

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

**REPORT ON AUDIT
FOR THE PERIOD
JANUARY 1, 2001 THROUGH DECEMBER 31, 2001**



AUDIT SUMMARY

Our audit of Virginia Correctional Enterprises, a division of the Department of Corrections, for the period of January 1, 2001 through December 31, 2001, found:

- internal control matters that we consider reportable conditions; however, we do not consider these to be material weaknesses;
- no instances of noncompliance 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
- inadequate implementation of corrective action with respect to audit findings reported in the prior year.

Our audit findings include the following:

- Develop Procedures for Establishing and Managing “Prison Industry Enhancement” Contracts
- Enforce and Perform Job Sampling to Validate Standard Costs
- Enforce Procedures to Remove and Dispose of Slow-moving, Obsolete, and Excessive Inventory
- Improve Inventory Management and Enforce Inventory Procedures
- Review Accounting Policies for Inventorying or Expensing Materials
- Improve Reporting and Recording of Leases
- Improve Procedures for the Small Purchase Charge Card Program
- Enforce State Procurement Procedures

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AGENCY OVERVIEW

The Virginia Department of Corrections has operated Virginia Correctional Enterprises (VCE) since 1934 as 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. Out of its revenues, VCE also pays Corrections approximately \$2.0 million for security for inmates in the work program.

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 VCE manufactures 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 98 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 2001, these types of customers accounted for approximately two percent of sales.

The Code of Virginia requires VCE to provide job skill training and wage earning opportunities for the Department of Corrections' inmates. As of May 15, 2002, VCE employed 4.7 percent or 1,345 of the 28,349 inmates housed in state correctional institutions. VCE also employed 160 civilian staff throughout the Commonwealth. VCE offers products and services to government and not-for-profit entities. All revenues go to operate and manage 15 industries located in 16 state prisons.

Industry Locations

Clothing Plants

- Halifax
- Haynesville
- Augusta
- Staunton

Copy Center

- Atmore
- Central Warehouse

Dental Plant

- Southampton

Laundry Plant

- VCCW
- Greenville

Metal Plants

- Dillwyn
- Buckingham

Microfilm Plant

- VCCW

Office Systems

- Brunswick

Optical Plant

- Fluvanna

Printing

- Powhatan

Shoe Plants

- Augusta
- Staunton

Tag Plant

- Powhatan

Vinyl Binders

- Powhatan

Wood Plants

- Greenville
- Lunenburg
- Nottoway

<u><i>Joint Venture:</i></u>	<u><i>Prison Industry Enhancement:</i></u>
Automotive Services	Wooden Pallets
➤ Coffeewood	➤ Haynesville

NEW PRODUCTS AND MARKETS

In May 2000, VCE developed a new line of ready-to-assemble dorm room furniture, called Collegiate, for state colleges and universities. VCE plans to develop lower cost furniture lines to meet the changes in demand due to the current state budget situation. VCE is currently developing a cheaper line of dorm room furniture and several new lines of office furniture to build and sell at lower costs. In addition to the changes in the wood industry, VCE is preparing the optical plant at Fluvanna Correctional Center for production. The plant will produce all eyewear products for the Department of Corrections' inmates. VCE is also developing a garbage bag production plant at Indian Creek Correctional Center. VCE is purchasing the equipment for the plant and plans to begin production before the end of 2002.

VCE is working on an agreement with the State Corporation Commission (SCC) to manage its Copy Center. VCE will set up a sales office in the SCC building to advertise its copy services to other state agencies. In addition to the revenue VCE will earn for printing services for SCC, estimated at \$272,800 in the first year, VCE hopes to increase its sales to state agencies located in the city with its downtown presence. With its new location, VCE plans to increase its current job completion time of 7-14 days to 24-48 hours, matching the completion time of local private industries. VCE has also entered into contracts with private industries for the production of goods and services. See the "Prison Industries Enhancement Certification Program" and the "Joint Venture" sections below.

