and manage 13 industries located in 15 state prisons. During fiscal year 2000, VCE reopened the microfilm industry at the Virginia Correctional Center for Women (VCCW) on a small scale, employing approximately three inmates.

<u>Industry Locations</u>	
Clothing Plants	Copy Center
➤ Coffeewood	➤ Atmore
➤ Halifax	
➤ Haynesville	Dental Plant
➤ Augusta	➤ Southampton
➤ Staunton	
Laundry Plant	Metal Plants
➤ VCCW	➤ Dillwyn
➤ Greenville	➤ Buckingham
Microfilm Plant	Office Systems
➤ VCCW	➤ Brunswick
Optical Plant	Printing
➤ Fluvanna	➤ Powhatan
Shoe Plants	Tag Plant
➤ Augusta	➤ Powhatan
➤ Staunton	
Vinyl Binders	Wood Plants
➤ Powhatan	➤ Greenville
	➤ Lunenburg
	➤ Nottoway

As of December 31, 2000, VCE employed 152 civilian staff throughout the Commonwealth, including a new Customer Service Manager. VCE also employed 4.7 percent or 1,283 of the 27,259 inmates housed in state correctional institutions.

Section §53.1-47 of the Code of Virginia requires all Commonwealth departments, institutions, and agencies, supported in whole or in part with funds from the state treasury, to purchase goods manufactured by VCE. Agencies must obtain a waiver in order to purchase the same goods manufactured at VCE from another

vendor. VCE will issue a waiver if its goods do not meet criteria set by the purchasing agency. Currently state agencies, as defined in Section § 53.1-47, account for approximately 95 percent of sales.

The Code 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 year 2000, these types of customers accounted for less than 5 percent of sales.

Strategic Business Plan

During fiscal year 2000, the Chief Operating Officer took a lead role in completing VCE's Strategic Business and Expansion Plan. This plan is the result of a collaborative effort between VCE management, VCE employees, and Department of Corrections management. VCE is working to achieve the following goals and objectives:

Factory Asset Acquisition and Replacement

VCE plans to reach this goal by investing discretionary reserves into productivity initiatives including upgrading factory machinery, equipment, and information technology systems. Industries benefiting from this initiative during fiscal year 2000 were wood, metal, office systems, and laundry service.

Maximize Production Efficiencies and Add New Work Programs

By evaluating and consolidating manufacturing sites as necessary to provide elasticity in production capacity during peak demand seasons, VCE believes they can create efficiencies in production. They are striving to create swing facilities capable of transitioning to other products in order to relieve seasonal stress on production and delivery systems.

During fiscal year 2001, Sussex I and II became overflow storage facilities for dorm furniture. Sussex I and II will soon become partial manufacturing assembly sites for the wood industry. Using off-site storage to increase inventory of ready-to-finish products also helps VCE meet customers' "on demand" purchasing habits.

As part of the factory asset acquisition and replacement goal previously mentioned, Nottoway Correctional Center received a new five axis Komo Accu-Router that will mill laminated plywood into true shapes to size as well as drill and counter sink holes for sub-assembly parts. This new machinery will reduce purchasing costs for ready-to-assemble parts and increase cutting speeds. In addition, wood industry shops began using AutoCad during fiscal year 2000. This software program updates methods of instruction on the production floor pertaining to parts manufacturing and related specifications. Implementation of this software will dramatically reduce waste and increase production.

Upgrade VCE Information Technology System

VCE is planning the upgrade of its mainframe to a PC client/server based system in conjunction with the implementation of the Department of Corrections planned Integrated Corrections Information System (ICIS). In addition, VCE would like to install a bar code system and upgrade the data network in the distribution system during the ICIS implementation.

Expand and Improve VCE's Marketing Sales and Strategies

During the past fiscal year, VCE began testing different incentives to stimulate sales during off-peak seasons. The results are mixed, however, VCE will continue to test new ideas to increase sales.

