Secretary of State

State of Oregon

DEPARTMENT OF CORRECTIONS
Review of Prison Industries Operations

Audits Division

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No. 97-27

March 5, 1997

The Honorable John Kitzhaber
Governor of Oregon
State Capitol Building
Salem, Oregon 97310

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Department of Corrections
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This report presents the results of our audit of selected accounts of the Department of Corrections' (department) Prison Industries. The objective of this audit was to review the Prison Industries' financial records and operations related to inventories, accounts receivable, and cost of goods sold and to determine whether they are efficient and effective and that the financial records are reliable. In this regard, we inquired of agency personnel, reviewed policies and procedures, tested supporting documents and relevant reports, and evaluated management controls related to our audit objective. Other matters that came to our attention are included in this report.

Our review found that the department can make improvements in its management of the Prison Industries' inventories, accounts receivable, and the costing and pricing of services and products. The department's responses to our recommendations are included in this report.

This report is the final report in a three-phase review of the department's Prison Industries and Inmate Work Programs. The first report was issued on November 28, 1995, as an assessment of the inmate work program expenses for the period April 1, 1995, to September 30, 1995. The phase two report was issued on October 8, 1996, as a special review of the implementation of Ballot Measure 17 by the department.

OREGON AUDITS DIVISION

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Fieldwork Completion Date:
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T A B L E   O F   C O N T E N T S

SUMMARY

To reduce the cost of prison operations and to provide inmates with meaningful work experience, the Department of Corrections (department) operates several prison industries programs where inmate labor is used in production, manufacturing, and service jobs. Prison industries are operated by the department as long-term or "permanent" businesses in competition with the private sector. On November 8, 1994, Oregon voters passed Ballot Measure 17, an initiative petition to amend the state constitution, which requires all eligible inmates to work full time, and inmate work programs to either reduce the cost of government or make a profit in private sector activities. Although Ballot Measure 17 requires the department to operate its prison industries programs in a business-like fashion, the department has not established sound management and accounting practices to do so. Specifically, our review of Prison Industries found that:

- Inventories were not properly managed: deficiencies existed in record keeping, the care and custody of inventories, the separation of job responsibilities relating to moving, recording and maintaining custody of inventories;

- The cost of goods sold for the furniture factory, the upholstery shop and the garment factory may be misstated because of inconsistent and unsubstantiated methods for determining the manufacturing costs of products; prices of products may not be covering manufacturing costs because of unsubstantiated methods for determining sales prices; all the costs of operating the Prison Industries programs may not be known because not all costs are accumulated in the Prison Industries programs' accounting records; and

- Accounts receivable (amounts due to the department) were overstated by uncollectable and erroneous amounts; interest was not charged on past due accounts; the department lacked policies and procedures to control accounts receivable.

In addition, during the course of our audit, other matters came to our attention where the department needs to improve controls over its Prison Industries operations:

- Farm personnel did not bill the proper amount or charge interest on the past due amount for the grazing lease resulting in a loss of $489 in lease payments and over $365 in interest.

- A personal services contractor, hired to purchase cattle for the farm, was not always making the purchases as required by the terms of the contract.

- The farm-raised beef cattle, slaughtered at the farm, had a meat yield rate significantly lower than industry standards and lower than the farm's slaughtered dairy cattle, thus raising questions concerning the viability of the farm's cattle raising operation.

- The incentive pay for inmates working at the garment factory was not always calculated correctly and was not reviewed by non-inmate supervisory staff.

- The Prison Industries cash account has not been reconciled since June 1995.

- The enhancement and maintenance of the Prison Industries' management information system, a complex data base, is performed by the Fiscal Services Division instead of the Information Systems Division. Designing and programming functions are not separated.

The department's management generally concurred with the audit's recommendations. Several recommendations for improving the accounting for cost of goods sold are dependent on the department's cost accounting system becoming fully operational. The department plans for this to occur by June 30, 1997.

During this audit we also reviewed the status of recommendations contained in the prior report of our review of inmate work program expenses issued November 28, 1995. The department reported that it is acting to resolve one of the five findings listed in the FOLLOW-UP ON PRIOR AUDIT FINDINGS section of this report. Three of the final findings have been resolved. One finding relating to the management of inventories remains unresolved and is repeated in this report.

INTRODUCTION

To reduce the cost of prison operations and to provide inmates with meaningful work experience, the Department of Corrections (department) established several prison industries programs where inmate labor is used to produce goods and services for sale to the public and private sectors. While the department's Prison Industries has a long history, attention to the work programs has been raised to a new level with the passage of Ballot Measure 17. This measure, an initiative petition to amend the state constitution passed by Oregon voters on November 8, 1994, requires all eligible inmates to work full time and also requires inmate work programs to either reduce the cost of government or make a profit in private sector activities. To determine if it has accomplished these objectives, the department must establish and use sound practices when accounting for Prison Industries' assets and activities.

BACKGROUND

The department was established in June 1987 under the provisions of Chapter 423 of the Oregon Revised Statutes and is responsible for centrally administering state correctional institutions. The mission of the department has been to reduce the risk of criminal conduct through a partnership with communities, with a continuum of community supervision, incarceration, sanctions and services to manage offender behavior. To carry out its mission, the department was appropriated $689.8 million by the Legislature for the 1995-1997 biennium, an amount that included a special appropriation of $22 million for the implementation of Ballot Measure 17.

To maintain secure confinement of inmates, the department operates 12 correctional facilities located throughout the state. These facilities house minimum, medium, close, and maximum custody inmates in dormitories and cells. As of June 26, 1996, the department had a total of 7,254 inmates housed in its facilities.

PRISON INDUSTRIES

To help offset the costs of operating the institutions and to provide inmates with work experience, the department employs inmates in a variety of jobs at each institution. Inmates work in all facets of institutional support, government service, and also for private sector businesses. In these positions, inmates are involved with, among other things, food service, building and grounds maintenance, city and state park cleaning, new prison construction, and wood pallet manufacturing. In addition to these work activities, the department also has several prison industries programs. Prison industries are long-term or “permanent” businesses operated by the department, in competition with the private sector, using inmate labor in production, manufacturing and service jobs. Over the years, Oregon’s prison industries has become a well-established operation. In 1989, the department created Unigroup to manage and operate its prison industries. Under Unigroup, Oregon’s prison industries developed new products and entered new markets. However, shortly after Ballot Measure 17 was passed, Unigroup was abolished and Prison Industries was placed within the department’s inmate work program. The department currently operates nine prison industries programs: a garment factory, a furniture factory, an upholstery shop, a metal shop, a laundry and dry cleaning operation, a farm, a telephone answering service, a mail fulfillment service, and a map digitizing service. As of April 5, 1996, these work programs employed 571 inmates at five correctional institutions. According to the department’s financial records, the calendar year 1995 sales of goods and services for Prison Industries totaled approximately $8 million. Table 1.1 lists and describes the industries programs and the number of inmates employed at each institution.

Table 1.1
Prison Industries Programs - April 1996

Institution	Industry	Primary Goods/Services Provided to the Public and Private Sectors	Number of Inmates Assigned
Eastern Oregon Correctional Institute (Pendleton)	Garment Factory	Prison Blues line of blue denim jeans, T-shirts, sweatshirts, jackets and hickory shirts production	50
	Laundry	Commercial laundry operation	25
Oregon State Correctional Institute (Salem)	Computer-aided Mapping	Map digitizing services	37
	Telecommunications	Phone answering services	22
	Mailroom	Mail fulfillment operation	14
Oregon State Penitentiary (Salem)	Furniture Factory	Wood office furniture and alder bedroom furniture manufacturing	107
	Upholstery Shop	Upholstered office furniture, mattresses, and pillows manufacturing	17
	Laundry	Commercial laundry and dry cleaning operation	73
Oregon Women's Correctional Center (Salem)	Telecommunications	Phone answering service for Driver and Motor Vehicle Services, Secretary of State, Department of Environmental Quality-Vehicle Inspections, and several other agencies	45
Mill Creek Correctional Facility (Salem)	Farm	Cattle raising, milk and meat processing, production of grain for livestock	150*
	Laundry	Laundry sorting and delivery service	15
	Furniture Deliveries	Furniture delivery and installation	5
	Warehouse	Warehouse operations support	6
	Office Support	Prison Industries office support	5
Total Inmates Employed			**571**

* From Department of Corrections' Report to the Governor dated October 25, 1996. All other information in this table is from Department of Corrections' statistics as of April 5, 1996.

PRISON INDUSTRIES ENHANCEMENT PROGRAM

Prison Industries jobs are desired by inmates because the jobs offer an opportunity to learn marketable skills and the jobs typically pay more than other inmate work programs. As required by federal law, when inmate labor is used to produce products for interstate commerce or to fulfill contracts with the federal government that are over $10,000, inmates must be paid prevailing wages and the work programs must be certified by the federal Prison Industries Enhancement (PIE) program. The PIE program, administered by the U.S. Department of Justice, Bureau of Justice Assistance, was established in 1979 to provide limited deregulation of federal prohibitions affecting the movement of state prisoner-made goods in interstate commerce and contracts in excess of $10,000 with the federal government. Oregon was first certified by the PIE program in 1989 and currently has four certified programs, three of which are prison industries: the furniture factory, the garment factory and the map digitizing service. The fourth program, a wood pallet manufacturing operation, is managed by a private sector business. To become and remain PIE certified, a work program must: 1) pay inmates prevailing wages, 2) provide financial contributions to a victim's assistance fund, 3) consult with organized labor and local businesses that might be affected by the work program prior to start-up, 4) provide assurance that inmate labor will not displace workers in the free society, 5) provide worker's compensation, 6) provide assurance that inmate participation is voluntary, and 7) involve the private sector.

BALLOT MEASURE 17 REQUIREMENTS

While Oregon has a long history of putting inmates to work through prison industries and other work programs, these activities were recently elevated to a new level of priority. On November 8, 1994, Oregon voters passed Ballot Measure 17, an initiative petition to amend the state constitution, which requires that all eligible inmates work full time (40 hours a week) and allows for 20 of the 40 hours to be spent in education and training programs. To oversee inmate work programs, Ballot Measure 17 established the Prison Industries Board (board) which is comprised of the governor, the secretary of state, and the state treasurer. The board is responsible for regulating the department's inmate work programs, approving expenditures of the prison work programs, and for approving all private partnerships. In addition to requiring all eligible inmates to work, the measure mandates that inmate work programs either reduce the cost of government or make a profit in private sector activities. The department had until April 1, 1995, to be in full compliance with the provisions of Ballot Measure 17.

