

California State Auditor

B U R E A U O F S T A T E A U D I T S

Prison Industry Authority:

**Has Failed To Take Significant
Corrective Action on Many
State Auditor Recommendations**



August 1997
97502

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August 20, 1997

97502

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

The Bureau of State Audits presents its audit report concerning the Prison Industry Authority (PIA) titled "Prison Industry Authority: Has Failed To Take Significant Corrective Action on Many State Auditor Recommendations." This audit was performed as a follow-up to our April 1996 audit. We reviewed the actions taken by the PIA to the numerous recommendations we made in our April 1996 report. This report concludes that overall, the PIA and the California Department of Corrections have been slow to implement the recommendations made in our 1996 report. Specifically, the PIA's Enterprise Review Teams have not addressed the recommendations regarding cost controls and operational improvements as the PIA claims. Also, we estimate that the PIA's excess inventories have doubled since fiscal year 1994-95. The PIA's Prompt Delivery Program is a one-dimensional approach to meeting delivery goals which has contributed to the increase in excess inventory. Finally, we found that the PIA has taken little or no action to implement the cost accounting recommendations that are key to managing its operations.

Respectfully submitted,

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Summary



Audit Highlights . . .

In April 1996, we examined the PIA's operations and reported 37 recommendations indicating needed improvements. In this follow-up audit we found that the PIA:

- Has been slow to implement improvements;***
- Conducted limited product reviews that did not address critical cost control or operational improvement recommendations;***
- Focused its efforts on prompt delivery which contributed to the doubling of excess inventory levels to \$31.9 million; and***
- Has overlooked a significant part of its mission, the inmates.***

Results in Brief

The Prison Industry Authority (PIA) was established on January 1, 1983, as the successor to the California Correctional Industries Commission. The PIA is a penal program that employs inmates, develops inmate work skills, and reduces the cost of California Department of Corrections (CDC) operations. As such, the PIA manages approximately 73 manufacturing, service, and agricultural facilities at 23 of the 30 CDC institutions throughout the State. The PIA employs roughly 6,600 male and female inmates. Its products are sold principally to departments of the State, which are required by law to purchase items manufactured by the PIA. For fiscal year 1995-96, the PIA had sales of approximately \$147 million, the third highest in its history.

In 1995, the Joint Legislative Audit Committee requested the Bureau of State Audits (BSA) to evaluate the PIA's costs, quality, and customer service. In April 1996, the BSA issued an audit report titled "Prison Industry Authority: Statutory and Cost Control Problems Adversely Affect the State." The report was very critical of the PIA and its operations. The audit concluded that the PIA has significant weaknesses in its financial management, cost-accounting systems, and operations management, and, along with the CDC, does not measure or report on the benefits inmates derive from the PIA's work program. Our 1996 report included 37 recommendations for the PIA and CDC to improve the PIA's operations. In addition, we made 4 recommendations specifically to the CDC addressing steps it could take to improve its operations affecting the PIA. Because of the significance of these recommendations, the BSA determined a follow-up audit of the PIA was warranted. Our current audit examines the actions the PIA has taken over the past 15 months to implement the April 1996 audit recommendations.

Overall, the PIA has been slow to implement the recommendations made in our 1996 report. We found that, despite the PIA's claims, its Enterprise Review Teams do not address the critical cost control or operational improvement recommendations. However, the PIA has closed and consolidated several enterprises, actions that address our recommendation to identify enterprises to be scaled back or

eliminated. Further, its one-dimensional approach to meeting delivery goals has contributed to steadily increasing inventories; we estimate that the PIA's excess inventory has doubled from \$15.9 million in fiscal year 1994-95 to \$31.9 million in fiscal year 1996-97. The PIA has taken little or no action to implement the cost-accounting recommendations that are key to managing its operations. Finally, neither the PIA nor the CDC has focused on the benefits inmates derive from the PIA's program. However, the PIA has responded to several recommendations, including conducting a customer survey, incorporating performance measures in its strategic plan, and modifying its annual report to the Legislature.

Recommendation

We believe the recommendations made in our April 1996 report are critical to the PIA's successful operations as a business and as a penal program. As such, the PIA should re-examine all the recommendations and its current course of action and ensure its efforts bring prompt and effective change to its operations.

Agency Comments

In their response, the Prison Industry Board (board) and the PIA recognize that although progress has been made, there is still work to be done to address the recommendations contained in the April 1996 report. The board and the PIA state that the Enterprise Review Teams provided valuable information but were not the only method the PIA used to analyze enterprises for improvement. The PIA believes that comparisons of its inventory levels with the private sector is inappropriate citing its operational environment and new Prompt Delivery Program (PDP) as factors. However, the PIA also acknowledges that there is room for improvement in its inventory management. The PIA does not agree with the report's finding regarding its progress in implementing the cost accounting recommendations from the April 1996 report. However, the PIA does not believe that these recommendations should be pursued independent of the three phase framework recently developed by its outside consultant. The PIA states that it is committed to long-term improvement of its cost-accounting system. Finally, the PIA and the California Department of Corrections (CDC) state that a measure of the benefits inmates derive from the PIA's inmate work program could be developed; an evaluation of the PIA's effectiveness in helping to provide a safe prison environment is

planned. Both parties anticipate that the inmates involved in the PIA's work program will reflect less incidence of wrongdoing.

To provide clarity and perspective, we provide our comments to the response from the board and the PIA at the end of this report.

Introduction

Background

The Prison Industry Authority (PIA) was established on January 1, 1983, as the successor to the California Correctional Industries Commission. The PIA is under the policy direction of an 11-member board of directors. Three of the board members serve as a function of their state positions. The remaining eight members are appointed by the governor and Legislature. The PIA is technically part of the California Department of Corrections (CDC). Approximately 765 civilian state employees work for the PIA throughout the State. The PIA's administrative headquarters is located near Folsom, California, adjacent to the recently constructed California State Prison, Sacramento.

The PIA manages approximately 73 factories at 23 of the 30 CDC institutions in California. Its factories manufacture textiles to license plates to office furniture and employ roughly 6,600 male and female inmates. For fiscal year 1995-96, the PIA had sales of approximately \$147 million, the third highest in its history.

The products manufactured by the PIA are sold principally to state agencies and departments. These products include services such as laundry and printing, and goods such as eyeglass lenses and office supplies and furniture. The California Penal Code, Section 2807(b), requires the State to purchase the PIA's products. In addition, PIA products also can be sold to cities, counties, special districts, and public schools in the State, as well as to public agencies in other states whose laws permit it, federal agencies (subject to their own regulations), and foreign governments and businesses.

In 1995, the Bureau of State Audits (BSA) was asked by the Joint Legislative Audit Committee to evaluate the PIA's costs, quality, and customer service. In April 1996, the BSA issued an audit report titled "Prison Industry Authority: Statutory and Cost Control Problems Adversely Affect the State." The report was very critical of the PIA and its operations. Specifically, we found that the PIA:

- Was heavily subsidized by the CDC and the General Fund through low rents and interest-free contributed capital;

- Had a practice of subsidizing nonself-supporting enterprises with those that are;
- Had cost-accounting processes that are inadequate and do not encompass common industry practices;
- Maintained excessive and costly raw material and finished goods inventories and warehouse space; and
- Had dissatisfied customers, especially because of the PIA's long delivery times and high prices.

Our 1996 report included 37 recommendations for the PIA and the CDC to improve the PIA's operations. In addition, we made 4 recommendations specifically to the CDC addressing steps it could take to improve operations affecting the PIA. Because of the significance of these recommendations, the BSA determined a follow-up audit of the PIA was warranted. Our current audit examines the actions the PIA has taken over the past 15 months to implement the April 1996 audit recommendations.

Scope and Methodology

The follow-up audit we performed required us to assess the actions the PIA and CDC have taken since the April 1996 report. In general, to determine the PIA's and the CDC's responsiveness to the recommendations, we reviewed the 60-day, 6-month, and 1-year responses they submitted. For those items not addressed in these letters, we inquired specifically about them and assessed the PIA's and the CDC's responses for reasonableness. For items the PIA disagreed about and took no action on, we simply confirmed they disagreed and took no action.

To assess the adequacy of the PIA's and the CDC's actions on the remaining recommendations, we interviewed management and other key personnel to understand the details of the PIA's letter responses. We reviewed reports and other documents prepared by and for the PIA concerning important operational issues such as the Enterprise Review Teams, Prompt Delivery Program, and the cost-accounting needs assessment. Our review of these documents helped us determine whether the PIA was identifying and taking the appropriate corrective actions and what impact these actions were having on the PIA's operations. Finally, we performed a limited financial analysis of the PIA's inventories to determine whether excess inventories had been reduced as previously reported.