VCE is working to make its catalog more user friendly and adaptable to future e-commerce applications. The new VCE catalog has new divider pages with color photographs, improved product listings and descriptions, and color swatches in response to customer suggestions.

VCE is involved with eVA, the electronic purchasing initiative proposed by the Division of Purchase and Supply. Initially, VCE will offer many of the "Quick Ship" items through the site. As eVA matures and VCE moves forward with the new automation system, VCE will add product lines to this state mandated procurement site. This site will eventually permit use of the American Express small purchase charge card for payment.

Explore New Products and Markets

VCE is assessing the potential for inter-state sales of existing VCE products and ready-to-assemble kits. A new line of ready-to-assemble wood products is complete, and VCE is currently developing marketing strategies for them. The line, "Collegiate," will target higher education institutions.

To aggressively pursue Prison Industry Enhancement (PIE) and manpower relationships with private companies, VCE has created and filled a PIE Coordinator position. VCE began discussions with four new private companies during fiscal 2001. Additional industries under current review include an optical shop, plastic bag operation, embroidery operation, upgrade of shoe and boot models for new potential customers, pallet operation, tire recycling operation, and the new alternator refurbishing project.

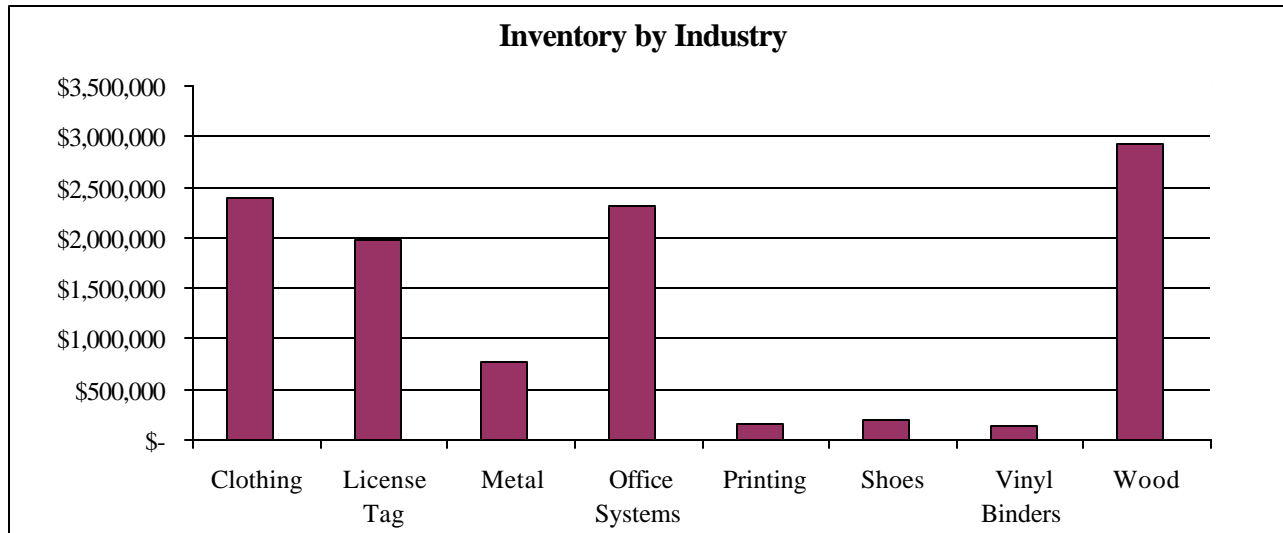
Financial Operations

VCE experienced a \$1,001,768 increase in sales and a \$2,670,192 decrease in net income for fiscal year 2000. This reduction in net income primarily reflects an increase in operating expenses of \$3,665,735 caused by the purchase of new plant assets. As VCE continues to purchase plant assets to create efficiencies in production, operating expenses will be higher than normal.