Since Ballot Measure 17 requires that inmate work programs be run in a business-like fashion, the department has determined its prison industries programs will be self-sufficient. Over the long-term, prison industries are to help reduce the cost of prison and other state agency operations by providing goods and services at or below market costs. Historically, however, some prison industries programs have struggled with meeting costs. For operations to become self-sufficient, it is vital that the department properly manage all facets of prison industries programs which include appropriate accounting for its financial activities and assets. Key areas where strong accounting controls are needed include: inventory -- the finished products for sale; accounts receivable -- the dollar amounts due from customers; and cost of goods sold -- the costs to produce and sell products. These three areas of operation also involve sizable dollar amounts. For example, as of December 31, 1995, the department had recorded for all industries $805,506 in finished goods inventory, $826,094 in accounts receivable, and $2,740,435 in cost of goods sold.

SCOPE AND METHODOLOGY

The Audits Division conducted this audit of the Department of Corrections' (department) Prison Industries as a result of the Prison Industries Board's need for assurance that financial information provided by the department for its inmate work programs was fairly presented. We completed a preliminary assessment and issued a report in November 1995 regarding inmate work program expenditures for the period of April 1, 1995, to September 30, 1995. The current audit is a continuation of our review of the department's inmate work programs and focuses on the financial issues of the department's Prison Industries operations. Specifically, this audit reviewed Prison Industries' major financial accounts: accounts receivable, inventory, and cost of goods sold.

We conducted our audit work at the department's central office and at the following industries programs: the garment factory located at the Eastern Oregon Correctional Institution in Pendleton; the furniture factory, the upholstery shop and the laundry operation located at the Oregon State Penitentiary in Salem; and the farm operation at the Mill Creek Correctional Facility in Salem. Also, the Audits Division conducted a related special review of the Department of Corrections' implementation of Ballot Measure 17. The special review was part of a cooperative effort organized for the National State Auditors Association to produce a nation-wide audit of prison industries programs. The result of Oregon's special review was issued in a separate report on October 8, 1996. The nation-wide audit report will be compiled by the Oregon Audits Division and is planned for release in 1997.

For Prison Industries' accounts receivable, we reviewed applicable laws, attorney general opinions, and policies and procedures for extending credit and collecting on accounts. We identified the number of accounts and dollar amounts due to each industries program as of December 31, 1995, and confirmed the balances owed to the department by a random sample of customers of the garment factory, the furniture factory, the upholstery shop, the laundry and the farm work programs. We interviewed department managers to identify credit application practices, aging trial balance procedures, and collection practices. We also attempted to determine the collectability of the department's accounts.

For Prison Industries' inventories, we reviewed applicable policies and procedures and followed up on prior audit findings related to inventory and purchasing. We compared inventory records and products actually on hand by selecting a random sample of inventory items from the garment factory at February 27, 1996, the furniture factory at February 28, 1996, and the upholstery shop at March 11, 1996. We observed the physical inventory count of cattle conducted at the farm from June 4 to 11, 1996, and reviewed the resulting inventory listing dated June 17, 1996. To determine actual purchasing and inventory practices, we interviewed department managers about procurement practices and observed personnel receiving and issuing inventory.

For cost of goods sold expense, we reviewed applicable policies and procedures and cost accounting practices about how the cost of finished products should be determined. We reviewed product lines to test the appropriateness of cost of goods sold transactions and determined the methods used by the department to allocate costs. We selected several products at the garment factory, the furniture factory, and the upholstery shop to identify how the production costs were determined. Finally, we interviewed department managers to determine what controls are in place to ensure that production costs are appropriate and kept to a minimum thereby allowing the inmate work program to be profitable.

To follow up on prior audit findings, we interviewed department managers to determine what steps had been taken to implement the recommendations contained in the prior review report. We reviewed pertinent documentation supporting the actions taken by management to resolve the findings. We also conducted tests of transactions relating to the problem areas to determine whether improvements had been made.

Except as qualified below, this audit was conducted in accordance with generally accepted government auditing standards. Auditing standards require auditors to be organizationally independent to avoid the possibility of perception that a supervisory relationship impaired the audit work done or the findings reported. The Secretary of State, a statewide elected official, serves as the constitutional Auditor of Public Accounts. The State Auditor of the Audits Division carries out the constitutional audit responsibility on behalf of the Secretary of State. The Secretary of State also serves as a member of the Prison Industries Board, the body that oversees the prison industries program, the subject of this report. Although the reporting relationship between the State Auditor and the Secretary of State did not impair the audit work planned or completed or the findings reported, we are required by generally accepted government auditing standards to disclose this relationship.

CHAPTER I CONTROL OVER INVENTORY

While the department has specific procedures for managing and controlling Prison Industries' inventory items, it is not always following these procedures to ensure proper care and custody of these items. Inventory is a valuable asset to Prison Industries, and management of this asset directly impacts its profitability and ability to remain viable. For Prison Industries to receive maximum value for its products, inventory items must be accounted for properly, controlled and safeguarded from waste and misuse. However, our review of finished goods inventories at the upholstery shop, the furniture factory, the garment factory and the cattle inventory at the farm found deficiencies in record keeping, proper care and custody of the inventory, and inadequate separation of some job responsibilities.

NEED FOR CONTROL OVER INVENTORY

To achieve the maximum return on an investment in materials, supplies and labor, inventories of raw and finished products must be managed with proper care and custody. Finished goods are those products that have gone through the manufacturing process and are ready for sale. By adequately protecting and storing its finished goods inventory, Prison Industries can avoid unnecessary costs resulting from damages incurred during handing and storage.

To assist with inventory management, the department has administrative rules which provide specific procedures for controlling inventory items, including guidance for conducting physical inventory counts. These rules require physical inventory counts of specified inventory types on a periodic basis, some as frequently as weekly. Annual physical inventories are to be taken as directed by the department's fiscal services administrator. These physical inventory counts are necessary to ensure that accounting records accurately reflect what is on hand and that the inventory is properly valued on the financial statements. Also, these inventory counts provide management with the assurance that products are in good condition, are available for sale, and that damage and losses are quickly identified and causes are resolved.

In addition, safeguarding of inventories includes having effective internal controls in place and operating. For example, the department should have policies and procedures for proper separation of job responsibilities to ensure that the same person does not initiate and complete all aspects of a transaction. The responsibilities for authorizing movement, recording additions and sales, and maintaining custody of inventory should be separated and assigned to different employees to help ensure that errors or irregularities will be detected. The department can also safeguard inventory items by billing on a daily basis to ensure that the high volume movement of goods is controlled. Regularly reconciling the inventory detail records with the summary records that support the financial statements is also a necessary control.

Based on our review of the upholstery shop, the furniture factory, the garment factory and the farm operations, we found that the department is not always taking the necessary steps to properly manage the inventory of the Prison Industries operations.

UPHOLSTERY SHOP

Our tests of the upholstery shop's finished goods inventory disclosed several items that could not be located and several items that were not accurately accounted for in the inventory records. We also found that required inventory counts had not been conducted for approximately four months. In addition, the inventory records do not accurately and completely describe specific items, making it difficult to locate and identify them with certainty. The department accounts for chairs used as loaners (samples) in its finished goods inventory when these chairs cannot be sold as new. Furthermore, chairs were not adequately protected from dirt and damage during storage, and chairs returned for repair may not have been handled in the most economical way.

The upholstery shop's finished goods inventory was valued at $106,792 as of May 14, 1996. The inventory is categorized by type of chair, with a distinct number assigned to each type. Within each category, there may be several different colors of chairs and some chairs that have been designated as "loaners." Loaners are chairs provided as samples to potential customers. We conducted two tests of the finished goods inventory as of March 11, 1996. First, we selected a sample of chairs from the inventory listing to verify existence. We then selected a sample of chairs in the warehouse to determine whether they were properly recorded in the inventory records.

For our first test, we selected seven categories of chairs that included 28 chairs ready for sale and 20 loaners. Of the 28 chairs listed as ready for sale, eight (28.6 percent) could not be located in the warehouse. Recorded costs for these eight chairs were $2,326. For our second test, we selected 25 chairs from the warehouse and found discrepancies in the inventory records for 12 (48 percent) of the chairs. One chair was not listed in the records. Four chairs were prototypes, and were not individually identifiable in the records. Seven other chairs in our sample, which were of the same type, were shown in the records at a count of 12. The upholstery shop staff was not able to provide documentation to explain the differences we found.

Although a portion of the inventory is required to be counted each week, the warehouse manager had not conducted these inventories for four months. Also, record-keeping problems occurred because of the wide variety of chair styles and colors in inventory. Many chairs in inventory were not accurately described in the inventory records as to color, sales order number, or customer name. Inventory that is not clearly identifiable cannot be easily managed or accounted for properly.

We also noted that the loaner chairs are maintained in the accounting records as finished goods inventory. As of March 11, 1996, 49 (14 percent) of the 349 items in finished goods inventory were identified as loaners. During our tests of inventory, we found four loaners that obviously had been used; however, these chairs were not separated from the inventory that was held for sale. Since the chairs have been used, they cannot be sold as new chairs.

Furthermore, we found the upholstered chairs were inadequately protected. A few chairs had plastic wrap covering the cloth surfaces, but others were exposed to the dust and dirt of the warehouse operations. The chairs were not organized or grouped by type and were crowded together in the storage area, therefore risking scratches or other damage.

Our review of the upholstery shop's inventory also found instances where the department may not be using the most economical practices when handling returned inventory. For example, at the time of our review of the inventory, seven straight back chairs had been returned by the customer and were waiting to be delivered inside the prison for repair. The chairs had been upholstered with the wrong fabric, the chair legs were uneven, and some of the glued joints were loose. For security reasons, the upholstery and padding had been cut off the chairs prior to sending the chairs inside the prison for repairs. It may have been more efficient and economical to replace the chairs with available new ones, then discount the defective chairs for sale or to make the repairs outside the prison, thereby preserving the upholstery.

FURNITURE FACTORY

The inventory records for the furniture shop showed differences between what was recorded and what was actually on hand when we tested a sample of furniture items. For example, several items listed in the records could not be located, several items had been delivered or damaged beyond repair but had not been removed from the inventory records, and other items we observed were not accurately accounted for in the records.

The furniture finished goods inventory was valued at $392,341 as of May 14, 1996. As with the upholstery shop's inventory, the furniture finished goods inventory is categorized by type of furniture. As with our upholstery shop audit procedures, we selected items from the inventory listing of February 28, 1996, to verify existence. We then selected items from the warehouse to trace back to the inventory records.

For our first test, we selected 346 pieces of furniture to physically observe. Of the 346 items tested, 18 (5.2 percent) could not be located. Seventeen (4.9 percent) had been delivered or damaged beyond repair and destroyed, but had not been removed from the inventory records. Finally, for four types of furniture, the inventory records showed a count of 9 more than the 59 we located in the warehouse. These errors may have created an overstatement of finished goods inventory of approximately $3,600.

