PERFORMANCE AUDIT

DEPARTMENT OF CORRECTIONS

ARIZONA CORRECTIONAL INDUSTRIES

Report to the Arizona Legislature
By the Auditor General
September 1991
91-13

DOUGLAS R. NORTON, CPA
AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

September 30, 1991

Members of the Arizona Legislature

The Honorable Fife Symington, Governor

Mr. Samuel A. Lewis, Director
Arizona Department of Corrections

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Corrections, Arizona Correctional Industries (ACI). This report is in response to a June 14, 1989, resolution of the Joint Legislative Oversight Committee.

The report addresses ACI's inability to operate in a self-supporting manner due to several poor business practices. We found that although ACI has reduced the size of the losses experienced by its predecessor, ARCOR, it has yet to demonstrate that it can achieve the statutory mandate of self-sufficiency.

My staff and I will be pleased to discuss or clarify items in this report.

The report will be released to the public on October 1, 1991.

Sincerely,

Douglas R. Norton
Auditor General

DRN:lmn

Enclosure

2700 NORTH CENTRAL AVENUE • SUITE 700 • PHOENIX, ARIZONA 85004 • (602) 255-4385 • FAX (602) 255-1251

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Corrections (DOC), Arizona Correctional Industries. The audit was conducted in response to a June 14, 1989, resolution of the Joint Legislative Oversight Committee as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§ 41-2351 through 41-2379.

In 1987, the Legislature established Arizona Correctional Industries (ACI) to provide employment for inmates, reduce inmate idleness, manufacture goods, and provide services needed by State and local governments, nonprofit organizations and the general public. The program is required to be self-supporting as of July 1, 1991. Unlike its predecessor, Arizona Correctional Enterprises (ARCOR), ACI operates under the direct control of the Director of the Department of Corrections and does not have a separate Board to provide private industry expertise. According to the Department, ACI has corrected many deficiencies which existed under ARCOR. ACI has also reduced the size of the losses experienced during the ARCOR years. However, ACI has yet to demonstrate an ability to meet its statutory mandate of self-sufficiency.

Poor Business Practices Hamper ACI's Ability To Become Self-Supporting **(See pages 5 through 14)**

In part, ACI has not become self-supporting due to a number of inadequate business practices. Most importantly, ACI's sales effort is poorly planned and managed, and sales fall far short of what is necessary to sustain its operations. Over the past few years, ACI has remained in business only by relying on State appropriations and its revolving fund reserves rather than generating sufficient sales to support the program.

ACI lacks a sales plan and program to effectively market its products and services. It has no structured sales approach to guide its four-person sales staff. Sales representatives do not work from a written schedule, nor do they use a formal plan of action. We found that the three sales staff involved in selling ACI's general product line averaged only eight

customer contacts per day (including telephone calls), and that large blocks of time (as much as four hours in a day) are not accounted for. The weak sales effort results in a limited customer base. ACI relies on sales to two major customers, DOC and the Department of Transportation, which purchases license plates. These two customers generate nearly 70 percent of ACI's sales revenue. Some potential customers on ACI's master list of State and local agencies, school districts, and hospitals are not contacted by ACI sales staff. In fact, the few new customers ACI obtains each year appear to result mostly from the customers contacting ACI, not from sales contacts.

In addition to problems with sales, we identified several other poor business practices that any business could not sustain and remain in business.

- ACI's overhead may be too high for its sales volume.
- Internal budgets do not provide an accurate picture of expenses and are not always maintained and updated.
- Financial information available to shop supervisors is not timely. One shop supervisor we interviewed was so unaware of his shop's financial status that he was under the impression his shop was making a profit when, in actuality, it was operating at a loss.
- ACI's approach to product pricing is not competitive. For example, ACI overbid a print job by two and one-half times the price offered by the winning competitor.
- Production scheduling is not conducive to timely delivery because shops maintain a limited inventory of finished products.
- Shop staffing is not always adjusted when workload and revenue decline.

While ACI has spent time and effort developing plans to improve the program, it has not been able to meet some of the goals it established. Instead, ACI has relied on its revolving fund reserves to continue operations.

To Meet Its Mandate, ACI May Need Further Changes **(See pages 15 through 21)**

The Legislature and the Director may need to take further steps to address ACI's deficiencies. It is not operating in a self-supporting

manner, nor is it employing a sufficient number of inmates. We reviewed financial information on shop performance for fiscal years 1988-1989 through March 31, 1991. Only three of twenty industries that ACI operated during that time have realized a profit. Several shops have lost substantial amounts of money. For example, the print shop has lost over $400,000 during the three-year period. ACI's only consistently profitable business is its license plate shop, which earned gross profits of almost $2 million during the three-year period reviewed. However, these earnings were still insufficient to offset losses sustained by most of ACI's other enterprises.

In addition, ACI employs fewer inmates today than it did when it was first established. In 1987 ACI employed 750 inmates, almost 8 percent of the total prison population at that time. Today ACI employs only about 535 inmates, 3.7 percent of the inmate population. Other states we contacted employ at least 6 percent of their inmate population, and some employ over 10 percent.

Near the end of our audit ACI took several steps in an effort to improve. A new marketing program was developed to assist the sales staff in increasing sales. In addition, staff and shop overhead was reduced by eliminating 18 positions and relocating some shops. Finally, ACI developed a strategic plan that, if met, will allow ACI to achieve break-even status this fiscal year and net profits in future years.

