JACK WAGNER
AUDITOR GENERAL

Performance Audit of

Pennsylvania Correctional Industries

of the Department of Corrections

September 2005

Pennsylvania Department of the Auditor General
Jack Wagner, Auditor General

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Department of the Auditor General
Commonwealth of Pennsylvania
Harrisburg, Pennsylvania 17120-0018

September 13, 2005

The Honorable Edward G. Rendell
GOVERNOR
Commonwealth of Pennsylvania
225 Main Capitol Building
Harrisburg, Pennsylvania 17120

Dear Governor Rendell:

This report contains the results of the Department of the Auditor General's special performance audit of Pennsylvania Correctional Industries (PCI), part of the Department of Corrections, for the period July 1, 2000, through February 18, 2005. The audit was conducted pursuant to Section 402 of the Fiscal Code and in accordance with *Government Auditing Standards* as issued by the Comptroller General of the United States.

Our auditors found significant performance problems in this program. As you know, PCI teaches inmates to work and employs them to produce goods and offer services for sale to government agencies and other taxpayer-supported entities. Several significant findings in the report include the following:

- PCI did not live up to its stated mission or its own strategic plans.
- PCI stockpiled $32 million in cash and investments from profits accumulated from sales made mostly to itself—that is, the Department of Corrections—and to other state departments.
- PCI did not maximize inmate employment. Even though inmate population grew, inmate employment decreased.
- PCI used its excessive profits and high prices to subsidize 14 unprofitable businesses.
- PCI used a one-time irregular accounting method to account for a $2 million giveback to the Department of Corrections.
- PCI did not aggressively market its goods and services.

Please know that I have discussed the audit report with Secretary of Corrections Jeffrey Beard. Both Secretary Beard and his staff have responded with professionalism and a pledge of cooperation to work toward addressing our findings and recommendations. In Secretary Beard's response, which begins on page 56 of the report, he agrees with the majority of our findings and notes that the audit "provides a fair assessment of PCI." This type of collaboration not only will improve the Pennsylvania Correctional Industries program but also will serve as an example of how government agencies can work together constructively.

Several items in the report will require legislative changes. They include the following:

1. PCI has stockpiled $32 million in cash and temporary investments in the Commonwealth's Manufacturing Fund. In light of the Commonwealth's severe budget constraints, any Manufacturing Fund monies not needed to sustain the PCI program could be put to excellent use for other purposes. Currently, state law does not permit transfers from that fund to the Commonwealth's General Fund, even for accumulated monies not used within a certain period of time. We recommend legislation that would allow for such transfers so that unused monies can be used to meet other essential needs of the Commonwealth and its citizens.[1] I ask that your Office of Legislative Affairs work closely with the appropriations committees of the Pennsylvania Senate and the Pennsylvania House of Representatives to enact legislation amending the Fiscal Code to authorize the transfer of excess funds as described herein.

2. The current statutory provisions pertaining to inmate labor and PCI are outdated and woefully inadequate to meet the current needs and demands of a modern, well-functioning state prison industry program and should, therefore, be replaced as soon as possible. I ask that your Office of Legislative Affairs work closely with the judiciary committees of the Pennsylvania Senate and the Pennsylvania House of Representatives to enact legislation governing PCI's operations and the scope of its customer base. PCI's operations are currently governed by Act 245 of 1984, which transferred to the Department of Corrections all the powers and duties of the former Bureau of Corrections contained in Section 915 of Act 408 of 1953.[2]

Auditors from this Department will follow up with the Department of Corrections within 24 months to determine the status of our findings and recommendations. In the meantime, we are available to work with Department of Corrections' officials to provide technical advice and expertise as necessary to move forward.

Please contact me if we can answer any questions or be of further assistance.

Sincerely,

JACK WAGNER
Auditor General

[1] An example of a statutory provision of a state agency's restricted receipts account mandating the transfer to the General Fund of any surplus that arises after two consecutive years can be found at 5 Pa.C.S. § 1512.
[2] Section 915 of Act 408, which largely incorporated language from laws enacted in the 1920s, contains outdated provisions that have little relevance for today's PCI program. Please see the observation on page 46 of our report for a more detailed discussion of this issue.

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Results in Brief

While paying inmates between 19 cents and 42 cents an hour, this state-run prison business let sales slide, charged higher prices, and used irregular accounting to help its own Department of Corrections.

Pennsylvania Correctional Industries, or PCI, a part of the Department of Corrections, experienced significant performance problems during our audit period of July 1, 2000, through February 18, 2005. These problems included deficiencies in planning and marketing and might have been significantly lessened with stronger management.

As a bureau within the Department of Corrections, PCI has a director who reports to a Department of Corrections' deputy secretary. Next in line is an executive deputy secretary reporting directly to the Secretary of Corrections, who is accountable to the governor.

PCI employs selected inmates at 18 state prison locations to produce products (apparel, personal care, containers/bags, food, furniture, household items, recreation and storage) and perform services (e.g., printing, laundry, furniture restoration). These goods and services are sold to state agencies and other government entities that are funded by tax dollars. The inmates are paid between 19 cents and 42 cents an hour and can earn up to 70 cents an hour more with production bonuses. PCI calculated the average hourly pay for inmates in 2004 to be 59 cents.

During our audit period, PCI's sales declined by nearly 25 percent, from $44.1 million in 2001 to $33.4 million in 2004. At the same time, PCI netted nearly $19 million in profits, bringing to more than $32 million the cash and investments it amassed primarily since 1996, the time we last released an audit report of PCI. But rather than spend its millions to improve sales or train more inmates for post-release employment, PCI kept the money to itself and—in fiscal year 2002-03—actually created an irregular one-time accounting method to help its own Department of Corrections during a budget crunch. Because no other PCI customer received the same consideration, and because PCI's customers are all taxpayer supported, Pennsylvania taxpayers were the losers.

These issues and others are identified in seven findings and one observation that are discussed in detail in our audit report. We also present 21 recommendations. Within 24 months, we will follow up with PCI and the Department of Corrections to determine what actions have been taken with respect to our findings and recommendations.

The seven findings, which include deficiencies identified in our earlier audit, are as follows:

- **Finding 1:** PCI did not maximize inmate employment, could not show that it improved post-release job opportunities, gave coveted job spots to inmates who would never be released, did not aid reentry for inmates who were released, and could not show if it reduced recidivism. Overall, it did not live up to its stated mission or its strategic plans.

- **Finding 2:** PCI went beyond self-sufficiency by netting nearly $19 million in profits during our audit period alone and stockpiling nearly $32 million in cash and investments overall. It didn't use those funds to make many improvements, and it didn't pursue legislation to return the surplus money to the state treasury.

- **Finding 3:** PCI charged higher prices for its products than prison businesses charged for similar products in other states. In addition, PCI appeared to price some of its products well in excess of its actual costs. This noncompetitive pricing cost taxpayers money, made it difficult to evaluate the real costs of the program, and ran counter to PCI's mission.

- **Finding 4:** PCI used its excessive profits and high prices to keep 14 unprofitable businesses operating, even when those businesses lost more than $7.7 million over the audit period and PCI's overall profits kept declining. If PCI continues to operate in this way, it will jeopardize its continued profitability.

- **Finding 5:** PCI misrepresented the true financial performance of its operations when it improperly accounted for more than $2 million in rebates it gave to its own Department of Corrections to reduce the department's budget shortfall. No other customers were offered these insider rebates, and those customers therefore had to spend more taxpayer dollars for their purchases.

- **Finding 6:** PCI did not aggressively market its goods and services, nor did it make sound new product decisions. Based on the fact that most PCI customers we surveyed expressed satisfaction with the quality of purchased products and services, PCI's lack of aggressive marketing most likely resulted in significant lost sales and inmate work opportunities.

- **Finding 7: PCI** did not use updated standards to measure productivity or to control the quality of its products and its business operations.

In addition to the findings, we made the following observation:

- **Observation:** PCI's ability to expand its share of the market is limited by law.

This report was discussed with management officials of the Department of Corrections, and their full response appears in Appendix C. In addition, following each finding throughout the audit report, we have also summarized the Department of Corrections' response and included our comments.

Introduction and Background

According to information available in July 2005 on the state Department of Corrections' Web site, Pennsylvania Correctional Industries, or PCI, employs 1,640 inmate workers at 18 state prison locations. These workers are paid between 19 cents and 42 cents an hour, plus bonuses of up to 70 cents an hour more, to produce products and provide services for purchase by state agencies, schools and universities, local governments, and other non-profit tax-supported groups throughout Pennsylvania.

The business also uses a trade name, Big House Products, based on prison vernacular.

In 2004, according to the Web site, PCI produced nearly 1.7 million license plates, 46,000 pairs of inmate work boots, and nearly 12,000 pairs of eyeglasses. In the provision of services, PCI canned almost 114,000 cases of fruit and vegetables, washed 13 million pounds of laundry, and processed 4.1 million pounds of beef, pork, turkey, and fish.

Examples of other products and services offered for purchase by PCI include uniforms, cleaning products and soaps, modular office systems, metal and wood furniture, file cabinets, office seating, mattresses, towels and linens, picnic tables and park benches, storage facilities, vehicle restoration, furniture reupholstering and refinishing, printing, and mail distribution.

To be employed by PCI, inmates must be of good conduct and be able to read at least at an eighth grade level. Up to 30 percent of inmate wages are used for victim restitution, child support, court costs, and fines, notes the Web site, which says that inmate wages for 2003-04 were $1.93 million.

The Web site also contains the following quote:

> No tax dollars are used to support Correctional Industries. PCI manufactures products of high quality and sells them at a competitive price, thereby helping many state and local government agencies save

> taxpayer dollars. Profits are used to modernize shop facilities and expand work opportunities for inmates.[3]

Our audit report will dispute the preceding assertions by showing that tax dollars *were* used in one way or another to support Correctional Industries, products were *not* sold at competitive prices in many cases we sampled, tax dollars were *not* saved when PCI charged prices higher than necessary, and profits were stockpiled rather than used. These problems occurred during our audit period of July 1, 2000, through February 18, 2005.

Please note that we found similar problems during a previous audit of PCI for the fiscal year ended June 30, 1995. At that time, our findings were as follows:

We also found serious problems when we audited PCI nearly 10 years ago. Some of those problems were never fixed and, in fact, formed the basis for the issues we found this time around.

- The program did not have a mission statement, a strategic plan, or any other organized plan.
- The program's organization was not conducive to effective work activity.
- Communication often broke down or was misinterpreted by parts of the organization.
- The program did not have a marketing concept, and the sales force was not motivated.
- Product pricing policies were inconsistent and disorganized, and the product list was out of date.
- Product quality was poor, and delivery was chronically late.
- Adverse laws affected performance.

[3] Pennsylvania Department of Corrections, *Pennsylvania Correctional Industries*, p. 2, March 2005, <http://www.cor.state.pa.us/stats/lib/stats/ci.pdf>, accessed on June 20, 2005.

Objectives and Methodology

We based our objectives for this audit primarily on the findings from our previous PCI audit, which was released in 1996. Those findings are summarized on the preceding page. By reviewing those findings and using both new and previously collected information, we determined preliminarily how PCI may or may not have addressed those earlier issues. With that information, we constructed the following three new objectives:

1. Assess the effectiveness of PCI's planning efforts following the previous audit. For example, did PCI establish strategic plans and implement other efforts to carry out its mission statement, particularly as it relates to inmate employment and program self-sufficiency?

2. Assess how effectively PCI managed its operations. For example, how well did PCI perform in marketing, sales, manufacturing, and quality control?

3. Identify obstacles to fulfilling PCI's mission statement and to operating the program efficiently and effectively. For example, were there impairments based on statutory requirements or other issues?