	Totals Year Ended June 30, 2000	Totals Year Ended June 30, 1999
Operating Revenues	\$35,324,795	\$34,323,027
Operating Expenses	(31,622,408)	(27,956,673)
Non-operating Revenues (Expenses)	(245,573)	(239,348)
Net Income	3,456,814	6,127,006
Retained Earnings/Fund Balance - July 1	9,510,988	3,383,982
Retained Earnings/Fund Balance – June 30	\$12,967,802	\$ 9,510,988

Inventory

Between fiscal years 1999 and 2000, VCE inventory increased \$572,598 to \$10,866,514. The majority of this increase occurred in wood products due to large orders for dormitory furniture at year-end and VCE's disposal of \$474,707 of obsolete wood inventory that reduced the inventory reserve and increased overall inventory balances. While VCE recognizes the importance of disposing of surplus items, they are restricted to the types of organizations they can convey inventory to, due to their statutory mandate. VCE management will continue to make efforts to surplus obsolete inventory in the future.



VCE maintains a perpetual inventory system. The plant staff perform complete inventory counts each February, instead of at fiscal year end, due to the high level of production at June 30th. VCE requires all plant managers, distribution supervisors, and staff to follow VCE's established inventory procedures. On the date of the 2001 inventory counts, February 27, 2001, VCE's total inventory was approximately \$9.6 million. The Tag Warehouse and Shop made up \$2.6 million, approximately 27 percent of that total. In addition, the Tag Industry is vital to VCE's economic stability. It is one of three industries that provide in excess of \$2.0 million in net income annually.

Improve Inventory Management for the License Tag Industry

The VCE Tag Warehouse and Shop staff did not perform inventory counts following VCE procedures, thus failing to validate the inventory value and limiting the auditor's ability to observe the counts. The Powhatan Industrial Group Manager oversees all operations at the Tag Warehouse and Shop. The Industrial Group Manager failed to communicate and enforce VCE's documented inventory procedures to his staff in the Tag Warehouse and Shop. The auditors made two visits to the Tag Warehouse and Shop to observe inventory. On the first visit, Tag Warehouse and Shop staff were not performing inventory pre-counts, contrary to information provided by the Industrial Group Manager before the auditors' arrival. On the second visit, VCE staff claimed to have completed the physical inventory count prior to the auditor's arrival. However, it was impossible for the staff to properly perform a 100 percent inventory count in compliance with VCE procedures before the auditors' arrival due to the size of the inventory.

The Warehouse Supervisor improperly recorded inventory counts by recording the count on inventory tags before receiving count sheets, transferring the amounts from the inventory tags to the count sheets, and then looking for inventory on the floor and affixing the tags to it. VCE procedures state, "As you count, you will record the quantities on the cycle count sheet..." In addition, the Warehouse Supervisor did not provide an adequate plant layout for auditors to independently locate inventory for test counts. These actions limited the auditors' ability to collect sufficient and competent evidence to substantiate the value of inventory for VCE.

As a result of the scope limitation, the auditors performed a surprise inventory count on March 8, 2001 to substantiate the value of inventory. The surprise count uncovered various internal control issues and non-compliance with VCE inventory procedures. Warehouse staff received orders for goods, pulled raw materials for production, manufactured the item, and shipped the finished goods to the customer before entering any transactions in the inventory system. As a result, the perpetual inventory records are inaccurate.

The Tag Shop Support Technician must enter all license tag orders from the Department of Motor Vehicles into the system manually, creating volumes of data entry. The Tag Shop Support Technician is the only individual responsible for data entry and cannot stay current with the data entry requirements. In addition, the Warehouse Supervisor did not maintain adequate documentation for the release of inventory to the warehouse or Motor Vehicles. The lack of proper supervision of the Warehouse and Shop, the timing and inconsistencies over data entry, and improper inventory counts place the VCE inventory at risk for potential material misstatement.

During the surprise inventory count, auditors found \$173,386 in variances out of a total inventory value of \$2,350,453. Due to the lack of proper documentation and inadequate records, the auditors could not determine whether items were actually missing or if documentation was inaccurate.