The Legislature should monitor ACI's attempts to achieve self-sufficiency this fiscal year. If ACI is unable to achieve this goal for fiscal year 1991-1992, other options for the program should be considered. One option is restructuring the program. Two states, Florida and Mississippi, have restructured their programs. Florida's program has been operated by a non-profit corporation since 1981 and has realized a profit every year since 1984. In 1990 Mississippi created a private, nonprofit corporation to manage its prison industries. Another option is retaining ACI within the Department of Corrections, but making whatever personnel and organizational changes are needed to bring success.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Corrections (DOC), Arizona Correctional Industries. The audit was conducted in response to a June 14, 1989, resolution of the Joint Legislative Oversight Committee as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

Background

In 1981, the Legislature created Arizona Correctional Enterprises (ARCOR) for the purpose of employing inmates to provide services and to manufacture various products for use by State agencies or for sale to the general public.[1] ARCOR was intended to be managed cooperatively between a nine-member advisory board (all of whom were to have private industry experience) and the Director of the Department of Corrections. However, after five years of operation ARCOR faced numerous operating and internal control problems. A 1986 review of ARCOR by the accounting firm of Arthur Andersen & Co. revealed that ARCOR needed to improve internal controls in the areas of cash receipts and disbursements, accounts receivable and payable, and inventory. That review also found that management's decision-making process often was not well documented and there was inadequate up-front analysis of contemplated projects. In ARCOR's last two years of operations, it had net losses of $1.8 million and $2.7 million, respectively.

In 1987, the Legislature replaced ARCOR with Arizona Correctional Industries (ACI) as a division under the authority of the Director of the Department of Corrections. According to the Assistant Director over ACI, the Arthur Andersen & Co. report resulted in the implementation of a number of operational changes:

- Development of an internal operational budget

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(1) Prior to this time, correctional industries were operated in the State prison in Florence. Most of the enterprises manufactured goods and services to be used within the institution rather than for sale to other governmental agencies or to the public.

- Specific internal accounting controls that pertain to cash receipts, cash disbursements, accounts payable, accounts receivable and inventory
- Ongoing restructuring to curtail losses, maintain ACI's cash position and improve ACI's image.

Although part of a State agency, ACI was expected to operate like a private business with revolving account funds generated through the sale of goods and services. To achieve this goal, the Legislature initially provided $2.1 million, but mandated that ACI become self-supporting by July 1, 1989. The Legislature later extended this effective date to July 1, 1991, at the Director's request. ACI, with no State appropriations, is expected to effectively and efficiently employ inmates to reduce inmate idleness, produce and market quality products and services primarily to meet the needs of State and local governments and non-profit organizations, and to operate according to sound, professional business practices.

Current Operations

The administration of ACI is coordinated through three bureaus, Operations and Agribusiness, Business and Finance, and Marketing and Sales, with a current staff of 49 full-time employees.(1) ACI staff are responsible for managing, operating, and supervising industrial and agribusiness enterprises that employ inmates committed to the State prisons under the jurisdiction of the Department of Corrections. An average of 535 inmates are employed by ACI each month. Inmates that work in ACI shops can earn up to $.80 per hour and inmates that provide contract labor earn minimum wage. ACI wages are substantially higher than the wages earned by inmates in DOC's other work program, Work Incentive Pay Plan (WIPP), where inmates earn an average hourly rate of $.26. Typically, the inmates that work for ACI have higher skill levels, thus are able to obtain the higher paying jobs.

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(1) During the audit, ACI was staffed with 67 full-time employees. Near the end of the audit (July 1991) ACI announced the elimination of 18 positions in an effort to reduce overhead costs. This reduction in staff is to be completed by mid-September 1991. Additionally, another position is expected to be eliminated in early 1992.

ACI businesses include metal fabrication; the manufacture of license plates, bedding, signs, vinyl binders, and office products; farming; furniture refurbishing; data entry; graphic arts; rebate fulfillment (i.e., coupon processing); and sewing. ACI's catalog lists over 600 standard products. Two-thirds of these products are on a State contract as authorized by the State Procurement Set-Aside Committee. In addition to manufacturing and agribusiness, ACI provides employment opportunities for inmates with private sector companies through both contract labor and joint ventures.

Most of ACI's industries have not been profitable. Only three of the twenty enterprises that operated during the last three fiscal years have made a gross profit. ACI's leading enterprise is the license plate shop, which manufactures license plates for the Department of Transportation. ACI has also had some success with its copying service and metal fabrication shop. As of the third-quarter of fiscal year 1990-1991, ACI had a loss of $857,040 before receiving a State appropriation.

Scope And Methodology

This audit was conducted as part of the Sunset Review of the Department of Corrections as defined by A.R.S. §41-2352. The purpose of the audit was to determine whether ACI is needed and the extent to which it has accomplished its statutory goals. The audit focuses primarily on ACI's efforts to achieve self-sufficiency as well as serving its purpose of employing inmates and operating according to sound business practices.

During our audit, we utilized the services of a volunteer consultant, Mr. Morton Leeper, in our review of ACI's sales program. Mr. Leeper has an extensive background in managing a national sales program as well as experience in owning and operating a small chain of retail businesses. This expertise proved invaluable in evaluating ACI's sales program.

We also contacted several states for comparative information.(1) These states were selected based on the recommendation of various individuals

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(1) States contacted include California, Florida, Michigan, Minnesota, Mississippi, Nevada, New York, Texas, and Washington.

having extensive knowledge of prison industries across the country. The Federal prison industry program, UNICOR, was also contacted.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Director of the Department of Corrections and Assistant Director and staff of Arizona Correctional Industries for their cooperation and assistance during the audit.