Auditors addressed these objectives by reviewing applicable laws, regulations, and policies; conducting interviews; reviewing financial statements; and examining various documents from PCI or other sources. We conducted our work according to *Government Auditing Standards* as issued by the Comptroller General of the United States.

Unless otherwise indicated, this audit covers the activities of PCI from July 1, 2000, through June 30, 2004. We completed most of our field work by February 18, 2005, provided a draft report to the Department of Corrections on August 3, 2005, and received written comments from that department on August 23, 2005. The relevant comments are presented in Appendix C.

Findings and Observation

We made seven findings and one observation during our review of PCI's performance for the current audit period, and we present 21 recommendations to address the issues we identified.

Please note that we have included timeframes for the implementation of our recommendations, and that we intend to follow up within the next 24 months to determine the status of the findings. In so doing, we will work collaboratively with PCI and the Department of Corrections to meet an important government auditing standard that promotes government accountability:

> Providing continuing attention to significant findings and recommendations is important to ensure that the benefits of audit work are realized. Ultimately, the benefits of audit work occur when officials of the audited entity take meaningful and effective corrective action in response to the auditors' findings and recommendations. Officials of the audited entity are responsible for resolving audit findings and recommendations directed to them and for having a process to track their status. If the audited entity does not have such a process, auditors may wish to establish their own process.[4]

At the time of our follow-up, we will determine a subsequent course of action. For example, we may issue a status update jointly with the audited entity, issue an update independently, or conduct a new audit entirely.

[4] *Government Auditing Standards* § 7.30 (2003).

Finding 1

PCI did not maximize inmate employment, could not show that it improved post-release job opportunities, gave coveted job spots to inmates who would never be released, did not aid reentry for inmates who were released, and could not show if it reduced recidivism. Overall, it did not live up to its stated mission or its strategic plans.

PCI did not live up to its stated mission or its strategic plans.

Our earlier audit of PCI found that it had neither a strategic plan nor a mission statement. This time around, PCI had both, with the first strategic plan developed for 2002-03, five years after our report was issued, and then updated for 2004 and 2005.

Regarding the mission statement, PCI has published several variations. The ones in PCI's strategic plans for 2004 and 2005 share the following elements:

- To reduce inmate idleness
- To provide valuable vocational training and work experience
- To maximize inmate employment
- To aid inmate reentry upon release into the community
- To reduce recidivism after return to society
- To remain self-sufficient
- To produce and sell quality products and services

Through its very concept of teaching inmates to work, there can be little question that PCI reduced inmate idleness and provided vocational training and work experience. Also, based on survey results that we report in Finding 6, many PCI customers believed that PCI produced and sold quality products and services. However, PCI was far less successful with the other elements of its mission in the following ways:

- **PCI employed fewer inmates and therefore did not maximize inmate employment.** Although the state prison inmate population *increased* by nearly 3,000 during the audit period, PCI employed fewer inmates over that same period. For example, as of December 31, 2004, PCI employed approximately 1,600 inmates of the

41,000 total, or 3.9 percent of the total state prison population. That's about **230 fewer inmates** than PCI employed as of December 31, 2001.

Compare that percentage to the one reported in our previous audit as of June 30, 1995, when PCI employed 6.1 percent of the state prison population. At the time of that audit, we expected that PCI could increase its efforts to maximize inmate employment even more. We recommended, for example, that PCI research product and location profitability to determine where operations could be added or eliminated. PCI management and other Department of Corrections' officials have told us that they are working on these matters, but we found that documentation of such planning and of the accompanying rationale was weak.

Overall, PCI's figures related to inmate hiring headed in the wrong direction following our previous audit and must still be addressed. Otherwise, PCI's goal of maximizing inmate employment will remain compromised.

- **PCI did not effectively aid inmate reentry into the community.**

  Inmate employment with PCI is viewed positively by PCI officials and by the inmates themselves, according to our interviews with PCI staff who supervised employees on the job. By all accounts, inmates selected for PCI employment learn work habits that can aid in post-release employment. PCI management and other Department of Corrections' officials echoed that sentiment, saying that even though most inmates are employed at *some* wage-making job within the state prison system, the jobs at PCI are known for paying higher wages and bringing greater job satisfaction.

PCI could have aided successful inmate reentry by taking the fundamental step of hiring only inmates who would eventually be released. But it did not. For example, as of June 30, 2003, a full third of inmates working in PCI's various businesses were serving life terms and would likely never be released. When asked, PCI officials justified this hiring practice by saying that inmates who serve life sentences provide a stable workforce and also function as workplace role models for new and younger inmates. PCI management and other Department of Corrections' officials further pointed out that inmate hiring decisions are handled not by PCI but by the management at the state prisons themselves, and that PCI and other bureaus within the Department of Corrections would have to work together to change the balance in hiring. Those same officials indicated a willingness to work toward such a goal.

For inmates who were not serving life sentences, PCI provided no formal job placement opportunities. Nor did PCI monitor inmates' post-release employment. Some of the inmates' supervisors and other PCI staff told us they informally tried to help inmates find employment prior to their release, but there was no documentation of such efforts. Moreover, PCI staff members also said they are prohibited from having post-release contact with inmates.

Finally, although any job training and vocational experience clearly have value, many of PCI's job opportunities did not appear to be optimally matched with those available in private industry. For example, 55 percent of PCI's jobs during our audit period were in clothing shops, but post-release opportunities in clothing manufacturing appear to be limited because relatively few such manufacturers operate within the United States. Again, PCI and other Department of Corrections' officials told us they were working toward improving post-release job opportunities, including developing initiatives with the Bureau of Correction Education in the Department of Corrections, but precise details and results have yet to be documented.

- **PCI could not show that it reduced recidivism.**

  In its 2004 strategic plan, PCI acknowledged that, while it believed inmate-learned work skills assist in reducing a return to prison, there were few studies to directly reflect that belief. Accordingly, PCI noted it would "examine several activities that will address how the PCI work experience affects recidivism."

  In its 2005 strategic plan, PCI again addressed a reduction in recidivism and its belief that the PCI work experience makes reentry to society more successful. To this end, PCI noted that it was "engaged in an exploratory research effort with the Criminal Justice department at the Indiana University of Pennsylvania to assess how best to quantify these observations." PCI provided no further information to us by the end of our field work.

- **PCI went beyond self-sufficiency, and it charged too much for its products and services.**

  These issues are addressed separately in Findings 2, 3, and 4.

PCI appeared to recognize some of the preceding problems, as evidenced by their mention in the 2004 and 2005 strategic plans. Time will tell if PCI's planning efforts will resolve the problems. Unfortunately, however, we found that none of the three plans—2002-03, 2004, or 2005—include adequate information to show how PCI conducted its planning efforts and on what its plans were based. We were disappointed by the results of our assessment, especially because now, in

2005 when this audit report is issued, more than *eight* years have passed since we first reported PCI's deficiencies in strategic planning.

The exploratory research about recidivism, mentioned above, appears to be a good start in PCI's latest planning efforts, but—as before—more information is needed.

Another worthy planning effort is PCI's goal to increase inmate employment, but there are problems with this effort as well. For example, in the 2004 plan, PCI said a realistic goal was to employ 10 percent of the state inmate population within 5-7 years of adopting a federally approved program that—in brief—permits partnership with private industries. In the 2005 plan, PCI said much the same thing, but it offered only a few more generalized details.[5] Again, time will tell if this effort materializes.

In the meantime, PCI's 2004 and 2005 plans both established a specific goal to employ 5 percent of the state inmate population. But the establishment of that percentage was not based on any particular research or reasoned thought, according to PCI officials we interviewed, and instead was arbitrarily chosen.[6] Moreover, the timeframe appeared to change arbitrarily, too: the 2004 plan said that the 5 percent goal was achievable by 2007; the 2005 plan—without explanation—said the goal was achievable by 2008.

[5] The PCI 2004 strategic plan, page 6, names the Prison Industry Enhancement Certification Program, or PIECP, and notes that it requires approvals by the Pennsylvania General Assembly before PCI can apply to the federal government to participate. PCI said that its effort to obtain the certification would continue through the year. Subsequently, in the 2005 strategic plan, pages 4 and 5, PCI reaffirmed that its efforts would continue, including discussing the initiative at various top levels of government, drafting legislation, and establishing a PIECP advisory committee.

[6] Our concern is that PCI management did not follow any apparent process to establish the 5 percent goal, not that the goal itself is necessarily faulty (although it does appear low in light of PCI's mission). Based on our review of publicly available data from a random sample of other states regarding the percentage of inmate populations employed in state correctional industries programs, PCI's goal of 5 percent may be reasonable. For example, Virginia had approximately 3 percent of its state inmate population employed in its correctional industries program; Oklahoma and Illinois, 4 percent; Arizona, 5 percent; Ohio, 9 percent; Kansas, 10 percent; and Utah—with a very small state inmate population of about 4,000—19 percent.

While they were obviously well-intentioned responses to the previous audit, PCI's strategic plans overall suffered from the same apparent weaknesses reported in our first audit. In addition to observing this problem directly through our interviews, we came to this conclusion by comparing PCI's planning efforts to best-practice planning activities.[7] In summary, PCI's planning efforts fell short in six ways:

1. Not included in the original 2002-03 plan was **a mission**, although this deficiency was addressed in the 2004 and 2005 updates.

2. The original plan developed for 2002-03 included **objectives** only in part. Again, however, this deficiency was addressed in the 2004 and 2005 plans.

3. Not included in any of the three plans was an **"environmental scan"**—that is, detailed analyses of PCI's strengths, weaknesses, opportunities, and threats; its suppliers, customers, substitute products, and industry rivalries; and its applicable political, economic, social, and technological issues. The latter issues—political, economic, social, and technological—were addressed at least in part in the 2004 and 2005 plans.

4. Not included in any of the three plans were **strategy formulations**—that is, precisely how PCI should match its strengths to opportunities, how it should address its weaknesses and threats, and how it should establish a competitive advantage.

5. For all three plans, included only in part was **strategy implementation**—that is, programs, budgets, and procedures.

6. Finally, not included in any of the years' plans were methods of **evaluation and control**—that is, how the

[7] *Steps in a Strategic Planning Process*, no date, <http://www.des.calstate.edu/processmodel.html> , accessed on September 3, 2004.

plans would be evaluated and what parameters should be measured.

Recommendations[8]

- PCI should follow recommended best practices for strategic planning as outlined in this finding. *Target date: Implement with the 2006 strategic plan.*

- PCI should hire inmates according to a percentage goal that is determined by a thoughtful, reasoned, and documented process based on the mission of the program, and in coordination with other bureaus within the Department of Corrections. *Target date: Begin coordinating immediately with other bureaus; improve percentages by June 30, 2006.*

- PCI, in coordination with other bureaus within the Department of Corrections, should establish, apply, and document inmate selection criteria to ensure that inmates with shorter-term release dates are given hiring priority, in accordance with its mission to aid inmate re-entry to the community. *Target date: Begin coordinating immediately with other bureaus; improve percentages by June 30, 2006.*

- PCI, in coordination with other bureaus within the Department of Corrections, should develop a means to provide and document job placement assistance and post-release employment monitoring for PCI inmate participants so that the outcome of PCI's program—including recidivism—can be measured. *Target date: Begin coordinating immediately with other bureaus; report outcomes by June 30, 2006.*

- PCI should use labor market studies to identify the industries, jobs, and job skills that are in demand and

[8] For any recommendations in this report requiring coordination with other bureaus and/or officials within the Department of Corrections, PCI should take responsibility and maintain accountability for the lead role.

then factor this information into developing industries and jobs that are responsive to this demand. *Target date: Show significant improvements by June 30, 2007.*

Summary of Department of Corrections' response and Comments by Department of the Auditor General

See Appendix C for the full response of the Department of Corrections to this finding. In summary, the response makes several points: PCI has a limited ability to participate in reentry efforts and, instead, complements treatment and education programs run by other Corrections' offices; PCI over the past two years has partnered with the Department of Corrections' Bureau of Corrections Education to improve reentry programs by providing inmates with education, vocational experience, and work experience; PCI has a limited ability to conduct meaningful research on the effect of inmate work experience on recidivism; PCI has a lower inmate employment rate mainly because inmate jobs were lost because of (1) the closure of PCI-run farms and (2) the Pennsylvania Department of General Services' procurement initiative, known as Strategic Sourcing; and PCI employs "lifers" to reduce inmate idleness, to reduce inmate misconduct, and to maintain a certain amount of consistency in the workforce.

