

State of New York
Office of the State Comptroller
Division of Management Audit

**DEPARTMENT OF CORRECTIONAL
SERVICES**

INDUSTRIES PROGRAM

REPORT 96-S-24



H. Carl McCall

Comptroller



State of New York Office of the State Comptroller

Division of Management Audit

Report 96-S-24

Mr. Glenn S. Goord
Commissioner
Department of Correctional Services
The Harriman State Campus
1220 Washington Avenue
Albany, New York 12226-2050

Dear Mr. Goord:

The following is our audit report on the Department of Correctional Services' industries program.

We did this audit according to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution and Section 8, Article 2 of the State Finance Law. We list major contributors to the report in Appendix A.

*Office of the State Comptroller
Division of Management Audit*

July 24, 1997

Executive Summary

Department Of Correctional Services Industries Program

Scope of Audit

The Department of Correctional Services (Department) operates a prison industries program (Corcraft). The mission of Corcraft is to use inmates to produce quality goods and services that are delivered on time, and to operate at no cost to taxpayers. Corcraft produces furniture, apparel, license plates, as well as several other types of products, and provides services such as answering telephones and abating asbestos. According to State law, Corcraft can provide its goods and services to government entities only. During the year ended March 31, 1996, Corcraft's revenues totaled \$54.7 million.

Our audit addressed the following questions about Corcraft's operations:

- Does management ensure that Corcraft operates efficiently and effectively in its efforts to employ inmates in real work situations, provide quality products to customers in a timely manner, and attain self-sufficiency?
- What actions should management take to better fulfill Corcraft's mission in the future?

Audit Observations and Conclusions

We found that Corcraft management has not fully accomplished its mission, and believe management would be more likely to do so if certain internal control weaknesses were corrected. We are particularly concerned about internal control weaknesses related to long-range planning, staff qualifications, and information system development.

We found that Corcraft employs relatively few inmates (only about 3 percent of the total inmate population). We therefore conclude that Corcraft could be more effective in its employment of inmates. We note that approaches taken by other states in their correctional industry programs may be more effective in their employment of inmates, as inmates in these states work for private businesses in less restrictive security environments. We also recommend that Department management work with State policy makers to comprehensively assess the role of Corcraft and establish a long-range strategic plan that will assist Corcraft in fulfilling its mission. (see pp. 5-8)

Corcraft seeks to provide quality goods and services in a timely manner. According to a customer survey completed by Corcraft and customer complaints received by Corcraft, improvements can be made in Corcraft's products and services. For example, customers have often complained about delays in deliveries and the delivery of damaged or defective products. (see p. 6)

Corcraft seeks to operate at no cost to taxpayers. However, during the year ended March 31, 1996, Corcraft's expenses exceeded its revenues by \$4.4 million. Such operating losses are covered by State appropriations. Corcraft has reported operating losses over the past five fiscal years, and Corcraft management does not project operating profits in the near future. We note that Corcraft could report an operating profit if the cost of correction officers assigned to provide security for Corcraft operations were charged to the Department instead of to Corcraft, as is done in at least one other state. We recommend that Department officials work with the State Division of the Budget to evaluate the appropriateness of this practice and its impact on Corcraft's ability to achieve its goal of self-sufficiency. (see pp. 6-8)

We examined Corcraft's internal control system and identified several operating practices that we believe contribute to Corcraft's problems in achieving its mission. For example Corcraft needs to:

- adequately project profit for new products,
- develop a formal pricing strategy,
- formally analyze its marketing strategies,
- compare its sales forecasts to actual sales performance, and
- develop a product policy that defines Corcraft's role in each market.

We also found that minimum qualifications are not required for the sales and marketing staff, and information systems have not been developed for a number of critical areas of Corcraft's operations. We made several recommendations aimed at improving Corcraft's internal controls. (see pp. 13-25)

Response of Department Officials

Department officials did not agree with most of our recommendations because they felt that proper procedures were already in place and require no action. However in some instances, we believe the Department Officials did not address or may have misinterpreted the intent of our recommendations. Their response along with our comments have been incorporated after each recommendation.

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Introduction

Background

The Department of Correctional Services (Department) operates a prison industries program (Corcraft). Corcraft's primary mission is to use inmates to:

- produce quality goods and services that are delivered on time; and
- operate at no cost to taxpayers.

For the year ended March 31, 1996, Corcraft reported revenues of \$54.7 million and expenses of \$59.1 million, for a net loss of \$4.4 million. During that year, Corcraft employed an average of 2,160 inmates at 14 of the Department's 70 facilities statewide. This represents about 10 percent of the inmate population at those 14 facilities, and 3.1 percent of the State's total inmate population (about 69,700). The Department has assigned 485 staff to Corcraft operations, including 366 civilians, 111 correction officers and 8 vocational staff.

Corcraft manufactures products in 11 product lines, including cleaning products, chairs and wood furniture, metal furniture, apparel and license plates. In addition, Corcraft provides services such as answering telephone calls for the Department of Motor Vehicles and providing construction and asbestos abatement work within Department facilities. By law, Corcraft can sell goods to New York State agencies, local governments, public authorities, the Federal government, and other state governments. Corcraft's largest customers are the Department itself (24 percent of sales) and the Department of Motor Vehicles (21 percent of sales). Other State agencies account for 33 percent of Corcraft's sales, New York City accounts for 12 percent of the sales, and other customers account for the remaining 10 percent.

In the past, if a State agency wanted to purchase a product and that product was produced by Corcraft, the agency was required to purchase the product from Corcraft (or obtain Corcraft's approval to purchase the product elsewhere). However, the Procurement and Stewardship Act of June 1995 now allows State agencies to purchase similar items from outside vendors without Corcraft's approval.