Our report is organized into two sections. The first section is an analysis of several of the key recommendations made in the April 1996 report and the PIA's actions in response to those recommendations. The second section, the Appendix, is an analysis of the major findings contained in the previous audit report, the related recommendations, and corrective actions the PIA and the CDC have taken.

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Analysis of Major Recommendations

The Prison Industry Authority Has Failed To Take Significant Corrective Action on Many State Auditor Recommendations

The Effects of the PIA's Monopoly


The California Penal Code, Section 2800 et seq., established the PIA as a monopoly. The Penal Code, Section 2807(b), specifies that all products the PIA produces shall be purchased by the State (mandatory use). In our 1996 audit, we found that the PIA has a practice of setting prices and operating factories, allowing some products and factories to subsidize others. As a result, the PIA's focus is on its overall profitability and not on managing the costs of each enterprise it operates. For example, during fiscal year 1994-95, the PIA operated 41 factories that generated \$18.5 million in excess of their total costs. The PIA used this excess to fund 30 factories that had net losses of \$8.6 million.

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PIA's "profits," \$9.9 million in fiscal year 1994-95, result from state agencies purchasing goods at a higher price than PIA's cost.


During fiscal year 1994-95, the PIA reported a net income of \$9.9 million. However, the concept of "profit" is inappropriate for an organization such as the PIA. Because all of the PIA's customers are other agencies in the State, any "profit" is simply a transfer of taxpayer funds from one state agency to another. Furthermore, the PIA's "profit" is ultimately funded by taxpayers paying for goods and services that are priced higher than the PIA's cost or the price the State could obtain in the open market.

The effects of the PIA's practice of setting prices and subsidizing ineffective factories include:

- State agencies unknowingly subsidizing the inefficiencies of many PIA factories;
- The true cost of inmate employment programs being hidden in the expenditures of other state agencies; and
- Taxpayers losing the benefit of efficient PIA operations by paying more than the true cost for PIA products.



The CDC paid \$6.9 million more for PIA goods than was necessary for the PIA to recover its costs.



The Penal Code also specifies that the PIA help reduce the cost of CDC operations. However, the 1996 audit found that for certain goods and services, the CDC paid \$6.9 million more than was necessary for the PIA to recover its costs. The CDC is the PIA's primary customer, consuming 57 percent of the PIA's goods and services in fiscal year 1994-95. Because of the PIA's policy of subsidizing enterprises, the CDC paid a premium for some of the goods and services it purchased from the PIA.

As a result of the circumstances described above, the 1996 report contained several recommendations for controlling costs and improving operations. Specifically, we recommended that the PIA:


- Establish policies and practices that ensure PIA prices do not exceed market prices;
- Perform a comprehensive review of all industries and products to determine which are self-supporting or should be scaled back or eliminated;
- Determine how to reduce operating costs from current levels;
- Identify optimal production levels for each factory and focus efforts to increase sales of these products; and
- Reduce delivery times for its products.

Contrary to the PIA's Assertions, the Enterprise Review Teams Did Not Address Our Recommendations


In response to our audit recommendations, the PIA indicated it had formed Enterprise Review Teams (ERT) designed to conduct comprehensive reviews of selected enterprises and assist in implementing our recommendations. At the time of our review, the PIA had completed only two ERT reports, the dairy and bindery. We reviewed these ERT reports to determine whether the ERTs were responsive to our recommendations. We found that the ERTs did not address the cost control or operational improvements as recommended; rather, the actions of the ERTs focused narrowly on making prices competitive with private suppliers. Moreover, the ERTs used flawed cost data as a basis for many conclusions. Nevertheless, the ERTs did identify several potential improvements that we will discuss later.

The ERTs Did Not Adequately Address Cost Controls or Operational Improvements

In our April 1996 report, we recommended that the PIA improve its operations by identifying ways to reduce costs and operate more efficiently. However, we found that the bindery and dairy ERTs performed only a limited analysis of costs at each enterprise reviewed and that these analyses did not consider ways to control or reduce costs or make the PIA's operations more efficient. For example, the bindery report categorized costs into administration, maintenance and repair, and warehousing, then compared the categories to enterprises at other institutions for reasonableness. The dairy ERT was conducted in a similar manner. However, the ERTs did not conduct any further analysis such as reviewing the underlying details to determine the nature of the costs or for ways to reduce the costs. In order to reduce costs and operate more efficiently, an entity needs to understand what costs are incurred and why. A simple comparison of costs, such as the one performed by the ERTs, does not achieve this purpose. As a result, the ERTs did not implement our recommendation to identify cost reductions or ways to make the bindery and dairy enterprises operate more efficiently.




The ERTs performed a limited analysis of costs which did not consider the nature of these costs or ways to reduce them.




Operational improvements were also not a focus of the ERTs. Operational improvements are changes that result in increased efficiency in the production process that may lower product costs. For example, an operational improvement may stem from automating a process that was performed manually or reordering an assembly process to eliminate time delays between steps. The PIA asserted that the ERTs would address our recommendations to make operational improvements. We reviewed a general outline prepared by the ERT steering committee identifying the areas an ERT might study as well as the reports prepared by the ERTs to determine whether they addressed our recommendations. We found that the outline contained no procedures to review the operations of an enterprise or identify areas for increasing efficiency.

ERT Suggestions on Pricing Are Contrary to Our Recommendations

Our 1996 audit indicated that more than one-half of the PIA's products would not be competitive in standard state procurements because the PIA's prices are higher than the private sector. In addition, the pricing reflected the PIA's practice of subsidizing nonself-supporting enterprises with those that are. Therefore, we recommended that the PIA implement



The ERT's recommendations to reduce prices were based on price comparisons rather than on reductions in the costs to produce the products.



revised pricing policies. To this end, the ERTs' main focus appeared to be on pricing comparisons. For example, for two products, the bindery ERT determined who the PIA's competitors were, or who they would be in a nonmandatory environment, and obtained pricing data for products similar to those sold by the PIA. Specifically, the bindery ERT determined that Office Depot (a commercial retailer) was the PIA's competitor for binder sales. The ERT compared the PIA's selling price with Office Depot's for similar products. Based on these comparisons, the bindery ERT recommended that the prices of two types of binders be reduced in order to be comparable to Office Depot's. In another instance, the bindery ERT examined its prices on the PIA's mesh sign product line. Mesh signs are commonly used to warn of an approaching highway construction zone. The ERT noted that the market for mesh signs is currently limited to one customer, CALTRANS, and that the PIA's current price is approximately one-half that of its closest competitor. Therefore, on the surface, the PIA's mesh signs appear to be a good buy for CALTRANS. Unfortunately, the ERT determined that a PIA mesh sign is priced approximately \$13 below the cost to produce it. The ERT's recommendation was to raise the price of the mesh sign by 30 percent, which would cover costs, and the new price would still be below the competition's.

The examples above highlight two of the PIA's problems. First, in making its recommendations, the ERT did not analyze the factors underlying the cost of either product to determine if the costs were accurate or if there were ways to control them. With the binders, price reductions should be driven by reduced manufacturing costs or should result from increased efficiency (e.g., decreased raw material use or increased automation). The ERT's recommendations for price reductions were based solely on price comparisons rather than reductions in the costs of producing the products. To respond properly to our recommendation, the PIA should be using cost controls and operating its factories more efficiently to reduce costs, not making arbitrary pricing decisions based on competitors' prices.

Second, with the mesh signs, the ERT concluded that raising the price would make the mesh sign product line profitable and still marginally less expensive than that of the PIA's competitor. In the ERT report, no consideration was given to setting a price that would cover the PIA's cost while lowering the cost to its state customers. The pricing recommendation made by the bindery ERT demonstrates that the PIA is still focused on making a profit. The pricing approach recommended by the ERT costs the taxpayers money because state agencies are potentially spending more for some products than necessary (i.e., more than the PIA's cost to make the products). As a result, the PIA

continues to risk operating enterprises that are not self-supporting, or charging state customers excessive prices. Having competitive prices is just one piece of the equation; the PIA also needs to become more efficient. By not using the ERTs to explore ways to become more efficient and reduce its costs, the PIA is missing an opportunity to benefit the State.

The ERTs Used Flawed Cost Data

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Despite knowing the data were inaccurate, the ERTs made recommendations to adjust prices based on this data.