The Department of the Auditor General, while in agreement with the points made by the Department of Corrections, nevertheless maintains that PCI can do better in all the areas discussed in this finding. Again, PCI should take the lead to improve reentry efforts while working with other Corrections' offices and should provide detailed documentation on how it and those other offices will do so. Moreover, although PCI itself may be limited in its ability to conduct research about work *experience and recidivism, PCI/Corrections surely can maintain records that show how many former inmates are or are not returned to the state prison system.*

We also understand the stated reasons for PCI's lowered inmate employment but, as we recommended in our previous report and once again in this one, PCI <u>must</u> work harder and show greater initiative to improve the employment numbers. The Department of Corrections' response does not address the implementation of a process for setting a percentage goal for inmate hiring.

Regarding the hiring of "lifers," the Department of Corrections' response is plausible and well-reasoned, but PCI should adjust its public documents accordingly to reflect its hiring philosophy and mission more accurately.

Finally, although much of this finding focuses in improving PCI's strategic planning efforts through the adoption of best practice planning activities, the Department of Corrections' response is entirely silent with regard to this major issue.

Finding 2

PCI went beyond self-sufficiency by netting nearly $19 million in profits during our audit period alone and stockpiling nearly $32 million in cash and investments overall. It didn't use those funds to make many improvements, and it didn't pursue legislation to return the surplus money to the state treasury.

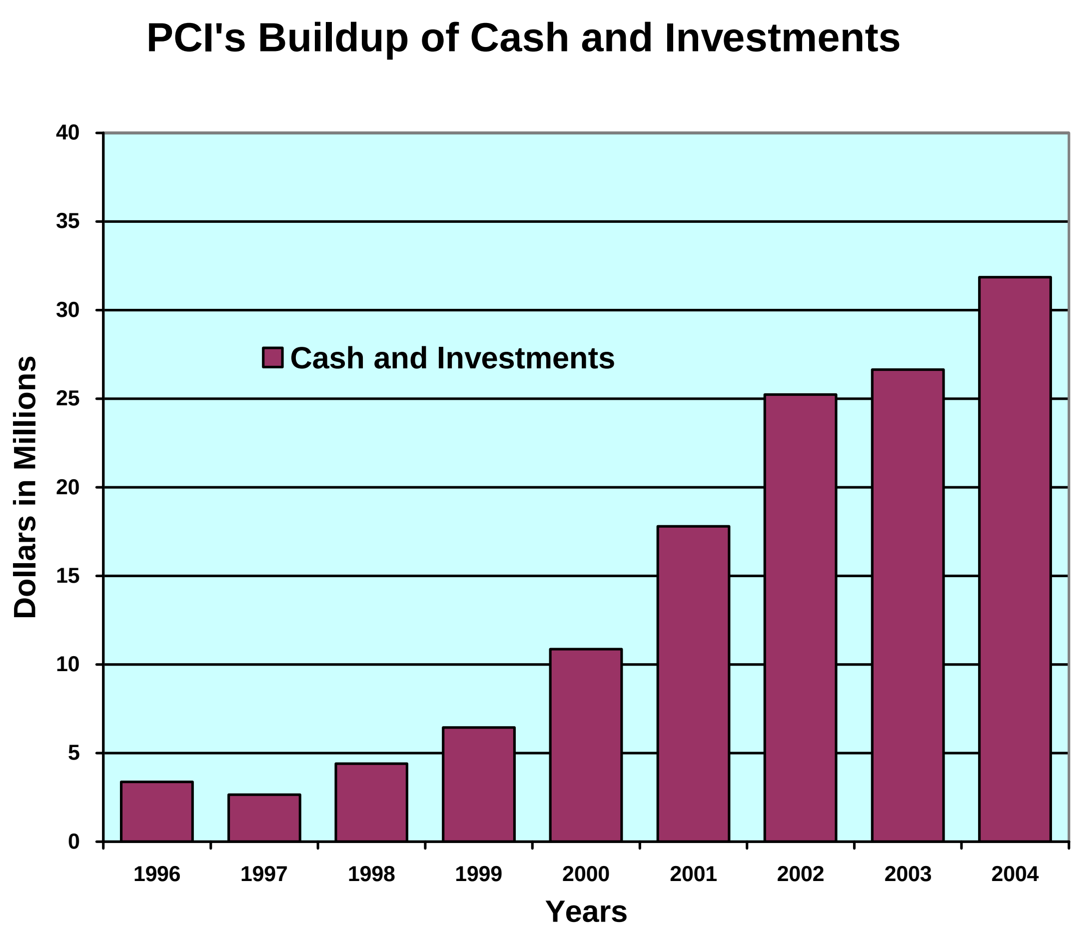
PCI should have used its stockpiled monies to improve its program. If it could not do so, then it should have sought a legislative mandate to return the excess $32 million to Pennsylvania's treasury so the money could be used for other government programs.

One of PCI's stated missions is to remain self-sufficient. However, PCI went beyond self-sufficiency by stockpiling excess unused funds both during and prior to our audit period. Specifically, for the four fiscal years that ended on June 30, 2004, PCI amassed $18.9 million in net profits, bringing to $31.9 million a surplus it stockpiled primarily since our last audit period ending June 30, 1995.

To put that $31.9 million in perspective, consider the fact that it would have been more than enough to cover the entire increase in the Department of Corrections' general fund budget request for the year 2005-06. Also consider that New York state's prison industry program had goals to break even each year, and that any revenues in excess of costs were returned to its state treasury.

In the case of PCI, it is prohibited from returning its profits to the state treasury.[9] Instead, the applicable statute mandates that excess funds be used for program improvements, inmate expenses, and inmate rehabilitation. However, the fact that PCI accumulated nearly $32 million indicates clearly that it had no pressing plans to make such improvements. Furthermore, there is no indication that PCI attempted to bring about a change in the statute so that the excess funds could be returned to the state treasury.

[9] The Commonwealth maintains a fund called the "Manufacturing Fund"—separate from the General Fund—out of which PCI's expenses are paid and into which its sales receipts are placed. The Manufacturing Fund is a restricted fund that contains monies available to spend for specified purposes only and may not be credited to the Commonwealth's General Fund. As a note of historical interest, the Manufacturing Fund in its original version was referenced in a 1915 statute, which was later repealed, mandating an initial special appropriation of $75,000.



Rather than using its surplus for program improvements or seeking a way to return the excess monies to the state treasury, Pennsylvania Correctional Industries built up $31.9 million over nine years. The buildup was generated in part by high prices that PCI charged to state agencies, including the Department of Corrections, who used tax dollars to pay for their purchases.

How PCI could stockpile such a huge amount becomes evident in the next finding, Finding 3. Specifically, PCI priced some of its products higher than necessary, a pricing policy that meant government agencies paid more taxpayer dollars than they should have paid to buy PCI products. Because taxpayer monies support entities that purchase PCI products, these "overpayments" meant that, in effect, taxpayers gave PCI a subsidy to operate. Furthermore, as we discuss in Finding 4, taxpayers in this same way also gave PCI a subsidy to rescue unprofitable product lines.

Causing further concern is this: At the same time PCI was stockpiling profits, its sales were declining significantly. We discuss this downward trend further in Finding 4 and point out that, if such a trend continues over the coming years, PCI's continued operation would be jeopardized. However, the relevancy to *this* present finding (Finding 2) is in the following unanswered questions: Will PCI attempt to use its millions in stockpiled funds to stay in operation if the decline in sales and profits continues? Why wouldn't PCI have used its stockpiled funds to improve its dismal sales and marketing efforts, to expand its markets where possible, and to focus on better and more profitable product development?

Recommendations

- PCI—with oversight by the governor and the General Assembly—should use its accumulated monies to improve its program. Alternatively, if PCI lacks the expertise to plan and carry out such improvements effectively, it should seek a statutory change so that it can return the unused funds to the state treasury. *Target date: Make determination by June 30, 2006.*

- Going forward, PCI should be self-sufficient on a break-even basis after paying for operational expenses and justifiable capital needs. *Target date: Move into a break-even basis by June 30, 2007.*

Summary of Department of Corrections' response
and
Comments by Department of the Auditor General

See Appendix C for the Department of Corrections' full response to this finding. In summary, the Department of Corrections believes that we have oversimplified the matter by characterizing PCI's nearly $32 million as a "surplus" or "stockpile." In the response, the Department of Corrections says that PCI told our audit team how the money would be used and goes on to list examples of seven expenditures—totaling $22 million—that PCI has made or says it is planning to make to modernize or add new businesses. The Department of Corrections also lists other considerations—including covering contractual and other obligations—in determining how it might accumulate cash and investments, states that the cash and investments available for other purposes is lower than we have reported, says that it would be "unwise" to operate on a break-even basis because "profits are necessary for the long-term growth and financial health of the business," and says that its "profits on operations as a whole are not excessive" with profit margins that have averaged 11.54 percent, which the response says represents a decrease of 5.03 percent a year since 2001. Finally, the Department of Corrections takes exception to our comparison of prices on specific products, saying that "it is impossible to determine the actual difference between the selling price and the actual cost" and that a better measure would be PCI's overall profits on all product lines as a whole.

While it is true that PCI did list future expansion projects in the strategic plans that we reviewed, the stated time periods for those expansion projects passed by with no expansion and no use of the surplus funds. Therefore, without evidence that PCI conducted a thorough assessment of the potential customer base and the costs necessary to make and sell the latest products that the Department of Corrections lists in its response, we do not have a level of comfort that the expansion plans would fare any better than those on the earlier lists.

The portion of the response stating "profits are necessary for the long-term growth and financial health of the business" ignores the fact that PCI continued to amass additional net profits each fiscal year (including profits through June 30, 2005), thereby already ensuring that it could cover its necessary expenses for long-term growth and health. More important, however, is that the response does not address the point that some of the accumulated funds not used within a certain period of time—or a certain percentage of those funds—<u>could</u> have been transferred to the Commonwealth's General Fund (had Corrections pursued appropriate legislation) to be used for more pressing needs of the Commonwealth without in any way undermining PCI's financial stability or program feasibility.

The analysis of sales versus profits in the Department of Corrections' response lends additional support to the need for PCI to implement real expansion projects and replace existing industries that are not profitable, as we explain more fully in Finding 4 of this report. As noted, industries that operated under a monopoly arrangement accounted for most of PCI's profits and, at the same time, operated at profit margins well in excess of the 11.54 percent average that the Department of Corrections uses in its response.

With respect to the need to cover additional contractual and other obligations, the annual financial statements of the Commonwealth show that additional assets in the form of receivables from other state government agencies more than exceeded PCI's accounts payable. In addition, for the fiscal year ended June 30, 2004, the final year of our audit period, <u>current assets exceeded liabilities by 437 percent</u>. Clearly, PCI's working capital position is strong.