New York's correctional industry system began at the Auburn Facility in 1823 and comprised various workshops where inmate labor was contracted to private businesses. This type of correctional industry system was soon adopted by other states because of its economic profitability. However, by the 1840s, concerns mounted about the fairness of allowing some businesses to use low-cost, prison-made products. Concerns were also expressed about inmate treatment and community security. As a result, legislation was enacted to restrict the use of inmate labor and private business involvement with correctional industries.

For example, State legislation in the late 1880s abolished all labor contracts, and an 1896 State Constitutional provision outlawed prison labor for private interests and established the State-use system in which State agencies were required to purchase goods from the prisons. Between the 1890s and the 1920s, many other states adopted similar state-use systems and also prohibited the sale of inmate-made goods on the open market. In addition, Federal legislation restricted interstate commerce of inmate-made goods, and placed a \$10,000 limit per contract for sales of inmate-made goods to the Federal government.

In 1979, Congress relaxed restrictions on inmate labor when it authorized the Private Sector/Prison Industry Enhancement Certification Program, a first step in allowing private industry to employ inmate labor in interstate commerce and in the open market again. Today, many states are expanding correctional industries to produce and sell inmate-made goods and services in conjunction with private businesses.

Audit Scope, Objectives and Methodology

We audited selected aspects of Corcraft's operations for the period April 1, 1992 through October 31, 1996. The primary objectives of this audit were to determine whether Corcraft is operating efficiently and effectively in its efforts to employ inmates in real work situations, provide quality products to its customers in a timely manner, and attain self-sufficiency. In addition, we identified potential directions Corcraft could take to better fulfill its mission in the future.

We accomplished our audit objectives by interviewing responsible Corcraft officials and staff at both the central office and at selected facilities. We also reviewed pertinent State and Federal laws, examined relevant Corcraft records, and observed Corcraft operations at five Department facilities. In addition, we reviewed the workpapers of Corcraft's external auditors, contacted correctional industry officials in other states, interviewed academic experts in the field of correctional industries, and reviewed publications related to manufacturing. This audit was part of a coordi-

nated national audit of state correctional industry programs sponsored by the National State Auditors Association.

We did our audit according to generally accepted government auditing standards. Such standards require that we plan and do our audit to adequately assess those operations we include in our audit scope. Further, these standards require that we understand the Department's internal control structures and its compliance with the laws, rules and regulations that are relevant to the operations included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments, and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those operations that we have identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, we devote little audit effort to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address, in detail, activities that may be functioning properly.

Response of Department Officials

Draft copies of the matters presented in this report were provided to Department officials for their review and comment. Their comments have been considered in preparing this report and are included as Appendix B.

Department officials did not agree with most of our recommendations because they felt that proper procedures were already in place and require no action. However in some instances, we believe the Department Officials did not address or may have misinterpreted the intent of our recommendations. Their response along with our comments have been incorporated after each recommendation.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of the Department of Correctional Services shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

Corcraft's Mission

We found that Corcraft management has not fully accomplished its stated mission. In particular, Corcraft management could effectively employ more inmates and provide quality goods and services in a more timely manner. We also conclude that Corcraft management may not achieve its goal of operating at no cost to taxpayers, in part, because the Department uses Corcraft revenues to supplement its own budget.

We recommend that Department management work with State policy makers to comprehensively assess the role of Corcraft and establish a long-range strategic plan that will assist Corcraft in fulfilling its mission.

Providing Employment to Inmates

We examined Corcraft employment levels and found that they have declined. Between fiscal years 1987-88 and 1995-96, inmate employment decreased by about 18 percent, from 2,632 to 2,160, even though the prison population increased 75 percent, from 39,910 to 69,717. We conclude that Corcraft could effectively employ more inmates. Corcraft officials stated that maximizing inmate employment is neither a program goal nor has it been emphasized by Department management.

We note that approaches taken by other states in their correctional industry programs may be more effective in their employment of inmates. These states are involving the private sector in their prison industries and are allowing inmate-made products to be sold in private markets. In addition, some states are locating industries in less restrictive security environments. If such trends continue in the other states, substantially more inmates may be engaged in productive, real-life work situations, and may therefore obtain valuable job skills leading to possible future employment upon release.

In September 1996, the National Center for Policy Analysis, a non-profit, non-partisan research institute, issued "Factories Behind Bars," a report on current actions to expand prison industries nationwide. The report recommends expanding the role of the private sector in prison work, either as part of the Private Sector/Prison Industry Enhancement Certification Program or through other private partnerships with prison industries. The report projected that taxpayers nationwide could save \$2.4 billion annually if 25 percent of all prison inmates were employed privately, earning \$5 hourly for 40 hours a week, and if 60 percent of

inmate earnings could go toward paying taxes, funding family support and victims' programs, and contributing to the cost of imprisonment.

Based on existing statutes in New York State, legislative changes would be needed before Corcraft could be authorized to initiate prison industry enhancements involving the private sector. We note that Corcraft management is considering proposing such legislation and is also exploring other new directions for Corcraft's future, such as modular cell fabrication and assembly and potential new industries such as imaging technology and geographic mapping using computer technology.

Providing Quality Goods and Services in a Timely Manner

Corcraft management has established a customer complaint committee, a customer satisfaction committee and completed a customer survey in December 1994. Survey results indicated that customers were somewhat satisfied with their sales experience and product, and rated customer service favorably. The most unfavorable ratings were for product delivery, installation and repair.

Customers have been particularly critical of delays in deliveries and the delivery of damaged or defective products. In fact, for the 18 months ended June 30, 1996, damaged or defective products were the subject of at least 60 percent of the complaints received. In light of these complaints and the results of the customer survey, we conclude that Corcraft could be more effective at providing quality goods and services in a timely manner.