For our second test, we selected 85 pieces of furniture in the warehouse. Of these 85 items tested, four (4.7 percent) were not recorded on the inventory records. For 19 items located, the inventory records showed a count of 5 more. It does not appear that these errors had an effect on the value of finished goods inventory because the overstatements nearly equaled the understatements. Regardless of the dollar effect, however, the number of errors indicate a need for improvement of controls over inventory.

One reason for the differences is that similar items are stored at multiple locations, making them difficult to locate for shipping or for inventory counts. As was also noted in the upholstery shop, the required physical inventory counts have not been taken of the furniture factory's finished goods for several months.

CUSTODY AND CARE OF FURNITURE INVENTORY

In addition, our review of the warehouse operations found that the furniture inventory was not properly cared for or protected from dirt and damage. We observed some furniture as it was moved and stacked with no precautions taken to prevent damage. In the inventory items we sampled (both furniture and upholstery) and in other inventory we observed, we found 10 damaged items valued at $2,764. Poor handling and storage of inventory may result in damage to finished goods, which becomes an added cost of the product. Damaged items need to be returned to the furniture factory for repair, resulting in diminished efficiency and profitability for the Prison Industries programs.

Also, there was a lack of separation of job responsibilities related to the inventory, resulting in incompatible functions being performed by the same employee at the furniture warehouse. These functions included (1) authorization of shipping and receiving goods, (2) recording inventory additions and sales, (3) preparing invoices for the inventory that was sold, and (4) maintaining custody of the inventory. Due to a loss of personnel at the warehouse, the one remaining employee has assumed more and more duties. In addition, incorrect information recorded by inmates was being corrected by this same employee. Subsequently, this employee has assumed the inmates' data entry duties to eliminate data entry errors. As a result of this increase in the work load for this one employee, invoices were not being prepared daily as was needed to control the high volume of inventory movement that occurs daily. Furthermore, the risk of errors actually increases with lack of a supervisory review function since the employee is now performing data entry.

GARMENT FACTORY

During our review of inventory at the garment factory, we found the inventory disorganized, making it difficult to locate specific items. We also found overages and shortages in the inventory accounting records.

Finished goods inventory at the garment factory was recorded at $398,575 as of May 14, 1996. The value of raw materials was stated at $332,461. From inventory records as of February 27, 1996, we selected 47 categories to test, including finished goods garments and raw materials. The inventory records showed 2,736 individual items in the finished goods and raw materials categories. Several types of garments we were looking for could not be located initially. It was only after extensive searching by garment factory staff that we could verify the existence of most of the inventory. However, 101 items (3.7 percent) remained unaccounted for when we completed our tests. These items were valued at approximately $1,000. In addition to these shortages, we found inventory overages. For 14 categories of garments, we counted 58 more items than what was recorded in the inventory records.

These conditions are occurring because staff has not been assigned to maintain the inventory in an organized manner. As a result, boxes of the same types of garments were stored in different unmarked locations. Shelf tags did not agree with the garments located at those sites. Some garments were not tagged to identify the style number, or were marked by part number only.

Without effective controls over inventory, sales orders may not be processed efficiently due to the time it takes to locate items. In addition, inventory may be lost and missing for long periods of time, resulting in obsolete inventory. Also, required periodic counts of portions of the inventory are difficult to perform because of the condition of the inventory.

FARM

Our tests of cattle inventory at the farm revealed differences between the inventory records and the number of cattle located at the farm. For example, a physical count of cattle was conducted by farm staff in June 1995. Twelve cattle were removed from the inventory records, but their disposition was not documented. Upon questioning, the farm manager was able to provide documentation to account for four of the 12 cattle, but the disposition of the other eight remained in question.

On March 18, 1996, we compared the cattle inventory listing with the previous physical count performed on June 28, 1995. We reviewed records for additions to the inventory from births and purchases and deletions resulting from deaths, sales and slaughtering. Adjusting the June 1995 inventory total for these additions and deletions, we determined that the farm should have 716 head of cattle at March 18, 1996. However, the farm's March inventory listing showed 28 more cattle than our estimated total. The farm staff was not able to provide documentation or an explanation for the additional cattle.

The farm staff conducted a complete physical inventory of cattle June 4 through June 11, 1996, which we observed. The staff counted 734 head of cattle. We compared the March 18, 1996, inventory listing to the June 17, 1996, listing prepared after the physical count. After adjusting the March 1996 total by the additions and deletions to inventory, the physical count was 12 cattle short of the number that should have been at the farm. However, once the inventory was complete, farm staff simply adjusted the recorded number of cattle to agree with the physical count without investigating the cause of the differences. As a result, the farm staff was not able to explain or provide documentation or justification to support the disposition of the 12 missing cattle.

The farm manager stated that some of the 12 missing cattle from the June 1996, count could be related to renumbering the animals. In the past, the same ear tag number may have been assigned to different cattle, but on a different colored tag. The farm manager stated that the ear tags faded in the sun, and it became difficult to determine the color. This created problems in determining which ear tag number should be taken off the inventory as each animal was sold or slaughtered. To correct this problem and to avoid duplicate numbers, the farm manager said that he has completed re-tagging all the animals with white sequentially-numbered tags since June of 1996.

After further questioning, the farm manager provided us with an explanation as to what he believes happened to the 12 cattle. He stated that the 12 cattle were sold or slaughtered at the farm. However, based on our review of the documentation provided by the farm manager, only four of the 12 cattle we identified as unaccounted for appeared to have been slaughtered or sold. The disposition of the remaining eight cattle is still unknown. The value of a 1,000-pound cow is estimated at $300 to $500 dollars, depending on the breed and quality.

CONCLUSION

Inventories of finished products must be managed with proper care and custody to achieve the maximum return on an investment in materials, supplies, and labor. By adequately protecting and storing inventory, unnecessary costs resulting from damages incurred during handling and storage can be avoided. Also, by conducting periodic physical inventory counts, management can ensure that accounting records and financial statements are accurate. Additionally, management is assured that products are in good condition, available for sale, and that damage and losses are quickly identified and causes resolved. However, control of over $1 million in inventories of products produced by the upholstery shop, furniture factory, garment factory, and farm operation needs to be improved. Accounting records do not accurately reflect what is on hand for sale, products are being improperly stored, resulting in additional costs, and causes of shortages and losses in inventory are not being appropriately resolved.

RECOMMENDATIONS

To improve controls over record keeping and the care and custody of inventories, and to provide for adequate separation of functions relating to inventory, **we recommend** that the department take the following actions:

1. Conduct the weekly physical inventory counts of the upholstery shop and the furniture factory inventories as required by the department's administrative rules. Differences between the physical counts and the inventory records should be reconciled and appropriate adjustments should be made to the accounting records. In addition, the chairs should be accurately and clearly identified on the inventory records to ensure that the correct chairs are selected for sale and reflected in inventory counts.

2. Provide additional space for storing the chairs and furniture to avoid damage from overcrowding. Upholstered surfaces should be wrapped in plastic or other protective covering to avoid dirt and damage during storage. Furniture items should also be properly packaged for protection against damage during movement and storage. The packaging should protect finished surfaces, upholstery, and corners. Delicate or easily damaged goods should be provided with additional protection. If items are damaged, an evaluation should be made before repairs are ordered to consider whether it would be more cost effective to sell the damaged items at a discount.

3. Discontinue the practice of maintaining "loaner" chairs in finished goods inventory. Instead, the cost of these chairs should be expensed as marketing or selling costs. To maintain control over the loaned chairs, they should be accounted for in a separate record.

4. Separate the job responsibilities for the inventory functions in the furniture factory. We understand

that effective in April 1996 the responsibility of preparing invoices was assigned to the Prison Industries central office staff. We encourage the department to assign incompatible duties to other warehouse personnel.

5. Assign staff to improve the organization of the inventory at the garment factory.

6. On a monthly basis, prepare a summary of changes in the cattle inventory between beginning and ending inventories. Attached to this summary should be copies of the additions and deletions to inventory that support the ending inventory balance. A reconciliation should also be prepared between the count and the inventory records when a physical inventory of the farm's cattle is taken. Appropriate documentation needs to be retained to support the differences. The farm manager should review the monthly summaries and the reconciliations and initial them, indicating his approval.

CHAPTER II: COSTS OF GOODS SOLD

One of the basic elements of operating a successful business is to "know your costs." This requires a complete analysis of the direct costs, those materials and labor which can be specifically identified with certain products or services, and the amount of indirect costs, such as rent, utilities, and supervisors' salaries, that will be allocated to each product or service. Together, these costs make up the costs of goods produced, also called costs of goods sold. Without a good understanding of these costs, businesses cannot control costs, price products appropriately, or determine whether they are covering costs or making a profit. Our review of Prison Industries' costs of goods sold found that the department is not properly identifying and recording the costs it incurs to produce its products. Specifically, we found deficiencies in the determination of manufacturing costs in the furniture factory, the upholstery shop and the garment factory, and in the methods for pricing products.

NEED FOR KNOWING COSTS OF GOODS SOLD

To price products so that the maximum value is received and all appropriate costs are covered, it is critical for businesses to understand the costs that go into making their products or providing their services. To determine the costs of goods sold, a business must be able to identify not only the direct costs of materials and labor but also the indirect costs associated with each product. Indirect costs (also called overhead) include such costs as insurance, rent, repairs and maintenance, utilities, production supervisors' salaries, and manufacturing supplies. Manufacturing supplies include low-cost items that are difficult to associate with specific units of product, such as lubricants, nails, glue and small tools.

Once costs are determined, it is important to show the reliability of the cost value assigned by documenting how the costs relate to each product. It is also important that the costs be monitored and tracked regularly to assess their continued relevance and accuracy. In particular, material costs, labor costs and indirect costs should be assessed regularly to properly identify work-in-process costs. Work-in-process costs are the accumulated manufacturing costs of products that are in the production process but are not fully completed. Labor hours spent on a job should be reviewed periodically for consistent performance. Significant variances from standard costs or hours should be investigated. Another component to consider when determining the selling price of a product is the percentage of profit. Unless managers have a clear understanding of their manufacturing costs, they will not be able to determine whether a percentage of profit is included in the selling price. In addition, once product prices have been determined, it is important for businesses to review them regularly to assess the effects of inflation, changes in the costs of materials, and other factors affecting the cost components. Our review of the cost of goods sold at the furniture factory, the upholstery shop and the garment factory found that the department had not properly valued and documented the cost of production for some customized orders and stock items.

DETERMINING COSTS: FURNITURE FACTORY AND UPHOLSTERY SHOP

Our review of the Prison Industries' costs of manufacturing items at the furniture factory and upholstery shop found that the methods used for expensing its costs for producing products does not accurately reflect costs and is inconsistently applied. We also found that adjustments to costs were not sufficiently documented to determine whether the adjustments are accurate and valid.