Prison Industries Enhancement Certification Program

VCE received federal certification under the Prison Industries Enhancement (PIE) program on March 2, 1995. PIE is a federal Bureau of Justice Assistance certification program where prison industry goods are exempt from federal interstate commerce regulations. All states and local government correctional agencies authorized to administer prison industry programs are eligible to apply for project certification and project partnerships. Certified programs must provide certain safeguards to private sector labor and industry and to prisoner-workers. These requirements include:

1. Inmate workers must receive a prevailing wage consistent with similar conditions in the private sector that can never be less than federal minimum wage.
2. Deductions for taxes, reasonable charges for room and board, allocation for family, and contributions to victim compensation funds will not exceed 80 percent of the gross wages.
3. The program must consult with organized labor and local businesses before initiating any certified project. The program must also identify the scope of the intended project and its initiation date.

4. Programs must show that the project will not result in a significant displacement of employed workers. Workers should not work in skills, crafts, or trades when there is a surplus of available laborers in the community.

Since October 2001, VCE has entered into PIE contracts with World Wide Automotive, Inc. and Potomac Supply Corporation. The World Wide Automotive (WWA) agreement is for VCE to produce various products at a mutually agreed-upon rate. VCE is not currently producing any products for WWA under this contract. The Potomac agreement is for VCE to repair broken wooden pallets.

Develop Procedures for Establishing and Managing "Prison Industry Enhancement" Contracts

VCE has not established procedures to determine whether private industry contracts will generate sufficient revenue to cover costs before entering into the contract. Additionally, VCE does not have established procedures for changing contracts and the effects the changes will cause.

In 1997, VCE entered into two PIE contracts for the production and sale of goods. At that time, VCE did not perform a proper analysis of the costs associated with the PIE agreements before signing the contracts. The contracts resulted in an operating loss for VCE. Due to its losses, we recommended that VCE develop procedures to perform cost benefit analysis on current and future agreements. VCE has not developed those procedures. VCE did perform a cost benefit analysis with the current PIE contract with Potomac Supply Corporation but did not keep the documentation.

In addition, VCE has not documented its procedures for entering into and managing the PIE contracts. VCE allowed the private corporation to modify the contract without a written agreement. Without the proper documentation, the auditor could not determine what conditions VCE and the corporation agreed to or whether VCE and the corporation are complying with the conditions.

Recommendation

VCE should document its procedures for meeting the federal requirements for entering into the PIE contracts, including performing a cost benefit analysis. VCE should also document its procedures for managing the contract to ensure that payments received from the private corporations comply with the terms of the contract. VCE should perform a cost benefit analysis of its current PIE contract before renewing the contract. Performing a cost benefit analysis and documenting and following procedures will allow VCE to ensure that the PIE contracts are cost beneficial and properly managed.

Joint Ventures

In November 2000, VCE entered into a joint venture agreement with World Wide Automotive to disassemble, clean, repair, test and reassemble used automotive parts at Coffeewood Correctional Center. Joint venture's differ from PIE programs in that they represent an agreement for services performed, for a private industry, instead of the actual production of a good or product. For joint ventures, VCE is not required to meet the federal regulations established for PIE programs; including the requirement that they pay inmates the prevailing wage rate.

FINANCIAL OPERATIONS

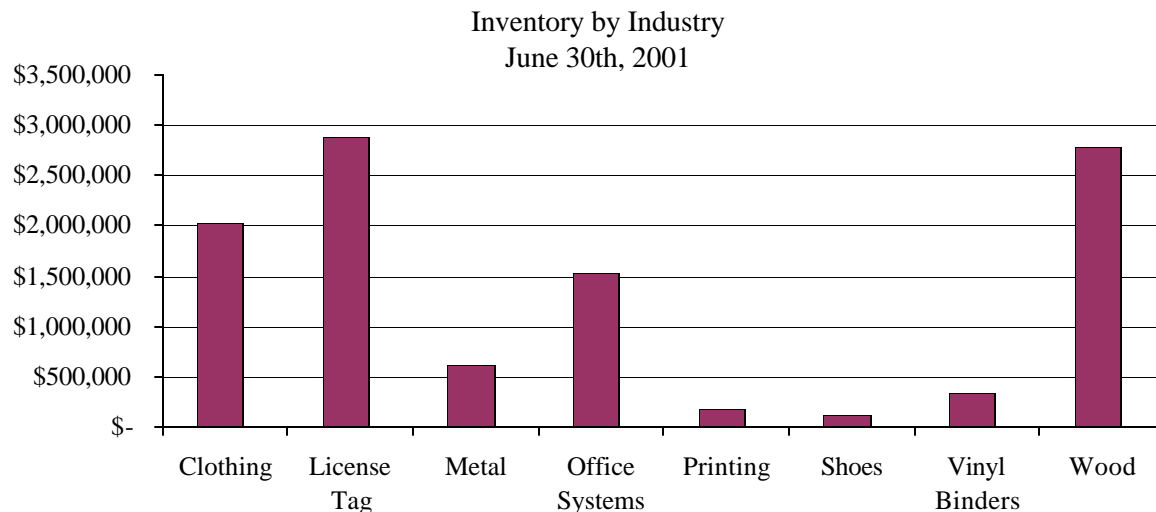
VCE experienced a \$3.1 million increase in sales and a \$2.0 million decrease in net income for fiscal year 2001. This reduction in net income resulted primarily from an increase in production of dorm room