We note that Corcraft has reduced its backlog of open customer complaints by more than 80 percent from 322 unresolved complaints in January 1995 to 61 unresolved complaints in August 1996. Corcraft also reduced the average complaint response time from 60 to 34 days, with 43 percent of the complaints resolved within 14 days. In addition, Corcraft's product engineers reported a decrease in the average monthly damaged goods rate during the 1995-96 fiscal year. Damages decreased from an average rate of 253 items a month for the first seven months of the year to 143 items a month during the last five months of the year.

Cost to Taxpayers

During the 1995-96 fiscal year, Corcraft reported revenues of \$54.7 million and expenses of \$59.1 million, for an operating loss of \$4.4 million. Such losses are covered by State appropriations. In addition, Corcraft has reported operating losses for the last five fiscal years. Corcraft management told us they expect a large increase in revenues in the 1996-97 and 1997-98 fiscal years from reissuing motor vehicle license

plates and selling new prefabricated prison cells to the Department. However, the profitability of the prefabricated prison cells is uncertain at this time. We therefore conclude that Corcraft may not achieve its goal of operating at no cost to taxpayers.

We note that between April 1, 1980 and March 31, 1996, Corcraft reported accumulated losses of about \$46.9 million. However, we believe these losses were overstated because, during the five years ended March 31, 1991, Corcraft was charged about \$11 million in personal service costs for vocational education instructors who did not work for Corcraft. The instructors worked in other Department programs and, therefore, their personal service costs should have been charged to these other programs. In effect, Department management has used Corcraft revenue to supplement its own budget.

Moreover, beginning in the 1985-86 fiscal year, the Department began charging Corcraft for the personal service costs of the correction officers whose posts are within the Corcraft areas of the 14 participating facilities. During the 1995-96 fiscal year, Corcraft paid \$6.4 million for the personal service costs of 111 correction officers. From April 1, 1985 through March 31, 1996, Corcraft had paid \$57.1 million in total for correction officers. If the cost of these officers was not charged to Corcraft, Corcraft would report an operating profit, and it is not clear that this cost should be charged to Corcraft. For example, if the 2,100 inmates employed by Corcraft were in general population confinement instead, the Department would most likely need substantially more officers to supervise them based on the Department's overall inmate-to-officer staffing ratio (which is about 3.8 inmates per officer, compared to about 19 inmates per officer in Corcraft). When inmates are working for Corcraft, the Department does not have to incur the additional security costs, and pays nothing for the 111 correction officers assigned to Corcraft.

We note that, according to an April 1995 report by the Virginia Auditor of Public Accounts, Virginia law requires its state department of corrections, and not the correctional industry enterprise, to provide discipline and control over inmates. The Virginia Auditor therefore concludes that the industry program should not pay for ordinary correction officers' duties. New York law is not as clear cut on this issue.

We were told by Corcraft officials that, in 1985, an arrangement was made between Department management and the State Division of the Budget allowing the correction officers to be charged to Corcraft. However, no documentation was provided to us justifying this arrangement. In January 1997, we were told, by an official from the Division of the Budget, that only those supervisory and instructional costs directly

related to Corcraft operations should be paid for by Corcraft, not routine security costs. In light of this and the developments in other states, we believe that the existing practice should be re-visited to clarify the arrangement and help ensure that costs are properly allocated between the Department and Corcraft.

This accounting issue can be less significant when correctional industry programs become involved with private businesses. Other states involved with the private sector in enhancing their prison industry programs have a lease or other contractual arrangements which result in the recovery of certain government costs. For example, under the Federal Private Sector/Prison Industry Enhancement Certification Program, inmates reimburse the government for room and board, pay taxes, and contribute to crime victims' and family support programs. South Carolina has private partner leases in which the private partner is charged a cost per inmate for security, overall supervision and handling inmate payrolls.

Recommendations

1. Work with State policy makers to clarify the role of the correctional industries program.

(Department officials disagreed and stated that their Mission Statement is clear, concise and requires no further clarification.

Department officials have misinterpreted the intent of our recommendation. We recognize that Corcraft's mission statement is clear. However, as detailed on pages 5 through 8 of this report, Department officials and State policy makers need to assess Corcraft's overall future role in light of current developments in other states. Possible program enhancements which should be considered include private sector involvement with Corcraft, selling products in the open market, and restructuring industries programs in less restrictive security environments as new prisons are built. In fact, in January 1997, subsequent to our audit fieldwork, Department officials submitted its proposed legislation to enable New York to participate in the Federal Prison Industries Enhancement Program (PIE). This action is a first step in addressing the need to assess Corcraft's future role.)

Recommendations (continued)

2. Determine the reasons for the decline in the number of inmates participating in the program.

(Department officials stated that they already know the reasons for the decline in the number of inmates participating in the program and that no further study is necessary. Officials responded that the decline is due to an overall increase in the productive hours worked by inmates on the first shift along with the purchase of new equipment.

We believe that the reasons cited by Department officials do not address the core problem or the intent of our recommendation. As reported on page 1, the Procurement and Stewardship Act of 1995 allowed State agencies to purchase items similar to Corcraft's from outside vendors without Corcraft's approval. As a result, Corcraft sales of wood and metal furniture declined drastically during the last two years, requiring less inmates to produce these goods. Unless Corcraft can meet the quality, time, and price demands of its customers in the future, sales and production will continue to decline, causing a further erosion of the number of inmates employed in the program. Therefore, it is vital for Department officials to pursue program enhancements which may result in new products and markets, leading to increased inmate employment and program self-sufficiency.)

Recommendations (continued)

3. Establish a long-range strategic plan which incorporates Corcraft's vision, mission, guiding principles and goals to better enable Corcraft management to accomplish Corcraft's mission. The strategic plan should address the major activities, the laws affecting Corcraft, and the business environment. Each goal should be supported by relevant objectives, strategies, activities and performance measures.