Finally, our recommendation that PCI should operate on a break-even basis states that the break-even basis should be achieved <u>after</u> PCI pays "for operational expenses and justifiable capital needs." (PCI's operating expenses for the fiscal year ended June 30, 2004, totaled $32.1 million.) We *further recognize, as discussed in Finding 3, that break-even pricing includes a reasonable mark-up to cover the costs of program improvements, which naturally include real expansion efforts.*

Finding 3

PCI charged higher prices for its products than prison businesses charged for similar products in other states. In addition, PCI appeared to price some of its products well in excess of its actual costs. This noncompetitive pricing cost taxpayers money, made it difficult to evaluate the real costs of the program, and ran counter to PCI's mission.

If PCI had charged the average price charged by other states' prison businesses we reviewed, Pennsylvania could have saved $825,000 in taxpayer dollars over an 18-month period for certain products bought by state prisons and other state agencies. Moreover, because those savings are based on just a <u>*sample*</u> *of PCI products, the savings on* <u>*all*</u> *products would likely have been much higher.*

In short, PCI earned its profits at taxpayers' expense.

In our previous audit, we reported that PCI's management failed to set prices that accurately reflected the actual costs. This time around, we found nearly the same thing: First, PCI charged higher prices than other prison industries' prices and also higher than private suppliers' prices. Second, as we discuss further in the next finding, PCI appeared to price some its products well in excess of actual costs.

Higher than other prison industries' prices. By comparing PCI's prices for 18 products to the prices charged by prison industries in Georgia, Missouri, New York, South Carolina, Texas, and Virginia, auditors developed the table on the following page. For every similar item, PCI charged higher prices than all or most of the other six states:

- For 14 of the 18 products, PCI charged the **highest price** among the other states that offered a similar product.
- For 3 of the 18 products, PCI charged the **second-highest price**.
- For the remaining product we reviewed, PCI charged the **third-highest price**.

Higher than private suppliers' prices. By comparing prices for 27 PCI products with prices charged for similar items by a large private supplier of correctional products, we found that the private supplier had lower prices for 23 of the 27 items. In some cases, the PCI prices for items such as flat sheets, shaving cream, and T-shirts were *more than twice as high* as the private supplier's price. The most significant difference was for towels: PCI's price for towels was *four times higher* than that of the private vendor.

High Prices: Comparisons for 18 Products Sold by PCI	**PCI's price**	**Average price of similar product from prison industries in various other States****	**Percent (+ or -) difference between PCI's price and that of the state that charged the price closest to PCI's for this product**	**Percent (+ or -) difference between PCI's price and that of the state that charged the lowest price for this product**
Single dormitory bed	$ 997.18	$ 182.20	+ 76.3%	+ 87.9%
Dormitory dresser	$ 549.01	$ 351.70	+ 20.8%	+ 64.5%
Student dormitory desk	$ 516.00	$ 309.00	+ 13.8%	+ 66.1%
Leather boots	$ 28.00	$ 22.00	- 2.7%	+ 42.0%
Bed pillow	$ 9.98	$ 7.37	+ 14.8%	+ 34.1%
Bed sheet	$ 9.25	$ 4.53	+ 43.2%	+ 65.4%
Towel	$ 4.75	$ 2.10	+ 51.6%	+ 60.0%
T-shirt	$ 3.80	$ 2.63	+ 25.5%	+ 34.2%
Pillowcase	$ 2.75	$ 1.59	+ 9.1%	+ 66.9%
Men's boxer shorts	$ 2.75	$ 2.22	+ 7.3%	+ 38.2%
Tube socks	$ 1.25	$ 1.00	+40.0%	n/a
Dishwashing detergent*	$ 1.08	$ .79	+12.0%	+47.2%
Washcloth	$ .90	$ .55	+33.3%	+44.4%
Shampoo*	$ .20	$ .12	- 5.0%	+ 80.0%
Bar soap*	$ .193	$ .08	+ 35.2%	+ 73.1%
All-purpose cleaner*	$ .045	$ .026	+ 24.4%	+ 60.0%
Hand soap*	$ .039	$ .042	- 58.7%	+ 27.5%
Glass/mirror cleaner*	$ .023	$ .022	- 21.7%	+43.5%

** For these items, auditors computed a unit price based on ounces or pounds.*
*** States were selected based on comparable inmate populations, similar products, and data availability.*

PCI's pricing strategy may have generated profits for PCI itself, but it resulted in adverse effects for others:

1. **State prisons were adversely affected** because they purchased items at a premium. They had no choice to go elsewhere because the Department of Corrections directs its prisons to purchase items from PCI. Approximately 70 percent of PCI's annual sales were made to state prisons.

2. **Taxpayers were adversely affected** because they pay to operate state prisons and other state or local agencies that buy PCI products. For example, for the 18-month period from January 2003 through June 2004, the Department of Corrections and other agencies paid more than $2.2 million for just the 18 products we sampled. If PCI had charged just the average price set by the states we reviewed, the Department of Corrections and others would have saved $825,000—equivalent to nearly a 40-percent markdown!

3. **Legislators, other government agencies, and policymakers were adversely affected** because the true costs of inmate employment programs were, in effect, hidden in the expenditures of other state agencies and therefore unavailable for real review and debate.

4. **PCI's credibility was adversely affected** because it was not truly self-sufficient as it reported but instead was subsidized largely by the excessive prices it charged the Department of Corrections for goods and services used in state prisons, and by the excessive prices it charged other state agencies that also used tax dollars to make their purchases.

PCI reports its financial operations in a special internal Commonwealth fund (described in Footnote 6), which is used only for PCI and which is separate from the Commonwealth's General Fund. Under generally accepted accounting principles, an internal service fund should provide a service or product to governmental units and non-profit entities at a reasonable cost. Accordingly, while PCI should establish prices to recover all direct and indirect costs associated with manufacturing its products and providing its services, the prices should not be excessive.

Recommendations

- PCI should price its goods and services according to actual costs and should add a reasonable mark-up only if the resulting profits will be used for program improvements. *Target date: Restructure pricing immediately.*

- PCI should develop, maintain, and routinely update a database to track the prices of similar products made by prison industries in other states, as well as by private businesses. PCI should use this database to review and compare its own prices. *Target date: Establish database by June 30, 2006.*

Summary of Department of Corrections' response
and
Comments by Department of the Auditor General

See Appendix C for the full response of the Department of Corrections to this finding. In summary, the Department of Corrections states that PCI's prices "have become much more competitive over the past several years," that "PCI has won a significant number of competitive bids based on their pricing and quality," and that PCI "recently reduced pricing on a number of prison-related items that saved [the Department of Corrections] approximately $1.5M last fiscal year." The response also notes that PCI's products are "generally higher quality and longer lasting, which may also make them somewhat more expensive than discount suppliers."

The response does not address either of our two recommendations. Although it does address the quality of PCI's products ("generally higher quality and longer lasting") when compared to those offered by some discount suppliers, the response does not address the quality of products made by state prison industries run by states other than Pennsylvania. We acknowledge that quality is of the utmost importance. Indeed, during our audit work, we attempted to compare like products in terms of quality, quantity, size, material, and workmanship. Even so, PCI's prices were almost always at the top.

As noted throughout the report, the operational expenses and receipts of PCI are reported in the Commonwealth's Manufacturing Fund, an internal service fund. An internal service fund accounts for the financing of goods or services provided by one department or agency to other departments or agencies of the Commonwealth, or to other governmental units, on <u>a cost-reimbursement basis</u>. Charging prices that are higher than actual costs and higher than market prices runs counter to cost-reimbursement accounting and, moreover, runs counter to PCI's mission.

In its response, the Department of Correction does not address the direct impact on other state agencies and the indirect impact on taxpayers—who fund the operations of those state agencies—when PCI charges prices well in excess of costs. For example, the profit margins for the products manufactured by the state prison businesses at Graterford, Huntingdon, and Smithfield ranged from a low of 17.2 percent to a high of 41.3 percent—and these were products sold via the monopolistic arrangement with the Department of Corrections' own prisons. Clearly, the Department of Corrections, and by extension the taxpayers, paid excessive prices for those products.

Finding 4

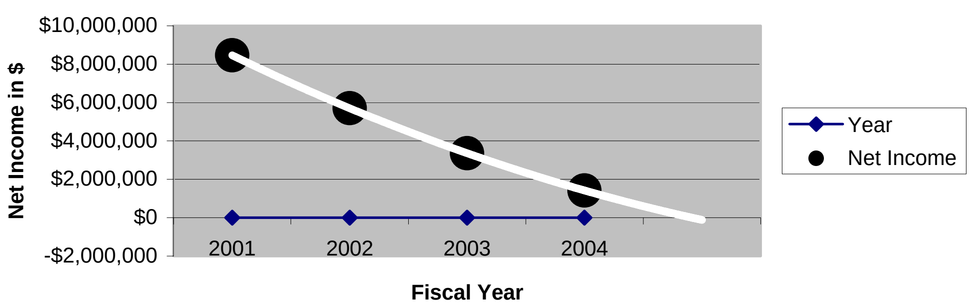
PCI used its excessive profits and high prices to keep 14 unprofitable businesses operating, even when those businesses lost more than $7.7 million over the audit period and PCI's overall profits kept declining. If PCI continues to operate in this way, it will jeopardize its continued profitability.

Nine profitable businesses of PCI subsidized the operation of its 14 businesses that lost more than $7.7 million over the audit period.

During the four fiscal years ended June 30, 2004, PCI operated 9 businesses/industries at a profit (i.e., sales in excess of costs) and 14 businesses/industries at a loss. Profits from the 9 businesses subsidized the 14 businesses that were unprofitable. Auditors found the same problem during the previous audit period, when profits at 5 businesses compensated for losses at 12 others.

Even though PCI made profits overall during our audit period, those profits declined at a steady pace—from $8.5 million in 2001 to $1.4 million in 2004.

Trend Analysis of PCI Net Income from Operations



PCI's continued profitability would have been seriously compromised if not for the sale of license plates to the Pennsylvania Department of Transportation and the sale of various products sold to the Department of Corrections. Sales in those areas alone—for which PCI has a monopolistic built-in market—accounted for at least 70 percent of PCI's sales.

The fact that PCI made significant profits in the 9 businesses—nearly $27 million over the audit period—

indicates that PCI priced its products well in excess of its actual costs. Even more specifically, as illustrated in the table on the next page, $13.8 million of those profits were generated by the prison businesses in just three locations—Huntingdon, Graterford, and Smithfield; another $8.5 million in profits were generated by the prison business that manufactured license plates. Accordingly, based on those profits, it is reasonable to conclude that the actual prices charged by PCI were well in excess of actual costs and that, by extension, the prices paid by state agencies and others were too high. This is an issue we introduced in the previous finding and an issue that PCI should analyze, document, and address going forward.

It must be noted that PCI's decline in sales is in part attributable to the closing of its license plate production at the Pittsburgh state prison at the end of 2003. License plate manufacturing was transferred to the state prison in Fayette County, where production resumed in 2004. Therefore, the decline in profits should reverse itself but, even so, PCI's management should not expect those sales to carry all of PCI.

The table that follows identifies PCI's businesses and shows profits or losses during the current audit period.

- **Losses.** The State Correctional Institution at Coal Township in Northumberland County fared the worst over the four years, incurring a total net loss of nearly $1.8 million in the production of furniture and modular systems.