furniture and office systems, which have a low profit margin but employ a large number of inmates. The rest of the reduction is due to a \$700,000 transfer to DOA for mandated budget cuts in 2001.

	Totals Year Ended June 30, 2001	Totals Year Ended June 30, 2000
Operating Revenues	\$ 38,422,922	\$ 35,324,795
Operating Expenses	(35,575,581)	(31,555,378)
Non-operating Revenues (Expenses)	(589,191)	(245,573)
Transfers In (Out)	<u>(847,284)</u>	<u>(67,030)</u>
Net Income	1,410,866	3,456,814
Retained Earnings/Fund Balance – July 1	<u>12,967,802</u>	<u>9,510,988</u>
Retained Earnings/Fund Balance – June 30	<u>\$ 14,378,668</u>	<u>\$ 12,967,802</u>

Inventory

VCE has 22 decentralized plant sites that produce finished goods for 14 of its 15 industries. In addition, VCE has a central warehouse that maintains its finished goods for shipment to its customers. A plant manager manages the decentralized plants and the central warehouse. VCE's inventory at the end of fiscal year 2001 was \$10.5 million. This inventory balance consists of raw materials, work-in-progress, and finished goods from all industries.



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 30. VCE held its inventory count February 25, 2002. VCE requires all plant managers, distribution supervisors, and staff to follow VCE's established inventory procedures. After the inventory count, VCE's total inventory was approximately \$9.4 million. The majority of the inventory was comprised of four industries.

<u>Industry</u>	<u>Inventory Amount</u>	<u>Percent of Total Inventory</u>
Tag Warehouse and Shop	\$2.8 million	30%
Clothing Industry	\$2.2 million	23%
Wood Industry	\$1.7 million	18%
Office Systems	\$1.4 million	15%

The difference in the inventory, \$10.5 million at the end of fiscal year 2001 and \$9.4 million for the period ending February 28, 2002, is due to the increase in demand at the end of the fiscal year, requiring VCE to increase its inventory on hand.

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 job 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, and VCE management is not reviewing the samples and using the results to update and validate VCE's standard costs. We have reported this issue for three years. VCE implemented this sampling procedure to sample and determine standard costs because of issues we reported over three years ago concerning its procedures for determining standard costs. Management has not emphasized the importance of these procedures, has not tailored the process to fit individual industries, and has not enforced the procedures. Without properly sampling production jobs, VCE cannot validate standard costs for products. Continued inconsistencies in enforcing this policy could misstate VCE's inventory balances and result in improper sales prices.

Recommendation

VCE management must emphasize the importance of the job sampling process. Management must enforce performance of this process, review the samples, and use the results to update and validate standard costs.

Enforce Procedures to Remove and Dispose of Slow-moving, Obsolete, and Excessive Inventory

As of February 28, 2002, VCE had \$9.4 million in inventory of which we found over \$1 million, retail value, in slow moving, obsolete, excessive, or scrap inventory. Including these amounts in its finished goods inventory balance materially overstates inventory and will overstate year-end profits.

As of April 2, 2002, VCE had over 22,800 units of finished goods inventory with a sales value of over \$1.055 million in inventory that have not moved in over a year. Approximately \$630,000 of the \$1.055 million represented clothing, which may not be sellable. The majority of the clothing is several years old, produced as far back as the late 1990's, including large quantities of unique specialty sizes.