In our 1996 report, we indicated that the PIA does not maintain accurate unit costs for its products and that its cost-accounting system is inadequate, poorly developed and implemented, and produces inaccurate cost information. However, despite knowing the flaws, the ERTs used the cost-accounting information from the PIA's existing system throughout their reviews. As a result, the ERTs made recommendations to adjust prices and continue producing certain products without knowing the real underlying costs of the products. As an example, for three of the bindery's four product lines, the ERT indicated various problems with the bills of material (BOMs) and routings on which prices are based. A BOM specifies the type and quantity of materials needed to produce a product. The BOM is used to develop a product's total raw material costs. A routing specifies the length of time each manufacturing step will take and is used to calculate a product's total labor cost. Specifically, in the bindery ERT report, the team indicated that it could not obtain accurate product costs for placards produced for disabled motorists. The team noted that the BOMs and routings in the PIA's Manufacturing and Accounting Planning System (MAPS) were incorrect or outdated. In addition, after the ERT concluded that the bindery's medical file line was profitable, the team discovered that the medical files actually cost \$11.04 each to produce rather than the \$2.65 cost used in its analysis. The team added an addendum to its report highlighting this discrepancy and stated that the discrepancy would be addressed in an addendum to the original report. In summary, the ERT based its financial and cost-accounting conclusions on data that was known to be inaccurate. Any conclusions or recommendations based upon such data are likewise flawed.

The ERTs Made Several Good Recommendations


The work of the PIA's two ERTs is not without merit. Our review of the ERT reports identified several recommendations from which we believe the PIA could benefit. These

recommendations included revisions to product lines and the identification of new or alternative markets for PIA products.

Our 1996 report recommended that the PIA should review its product lines to determine which should be revised. The dairy ERT was responsive by recommending changes to its product lines to make them more competitive. For example, the dairy ERT reviewed the current product line and recommended that one size of milk be discontinued because of poor sales. Also, the ERT recommended to further study another product size to determine potential customer demand. As a result of these recommendations, the PIA can eliminate slow-moving products, focus marketing and production efforts on more successful products, and reduce its purchases of raw materials for unwanted products.



The ERTs identified new target markets for PIA goods.





The 1996 report also recommended that the PIA review its existing enterprises to determine if any should be expanded; the ERTs appeared to be responsive to this recommendation. For example, the bindery ERT noted that Office Depot is now a supplier to state agencies in lieu of state stores. State stores was the central office-product warehouse run by the Department of General Services. The ERT suggested that an agreement to sell bindery products to Office Depot might benefit the PIA. This arrangement would benefit the PIA because it would help maintain some of its customer base (i.e., state agencies who purchased from state stores). Also, the ERT suggested that Cal Card users be identified and targeted for increased marketing efforts. (Cal Card is a credit card system that allows individual units within a state department to make purchases.) For the medical file and mesh sign/vest product lines, the ERT suggested targeting (for product expansion) a number of new customers such as hospitals, universities, and counties. Finally, the dairy ERT identified several customers that were interested in purchasing a full range of dairy products rather than just milk as the PIA currently sells. The ERT recommended that the PIA determine the demand for this product expansion. By identifying potential new markets, the PIA has the opportunity to increase sales by targeting these customers.

The PIA Has Closed and Consolidated Some Enterprises

The ERTs did not address our recommendation to perform a comprehensive review of all industries to determine which should be scaled back or eliminated. However, the PIA did take other responsive actions. Specifically, between June 1996 and February 1997, the PIA identified several enterprises for closure or consolidation. The PIA targeted two of its fabric

products enterprises—California State Prison (CSP), Corcoran and the California Institution for Men East—for temporary and permanent closure, respectively. Further, the PIA consolidated its printing enterprise at CSP, Los Angeles County with an existing operation at CSP, Sacramento. The PIA estimates it will save personnel costs, inmate wages, and other operating costs as a result of two of these closures. In May 1997, the PIA identified two more enterprises for temporary and permanent closure. The PIA decided to temporarily close the concrete precast enterprise at CSP, Solano, until the CDC builds more prisons. Finally, the Northern California Women’s Facility key data-entry enterprise will be closed because of declining sales. Efforts to restore the key data-entry enterprise’s customer base have failed and the enterprise is unprofitable. The PIA’s past and continued examination and elimination of unprofitable enterprises will help to make it more efficient and competitive in the future.

***The PIA’s Excess Inventory Levels
Have Increased Dramatically
Since Fiscal Year 1994-95***



The PIA has wasted more than \$12.2 million over the past three years carrying excess inventory.


Our 1996 report on the PIA was very critical of its inventory management. Specifically, we found that for its 12 largest industries, the PIA was carrying approximately \$16 million in excess inventory. We recommended that the PIA take steps to dispose of the inventory and modify the policies that led to the buildup. However, our current audit has shown that for the same 12 industries the PIA’s excess inventory has continued to increase. We estimate that for fiscal year 1996-97, the PIA is carrying \$31.9 million in excess inventory. Further, between fiscal years 1994-95 and 1996-97, we estimate that the PIA has wasted over \$12.2 million carrying inventory it does not need to meet demand. Finally, we believe that the PIA’s Prompt Delivery Program (PDP) has contributed to its inventory problems.


Excess inventory is the difference between inventory on hand versus what is required to meet customer demand. We estimated the PIA’s excess inventory by comparing its levels to average inventory levels of comparable industries in the private sector. Excess inventory carrying cost is composed of the costs of depreciation, obsolescence, storage, and interest. For example, as inventory sits idle it becomes less valuable because of depreciation and the risk of the product becoming obsolete and unsellable. Additionally, the entity incurs a cost to warehouse the extra goods. Finally, the entity must consider the dollars invested in stagnant inventory that cannot be used

for other purposes, measured by lost interest earnings. These four factors are added together to calculate the money an entity wastes carrying excess inventory.

The PIA's Excess Inventory Continues To Grow



The PIA's excess inventory has doubled since fiscal year 1994-95 to an estimated \$31.9 million.



The PIA's excess inventory levels have doubled over the last three fiscal years as shown in Figure 1. Specifically, for fiscal year 1994-95, the PIA had excess inventory of \$15.9 million, resulting in excess carrying costs of \$2.7 million. Consistent with our April 1996 report, excess carrying costs are calculated as 17 percent of excess inventory. The 17 percent is comprised as follows: 3 percent for depreciation, 3 percent for obsolescence, 5 percent for storage, and 6 percent for interest. For fiscal year 1995-96, the PIA's excess inventory levels had grown to \$24.2 million, resulting in excess carrying costs of \$4.1 million.

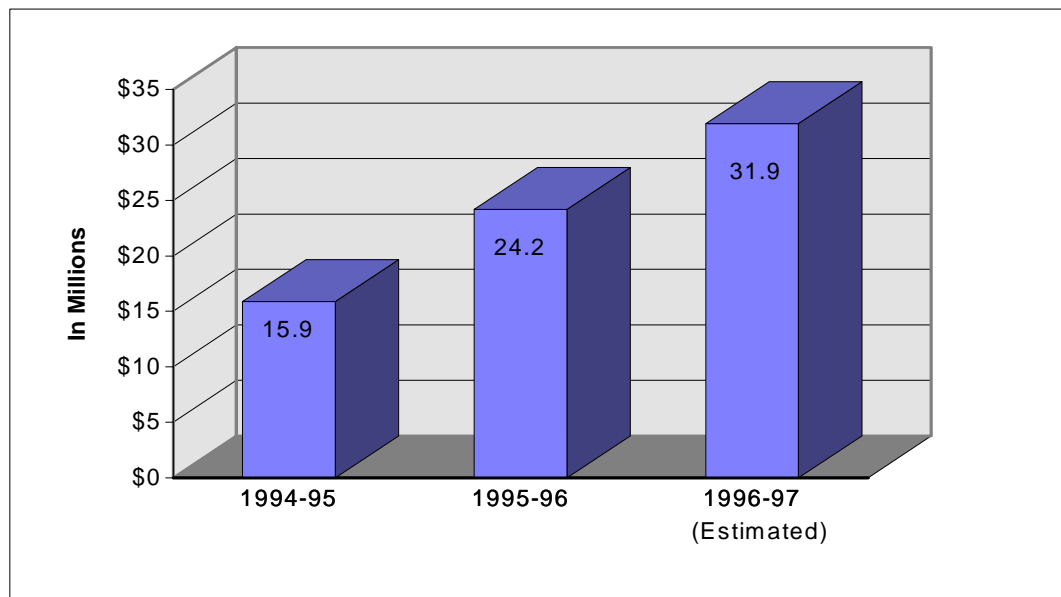
We estimate that the PIA's excess inventory levels have increased once again during fiscal year 1996-97. Based upon the PIA's unaudited inventory data, we estimate that the PIA's excess inventory level could grow to as much as \$31.9 million, resulting in estimated excess carrying costs of \$5.1 million. As a part of the PIA's annual financial audit, a physical inventory is taken and the financial records are adjusted accordingly. Therefore, the true inventory numbers will not be known until the PIA's financial statements are issued later this year.