Pennsylvania Correctional Industries:
Summary of Net Profits/Losses from Operations
July 1, 2000, through June 30, 2004

	Location of state correctional institution or facility*	Products made, services provided, or type of business/industry	(Net losses) or Net profits
Not profitable	Coal Township	Furniture, modulars	$ (1,763,546)
	Camp Hill	Freight services	(1,369,726)
	Albion	Vehicle restoration services	(1,336,104)
	Mercer	Signs, engraving, stickers	(1,255,654)
	Cambridge Springs	Optical lab	(465,701)
	Cresson	Plastic bag production	(309,627)
	Houtzdale	Furniture	(271,778)
	Rockview	Cannery	(226,776)
	Frackville	Printing	(192,574)
	Muncy	Garments	(168,167)
	Greensburg	Freight, modulars, textiles, shoes	(166,657)
	Greene	Garments, toilet tissue	(120,014)
	Fayette	Metal products, license plates	(56,912)
	Retreat	Laundry	(4,965)
		Total losses for 14 businesses/industries =	$(7,708,201)
Profitable	Huntingdon	Garments, printing, soap, detergent	9,332,240
	Pittsburgh	Metal products, license plates	8,548,044
	Camp Hill	Meat processing	3,395,220
	Graterford	Garments, textiles	2,891,962
	Smithfield	Garments	1,663,680
	Dallas	Garments, mattresses	423,127
	Mahanoy	Precision metal, modulars	182,345
	Waymart	Garments, personal care kits	149,002
	Somerset	Laundry	68,289
		Total profits for 9 businesses/industries =	$26,653,909

Grand total for all 23 businesses/industries = $18,945,708

**Elsewhere in this report, we note that PCI operates businesses at 18 state prison locations. That number represents the state prison locations operating businesses in 2005. The chart above shows more than 18 locations because it lists additional sites that operated businesses during our audit period.*

- **Losses.** Almost as bad were the state correctional institutions at Camp Hill in Cumberland County, which lost nearly $1.4 million in providing freight services; Albion in Erie County, which lost more than $1.3 million in its vehicle restoration services; and Mercer in Mercer County, which lost more than $1.2 million in making signs and stickers and providing engraving services.

- **Profits.** The State Correctional Institution at Pittsburgh (Allegheny County) alone accounted for nearly a third of the profits, or 32 percent, over the four-year period by manufacturing license plates for the Pennsylvania Department of Transportation.[10]

- **Profits.** Together, the state correctional institutions at Huntingdon (Huntingdon County), Graterford (Montgomery County), and Smithfield (Huntingdon County) generated more than half of the profits, or 52 percent, over the four-year period. These three institutions made and sold garments and other items primarily to the Department of Corrections.

During the most recent fiscal year in the four-year period—i.e., fiscal year ended June 30, 2004—PCI generated $3.8 million in profits for 9 businesses/industries and had operating losses of $2.4 million for the other 14 businesses.

If PCI had a reasoned motivation and had shown benefits for maintaining unprofitable businesses—such as providing critical training that actually resulted in proven higher post-release employment for inmates—the losses might have been sufficiently justified. Indeed, PCI has noted that it is in business to do exactly that. Unfortunately, as we discussed earlier, PCI cannot show that it has done so. Therefore, beyond reducing inmate idleness and providing basic work experience, we saw no evidence that PCI had any other type of plan or documented logic for continuing to subsidize its

[10] The Pittsburgh facility has since closed (as of January 2005). The State Correctional Institution at Fayette took over the manufacturing of the products.

unprofitable businesses with the revenues from its profitable ones.

<u>Recommendations</u>

- PCI should stop subsidizing unprofitable businesses/industries with revenues from profitable ones unless it can document valid justifications and actual proven benefits for the unprofitable businesses. *Target date: Establish this recommended practice immediately.*

- PCI should thoroughly review and analyze all its businesses, products, and services to show which businesses are truly self-sufficient and which should be modified, eliminated, and/or replaced with others to strike an effective balance in its operations. *Target date: Complete this review and analysis for inclusion in the 2006 strategic plan.*

<u>Summary of Department of Corrections' response</u>
and
<u>Comments by Department of the Auditor General</u>

See Appendix C for the full response of the Department of Corrections to this finding. In summary, the response addresses the 14 unprofitable locations listed in our report and provides information about each. Specifically, the response states that 5 industries/businesses have been closed or restructured, 2 have been temporarily closed but will reopen next year as something different, 4 are now profitable, and 3 locations, although still unprofitable, "appear to be improving financially as a result of changes put into place by PCI management." The response further states, "PCI closely monitors the financial performance of each industry location" and notes that "[while] some locations may be unprofitable for some years, they rarely remain so indefinitely."

Because the response summarizes corrective actions that PCI put into place to address the unprofitable operations that we found during our audit period, we have no further comment except to say that the Department of Corrections clearly views the subsidization of unprofitable businesses—at least "for some years"—as a necessary part of PCI's program.

Finding 5

PCI misrepresented the true financial performance of its operations when it improperly accounted for more than $2 million in rebates it gave to its own Department of Corrections to reduce the department's budget shortfall. No other customers were offered these insider rebates, and those customers therefore had to spend more taxpayer dollars for their purchases.

PCI offered one-time rebates to its own Department of Corrections and then accounted for the rebates in an irregular way.

When the Department of Corrections was faced with a budget shortfall during the 2002-03 fiscal year, PCI developed a method to give state prisons—and no other customers *except* state prisons—a one-time 10 percent rebate for goods and services that the prisons had already purchased from PCI during the year. The rebates allowed PCI to return the equivalent of almost 40 percent of its annual earnings to its own Department of Corrections in what was clearly an inside deal.

PCI management and other Department of Corrections' officials are adamant that the rebates were warranted and that there was no intention to hide them. Still, while it appears that PCI was not legally prohibited from making these unprecedented rebates to its largest customer, the decision to make them is suspect based on the following:

- **Irregular accounting.** Once the rebates were made, PCI should have classified them as a <u>reduction in sales revenue</u>. Instead, PCI buried the rebates within <u>general and administrative expenses</u> by classifying them almost anonymously as "Other Services and Supplies – Misc."

- **Overstated costs.** This irregular method of recording the rebates as a miscellaneous expense resulted in increased general and administrative costs. These increased costs were then allocated to the various other prison businesses and resulted in overstated costs for those businesses.

- **Wrongly motivated.** The rebates were not part of a strategic pricing plan. Indeed, they were not even part of the Department of Corrections original budget but instead were included in a *re-budget* request. Auditors learned during an August 2004 interview with PCI's director that, initially, the Department of Corrections sought to supplement its tight budget and discussed with PCI the idea of simply transferring some of its profits. However, the concept of a direct transfer was apparently ruled out on the advice of Department of Corrections' legal staff.

- **Unfair to other customers.** After a direct transfer was nixed, PCI and the Department of Corrections considered offering a purchase discount to state prisons as a way to save them money. That idea was abandoned in favor of after-purchase rebates so that PCI would not have to publish two different sets of prices and thereby alert its other customers to the in-house deal.

PCI acknowledged to our auditors that it accounted for the rebates incorrectly and also that it made the rebates only that one time. And again, PCI and other Department of Corrections' officials insisted that the mistake was unintentional.

Nevertheless, perhaps the most detrimental aspect of the irregular accounting is that it hid PCI's actual costs from policymakers, thereby compromising their ability to evaluate the program using true numbers. The relevancy, accuracy, and completeness of PCI's financial affairs are especially important to legislators, who determine the Department of Corrections' funding. Without the availability and assurance of accurate financial statements, it is impossible for legislators to make informed decisions about the Department of Corrections' needs, or to have confidence that the Department of Corrections will then make appropriate decisions about its programs such as PCI.

For the next fiscal year, 2003-04, PCI looked for another way to help the Department of Corrections cut its costs. However, the new solution—which was to review the actual products purchased by the Department of Corrections and then lower the prices—had its own set of problems:

- **Preferential self-treatment.** Again, PCI was looking only at its most-favored customer—its own Department of Corrections—rather than its external customer base.

- **Bad customer relations.** While it may be reasonable for businesses to offer their biggest customers the largest discounts, the fact that PCI was offering discounts only to its own Department of Corrections is questionable, particularly when its prices to other customers were so out of line.

Recommendation

- PCI should evaluate its pricing structure and consider ways to offer benefits to all customers, not just to its own Department of Corrections. *Target date: Evaluate pricing structure immediately.*

Summary of Department of Corrections' response and Comments by Department of the Auditor General

See Appendix C for the full response of the Department of Corrections to this finding. In summary, PCI strongly rejects our calling the rebate "suspect," disagrees that PCI hid actual costs from policymakers, and further disagrees that irregular accounting associated with the rebate facilitated the hiding of costs from policymakers. "The rebate was not illegal and there is no prohibition against rewarding best customers," the response states. At the same time, the response also notes the Department of Corrections' *acknowledgement—after "exhaustive research on the accounting treatment of rebates"—that our conclusion was correct that the accounting of the rebates should have been handled as we stated in the finding. Corrections also notes, however, "The original accounting treatment and that suggested by the [Department of the Auditor General] would produce the same Manufacturing Fund net profit and would not have changed the Cash Balances presented in the Governor's Executive Budget book nor in the Commonwealth's Comprehensive Annual Financial report." Finally, Corrections states, "As for [the Department of the Auditor General's] specific recommendation, there is no industry standard requiring discounts be provided to 'all' customers."*

While it is true that PCI's net profit as recorded in the Commonwealth's comprehensive annual financial report was not impacted by the irregular accounting, net profit is only one measurement of operations. Both sales and expenses were overstated by more than $2 million for the fiscal year ended June 30, 2003. Overstatements of this magnitude impact the reliability of financial statement presentations and may change the views of policymakers and others who rely on those financial statements.

With regard to Corrections' comment suggesting that we recommended that discounts should be provided to all customers, we did not. Rather, we recommended that PCI, in addition to evaluating its pricing structure, "should consider ways to offer benefits to all customers." Such benefits could include discounts but could also include other special promotions to reward new or existing customers.

Finding 6

PCI did not aggressively market its goods and services, nor did it make sound new product decisions. Based on the fact that most PCI customers we surveyed expressed satisfaction with the quality of purchased products and services, PCI's lack of aggressive marketing most likely resulted in significant lost sales and inmate work opportunities.

PCI's sales declined at the same time that previous profits were being stockpiled. Management should have taken far more action to make program improvements—especially in sales and marketing.

Although PCI continued to operate at a profit during our audit period, we have already noted that its profits declined steadily. PCI's annual sales also dropped each year of the audit period, sliding from $44.1 million in 2001 to $33.4 million in 2004. That's nearly a 25 percent decline.

When PCI missed opportunities to develop better product lines and more aggressively market its products and services, it also missed out on opportunities to make more sales and to provide greater work experience and training for its inmate employees. In the previous audit, we found virtually these same deficiencies.

During this current audit, we found that PCI sold to only a fraction of the customers it can legally sell to, which include federal, state, and local governments, including government agencies in other states; state, municipal, and county authorities created by Pennsylvania law; educational or charitable institutions that receive funding from the Commonwealth; and institutions that receive funding from the federal government or from any other state.

Examples of PCI's sales efforts between January 2002 and June 2004 are illustrated by the meager numbers of actual customers that were not state agencies:

- PCI sold to just 78 municipalities or townships out of a potential of more than 2,500.

- PCI sold to just 35 schools, but there are 501 school districts in Pennsylvania.

- PCI sold to 18 colleges, 5 libraries, 24 fire departments, 84 non-profit organizations, 47 hospitals, 9 local police departments, and 47 county offices.

- In total, PCI sold to fewer than 400 non-state agencies during the period we reviewed.

Clearly, PCI could do exponentially better.

To make additional determinations about PCI's marketing efforts, we surveyed current PCI customers as well as potential customers, something that PCI did not routinely do.[11]

Regarding potential customers, we mailed surveys to 100 local government entities and non-profit organizations chosen according to auditor judgment:

- Of the 60 respondents, 59 said they had never purchased goods or services from PCI.