(Department officials stated that they have always developed an annual Business Plan which includes goals for the upcoming year. They further indicate that their long-range strategic plan has been more informal, allowing the flexibility Corcraft needs to respond to changes in its mission or goals as determined annually by the Governor and the Legislature.

We believe that Corcraft's informal long-range plan is not sufficient because it does not link Corcraft's mission to any relevant objectives, strategies, activities and performance measures. Annual business plans of current activities should supplement the long-range vision, mission and goals. Moreover a formal long-range strategic plan should be flexible and allow for the input of the Governor and the Legislature as part of the environment that Corcraft exists within.)

4. Continue to improve quality control and customer satisfaction.

(Department officials re-emphasized their commitment to continually improve product quality and customer satisfaction as a major means to attract new and repeat customers.

In light of the fact that the Department has proposed legislation to enhance its industry program through the Federal PIE legislation, we applaud Corcraft officials on their continuing improvements in product quality and customer satisfaction which will become even more critical as new products and markets are identified.)

Recommendations (continued)

5. Work with Division of the Budget officials to evaluate the appropriateness of Department personal service costs charged to Corcraft and whether alternative approaches can or should be used.

(Department officials stated they have done this and further discussions are not required.)

However, as previously stated in this report, certain costs are not being properly allocated between the Department and Corcraft. Since Corcraft is supposed to operate at no cost to taxpayers, it is essential that Department officials ensure that the methodology use is fair and equitable to Corcraft.)

Internal Control System

Management is responsible for establishing, maintaining and monitoring appropriate systems of internal control. Such systems are to be designed and implemented to provide reasonable assurance that the agency's operations are efficient and effective, that financial reports are reliable, and that the agency complies with applicable laws and regulations.

The following are five interrelated components of a good internal control system:

- *Control Environment* - The control environment provides an atmosphere which is conducive to carrying out control responsibilities. It includes the integrity, ethical values and competence of the agency's people, the management philosophy and operating style, and the way management assigns authority and responsibility and organizes and develops its people.
- *Risk Assessment* - Every agency faces a variety of risks from external and internal sources. Risk assessment is the identification and analysis of the risks that are relevant to achieving the agency's objectives.
- *Information and Communication* - Pertinent information must be identified, captured and communicated in a form that enables people to carry out their responsibilities. Information systems produce reports containing operational, financial and compliance related information.
- *Control Activities* - Control activities are the policies and procedures established by management that help ensure that management directives are carried out.
- *Monitoring* - Internal control systems need to be monitored to ensure they are being adhered to.

As detailed in the following sections of this report, we found that management has not established or maintained an appropriate internal control system for Corcraft. While management has established certain internal controls, management has not focused on establishing and maintaining a complete system, including an appropriate control environ-

ment, risk assessment function, information and communication, and monitoring.

These weaknesses contribute to Corcraft management not accomplishing its mission. Moreover, Corcraft's assets may not be used as efficiently or effectively as possible, and such an environment is more conducive to error, waste and abuse. Corcraft management needs to establish appropriate internal controls and stress their importance by assigning monitoring and oversight responsibilities to appropriate managers and staff, developing comprehensive policies and procedures, assessing existing risks, establishing a comprehensive information and monitoring system, and providing relevant training to staff and supervisors.

Control Environment

The control environment includes management's philosophy and operating style. An important part of this philosophy and operating style is management's approach to long-range planning. However, we found that Corcraft management performs no formal long-range planning for its markets, products and prices. Consequently, Corcraft's operating departments have no clear idea of Corcraft's current and future direction or its strategic objectives.

Corcraft management does prepare an annual business plan. However, the plan includes only broad overall strategies and goals, and is not sufficiently detailed. For example, sales forecasts are prepared by facility and by product, but the forecasts are not compared to actual performance. In addition, marketing goals do not specify which products will be removed or emphasized, and the plan is not sufficiently specific to address the business environment or other external factors affecting performance.

Corcraft management also has no formal system for long-range planning of new product development and introduction, or analyzing various marketing strategies. Moreover, Corcraft management has not developed a product policy which defines Corcraft's role in each market. Corcraft's Director told us that Corcraft's operations may be viewed as attempting to be everything to everybody, because of the diverse political and business environment. We believe this lack of definition has hindered management's attempt to operate on a self-sufficient basis.

Corcraft management also introduces new products without adequately projecting sales or profitability. For example, Corcraft has begun producing modular prison cells, yet there is uncertainty whether the price charged for the cells will recover all overhead costs or result in a profit. Management is also considering new products and services such as

geographic mapping and computer imaging. While management has done some market research and believe they can enter these markets, they have not developed a strategic business plan for such operations.

Corcraft management also does not have a formal or comprehensive pricing policy or strategy. When we compared the prices charged by Corcraft for its products to the products' recorded standard cost (the cost of the direct labor and materials used in producing the products), we found that the prices ranged from 300 percent over standard cost to 50 percent under standard cost. In fact, as of July 1996, Corcraft records showed 851 items, produced at ten facilities, that were priced below their standard cost. Between April and June 1996, Corcraft sold 27,645 of these items resulting in a loss (below standard cost) of \$58,009. In addition, we calculated that Corcraft may have lost over \$250,000 on the sales of 828 of these items during the 1995-96 fiscal year.

For example, student desks were priced at \$10 under standard cost (\$45 vs. \$55). Marketing managers explained they were employing penetration pricing as a marketing strategy to enter the education market across the State. (Penetration pricing involves setting a low price for a new product to help increase early product sales.) When we requested to review the documentation relating to this strategy, management stated they had no formal penetration plan, including sales and profit forecasts. Moreover, we question whether penetration pricing is an appropriate strategy for the desks, because they are not new products. Corcraft officials subsequently told us that items may be priced to market to meet the competition. However, we believe Corcraft management should formally evaluate the viability of any product that is sold for less than standard cost.