FINDING I

ACI'S POOR BUSINESS PRACTICES HAMPER ITS ABILITY TO BECOME SELF-SUPPORTING

ACI's poor business practices hamper its ability to become self-supporting. ACI operates with a weak sales effort and other inadequate business practices that other businesses could not tolerate and still survive. While many of these problems have been previously identified in ACI's business and strategic plans, the problems still persist.

ACI's Sales Efforts Are Weak

ACI's sales program is not adequate and does not generate sufficient revenue to meet its operating costs. Lack of a systematic sales approach and inadequate oversight of the sales staff may be two reasons the program is not effective. The ineffectiveness of the program has forced ACI to rely on its revolving fund to support its operations.

ACI does not generate sufficient sales - ACI does not achieve the sales volume necessary to become a self-supporting business. Financial statements prepared by ACI[1] indicate that for the first three quarters of fiscal year 1990-1991, production costs for the products and services it sold were $124,219 more than ACI's gross revenues of $3.9 million.

Because of insufficient sales, ACI shops operate at less than full capacity. Each shop is dependent on the orders generated by its sales staff to keep it operating throughout the year; therefore, each shop is unable to operate at desired levels without sufficient sales efforts. At the time of the audit, we found that eleven of ACI's fourteen shops were

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(1) These are unaudited financial statements, which have not been fully adjusted for accruals such as accounts receivable and accounts payable.

not operating at full or, in some cases, even 50 percent capacity due to insufficient sales. For example, the bedding shop was operating at 25 percent capacity due to a lack of sales.

<u>Lack of a systematic approach and inadequate supervision may be reasons ACI's sales program is ineffective</u> - ACI lacks a sales plan for effectively marketing its products and services. At the present time, ACI has three sales representatives that are responsible for selling all ACI products and services throughout the State. A fourth sales representative is solely responsible for selling to the Department of Corrections and for selling metal fabrication products outside the State. While the territory covered by each sales representative is large and the types of products and services ACI sells are quite diverse, ACI has no structured approach to sales that would provide direction for effectively marketing all of its products and services. ACI does not use a listing to record and monitor customer purchases or the date of next contact. All client documentation is the responsibility of the individual salesperson and is not part of an overall sales effort.

Unlike the sales representatives in most states we surveyed, ACI's sales representatives do not work from a written schedule or use a formal plan of action which typically outlines a sale representative's planned sales contacts for an upcoming week. Instead, ACI uses a customer list as a guide for its sales representatives. This list is basically a listing of all State and local governmental agencies, school districts, and some hospitals that is divided among three sales representatives. However, some agencies on the list have never been contacted by an ACI sales representative. For example, when we reviewed a client list with one sales representative, he noted that he had primarily sold products to about 50 percent of the agencies that were assigned to him. When asked about the other agencies, he stated that he would not contact some of them because he felt they lacked sales potential, he was unaware of the location of some, and was apparently unaware of others on his list because he indicated that reviewing the list was an "education" for him.

In addition, ACI's efforts to broaden its customer base are limited. For instance, we found that new customer contacts were made infrequently by sales staff. For the first ten months of fiscal year 1990-1991, ACI received orders from 40 new customers. Follow-up interviews with 22 of these new customers revealed that nineteen orders were initiated by the customer rather than obtained as a result of a direct sales effort by ACI sales staff. Some of the customers we spoke with indicated that they initiated the sales order based on their knowledge of ACI products or by word of mouth from a previous customer. Rather than developing and expanding its customer base, ACI relies largely on sales to two major customers. ACI's largest customer, DOC, requires that the divisions within the Department purchase from ACI whenever possible. An analysis of customer sales for the first ten months of fiscal year 1990-1991, revealed that sales to DOC amounted to approximately 37 percent of ACI's sales revenues. An additional 32 percent of ACI's revenue is generated from sales to the Department of Transportation.

In addition to the lack of a systematic sales approach, ACI sales staff may also lack the necessary supervision to ensure that they sell to their optimum potential. While sales staff are meeting quotas set for them, these quotas could be raised. An analysis of how the sales staff spend their time shows a potential to increase sales. Sales staff are not required to report their time; therefore, their time cannot be adequately monitored to ensure it is utilized in an efficient and effective manner. We analyzed eight weeks of daily logs maintained by three sales representatives during the course of our audit.(1) We found that the sales staff made, on average, eight customer contacts per day (which includes telephone contacts). At least 19 percent of these contacts were oriented more toward customer service than toward generating sales.

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(1) At the time of the audit, one sales representative was solely responsible for selling modular office furniture. Because the nature of this business reduces the number of calls that can be made, this sales representative's contacts were not included in our analysis.

Activities such as attempts to resolve problemswith current orders and picking up and delivering bids, purchase orders, and products were frequently cited. In addition, we found that large blocks of time (as much as four hours in a day) were not accounted for.

ACI needs a more systematic approach to its sales program. A common practice in private industry sales programs is to have sales personnel prepare detailed schedules for sales contacts and to log their sales contacts. A schedule and a daily log for recording sales activities, should be used for a variety of reasons: (1) to track sales calls, (2) as a training device, (3) to monitor sales by customer, (4) to systematically add new customers or delete nonproductive customers, and (5) to computerize, by customer, the results of sales efforts. Many major corporations use schedules and daily logs as part of their sales programs. In addition, of the seven correctional industry programs that we contacted about their sales programs, six indicated that their sales staff maintained daily logs that contained information such as the date of the last visit with the customer, the name of the person sales staff spoke with, and the nature of the contact. This information is computerized and used to monitor sales in one state. In all of the states, sales managers use the logs to monitor sales by customer.