In addition to not disposing of inventory at the Central Warehouse, we observed obsolete inventory at Sussex II and Brunswick, and through review of variance reports, we found scrap materials at the Powhatan License Tag Shop and the Vinyl Industry. Personnel at the Powhatan License Tag Shop and the Vinyl Industry were improperly recording the disposal of the scrap items by misstating production variances.

Recommendation

VCE should enforce its procedures to write off and dispose of all inactive inventories. Additionally, management should instruct and ensure that personnel properly record inventory losses as they occur.

Improve Inventory Management and Enforce Inventory Procedures

VCE performs a yearly physical count of the entire inventory at the end of February. VCE has developed central procedures to ensure proper counting of inventory at each industry. The Plant Manager is responsible for ensuring that staff perform plant operations and inventory counts in compliance with VCE procedures. Four of the five industries selected for testwork: Greenville, Powhatan License Tag Shop, Powhatan License Tag Warehouse and the Central Distribution Center; did not perform inventory counts in compliance with VCE procedures.

The Central Distribution Center did not have any documented procedures to indicate a new methodology for completing year-end inventory counts. The Greenville wood industry plant could not provide a plant layout, which details the location of all inventory items. The industry staff at the Powhatan License Tag Shop did not fully understand the inventory procedures even though they read the procedures and signed them, indicating that they did understand the inventory procedures and related schedules. The License Tag Shop does not have a consistent and accurate methodology for stacking and counting license tags in an efficient manner. In addition, the License Tag Shop does not properly calculate linear footage for tag metal sheeting. The plant staff at the Powhatan License Tag Warehouse did not properly follow the inventory count procedures relating to counting and recording inventory counts.

Recommendation

VCE should ensure that each Industry completes and conducts inventory in accordance with policies and procedures established by central office. Central management should ensure that all industry staff involved in the inventory counts receive specific training on the proper procedures used to perform a physical inventory count, and that they understand the procedures and their purpose. VCE should hold each plant manager accountable for the inventory procedures.

Review Accounting Policies for Inventorying or Expensing Materials

VCE has not reviewed its accounting policies on whether to expense or inventory items since April 1989. The current accounting policy recommends inventorying items that have a one to three percent value to the finished good. Because of bookkeeping and other cost, VCE management is now using a four percent guideline, and in the Dental shop, expenses all items.

Recommendation

VCE should review and update its accounting policy for determining whether an item is an expense or inventory amount. This review should include the cost of maintaining inventory records and whether the exclusion of these items would significantly distort the cost of finished goods or overall operating expenses.

VCE Information System Upgrade

VCE is planning the upgrade of its financial system, SYMIX, to a Windows based accounting system. VCE is in the process of determining whether or not the upgrade will meet its needs. VCE anticipates that implementation costs will be approximately \$115,000. In addition to upgrading its financial system, VCE is working with Virginia Information Provider Network and the Department of Information Technology to develop a website for its catalog and to interface its catalog and SYMIX with eVA, the State's electronic procurement system.

Operating and Capital Leases

Improve Reporting and Recording of Leases

VCE did not properly record and track leases in the Lease Accounting System (LAS) and its financial statements. More importantly, VCE did not complete an adequate economic analysis to determine the best acquisition method for the asset. These weaknesses arose from poor communication between agency personnel and not following procedures for evaluating, entering into, and tracking leases.

The auditor found an equipment lease, in place since 1998, that VCE had not identified as a lease and was not including the agreement as a lease in either its accounting records or LAS. A lack of communication between the Accounts Payable Department and the Procurement Department caused the error. VCE does not reconcile its lease accounting records to LAS, resulting in an overstatement of the LAS liabilities by approximately \$333,000.

VCE did not properly perform an economic analysis to determine the cost benefit of leasing or purchasing equipment, before entering into a six-year, \$3.7 million lease agreement for copier equipment and management services. In addition, VCE entered into this lease agreement in December 2001; however, VCE still has not submitted the lease information to the Department of Accounts (DOA) to determine whether the lease is capital or operating and to input the lease into LAS. VCE must submit the proper information to DOA so that they can determine whether the lease is a capital or operating lease.

