

# California State Auditor

B U R E A U O F S T A T E A U D I T S

## **Prison Industry Authority:**

*Its Outside Purchase of Goods and Services  
Neither Well Planned nor Cost Effective*



September 1998  
98102

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# CALIFORNIA STATE AUDITOR

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September 24, 1998

98102

The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the Prison Industry Authority's (PIA) purchase and resale of finished goods and services. This report concludes that the PIA bought finished goods from the private sector 656 times and lost \$208,000 on their resale during the period we reviewed with the losses being subsidized by customers buying the PIA's other goods and services. Further, for some items it frequently purchases from the private sector, the PIA does not plan ahead to meet its customers' demands. Instead, the PIA sometimes uses emergency procurement procedures inappropriately to purchase finished goods and services, which limits competition and may not reflect the lowest cost. In addition, the PIA does not technically have the legal authority to buy and resell finished goods and services to its customers. This authority is vested in the Prison Industry Board and has not been delegated to the PIA. Finally, the PIA is acting strictly as a middleman in its purchase and resale of processed eggs, a product the PIA does not produce. Such an arrangement does not contribute to its mission of promoting inmate employment, duplicates the efforts of other state procurement units, and may result in additional administrative costs.

Respectfully submitted,

KURT R. SJOBERG  
State Auditor

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# SUMMARY

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## Audit Highlights . . .

### *The Prison Industry Authority:*

- ✔ *Lost \$208,000 on the resale of finished goods purchased from the private sector.*
  - ✔ *Uses emergency procurement procedures inappropriately.*
  - ✔ *Does not adequately plan to meet the demand of its customers.*
  - ✔ *Functions strictly as a middleman in its processed egg sales, which does not promote its mission of inmate employment.*
- 

## RESULTS IN BRIEF

The Prison Industry Authority (PIA) was established on January 1, 1983, as the successor to the California Correctional Industries Commission. The PIA is a penal program whose goals are to employ inmates, develop inmate work skills, and reduce the cost of operations of the California Department of Corrections (CDC). As such, the PIA employs inmates in the manufacturing, service, and agricultural industry programs it operates and manages statewide. Its products are sold principally to state agencies, which are required by law to purchase the PIA's manufactured goods. However, in instances when the PIA cannot produce enough products or render services to meet demand, it conducts a "buyout," which means it purchases comparable finished goods and services from the private sector. The PIA subsequently resells these items to its customers at its published prices.

Our review examined the extent to which the PIA buys and resells finished goods and services to its customers, and whether this activity is in accordance with state government rules, regulations, and policies. This examination covered July 1994 through December 1997 and revealed the following facts:

- The PIA bought finished goods and services from the private sector 656 times with a resale value averaging 1.7 percent of total sales, and in conducting these buyouts lost \$208,000.
- The PIA profited on the sales of its other goods and services, indicating that some of its customers are subsidizing its losses on buyouts.

Also, when purchasing finished goods and services for resale, the PIA inappropriately uses emergency procurement procedures, which limits competition for the State's business, precludes its customers from choosing other vendors to supply their needs, and may not reflect the lowest cost available to the State. Moreover, we found that the PIA does not adequately plan ahead to meet the demand of its customers, especially in its poultry enterprise. Instead of establishing a statewide contract for chicken, the PIA uses emergency procurement procedures, rather than other alternatives, to purchase chicken when needed.

Further, according to our legal counsel, the PIA does not currently have the legal authority to buy and resell finished goods and services to its customers. This authority is vested in the Prison Industry Board and has not been delegated to the PIA.

Finally, the PIA purchases and resells processed eggs, primarily to the CDC. However, in these transactions the PIA functions strictly as a middleman because it does not produce processed eggs. Consequently, the PIA is not promoting inmate employment and is duplicating the efforts of the CDC's own procurement unit and that of the Department of General Services, which may result in additional administrative costs.

## **RECOMMENDATIONS**

The Legislature should clarify its intention for the PIA to purchase and resell finished goods and services to its customers. If the PIA's current practice is as the Legislature intends, the Prison Industry Board should delegate authority in writing to the PIA to do so.

The PIA should establish appropriate statewide contracts for finished goods and services it frequently must purchase from the private sector to supplement its own production. The PIA should also abide by the State's procurement procedures when purchasing any items not covered by a statewide contract.

The PIA should discontinue acting as an agent for the California Department of Corrections or other state agencies to purchase items it does not produce.

## **AGENCY COMMENTS**

The Prison Industry Authority agrees that it could improve its planning and use of contracts for purchases of finished goods and services. The PIA pledges to work with the Department of General Services to identify those contracts that would be in the best interest of the State. However, the PIA disagrees with the conclusion that it lacks the authority to purchase and resell finished goods and that its buyouts are not cost effective. ■

# INTRODUCTION

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The Prison Industry Authority (PIA) was established on January 1, 1983, as the successor to the California Correctional Industries Commission. Although it is under the policy direction of an 11-member board of directors, the PIA is technically part of the California Department of Corrections (CDC). Approximately 725 civilian employees work for the PIA throughout the State. Its administrative headquarters is located in Folsom, California.

The PIA operates and manages 68 manufacturing, service, and agricultural industry programs at 23 of the 32 CDC institutions in California. It manufactures a wide range of products, including textiles, license plates, and office furniture. It also has laundry and printing service programs and sells milk, eggs, and poultry through its agricultural programs. Overall, PIA enterprises employ roughly 6,600 male and female inmates statewide. For fiscal year 1996-97, the PIA recorded sales of approximately \$155 million.

The California Penal Code, Section 2807(b), requires state agencies to purchase the PIA's products or the PIA can grant state agencies a waiver allowing them to purchase goods and services from other sources. The PIA can also sell its products and services to cities, counties, special districts, and public schools in the State, as well as to public agencies in other states whose laws permit it, federal agencies, and foreign governments and businesses. The CDC is the PIA's largest single customer.