The sales management needs to have information available, by shop, to determine the sales volume necessary to make each shop profitable. For example, California's prison industry program noted that their shops conduct break-even analyses that identify the amount of revenue needed for the shop to break even. This amount is then considered in determining the target for the sales representatives. Finally, sales management needs to instill a desire to succeed and guide the employees' energies into productive sales activity.

<u>ACI's revolving fund is used to cover its continual losses</u> - ACI's revolving fund reserves will be depleted if it continues to rely on the fund to support its operations. Although ACI has a revolving fund with a large balance (approximately $2.4 million as of May 29, 1991), the future of the revolving fund may be in jeopardy without increased sales. In the

last two fiscal years, ACI received approximately $1.9 million from State appropriations and from the sale of assets.[1] This infusion of funding helped cover operating losses of more than $1.7 million during this period.[2] However, this funding will not be available in fiscal year 1991-1992. Should such losses continue, ACI could deplete its entire reserve within a few years.

Several Other Poor Business Practices Identified

In addition to problems with sales, we identified several other poor business practices that any business could not sustain and remain in business. Together, the practices listed below have resulted in ACI's inability to effectively manage its operations in a competitive, businesslike manner.

- High Overhead - ACI appears to operate with high overhead costs. ACI's general and administrative expenses have been approximately 16 percent of sales. Personnel, one-half of which are in the central office, comprise most (72 percent) of ACI's overhead. In contrast, Florida's general and administrative expenses are about 10 percent of its total sales of approximately $81 million.

  The profitability of the shops is further hampered by having to carry unplanned staff overhead. For example, while ACI had planned to decrease staff costs in fiscal year 1990-1991, no cuts had been made and, as of April 30, 1991, ACI had spent $89,248 more than it had budgeted for in personnel costs (salaries and ERE). However, in July 1991, ACI announced a reduction in staff of 18 positions which ACI anticipates will result in an annual cost savings of approximately $590,000.

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(1) During fiscal year 1989-1990, ACI sold its dairy herd, livestock herd, dairy, slaughterhouse and hog operations, and received $385,463.

(2) ACI's operating losses would have been even greater, however, ACI changed its accounting procedures to allow it to recognize revenue from license plate sales when the contractual obligations were completed to provide a better matching of revenues and expenditures. This change resulted in an increase in revenue and net income by $909,783 and $162,551, respectively for fiscal year 1989-1990.

- Budgeting - ACI's internal budgeting process could be improved. During our review, we identified two shops that have operated without a budget for fiscal year 1990-1991. The vinyl binder shop had been considered for closure at the beginning of the fiscal year. As a result, ACI never established a budget for that shop. However, the shop was not closed and has been operating without a budget for the entire year.(1) In addition, the sewing shop in Florence, which began operation halfway through the fiscal year, has also operated without a budget for fiscal year 1990-1991.

- Shop Financial Information - During our interviews with shop supervisors, we found that one supervisor was under the impression he was making a profit, when the shop was actually operating at a loss. Other shop supervisors indicated that they were unaware of their financial status. Further, some supervisors told us they do not receive budget information on a timely basis. And, according to one regional administrator, his biggest problem is providing the shops with the necessary financial information they need to operate in a cost efficient manner.

- Product Pricing - While ACI attempts to make a profit on the sale of its products, its approach to pricing does not appear to be sensitive to the competitive environment. Bid pricing is coordinated by ACI's customer service division.(2) Until recently, ACI had not analyzed lost bids, which would provide information on the discrepancy between ACI's bid and the winning bid as well as other competitors' bids. Of the 51 bids which ACI lost between July 2, 1990 and June 6, 1991, ACI did not have information on what the winning proposals were for 33 bids. For the 18 bids in which ACI had competitor information, we found that ACI's bids are at times, not competitive. For example, 15 of ACI's bids were priced 25 percent higher than its competitors. In addition, three of those 15 bids were priced over 100 percent higher than ACI's competitors. According to an ACI official, the Division bids what it needs to cover all expenses and to meet a predetermined profit margin. However, if its expenses are too high or if the profit sought is too large, ACI cannot compete. ACI needs to analyze lost bids on a regular basis to determine its competitive position and what adjustments, if any, are necessary.

- Production Scheduling - The manner in which ACI schedules its production is not conducive to timely delivery. ACI operates with a job shop approach in which it carries a limited finished goods inventory, and shops are not allowed to begin production until a work order is received. Thus, in many cases, customers must wait (up to 8 weeks) for delivery of their order, which may result in their buying elsewhere. This method of production scheduling was identified in 1988 in ACI's strategic planning process as in need of revision. ACI's business plan noted that ACI should transfer its method of operations from a job shop to a mass production approach in which stock is produced for inventory rather than to fill an order. (For more information on ACI's business plan, see pages 11 through 13.)

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(1) According to the Assistant Director, for fiscal year 1991-1992, the vinyl binder shop's budget will be combined with the sign shop's budget.

(2) Bids are forwarded to the appropriate shop to prepare a cost-of-manufacturing estimate and then returned to customer service to prepare the paperwork and preliminary pricing.

- Shop Staffing - Staffing at ACI shops is not always adjusted in response to the changing workload. For instance, in April 1991 the sewing shop in Douglas was reduced from two shifts to one due to a reduction in workload. When the two shifts were running, there were two supervisors on each shift who were responsible for up to 50 inmates per shift. However, the consolidation of the shifts left four supervisors plus a shop manager on one shift who are supervising approximately 50 inmates. According to the Assistant Director, staffing at the Douglas shop was based on projected orders from DOC. However, during the year actual orders from DOC fell far below projections. Anticipating orders would eventually increase, ACI didn't adjust staffing because of the length of time it would take to reduce the work force following the State's reduction in work force procedures.

