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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

B-198500

JUNE 9, 1980

Mr. Norman A. Carlson
Commissioner, Federal Prison
Industries, Inc.
Department of Justice

ACC 714

Dear Mr. Carlson:

Subject: [Improvements Needed in the Management of
Federal Prison Industries' Factories]
(GGD-80-67)

During our recent examination of the fiscal year 1979 financial statements of Federal Prison Industries, Inc. (FPI), we found a number of problems which we believe should be corrected. Deficiencies exist in pricing products, determining manufacturing costs, purchasing materials, maintaining inventories, collecting accounts receivable, authorizing and reimbursing travel, and internal reporting of financial information. These problems, which are discussed in detail below, affect the efficiency of FPI's operations and its net profit.

Our work and the work of Department of Justice and FPI internal auditors showed that the problems often occurred because FPI factory staff did not comply with established policies and procedures. In some instances, however, policies and procedures did not provide sufficient guidance for factory staff to carry out their activities. Further, we believe that many of the problems are attributable, in large part, to inexperienced personnel.

We conducted our review at the following FPI locations:



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- The central office in Washington, D.C.
- Six division offices: Textile, Atlanta, Georgia; Shoe/Brush, Leavenworth, Kansas; Data/Graphics, Washington, D.C.; Wood/Plastics, Washington, D.C.; Electronics, Washington, D.C.; and Metals, Washington, D.C.
- Eight institutions: Atlanta, Georgia; Alderson, West Virginia; Safford, Arizona; Petersburg, Virginia; Terminal Island, California; Fort Worth, Texas; Tallahassee, Florida; and Texarkana, Texas.

PRICING OF PRODUCTS

Although the Government Corporation Control Act prescribes that prices for FPI products shall not exceed market prices, FPI regulations provide that its products shall be near market prices. Where FPI cannot establish market prices, it is to base them on cost. Some divisions, however, do little to establish market based prices and base prices on cost. As discussed below, the problem is compounded by a number of deficiencies in how product costs are determined.

FPI procedures provide that FPI divisions obtain market prices from several sources, such as trade papers or confidential inquiries. Generally, however, division managers do not follow these procedures. Several division managers said that they refer to catalogs which contain items similar to those FPI manufactures, but they generally did little more to survey market prices. Instead, managers relied on cost data to establish prices. For example, division managers commonly divided the cost of an item by 0.85 to determine its selling price.

In one instance, the manager of the Terminal Island ADP facility used neither market prices nor cost to determine selling price. On the contrary, the manager established prices for keypunching services on the basis of personal experience. One customer told us that Terminal Island's prices were far below market prices for similar services. In fiscal year 1979, the Terminal Island

ADP facility incurred a loss of \$80,256 on sales of \$68,587. Although we did not evaluate all the reasons for the significant loss on operations, it is evident that the manager's failure to follow FPI pricing procedures was a significant factor.

At the time of our fieldwork, the Deputy Associate Commissioner stated that a memorandum would be sent to all FPI divisions stressing that FPI prices should be based on market prices whenever possible.

MANUFACTURING COSTS

FPI regulations require estimates for all products and controls to ensure accurate recording of costs by job. Actual costs per job are to be compared to estimates, variances analyzed, and estimates changed, if unrealistic. Department of Justice and FPI internal auditors have frequently reported the failure of factories to follow such procedures. These auditors reported instances in which cost estimates were not made, costs were recorded inaccurately, variances were not analyzed, or estimates were not changed. In our examination we found similar problems.

Accumulating costs

At three of the eight factories we visited, we found instances where costs were improperly charged to jobs. For example, at the Alderson Garment factory, the amount of material charged to jobs frequently differed from the amount of material actually used, because material charged to a specific job was sometimes used for another job. At the Petersburg Cable factory, direct labor was not always charged to the proper jobs.

Manufacturing overhead costs

We found problems in how manufacturing overhead costs were determined and in the method by which these costs were distributed to jobs. As a result, the overhead costs included in the total cost of jobs and products were often inaccurate.

Manufacturing overhead costs are costs, such as depreciation of equipment and utilities expenses, that relate to factory operations but are not readily identifiable with specific jobs. Because overhead costs cannot be determined with precision until the end of an accounting period, many manufacturers overcome this problem by developing a budget of estimated overhead costs. Estimated overhead costs are then applied to jobs by developing a rate based on a level of activity, such as direct labor costs or direct labor hours. At the end of an accounting period, adjustments are made to reflect differences between (1) actual and estimated overhead costs and (2) actual and estimated activity levels.

For accounting purposes, FPI directs its factories to accumulate manufacturing overhead costs in a single account. The accumulated costs are in turn used to establish an overhead rate which is applied on the basis of direct labor cost. We found that factories were charging nonproduction costs, such as expenses for employees' permanent changes of station, to manufacturing overhead, thereby overstating manufacturing overhead costs, overhead application rates, and costs of jobs.

Further, FPI procedures require that overhead costs be applied using either a rate based on a 6-month running average of manufacturing overhead costs or a rate prescribed by a parent division. Rates determined by a division are based on data furnished by its factories. These methods used by FPI to determine overhead rates, when coupled with the inclusion of nonmanufacturing costs, resulted in rates which fluctuated substantially from month to month and often resulted in inaccurate overhead costs being charged to jobs and products.

Variance analyses

We found a number of instances where, although actual production costs differed from estimated production costs, factory staff did not properly analyze the variances. FPI procedures require that when actual and estimated production costs vary by more than 10 percent,

managers should determine why the variances occurred, who was responsible, and take corrective action. At the Alderson Garment factory, actual and estimated costs differed by more than 10 percent on many jobs, but variance analyses were incomplete. At the Petersburg Cable factory, variances were substantial. Although the staff determined the difference between actual and estimated costs, they did not analyze the reasons for the variances. Instead, they reclassified certain costs to reduce the variances.