Prison Industries uses the department's Automated Factory Accounting Management Information System (AFAMIS) to record its financial transactions. AFAMIS also has the capability of recording cost accounting data including, but not limited to, tracking costs of raw materials, work-in-process and finished goods inventory. While the department is using the work-in-process module for the garment factory, it is still in the process of implementing the work-in-process module for the furniture factory and upholstery shop. Until installation of the cost accounting module is completed, the Prison Industries staff is using estimates to account for manufacturing costs at the furniture factory and the upholstery shop.

Costs are calculated at 80 percent of the sales price for items manufactured in the furniture factory and the upholstery shop and manually entered into the accounting records. This percentage methodology was developed by prior management and has been used for several years. However, current Prison Industries staff could not provide documentation of the method for arriving at this percentage nor show that the percentage is reasonable. In addition, the application of this percentage is not consistent. We examined a product listing of costs and prices for 71 furniture factory items and found that costs of 61 items were at an average of 73.4 percent rather than the 80 percent of sales price level. Apparently, across-the-board price increases had been implemented during the audit period, but costs were not adjusted to maintain the 80 percent cost-price relationship. Furthermore, the costs of five of the 61 items ranged from 98 percent to 100 percent of the sales price.

The recorded cost of goods sold amount is adjusted monthly to eliminate a presumed double counting of raw materials. When goods are produced in the furniture factory and the upholstery shop, AFAMIS automatically allocates costs for raw materials to the cost of goods sold account. However, when Prison Industries staff records cost of goods sold at 80 percent of the sales price, as described in the preceding paragraph, raw materials is included. As a result, raw materials is double counted. To compensate, the staff makes a monthly adjustment to cost of goods sold to eliminate the double counting. The adjustment is based on a percentage of sales, with one specific percent being used for the furniture factory and another for the upholstery shop. However, staff could not provide documentation to show how the percentages were calculated nor could they show the percentages were based on accurate and reliable data. It appears the percentages are over two years old, and there was no evidence of any recalculations to determine if the percentages were still accurate.

Without documentation to evaluate the reasonableness of the 80 percent of sales price estimate for cost of goods sold and the subsequent adjustments made to cost of goods sold, we cannot determine whether the recorded amounts accurately reflect the cost of manufacturing products in the furniture factory and the upholstery shop. Without accurate cost information, management cannot make reasonable decisions relating to the production and sale of merchandise.

ACCOUNTING METHODS

The department does not use a proper cost accounting method for the furniture factory and the upholstery shop. In addition, no reconciliation between subsidiary and general ledger inventory accounts is prepared for the garment factory.

Accounting systems consist of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. The composite of all the accounts used by an entity is known as the general ledger. The general ledger is the underlying support for information reported in the financial statements. It is common for entities to use subsidiary ledgers to provide detailed information about the composition of a general ledger account balance. Subsidiary ledgers are especially useful for accumulating costs of the three major elements of a manufactured product: direct materials, direct labor and indirect costs. These costs are usually accumulated in three subsidiary ledger accounts which have corresponding "controlling" accounts in the general ledger. The general ledger accounts are called controlling accounts because they contain a balance equal to the sum of the balances of the subsidiary ledger accounts. Depending on what stage of completion a product is at, associated costs will be recorded in raw materials inventory; work-in-process inventory, which contains costs of partially completed products; and finished goods inventory.

The department uses subsidiary ledger accounts to accumulate cost information related to its manufacturing processes of the furniture factory, the upholstery shop and the garment factory. These accounts are set up on the department's Automatic Factory Accounting Management Information System (AFAMIS). However, for the furniture factory and the upholstery shop, the work-in-process subsidiary accounts are not used properly. The costs of raw materials appropriately flow from the subsidiary ledger to the general ledger, but labor and overhead costs are not recorded to the general ledger work-in-process account nor to the finished goods account. To compensate, as previously discussed, the department assigns a cost of goods manufactured to finished goods inventory equal to 80 percent of the sales price. This 80 percent amount includes elements for raw materials, labor and indirect costs. Also, manual adjustments are made to the general ledger work-in-process inventories and cost of goods sold to compensate for the double counting of raw materials. As a result, it is not known whether recorded costs in the general ledger, after adjustments, approximate actual costs. Also, because of the accounting methodology used by the department to estimate costs, the subsidiary ledgers are not used for the purposes for which they were designed.

For the garment factory, although the work-in-process subsidiary ledger on AFAMIS is used properly, a reconciliation is not prepared between the subsidiary ledger and the general ledger inventory accounts. It is not known if they are in balance at a given point in time. The computer system that accounts for inventory keeps the records in real time and a history of inventory subsidiary balances is not maintained. Prison Industries staff has not retained printouts of these balances from the time they were available. If balances are not documented on cut-off dates, the information is difficult to accumulate because the inventory subsidiary balances change as new transactions are recorded.

Without a properly operating cost accounting method, management has no assurance that recorded costs reflect actual costs and contain all costs associated with the manufacturing of products. Reconciliations between subsidiary ledger accounts and general ledger controlling accounts are necessary to ensure that the cost accounting method is operating as expected and costs are accurately recorded to the proper general ledger inventory accounts.

DETERMINING COSTS - GARMENT FACTORY

The cost accounting system established at the garment factory may not be accumulating the correct costs for all of its products. We specifically found problems with costs for stenciled sweatshirts and T-shirts. For example, during our review of costs of goods produced at the garment factory, we found a stenciled sweatshirt with a finished goods cost (an inventory value) that was less than the cost of raw materials used to produce the item.

This occurred because an increase in the costs of raw materials did not get reflected in the final production costs. For example, for an order processed in April 1996, a blank sweatshirt prior to stenciling was recorded at a cost of $8.51. The finished goods cost for the sweatshirt after stenciling was recorded at only $8.09. The $8.09 amount was the cost assigned to the sweatshirt prior to the cost increase in January 1996. Although the cost increase was reflected in the raw materials accounting records, it did not get carried forward to the finished goods accounting records.

DETERMINING SALES PRICES

Prison Industries staff could not provide justification or documentation to support the design and basis for the method it uses to determine the sales price for items produced in the furniture factory and the upholstery shop. The staff uses the sales price information to calculate the cost of goods sold at 80 percent of the sales price. However, the pricing method bases the sales price on estimated costs, which may not reflect the recorded cost of goods produced. In addition, the sales staff may adjust the sales price to what they believe they can get for the product. As a result, procedures are not adequate to ensure that sales prices adjusted by the sales staff cover all manufacturing costs—direct and indirect costs.

Specifically for the furniture factory, a pricing worksheet is used for customized orders and some regularly stocked items. Prison Industries staff could not provide documentation to show that the method used to determine sales prices was reasonable and that the sales prices developed by the method covered all its costs. The pricing method was developed by prior management who did not retain the documentation to support the method. Current management continues to use this method without determining its validity.

In addition, it appears that the purpose of the pricing worksheet is to estimate all the costs of producing goods, including raw materials, labor and overhead.

However, costs calculated with this pricing worksheet may not be the cost actually recorded in the accounting records as the cost of goods. For example, we found one furniture item that had a cost of $513 based on the pricing worksheet, but had a cost of $396 recorded in the accounting records.

Prison Industries' salespersons use the pricing worksheet as a guideline for determining sales prices, but there is no profit margin included in the final calculation. As a result, on the worksheet, total estimated costs equals the selling price. Also, the salespersons may adjust the price if they consider the calculated price to be "out of line." Therefore, it appears procedures are not adequate to ensure that adjusted sales prices cover all costs. For example, an order for 20 customized mattresses was sold at a sales price of $89 each. Using the pricing worksheet, the cost of each mattress was calculated at $152. Based on the calculated cost, the department lost approximately $63 per mattress on this order. The furniture factory manager reported the pricing worksheet contained too much overhead, and the salesperson had already established a price with the customer before the pricing worksheet was completed.

Without adequate documentation to support the pricing method used for items manufactured in the furniture factory and the upholstery shop, it cannot be determined whether the method is valid, estimated costs reflect actual costs, and sales prices cover all the costs of manufacturing products. Without procedures to ensure that prices be set to cover at least estimated costs, the department's Prison Industries may be operating at a loss.

PROGRAM COSTS

Our review of Prison Industries programs found that not all costs associated with the programs are accumulated in the Prison Industries' accounting records. Some related costs are recorded in the accounting records of the institutions and other divisions of the department. Therefore, management cannot know the financial results of each program.

To facilitate management control of the financial results of Prison Industries, all costs of operating the programs need to be reflected in the accounting records of the programs. The department and the legislature need to know the total costs associated with operating the various programs in order to make informed decisions to control current operations, plan for the future and allocate resources. However, our review found that some of the direct costs of operating the programs are paid out of Ballot Measure 17 funds or general fund money allocated to the department's correctional institutions. These expenditures are recorded in the department's accounting records and not in the Prison Industries's records. While the budget allows for the use of the funds, it is difficult to determine the actual financial condition of the prison industries programs when these costs are not accumulated in the accounting records of the programs. Not only does management lack the information it needs for making decisions, but it may consider a prison industries program to be self-sustaining when the program may actually be losing money.

The following describes some of the prison industries' costs recorded in other department accounting records:

- The services division manager's salary has been paid from Ballot Measure 17 funds since January 1996 and recorded in the department's accounting records.

- The farm manager's salary and some of the security provided to the farm have been paid out of the Mill Creek Correctional Facility's budgeted funds.

- The acting Prison Industries manager and controller have been paid from department administration funds.

- The department received a $1.2 million General Fund appropriation from the Emergency Board to pay for past due payroll costs of Prison Industries. Instead of reflecting this amount in the Prison Industries' accounting records as contributed capital, the department transferred Prison Industries expenditures to the affected institutions' accounting records.

- The set-up and operation of the metal shop was funded from the Oregon State Penitentiary's physical plant budget. The associated expenditures were recorded in the physical plant's accounting records. Operating supplies were purchased using Measure 17 General Fund appropriation.

CONCLUSION

The potential for incurring losses is very high when the associated costs of producing a product are not accurately identified and accounted for properly. Also, without a good understanding of direct and indirect costs, effective cost control and appropriate pricing of products cannot occur. Our review of Prison Industries' operations found that the costs for producing many of its products are not properly accumulated. Also, the pricing methodology used by the department does not always assure that all costs are covered. As a result, the department cannot know whether its prison industries operations are profitable or not.

RECOMMENDATIONS

To enable the department to better know its costs of manufacturing furniture, upholstered goods and garments, and to improve its methods for pricing products, **we recommend** the department:

1. Review its current method of determining and allocating costs to products produced in the furniture factory and the upholstery shop and ensure that it reflects actual costs. Documentation supporting the cost allocation methodology should be prepared and retained for management's use and for audit purposes.