If the PIA cannot produce enough products or render services to meet demand, it purchases comparable finished goods and services from the private sector. The PIA calls this activity a "buyout." The PIA subsequently resells these items to its customers at its published prices. Buyouts frequently occur for the PIA's food, including bread and milk. From July 1994 through December 1997, the PIA purchased finished goods and services, including clothing, printing, and food items, 656 times from the private sector.

## SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee requested the Bureau of State Audits (bureau) to determine the extent to which the PIA buys and resells finished goods and services to its customers and the propriety of those activities under state government rules, regulations, and policies.

To determine whether the PIA has the authority to purchase and resell finished goods and services, we reviewed the laws and regulations governing it. We also examined the laws and regulations that control state procurement practices. Finally, we sought a legal opinion asking whether the PIA has the authority to purchase and resell goods and services and whether its use of emergency procurement procedures in these situations meets the State's definition of an emergency.

To determine the frequency and extent of its purchase of finished goods and services, we reviewed the PIA's purchases and sales from July 1, 1994, through December 31, 1997, and identified those instances where it bought finished goods and services from the private sector. We excluded from the scope of our analysis purchases of eyeglasses for Medi-Cal and laundry services for state hospitals and developmental centers, because the PIA has entered into contracts to provide them. These contracts obligate the PIA to provide eyeglasses and laundry services whether or not it can do so through its own operations. The PIA has secured backup suppliers through a competitive bid process to supply the eyeglasses and laundry services when it cannot.

To determine the cost effectiveness of the PIA's buyouts, we used purchase orders, the PIA's price schedules, and selling and administrative costs to analyze the cost of the finished goods and services and calculate the resale amount.

In addition, we noted that the PIA purchased raw chicken numerous times. Although these purchases are not technically buyouts because the PIA further processes the meat, we separately analyzed raw chicken purchases from July 1995 through December 1997 to assess the PIA's efforts to plan for customer demand.

Finally, we compared the PIA's production capacity to the quantities of finished goods and services purchased to assess the impact buyouts might have on inmate employment.



However, because inmate employment fluctuates widely due to many factors, we could not determine the impact, if any, buyouts have. ■

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# AUDIT RESULTS

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## ***The Prison Industry Authority's Current Purchasing Process Needs Improvement***

### SUMMARY

**F**rom July 1994 through December 1997, the Prison Industry Authority (PIA) spent over \$9.6 million on 656 buyouts for finished goods and services from the private sector. The PIA's resale value of these finished goods and services approximates 1.7 percent of its total sales revenue for the same period. Although about 46 percent of these buyouts generated profits, 54 percent were sold at a loss of roughly \$208,000 during the period reviewed. These losses were likely subsidized by the PIA's customers for other goods and services.

When it purchases finished goods and services for resale, the PIA inappropriately uses emergency procurement procedures. In so doing, the PIA effectively limits competition for the State's business, precludes its customers from choosing other vendors to supply their needs, and possibly pays more than necessary for the goods and services it purchases.

In addition, although not considered a buyout, the PIA purchases raw chicken from the private sector, often using emergency procurement procedures and contacting the same suppliers for bids. From July 1995 through December 1997, the PIA purchased approximately 2.2 million pounds of raw chicken worth over \$1 million from the same vendor. As a result of not better planning these purchases, the PIA has effectively limited competition for its business.

Despite its activity of buying and reselling finished goods, the PIA does not technically have the legal authority to do so. This authority is vested in the Prison Industry Board but has never been delegated to the PIA. Finally, in some transactions, the PIA functions strictly as a middleman. For example, it sells processed eggs, which it purchases but is not equipped to produce, to the California Department of Corrections (CDC) and other state agencies. The PIA is merely acting as a purchasing agent in this circumstance and, as such, is duplicating the efforts of CDC's

own procurement unit and those of the Department of General Services. Moreover, this arrangement runs counter to the PIA's statutory mandate of providing inmate employment opportunities. Consequently, this practice does nothing to promote inmate industry and the State incurs unnecessary administrative expense.

## BACKGROUND

When procuring goods and services, most agencies must follow the requirements set forth in the Public Contract Code and the State Administrative Manual (SAM); these same requirements apply to the PIA. An agency has three avenues for procuring goods. First, with assistance from the Department of General Services (DGS), it can obtain written bids and award a contract. Second, an agency may seek authority from the DGS to procure goods and services without DGS assistance under a certain dollar value, generally \$15,000. In these cases, the agency still must obtain price quotes, although this is done informally—usually by telephone. Lastly, in cases of emergency, an agency may procure necessary goods and services, then request DGS approval afterward. An emergency condition, as defined by the SAM, Section 3511, “... is one which would not have been avoided by reasonable care and diligence or [the condition carries] an immediate threat of substantial damage or injury to ... employees of the agency ... the general public, or to property for which the agency is responsible.”

## BUYOUTS INCREASE COSTS FOR THE STATE

The PIA bought finished goods and services from the private sector 656 times from July 1994 through December 1997, an average of 16 buyouts a month. These buyouts predominantly included milk, bread, clothing, and printing services. During that time period, revenue from the resale of buyouts averaged 1.7 percent of the PIA's total sales revenue, or about \$8.9 million. Although this is a relatively small percentage, these buyouts cost the PIA approximately \$208,000 more than it charged its customers for the goods.

As depicted in Table 1, the PIA's revenue from the resale of its buyouts ranged from 1.53 percent to 2.75 percent for an average of 1.74 percent in total sales revenue for the period reviewed.

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*The PIA lost approximately \$208,000 on its 656 buyouts since July 1994.*

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From July 1994 through December 1997, buyouts cost the PIA approximately \$208,000 more than it charged its customers. About 46 percent of the buyouts were resold for a profit while 54 percent were sold at a loss. (For tables detailing buyouts by fiscal year and product, see the Appendix.)