We further found that Corcraft does not routinely offer a discount for prompt payment. Consequently, customers have no incentive to pay on time. We note that, while Corcraft managers have made progress in recent years to make accounts receivable more current, many accounts are still more than 90 days past due.

Management told us that perennially late State budgets have inhibited long-range planning because of uncertainties at Corcraft, and at many of Corcraft's customers, about available resources. However, we believe management should consider late budgets as an external program risk and develop an alternative plan to guide activities during budget delays.

Appropriate qualifications for staff are also an important part of the control environment. However, we found there are no minimum qualifications for the Corcraft sales and marketing staff, which include a

Deputy Director, two managers, and ten sales positions. We note that the Deputy Director of Sales and Marketing position was recently upgraded, and even though the current Deputy Director has a long history of government service, he has no previous sales or marketing education and no experience related to a manufacturing environment. We were told that the people in these 13 positions are appointed and removed based on recommendations made by the Governor's appointment office, and it is not uncommon for new people to be appointed after gubernatorial elections.

Corcraft officials told us that minimum qualifications are not needed for the sales and marketing positions, because the positions are classified by the Department of Civil Service as exempt positions (employees in exempt positions are not hired through competitive civil service examinations). However, the fact that the exempt sales and marketing positions are not filled through competitive examinations, should not preclude the need to ensure that the incumbents have the qualifications and skills needed to perform their duties competently. We believe the Corcraft operation could benefit significantly from the addition of staff who have experience or training in sales and marketing.

Recommendations

6. Develop formal long-range plans relating to product development, pricing and marketing.

(Department officials stated that Corcraft has always developed plans relating to product development, pricing, and marketing, and that recent increases in their marketing and sales staff will permit the development of a more formalized process.

Department officials did not provide us with any written long-range plans for product development, pricing, or marketing.)

7. Formally evaluate the viability of any product that is being sold for less than its standard cost.

(Department officials stated that Corcraft has always evaluated product pricing and costs and that they will continue to evaluate the viability of any product that is being sold for less than its standard cost.

Recommendations (continued)

Department officials did not provide us with formal evidence that product viability was evaluated when items were sold below standard cost. Moreover, records showed this problem is not isolated. As detailed on page 15 of this report, we identified 851 items which were priced below standard cost. Responsible Corcraft managers were generally unaware that these products were priced below standard cost.)

8. Enhance staff's capability in sales and marketing skills through recruitment and/or training activities in an effort to boost their effectiveness.

(Department officials responded that sales and marketing staff receive on-going training.

Department officials did not address that part of the recommendation which was geared toward recruiting qualified staff. We believe that prospective candidates for these positions should be recruited based on established relevant qualifications and skills. Currently, such minimum qualifications do not exist, allowing anyone to be appointed to these positions. Further, while we agree that a certain level of training is provided to staff, it should not be a substitute for hiring people qualified in the profession.)

Risk Assessment

Corcraft management faces a variety of external and internal risks that could prevent Corcraft from achieving its goals and could even prevent Corcraft from surviving. Significant risks result from changes in laws, increased competition, the need for new products and markets, the degree of operating efficiency and effectiveness, the State's economy, and the willingness of government to support Corcraft. Corcraft management, while recognizing many of these risk factors, has not formally assessed the likelihood these risks will occur or their impact on the business if they do occur. As a result, management has not identified or analyzed those risks relevant to the achievement of its stated mission and Corcraft's continued existence. In fact, Corcraft's internal auditor advised our auditors that risk assessments completed are merely a paper exercise. We

believe this attitude does not promote an appropriate internal control environment.

Recommendation

9. Do periodic assessments of the risks to Corcraft's operations.

(Department officials indicated the Internal Audit staff have for years performed periodic audits of Corcraft Central Office and facilities and that these audits would now include risk assessments.

Department officials misinterpreted the intent of our recommendation. Management, and not the internal auditor, needs to identify and analyze the internal and external risks relevant to the achievement of Corcrafts' stated mission and Corcrafts' continued existence. As far as the internal auditor is concerned, periodic audit risk assessments of operations should be the basis for developing an organization's annual audit plan and audit priorities.)

Information and Communication

Appropriate information systems are an important part of a good internal control system. However, Corcraft management has not developed critical information systems to capture and use existing data for assessing and improving the performance of its business operations. For example, management does not routinely compile information in order to:

- analyze which product lines are profitable and which are not;
- analyze existing product mix as it relates to facility production capacity;
- determine the break-even point for products and facilities;
- analyze sales and revenue trends by product and customer; and
- assess product life cycles and markets.

Consequently, Corcraft management is not in the best possible position to assess and redirect operations, or to respond to changes in business and market conditions.

For example, Corcraft accepted a Department order for 43,320 jockey shorts. Because Corcraft could not produce these items within the given time constraints, Corcraft purchased the items from another vendor for about \$54,000. This price was only about \$2,400 more than it would have cost Corcraft to produce the items, so when Corcraft sold the items to the Department for about \$115,500, it still made a profit of \$61,500. We question whether Corcraft should produce products that cost as much to produce as to buy, and whether Corcraft should charge more than twice the going price for its products. We also question why the Department is purchasing goods from Corcraft at more than double the price of the same items from other vendors. In the absence of adequate information systems, that provide production cost data that is used by Corcraft's management such questionable transactions are more likely to occur.

Corcraft management did implement a computerized production and cost accounting system in 1988. However, management did not instruct facility managers on what they were expected to monitor through the system and when to report to the central office. In addition, facility managers were not given comprehensive training in using the system as a monitoring tool. We found that each facility manager performs varying degrees of monitoring through the system, and central office staff also monitor daily facility activities. As a result, some activities are monitored by more than one person (a duplication of effort), and other activities are not monitored at all.