2. Review the monthly adjustments the department's staff makes to eliminate the double counting of raw materials in the cost of goods sold account for the furniture factory and the upholstery shop. The department should determine whether the percentages used in the adjustments are valid. Documentation supporting the basis for these adjustments should be prepared and retained for management's use and for audit purposes.

3. Develop a cost accounting system for the furniture factory and upholstery shop that conforms to a generally accepted method for accumulating actual costs of manufacturing goods. Reconciliations between the subsidiary ledger and general ledger inventory accounts of the furniture factory, the upholstery shop and the garment factory should be performed on a regular basis.

4. Revise the process used to cost the stenciled sweatshirts and T-shirts at the garment factory to ensure that the finished goods account reflects the appropriate costs of raw materials.

5. Review the process for establishing sales prices for goods produced in the furniture factory and the upholstery shop. The department should determine whether the pricing worksheet is a valid method for developing sales prices for customized and regularly stocked furniture. Documentation to support the method for pricing goods should be prepared and retained for management's use and for audit purposes.

6. Review the functions performed by department administration, work programs and correctional institutions to identify costs associated with Prison Industries' programs. All costs associated with operating the prison industries programs should be accumulated in the accounting records for the programs.

CHAPTER III: ACCOUNTS RECEIVABLE

To assist the prison industries programs in becoming self-sufficient, the department must pay close attention to the management of Prison Industries' accounts receivable. These receivables primarily represent sales of finished goods and services and provide the cash flow needed to fund the business activities. Our review found instances where the department can improve its management of Prison Industries' accounts receivable, including its practices of not charging interest on past due accounts, not writing off uncollectable and erroneous accounts, and not actively pursuing collection of past due accounts.

NEED FOR BETTER CONTROL OVER ACCOUNTS RECEIVABLE

Accounts receivable are valuable assets to Prison Industries. As of December 31, 1995, Prison Industries' accounts receivable was valued at over $826,000. The ability of the department to control and collect the amounts due directly impacts the cash resources Prison Industries has available to carry out its operations. The longer accounts go uncollected the less likely the money due will be collected. To help agencies manage their accounts receivable, the Department of Administrative Services has established, in the Oregon Accounting Manual (OAM), policies and procedures for controlling and collecting past due accounts. These guidelines include procedures for charging interest on delinquent accounts and writing off uncollectable or past due accounts. The OAM specifically requires each state agency to "actively and aggressively pursue the collection of all receivables owed to the state that are material and cost beneficial."

CHARGING INTEREST

The department is not charging interest on past due accounts of the prison industries programs and the farm as is recommended by state policies and procedures.

When an account becomes past due or delinquent, it is a common business practice to charge interest on the money due. Interest charges on past due amounts encourage the customer to pay timely and allow the business to recover the loss of income and the collection costs for overdue accounts. The Oregon

Accounting Manual states that agencies should charge interest on delinquent accounts and interest should start accruing on past due accounts effective as of the due date. If no statute specifically regulates interest rates on debts owed to the agency, a general statute (ORS 82.010) governing interest rates currently provides for interest at the rate of nine percent on moneys due. Our review of Prison Industries' accounts receivable found, however, that the department has not charged or collected interest on its delinquent accounts. Invoices sent by the department requesting customer payment do not state that interest will be charged on past due accounts. As of December 31, 1995, the prison industries had 326 accounts comprising its accounts receivable balance; 177 accounts valued at over $400,000 were past due.

COLLECTION ACTIVITIES

The department is also not actively pursuing collection of its accounts receivables for the farm and the inmate work crews. A useful tool to help monitor past due accounts is an aging report, however, the department is not using the appropriate date to age its accounts.

During our audit, we reviewed the collection activities for receivables related to the farm and inmate work crews. The farm sells meat and milk to the state's correctional facilities, cream and tenderloin cuts of beef to private contractors, and hides and bones to a rendering plant. The farm bills customers upon delivery of goods, then the department accounts for the receipt of payment and for monitoring accounts receivable. The department also handles the accounts receivable created when work crews provide services. Neither the farm nor the department pursues collection of past due farm accounts by calling or mailing statements as recommended in the Oregon Accounting Manual. The OAM states that accounts should be contacted as soon as they become delinquent, that is, if they are not paid by the scheduled due date. It appears the responsibility for this activity has not been clearly assigned to either the farm or the department's accounting section.

According to the department's accounts receivable aging report for the farm and work crews, the date used to determine the age of the accounts is the date the payment is due from the customer and not the purchase date. As of December 31, 1995, the department's accounting records showed approximately $50,000 as current receivables when that amount was over 30 days beyond the due date. The records showed only about $20,000 in the farm and work crew accounts that was considered past due.

By not actively pursuing collection of past due amounts, the department runs the risk of not being able to collect. The older an account is, the less likely collection will occur. In addition, improperly aged accounts do not reflect the actual collectability of the receivables, thus increasing the risk of misstated financial statements.

WRITING OFF ACCOUNTS

Our review of Prison Industries' accounts receivable found that the department's assets are overstated because uncollectable amounts are not written off and the department does not have adequate policies and procedures to control accounts receivable.

In the course of normal business operations, it is common for businesses to experience some loss due to customers not paying for merchandise or services received. To account for this loss, it is appropriate for businesses to write off these uncollectable amounts as an expense of doing business. The Oregon Accounting Manual provides criteria to assist agencies with determining when an account becomes uncollectable and the authorization needed within the agency to write off the debt. By not appropriately writing off accounts receivable that are deemed uncollectable, the assets of an agency or business organization may be overstated.

During our review, we tested 40 accounts receivable balances as of December 31, 1995. Of these 40 accounts, nine (22.5 percent) were either uncollectable or erroneous. Four of these nine accounts totaling $3,672 were considered uncollectable, but had not been written off by the department. One customer had declared bankruptcy, two had been sent to collections 10 months earlier, and one account would cost more to collect than was due. This last account, which had a $16 balance, was written off during our audit; however, the write-off was recorded as a reduction to sales revenue instead of an increase in bad debt expense. The other five accounts receivable balances we reviewed totaling $2,757 were erroneous accounts. Three of the five were used for tracking sample items ("loaners," as defined in Chapter I) given to customers or sales representatives, and two were created by the staff in error when trying to make other correcting entries. If the department does not identify and write off uncollectable and erroneous accounts as described above, the financial statements for Prison Industries may be misstated and not reflect the true financial condition of the program.

CONCLUSION

Improvements are needed in the management of Prison Industries accounts receivable. Specifically, past due accounts need to be monitored and interest charged to customers who do not pay for services or products on time, and uncollectable accounts need to be written off. Collecting receivables in a timely manner directly impacts the cash resources Prison Industries has available to carry out its operations. The longer an account goes uncollected the less likely it is the money owed will be collected. Also, charging interest on past due accounts encourages customers to pay and helps to cover collection costs. In addition, uncollectable amounts need to be written off to ensure that the true financial condition of the operation is known, and that assets are not overstated.

RECOMMENDATIONS

To improve controls over its management of accounts receivable, **we recommend** that the department:

1. Follow the guidelines provided in the Oregon Accounting Manual for calculating and collecting interest on past due accounts. Invoices sent to customers should state the percentage of interest to be charged on past due accounts.

2. Assign responsibility for monitoring the accounts receivable of the farm and work crews to appropriate staff, and implement procedures to

actively pursue past due accounts. The accounts receivable aging reports for the farm and work crews should be revised so that the purchase date is used to age the accounts.

3. Adhere to the policies and procedures set forth in the Oregon Accounting Manual for writing off uncollectable accounts. Sample items provided to customers and sales representatives should not be established as accounts receivable; instead, they should be recognized as a marketing expense. The value of the sample items should be recorded in a specific account so their cost can be monitored by management.

CHAPTER IV: OTHER MATTERS

During the course of our audit, we found additional areas of concern regarding Prison Industries operations. These other matters came to our attention as we reviewed specific accounts at the farm and the garment factory and at the department's central office for Prison Industries.

FARM GRAZING LAND LEASE

The department owns pastureland at the Mill Creek Correctional Facility. Seven hundred acres of this land is leased for livestock grazing. We reviewed the lease that was effective from April 28, 1995, to October 30, 1995. We found the department did not enforce the terms of the lease, thereby losing income as a result of the lessee's noncompliance. The department did not bill the lessee in a timely manner, the correct amount was not billed to the lessee for two months of the six-month lease, interest was not charged on late payments, and the lessee was not charged for grazing cattle left on the department's land after the end of the lease.

The lease, which was competitively bid, was held by an individual who also holds a personal services contract with the department to purchase cattle for the farm. Lease payments for the land were established at a fee-per-head basis with a minimum payment of $2,600 required for each full month. The lease agreement also specified that payments were due 10 days following the end of the month for the previous month, and that interest would be charged at 12 percent on any payments past due. Although the lease agreement required the lessee to make the lease payments without notification from the department, the lessee made no payments until he was notified. The department did not provide the lessee with a past due notice in a timely manner, sometimes waiting up to three months before preparing an invoice. In addition, for two months of the lease period, the department did not bill the lessee the minimum charge that was required, therefore undercharging the lessee by $489. Finally, the contractor was not charged interest on lease payments considered past due. Not one of the monthly lease payments were paid on time, and the lessee's account was delinquent by $10,433 from November 10, 1995, until he received our accounts receivable confirmation letter in March 1996. We also determined that the department failed to bill the contractor over $365 in interest for the $10,433 delinquent amount. In addition, the lease agreement stipulated that in "October (thereafter, until cattle are removed)" the lease payment will be 34.6 cents per head, per day. At least seven cattle remained on the land from the end of October 1995 through March 14, 1996, when we interviewed the farm manager about the lease arrangement. Rent, which would have totaled approximately $327, was not charged or collected for grazing these cattle on the department's land. The farm manager stated that the cattle would be removed when the pasture dried out.

The responsibility for administering the land lease was assigned to the farm manager. However, because this duty was not given a high priority, the late billings and undercharges occurred.

We recommend that the department bill the lessee for the additional $489 due according to the lease agreement. The department should charge the lessee for the seven cattle that remained on the property beyond the end of the lease. Interest charges for late payment should also be determined and charged to the lessee as required by the contract. Due to organizational changes within the department, responsibility for the farm's operation has been transferred to the Inmate Work Program. Therefore, the department should consider centralizing the farm's lease administration processes with other Prison Industries' programs to provide better control over the billing and collecting of lease payments.