- 36 respondents said they were unaware of PCI.

- 52 respondents said they did not know that PCI had an online catalog.

- 45 respondents said they were interested in learning more about PCI and/or accessing PCI's online catalog.

Regarding existing PCI customers, we mailed surveys to 150 randomly selected organizations that had done business with PCI. We received 104 responses:

- Of 94 respondents who rated the overall quality of products they purchased, 83 rated the quality as excellent, very good, or good; the remaining 11 respondents rated the quality as fair, and none rated the products as poor.

[11] Complete survey results appear in Appendix A to this report.

- Of 48 respondents who rated the overall quality of services they purchased, 43 rated the quality as excellent, very good, or good. Only 5 rated the quality as fair, and none rated the quality as poor.

- Of 98 customers who answered our question about the frequency of contacts made by a sales representative from PCI, 66—or about two-thirds—said they were contacted less than once a year; 19 said they were contacted once a year, and only 13 said they were contacted more than once a year.

Overall, the survey results illustrate three major points about PCI and its marketing potential:

1. Given that 45 of 60 potential customers said they would like to hear more about PCI, clearly an untapped interest exists.

2. Given that most of PCI's existing customers were satisfied with the products and services they purchased, PCI can project this image and use it to market those products and services.

3. Given that more than half of PCI's potential customers said they had not heard of PCI, and that about two-thirds of PCI's existing customers said they had not heard from a PCI sales representative in the course of a year, PCI has some major weaknesses to address and some significant marketing efforts to make.

PCI's lack of aggressive marketing during our audit period manifested itself in the same deficiencies that we identified in our previous audit of PCI's sales and marketing efforts. Specifically, we found that PCI's sales force suffered from poor training, inadequate documentation of sales efforts, ineffective communication, and poor planning. These deficiencies—which PCI said it would address in the previous audit and which were also identified in an assessment by an outside organization, the Service Corps of Retired Executives—continued to hinder PCI during the current audit. Examples follow:

- **Poor training.** When auditors asked PCI management officials if they offered a training program for sales staff, the officials noted that training was basically “on-the-job” by way of riding with a more experienced sales representative.

- **Inefficient tracking of customer calls.** PCI management officials told auditors that sales representatives maintained their own files rather than keeping the files in a central location to be used for follow-up and analysis. During interviews, we also learned that the sales representatives did not routinely keep itineraries or log books, did not track or account for their time, and—most important—were not even asked to do so.

The location and make-up of the sales representatives also hindered their ability to aggressively market PCI:

- **Sales staff not headquartered throughout the Commonwealth.** Even though PCI assigned each of its sales representatives to be responsible for one of six regions, the representatives were based solely out of PCI’s central office in Harrisburg. Accordingly, the staff was limited in its ability to make frequent and effective contacts throughout the state. Such contacts would have been necessary to maintain the most positive customer-client relationships.

- **Vacancies on sales staff further compromised effectiveness.** At the end of our field work, one of the sales positions was vacant, as was one of the clerical positions. These vacancies further compounded the deficiencies already noted.

In total, PCI had <u>50</u> positions available in its complement at its Harrisburg headquarters to carry out management and program operations, and 163 more positions assigned to run the work operations at the state prisons. Surely PCI could have carried out its operations much more effectively than it did.

Finally, we also found that new product and production decisions—an inherent part of any marketing effort—were made very informally and often with little research and documentation. We also found little evidence that PCI explored ways to enter potential new markets while staying within the limitations of law (these limitations are discussed in the observation following the next finding) *and* while not taking jobs away from the private sector.

One of the best illustrations to show the results of PCI's product and production decisions is the number of products that PCI offered for purchase—more than 2,500—and the fact that many of these products were not produced because there were no orders for them.

Performance standards published by the American Correctional Association say the following about the development of new products and services:

> There should be a distinct process in place to develop new products and services, to expand markets and to develop business opportunities. Market research, as well as compatible product analysis and pricing studies, is essential.[12]

The standards go on to indicate that the product development process should include business and marketing plans, written policies and procedures, and research-supported documentation. However, the process at PCI was only a rudimentary look at (1) PCI's ability to produce products based on inherent restrictions in the prison environment, (2)

[12] The American Correctional Association, *Performance-Based Standards for Correctional Industries*, 2d ed., Graphic Communications, Maryland, 2002, Part VI, "Administration and Management," Marketing 2-CI-6A-10, p. 19.

available employees and their skill levels, (3) the potential to make a profit, and (4) the identified needs of a specific customer.

During our discussions with PCI officials, they attributed the marketing problems to high turnover of sales staff, which resulted in an inexperienced staff, and also to low compensation for sales positions and a related lack of motivation. These problems, however, might all have been lessened if PCI and its lead management officials had engaged in better strategic planning, including plans for better training and motivation as well as for new product development.

Recommendations

- PCI should routinely conduct surveys of potential and existing customers to determine their needs and—for existing customers—to gauge their satisfaction, and then should use these surveys to determine marketing efforts. *Target date: Begin the survey process immediately and use survey results to adjust marketing efforts by June 2006.*

- PCI should ensure that its sales representatives are adequately trained and competently directed, sufficiently staffed, based throughout the Commonwealth, knowledgeable about PCI products, and skilled in customer service. *Target date: Begin this training immediately for existing staff, offer it for new staff when hired, and provide continuing training/education for all staff.*

- PCI should develop and implement detailed marketing plans and establish appropriate policies and procedures for the implementation of those plans. All information should be analyzed and documented; at a minimum, the plans should include research (e.g., competition and trends), product development, pricing, sales history, sales initiatives, training activities, and communications strategies. *Target date: Develop and implement marketing plans for start of fiscal year July 1, 2006.*

- PCI's management should dedicate itself to directing the marketing and sales efforts successfully; to maintaining, motivating, training, and evaluating the appropriate staff; and to placing the staff geographically to serve the entire Commonwealth. *Target date: Establish recommended practices immediately.*

- PCI should take steps to expand its customer base significantly for its existing product lines by developing effective marketing and sales efforts that reach far more county, local, and non-profit entities than it reaches now. *Target date: Begin implementing recommended practices immediately.*

- PCI should explore new product lines and businesses while operating within the limitations prescribed by law *and* while not taking jobs from the private sector. *Target date: Report product line expansion recommendations to the Department of Corrections' Deputy Secretary of Administration for review and approval by June 30, 2006.*

Summary of Department of Corrections' response
and
Comments by Department of the Auditor General

See Appendix C for the full response of the Department of Corrections to this finding. In summary, the Department of Corrections acknowledges that improvements are needed in sales and marketing and discusses some of the challenges in attracting and retaining a capable sales and marketing team. Mentioned also in the response are two initiatives "that are underway" with the Commonwealth's Office of Administration: (1) "a request for a pilot project that will *allow for the payment of a sales incentive" and (2) "the establishment of a Sales and Marketing Trainee and a Sales and Marketing Supervisor Classification."*

The initiatives described, if approved, appear to hold good potential to address the sales and marketing weaknesses. However, the response by the Department of Corrections does <u>not</u> address our recommendations for equally important initiatives: that PCI's customers should be routinely surveyed and that detailed marketing plans and related policies and procedures should be developed and implemented.

We must reiterate the need for completing a thorough sales and marketing analysis prior to introducing new product lines. Although PCI's response to Finding 2 lists planned expenditures for new or expanded product lines, PCI management has not supported its new product decisions with a thorough assessment of the potential customer bases and the costs necessary to make and sell the products at a price competitive with the market.

Finding 7

PCI did not use updated standards to measure productivity or to control the quality of its products and its business operations.

PCI has still not updated its written quality control procedures as we recommended in our previous audit.

In our earlier audit, we reported that PCI's policy manual provided for centralized quality control but that production managers instead established programs independent of one another. The result of this decentralized control was a lack of uniformity and effectiveness in production. To ensure operating efficiency, effectiveness, and consistency, we recommended that PCI coordinate its quality control efforts according to current operational standards and guidelines published in a policy manual.

Our present audit found that PCI failed to update its written policies and procedures not only for quality and product control, but for other areas as well. In fact, we determined that most of PCI's operating polices were issued in 1990, meaning that PCI conducted business for nearly 15 years without updating those policies.

PCI said that, absent its own updated written policies, it followed guidelines issued by the Department of Corrections for general administrative and operational issues, and guidelines issued by the Department of General Services for procurement and inventory processes. For training in machinery operation, PCI taught its inmates on the job. One exception was PCI's policy on safety training for inmates, which consisted of a read-and-sign policy to ensure that inmates were made aware of specific safety issues on each production line.

When we requested copies of the Department of Corrections' policies related to general administrative issues, as noted above, PCI provided auditors with five one-paragraph Department of Corrections policy statements—all dated June 1990 and therefore as old as PCI's policy manual. PCI also provided us with a fiscal administration policy from the Department of Corrections, as well as several other policy statements, but they were not specific to PCI.

The American Correctional Association expects every entity that it accredits to maintain and follow written policies and procedures. While PCI is not accredited by the American Correctional Association, having such written policies and procedures is a best practice that PCI should attempt to establish so the quality and delivery of its products and services can measure up to its stated mission.

Recommendations

- PCI should develop, distribute, and follow comprehensive written policies and operating procedures designed to improve and control the quality of its business and sales operations. *Target date: PCI should complete this recommendation by June 30, 2006.*

- PCI should ensure that compliance with the above policies and procedures is tracked and that they are updated at least annually. *Target date: Complete by June 30, 2007.*

- PCI should pursue accreditation from the American Correctional Association. *Target date: Complete by June 30, 2007.*

Summary of Department of Corrections' response
and
Comments by Department of the Auditor General

See Appendix C for the full response of the Department of Corrections to this finding. In summary, the response notes that existing Department of Corrections' policies cover many of the PCI practices and operations and that other PCI procedures are being developed. The response also states that PCI is seeking accreditation from the American Correctional Association in March 2006.

Regarding the updating of procedures, such updating is critical. This recommendation should be followed through and not skipped as it was following the issuance of our earlier report.

Observation

PCI's ability to expand its share of the market is limited by law.

PCI might be able to pursue expansion of its market share. If it pursues expansion opportunities, however, it must not displace private sector jobs.

Throughout this report, when we present negative findings about PCI's operation, it is clear that those findings were caused primarily by deficiencies in planning, management, and/or marketing. Those same findings, conversely, can be *resolved* by effective planning, management, and marketing, and our recommendations are made with that effect as the goal.

There are some hindrances to PCI's successful operation that are not so readily resolvable, and we discussed such barriers in our earlier audit. For example, we reported that Commonwealth procurement procedures restricted PCI's purchasing abilities, but we can now report that a revised Commonwealth procurement code (codified at 62 Pa.C.S. §101 *et seq.* (2005)) has improved PCI's purchasing potential.

Unfortunately, there is another limitation that has not improved, and it significantly limits PCI's ability to increase its market share. The significant limitation is not the result of PCI's management, however, and hence we report it solely as an observation.

This limitation on expanding PCI's market share is contained in the 1984 state law that established the Department of Corrections,[13] granting the Department of Corrections all the powers and duties of the former Bureau of Corrections. The pre-existing powers and duties[14] included selling prison

[13] 71 P.S. § 310-1 (1990).