**TABLE I**

**Profit or Loss on the Resale of Buyouts  
Fiscal Years 1994-95 to December 1997**

<b>Fiscal Year</b>	<b>Number of Buyouts</b>	<b>Net Profit/(Loss) (in Thousands)</b>	<b>Percent of Buyout Sales Revenue to Total Sales Revenue</b>
1994-95	280	\$ 417	1.54%
1995-96	156	(184)	1.53
1996-97	160	(429)	1.66
7/97 to 12/97*	60	(12)	2.75
<b>Total</b>	<b>656</b>	<b>\$(208)</b>	<b>1.74%</b>

\*This time period represents the first six months of fiscal year 1997-98.

The PIA's losses arose from a variety of goods and services. In particular, it sustained sizable losses on the resale of bar soap. For example, in fiscal year 1995-96, the PIA lost approximately \$170,000 on its resale of bar soap and in fiscal year 1996-97, its loss nearly doubled to \$339,000.

***Customers may be paying more than necessary to subsidize the PIA's losses on buyouts.***

Even though it resold its buyouts at a loss, the PIA has exhibited an overall profit during the period reviewed. Although the California Penal Code mandates that the PIA be self-supporting, if the PIA's profits cover its losses on buyouts, some agencies and customers may be paying more than necessary for other goods and services.

We calculated the PIA's profit and loss on the resale of buyouts using its published prices and factoring in its selling and administrative expenses, including such costs as distribution. From July 1994 to December 1997, the PIA's selling and administrative expenses averaged 14.7 percent. Therefore, the net loss shown in Table 1 is not simply the difference in the prices the PIA charged for buyouts and what it paid, but also reflects the cost to market

and distribute the buyout items. We did not include certain costs, such as plant startup or interest expense, because they are not reasonably attributable to finished goods and services purchased by the PIA for its customers.

## **THE PIA IMPROPERLY USES EMERGENCY PROCUREMENT PROCEDURES**

The PIA uses emergency procurement procedures to purchase finished goods and services without appropriate justification. It uses these procedures to accommodate customer needs—usually to ensure delivery of goods and services—which are not emergencies.

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*The PIA's definition of an emergency does not meet state regulations.*

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For the 656 buyouts the PIA made during the period we reviewed, it used emergency procurement procedures on 52 occasions and its delegated purchase authority for the remaining 604. The documents we reviewed indicate that most of these finished goods purchases were made to “meet [the] customer’s delivery date.” According to the PIA’s chief counsel, when buyouts are required, emergency procurement procedures “are the only means of purchasing goods since the dollar value of the buyout usually exceeds PIA’s delegated purchasing authority.” In other words, because DGS approval can be sought concurrently, or after the fact, for emergency purchases, this procurement process is much faster. Further, the chief counsel stated that using the DGS to develop specifications and bid for goods and services “would take approximately 90 days,” a time frame that is unacceptable to the PIA’s customers; however, the PIA has the power to grant a purchase waiver releasing any state agency from its obligation to buy from the PIA. Granting such purchase waivers could prevent PIA customers from suffering unreasonable time delays because, if the circumstances are truly of an emergency nature, the PIA’s customers should be able to justify using emergency purchase procedures. Otherwise, the use of emergency purchase procedures is not warranted.

Moreover, our legal counsel determined that ensuring customer delivery does not meet the State’s definition of an emergency. The use of these procedures requires the purchasing agency, in this case the PIA, to demonstrate that the emergency condition could not have been avoided by reasonable care and diligence, or that there is an immediate threat of substantial damage or injury.

## Better Planning Would Ensure Competition for the PIA's Business

As mentioned previously, the PIA bought finished goods and services from the private sector 16 times per month on average, frequently for the same goods and services. For some of the most common purchases, the PIA has not planned for its needs.

*The PIA has not used historical buyout amounts and ordering requirements to predict its customers' needs.*

For example, agencies must buy milk and bread from the PIA because it offers them for sale. Agencies may order milk annually, semi-annually, or quarterly; therefore, the PIA can reasonably anticipate its milk demand at least 12 weeks in advance. Sixty-four percent of all buyouts for the fiscal years reviewed were for milk and bread. Although the PIA cannot anticipate equipment failures or prison lockdowns, which make its workforce inaccessible, historical buyout amounts, known demand, and planned interruptions in production afford the PIA the opportunity to plan ahead to meet its customers' needs.

According to the PIA's branch manager for consumable goods, its milk buyouts for fiscal years 1995-96 and 1996-97 do not represent a normal need to purchase prepackaged milk. The branch manager stated that the remodeling of two of its dairies located at the California Institution for Men and the Deuel Vocational Institution interfered with the PIA's normal milk production. According to the branch manager, 83 percent of one dairy's purchases occurred during its remodel in May and June 1996. Similarly, the branch manager told us that remodeling the other dairy began in March 1997 and continued into the next fiscal year. During fiscal year 1996-97, the second dairy made 95 percent of its prepackaged milk purchases during this remodel.

Although the remodeling of these two dairies could not have been undertaken without significant planning, the PIA did not use this opportunity to anticipate its prepackaged milk needs. Instead of securing backup suppliers ahead of time, the PIA bought the majority of its prepackaged milk using emergency procurement procedures. While the remodeling of the two dairies explains why the buyouts occurred, it does not mitigate the PIA's lack of planning for its milk purchases.

When the PIA cannot produce enough milk or bread to meet demand, it randomly seeks a supplier. Because its need is immediate, and it has not planned ahead for suppliers, the PIA may pay more for milk or bread than necessary. Planning ahead

could include securing a vendor to provide the needed goods or services through a statewide contract, which the DGS would establish after developing product specifications and advertising for bidders. Anyone meeting the specifications can bid on the contract with the award going to the lowest responsive bidder. A responsive bidder is one that meets all the requirements as set out in the bid instructions. Once the contract is in place, agencies can order directly from that vendor and, because of the quantities the State purchases, pay a lower price than they would pay individually.