During our fieldwork, the Deputy Associate Commissioner told us that the FPI Policy and Procedures Manual was being revised to include further guidance on accumulating accurate cost data and analyzing cost variances.

PURCHASING

Department of Justice and FPI internal auditors have devoted considerable effort to reviewing procurement activities at factories. The internal auditors found numerous examples where factory staff had not complied with Federal Procurement Regulations. Also, the internal auditors found that records at some factories were so poorly maintained that it was very difficult to determine if applicable regulations had been followed.

In our work, we noted similar problems. We also followed up on a problem raised by Department of Justice internal auditors concerning procurement of laminates by furniture factories. Furniture laminates are purchased on a brand name basis. Factory officials said that they purchase in this manner to ensure that the texture of laminates is consistent. While we did not review these purchasing practices in depth, we believe that, because several factories use the same laminates, potential exists for savings by consolidating requirements and buying in larger quantities.

INVENTORY

Inaccurate inventory records and problems in inventory management existed at some of the factories. Specifically, problems in inventory management included

(1) similar items stored in multiple locations;
(2) obsolete and unused equipment and material, commingled with the regular inventory, scattered throughout the warehouse; and (3) excessive stock levels of plastic laminate, chipboard, and plywood stored in a manner requiring frequent moving and handling. Furthermore, slow moving or excess items were not promptly removed from inventory, and damaged materials and finished goods were still carried in inventory at their undamaged value.

ACCOUNTS RECEIVABLE

The internal auditors and we noted a number of deficiencies in the collection of delinquent accounts receivable. As shown in the notes to FPI's financial statements, accounts receivable more than 90 days old have increased from \$725,000 (6 percent of receivables) at September 30, 1978, to \$1,593,500 (11 percent of receivables) at September 30, 1979. At seven of the eight factories visited, deficiencies in followup efforts to collect delinquent accounts receivable existed. In one case, the factory complained of lack of help in its parent division, citing a 5-month delay from the first request until the division took action.

TRAVEL

Many employees, including those responsible for approving travel and certifying travel vouchers, appear to have inadequate knowledge of Federal travel regulations. Department of Justice and FPI internal auditors have cited numerous problems in travel administration. We reviewed 76 travel vouchers and found problems and potential erroneous payments in 41 cases. The problems involved matters such as

- selecting the method of transportation to assure it is the most advantageous to the Government;
- paying subsistence at employee's permanent duty station;
- paying per diem on the basis of an employee's departure from residence or arrival at residence,

even though the employee worked at the official duty station; and

--reimbursing a traveler for the use of a rental car and privately owned vehicle on the same trip.

During our fieldwork, we provided this information to the Deputy Associate Commissioner who subsequently told us that corrective action had been taken in each of the cases.

INTERNAL REPORTING OF FINANCIAL DATA

The FPI Control Accountant had considerable difficulty preparing consolidated financial statements for fiscal year 1979, because the data provided by many factories contained a number of errors. For example, the financial records of 20 factories (25 percent of all factories) had to be reopened after yearend closing to correct records and revise prepared statements. Also, numerous inventory certificates needed revision, because the responsible persons failed to follow prescribed reporting and accounting procedures.

WHY PROBLEMS OCCURRED

FPI officials said that many of the problems discussed above resulted, in part, from the assignment of new or inexperienced personnel at factories. In addition, FPI officials recognized that inadequacies in FPI policies and procedures have also contributed to these problems and have therefore agreed to make certain changes.

Further, FPI officials recognized the need to make a concerted effort throughout FPI to improve management. In this regard, the Associate Commissioner, in a September 26, 1979, memorandum to all Superintendents of Industries, noted that the same findings by internal auditors appeared year after year and that, despite promises, little corrective action had been taken. He placed full responsibility on superintendents to ensure compliance with FPI policies and procedures.

CONCLUSIONS

FPI needs to improve the management of its factories. Problems exist in pricing products, determining manufacturing costs, purchasing materials, maintaining inventories, collecting accounts receivable, authorizing and reimbursing travel, and internal reporting of financial information. These problems affect the efficiency of FPI's operations and its net profit.

These problems often occurred because staff at FPI factories did not follow established policies and procedures. In some cases, however, policies and procedures need to be clarified and strengthened. A number of these problems are attributable, in large part, to inexperienced personnel.

RECOMMENDATIONS

During our fieldwork, FPI officials told us of several actions being taken to strengthen FPI policies and procedures. In this regard, we recommend that you direct the Associate Commissioner to complete the development of additional guidelines to factories to ensure that

- selling prices are based on market prices,
- accumulated cost data are complete and accurate,
and
- cost variances are analyzed and appropriate corrective action is taken.

We also recommend that you direct the Associate Commissioner to

- revise overhead accounting procedures to ensure that nonmanufacturing costs, such as permanent change of station costs, are not included as manufacturing overhead and
- revise overhead accounting procedures to provide for the development of stable overhead rates. One

approach would be to require annual overhead rates which could be adjusted to recognize significant changes in overhead costs or levels of activity.

Because a number of the problems we identified can be traced to staff inexperience, we further recommend that you direct the Associate Commissioner to develop a training program for factory financial management personnel.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report. Copies of this report are being sent to the Chairmen of those committees; the Senate Committee on the Judiciary; and the House Committee on the Judiciary.

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We appreciate very much the cooperation and courtesies extended to our staff during the course of our work.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director