ACI Has Not Adequately Addressed Its Operational Problems

Despite operational problems, ACI has not taken the actions necessary to overcome its weaknesses. A business plan developed in 1988 identified the main weaknesses in ACI's operations and outlined a strategy to improve the program. However, the steps ACI has taken have not been sufficient to turn the program around.

Plan identified weaknesses - A business plan developed with the assistance of an outside consultant in 1988 identified the weaknesses ACI needed to address to become a successful enterprise. As part of a strategic planning effort initiated in 1987, ACI utilized the services of an outside consultant to help design a business plan. The consultant who had worked with the State of Florida in developing its successful PRIDE program assisted in developing a business plan to guide future program efforts. ACI's business plan was seen as the foundation upon which it could work toward a self-sufficient enterprise. The plan identified the strengths and weaknesses facing the program and outlined a specific plan of action to turn the program around.

Key weaknesses that had to be overcome were clearly spelled out in the business plan. The plan notes that any business, including ACI, must identify and quickly address its weaknesses in order to successfully achieve its objectives. Among the major program weaknesses identified were the following:

- Sales - The plan noted that ACI's customer base was too small, its sales volume was too low, and the Division depended too heavily on

its license plate (tag) operation. In addition, ACI had not adequately penetrated the State purchasing market. In its assessment of ACI's external business environment, the business plan stated that a dramatic increase in sales volume was needed.

- New products - The plan identified the need to develop new products and industries, and the need to develop a product design and improvement function. Again, in its assessment of ACI's business environment, the plan recognized the need to employ more inmates in more shops and to improve the affordability of ACI products.

Twenty-one additional weaknesses were identified at the time, many involving ACI's internal operations and management control systems. Many of these weaknesses are similar to those we identified during our review.

The plan also spelled out the strategies and goals designed to overcome ACI's weaknesses and operational problems. Many of these strategies and goals were specific and measurable and included dates for implementation. For example, the plan called for an increase in the number of eligible inmates employed in the program, an increase in sales volume, and the development of new industries. It set goals of increasing the number of inmates employed to a minimum of 750 inmates and for increasing the percentage of sales from new customers from 5 percent to a minimum of 8 percent. It also established a goal of developing more concept papers for new industries. Most of these goals were to be achieved by December, 1988.

Steps taken insufficient - While the plan spelled out actions needed to improve, it was never approved by the Director. Instead, the business plan was subsequently replaced by strategic plans as part of a Department wide integrated planning effort. The strategic plans reflect the general objectives outlined in the business plan.

Despite having developed a business plan and subsequent strategic plans, ACI has not taken sufficient actions to meet the statutory objectives of becoming self-sufficient and employing inmates. The number of inmates employed by the program has not increased since the plan was developed in 1988. In fact, fewer inmates are employed by ACI now than in 1987 (see Finding II, pages 17 through 18). In addition, sales are still not adequate to support the program and cover all costs. Furthermore, ACI

has not concentrated its efforts on broadening its customer base. In fact, sales from new customers in the first eleven months of fiscal year 1990-1991 represented only 2 percent of total sales. Finally, ACI has not always adequately researched new industries and/or products prior to implementation. While the business plan called for ACI to complete concept papers on several new industries and product opportunities, our review of the concept papers revealed that the information compiled was inconsistent and, in some cases, lacked important elements (such as a cost benefit analysis).

Perhaps the most serious departure from the business plan has been ACI management's reliance on the revolving fund reserves to cover the losses of its unprofitable shops. The business plan viewed the revolving fund reserves at the time as a strength of the program. In fact, the plan asserted that funds in the revolving fund account, while a strength of the program, "may not yet be sufficient to meet capital needs." By relying on revolving fund reserves to continue operations, ACI may have "mortgaged its future" by jeopardizing its ability to respond to its future capital requirements. Thus, the reliance on the revolving fund without adequate sales to support the program will weaken ACI's financial condition, and make its goal of becoming self-sufficient even more difficult to attain.

RECOMMENDATIONS

1. ACI should develop a more structured sales program by

    - requiring sales staff to maintain daily logs of their activities, such as the date of the last visit with the customer, the name of the person the sales representative spoke with and the nature of the contact,
    - maintaining a data base for all customers to allow easy access by sales staff to monitor customer histories and to use such data to plan future sales contacts, and
    - placing greater emphasis on securing new customers.

2. ACI should conduct a comprehensive review of all of its business practices and identify areas that will enable it to operate in a more efficient and cost-effective manner. This analysis, at a minimum,

should address ACI's sales program, overhead expenses, internal budgeting, shop financial information, product pricing and shop staffing.

3. To reduce operational losses, ACI should closely study each of its shops to determine which shops may not become profitable within a reasonable period of time, and perhaps should be closed.

FINDING II

TO MEET ITS MANDATE, ACI MAY NEED FURTHER CHANGES

The Legislature and the Director may need to take further steps to address ACI's deficiencies. The problems identified in Finding I, contribute to ACI's inability to operate in a self-supporting manner and to employ a sufficient number of inmates. During the course of our audit ACI took several steps in an effort to turn its program around. However, ACI has yet to demonstrate that it can achieve the statutory mandate of self-sufficiency. If ACI is unable to become self-sufficient during this current fiscal year, Arizona should consider even stronger steps taken by other states which also performed poorly in the past, but turned their programs around.

ACI Is Not Serving Its Purpose

ACI is not meeting its two prime objectives. It is neither operating in a businesslike and self-supporting manner, nor employing enough inmates.