Establishing a statewide contract gives all interested vendors the opportunity to compete for the State's business; however, the PIA limits competition for the State's business because it seeks price quotes from a select group. It does not allow all qualified vendors to respond through a competitive bid. Between July 1994 and December 1997, the PIA used emergency procurement procedures for 80 percent of its milk buyouts and contacted a total of ten dairies for bids on these purchases. However, the PIA contacted one dairy 80 percent of the time and ultimately purchased 40 percent of its milk buyouts from that dairy. Overall, the PIA contacted the same three dairies for bids more than half the time and purchased milk from these three 93 percent of the time, thereby limiting competition for the State's business.

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*The PIA's focus on a select group of dairies limits competition for the State's business.*

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According to the consumable goods branch manager, the PIA can purchase milk only from a limited number of dairies due to the dairies' locations and production capacities; therefore, the PIA contacted only certain dairies because they serve the regions of the State where there was a need. We analyzed the quotes the PIA sought for its emergency milk buyouts and found it could have fostered more competition. For example, in November 1995, the PIA listed five dairies as known milk suppliers to the dairy at Corcoran State Prison; however, for subsequent emergency milk purchases, the PIA did not contact four of the five listed dairies, and in two instances, milk purchases were awarded on a sole-source basis, thus limiting competition.

### **Lack of Planning in the PIA's Poultry Operation Limits Competition**

The PIA operates a poultry enterprise at the Avenal State Prison. The enterprise hatches and raises live birds and processes them for consumption. The PIA also frequently purchases raw chicken from the private sector whenever its own production cannot



keep pace with demand. Unlike other products it buys from the private sector and simply distributes to its customers, the PIA further processes the raw chicken by sectioning it into pieces, freezing the meat, and packaging it for distribution. Because the PIA does some processing of the raw chicken, this item is not included in our analysis of buyouts. However, the PIA's purchase of raw chicken is a further example of its lack of planning for purchases and constraints on competition.

The PIA's poultry enterprise runs on a 36-week production cycle; for 24 of those 36 weeks it processes chickens it has raised. During the remaining 12 weeks, no processing of live birds occurs because either the inmates clean the chicken barns to control disease or the chickens are not yet mature enough to be killed. Therefore, for over 30 percent of its production cycle, the PIA does not have mature, live birds available for slaughter and must purchase raw chicken to meet continued customer demand.

Because the PIA can anticipate when barns are being cleaned and the rate its chickens will mature, it can reasonably plan the amount of raw chicken it must purchase from the private sector and when. Nonetheless, from July 1995 through December 1997, the PIA made 38 separate purchases of raw chicken, considering each an emergency. These purchases amounted to approximately 2.2 million pounds of raw chicken worth over \$1 million. Each time, the PIA selected three vendors and sought price quotes over the telephone; however, it requested bids from the same two vendors on every occasion and from the third vendor 81 percent of the time. Despite obtaining three quotes each time, the PIA awarded all 38 purchases to the same vendor. Although the vendor the PIA purchased its chicken from had the lowest quote (except on three occasions), the PIA has nevertheless effectively limited competition for its business by nearly always contacting the same vendors.

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*From July 1995 to December 1997, the PIA made 38 separate purchases totaling 2.2 million pounds of chicken from one vendor.*

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### **AUTHORITY TO PURCHASE AND RESELL FINISHED GOODS IS VESTED IN THE PRISON INDUSTRY BOARD**

Until the Prison Industry Board (board) delegates it, the PIA technically does not have the authority to purchase and resell finished goods and services. Section 2802 of the Penal Code created the board and Section 2808 gives it the authority to do

all things that the board of directors of a private corporation would do. However, we could find no basis in the law for an employee of the PIA to purchase and resell finished goods. Therefore, we sought a legal opinion to determine the extent of the PIA's authority. According to our legal counsel, the board has the authority to purchase and resell finished goods and services and can delegate that authority to the PIA. Nonetheless, the PIA was unable to supply evidence that the board had delegated this authority. Technically, until the PIA receives this authority, it cannot purchase and resell finished goods and services legally.

### **THE PIA ACTS AS A PURCHASING AGENT FOR GOODS IT DOES NOT PRODUCE**

In addition to the 656 buyouts the PIA made to supplement its own production, it also purchased another item from the private sector at the request, and on behalf, of the CDC. Specifically, in fiscal year 1994-95, the CDC asked the PIA to "look into providing processed eggs to our facilities" because the CDC's contracted vendor was not meeting its commitments of product quality and timely delivery. Processed eggs, either liquid or frozen, are an alternative to eggs in the shell. Although the PIA does not operate a processed egg enterprise, it routinely purchases and delivers this product to CDC institutions and other state agencies.