FARM PERSONAL SERVICES CONTRACT

To purchase farm livestock, the department has a personal services contract with a professional buyer. The contractor was selected to procure cattle for the department based on his knowledge of the industry and his location, availability and ability to meet the needs of the department. To comply with the terms of the contract, the contractor is required to attend and participate in scheduled public livestock auction sales throughout the state, and use professional judgment in offering bids to purchase the type of cattle specified by the farm manager. During the calendar year 1995, the contractor purchased livestock for the department at a cost of more than $500,000. For this work, the contractor was paid $4,465.

We found that the contractor does not always attend the livestock auctions, but delegates his responsibilities to another person approximately 50 percent of the time. This delegation appears to be a direct violation of the contract terms. We attended an auction in McMinnville on April 10, 1996, to observe the buying of cattle for the department's farm operations. At this auction, we noted that the cattle were bought for the department by a buyer who was not the person stipulated in the contract. By allowing another buyer to purchase cattle for the department, the department has no assurance that the individual is qualified and that the state is acquiring the desired quality of cattle at the lowest price.

We recommend the department notify the contractor in writing about this breach in contract terms and request that the contractor adhere to those terms. If the contractor cannot comply with the terms of the personal services contract, the department should consider terminating the contract and selecting a new contractor.

FARM ANIMAL MEAT YIELDS

The farm slaughters cattle for meat to feed inmates housed in the department's correctional facilities. The slaughtered cattle are primarily "canner" cows (a USDA low grade typically depicting older dairy cows) purchased by the department at public auctions. Other cattle slaughtered at the farm come from the farm's dairy and beef herds. According to the department's farm manager, the farm raises beef cattle, such as Angus and Herefords, for sale. The farm generally purchases calves in the fall to be raised and sold the following fall. The farm dairy cattle that are slaughtered are those no longer considered milk producers, while the beef cattle that are slaughtered are designated as slaughter animals at the discretion of the farm manager.

When reviewing the meat yields from the animals slaughtered at the farm in October 1995, we noted that the yields for beef cows were significantly lower than the United States Department of Agriculture's (USDA) average for commercial dressed cows. Furthermore, the beef cattle yields were even lower than the yields from the farm's dairy cows and from canner cows purchased for slaughter. According to the USDA's 1995 Red Meats Yearbook, the annual average commercial dressed weight of cows is 536 pounds or 59.5 percent for an average 900-pound animal. During October 1995, the farm slaughtered 117 head of 5-and 6-year-old cows from the farm's beef herd. These cows had an average live weight of 1,077 pounds, and provided an average yield of 500 pounds or 46.4 percent. In comparison, seventeen of the farm's dairy cattle, averaging 1,054 pounds live weight, yielded an average of 512 pounds or 48.5 percent. Also during this period, canner cows purchased for slaughter averaged 1,012 pounds live weight and produced an average of 480 pounds or 47.5 percent yield.

Although meat yields depend on the breed, age, weight and general feeding conditions of the cattle, it would be expected that the farm's beef cattle would produce a yield better than the farm's dairy cattle and certainly better than the canner cows purchased from auction. Since the yields from the farm's beef animals were so low, it raises concerns about the farm's husbandry practices. According to the farm manager, one of the reasons for the lower yields is that the cows were nursing calves up to the time of slaughter and as a result, were leaner than expected.

We also reviewed the yield of specific meat cuts from the carcasses of cattle slaughtered at the farm. The farm primarily cuts and grinds the meat into hamburger, cutting some meat as roasts and tenderloin. On June 3, 1996, we observed the cutting process for three carcasses. The total yield of meat, bones and fat after cutting exceeded the beginning weight of the carcasses. In addition, we reviewed the records of meat cuts for 30 kill days from July 5, 1995, through February 22, 1996. For 16 of these days, the total yield exceeded the beginning weight of the carcasses. From our observation of the cutting process, it appeared possible that meat already weighed was re-cut and then weighed again. Controls were not in place to distinguish the meat that had already been weighed or to remove it from the cutting process.

We also noted questionable management practices at the farm. For example, we were repeatedly told by the farm manager that he planned to increase the beef herd, yet he slaughtered 117 cows from the herd that may have been able to produce more calves for the farm. During the same month, October 1995, the farm purchased 233 beef cattle averaging 500 pounds each. The weight of these animals indicates they were probably too young to breed. As a result, the farm lost a calving season. Although the farm may have had valid reasons for slaughtering the 117 cattle in October 1995, it was not clear from the documentation provided to us that alternatives and the costs were considered.

We recommend the department review the farm's husbandry practices and herd maintenance policies to determine whether the state is obtaining the maximum benefit from the cattle. This review should also include a study of the farm's slaughtering and meat-cutting practices.

GARMENT FACTORY INMATE PAYROLL

When we reviewed inmates' incentive pay, we found mathematical errors that indicate a need for improved controls over the process used to calculate the incentive pay.

Inmates working at the garment factory are paid on a basis that provides an hourly wage, plus a production incentive. Each method of payment is controlled differently. A time clock is used to record work hours on the inmates' timecards. This information is entered into the computer by an inmate who works in the garment factory office. Based on the information entered into the system, the computer calculates the pay earned by each inmate. The incentive pay, however, is based on the number of production stickers that are placed on inmates' daily timecards. The production stickers indicate the standard time allowed for certain tasks, and when the inmate has completed the task, he places the sticker on the timecard. The more production stickers the inmate completes in a day, the more the inmate will be paid. To summarize the total time worked for the incentive pay, an inmate working in the garment factory office tallies the time from the production stickers on each inmate's time card. The incentive time is then entered into the computer that computes the incentive pay. Payroll costs at the garment factory, on average, are $30,000 per month.

To review the garment factory payroll, we sampled four days of incentive pay slips. Of these pay slips, we found eight mathematical errors. The errors appeared to be caused by carelessness in adding the total time on the production stickers. Even though the errors we found did not result in a substantial over or under payment to any inmate, the errors are indicative of poor control over the inmate payroll system at the garment factory. Effective internal controls require a system of checks and balances to detect inadvertent errors. The department does not provide for the inmate's calculations to be reviewed by non-inmate supervisory staff. Also, the inmate calculating the incentive pay is in a position to be pressured by other inmates to overstate their incentive time, resulting in increased costs to the garment factory. Supervisory review of the inmate's calculations could reduce the risk of influence from other inmates, especially if the other inmates are aware of the control.

We recommend that the department implement procedures to have non-inmate staff spot-check incentive pay calculations made by inmates and initial the daily summary sheet to indicate this review has been done. This control should be made known to all inmates working in the garment factory.

PRISON INDUSTRIES CASH ACCOUNT RECONCILIATION

During our review of Prison Industries accounting records, we found that the cash account had not been reconciled for almost a year.

Reconciliations are essential to safeguard cash accounts and ensure that cash transactions are properly reflected in the accounting records. The Oregon Accounting Manual recommends that cash accounts be reconciled to the State Treasury or the Department of Administrative Services' Control Accounting as appropriate. The reconciliation should be done on a monthly basis by someone who is not responsible for depositing cash or authorizing expenditures. While the department has properly segregated the duties of cash handling for Prison Industries, it has not reconciled the cash account with the State Treasury or the Department of Administrative Services' Control Accounting cash accounts since June 1995.

By not reconciling the Prison Industries' cash account, the department cannot determine whether cash deposits and expenditures were properly recorded. When cash accounts are not reconciled timely, errors may remain undetected for a long period, and it becomes more difficult to identify and correct problems. A lack of cash reconciliations also is indicative of weak controls over the safeguarding of cash. It appears the department has not placed a high priority on reconciling the cash account.

We recommend the department require the cash account to be reconciled by an employee who is not responsible for cash deposits or expenditures. The reconciliations should be prepared monthly, and appropriate adjusting entries should be promptly recorded. In addition, the reconciliations should be subject to supervisory review and approval.

AFAMIS ENHANCEMENT AND MAINTENANCE

To record financial transactions Prison Industries, as well as the department's Fiscal Services Division, uses the Automatic Factory Accounting Management Information System (AFAMIS). AFAMIS is a complex database that requires experienced personnel to make programming changes to the system. The department's Information Systems Division provides the hardware and back-up tapes for AFAMIS, but the department has not assigned a specific Information Systems employee to maintain or enhance AFAMIS. Instead, these duties are performed by Fiscal Services Division staff. In addition, there is a lack of segregation of duties between program design and implementation. A Fiscal Services Division staff member determines how the information is to be compiled, then he programs the system. By allowing the same person to determine what changes are needed and to implement those changes, the department is risking possible errors or misuse of its financial records. At a minimum, there should be a documented supervisory review of the changes to be made and the results from the programming change once it has occurred.

We recommend that the department separate the duties of the design and programming functions for AFAMIS to limit potential errors or misuse. The Fiscal Services Division and Prison Industries should determine the changes needed, but the Information Systems Division should implement the changes.

FOLLOW UP ON PRIOR AUDIT FINDINGS

This section reports follow-up action taken by the Department of Correction's management on findings presented in our prior review of inmate work program expenses, the report of which was issued on November 28, 1995.

We commend the department for taking prompt action to resolve some of these findings. However, other findings remain unresolved and, therefore, are included in the chapters of this report as referenced below.

Prior Audit Findings	Disposition
INTERNAL CONTROL PROCEDURES	
The department's established procedures for purchasing and receiving goods were not always followed.	Resolved.
Accounting errors were not always corrected in a timely manner.	Resolved.
We identified concerns about inventory problems which increased the risk that inventory records were not reliable.	Unresolved. We found additional instances where inventory was not properly managed; deficiencies existed in record keeping, the care and custody, the separation of job responsibilities relating to moving, recording and maintaining custody of inventories. See Chapter I of this report.
EXPENSES NOT BEFORE THE BOARD	
Since January 1, 1995, $516,647 in overhead costs had accumulated in two inventory accounts: work-in-process and finished goods inventory. It appeared likely the costs should have been reflected as costs of goods sold by September 30, 1995.	Resolved. The costs were directly related to an inventory adjustment and not due to additional costs of goods sold.
Inmate earnings disbursements from the State Prison Work Programs Account were not being approved by the Prison Industries Board.	In process. The department is seeking legal clarification from the Department of Justice on which expenditures must be approved by the board.

REPORT DISTRIBUTION

This report is public record and is intended for the information of the Oregon Department of Corrections' management, the Prison Industries Board, the governor of the state of Oregon, the Oregon Legislative Assembly, and all other interested parties.

COMMENDATION

The courtesies and cooperation extended by the officials and employees of the Oregon Department of Corrections during the course of our audit were very commendable and sincerely appreciated.