Most shops losing money - Although ACI has reduced the size of the losses experienced by its predecessor, ARCOR, most shops are still losing money. In fiscal year 1985-1986 ARCOR had net losses of $2,768,914.(1) As of its third quarter in fiscal year 1990-1991, ACI had net losses of $567,990. However ACI's statutes require it to be self-sufficient.

Currently most of ACI's shops are losing money. We reviewed financial data on shop performance for fiscal years 1988-1989 through the first three quarters of fiscal year 1990-1991. As shown in Table 1, page 16, only three of the twenty industries that ACI operated during that time have shown a gross profit.(2) Only five shops made gross profits during any of the three fiscal years. Several shops have lost substantial amounts of money. For example, the print shop had gross losses of $400,000 during the nearly three-year period. ACI's only consistently

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(1) In fiscal year 1984-1985, ARCOR had net losses of $1,852,803.

(2) Gross profits or losses include indirect overhead allocations.

TABLE 1

ACI INDUSTRIES
STATEMENT OF OPERATIONS

Industry	FY 1988-1989	FY 1989-1990	Nine Months Ended 3-31-91	Total
Gross Profit(Loss)				
Printing	($ 96,115)	($ 123,124)	($193,015)	($ 412,256)
Hog	(202,229)	(172,403)	(a)	(374,632)
Sewing(b)	(60,100)	(171,982)	(86,943)(c)	(319,025)
Wood	(150,177)	(158,812)	(a)	(308,989)
Dairy	(91,765)	(185,451)	(a)	(277,216)
Sign	(32,103)	(86,097)	(73,859)	(192,059)
Electronics	(108,439)	(7,277)	(a)	(115,716)
Vinyl Binders	(64,486)	(38,874)	(1,002)	(104,362)
Rebate Processing	(d)		(97,580)	(97,580)
Slaughterhouse	(83,740)	(2,164)	(a)	(85,904)
Furniture Refurb.	(80,665)	(e)		(80,665)
Farm	36,767	103,440	(218,162)	(77,955)
Sheet Metal	(43,687)	(35,293)	(a)	(78,980)
Data Entry	(f)	(18,926)	(45,696)	(64,622)
Office Products	(39,233)	12,883	(36,803)	(63,153)
Engraving	(13,710)	(g)		(13,710)
Bedding	(8,318)	6,949	(8,099)	(9,468)
Metal Fabrication	(55,357)	(71,684)	127,731	690
Copy Service	37,326	72,750	(2,521)	107,555
License Plates	302,756	992,999	511,730	1,807,485
Gross Profit(Loss)	(753,275)	116,934(h)	(124,219)	(760,560)
Total Operating Expenses(i)	(1,411,600)	(1,124,852)	(887,437)	(3,423,889)
Nonoperating Income	43,780	289,590	154,616	487,986
Gain on Assets Sold		141,641		141,641
Loss before State Appropriation	(2,121,095)	(576,687)	(857,040)	(3,554,822)
State Appropriation	2,181,834	1,240,634	289,050	3,711,518
Net Income (Loss)	$ 60,739	$ 663,947	($567,990)	$ 156,696

(a) Discontinued
(b) Includes the Florence and Douglas shops
(c) Figure doesn't include losses from operation of the Florence Shop. ACI places sales and expenses for this shop in a miscellaneous category because the availability of work is sporadic. Because the sales and expenses are "miscellaneous", no overhead is allocated. As of March 31, 1991, the operating loss was $11,469
(d) Began operation in June 1990
(e) Combined with the Office Products shop
(f) Began operation in February 1990
(g) Combined with the Sign shop
(h) This amount includes $308,016 of losses from discontinued agribusiness operations and $104,770 of losses from disposal of assets
(i) Includes selling and general and administrative expenses

Source: ACI unaudited Financial Statements for Fiscal Years 1988-1989, 1989-1990, and as of the third quarter Fiscal Year 1990-1991

profitable enterprise is its license plate shop, which earned gross profits of almost $2 million during the period reviewed. However, these earnings were insufficient to offset the losses sustained by most of ACI's other shops.

As noted in Finding I, pages 8 through 9, ACI has been able to cover its losses by relying on reserves from its revolving fund. However, unless its business practices change, revolving fund reserves will be depleted in a few years. At that point, ACI will need an appropriation from the State's General Fund to continue, or it will have to shut down.

This problem was pointed out to the Director of Corrections in 1988. In its 1987-1988 annual report, the Assistant Director indicated in a letter to the Director that ACI's mandate of self-sufficiency by July 1, 1989 was unachievable. At that time, the revolving account was used to fund existing operations, including maintenance and repair costs and expanding into new industries. The revolving fund could not, in addition, absorb all ACI payroll costs. However, the letter stated that ACI could maintain self-sufficiency by closing selected nonprofitable industries and agribusiness. The Assistant Director proposed abolishing six industries and all agribusiness. This would result in five industries remaining, employing 160 inmates and generating an estimated profit of $136,000. Finally, the letter urged that the critical decision must be made to either maintain financially unstable programs for inmate employment purposes or eliminate unprofitable industries to achieve self-sufficiency. The Director's position has been to consider ACI first and foremost as an inmate work program. He has been reluctant to close enterprises and reduce inmate jobs, in part, due to security concerns. Lack of work for inmates results in idleness, which can become a serious security matter. Additionally, the Director, before closing any shops, wanted every effort made to make the programs succeed. Therefore, ACI has continued to run unprofitable enterprises.