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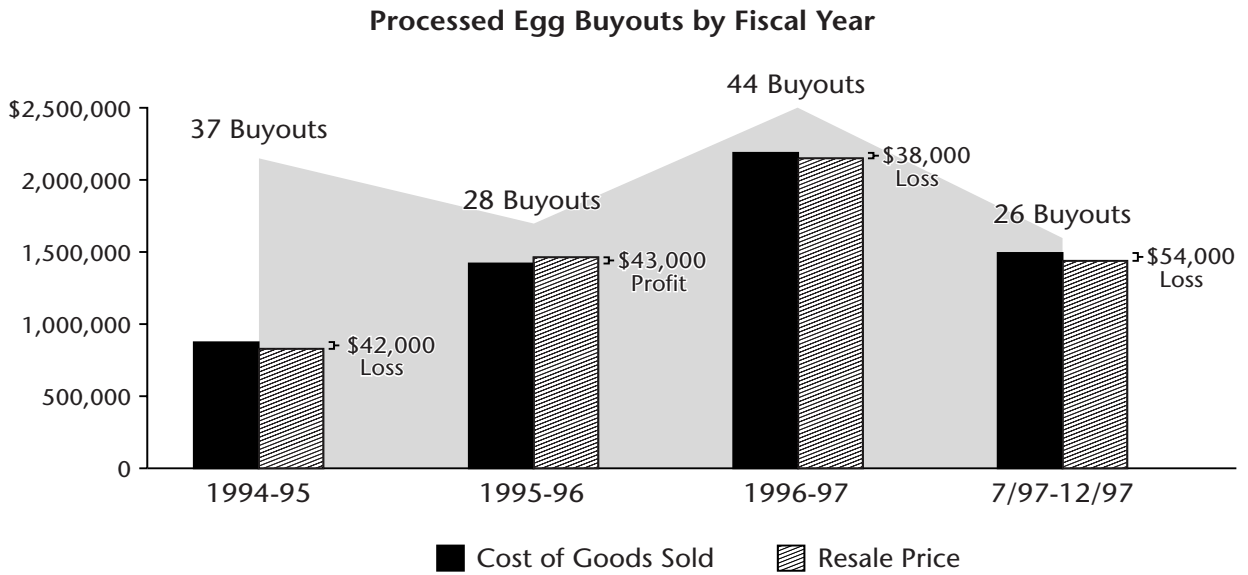
*The PIA routinely purchases and resells processed eggs. However, since it does not produce this product, it is functioning strictly as a middleman.*

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The PIA has lost approximately \$91,000 on its sales of processed eggs from July 1994 to December 1997. To calculate this amount, we considered the PIA's distribution costs as well as all other selling and administrative expenses. Figure 1 illustrates the number of purchases the PIA has made during the period we reviewed and the profit or loss it sustained on processed egg sales. However, this is not a product the PIA is equipped to produce, so its role is merely to act as the purchasing agent for the CDC or other state agencies wishing to buy this product.

The PIA's role as purchasing agent does nothing to address the CDC's concerns about quality and timely delivery. The PIA does not employ any inmates to produce the egg product, but simply purchases and delivers the eggs from a contracted supplier. Therefore, the CDC's concerns over product quality and timely delivery have only shifted to the PIA. Moreover, in fulfilling this role, the PIA is effectively duplicating the efforts of the DGS and CDC procurement units. As a result, between July 1994 and

**FIGURE 1**



December 1997, the State has incurred costs that it could have avoided, namely the PIA’s additional administrative expense for procuring and delivering the processed eggs.

***The PIA’s role as a purchasing agent does not fulfill its statutory purpose of inmate employment.***

According to the PIA’s branch manager for consumable goods, between 20 percent and 34 percent of the processed eggs it purchases and resells contain unusable eggs in the shell (breaker eggs) from its own operation. The PIA sells these breaker eggs to the processor which enables it to receive some processed eggs at a lower price. While we recognize the advantage of selling breaker eggs rather than disposing of them, we believe the PIA could continue to sell its breakers without purchasing processed eggs on the CDC’s or any other agency’s behalf. Moreover, receiving a cost offset does not alter the fact that acting as a purchasing agent for items the PIA does not produce is inappropriate. Such an arrangement does nothing to fulfill the PIA’s statutory purpose of providing inmate employment. In addition, this arrangement causes the PIA to duplicate the efforts of existing procurement units, such as those of the CDC and the DGS, and incur unnecessary administrative costs.

**RECOMMENDATIONS**

The Legislature should determine if it intended the PIA to purchase and resell finished goods to its customers or if it intended the PIA to simply grant agencies a waiver to procure these products directly.

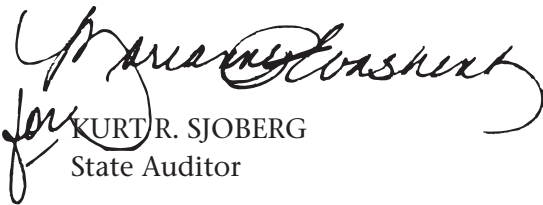
If the Legislature intends the PIA to purchase and resell finished goods, the Prison Industry Board should delegate in writing to the PIA its authority to do so.

The PIA should do the following:

- Better plan for those instances when it is unable to meet customer demand and establish its own statewide contracts as appropriate to ensure the State receives the most competitive price for the goods and services normally produced by the PIA.
- Follow the appropriate procurement practices when purchasing finished goods rather than claiming that purchases are “emergencies,” and thus avoiding the State’s normal procurement oversight.
- Discontinue acting as a purchasing agent for the CDC and other state agencies in cases where the PIA does not produce the particular item desired.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



KURT R. SJOBERG  
State Auditor

Date: September 24, 1998

Staff: Doug Cordiner, Audit Principal  
Sharon L. Smagala, CPA  
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# APPENDIX

## ***Buyouts by Fiscal Year and Product***

**W**e reviewed the Prison Industry Authority's (PIA) buyouts from July 1994 through December 1997. The following tables display the PIA's buyouts by product and fiscal year. In addition, we list the number of buyouts for each product, the cost, the PIA's selling price, and its net profit or loss on the resale.

### **Buyouts Fiscal Year 1994-95 (Dollars in Thousands)**

<b>Product</b>	<b>Number of Buyouts</b>	<b>Cost</b>	<b>Resale</b>	<b>Net Profit/ (Loss)<sup>1</sup></b>
Bakery	175	\$ 333	\$ 302	\$(31)
Dairy/farm	16	78	72	(6)
Egg production <sup>2</sup>	26	277	408	131
Fabric products	5	1,067	1,306	239
Meat cutting	1	141	135	(6)
Metal products	1	21	18	(3)
Metal signs	1	2	4	2
Optical <sup>3</sup>	11	72	72	0
Shoe factory	3	130	225	95
Specialty print	41	162	160	(2)
<b>Total</b>	<b>280</b>	<b>\$2,283</b>	<b>\$2,702</b>	<b>\$419</b>

<sup>1</sup>Differences in Net Profit/Loss shown in this Appendix and Table 1 on page 9 of our report are due to rounding.