[14] The pre-existing powers and duties are pursuant to Act 408 of 1953, Section 915(c), P.L. 1428 (July 29, 1953). Note that this provision cannot be easily found "on the books" of Pennsylvania law. Section 915 was expressly repealed by Section 3 of Act 245 of 1984; however, all the powers and duties of the Bureau of Corrections contained therein were transferred to the Department of Corrections by Section 4 of the same 1984 law, which added Section 901-B to the Administrative Code of 1929. To further confuse the matter, Section 21 of Act 425 of 1921, *codified at* 71 P.S. § 1481 (1990), is quite similar to Section 915 in its limitation on the sale of PCI goods and services; although this provision was repealed in 1923, it may appear to remain in effect. We encourage the Department of Corrections to work with the General Assembly to draft and enact a modern law that clearly governs PCI and sets forth the authorized scope of PCI's sales.

prison-produced goods that cannot be used in the correctional institutions themselves. In other words, if for whatever reason the prison-produced goods are not needed for use in the correctional institution, they can be sold. However, the applicable provision of law expressly limits such sales to the following entities:

- government agencies at the federal, state, and local level, including government agencies in other states
- state, municipal, and county authorities created pursuant to Pennsylvania law
- educational or charitable institutions receiving funding from the Commonwealth
- institutions receiving funding from the federal government or from any state

These limitations mean that, unlike correctional industries operated by some other states, PCI cannot sell to the private sector. If PCI were authorized to expand its customer base, there might be a dramatic impact on PCI's market share.

Several states, such as Kansas, Oregon, and Utah, allow the private sector to establish and maintain operations inside or in close proximity to correctional facilities, and to use inmate labor as the employees of those businesses. The federal Prison Industry Enhancement Certification Program, for example, allows the private sector to establish joint ventures with state and local correctional agencies to produce goods using prison labor. In its 2004 and 2005 strategic plans, PCI has listed the Prison Industry Enhancement Certification Program as a future initiative but has provided few details, as we note in Finding 1 of this report.

In addition to increasing market share, public-private partnerships enable the inmates to learn "real-world" skills that improve their prospects of finding meaningful employment following their release. The inmates also earn higher wages, which are used to defray the costs of their incarceration, provide restitution to their victims, and support their families.

For example, the Oregon Department of Corrections has a successful joint venture with a private corporation to produce a trademarked line of clothing that is sold throughout the United States, Europe, and Japan. However, before embarking on this endeavor, Oregon conducted a study that determined manufacturers in that state would not be harmed by a prison garment industry.

Similarly, the Pennsylvania Department of Corrections should ensure that any expansion of the PCI program would not result in the displacement of private sector jobs. An example of such displacement was reported by the *Pittsburgh Tribune-Review* in May 2005, whereby a flag manufacturer in New Jersey said he could not compete with prison factories in New Jersey and Pennsylvania that also made flags, including those for veterans' graves.[15]

Summary of Department of Corrections' response
and
Comments by Department of the Auditor General

See Appendix C for the full response of the Department of Corrections to this observation. In summary, Corrections states, "We believe it is extremely unlikely that the Legislature will authorize sales to the public or to private enterprises in PCI's present form as a traditional prison industry." The response also addresses the federal Prison Industry Enhancement Certification Program that we discuss in the observation.

[15] Rich Cholodofsky, "Prison industry thriving," *Pittsburgh Tribune-Review*, May 1, 2005, <http://www.pittsburghlive.com/x/tribune-review/trib/regional/print_329746.html>, accessed on June 20, 2005.

The Department of Corrections' response fails to acknowledge, however, the severely outdated condition of PCI's governing statutory provisions. Corrections also fails to consider the possibility that our General Assembly, like the legislatures of some other states, may be willing to consider expanding PCI's current customer base to include joint public-private ventures if the proposal would be presented with adequate evidence of the potential benefits of such an initiative and with well-documented assurances that Pennsylvania businesses and jobs would not be adversely affected.

Appendices

Appendix A: Summary of Survey Responses by PCI Customers

Appendix B: Summary of Survey Responses by Potential PCI Customers

Appendix C: Response from PCI/Department of Corrections

Appendix D: Audit Report Distribution List

Appendix A

Summary of Survey Responses From PCI Customers

Auditors surveyed 150 current or former customers of PCI and received 104 responses, for a response rate of 69 percent. The numbers following each question are the numbers of responses, not percentages. NR = no response.

1. How frequently do you purchase PCI products?
   Less than once a year: 33
   Once a year: 21
   More than once a year 42
   NR: 8

2. How would you rate the overall quality of the products purchased?
   Excellent: 20 Very Good: 32 Good: 31 Fair: 11 Poor: 0 NR: 10

3. How would you rate the overall quality of the services purchased?
   Excellent: 8 Very Good: 18 Good: 17 Fair: 5 Poor: 0 NR: 56

4. Have goods and services been delivered in a timely manner?
   Always: 25 Usually: 48 Sometimes: 13 Seldom: 6 Never: 1 NR: 11

5. Have you had to return any products purchased from PCI?
   Yes: 18 No: 80 NR: 6

6. If you responded "yes," how would you rate PCI's handling of your return?
   Excellent: 4 Very Good: 3 Good: 6 Fair: 5 Poor: 1 NR: 86

7. How would you compare prices of PCI products or services to other suppliers?
   Excellent: 9 Very Good: 25 Good: 32 Fair: 18 Poor: 9 NR: 11

8. Overall, how would you rate PCI sales people in their contacts with you?
   Excellent: 11 Very Good: 37 Good: 29 Fair: 10 Poor: 4 NR: 13

9. How frequently are you contacted by a PCI sales representative?
   Less than once a year: 66
   Once a year: 19
   More than once a year: 13
   NR: 6

10. Are you aware of PCI's on-line catalog Web site, www.bighouse.state.pa.us/catalog?
    Yes: 48 No: 34 NR: 2

(Summary of Survey Responses From PCI Customers, continued)

11. If you answered yes to question no. 11, have you used PCI's Web site to purchase products and/or services?

Less than once a year:	35
Once a year:	13
More than once a year:	21
NR:	35

12. Overall, how would you rate PCI's efforts to serve and satisfy your needs?
    Excellent: 10 Very Good: 32 Good: 35 Fair: 18 Poor: 3 NR: 6

13. Are there any areas in which you believe PCI could improve the quality of its products or services?
    Yes: 38 No: 17 Unclear: 19 NR: 30

14. Are there any products or services you would like PCI to offer that it does not currently offer?
    Yes: 9 No: 35 Unclear: 23 NR: 47

15. Have you purchased the following from PCI during the past three years?

a) Products	Yes: 90	No: 10	NR: 4
b) Services	Yes: 27	No: 48	NR: 29

16. Additional comments (summarized below by auditors):

"Faster service – sometimes takes a month to get basic needs."

One respondent indicated that the PCI "representative stated delivery time of 4 to 6 weeks. Product not delivered until 3 months after purchase date. Numerous phone calls to PCI . . . during the period were either unanswered or clarification of shipment date went unanswered."

"Clothing needs improved severely."

"Fire rings – welds on grates do not hold up to repeated use – not sturdy enough for public use. Also, in past . . . sweat shirts and pants – stitching came apart."

"Apparel, uniforms, quality control needs improvement when alterations are requested for sizing + (hemming)."

"Provide better quality meat products."

"Locks on desks are poor, file cabinets are not too great. They're flimsy."

"Pricing, delivery times could be improved. Food products availability is inconsistent."

(Summary of Survey Responses From PCI Customers, continued)

"More reasonable prices, quicker turnaround on standard items."

"Wood chairs are so overpriced, we will not buy any more. Quality is great, but they're about $250 for each wood chair."

"Greater attention to small details."

"Customer service contact, hard to keep track of serving area, keeps changing."

"There is room for improvement in every office at CI or otherwise. No operation is perfect."

"We were using them more often, but it appears they have become short staffed."

"Use of Visa – SAP is difficult to use for small purchases."

"We wanted to purchase more signs and then (they) could not do them. The timing of getting the order placed is the only problem area, not delivery."

" . . . photos of the merchandise (on the Web site) would be nice."

" . . . pictures of the products would increase the usage and value of this Web site."

"Photos of the products would be helpful."

Appendix B

Survey of Potential PCI Customers

Auditors surveyed 100 potential PCI customers and received 60 responses, for a response rate of 60 percent. The numbers following each question represent the number of responses, not percentages. NR = no response.

1. Have you purchased the following from PCI during the past three years?

a) Products	Yes: 1	No: 59	NR: 0
b) Services	Yes: 1	No: 59	NR: 0

2. If you responded "No" to question no. 1, what are the reasons why you have not purchased from PCI?

36	I was unaware of PCI.
13	I was unaware that my organization could purchase from PCI.
19	I was unaware of products/services available from PCI.
0	PCI does not have competitive prices.
7	PCI does not have quality products.
0	PCI does not have quality products/services.
0	PCI delivery time for products was unacceptable.
14	Other reason.

3. Please identify which, if any, of the following products and services you did not know were available from PCI.

Modular office systems	30
Precision metal	27
Vehicle restoration	31
Soap and detergent	29
Plastic bag production	32
Signs, engraving, and stickers	32
Cannery (fruits and vegetables)	29
Garments, hosiery, shoes, textiles, underwear, cardboard cartons	25
Silk screening and embroidery	39
Mattresses	26
Meat processing	30
Laundry services	29
Mail distribution services	32
Freight terminal services	30
Optical lab products and services	29
Fine wood furniture (tables, chairs, shelving, wood flooring, etc.)	29

4. Are you aware of PCI's on-line product catalog?

   Yes: 7 No: 52 NR: 1

5. Are you interested in learning more about PCI and/or receiving a copy of PCI's on-line products catalog (www.bighouse.state.pa.us/catalog)?

   Yes: 45 No: 15 NR: 0

Appendix C

Response from PCI/Department of Corrections

The full response from the Department of Corrections is reproduced beginning on the next page.

COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF CORRECTIONS
P. O. BOX 598
CAMP HILL, PENNSYLVANIA 17001-0598

OFFICE OF THE
SECRETARY OF CORRECTIONS

August 23, 2005

The Honorable Jack Wagner
Auditor General
Pennsylvania Department of the Auditor General
Room 229 Finance Building
Harrisburg, PA 17120

Dear Auditor General Wagner:

We have received your draft copy of the performance audit of Pennsylvania Correctional Industries for the period of July 1, 2000 through February 18, 2005. My staff and I appreciate the opportunity to review it and offer comments.

Overall, I believe the audit provides a fair assessment of Pennsylvania Correctional Industries. Recently, PCI has encountered a rapidly changing business environment and, in my estimation, has made a conscientious effort to respond to declining state and municipal budgets and adverse economic conditions by revising plans and redirecting resources. My Department will consider your recommendations as we continue to improve PCI business practices.

Following are comments concerning the specific issues you raised in your findings:

Finding 1: This finding discussed PCI's role in employing inmates and preparing them for reentry. The work experience PCI provides to inmates is a valuable contribution to the Department's overall reentry strategy. PCI work experience complements treatment and education programs run by other DOC offices. PCI, itself, has limited ability to participate in reentry efforts, which are conducted by the Bureau of Inmate Services and the Bureau of Community Corrections. PCI also has limited ability to conduct meaningful research on the effect of inmate work experience on recidivism. However, a number of studies at the national level have shown a positive correlation of prison work programs to reducing recidivism, which is fundamentally why most states, many large counties, and the federal prison system all provide inmate work opportunities through prison industries.

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In the past two years, PCI has initiated a close partnership with the Department's Bureau of Corrections Education and has taken steps to better align industry programs with education programs. These steps will allow a greater synergy to improve reentry programs by providing inmates with a well-rounded experience of education, vocational training, and work experience. PCI's coordination with Corrections Education takes advantage of the Department's job assessment research with the Department of Labor and Industry, which will better focus PCI inmate work experiences on job classifications more likely to result in post-release employment.