<u>Inmate employment insufficient</u> - Despite the Director's desire, ACI is not employing a sufficient number of inmates. ACI was established to provide work for inmates. Prison industry jobs reduce idleness, help develop good working habits, and teach marketable skills useful to inmates in securing employment after they are released from prison.

However, this purpose is not being fully met as ACI employs only about 535 inmates, 3.7 percent of Arizona's prison population at the present time. Moreover, despite the rapid growth of Arizona's prison population, ACI employs fewer inmates now than it did in 1987. In January 1987 ACI employed 750 inmates, almost 8 percent of the prison population at that time.

Other states employ a proportionately larger number of inmates in their prison industry programs. Compared to nine other correctional industry programs we contacted, Arizona ranks last in the percentage of inmates employed. All the other prison industries we contacted employ at least 6 percent of their total inmate population; three states employ 10 percent or more. The Federal prison industry program employs 24 percent of its inmates.

The goal of achieving self-sufficiency is not incompatible with the goal of employing inmates, as the Department's philosophy seems to suggest. States we examined which have encountered difficulties with their programs, and managed to reverse their decline, have placed emphasis first on running like a business. While inmate employment levels may have been low initially, levels of employment grew over time as sales increased and businesses prospered. These states now employ proportionately more inmates than does ACI despite the fact that inmate employment is a secondary goal. (See pages 19 through 21 for further discussion of experiences in other states.)

ACI Has Taken Recent Steps To Improve

ACI has begun making changes in an attempt to improve its program:

- Sales Program - In an effort to upgrade its image and better compete in the market place, a new marketing program was developed. The new program consists of a new logo, a new catalog, product specific brochures, direct mail pieces, and new signs, stationary and business cards. ACI also plans to provide continued training to sales staff n the areas of time management, special product knowledge, sales techniques, use of the new marketing program and other sales materials. According to ACI's sales manager, the program should be fully implemented by early November 1991.

- Reduced Overhead - As mentioned earlier, late in the course of the audit ACI eliminated 18 positions, resulting in a current staff size of 49 full-time employees. Twenty-seven other positions that had been vacant were also eliminated. ACI estimates that this staff reduction will result in an annual cost savings of approximately $590,000.

  ACI also plans to reorganize some of its shops. For instance, it is considering consolidating its two sewing shops into one shop in Douglas. In addition, the management of the sign shop will be transferred to the Department. Finally, the Perryville office products shop will be relocated to Florence.

- Improved Profits - ACI's fiscal year 1991-1992 strategic plan calls for ACI to break even. To achieve break-even status, ACI has estimated revenues of $5.5 million for the current fiscal year. Seventy-six percent of these revenues are expected to come from license plate sales, farm revenues, print shop, office products and metal fabrication product sales.

Other Options May Need To Be Considered

To date, neither ACI nor the majority of its industries have become profitable. If ACI's current attempts to improve its program are unsuccessful, the Legislature and the Director may need to consider even stronger measures. Other states facing similar problems have reorganized their prison industry program. Two states have restructured, and others have undergone significant management changes.

During our audit, we asked national organizations with expertise in corrections and correctional industries to identify other states which had successful prison industry programs. We focused on three states repeatedly identified by experts - Florida, Washington, and Nevada - because those states had performed poorly in the past and found ways to turn their programs around. In our opinion, the experiences in these states are relevant to Arizona. ACI has struggled in recent years and needs to take positive steps to change its direction.

Restructuring - In the last decade, two states with problems similar to ACI's have restructured their prison industry program. In fiscal year 1980-1981, Florida's program experienced an operating loss of nearly $1 million. That year, Florida enacted legislation establishing a non-profit corporation to run the prison industries program. By 1984, Prison Industries and Diversified Enterprises (PRIDE) had assumed

responsibility for operating all of Florida's prison industries. The program operates without a state appropriation and requires inmates to return 60 percent of their base pay to the state to offset the costs of incarceration and 10 percent of their base pay for victim restitution. PRIDE has been profitable every year since 1984 and, as of fiscal year 1989-1990, has returned almost $5 million to the state for inmate care. In fiscal year 1989-1990, PRIDE achieved gross sales of over $81 million and continues to employ over seven percent of Florida's growing inmate population.

PRIDE has successfully improved Florida's program without some of the benefits available to ACI and other states' programs, and without using some of the statutory provisions designed to facilitate sales of its goods and services. Unlike ACI's program and programs in some other states, PRIDE is limited to selling its products to government agencies. Further, PRIDE has not taken advantage of a state law allowing its products to be certified for state purchase. PRIDE officials indicate they prefer to obtain customers by producing quality products at reasonable prices and not by forcing agencies to purchase through the certification process.

More recently Mississippi has also restructured its correctional industries program. As the number of inmates employed slipped from about 700 to 150-200, the Mississippi program faced serious problems. In 1990, to improve the program, the Mississippi Legislature also organized a private, nonprofit corporation to lease and manage the state's prison industries. A chief executive officer (CEO) with prison industry experience was hired, and an eleven-member board of directors was appointed by the Governor to direct the operation. The CEO operates and manages the industry program and reports directly to the board of directors.

<u>Management changes</u> - Other states have focused on personnel and organizational changes to improve their correctional industry programs. For example, a few years ago, legislators in Washington and Nevada began to question whether their prison industry programs should be continued since both were experiencing serious difficulties and operating at a

loss. Each of these states appointed a new director and adopted stronger business philosophies and practices. Both programs, although not necessarily truly self-sufficient, now appear on their way to achieving success and improved profitability.