Recommendation

VCE should review its policies and procedures for reporting and recording leases to ensure they properly identify, report, and record all leases. VCE should ensure financial statements reconcile to LAS and properly disclose lease commitments. VCE should report changes to leases immediately to the Department of Accounts, including the proper documentation for capital versus operating lease determination. VCE should complete a proper economic analysis to ensure that all agreements are in the best interests of the Commonwealth as a whole.

Procurement

Improve Procedures for the Small Purchase Charge Card Program

VCE needs to improve procedures over its small purchase charge card program (SPCC). VCE has issued the charge card to approximately 40 employees for purchasing various goods and services. VCE employees made purchases of over \$1.5 million under the program during fiscal year 2001. VCE has developed policies and procedures for the program to ensure that all purchases made using the SPCC are appropriate and that charge card statements are accurate. However, we found the following specific internal

control weaknesses over the SPCC program, some of which arose from poor communication between agency financial personnel and other agency employees, and some resulted from staff not following procedures.

- Agency personnel are not tracking its purchases in accordance with the Commonwealth Accounting Policies and Procedures (CAPP) Manual. Ninety-three percent of the cardholders tested did not track its purchases on a Master Purchasing Log. Due to the fact that personnel are not tracking its purchases on a Master Purchasing log, agency personnel are not identifying and documenting discrepancies between the purchasing log and the card member statement.
- VCE did not maintain adequate support for purchases made with the small purchase charge card. The auditor found two instances in which VCE did not maintain proper documentation to support purchases, including one instance in which the same vendor invoice supported two different purchases.
- VCE employees are sharing their American Express card number. The auditor found several instances where one agency employee purchased items from a vendor but requested that the vendor charge another employee's small purchase charge card. Only the employee assigned the charge card has authority to make purchases using the card. This has caused VCE several problems including instances in which the vendor charged the wrong card for purchases.

Recommendation

Management should develop and implement a training program to adequately train card members and supervisors on all policies and procedures including maintaining a purchasing log, supervisory review, and the importance of the reconciliation and certification process. Management should ensure that only the employees authorized to use their charge cards make purchases and discontinue the use of authorizing vendors to charge another employee's charge card. Strengthening the internal controls over the Small Purchase Charge Card Program will reduce the risk of fraudulent charges and ensure purchases are proper.

Enforce State Procurement Procedures

Virginia Correctional Enterprises needs to improve procedures over the purchase of goods and services. Since 1997, VCE has purchased specialized pickup and delivery services from a vendor without a contract or written agreement. During calendar year 2001, VCE made 66 separate payments to the vendor totaling \$117,000. Procurement regulations require agencies to competitively procure all purchases over \$5,000. In addition, the auditor found two separate instances where agency employees split up the payments for a vendor invoice to avoid any time delay caused by receiving proper authorization from the central purchasing office to purchase goods. In both instances, the total purchases exceeded the employee's purchasing authority for the individual purchases made.

Recommendation

VCE should ensure that all employees responsible for the procurement of goods or services and the approval of payments for goods or services receive the proper training to ensure they meet state procurement guidelines.

June 19, 2002

The Honorable Mark R. Warner
Governor of Virginia
State Capitol
Richmond, Virginia

The Honorable Kevin G. Miller
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, 2001 through December 31, 2001. 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, review the adequacy of VCE's 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:

Revenues and Cash Receipts
Expenditures
Private Industry Contracts
Fixed Assets
Leases

Accounts Receivable
Procurement
Inventory
Controllable Assets
Installment Purchases

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 are discussed in the sections entitled "New Products and Markets" and "Financial Operations." We believe that none of the reportable conditions is a material weakness.

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 audit findings, titled "Enforce and Perform Job Sampling to Validate Standard Costs," and "Improve Inventory Management for the License Tag Industry." Accordingly, we included these issues in the section entitled "Financial Operations."

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 12, 2002.

AUDITOR OF PUBLIC ACCOUNTS

DBC:whb
whb:31

DEPARTMENT OF CORRECTIONS
VIRGINIA CORRECTIONAL ENTERPRISES

Richmond, VA

As of December 31, 2001

Ronald J. Angelone, DOC Director

John Jabe, DOC Assistant Director

Don Guillory, VCE Chief Executive Officer

Jim Sacher, VCE Business Manager

VCE ADVISORY BOARD

All Positions Vacant