Recommendation:

The Industrial Group Manager should ensure that staff perform plant operations and inventory counts using VCE procedures. If the Industrial Group Manager fails to properly oversee the Warehouse and Shop, VCE management should hold him responsible for the inadequacies. Tag Warehouse and Tag Shop staff should receive hands-on-training in the proper procedures to use when performing a physical inventory. VCE should consider working with Motor Vehicles to obtain downloads for specialty plate orders to reduce the volume of data entry work at the plant level. Meanwhile, VCE management should consider hiring a part-time staff to help the Tag Shop Support Technician keep the perpetual inventory records updated. In response to our findings, VCE management has implemented 100 percent counts every 60 days at the Tag Warehouse and Shop to ensure proper inventory valuation at year-end. VCE fiscal staff will observe these counts to ensure they are proper.

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. To ensure the accuracy of these standard costs, VCE requires each plant to sample one unit per week and document actual costs. Based on these samples, VCE adjusts the system for variances between the sample and what the system reports.

Enforce and Perform Job Sampling to Validate Standard Costs

VCE production plants are still not sampling production jobs as required by agency policy. VCE's written policy requires plants to sample at least one production job per week in order to determine the actual cost of items. However, VCE management considers the requirements satisfied when plants sample at least four jobs per month. Of the four months we tested, we found that four plants did not sample an adequate number of jobs nor did they provide adequate or timely explanations for not sampling. Specifically, the Metal plant at Dillwyn only performed one sample job during the month of April. The Tag plant and the Vinyl Silkscreen plant at Powhatan did not perform any sample jobs in December and June, respectively. The Shoe plant at Augusta also fell short of the required number of sample jobs during April. While there are undocumented exemptions for not performing sample jobs, for example lockdowns, the plants are still responsible for making every effort to complete one sample per week. If the plants do not perform sample jobs, then variances between standard and actual costs may adversely affect inventory valuation on the financial statements and the establishment of sales prices.

VCE's inventory balance is material to the Virginia Comprehensive Annual Financial Report. Continued inconsistencies in enforcing this policy could misstate VCE's inventory balances, and ultimately, the Commonwealth's financial statements. VCE policy requires plant managers to provide written explanations for deviations from meeting the sampling criteria. However, the Program Support Technician for the Standards and Codes Department does not follow up on these explanations to ensure that the plants submit the explanations or that they are reasonable. In addition, there is no formal penalty when plant managers do not meet VCE's requirement. Without repercussions, there is no incentive for plant managers to perform sample production jobs.

Recommendation:

VCE should develop and implement a plan to enforce compliance with the sampling requirement. One such suggestion is to include job sampling in the plant managers' performance evaluations. VCE should also clarify its policy on performing sample jobs to document acceptable situations that prevent a plant from performing the jobs. VCE's written policy should also include the fact that sampling at least four production jobs per month is acceptable if plant managers are unable to sample one per week.

April 30, 2001

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 January 1, 2000 through December 31, 2000. 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 "Improve Inventory Management for the License Tag Industry" and "Enforce and Perform Job Sampling to Validate Standard Costs," are described in the subsections entitled "Inventory" and "Standard Costing," respectively. 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 "Enforce and Perform Job Sampling to Validate Standard Costs." Accordingly, we included this issue in the subsection entitled "Standard Costing." 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 May 31, 2001.

AUDITOR OF PUBLIC ACCOUNTS

DBC:aom
aom:31

DEPARTMENT OF CORRECTIONS
VIRGINIA CORRECTIONAL ENTERPRISES

Richmond, VA

As of December 31, 2000

Ronald J. Angelone, DOC Director

John Jabe, DOC Assistant Director

Don Guillory, VCE Chief Executive Officer

Robert Martineau, VCE Chief Operating Officer

Jim Sacher, VCE Business Manager

VCE ADVISORY BOARD

All Positions Vacant