To ensure that the data in the production and cost accounting system is accurate and reliable, all changes in the data and the computer programs should be approved by management. However, we found that system programs and data can be modified by console operators, programmers and other staff without management review or approval. For example, staff can change product structures (i.e., the time and materials needed to produce a product) without management approval. As a result, the reported costs used to set product prices may be inaccurate.

For example, Corcraft managers identified two large inventory variances at the Auburn Facility during an annual physical inventory. Facility managers told us that while the number of items in error was correct, the related costs were incorrect. They explained that the actual time needed to make these two parts was much less than the time reported in the product structure. As a result, costs are overstated for all products made with these parts.

We note that the sales and marketing coordinator does not always rely on the system's overhead costing data to set prices. Management also told us that some staff do not trust the accuracy of the information on the system and do not always make decisions which are consistent with available data.

Recommendations

10. Develop information systems to capture accurate and reliable data, and use existing data to evaluate and improve operations.

(Department officials stated that the information is accurate and that management has the ability to use and evaluate this data.

However, we found that while management may have the ability to do this, there was no evidence that such existing data was being used to analyze and improve Corcraft operations.)

11. Train managers and staff in the use of the production and cost accounting system, as well as any other information systems that are developed.

(Department officials stated that this recommendation is a misstatement of the facts because Corcraft trains managers and staff in the use of the production and cost accounting system.

We agree that training has been provided on using the production and cost accounting computer system. However, as detailed on page 19 of our report, the system has monitoring capabilities, but Corcraft management has not instructed facility managers on how to use the system to monitor operations. Consequently, monitoring by facility managers was inconsistent and, in certain cases, was inadequate or inefficient.)

12. Ensure that all changes to systems data and computer programs are authorized by management.

(Department officials stated that all changes to data and programs are authorized either at a facility or central office.

During our audit, we found that certain changes were not authorized as claimed. As detailed on page 19 of the report, system programs and data can be changed without management review or approval.

Control Activities

Corcraft management has established procedures that are intended to control the inventories of raw materials and finished goods. We found that improvements can be made in some of these procedures. For example, both central office staff and facility staff spend large amounts of time verifying actual to reported inventory levels. However, little time is spent verifying whether the production and cost accounting system accurately reflects all product components and labor costs to make and assemble the items. As a result, management may ensure that the number of items in inventory is correct, but the value of the items may be under or overstated because of inaccurate recording of actual labor hours to produce the items.

Inventory records should accurately indicate the raw materials and finished goods on hand, and should not be overstated by the inclusion of obsolete or damaged items. In addition, the amount or quantity of individual inventory items on hand should not be excessive. However, when we visited the Attica, Auburn and Green Haven facilities, we found that inventory balances were overstated by the inclusion of damaged and potentially obsolete items, and the amount of some individual inventory items was excessive, as follows:

- At the Attica Facility, about \$293,000 of the \$1 million inventory in raw materials and finished goods was potentially obsolete, primarily due to low demand or usage, and excessive purchases. For example, 7,126 sign posts valued at about \$122,700 were on hand because most highway departments are currently using more modern break-away posts. The remaining \$170,300 consists of furniture and cabinet parts whose usage was overestimated. In addition, more than \$30,000 in returned/damaged or obsolete inventory items were included in the scrap account, overstating the scrap balance. By not segregating scrap from returned/damaged items, management cannot fully evaluate whether such activities are occurring within normal ranges, or whether any variances need to be further investigated.
- At the Auburn Facility, infrequently used and potentially obsolete raw materials, such as furniture and lamp parts, and old license plates, valued at \$122,000 were included in the inventory records. In addition, we reviewed 50 types of high-dollar raw materials valued at \$1 million and found that more than a five-month supply was on hand for 19 of the items totaling \$285,000. For example, we found 19,300 sports license plates (a 50 year supply) valued at about \$26,000. In addition, 60,000 feet of colored table edging

valued at \$24,000 has not been used since 1988. This excess supply resulted primarily from over-forecasting product need and over-purchasing.

- At the Green Haven Facility, we reviewed 50 types of raw materials valued at \$355,000 and found that more than a five-month supply was on hand for 18 of the items totaling \$164,000. For example, 107,000 furniture parts valued at \$52,000 had a 41 month supply. Again, this oversupply resulted primarily from over-purchasing and low demand.

We also found more than \$200,000 in obsolete or discontinued finished goods located at the central office warehouse. These items primarily included furniture that had been returned or had not been sold, and undersized inmate clothing. Management stated that they are attempting to sell these items at substantial discounts.

Recommendations

13. Periodically verify that product components and labor costs recorded on the production and cost accounting system are accurate.

(Department officials responded that this has been done for years through the use of weekly Material Requirements Planning (MRP) runs which adequately tests the validity of product components in the production and cost accounting system.

The MRP run discussed above adequately accounts for the number of component parts in production and inventory. It does not test the accuracy of the direct labor and materials to produce these parts. As a result, the number of component parts in production and in inventory may be accurate, but the cost of these component parts may not be accurate. As detailed on page 19 of the report, two large inventory variances at Auburn were caused by an overstatement of recorded labor hours to make these component parts. The labor hours were overstated because management has not reviewed component part structures or costs. As a result, the direct labor costs of these component parts, and the resulting final products are overstated on the system.)

Recommendations (continued)

14. Separably account for obsolete and damaged raw materials and finished goods, and dispose of these items either through sales or surplus to other governmental agencies.

(Department officials agreed.)

15. Ensure that raw materials are not overstocked by considering sales forecasts and current inventory levels when re-ordering the materials.

(Department officials stated that stock levels are monitored for inventory turns and established by the needs of the forecasted inventory program.

However, as detailed on pages 21 and 22 of our report, we did not find evidence that managers used sales forecasts or current inventory levels when re-ordering materials. This condition did result in overstocking.)

Monitoring

Management needs to monitor internal control systems to assess performance over time. Monitoring can be done through regular management and supervisory activities and the internal audit function, as well as through annual independent financial reviews of operations.