Prompt Delivery Program Contributes to Inventory Excess

The PIA has taken a one-dimensional approach in implementing its PDP, which has contributed to its increase in excess inventory. Implemented in July 1995, the PDP was introduced to improve delivery times and to build better customer relations by using a "make-to-stock" process, i.e., goods are produced and warehoused in anticipation of demand. Historically, the PIA used a "make-to-order" process, making products once an order was placed. Our 1996 report recognized the PIA's struggle to provide prompt delivery, noting that this was the major complaint of PIA customers. We reported that the PIA took approximately 150 days to deliver products from the time they were ordered. The audit also highlighted the problems the PIA had controlling its inventory levels and cautioned that

Figure 1

Excess PIA Inventory Levels



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The PIA has taken a one-dimensional approach to solving its delivery problems.
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the PIA's new program would exacerbate the inventory problem. Specifically, our 1996 report stated that "excessive inventory has been an ongoing and acute problem with the PIA for at least six years." Despite the PIA's delivery problems, we warned that make-to-stock is an expensive solution to the delivery problems and that the program may drive inventory levels higher.

The PDP has had mixed results, leading to improved customer delivery and satisfaction, but has contributed to higher inventory levels. The PDP, in operation for approximately two years, has increased customer satisfaction. According to the PIA's fiscal year 1995-96 report to the Legislature, delivery of products in the PDP is made within 8 days of the PIA receiving an order. The PIA attempts product delivery within 20 days to customers elsewhere in the State. Delivery is made from a central product warehouse in the Sacramento area. Before prompt delivery was instituted, customer satisfaction was very low because of delivery delays. The BSA, as part of its previous audit, distributed questionnaires to 120 PIA customers. Of the 74 respondents, 56 percent were dissatisfied or extremely dissatisfied with delivery times. However, in its most recent annual report to the governor, the PIA cited customer survey results reflecting marked improvement in customer satisfaction and attributed the improvement to its new program: "Overall, customer satisfaction improved greatly in this fiscal year . . .


The most notable improvement was in delivery times, with 70 percent reporting improvement as opposed to only 40 percent in 1995. This is due primarily to the Prompt Delivery Program . . .”

The PIA also tracks delivery times for the program, and we reviewed a sample of program deliveries made during fiscal year 1996-97. Based on a report prepared by the PIA listing 54 deliveries within Sacramento, the PIA had an on-time delivery record of 78 percent (i.e., 8 days or less). For a similar report of deliveries elsewhere in the State, the PIA had an 89 percent on-time delivery record (i.e., 20 days or less). Therefore, based solely on timely delivery and resulting customer satisfaction, the PDP has been a success for the PIA. However, the PIA’s improved delivery times and customer relations have come partially at the expense of creating high inventory levels.


The PDP was rolled out in three phases beginning in July 1995, offering 120 of the PIA’s top-selling furniture items; by June 1996, the program offered 618 discrete products. In the 1996 report, we commented, “To our knowledge, the PIA has not determined how a ‘make-to-stock’ strategy will affect inventory levels, nor what improvements must be made in forecasting sales, planning production, and managing risks of making products in advance of orders.”


Approximately 20 percent of the wood and 40 percent of the metal product lines in the PDP have not sold a single piece over a recent 18-month period.


We found, however, that the PIA’s approach to the PDP focuses only on delivery without making the necessary determinations regarding specific product demands, inventory turnover, and lead times. According to a recently completed internal review of the program, the PIA found that “based on the history of sales for the past 18 months . . . approximately 20 percent of the designated PDP wood products and 40 percent of PDP metal products have experienced zero sales out of the program.” The internal report highlighted additional problems with the PDP’s operations. Specifically, the PIA prepared a sales forecast for the PDP but only updated the forecast at “irregular and infrequent intervals.” We believe zero sales in stocked items, inaccurate sales forecasts, and lack of production planning demonstrate the PIA’s inability to manage the risks of a make-to-stock strategy. Moreover, the PIA’s own internal review confirms that many of the PDP characteristics the BSA anticipated the PIA would have difficulty managing have come to fruition. Despite these problems, as the PIA reviews its enterprises via Enterprise Review Teams, a recurring recommendation is to use a make-to-stock strategy for more of the PIA’s products.



Despite increasing inventories, the PIA considers its Prompt Delivery Program a success.



Despite the recognized dramatic increase in excess inventory and the large number of dormant stock items on warehouse shelves, the PIA considers its current PDP a success and may make more products available through a make-to-stock process. However, the PIA has not assessed the underlying reasons for needing to use the PDP, namely its inability to produce and deliver products on a timely basis. For example, mesh products are sold mainly to two customers and are currently operating at a loss. Nevertheless, one ERT recommendation for this product line was to “establish and maintain a make-to-stock inventory in order to provide on-time delivery.” The ERT did not explain the delivery delays but recommended as the solution prompt delivery via a make-to-stock process. Moreover, the impact of increasing inventory levels and carrying costs does not appear to be considered.


The PIA Has Made Little Progress to Date Implementing the Cost-Accounting Recommendations

As part of the 1996 report, we recommended that the PIA make numerous changes and improvements to its cost-accounting system. The recommended changes and improvements highlight the lack of understanding and existence of a viable cost-accounting process within the PIA. The recommendations included:

- Performing an initial review and conducting updates of BOMs and routings and continuing to adjust and update them semiannually;
- Performing variance analysis monthly;
- Developing an activity-based methodology to allocate production overhead;
- Hiring a cost-accounting manager; and
- Improving the use of its Manufacturing and Accounting Planning System (MAPS).



To date, however, the PIA has addressed these recommendations only in a limited fashion. For example, the PIA has contracted for a cost-accounting needs assessment and decided to upgrade its existing automated system. Nonetheless,

the PIA has not seriously addressed the cost-accounting issues it could implement with little or no outside assistance.


The cost-accounting needs assessment simply reiterated information we provided the PIA in our 1996 report.

In response to our 1996 report, the PIA hired KPMG Peat Marwick (KPMG), a national accounting firm, to perform a cost-accounting needs assessment. According to the resulting report prepared by KPMG, the reason for the assessment was to “analyze the current cost-management information needs and what activities must be undertaken to meet those needs.” In March 1997, KPMG completed its study and provided the PIA with a written assessment of the PIA’s cost-accounting needs. This report is the first in a series of three phases of reports KPMG proposed to do for the PIA. The overall need identified by KPMG was “effective cost and performance management.” The assessment broke this information down further into 10 components; these components, in many cases, mirrored those previously identified by the BSA. For example, the report stresses the need to make sure BOMs and routings are accurate and that the PIA performs variance analysis. Variance analysis is a study of the difference between the estimated cost of producing a product (BOMs and routings) and the actual cost. KPMG’s assessment also emphasized the PIA’s need to develop an activity-based methodology for allocating production overhead costs. Activity-based costing is an approach to allocating costs based on the activity that drives the cost. For example, if a product consumes 80 percent of a warehouse, 80 percent of the warehouse rent would be allocated to that product. Finally, KPMG noted that the PIA needed to hire a small team of well-trained cost-accounting staff to support the cost-accounting system.

Although it would appear that the needs assessment performed by KPMG was a progressive step, in many instances it simply reiterated information the PIA already had. Moreover, the assessment proposed two additional phases of work to design and implement the recommended improvements. The PIA has just begun bidding to secure a contractor to perform the additional work. As a result, we estimate that the project will not start until late 1997. The PIA therefore will not derive the benefits for months, maybe years to come.


In 1996, we identified a number of core cost-accounting practices critical to managing its operations; to date, the PIA has taken little or no action on these key issues.


Additionally, our 1996 report addressed a number of core cost-accounting practices that the PIA could address independent of the needs assessment or systems upgrade. Specifically, as noted earlier, our 1996 report found that the PIA's BOMs and routings were significantly inaccurate. Further, we found that these standards were not updated on a regular basis, and that the PIA did not analyze the variances between BOMs and routings and actual costs. Moreover, we concluded that the PIA had extremely high overhead and recommended that it should look for ways to reduce it. Finally, we determined that the PIA's system for allocating production overhead is based on outdated and estimated information. These issues are critical to managing its operations; however, to date, the PIA has taken little or no action on these key recommendations.

As for updating BOMs and routings and establishing a policy to do so regularly, the PIA determined that it needed to educate its staff as to the necessity of this practice. The PIA has established a timeline, beginning in August 1997, to start training its staff in developing accurate BOMs and routings. However, the PIA could not provide us with any information regarding its plans for variance analysis, including variance thresholds (i.e., the dollar or percentage variance requiring an explanation), how often the variances will be calculated, and to whom the explanation for the variance will be made. It is clear that the PIA has just begun considering this recommendation and has not formulated a complete approach to its implementation.