<sup>2</sup>Egg production includes eggs in the shell only. As discussed on page 14 of our report, processed eggs were analyzed separately.

<sup>3</sup>Optical buyouts noted here do not include eyeglasses manufactured under the Medi-Cal contract as discussed in the Scope and Methodology section of our report.

**Buyouts**  
**Fiscal Year 1995-96**  
(Dollars in Thousands)

Product	Number of Buyouts	Cost	Resale	Net Profit/(Loss) <sup>1</sup>
Bakery	68	\$ 230	\$ 225	\$ (5)
Bar soap and cleaning products	8	493	333	(160)
Dairy/farm	24	922	928	6
Egg production <sup>2</sup>	7	67	96	29
Mattress factory	2	313	264	(49)
Metal signs	1	2	4	2
Optical <sup>3</sup>	20	117	117	0
Specialty print	26	311	304	(7)
<b>Total</b>	<b>156</b>	<b>\$2,455</b>	<b>\$2,271</b>	<b>\$(184)</b>

<sup>1</sup>Differences in Net Profit/Loss shown in this Appendix and Table 1 on page 9 of our report are due to rounding.

<sup>2</sup>Egg production includes eggs in the shell only. As discussed on page 14 of our report, processed eggs were analyzed separately.

<sup>3</sup>Optical buyouts noted here do not include eyeglasses manufactured under the Medi-Cal contract as discussed in the Scope and Methodology section of our report.

**Buyouts**  
**Fiscal Year 1996-97**  
(Dollars in Thousands)

Product	Number of Buyouts	Cost	Resale	Net Profit/(Loss) <sup>1</sup>
Bakery	69	\$ 255	\$ 238	\$ (17)
Bar soap and cleaning products	8	1,037	700	(337)
Dairy/farm	36	530	482	(48)
Fabric products	2	674	645	(29)
Mattress factory	2	23	32	9
Optical <sup>2</sup>	20	150	150	0
Paper products	1	2	1	(1)
Specialty print	22	246	242	(4)
<b>Total</b>	<b>160</b>	<b>\$2,917</b>	<b>\$2,490</b>	<b>\$(427)</b>

<sup>1</sup>Differences in Net Profit/Loss shown in this Appendix and Table 1 on page 9 of our report are due to rounding.

<sup>2</sup>Optical buyouts noted here do not include eyeglasses manufactured under the Medi-Cal contract as discussed in the Scope and Methodology section of our report.

**Buyouts**  
**July 1997 Through December 1997**  
**(Dollars in Thousands)**

<b>Product</b>	<b>Number of Buyouts</b>	<b>Cost</b>	<b>Resale</b>	<b>Net Profit/(Loss)<sup>1</sup></b>
Bakery	17	\$ 67	\$ 63	\$ (4)
Dairy/farm	17	823	801	(22)
Fabric products	3	911	926	15
Optical <sup>2</sup>	5	53	53	0
Specialty print	18	109	108	(1)
<b>Total</b>	<b>60</b>	<b>\$1,963</b>	<b>\$1,951</b>	<b>\$(12)</b>

<sup>1</sup>Differences in Net Profit/Loss shown in this Appendix and Table 1 on page 9 of our report are due to rounding.

<sup>2</sup>Optical buyouts noted here do not include eyeglasses manufactured under the Medi-Cal contract as discussed in the Scope and Methodology section of our report.

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*Agency's response to the report provided as text only:*

Department of Corrections  
State of California  
PRISON INDUSTRY BOARD  
560 East Natoma Street  
Folsom, California 95630-2200  
(916)358-2677 Fax (916) 358-1732

September 15, 1998

Kurt Sjoberg  
Bureau of State Audits  
555 Capitol Mall, Ste 300  
Sacramento, California 95814

Dear Mr. Sjoberg:

**C. A. Terhune**, Chair  
John C. Lungren, Jr., Vice Chair

**MEMBERS**

Melanie Curtis Andrews  
Robert E. Burton  
Joel D. Corona  
Charles F. Grady  
Curtis R. Kelly  
Shaun J. Mathers  
Darshan H. Singh  
Willard S. Voit  
Thomas V.A. Wornham

**EXECUTIVE OFFICER**

Joella M. Fazio

**RESPONSE TO BUREAU OF STATE AUDITS' REPORT**

As Chairman of the Prison Industry Board (Board), I am pleased that the audit findings support the testimony of Prison Industry Authority (PIA) before the Joint Legislative Audit Committee in March 1998. The audit confirmed that buyout activity is minimal, representing only 1.74 percent of PIA's total sales. It also confirmed that PIA does not use buyouts to improve its overall profitability. Buyouts allow PIA to satisfy customer needs, provide timely delivery, keep lower inventories, and avoid excessive production capacity, all important areas that your two previous audit reports on PIA addressed.

We acknowledge that improved planning, coupled with expanded use of contracts, would reduce the number of PIA's emergency procurements; the audit found an average of only 15 annually, based on a 100 percent review of buyouts. The PIA will work with the Office of Procurement, Department of General Services, to determine when contracts in lieu of spot purchases are in the best interest of the State and will pursue those contracts.