We found serious deficiencies in Corcraft's internal audit function. However, Corcraft's internal auditor is also responsible for non-audit functions, such as overseeing inmates working at the Corcraft central office, monitoring inventories, and writing directives. Such responsibilities both impede his ability to perform the required internal audit work and compromise his independence when he has to review those operations he is responsible for.

The Institute of Internal Auditors, Internal Auditing Standard Number 9 states the internal auditor should use risk assessments to allocate audit resources to those areas of greatest risk. Without formal risk assessments, areas of significant risk to the organization are less likely to be properly assessed. However, we found that Corcraft's internal auditor does not use risk assessments in designing his audit plan. Instead, he stated that about

25 percent of his work is based on external auditors' comments and suggestions, and 75 percent of his work is assigned to him by Corcraft's Director. However, according to Corcraft's Director, many of the internal audit reports do not address issues that are significant to him. In addition, many of the operating weaknesses identified by external auditors have not been addressed by internal audits, including the following weaknesses:

- Corcraft's account payable records do not readily provide details.
- Corcraft issues credit memos to State agencies that overpay for goods not yet delivered. These State agencies, through these credit memos, avoid losing appropriated funds, and Corcraft records sales before they are shipped.

In addition, Corcraft management relies heavily on information contained on computer systems relating to production, pricing, inventory management, purchasing, and accounting. However, neither the internal auditor nor the external auditors have audited these systems. As a result, management has less assurance that the systems are reliable. We note that, according to management, staff are reluctant to rely on information from these systems.

According to professional auditing standards, audit reports should identify the cause of a reported problem, and the related recommendation should address this cause. However, we found that Corcraft's internal audit reports generally do not identify the causes of reported problems. As a result, the audit recommendations do not address the causes of the problems, and the problems themselves are more likely to recur.

For example, the internal auditor recommended that managers at the Attica facility perform weekly inventory counts of raw materials, work in process, and finished goods inventories to ensure that the inventory records are accurate. We found that the work-in-process counts have an abnormally high error rate when compared to other facilities. However, Attica managers simply change the inventory records to reflect the actual counts. We determined that, because of the way work-in-process is counted, it is probably the counts, rather than the records, that are inaccurate. This problem cannot be solved until the cause of the problem is identified, and the audit recommendation did not address this cause.

We were also told by the internal auditor that he distributes his calendar of audits in advance to all central office and facility managers. Consequently, management is forewarned and could potentially manipulate data and information in advance of the audits in order to conceal problems from the auditors.

Recommendation

16. Establish an effective internal audit function which operates in compliance with professional auditing standards. At a minimum, activities should include:
- ceasing auditor involvement in non-audit activities,
 - using a risk-based methodology to identify significant audit issues,
 - following up on all significant external auditors' recommendations,
 - ensuring that internal audit reports identify the causes of reported problems, and
 - ensuring that the internal auditor does not give advance notice of audits to the units being audited.

(Department officials responded that their current internal audit function does operate in compliance with professional auditing standards. They added that they have reduced the unit's non-audit activities and will work towards a more risk-based audit methodology for future audits.)

As detailed on pages 23 through 25 of this report, we found that most aspects of Corcraft's internal audit function were seriously deficient. Consequently, Department management needs to ensure the continued integrity and independence of the internal audit function. Moreover, the internal auditor should follow professional auditing standards and ensure that the audit work effectively addresses significant issues, including the results of external audits and the causes of problems identified.)

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April 28, 1997

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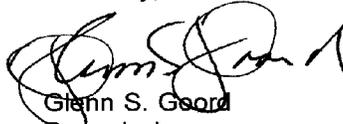
Re: Draft Audit 96-S-24
D.O.C.S. Industries Program

Dear Mr. Hancox:

In accordance with Section 170 of the Executive Law and in response to your correspondence of March 12, 1997, attached is the Department's reply to the Draft Audit of the Department's Industries Program, Report 96-S-24.

We have complied with the provisions of the Budget Policy and Reporting Manual, item B-410 by forwarding two copies of this response to the Division of the Budget.

Sincerely,



Glenn S. Goord
Commissioner

Attachment



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April 3, 1997

Mr. David R. Hancox
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Dear Mr. Hancox:

Attached is the Department of Correctional Services' response to the draft audit report (No. 96-S-24) on our Correctional Industries Program.

Sincerely,

John W. Conroy
Director of
Correctional Industries

JWC/kmb
Attachment

**NYS Department of
Correctional Services
Division of Industries**

Glenn S. Goord
Commissioner

Dr. Raymond Broaddus
Deputy Commissioner



DRAFT AUDIT REPORT (NO. 96-S-24) - DOCS Response to OSC Recommendations

OSC Recommendation #1 - Work with State policy makers to clarify the role of the Correctional Industries program.

DOCS Response - DOCS disagrees. Corcraft's mission is to employ inmates within the New York State Correctional System, in real work situations producing quality goods and services, delivered on time as required by the State of New York and its subsidiaries, at no cost to the tax payer. The Mission Statement is clear, concise and requires no further clarification.

OSC Recommendation #2 - Determine the reasons for the decline in the number of inmates participating in the program.

DOCS Response - The reasons for the decline in the number of inmates participating in the program is known and does not require further study. Inmate productivity increased by lengthening the productive hours inmates worked in the shop from 4-4½ hours/shift/day to approximately 7 hours/shift/day. The increased number of hours inmates work in the shops, along with purchases of equipment which increased productivity permitted Corcraft to manufacture products with fewer inmates. Beginning in 1988-89, this increased productivity permitted Corcraft to close down some 2nd and/or 3rd shifts. While this resulted in fewer inmates employed, it also resulted in a decrease in the average number of filled Correction Officer positions (from 155 in 1988-89 to 111 in 1995-96), an annualized savings of \$2.4 million at today's salary and fringe benefit rates. Corcraft now operates with fewer shifts. If additional production capacity is required on a short term basis, it is gained through the use of overtime.