Washington appointed a new director in 1988 and changed its operating philosophy. It re-wrote its mission statement to emphasize the need to run the program like a business. The director of Washington's program specifically noted that the program's performance has improved largely because of a change in philosophy, and a program that was initially established to reduce inmate idleness evolved into a program that needs to make a profit in order to operate effectively. Washington's sales have increased from about $2 million in 1981 to over $15 million today. The number of inmates employed has also increased from 200 to about 800. The Washington State program has historically received a General Fund appropriation which supports program administration. Thus, it is not, nor is it required to be, truly self-sufficient. However, it has established a goal of achieving profitability for its correctional industry fund, a goal which was reached for the first time in fiscal year 1989-1990.

In 1987, Nevada hired a new program director and began placing a greater emphasis on operating the program as a business. Over the past three years, the program more than doubled its sales (from $1 million to $2.4 million), and tripled the number of inmates employed (from 100 to 300).

RECOMMENDATIONS

1. The Legislature should monitor ACI's progress in fulfilling its goals to achieve self-sufficiency during fiscal year 1991-1992.

2. If ACI is unable to achieve self-sufficiency during fiscal year 1991-1992, two alternatives to further restructure Arizona Correctional Industries should be considered:

   - the Legislature should consider establishing the program as a private non-profit corporation, or

   - if the program is continued within the Department of Corrections, the Director should make whatever personnel and organizational changes are needed to bring success.

Arizona Department of Corrections

1601 WEST JEFFERSON
PHOENIX, ARIZONA 85007
(602) 542-5536

FIFE SYMINGTON
GOVERNOR

SAMUEL A. LEWIS
DIRECTOR

September 26, 1991

Douglas R. Norton, Auditor General
Office of the Auditor General
2700 N. Central Avenue, Suite 700
Phoenix, Arizona 85004

Dear Mr. Norton:

The Office of the Auditor General, State of Arizona, is looked upon to be the governmental entity that can be relied upon to thoroughly research facts, document findings, and present an opinion that is objective, constructive, and factual. The reports issued by that office should provide the reader with an accurate presentation of facts from which the agency can be judged on the merit of the facts as well as, hopefully, provide recommendations upon which the agency can capitalize and make improvements.

Unfortunately, this has not occurred with the ACI performance audit. Despite repeated attempts to provide the Auditor General and his audit staff with facts that should not be ignored, the performance audit that has been released contains many statements that can be proved false and/or without basis.

It is ironic that the Auditor General financial auditors have given ACI unqualified opinions regarding the reliability of ACI's financial information for the last two audited years, but the performance audit team refuses to acknowledge the facts presented and, instead, have chosen to publish an error plagued report that does not do justice to the Department of Corrections, the Office of the Auditor General, the legislature or the taxpayers of Arizona.

The errors in the report can be proven from historical data, the same historical data that has led to previous unqualified financial audits. However, the Office of the Auditor General has chosen to ignore the facts presented and reported findings that defy reality. Further, efforts to reconcile erroneous information has been

thwarted by the Auditor General's staff refusing to divulge the basis for their conclusions stating their work papers and sources are confidential information. In a review of the government auditing standards, the requirement of confidentiality of records could not be confirmed.

Specifically, ACI was compared to Nevada and Washington whose programs are described in the report as "having turned their programs around", of "businesses prospering", and, in the case of Washington, "having achieved profitability in fiscal year 1989-90." The facts are that without the appropriated money both states receive, both Nevada and Washington would continue to lose money with Washington's operating loss in fiscal year 1989-90 being in excess of $1.2 million. Despite our cautioning the Auditor General to seek the facts to insure ACI and other states are compared on the same basis, they have chosen to release mis-leading statements that give the reader the impression that other states have achieved success when this simply is not true. The Directors of both state prison industry programs have stated that state funding will continue for fiscal year 1991-92. Nevada is to receive in excess of $300,000, Washington $3.6 million. In contrast, ACI receives no state funding support but relies solely on revenue generated from the sale of goods and services provided by prison industry programs.

Also of concern is the manner in which the audit itself was conducted. After some difficulty, ACI management was able to obtain from the Auditor General the manual of Government Auditing Standards referred to in the report as the guide by which the audit was conducted. In this manual it is stated that "due professional care includes a mutual understanding of the audit objectives with the audited entity." Audit objectives and scope of the audit were to have been clearly defined and the means of measuring performance against those objectives determined. This was never done.

Any findings of the auditors should "stand the tests of sufficiency, relevance, and competence." This audit falls short of these tests. Further, the manual indicates "titles, captions, and the text of reports should be stated constructively" and this can best be done by avoiding language that unnecessarily generates defensiveness and opposition. The tone of the report does not follow these guidelines and appears to purposely attempt to influence the reader's opinion through many negative, while subjective, comments.

Finally, the audit standards call for recognition of significant management accomplishments and performance improvements. No mention is made of the significant gains made in professionalizing the ACI operations since 1986 when the organization was beset with

management problems, audit investigations of impropriety, and substantial operating losses. Nor does the report fully recognize restructuring that occurred in July of this year which resulted in a reduction in staff of 17 state employees, a new sales and marketing program, and an overall cost reduction plan that projects ACI breaking even in fiscal year 1991-92.

In short, it was my hope and that of ACI management that the audit would be conducted in a professional manner, that would be objective, and that would result in an accurate comparison of the past and present performance of ACI. I anticipated perhaps constructive ideas and suggestions to support ACI's plan to be self-sufficient recognizing the problems unique to the organization and the efforts being made to cope with those problems. The report, to be presented, falls far short of these expectations.

Consider this letter the Department's response to the ACI performance audit and Sunset Factors.

Sincerely,

Samuel A. Lewis
Director

SAL/MW/k