The PIA indicated that BOMs and routings currently are adjusted each January 1. Our recommendation was to make adjustments to these standards semiannually. The PIA informed us that it has selected two dates, March 31 and September 30, as targets for adjusting its BOMs each year. However, the PIA has not made the same determination for its routings. The PIA believes it must first improve its labor reporting capabilities. We stressed in our 1996 report the need for the PIA to update its routings. Unless the PIA makes this commitment, its ability to understand and control its labor costs is limited.

We also recommended that the PIA hire a cost-accounting manager and at least two staff with significant training in cost accounting. To date, the PIA has not done so. In its latest response to us, dated April 8, 1997, the PIA referred to the KPMG needs assessment. Despite KPMG's duplication of our recommendation, identifying a need for "well-trained cost accounting resources . . . a team of 2-4 personnel," the PIA has taken little action. As stated in our 1996 audit, we strongly believe the PIA lacks the necessary in-house expertise to

support a cost-accounting system or to reasonably address the recommendations related to cost accounting. It is therefore imperative that the PIA seek the cost-accounting support it needs in order to effect real change.


Finally, as for reducing administrative overhead and developing an activity-based method to allocate production overhead costs, the PIA has not yet addressed these areas in earnest. Overhead costs are traditionally costs incurred by an entity that relate to all activities it performs. For example, heating, electricity, and janitorial expenses benefit the whole organization and cannot be assigned in whole or in part to one segment of the organization. The PIA has reviewed its central administrative overhead costs and made some adjustments. These adjustments moved certain costs from one category to another and made some costs direct charges by removing them from the overhead pool. However, the information provided by the PIA did not demonstrate that lowering those overhead costs was part of the review. Therefore, though the actions taken by the PIA result in more accurate financial and budget information, they do not directly result in the reduction of costs as recommended. Similarly, the PIA has not developed a method to allocate production overhead based on the activity that drives the cost. The PIA indicated that this is an area it plans to have an outside contractor address.

***The PIA and the CDC Are Overlooking
Their Mission as a Penal Program
To Focus on the New Business Environment***



*The PIA and the CDC
have failed to implement
our recommendations to
develop the benefits
inmates derive from the
PIA's program.*

The PIA is governed by Sections 2800 et. al., of the California Penal Code, which identifies three purposes of the PIA: to employ inmates, to improve inmate work habits and occupational skills, and to be self-supporting and help reduce the cost of operations at the CDC. In our 1996 report, we cited several problems the PIA faced. These problems include a lack of measurement or reporting of the benefits inmates derive from the work program and that the PIA was employing fewer inmates in its enterprises. As a result, we made numerous recommendations to the PIA and the CDC to develop the benefits inmates derive from the PIA program. However, to date, both agencies have not taken action on this portion of our recommendations.

We asked the PIA and the CDC to respond at 60-day, 6-month, and 1-year intervals regarding their progress in implementing our recommendations. The PIA and the CDC, while responding promptly at each interval, failed each time to address the recommendations we made to develop the benefits inmates derive from the PIA program. Therefore, in order to clarify their intent, we sent letters at the start of the current audit to both the PIA and the CDC asking them to respond specifically to the recommendations. The PIA's response explained why it had not addressed these recommendations in its previous three letters. In a letter dated May 12, 1997, the PIA specifically stated that it is anticipating the elimination of the mandatory state-use law. As noted earlier, state agencies are currently required to purchase the PIA's goods and services. However, this mandate is under legislative review. According to the PIA, this will mean a "radical shift" from the PIA being a government penal program to it competing with private enterprise. Therefore, as stated in its letter, ". . . PIA's focus at this time cannot be programmatic but rather the business imperatives of the organization." We do not disagree that the PIA's environment may be changing in the future from a protected market to a competitive one. However, we believe that the PIA's current focus overlooks a significant part of its mission, the inmates. We further believe that the PIA is overlooking a prime opportunity to use ERTs to substantiate the benefits inmates derive from its program.



We believe the PIA's current focus on its "business imperatives" overlooks a significant part of its mission, the inmates.



The PIA has initiated a tremendous undertaking in reviewing the operations of many of its enterprises via Enterprise Review Teams. However, the ERTs did not perform a detailed analysis of the benefits inmates receive from the enterprises reviewed. For example, the bindery ERT noted that the skills the inmates learn could assist them in finding employment outside of prison. However, the ERT did not provide any solid evidence that inmates in fact secure employment upon release as a result of learning these skills.


The analyses performed by the ERTs, while positive, were not detailed or conducted for each of the different products produced by these enterprises. Furthermore, the ERTs did not determine the number of hours the inmates were employed at each enterprise, or the impact expanding or downsizing an enterprise would have on the number of inmates employed. As a result, the PIA missed an opportunity to monitor and disclose the benefits of its operations and show its potential success in meeting two of its statutory purposes—to employ inmates and improve inmate work habits and occupational skills.

Finally, the CDC's letter response to our inquiry regarding the recommendation to develop the benefits inmates receive from the PIA work program was unresponsive. In a memorandum to the BSA dated June 16, 1997, the CDC responded that "the Department of Corrections and PIA will work to improve the coordination of formal training and work opportunities (for inmates)." The response clearly indicates that the CDC is planning these activities for the future but does not specify how or when this coordination will occur. The CDC no doubt derives benefits from the activities the inmates are involved in through the PIA. However, if neither agency can substantiate these benefits the PIA's chances for retaining its protected market are greatly diminished.


Corrective Actions Taken by the PIA

There were several recommendations made in the 1996 report to which the PIA was responsive. These recommendations include the PIA conducting a customer survey, incorporating performance measures in its strategic plan, and modifying its annual report to the Legislature.

We recommended in our 1996 report that the PIA survey customers annually to determine their satisfaction with the PIA's cost, quality, and delivery times of products. The PIA conducted a customer survey in December 1996, using the same survey questions we used for our 1996 report. The PIA summarized the results and distributed them to management. The PIA intends to combine these results with other information it has gathered to form a plan of action, which is expected to summarize problems highlighted by the survey and create procedures and prioritize issues needing to be resolved. It appears the PIA has begun implementing this recommendation and should continue to use a survey as a tool to identify areas for improvement.



The PIA is conducting customer surveys and plans to prioritize issues needing resolution.



The PIA is also currently completing a new strategic plan in response to our recommendation to develop a revised mission statement and formulate new five-year goals and objectives with measurable criteria. The PIA took an "organization-wide" approach to developing the new strategic plan, seeking input from all staff levels. This input was summarized and incorporated in the new document. The PIA is developing goals and objectives to include measurable criteria that parallel the strategic plan. Currently, according to the PIA, its strategic plan is under review by the Prison Industry Board.

Finally, the PIA has added some clarifying information to its annual report to the Legislature. Our 1996 report noted that although the PIA report met minimum statutory requirements, we recommended incorporating more information to assist the Legislature in assessing the PIA's effectiveness as a penal program and the degree to which the PIA is meeting its statutory purposes. Specifically, we recommended adding 11 points to its report, including: mission and purpose, strategies and measurable objectives, various inmate employment statistics, costs of operations, customer survey results, and the development of new enterprises. Although not making every modification recommended, the PIA did add a number of items to the latest report. For example, it included information regarding its mission and purpose, the number of inmates employed, and the results of the customer satisfaction survey. This information will assist the Legislature in understanding all the benefits the PIA's program brings to the CDC.

Recommendation

We believe the recommendations made in our April 1996 audit report are critical to the PIA's successful operations as a business and as a penal program. As such, the PIA should re-examine all the recommendations and its current course of action and ensure its efforts bring prompt and effective change to its operations.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in this report. The information in this report was shared with the department, and we considered its comments.

Respectfully submitted,



KURT R. SJOBERG
State Auditor

Date: August 20, 1997

Staff: Fred S. C. Forrer, CPA
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Appendix

Summary of Major Past Recommendations, Findings, and Related Actions

As part of our 1996 report, the Bureau of State Audits (BSA) made numerous recommendations to the Prison Industry Authority (PIA) and the California Department of Corrections (CDC) for improvement. In the following paragraphs, we describe 28 of the major recommendations we made, the findings which led to the recommendations, and any corrective action taken by the PIA or the CDC. In summary, we found that of the 28 major recommendations, the CDC and the PIA have not taken any corrective action on 9 recommendations, including 4 with which the PIA and CDC disagreed. The PIA and CDC have partially implemented 17 recommendations, and have fully implemented only 2 recommendations.

Finding #1: The PIA has contradicting statutes governing it that contribute to its lack of direction. The Penal Code states that the purposes of the PIA are to (1) employ prisoners, (2) develop prisoners' work skills, and (3) be self-supporting.

Recommendation: The Legislature should amend state law to clarify the PIA's mission. At a minimum, where current law has conflicting purposes, the Legislature should clarify its intent by setting priorities for specific purposes.