AUDIT TEAM

Gary Colbert, Audit Administrator, CGFM
Dale Bond, CPA
Dennis Laughery, CPA
Margaret Kane, CPA
Sandra Pokorny, CPA
Lois Summer
Tony Marick

AGENCY'S RESPONSE TO THE AUDIT REPORT

January 24, 1997

Oregon

DEPARTMENT OF CORRECTIONS

OFFICE OF THE DIRECTOR

Sharon W. Goggins, CPA
Deputy State Auditor
Secretary of State Audits Division
255 Capitol Street NE, Suite 500
Salem, Oregon 97310

Dear Ms. Goggins:

Attached is the Department of Corrections' response to the Secretary of State Audits Division Review of Prison Industries Operations. I believe there has been tremendous improvement in the financial area of the Industries Program, and I look forward optimistically as we continue to implement Measure 17 and other Industries programs.

We appreciated the Audit Division's response to our request for a financial audit and remain willing to meet with you or your staff to discuss any aspect of the audit or our response. We also appreciated the assistance and cooperation we received from Audits Division staff and look forward to a continuing working relationship as we move forward with implementation of processes and internal controls to better manage the Department's financial affairs.

Again, thank you for your assistance. Please feel free to contact Sue Acuff, at 945-9007, if you have questions or need additional information.

Sincerely

David S. Cook
Director

DSC:ss

Attachment

c: James McAdler, DAS Statewide Accounting Manager
Sue Acuff, Budget & Finance Division Assistant Director
Michael Taaffee, Work Programs Administrator
Gary Weeber, Industries Manager

John A. Kitzhaber
Governor

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State of Oregon
Department of Corrections
Response To Secretary of State Audits Division
Review of Prison Industries Operations

January 24, 1997

INTRODUCTION

The Department of Corrections would like to express our appreciation to the staff of the Audits Division. The Division's response to our request for an audit and willingness to conduct an open, participatory process have greatly enhanced the quality of the final report.

It is our understanding the audit period was from January 1, 1995 to December 31, 1995. We are also aware that some of the testing of inventories and cost of goods sold were beyond December 31, 1995, for physical counts and audit effectiveness. Our response to the follow-up of the assessment audit shown on page 49 of their report has been sent to the Audits Division under a separate letter.

The Department believes it has made tremendous progress in all areas covered in this audit. The Department concurs with many of the recommendations and has already moved towards taking the necessary corrective action. We look forward to working with the Audits Division in putting this period behind us and moving forward with new improved internal controls and fiscal procedures.

Our response to specific issues follows:

CHAPTER I - CONTROL OVER INVENTORY

The Department acknowledges the importance of regular cycle counts and annual physical inventories of raw materials and finished goods. We have hired staff in the garment factory and the warehouse to specifically handle inventories. We will soon be adding a fiscal employee in the furniture factory. One of the primary duties of this person will be overseeing and controlling inventory. We have also instituted changes to our procedures to improve control over tracking cattle inventory.

1. **Conduct the weekly physical inventory counts of the upholstery shop and the furniture factory inventories as required by the Department's administrative rules. Differences between the physical counts and the inventory records should be reconciled and appropriate adjustments should be made to the accounting records. In addition, the chairs should be accurately and clearly identified on the inventory records to ensure that the correct chairs are selected for sale and reflected in inventory counts.**

   The Department plans to hire a fiscal employee who will be assigned to the Furniture Division. We anticipate having this employee on site by the middle of February. One of the primary duties of this position will be to monitor all inventories in the furniture factory, Upholstery Shop, and Warehouse. Regular cycle counts will be performed weekly so that all raw materials are counted once a month and finished goods are counted once a quarter. Any differences identified will be researched and adjusted in a timely manner.

The Department has taken steps to address concerns the audit staff expressed regarding chair inventories. Our line of stock chairs has been streamlined to include only those which are high volume sellers. Additionally, fabric is only offered in the six most popular colors. We have assigned item numbers to each chair which incorporates model number, fabric, and color of stain for better tracking. These measures allow for more accurate monitoring and counting of chairs.

2. **Provide additional space for storing the chairs and furniture to avoid damage from overcrowding. Upholstered surfaces should be wrapped in plastic or other protective covering to avoid dirt and damage during storage. Furniture items should also be properly packaged for protection against damage during movement and storage. The packaging should protect finished surfaces, upholstery, and corners. Delicate or easily damaged goods should be provided with additional protection. If items are damaged, an evaluation should be made before repairs are ordered to consider whether it would be more cost effective to sell the damaged items at a discount.**

The Department acknowledges the need for more warehouse space for storage of raw materials and finished goods. We are currently inquiring into various options for increasing warehouse space, including buying or building a warehouse. Until this happens, we have taken steps to alleviate some of our storage problems. We have reduced our furniture product line for items stocked which has increased space in the warehouse. This has allowed more space to be available for those limited items.

We are currently wrapping chairs in plastic to protect the fabric from dirt and have inquired about other packing options. Full protective covering prior to movement from the Furniture Factory to the Warehouse is not possible due to security inspection needs. The Department is pursuing other alternatives, such as electronic detection systems which would allow packaging in the factory. These options will be evaluated on a cost/benefit basis. By focusing on improving handling and storage methods, we are hoping to reduce damage. We have also instituted a process to track where damage is occurring and assign costs of repairs.

We will continue to evaluate repair versus replacement of items individually, based on security issues, limited storage space, and cost/benefit. We are also looking into the possibility of an outlet for our damaged and obsolete items.

3. **Discontinue the practice of maintaining "loaner" chairs in finished goods inventory. Instead, the cost of these chairs should be expensed as marketing or selling costs. To maintain control over the loaned chairs, they should be accounted for in a separate record.**

This practice has been discontinued since January 1996. At that time, the Furniture Factory purchased chairs to be used as "loaners" by the sales Department. As these chairs are loaned out, they are issued to a customer and monitored until returned. These "loaner" chairs were removed from inventory and expensed to the furniture factory. In the future, these expenses will be coded to "Promotional Items" for better accountability and control.

4. **Separate the job responsibilities for the inventory functions in the furniture factory. We understand that effective in April 1996 the responsibility of preparing invoices was assigned to the Prison Industries central office staff. We encourage the Department to assign incompatible duties to other Warehouse personnel.**

   Effective April 1996, we began making several changes to our inventory control procedures. The responsibility for invoicing of furniture and upholstery sales was transferred to the Industries fiscal staff. This was done as part of a conscious effort to centralize all invoicing for the Industries programs. We have also hired permanent staff in the warehouse which now includes: a supervisor, two property specialists, a delivery person, and an installer. This has allowed for proper segregation of duties in the warehouse for receiving of raw materials, receiving and custody of finished goods, and delivery of finished goods.

5. **Assign staff to improve the organization of the inventory at the garment factory.**

   Industries has hired an accounting technician to be located in the Garment Factory. One of the primary duties of this position will be to monitor inventory levels and perform regular cycle counts and physical inventories. We have also revised our return policy which allows for quicker return of items to the stocking shelves. Previously, our policy required the Garment Factory to wait until a credit invoice was created before restocking the items. This is no longer the case and should eliminate items being located in various areas of the factory. Garment items being sold to the Department of Corrections will continue to be located separate from available stock. These items must be packaged and stored awaiting shipment to Salem. For now, these will appear on our inventory records, but we plan to investigate other options for tracking these items.

6. **On a monthly basis, prepare a summary of changes in the cattle inventory between the beginning and ending inventories. Attached to this summary should be copies of the additions and deletions to inventory that support the ending inventory balance. A reconciliation should also be prepared between the count and the inventory records when a physical inventory of the farm's cattle is taken. Appropriate documentation needs to be retained to support the differences. The farm manager should review the monthly summaries and the reconciliations and initial them, indicating his approval.**

   The Department concurs that the complete description of our animal inventory did not match from one inventory to another. In late 1995, the farm realized that using a multicolored tag system with a change in the color tag each month to track inventory was not working. Each color had the same numbering system and the farm had trouble identifying tags when the colors faded. When the inventory was taken, it was difficult to identify the proper animal. To resolve these problems, the farm went to all white tags with non-repetitive numbers. We are also now tracking number of animals, not descriptions. Through the simplification of this process, it is much easier to control and monitor our cattle inventory. We also instituted the monthly cover sheet as suggested by the auditor. A monthly reconciliation is done to assure that the inventory system count is accurate and an annual physical count of the cattle will be conducted and necessary adjustments made.

The Department acknowledges that controlling and accounting for cost of goods sold is an important factor in managing a business and making business decisions. Due to inadequate staffing levels and prior management decisions, the manufacturing cost accounting system has not been implemented in the furniture factory and upholstery shop. The implementation of the system has been further delayed until a permanent fiscal manager can be appointed, as well as an accounting technician and additional staffing in the furniture factory. Although some of these staffing needs are not completed, we will be going ahead with the implementation of the cost accounting system and plan to be fully operational by June 30, 1997. This should alleviate most concerns in this area.

CHAPTER II - COST OF GOODS SOLD

1. **Review its current method of determining and allocating costs to products produced in the furniture factory and the upholstery shop and ensure that it reflects actual costs. Documentation supporting the cost allocation methodology should be prepared and retained for management's use and for audit purposes.**

   The Department concurs with this recommendation. The Department had planned to have the cost accounting system operational at this time but it has been delayed due to staffing and other priorities. Our plan is to be operational by June 30, 1997, and most of these concerns will be alleviated. The Department does not feel it is cost effective to currently address this issue with old methodology when the new system will allocate these costs more accurately in a few months.

2. **Review the monthly adjustments the Department's staff makes to eliminate the double counting of raw materials in the cost of goods sold account for the furniture factory and the upholstery shop. The Department should determine whether the percentages used in the adjustments are valid. Documentation supporting the basis for these adjustments should be prepared and retained for management's use and for audit purposes.**

   The Department also concurs with this recommendation and believes this issue will also be resolved with the implementation of the manufacturing cost accounting system planned to be operational by June 30, 1997.

3. **Develop a cost accounting system for the furniture factory and upholstery shop that conforms to a generally accepted method for accumulating actual costs of manufacturing goods. Reconciliations between the subsidiary ledger and general ledger inventory accounts of the furniture factory, the upholstery shop and the garment factory should be performed on a regular basis.**

   Again, this will occur when the manufacturing cost accounting system is operational by June 30, 1997. Reconciliations will also occur once the system is operational. Accurate records are dependent on the system making proper entries for acquisitions and disposal of inventories.

4. **Revise the process used to cost the stenciled sweatshirts and T-shirts at the garment factory to ensure that the finished goods account reflects the appropriate costs of raw materials.**

   The Department concurs with this recommendation and have been doing more frequent "standard cost roll-ups." This will allow the cost accounting system (operational at the garment factory) to calculate the raw material costs for these items. Industries fiscal staff will continue processing these "roll-ups" on a quarterly basis, review them for variances, and inform management of any pricing issues.