I am puzzled by the Bureau of State Audits' (BSA) position on the legal authority to perform buyouts and am disappointed that your office declines to provide a copy of the legal analysis for our review. The BSA concludes that only the Board has the clear authority to do buyouts, and that authority must be technically delegated to PIA. This is contrary to the Board's legal counsel, who has concluded that ample statutory authority exists for both the Board and PIA to do buyouts, without any technical delegation. It is difficult for the Board to accept the audit's conclusion when the Board has not been afforded the opportunity to review the supporting analysis. ①\*

I am also uncomfortable with the audit conclusion that buyouts are not cost effective. While PIA resold about half of its buyouts at a loss, it does not necessarily follow that the State would have saved money if the buyouts had not occurred. In fact, a further analysis of this issue may demonstrate that the economies of larger volume buyouts by PIA provide overall cost savings for the State as a whole. Without the complete analysis, the conclusion drawn seems questionable, at best. ②

My thanks for the opportunity to formally respond and your willingness to include our response in the report.

Sincerely,

*Signature of C. A. Terhune*

C. A. TERHUNE  
Chairman

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\*California State Auditor's comments on this response begin on page R-7.

**PRISON INDUSTRY AUTHORITY  
RESPONSE TO THE BUREAU OF STATE AUDITS**

**OVERVIEW**

3 The Prison Industry Authority (PIA) accepts orders from customers in good faith with the expectation that it can meet the order. An accepted order, whether it is on a purchase order or an interagency agreement, is a legal contract and PIA is obligated to provide the goods or services under the terms offered. However, lockdowns, plant safety problems, equipment failure, and other emergencies do occur. When this happens, buyouts may be used to satisfy the customers needs and provide timely delivery. It also allows PIA to keep lower inventories, and avoid excessive production capacity, both of which have been areas of concern in prior audits by the Bureau of State Audits (BSA). Customers pay the standard PIA price, even if doing so results in a loss to PIA.

The audit confirms that PIA buyout activity is minimal, with sales from buyouts representing only 1.74 percent of total sales, averaged over the audit period. Further, it confirms that PIA has used buyouts as a business tool to satisfy customer requirements and not as a means to enhance profitability.

**BSA Finding:** Buyouts Increase Costs for the State

2 **Response:** The BSA has not presented the data to support this conclusion. The BSA did not evaluate what the total costs to the State would have been for customer agencies to obtain these items through other vendors. Each agency would have incurred the administrative costs of the procurement and possibly could have paid a higher unit price for its smaller sized orders. The economies of PIA's large volume orders and single procurement activity may actually be saving the State money.

Also, PIA did have an overall net profit during the audit period. The small annual loss of approximately \$59,000 attributable to buyouts over the audit period, when measured against annual sales of \$150 million, reflects that PIA is managing as close to the margin as is reasonable and practical.

**BSA Finding:** The PIA Improperly Uses Emergency Procurement Procedures

4 **Response:** The BSA audited one hundred percent of PIA's 656 individual buyouts during the last three and one-half years and found 52 were done under emergency purchase procedures. This is not a significant number, averaging less than 15 per year. The PIA does not agree with the conclusion that PIA uses emergency purchase procedures without appropriate justification. Emergency purchases are authorized by the Department of General Services, Procurement Division, (DGS) in accordance with the definition of emergency contained in Public Contract Code Section 1102. The emergency purchase process is utilized when the "buyout" amount exceeds PIA's delegated purchasing authority of \$15,000 and could not be avoided through the use of reasonable care and diligence per State Administrative Manual Section 3511.

However, the PIA will consult with DGS Procurement Division to review emergency purchase procedures to ensure their appropriate application.

The BSA suggests that in lieu of buyouts, PIA could grant waivers to affected customers to permit the agency to purchase the goods or services elsewhere. However, receipt and acceptance of a purchase order by PIA is a legal contract. The PIA, through acceptance of a purchase order in which it agreed to provide a certain product, within a certain time, for a specific amount, could be in default of that contract if it did not fulfill the terms of that contract. The DGS has the authority and has declared private sector suppliers in default for failure to perform in the manner and time specified on a purchase order. (3)

Further, BSA concludes that if PIA granted waivers to customer agencies, those agencies could invoke the emergency purchasing procedures to avoid delays in their purchases. Thus, the State of California would make multiple emergency purchases. It is unclear why BSA concludes it would be in the State's best interest to pursue multiple emergency purchases by numerous customers instead of a single emergency purchase from PIA. The PIA does not believe that granting waivers after accepting the orders in lieu of a buyout is either desirable or advantageous for the customers, or the State. (4)

**BSA Finding:** Better Planning Would Ensure Competition for PIA's Business

**Response:** The PIA concurs that establishing contracts, where appropriate, for the buyout of finished goods should increase competition. It does not, however, agree that such contracts ensure that PIA will receive a better price than it has been getting through the informal bid process. This is especially true for its spot purchases of bread and milk.

Nonetheless, when PIA's buyouts are predictable, contracts can be established to cover them. To that end, PIA will establish a contract for chicken to meet customer demand during planned interruptions in chicken production. Should planned, temporary closures of PIA's dairies occur in the future, contracts for milk to meet customer demand will also be pursued.

The PIA does not believe that contracts for spot purchases are viable. Vendors are very reluctant to bid in situations where they do not know the quantities by product type and size, delivery locations, and delivery dates. If bids are received in these situations, they are usually very high to cover all possible contingencies. The PIA will, however, work with DGS, Office of Procurement, to establish backup contracts for PIA products where the Office of Procurement believes they would be in the best interests of the State.

**BSA Finding:** The PIA does not currently have the legal authority to buy and resell finished goods and services to its customers. This authority is vested in the Prison Industry Board (Board) and has not been delegated to PIA

**Response:** The BSA's "Draft Report" states that it has sought a legal opinion from its own counsel and, based on that opinion, its position is that PIA does not have the legal authority to buy and resell finished goods. The BSA does acknowledge that the Board is vested with this authority but that it has never been technically delegated to PIA. The PIA has requested that BSA share this legal opinion; however, BSA has refused to do so by asserting the attorney-client privilege. Absent a review of BSA's legal opinion, PIA is unable to concur with the conclusionary statements made by BSA with respect to its legal position and will continue to rely on its own counsel's advice.