PCI inmate employment is lower today than in previous years for two main reasons. The first reflects closure of PCI-run farms a number of years ago. These employed large numbers of inmates but were not profitable. The second reason concerns Strategic Sourcing; a Pennsylvania Department of General Services initiative to reduce procurement costs of the Commonwealth. Many of the areas that DGS targeted contracts for savings involved products previously provided by PCI. With the absence of a mandatory use law for PCI, and with PCI's relatively small business structure, PCI could not compete with the large suppliers selected for the contracts. As a result, the Meat Processing Plant, the Cannery, the Plastic Bag Factory, and the Metal Furniture factory were closed, and the Soap and Detergent Plant was reduced in size. These closures resulted in the loss of approximately 150 additional inmate jobs. PCI is currently participating in the Strategic Sourcing effort for print products. We currently employ 50-75 inmates in this area but this could change, depending on the strategic sourcing decision.

Replacing these inmate jobs is extremely difficult. PCI must first determine a product that their limited customer base needs and wants to purchase, and then determine if they can provide the product or service at a competitive price and at the quality desired by the customer. These industry initiatives are often expensive and can require substantial investments from the manufacturing fund. Finally, when a PCI initiative is successful (such as the veterans graveside marker product line that you footnote in your report), they are criticized by competitors in the business community for unfair competition. One solution to these problems is adopting the Prison Industry Enhancement Certification Program (see discussion of PIECP under Observation).

With respect to the employment of "lifers", there are several reasons why these inmates are not excluded from PCI employment. While preparing inmates for reentry is a stated objective of the industries program, PCI provided jobs reduce inmate idleness. By providing a productive and therapeutic outlet for inmate energy, PCI jobs contribute to the smooth operations within the prison. Furthermore, the life skills such as discipline, working with and respect for others, and respect for authority apply equally to those with longer sentences as they do to those nearer release. The fact that PCI

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jobs are some of the most desirable in the prison offers incentive for inmates employed there to avoid misconduct that would result in the loss of those jobs. Finally, there are operational reasons that make employing lifers reasonable. Like any business, employee turnover has a negative impact on productivity, and a certain amount of consistency in the workforce is desirable.

Finding 2: This finding discussed PCI's profits and accumulation of cash and investments in the Manufacturing Fund. To characterize the cash and investments as a "surplus" or stockpile of excess unused funds, as the Department of the Auditor General does, is an oversimplification of the matter. PCI presented its long-range plan for investing Manufacturing Fund resources to the audit team. In recent years, PCI investments have focused on modernizing or installing new industries. Some examples of these expenditures that have been made, or are in progress, accounting for approximately $22M of the Manufacturing Fund, are listed below. Although high, the current Manufacturing Fund balance is not adequate to fund all of the industrial expansion in PCI's long-range plan.

- Modernization of soap and detergent factory at SCI-Huntingdon- $1M
- Modernizing the license plate and metal factory at SCI-Fayette- $3M
- Establishing an industrial laundry at SCI-Graterford- $3M
- Establishing a Commissary distribution industry- $3M
- Installing an industrial laundry at the newest prison at SCI-Forest- $9M
- Modernizing manufacturing equipment at various locations- $3M
- Planning for an additional industrial laundry in the Northeast is underway, and is expected to cost approximately $10M

Expenditures related to plans for future fixed asset acquisitions or plant expansions are just one consideration in determining what might be an appropriate accumulation of cash and investments. There are others including:

- Contractual/Other Obligations – The timing and extent of future contractual obligations always should be a factor in determining the adequacy of cash and investments.

- Protection of Working Capital Position – The significance of accounts payable always should be a factor in determining the adequacy of cash and investments.

- The Existence of Possible or Expected Losses – The business climate must be assessed continuously and always should be a factor in determining the

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availability of a sufficient reserve for economic downturns or other contingencies.

The fact the above-mentioned considerations are not included in the financial statement does not preclude their existence. Accordingly, we submit the amount of cash and investments available for other purposes is substantially lower than the amount represented by the Auditor General report.

Considering that all industrial development, expansion, and capital investment comes from the Manufacturing Fund, and none comes from budget funds appropriated by the General Assembly, it would be unwise for PCI to operate on a break-even basis. Profits are necessary for the long-term growth and financial health of the business, as well as covering periods where risk of serious financial disruption might occur (such as the current efforts at industry restructuring). Like inmate jobs, the loss of revenues are difficult to replace. Simply closing shops does not eliminate all costs associated with those operations. PCI is facing some potentially difficult years financially as the full impact of the restructuring is realized.

Finally, PCI's profits on operations as a whole are not excessive. PCI's profit margins have averaged 11.54% and decreased an average of 5.03% per year since 2001. In 2004, PCI's profit margin (including the General and Administrative expenses) was 4%. This is significantly less than would be expected of a private sector business.

	(1)	(2)	(3)	
	(S)	(P)	P/S	Δ
YR	Sales	Profits	Profits/Sales	
2001	$ 44,092,688	$ 8,410,768	19.08%	
2002	$ 38,743,297	$ 5,596,287	14.44%	4.63%
2003	$ 36,082,518	$ 3,124,872	8.66%	5.78%
2004	$ 33,414,830	$ 1,335,338	4.00%	4.66%
		Avg	11.54%	5.03%

Since PCI does not track costs specifically by product or activity, it is impossible to determine the actual difference between the selling price and the actual cost. As a result, I believe that comparing pricing on specific products gives an inaccurate picture of the enterprise. Overall profit on the entire product offering more appropriately demonstrates the measure of success of business operations.

Finding 3: This finding discussed PCI pricing methods. PCI prices have become much more competitive over the past several years. As the organization has attempted to expand their customer base, PCI has won a significant number of competitive bids

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based on their pricing and quality. PCI recently reduced pricing on a number of prison-related items that saved DOC approximately $1.5M last fiscal year. In the prison supply business, there are a number of low cost suppliers offering imported goods of inferior quality. Our Department purchasing staff generally avoids these suppliers since we end up spending more to replace failed items. PCI's products, particularly in the prison supply area, are generally higher quality and longer lasting, which may also make them somewhat more expensive than discount suppliers. As noted earlier, Pennsylvania does not have a mandatory use law. Furthermore, your findings noted the relatively high level of customer satisfaction with PCI products and services. I believe that PCI's customers recognize that PCI products and services offer the best value for their scarce dollars.

<u>Finding 4</u>: This finding discussed the business practices related to keeping unprofitable factory locations operating. PCI closely monitors the financial performance of each industry location. While some locations may be unprofitable for some years, they rarely remain so indefinitely. In the listing of 14 unprofitable locations in your report, it should be noted that:

- 5 industries have been closed or restructured (SCI-Cresson, SCI-Frackville, and SCI-Greensburg closed; SCI-Albion in the process of being closed; PCI Freight at SCI-Camp Hill being restructured).
- 2 industries have been temporarily closed and will reopen next year as a new Commissary Distribution industry (SCI-Rockview, SCI-Houtzdale, along with SCI-Mahanoy which is not on the listing).
- 4 industries are now profitable (SCI-Muncy, SCI-Greene, SCI-Fayette, and SCI-Retreat).
- 3 locations (SCI-Coal Township, SCI-Cambridge Springs, and SRCF-Mercer), while still not profitable, appear to be improving financially as a result of changes put into place by PCI management.

<u>Finding 5</u>: This finding discussed the financial accounting of a sales rebate that PCI provided to the DOC in 2002. The Public Protection and Recreation Comptroller's Office as well as Pennsylvania Correctional Industries (PCI) management and other Corrections' officials disagree with the Department of the Auditor General's notion that PCI "hid" actual costs from policymakers and that "irregular accounting" associated with the rebate facilitated the same. In fact, the rebate was addressed in the DOC rebudget request to the Office of the Budget. Moreover, we strongly reject labeling the rebate as "suspect." The rebate was not illegal and there is no prohibition against rewarding best customers.

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The Department of the Auditor General (AG) is correct in stating that the rebate should have been classified as a "reduction in sales revenue." Exhaustive research on the accounting treatment of rebates confirms AG's conclusion.

Conceding that the accounting treatment for rebates would be as the AG suggests, it is still important to understand the circumstances behind the original accounting treatment. Those circumstances were as follows:

- The fair and accurate presentation of the Manufacturing Fund's net profit, for the benefit of all statement users, always has been of paramount importance. The original accounting treatment and that suggested by AG would produce the same Manufacturing Fund net profit and would not have changed the Cash Balances presented in the Governor's Executive Budget book nor in the Commonwealth's Comprehensive Annual Financial Report.

- As the AG notes, this was a one-time rebate. This was not a recurring transaction and, accordingly, there was no established accounting treatment or even the accounts in the Chart Of Accounts to handle the transaction. The circumstances at that time simply did not lend themselves to the accounting treatment that would be pursued today for this unique transaction.

As for AG's specific recommendation, there is no industry standard requiring discounts be provided to "all" customers. Accordingly, we do not believe that the rebate promoted bad customer relations. As always, PCI will continue to pursue ways to improve customer relations.

<u>Finding 6</u>: This finding discusses PCI's Sales and Marketing efforts. PCI faces difficult challenges in attracting and retaining a capable sales and marketing team. PCI sales positions are relatively low paying and do not provide a sales bonus or commission, a strong motivator that is a common practice in the private sector. The Sales and Marketing Representative classification is unique and does not lend itself to promotion or career path. As a result, Sales and Marketing representatives frequently leave PCI for higher paying opportunities or promotions elsewhere. The vacancies and resulting inexperience of new personnel makes the Sale and Marketing effort that much more difficult. PCI has two initiatives underway with the Office of Administration to address these issues- a request for a pilot project that will allow for the payment of a sales incentive, and the establishment of a Sales and Marketing Trainee and a Sales and Marketing Supervisor classification. We are hopeful that these programs will receive approval soon so that we can assess their success in improving the Sales and Marketing organization.

Finding 7: This finding discussed updated standards and procedures to control its business operations. Many PCI practices and operations are covered by current Departmental policies, and our Bureau of Standards and Practices will be happy to provide these to your audit team. Other PCI procedures are in the developmental stage and should be in place soon. PCI is scheduled for ACA Accreditation in March 2006.

Observation: In your observation, you discussed the legal limitations of PCI's customer base and the impact this has on expansion. We believe it is extremely unlikely that the Legislature will authorize sales to the public or to private enterprises in PCI's present form as a traditional prison industry. The low wage scale in our DOC institutions would raise serious concerns about unfair competition with private sector business.

As noted earlier, the Prison Industry Enhancement Certification Program (PIECP) has great promise to expand the number and relevance of inmate jobs. This federal program, which also requires Pennsylvania legislative authorization, would allow PCI to establish business partnerships with private enterprises and permit the sale of these products to the public. In PIECP, wages are paid at the prevailing rate, which serves to "level the playing field" with the competition. PIECP also contains safeguards to prevent the displacement of current jobs in the private sector. By eliminating the current business restrictions on traditional prison industries, PIECP holds the key to expanding inmate work opportunities and enhancing reentry. The DOC is currently examining how best to promote PIECP in the Commonwealth.

If I can be of further assistance in addressing any Pennsylvania Correctional Industries issues or concerns, please feel free to contact me.

Sincerely,

Jeffrey A. Beard, Ph.D.
Secretary of Corrections

cc: Executive Deputy Secretary Shaffer
Deputy Secretary Sprenkle
Mary Delutis, Comptroller's Office
Director Goldberg
Director Ringler

Appendix D

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Pennsylvania Department of Corrections

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John S. Shaffer
Executive Deputy Secretary

William D. Sprenkle, Acting Deputy
Secretary for Administration

Michael A. Farnan, Chief Counsel

Marc Goldberg, Director
Bureau of Correctional Industries

Timothy S. Ringler, Director
Bureau of Administration

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