5. **Review the process for establishing sales price for goods produced in the furniture factory and the upholstery shop. The Department should determine whether the pricing worksheet is a valid method for developing sales prices for customized and regularly stocked furniture. Documentation to support the method for pricing goods should be prepared and retained for management's use and for audit purposes.**

   The Department concurs with this recommendation. We do not currently have accurate costs for our items produced in the furniture factory or upholstery shop. We have set up bills of material and routings for the standard production items. When the manufacturing cost accounting system has operated for a few months, we will review the variances generated by the system and recommend appropriate action. Industries will also be establishing a pricing policy applying to all stock and custom items. This policy will address overhead rates, delivery costs, and installations, as well as raw material and labor costs. When the policy has been developed, we will forward a copy to the Audits Division for review.

   As the manufacturing cost accounting system is implemented, we will also explore better ways to track costs associated with custom or stock items. This will provide more accurate information for pricing the finished goods.

6. **Review the functions performed by Department administration, work programs and correctional institutions to identify costs associated with Prison Industries' programs. All costs associated with operating the Prison Industries programs should be accumulated in the accounting records for the programs.**

   The Department agrees with the recommendation that all costs associated with the Industries programs should be recorded in the appropriate cost centers. For the most part, this has been done consistently. All costs for Measure 17 programs are being analyzed and adjustments will be made where appropriate.

   The Services Division manager was not always charged to Industries cost centers due to the individual filling both a Measure 17 position and the Services Division manager position. When the Services Division manager position was filled, the costs associated with the position were charged to Industries.

This was also true for the Industries Manager. This position was filled part time with an employee who was also the Inmate Work Program Manager. Those costs were charged to the Measure 17 general fund appropriation. When a full time Industries Manager was hired, the costs associated with that position were charged to the Industries cost centers.

The Industries acting controller position has been filled by an employee on loan from Fiscal Services since October 1995. Since this was to be a temporary situation, the costs associated with that employee remained part of Fiscal Services' budget. Effective February 1, 1997, the costs associated with this position will be charged to Industries cost center and the position will be filled as soon as possible.

As with all programs working with inmates, security must be maintained at our farming operation. This requirement necessitates that General Fund be used to fund the security positions located at the farm. The farm manager position is not funded with General Fund. As the Farm changes from an institutional program to an industry business, this percentage is expected to decrease. Due to these security issues, there will probably always be General Fund expenditures in the institution budget for the farm as there are for other Industries businesses located inside the institutions.

The accounting entry for the $1.2 million appropriation for Industries was based on the advice received from the Department of Administrative Services, Statewide Financial Reporting Section. We will be communicating with them and making any adjustments deemed appropriate.

The initial costs associated with the startup of the metal shop at the Oregon State Penitentiary (OSP) were charged to the physical plant budget. These cost have since been transferred to the Measure 17 General Fund. A decision was made by OSP to use some of their Measure 17 General Fund for this purpose due to the number of jobs it would create at the institution. We believe this is an appropriate use of the Measure 17 funds and those costs should not be born by Industries Other Fund cost centers.

Since the start-up, ongoing expenditures for raw materials and supplies have also been charged to the Measure 17 General Fund budget. This was done initially because there was not sufficient cash available to acquire the large raw material and supply purchases necessary for the expansion of Snake River Correctional Institution. All of these costs will be transferred to the other funds cost center associated with the OSP metal shop.

CHAPTER III - ACCOUNTS RECEIVABLE

The accounts receivable for Industries are monitored and managed regularly by Industries fiscal staff. An entry has been made monthly since June 1995, to adjust the accounts receivable for bad debt allowance. We have also written off accounts receivable with the approval of the Secretary of State, Audits Division. All of these entries have been made according to the Oregon Accounting Manual. As the farm becomes more integrated with Industries, these same processes and procedures will be applied to their accounts receivable.

1. **Follow the guidelines provided in the Oregon Accounting Manual for calculating and collecting interest on past due accounts. Invoices sent to customers should state the percentage of interest to be charged on past due accounts.**

   The Department concurs with this recommendation. We will begin including a statement on all invoices indicating our payment terms and the percentage of interest to be charged on past due accounts. Since most of our customers are public entities and pay their bills within the allowable 45 day period, mimimal interest charges are anticipated.

   We will continue to put our efforts into monitoring and managing the receivables and keeping interest charges to a mimimum.

2. **Assign responsibility for monitoring the accounts receivable of the farm and work crews to appropriate staff, and implement procedures to actively pursue past due accounts. The accounts receivable aging reports for the farm and work crews should be revised so the purchase date is used to age the accounts.**

   Effective April 1996, the accounts receivable for work crew has been monitored and managed by Industries fiscal staff. As the farm becomes more integrated with Industries, we will analyze these functions to determine the need for centralization.

   We prefer to not use the purchase date for our aging process. Sometimes several weeks (6-8) will elapse between the purchase date and the delivery date. We are currently using the date of invoicing as the aging date. This is usually within one or two days after delivery or shipment of the items.

3. **Adhere to the policies and procedures set forth in the Oregon Accounting Manual for writing off uncollectible accounts. Sample items provided to customers and sales representatives should not be established as accounts receivable; instead, they should be recognized as a marketing expense. The value of the sample items should be recorded in a specific account so their cost can be monitored by management.**

   We currently are adhering to the policies and procedures set forth in the Oregon Accounting Manual for writing off uncollectible accounts. Since June 1995, regular monthly entries have been made to adjust our accounts receivable. When uncollectibles are written off, they are done in accordance with the OAM and with the approval of the Secretary of State Audits Division.

We are not establishing accounts receivable on customers for product samples or "loaner chairs." We are using the accounts receivable system to track where "loaner" chairs and product samples have been shipped. These receivables are entered into the system under customers called "Product Samples" and "Loaner Program." These accounts are monitored each month. If a chair has not been returned, the customer is contacted and all product samples are expensed to the appropriate cost center.

We are presently expensing sample items and charging them to the appropriate area, i.e., marketing, sales, furniture factory, etc. We have not been using a specific account for this in the past, but will move these expenses and record all future sample expenses in an account titled "Promotional Items."

CHAPTER IV - OTHER MATTERS

Recommendation on Farm Grazing Land

We recommend the Department bill the lessee for the additional $489 due according to the lease agreement. The Department should charge the lessee for the seven cattle that remained on the property beyond the end of the lease. Interest charges for late payment should also be determined and charged to the lessee as required by the contract. Due to organizational changes within the Department, responsibility for the farm's operation has been transferred to the Inmate Work Program. Therefore, the Department should consider centralizing the farms's lease administration processes with other Prison Industries' programs to provide better control over the billing and collecting of lease payments.

As previously reported, when the cattle grazing lease ended in October 1995, there were seven head of the leasee's cattle not recovered. It was later determined the animals had gone through a fence and were on a neighbor's property. The neighbor was notified, and a plan of recovery was initiated. Because the seven animals had left the farm property, no grazing fee was determined to be owed.

The Department concurs with the finding that a mistake has been made in computing the billings for interest charges. Information has been provided to Industries fiscal staff for invoicing and collection. As the farm becomes more integrated with the Industries program, centralization of invoicing and accounts receivable will occur.

Recommendation on Farm Personal Services Contract

We recommend the Department notify the contractor in writing about this breach in contract terms and request the contractor adhere to those terms. If the contractor cannot comply with the terms of the personal services contract, the Department should consider terminating the contract and selecting a new contractor.

The Department agrees with this recommendation. Upon notification of this finding by the audit team, the contractor was promptly contacted and reminded of his obligations under the contract. The contractor was also warned of the consequences of not following the provisions of the contract. To our knowledge, the contractor is complying with the terms of the contract.

Recommendation on Farm Animal Meat Yields

We recommend the Department review the farm's husbandry practices and herd maintenance policies to determine whether the state is obtaining the maximum benefit from the cattle. This review should also include a study of the farm's slaughtering and meat-cutting practices.

The audit team reviewed live to package weights on various cattle that were slaughtered. During their review, the team did not correctly interpret the age, frame, breed type, and "flesh" conditions of animals in determining percent of cutout. Also, their comparisons of USDA grades were not correct. The team did report 117 head of farm animals were butchered after raising calves. The interpretation of the results did not include the most important factor, net return. These 117 head were thin when slaughtered because of the late season grazing and the calves they were raising. The $300 (value) that the average calf returns more than compensates for any loss in cut-out percentage.

Recommendation on Garment Factory Inmate Payroll

We recommend the Department implement procedures to have non-inmate staff spot-check incentive pay calculations made by inmates and initial the daily summary sheet to indicate this review has been done. This control should be made known to all inmates working in the garment factory.

An Industries fiscal employee has been hired at the garment factory whose duties include supervision of the inmate payroll clerk and reviewing and approving the inmate payroll for processing. As the payroll duties change with the new compensation system, we will review and modify the procedures to maintain proper internal controls.

Recommendation on Prison Industries Cash Account Reconciliation

We recommend the Department require the cash account to be reconciled by an employee who is not responsible for cash deposits or expenditures. The reconciliations should be prepared monthly, and appropriate adjusting entries should be promptly recorded. In addition, the reconciliations should be subject to supervisory review and approval.

The Department concurs with this recommendation and agrees that at the time of the audit the account reconciliation was not current. At this time, the account is reconciled by an employee who is not responsible for cash deposits or expenditures and is current through June 30, 1996. Since June 1996, the Department has combined two cash accounts and has been working with the Department of Administrative Services, Control Accounting to make the necessary adjustments on this combined account. When this is complete, the account will be reconciled and maintained on a current basis.

Recommendation on AFAMIS Enhancement and Maintenance

We recommend the Department separate the duties of the design and programming functions for AFAMIS to limit potential errors or misuse. The Fiscal Services and Prison Industries should determine the changes needed, but the Information Systems Division should implement the changes.

Fiscal Services maintains a section responsible for most aspects of the Department's accounting system (AFAMIS). This is primarily a security and oversight function at this time. Duties also include the installation of new releases, training, system design, troubleshooting, and technical assistance to users. This system is primarily user defined in how it is used. The various modules of the system can be designed to adapt to a specific business environment. This should not be considered programming.

At times, additional programming is required to accomplish specific activities. An AFAMIS management group meets weekly to discuss the system, problems, and possible solutions. Included in this group are the accounting manager, purchasing manager, fiscal coordinator, budget analyst, two AFAMIS support staff, and the Fiscal Services Administrator. All changes to the system are reviewed by this group before programming changes are made. If programming is required, the group decides whether a consultant is hired or the project is handled internally. Ideally, the consulting would be done by the Department's Information Systems Division, but at this time, staffing is not available to allocate to the accounting system. Additional staffing may be available in the future.

CONCLUSION

In closing, the Department would like to express our appreciation for the work of the Audits Division staff. We believe there has been tremendous improvement in the financial area of the Industries program. We agree that there is still much more to do, and we look forward to working with the staff from the Audits Division in continuing to implement these improvements.