OSC Recommendation #3 - Establish a long-range strategic plan which incorporates Corcraft's vision, mission, guiding principles and goals to better enable Corcraft management to accomplish Corcraft's mission. The strategic plan should address the major activities, the laws affecting Corcraft, and the business environment. Each goal should be supported by relevant objectives, strategies, activities and performance measures.

DOCS Response - Corcraft has always developed an annual Business Plan which includes goals for the upcoming fiscal year. Corcraft's long range strategic plan has been a more informal plan, discussed with and approved by the Commissioner. That allows Corcraft to respond immediately to changes in its mission or goals as determined annually by the Governor and the Legislature in the budget that they approve.

OSC Recommendation #4 - Continue to improve quality control and customer satisfaction.

DOCS Response - As outlined in the audit, Corcraft has made significant improvements in quality and customer satisfaction. Of course, we will continue to improve quality and customer satisfaction--it goes without saying that we will continue to do what we have been doing successfully for years, as a major means to attract new and repeat customers.

OSC Recommendation #5 - Work with Division of the Budget officials to evaluate the appropriateness of Department personal service costs charged to Corcraft and whether alternative approaches can or should be used.

DOCS Response - DOCS has had discussions with Division of Budget officials concerning appropriateness of Department personal service costs charged to Corcraft. Further discussions are not required.

OSC Recommendation #6 - Develop formal long-range plans relating to product development, pricing and marketing.

DOCS Response - Corcraft has always developed plans relating to product development, pricing and marketing. Recent increases in Marketing and Sales staff will permit the development of a more formalized process.

OSC Recommendation #7 - Formally evaluate the viability of any product that is being sold for less than its standard cost.

DOCS Response - Corcraft has always evaluated our product pricing and costs. As mentioned in the DOCS Comments to the Draft Audit Report, it was a benefit financially for Corcraft to reduce the selling price of the Great Meadow tablet arm chairs. We continue to evaluate the viability of any product that is being sold for less than its standard cost.

OSC Recommendation #8 - Enhance staff's capability in sales and marketing skills through recruitment and/or training activities in an effort to boost their effectiveness.

DOCS Response - Marketing & Sales staff have always received training. New Marketing & Sales staff generally spend 4-6 weeks in Corcraft's Order Service Department to learn about Corcraft's product line, customer base, order entry system, etc. They then accompany more experienced Sales personnel on customer calls for additional orientation and training. Corcraft partners frequently put on training seminars for Marketing & Sales staff such as the sales training conducted by Krueger on March 25 & 26 at the DOCS Training Academy.

OSC Recommendation #9 - Do periodic assessments of the risks to Corcraft's operations.

DOCS Response - Internal Audit staff have for years performed periodic audits of Corcraft Central Office and facilities. These audits now include risk assessments.

OSC Recommendation #10 - Develop information systems to capture accurate and reliable data, and use existing data to evaluate and improve operations.

DOCS Response - Corcraft's current systems capture accurate and reliable data. Reports are available that analyze profitability. We are able to analyze product mix and determine break even points. As in all systems which involve people, we continually address areas where information can be inaccurate. On the whole, information is accurate.

OSC Recommendation #11 - Train managers and staff in the use of the production and cost accounting system, as well as any other information systems that are developed.

DOCS Response - This recommendation is a misstatement of the facts. Corcraft has always provided training for the Mapics system that was installed in 1989. Corcraft will continue to train managers and staff in the use of the production and cost accounting system, as well as any other information systems that are developed, within budgetary restrictions.

OSC Recommendation #12 - Ensure that all changes to systems data and computer programs are authorized by management.

DOCS Response - All changes are authorized by management, either at the facility level or Central Office level as appropriate for the degree/level of change. Many changes to systems data are relatively minor and are performed at facilities with the approval of the Industrial Superintendent (i.e. the number of screws that goes into a component product decreases from 6 to 5). It would be ridiculous to have Central Office management sign off on systems data changes such as this.

OSC Recommendation #13 - Periodically verify that product components and labor costs recorded on the production and cost accounting system are accurate.

DOCS Response - This has been done for years. The weekly MRP run adequately tests the validity of product components in the production and cost accounting system. The MRP system translates customer demand for finished product into detailed inventory requirements for components. Corcraft Bills of Material are structured parts lists and if incorrect, improper inventory levels and shortages would result. This weekly monitoring helps ensure components are accurate and is an effective tool utilized by manufacturing environments to monitor bill of material accuracy.

OSC Recommendation #14 - Separably account for obsolete and damaged raw materials and finished goods, and dispose of these items either through sales or surplus to other governmental agencies.

DOCS Response - DOCS agrees and has already revised our "Obsolete Stock" Directive to account for and dispose of these items judiciously.

OSC Recommendation #15 - Ensure that raw materials are not overstocked by considering sales forecasts and current inventory levels when re-ordering the materials.

DOCS Response - Stock levels are monitored for inventory turns and established by the needs of the forecasted inventory program, safety stock and tempered by OGS purchase contracts.

OSC Recommendation #16 - Establish an effective internal audit function which operates in compliance with professional auditing standards. At a minimum, activities should include:

- ceasing auditor involvement in non-audit activities,
- using a risk-based methodology to identify significant audit issues,
- following up on all significant external auditors' recommendations,
- ensuring that internal audit reports identify the causes of reported problems, and
- ensuring that the internal auditor does not give advance notice of audits to the units being audited

DOCS Response - Our current internal audit function does operate in compliance with professional auditing standards, provides a wide variety of audits, reports and assists management through other responsibilities. We have taken steps to reduce the non-audit activities and will work towards a more risk-based methodology regarding future audits.

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