Legislative Action: None.

Senate Bill 617 (Polanco) from the 1995-96 legislative session was intended to provide various reforms for the PIA. However, it was not successful in the Legislature.

The California Acquisition Reform Act, Senate Bill 937 (Polanco), is currently pending before the Legislature. This bill would, among other things, eliminate the requirement that state agencies purchase the goods produced by the PIA by January 1, 2000. Although this legislation does not directly address our recommendation to clarify the PIA's mission, such a change will likely have a profound impact on the PIA's operating environment.

Finding #2: The Prison Industry Board (board) does not effectively monitor the PIA's operations. Specifically, we concluded that the board is not independent, in part because the director of the CDC acts as the chair and has sole authority to fire the PIA general manager. Further, the board provides insufficient input to PIA policy and does not effectively monitor the PIA's operations. Most importantly, the board performs a weak budgetary review of the PIA.

Recommendation: The Legislature should either make the PIA a division of the CDC or reform the board. Among the potential changes, the Legislature should consider:

- Allowing the majority of the board to elect a chair rather than the director of the CDC automatically serving as chair;
- Allowing the majority of board members to hire and fire the general manager;
- Allowing the general manager to hire and fire his staff without interference from the board or the director of the CDC; and
- Increasing the expertise on the board in business, manufacturing, finance, accounting, and penal programs.

Legislative Action: None.

Senate Bill 617 (Polanco) from the 1995-96 legislative session was intended to provide various reforms for the PIA. However, it was not successful in the Legislature.

Finding #3: Neither the PIA nor the CDC measure or report on the benefits inmates derive from the Prison Industry Program.

Recommendation: Both the CDC and the PIA should develop the benefits inmates derive from the PIA program. Specifically, both entities should:

- Consider consolidating unprofitable, but worthwhile, PIA industries with other CDC vocational, educational, and prison support work programs;
- Undertake a systematic investigation of PIA inmate participation in terms of correctional outcomes (e.g., are PIA employed inmates less violent inside the prison);

- Periodically examine the relationship between prison industry participation and post-release employment; and
- Develop and report on program outcome and process statistics.

Department Action: None.

The PIA responded that it is focusing on the business aspects of the organization because of the impending elimination of the mandatory state-use law.

The CDC has taken no action on this recommendation but stated in its response that it will work with the PIA to improve the coordination of formal training and work opportunities. However, the CDC believes there is currently no clear mandate to measure the PIA's role in terms of correctional outcomes, and to take action on these recommendations requires legislative clarification of the statutes governing the PIA.

Finding #4: The PIA's customers pay high prices to subsidize the inmate work program. The PIA supports its industries and factories that are not self-supporting with those that are. As a result:

- State agencies unknowingly subsidize the inefficiencies of many PIA factories;
- The true cost of the inmate employment program is hidden in the expenditures of other state agencies;
- Policy-makers are unable to review and debate the costs and benefits of this taxpayer-subsidized inmate work program; and
- Taxpayers lose the benefits of efficient PIA operations by paying more than the true costs for PIA products.

Recommendation: The PIA should:

- Implement new guiding principles for its organization, including the following:

⇒ Develop a revised PIA mission statement;

- ⇒ Formulate new five-year goals and objectives with measurable criteria;
 - ⇒ Prepare an inmate employment and training plan;
 - ⇒ Implement revised pricing policies; and
 - ⇒ Perform product financial analyses and plans for self-supporting industries.
- Perform a comprehensive review of all PIA industries and products to determine which should be scaled back or eliminated; and
 - Identify optimal production levels for each factory and focus efforts to increase sales of the products made by these factories.

Department Action:

Revised mission, goals, and objectives with measurable criteria: **Partially implemented.** The PIA is developing a new strategic plan that includes a revised mission statement, goals and objectives, and measurable criteria. According to the PIA, its strategic plan is under review by the Prison Industry Board.

Inmate employment and training plan: **No action taken.** The PIA has not prepared an inmate employment and training plan; currently, the PIA is focused on the business needs of the program, not the benefits inmates derive from it.

Revised pricing policies, product financial analysis, comprehensive review of all industries, and optimal production levels: **Partially implemented.** The PIA's one-year response indicated that the Enterprise Review Teams (ERT) were performing comprehensive reviews of enterprises and would develop ideas to implement the recommendations noted above. Based on the detailed analyses developed in this report, we determined that the ERT did not adequately address these areas and, therefore, will not assist the PIA in implementing these changes. However, the PIA has closed and consolidated several enterprises as discussed in our analysis.

Finding #5: More than one-half of the PIA's products would not be competitive in standard state procurements because the PIA's prices are higher than those of other suppliers. We estimated that the higher prices cost state agencies an extra \$12 million during fiscal year 1994-95.

Recommendation: The PIA should formalize a process to systematically identify and track prices competitors charged for similar products that produce 80 percent of the PIA's annual sales.

Department Action: Partially implemented.

The PIA has developed a database to track the prices of similar products made by competitors. This database is updated continually, and the PIA has established a unit within its organization to focus on this issue. However, at the time of this report, the PIA had only developed comparable pricing data for its wood products.

Finding #6: The PIA's cost-accounting process is inadequate and does not encompass common industry practices. Specifically, its process is poorly developed and does not have a methodology that assigns responsibility to an individual to maintain accurate bills of material (BOM) and routings, review allocation procedures, and conduct variance analysis. Also, the PIA does not maintain accurate costs for its products, making it difficult for the PIA to manage its business; identify or manage product profitability; identify products that are losing money; establish fair and adequate prices; or develop plans to expand, reduce, or discontinue products. Inaccurate product costs also distort inventory and cost reporting at the factory level, making it difficult or impossible to manage factory profitability.

Recommendation: To improve its cost-accounting process, the PIA should:

- Assign responsibility and accountability for profitability of each industry to a single individual;
- Reduce its administrative overhead costs;
- Review and update the BOMs and routings used for each product, focusing on routings;
- Develop a method to allocate production overhead costs, based on the activity driving the cost;

- Evaluate and resolve each month any significant variance between each product's standards (BOMs and routings) and the actual cost;
- Adjust and update BOMs and routings every six months;
- Reduce from six weeks to three weeks the time required to prepare and deliver month-end financial management reports;
- Improve the use of the Manufacturing and Accounting Planning System (MAPS); and
- Hire an experienced cost-accounting manager and at least two staff with significant training and experience in cost-accounting methodologies and systems.

Department Action:

Assign responsibility of each industry to a single individual:

No action taken. The PIA has not indicated whether it agrees with this finding and recommendation. The PIA did state, however, that this recommendation would require a significant reorganization from the current operating structure and, with the pending privatization of the industry, it is premature to act on it.

Reduce administrative overhead: **Partially implemented.** The PIA stated in its one-year response that the ERTs and other actions taken would address this recommendation. As discussed in the analysis section, the ERTs did not focus on reducing overhead costs and did not propose any actions to implement this recommendation. However, as discussed in our analysis, the PIA has closed and consolidated several enterprises.

Review and update BOMs and routings: **Partially implemented.** The PIA responded that this recommendation, in order to be implemented properly, would require educating its employees as to the importance of accurate BOMs and routings. The PIA has assigned a two-person team the task of identifying the training needs and conducting the training. The team is currently assessing the organization's needs and in August 1997 is scheduled to begin training.

Activity-based overhead allocation: **Partially implemented.** The PIA hired a large accounting firm to perform a cost-accounting needs assessment; the assessment identified activity-based overhead allocation as one of the PIA's needs. The PIA has decided to pursue the recommendations made in the needs assessment; however, the PIA has not taken any action independent of the needs assessment to develop a method of allocating production overhead based on the activity driving it.

Perform variance analysis: **No action taken.** The PIA plans, as a part of its BOMs and routings training noted previously, to train its staff in variance analysis. However, the PIA is not currently performing variance analysis on a regular basis nor has it established guidelines for performing the analysis, such as variance thresholds, reporting timelines, and variance resolution.

Update BOMs and routings semiannually: **Partially implemented.** The PIA agrees with this recommendation and has identified two dates by which to complete the recommended updates: March 31 and September 30 of each fiscal year. However, the PIA only intends to update its BOMs at these times. It is not yet committed to updating its routings.

Reduce the time required to prepare and deliver month-end reports: **Partially implemented.** The PIA agrees with this recommendation and is taking steps to recognize and resolve the bottlenecks in its month-end report preparation.

Improve the use of MAPS: **Partially implemented.** The PIA has developed several reports to capture and summarize information as recommended. These include customer order processing times, product delivery timelines (products in the Prompt Delivery Program only), and customer complaints. However, the PIA has yet to capture and report timelines for ordering and receiving raw materials, making interindustry transfers, producing and assembling products, and reporting raw material values as recommended.