①

As was previously stated by PIA's Chief Counsel in a July 23, 1998 memorandum to BSA, there are several legal bases that provide PIA with the legal authority for effecting buyouts. First, Penal Code section 2808 vests the Board with all of the same powers as a private corporation, except as specifically limited in Article 1 of Chapter 6 of the Penal Code. It is common corporate law knowledge and practice that all day-to-day activities of a corporation are deferred to its employees, while the role of the board is the formulation of major management policies. Formal delegation of such day-to-day operation is not required as it is implied in law and practice. Furthermore, said delegation is also implied by Penal Code section 2808 (e) which authorizes the Board to "contract to employ a general manager to serve as the chief administrative officer of the authority."

⑤

Finally, it is clear that PIA is vested with its own authority to purchase and sell finished goods, when necessary. Penal Code section 2805 confers to PIA the control and power to buy and sell all equipment, supplies, and materials used in the operations over which it assumes control and jurisdiction. Therefore, a formal delegation from the Board to PIA does not appear to be supported by law.

**BSA Finding:** The PIA Procures Finished Goods at CDC's Request

**Response:** The BSA concludes PIA sustained a \$91,000 loss on processed eggs during the audit period. The PIA disputes the processed egg calculations presented by BSA and believes they are inaccurate. As a result of previous recommendations made by BSA, PIA has obtained the services of an independent cost accounting consultant. His review does not support BSA's numbers. The BSA limited the cost accountant's access to the detailed data used in its calculations, preventing him from performing a reconciliation and identifying errors in calculation or methodology. The BSA also made a significant calculation change during PIA's five-day report response period, which changed the earlier profit it had calculated on processed eggs to an overall loss. These numbers require additional review before one can be satisfied with their accuracy and any conclusion can be drawn.

⑥

The PIA is not strictly a middleman in the processed egg business. Approximately one-third of the processed eggs delivered to PIA's customers come from its shell egg "breakers" which are custom processed by an outside processor. The balance is purchased from that processor by PIA via a State contract. The processed egg products are delivered to PIA's customers along with the shell eggs and/or other PIA food products so transportation costs are minimized. In addition, contrary to BSA's conclusion that this activity does not provide inmate employment opportunities, being the processed egg supplier to State institutions has increased PIA's inmate assignments. Inmates have been added and are involved in the ordering paperwork, unloading shipments, inventory control, staging of shipments, and loading for delivery to PIA's customers. ⑦

Providing processed eggs in this manner is a win-win situation. The PIA wins by increasing the value of its "breakers" through custom processing and by increasing inmate assignments. State institutions win by receiving shipment sizes that do not strain their limited freezer space and at a lower price than what was charged by the previous processed eggs contractor. The previous contractor also required institutions to accept monthly or quarterly shipments, forcing some State customers to rent freezer space at additional cost. Also, the price for processed eggs during the last quarter of the contract period was \$.69 per pound. The PIA's price immediately after assuming the State contract ranged between \$.53 and \$.58 per pound.

The current relationship benefits all parties, particularly California taxpayers since overall costs are lower and there is no duplication of administrative or delivery costs.

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# COMMENTS

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## ***California State Auditor's Comments on the Response from the Prison Industry Authority***

To provide clarity and perspective, we are commenting on the Prison Industry Authority's (PIA) response to our audit report. The numbers correspond with the numbers we have placed in the response.

- ① We consider legal opinions confidential due to client-attorney privilege. However, we shared the basis of our legal counsel's opinion with the PIA and believe that this issue could easily be resolved by a simple delegation by its board.
- ② As we state on page 9, the 656 buyouts the PIA conducted over the period we reviewed resulted in a loss of \$208,000 that was absorbed by its other customers.
- ③ The PIA's statement that an accepted purchase order constitutes a legal contract obligating it to provide the goods or services ordered under the terms offered is unsupported.
- ④ As we state on page 10 of our report, the PIA's reason for using emergency procurement procedures—to ensure customer delivery—does not meet the State's definition of an emergency. Therefore, the emergency, if one exists, is not the PIA's. Further, we are not recommending numerous emergency purchases by multiple state agencies as the PIA implies; we do, however, acknowledge that a state agency has that option if it is truly faced with an emergency.
- ⑤ The PIA is not a corporation, it is an agency of the State; therefore, it is obligated to operate as the Legislature allows. As we discuss on page 13 of our report, the Legislature vested certain powers in the Prison Industry Board, the PIA's oversight body, and these powers must be delegated to the PIA. Furthermore, Section 2805 of the Penal Code only grants the PIA the authority to buy equipment, supplies, and materials it uses in its operations, not what it buys from the private sector to resell to its customers.

- ⑥ The claim that we limited the cost accountant's access to the work supporting our calculation is not true. The cost accountant requested access to the workpapers supporting the sections of our report concerning processed eggs. This access was granted and a review of the workpapers occurred on July 23. Since that time, the PIA requested and was granted access to these workpapers for a second time. At no time did we limit the PIA's ability to review these workpapers. Furthermore, in conducting our quality control process we discovered we had used the wrong price in computing the resale value for processed eggs purchased using the PIA's delegated authority. We contacted the PIA that day, the second full day of its five-day response period, to notify the PIA of the change in our calculation.
- ⑦ As we state on page 14 of our report, the PIA is indeed only a middleman in its processed egg sales because this is a product it is not equipped to produce. Furthermore, as noted on page 15, the PIA could sell its breaker eggs to the egg processor even if it does not purchase the finished product.



cc: Members of the Legislature  
Office of the Lieutenant Governor  
Attorney General  
State Controller  
Legislative Analyst  
Assembly Office of Research  
Senate Office of Research  
Assembly Majority/Minority Consultants  
Senate Majority/Minority Consultants  
Capitol Press Corps