Hire a cost-accounting manager: **Partially implemented.** The PIA recognizes the need for this type of expertise within its organization and has indicated that it has been actively seeking cost-accounting support from Sacramento accounting firms. However, the PIA has had limited success and has not hired a cost-accounting manager to date.

Finding #7: The PIA's annual report to the Legislature meets the minimum statutory requirements but does not provide any information to determine if the PIA is meeting two of its statutory purposes: to improve inmate work habits and occupational skills, and reduce the costs of the CDC's operations.

Recommendation: The PIA should add clarifying information to its annual report to the Legislature so it can assess the extent to which the PIA is meeting its statutory purposes.

Department Action: Partially implemented.

The PIA has incorporated into its legislative report much of the information we recommended. However, the PIA did not add to the report some recommended information such as:

- The number of PIA inmates receiving training certificates;
- Post-release employment statistics; and
- All costs of operating the PIA program (i.e., the subsidies that the PIA receives on rent and capital contributions).

Finding #8: The PIA's inventory levels are excessive. The PIA maintains inventory levels that are, for some industries, several times higher than comparable levels maintained by the private sector. As a result, the PIA incurred unnecessary carrying costs estimated at approximately \$12.2 million for fiscal years 1994-95 through 1996-97.

In addition to excessive inventory levels, customers are not always satisfied with the PIA's performance, particularly product delivery times. Based on our review of a random sample of sales ordered, it took the PIA an average of 150 days to deliver products to customers.

Recommendation: In order to control inventories and ensure timely delivery of customer orders, the PIA should:

- Improve its short-term forecasts of customer needs;
- Update customer unit sales forecasts at least quarterly, creating a moving and more current forecast of demand;

- Survey, at least annually, any customer that purchases more than \$100,000 of goods or services from the PIA during the year and determine the customer's satisfaction with the PIA's cost, quality, and product delivery times;
- Reduce average delivery times from 150 days to 90 days within one year, and to 60 days within two years;
- Order raw materials more frequently in smaller amounts to improve inventory management; and
- Increase the number of raw materials purchased under statewide contract.

Department Action:

Forecasting: **Partially implemented.** The PIA has formed a team that is currently working to develop a forecasting methodology to help the PIA predict product demand. The team is investigating the forecasting capabilities of the PIA's automated MAPS. However, the PIA does not expect the forecasting methodology to be complete until fall 1997.

Customer survey: **Implemented.** The PIA conducted a survey of its customers who purchased over \$100,000 of goods and services; it used the results to create a plan of action to address the problems noted. Additionally, the PIA has assigned responsibility to a staff person for administering future annual customer satisfaction surveys.

Delivery times: **Partially implemented.** The PIA implemented a Prompt Delivery Program (PDP) in which selected products are produced and stocked in a warehouse until purchased. The PDP attempts 8-day delivery within Sacramento and 20-day delivery outside of Sacramento. PDP delivery is monitored by the PIA using an automated tracking report. Based on this report prepared by the PIA, it has an on-time delivery record of 78 percent (8-day) and 89 percent (20-day). However, as discussed in the analysis section of this report, the PDP has contributed to the PIA's excess inventory levels and carrying costs of \$12.2 million. Unfortunately, the PIA does not have the same tracking capabilities for its non-PDP items and, therefore, does not know if delivery times have been improved for these items. Furthermore, we could find no evidence that delivery times for products not included in the PDP program have improved.

Order raw materials more frequently in smaller amounts: **No action taken.** The PIA responded that no action has been taken on this recommendation because of "limited resources."

Increase the number of raw materials purchased under statewide contract: **Partially implemented.** To our knowledge to date, the PIA has not secured any additional statewide material contracts in response to this recommendation. However, the PIA, effective July 1, 1997, created an analyst position with the purpose of developing more statewide material contracts.

Finding #9: The PIA is receiving significant rent subsidies. The PIA pays the CDC only between 1 cent and 3 cents per square foot for facility and warehouse space. However, the cost of that space is significantly greater. As part of our 1996 audit we estimated that the PIA received a rent subsidy that ranged from \$2.2 million to \$7.4 million in fiscal year 1994-95.

Recommendation: The PIA should pay rent to the CDC that sufficiently recovers the CDC's construction and maintenance costs of the rented facilities.

Department Action: None.

The PIA disagrees with this finding and recommendation. To support its position, the PIA cited the similarity between its rental relationship with the CDC to that of other correctional industries across the country, including the federal UNICOR program.

Finding #10: The PIA does not pay interest on \$109 million of capital contributed by the General Fund. This equates to a subsidy of approximately \$54 million from 1983 through June 30, 1995. This subsidy is more than three times the cumulative net profits earned by the PIA since its inception.

Recommendation: The PIA should recognize in its annual report to the Legislature the interest charges paid by the General Fund for capital it contributed to the PIA.

Department Action: None.

The PIA disagrees with this finding and recommendation. The PIA cites the lack of legislative intent, in that the statute does not specifically instruct for the payment of interest on the General Fund's contribution of capital. Furthermore, the PIA contends that the payment of interest on capital that is contributed is not a commonly accepted practice for correctional industries.

Finding #11: The PIA performs unfunded work for the CDC such as taking standing counts of inmates, making searches of institutions, conducting acting warden duties, and completing CDC time cards. We estimate that this unfunded work cost the PIA \$2.4 million in 1995.

Recommendation: The PIA should request reimbursement from the CDC for work performed by the PIA for the CDC.

Department Action: None.

The PIA disagrees with this finding and recommendation. Because the PIA is technically a part of the CDC, the PIA believes many cross subsidies exist. Therefore, the cost and effort of implementing this recommendation outweigh the benefits.

Finding #12: The PIA has unused or underused warehouse space. Based on visits we made to six PIA factories, we concluded that as little as 15 percent of the warehouse space provided is used to store inventory; the remaining space is empty. Industry standards are to use 30 percent to 40 percent of warehouse space.

Recommendation: To increase the efficiency of its warehouse use, the PIA should provide each warehouse manager with written policies and procedures regarding inventory levels, standards for the use of space, and effective materials management. In addition, the PIA should develop a formal, systemwide policy for determining and disposing of obsolete, slow-moving, or excess inventory.

Department Action:

Develop warehouse use policies: **Partially implemented.** The PIA, in a memorandum dated July 8, 1997, instructed its enterprises to establish target raw material inventory levels by August 15, 1997, and to measure inventory quarterly using an inventory turnover ratio.

Disposal of excess inventory: **Partially implemented.** The PIA has developed a procedure to identify obsolete, slow-moving, or excess inventory and is currently working on a plan of action to dispose of it.

Finding #13: The PIA should improve its cash management. The PIA does not prepare monthly cash projections and, as a result, missed an opportunity to pay off its long-term debt and incurred an expense of approximately \$755,000 in additional interest.

Recommendation: The PIA should:

- Develop a formal plan to identify the planned uses of cash reserves and consider paying off long-term debt and replacing inefficient and outdated equipment; and
- Change its cash reserve policy from maintaining a two-month operating cash reserve to a one-month reserve.

Department Action:

Planned uses of cash reserves: **Implemented.** The PIA, for fiscal year 1996-97, developed a formal plan to identify the planned uses of cash reserves as recommended.

Two-month cash reserve policy: **None.** The PIA fundamentally disagrees with this recommendation. However, the PIA recently informed us that its current initiatives are depleting its cash and, therefore, the PIA can no longer maintain a two-month reserve.

Finding #14: The California Penal Code, Section 2807(c), requires the Youth and Adult Correction Agency, of which CDC is a part, as well as 11 other state agencies, to report annually on its planned use of PIA products and services, but all of them have failed to do so. These 12 agencies account for over 90 percent of the PIA's sales. For example, the CDC alone accounts for approximately 57 percent of the PIA's annual sales. Further, the CDC has a fairly predictable population and a constant need for PIA products. However, the CDC does not report its planned use or place regularly scheduled orders with the PIA for these goods. By doing so, the PIA could more effectively forecast product demand.

Recommendation: The CDC should improve its operations that affect the PIA. Specifically, the CDC should:

- Develop a statistically valid profile of inmate clothing requirements; and
- Place one order for all PIA products, including clothing, and request quarterly or monthly shipments.

Department Action: Partially implemented.

The CDC agrees with this recommendation and is developing the Corrections Automated Materials Management Systems to help manage material purchases. Also, according to the PIA, the CDC has launched a pilot program that centrally procures undergarments for male and female inmates. The CDC made no mention of its other purchases from the PIA.

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Response to the report provided as text only

August 13, 1997

Kurt Sjoberg, State Auditor
660 'J' Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

RESPONSE TO BUREAU OF STATE AUDITS REPORT

Prison Industry Authority's (PIA) progress on many fronts in little more than one year is significant, and I appreciate the Bureau of State Audits (BSA) acknowledging actions PIA has taken, which included:

- Successfully addressed the number one complaint of its customers - long delivery delays - through the Prompt Delivery Program. Surveys show customer satisfaction has increased 50 percent.
- Performed reviews and closed/consolidated five industries to streamline operations and reduce operating costs.
- Held prices steady since 1993.
- Completed Phase One of the three-phase structured reform of PIA's cost accounting system.
- Developed and implemented, with CDC, a centralized procurement project for inmate clothing.
- Improved utilization of the Manufacturing and Accounting Planning System to provide additional tracking capabilities.

Although progress, as noted above, has been made, we acknowledge that work remains to be done to meet the goals of PIA and the BSA report. Many BSA recommendations address complex areas which require long-term efforts to fully implement. Comprehensive reviews of PIA's industries, design and implementation of a multidimensional cost accounting system and improved accuracy of the thousands of bills of materials and routings are projects that will take more than one year to complete, and the initial planning that occurred during Fiscal Year 1996-97 to support them was necessary.

I question the BSA's use of private industry standards to evaluate PIA's performance. The Penal Code establishes PIA as a State correctional program working inmates behind prison walls, and the differences between PIA and private industry are numerous. Comparison to private industry is not appropriate and distorts both the true performance of PIA and, I believe, establishes inappropriate expectations. Of the many audit reports PIA reviewed of other states' correctional industries programs, which were conducted for the 1996 National State Auditors

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Association Joint Audit of Correctional Industries, only California used private industry benchmarks to measure performance.

The BSA's own findings showed that PIA compares favorably on measures of operational performance to other major correctional industries programs it surveyed, including Florida, the model supported by the Legislative Analyst Office. This is a relevant and appropriate comparative base.

California, with the largest State-run prison industries program in the nation, provides productive employment for roughly 6,600 inmates. The PIA also represents a goal for inmates to reach, which we believe significantly enhances institutional behavior for all inmates.

Again, my thanks for the opportunity to formally respond, and your willingness to include our responses in the report.

Sincerely,

THOMAS M. MADDOCK, Chairman
Prison Industry Board

PRISON INDUSTRY AUTHORITY RESPONSE TO THE BUREAU OF STATE AUDITS

OVERVIEW

Prison Industry Authority (PIA) has made significant progress since the Bureau of State Audits (BSA) issued its April 1996 report. Customer satisfaction with PIA has increased markedly. Studies have been conducted that resulted in closure/consolidation of five industries to streamline operations and reduce operating costs. These improved efficiencies have allowed PIA to hold its prices steady for the fourth consecutive year. In addition, Phase One of a very complex and comprehensive reform of PIA's cost accounting system was completed.

BSA Finding: Contrary to Prison Industry Authority's (PIA) assertions, the Enterprise Review Teams did not address our recommendations.

Response: The enterprise review activity was initiated by PIA prior to the issuance of the BSA report and recommendations. The teams were formed to review enterprises that would be most vulnerable without the mandatory use law. The reviews provided PIA with valuable information with which to make enterprise improvements, including better comparative pricing data, information on the industry's ability to be competitive in a non-mandatory market, production capacities for the enterprise, and product line adjustments.

Specifically, the Dairy Enterprise Review Team also determined how the quality of the milk could be improved as well as how to segregate dairy/farm costs. The Bindery Enterprise Review Team determined that customers could be more expeditiously served by having the bindery accept custom orders directly and extending the operating hours of the warehouse.

As stated in the one year status report to BSA dated April 8, 1997, enterprise review teams are not the only vehicle in PIA for analyzing enterprises and making recommendations. The PIA routinely analyzes enterprises for potential improvements in efficiencies and cost effectiveness. Within the past year, five enterprise closures and consolidations occurred via this method. Improved customer service and timely deliveries were also a result of such analyses.

BSA's Finding: The PIA's excess inventory levels have increased dramatically since fiscal year 1994-95.

Response: The BSA continues to inappropriately benchmark PIA inventory level to the private sector. The environment in which PIA and any correctional industry, for that matter, operates is significantly different from the private sector. In a recent audit of 13 state correctional industries programs, the National State Auditors Association found some inventory management weaknesses, but clearly did not use a private sector benchmark in its audits (California excepted).

The reoccurring complaint about PIA over the past several years has been long delivery times, especially for office furniture. The Prompt Delivery Program (PDP) with a make- to-stock focus, was developed in response. The audit conducted by BSA in 1996 occurred during the start-up of the program and an increase in inventory levels was expected through 1996-97. The PIA believes that the success of the PDP is critical in changing customers' perceptions of PIA's deliveries and, as a result, planned for initially higher inventory levels to assure success of the program from the outset.

The PIA's inventory levels are also driven, in part, by the cumbersome State procurement process that must be followed, and product offerings which are more diverse than any found in the private sector. The BSA acknowledged in its 1996 report on PIA that the State procurement process can take up to nine months to complete. In addition, PIA does not have the same control over its workforce as found in the private sector. Lockdowns in the prison setting occur all too frequently resulting in significant losses in production. Inventories are used to help compensate for these losses.

Notwithstanding the preceding, PIA recognizes there is always room for improvement. A task force reviewed the Prompt Delivery Program, and provided PIA's executive management with recommendations for better developing and managing the inventory requirements of the Prompt Delivery Program. Additionally, PIA is currently implementing plans to dispose of its obsolete and surplus inventories and to monitor raw material levels for its manufacturing enterprises.

BSA's Finding: The PIA has made little progress to date implementing the Cost Accounting recommendations.

Response: The PIA does not concur with BSA's assessment that PIA has made little progress in implementing the cost accounting recommendations. By June 1996, PIA had contacted the same consultant BSA had utilized to perform the cost accounting segment of its audit, specifically, for assistance in implementing the audit recommendations. This consultant recommended a three phase comprehensive approach towards upgrading PIA's cost accounting capabilities. The three phases are 1) formulating a cost accounting improvement work plan with timelines, resource estimates, and specific tasks and their interrelationships, 2) design of priority improvements, and 3) implementation. This approach is intended to achieve structural change in the way PIA accounts for its costs.

The PIA engaged KPMG Peat Marwick to perform Phase One and the comprehensive strategy and work plan they developed is the basis for a Request for Proposal to secure a contractor for Phases 2 and 3 of the project. The KPMG report makes clear that a band-aid approach to the cost management issues will not solve the larger problem. PIA's current underlying accounting foundation is acceptable for financial accounting, but not for cost accounting. The issues to which BSA calls attention in its current report should not be addressed independently. For this reason, PIA is pursuing an integrated approach towards addressing these matters. Development of a plan prior to commencing design and implementation is a prudent course, which PIA chose.

Given the interrelationship and complexity of the cost accounting issues, structural reform of the cost accounting system is a long term effort to which PIA is committed. The task is all the more complicated because the State has no civil service classifications for cost accountants, and such expertise is unavailable within the State system. Moreover, PIA's research, with the assistance of both KPMG and Coopers and Lybrand, indicates that the availability of manufacturing cost accounting expertise in the private sector is limited as well, particularly in California, because both manufacturing and cost accounting support for it are concentrated in the Midwest and East. In addition to Coopers and Lybrand and KPMG, PIA contacted 16 firms for cost accounting support, and found only two who had manufacturing cost accounting background.

BSA's Finding: The PIA and CDC are overlooking their mission as a penal program.

Response: The California Department of Corrections' (CDC) primary mission is to provide safe and secure confinement of felons committed to prison (Penal Code Section 1170(a)(1)). Rehabilitation is not CDC's nor PIA's primary goal. **

Determining a dollar value of a programmatic benefit that is measured by something not happening, namely prison unrest, is difficult at best. However, CDC believes that appropriate measures for inmates employed in prison industries could be developed. The CDC and PIA will conduct an evaluation of the effectiveness of PIA in helping to provide a safe prison environment. It will present empirical information on the rate of involvement in serious misconduct among inmates while they are employed in PIA jobs compared to inmates not in PIA jobs. We anticipate PIA inmates will have a markedly lower rate of prison wrongdoing. The CDC and PIA would welcome specific suggestions from BSA in order to identify other appropriate measurable outcomes.

California State Auditor's Comment

**We do not state in the report that the primary goal of the CDC and the PIA is rehabilitation. We refer to the PIA's statutory purposes (Penal Code Section 2801) to employ inmates, improve inmate work habits and occupational skills, and to help reduce the cost of the CDC operations. The PIA and the CDC are overlooking these purposes by focusing solely on the 'business imperatives' of the PIA's operations.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps