
Procurement Audit of the Correctional Industries Program

A Report to the
Governor
and the
Legislature of
the State of
Hawaii

Report No. 96-16
November 1996

THE AUDITOR
STATE OF HAWAII

OVERVIEW

THE AUDITOR
STATE OF HAWAII

Procurement Audit of the Correctional Industries Program

Summary

The State Auditor initiated this audit of the procurement of goods and services through the Department of Public Safety's Correctional Industries Program to determine the cost effectiveness of selected practices. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, programs, and performance of all state agencies, and Chapter 103D, HRS, the Hawaii Public Procurement Code, which requires the Auditor to periodically audit procurement practices within government. Our audit was prompted by the program's expanding role in state procurement and the statutory exemptions on its operations.

The Correctional Industries Program was established to provide inmates with the opportunity to acquire marketable work skills while they produce goods and services for the state. To facilitate this mission, the program has been granted certain exemptions from the public bidding requirements of the Hawaii Public Procurement Code. First, those purchases by the Correctional Industries Program used in the manufacture of goods or to provide services to state agencies are exempt. Second, goods and services sold to state agencies that are manufactured and provided through Correctional Industries' training programs are exempt.

We found the program purchased items for agencies without benefit of bids or documented quotes, and simply resold the items to state agencies without using the items to manufacture goods or services. The reselling of another company's products does not fall within the exemptions granted in the corrections statute. This results in the circumvention of the procurement code which was enacted after the Correctional Industries statute. Further, the program added an overhead charge of as much as 37 percent, for the service of simply ordering the items for the state agencies, costing them thousands of dollars unnecessarily.

Another issue that came to our attention was the inefficiency and unnecessary cost resulting from forcing state agencies to buy all printing services from the Correctional Industries Program. Chapter 354D, HRS, requires state agencies to acquire goods and services from the program unless they receive a waiver from doing so. The specific goods and services are identified by the public safety director in consultation with other state agencies. Currently, printing has been so identified. If the correctional program cannot perform a requested printing job, or by the time required, at a better price than that of a private sector vendor, then the agency may request a waiver.



Hundreds of work hours are spent each year processing these waivers, which are routinely granted. Because of its printing capabilities and competitive pricing, the program's strength as a competitor in the printing market has become well established. State agencies' forced acquisition of printing services from Correctional Industries is inefficient and no longer necessary.

Recommendations and Response

We recommend that the Legislature amend Section 354D-6, HRS, to prohibit the Correctional Industries Program from acting essentially as a reseller of another company's products. Its product sales should be limited to those goods actually manufactured or produced by the program. Additionally, we recommend that the director of public safety remove printing services from the goods and services that must be purchased from the Correctional Industries Program.

The Department of Public Safety does not concur with our findings and recommendations. In its response, the department provided information to clarify one point made in our preliminary draft that has been incorporated in our final report. However, most of the response simply defends current practices and does not acknowledge the anomalies that have resulted from the passage of two statutes with differing goals. We stand by our audit evidence.

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State of Hawaii

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Governor
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Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 96-16
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Foreword

This is a report of our audit of the procurement of goods and services through the Department of Public Safety's Correctional Industries Program. Operating under certain statutory exemptions, the program plays an ever expanding role in state procurement. This role calls for procurement made through the program to be both cost effective and in the State's best interest. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, programs, and performance of all state agencies, and Chapter 103D, HRS, the Hawaii Public Procurement Code, which requires the Auditor to periodically audit procurement practices within government.

We wish to express our appreciation for the cooperation and assistance extended to us by the officials and staff of the Correctional Industries Program and the Department of Public Safety.

Marion M. Higa
State Auditor

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Chapter 1

Introduction

The State Auditor initiated this audit of the procurement of goods and services through the Department of Public Safety's Correctional Industries Program to determine the cost effectiveness of selected practices. This audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the Auditor to conduct postaudits of the transactions, programs, and performance of all state agencies, and Chapter 103D, HRS, the Hawaii Public Procurement Code, which requires the Auditor to periodically audit procurement practices within government. Our audit was prompted by the program's expanding role in state procurement and the statutory exemptions on its operations.

Background

In 1963 the Legislature created an opportunity for inmates to acquire work skills while they produced goods and services for the state. The "Prison-Made Goods Act" created an inmate training program in the Department of Social Services. In 1987, the prisons were transferred to a new Department of Corrections that in 1990 was renamed the Department of Public Safety. The Correctional Industries Program was established in the new department in 1990 with the expectation that inmate employment opportunities would be expanded to enable correctional industries programs to operate more cost effectively. The program is expected to:

- generate revenue to sustain its operation and allow for capital investment;
- provide specific training skills for offenders that increase their employment prospects when they return to their communities;
- provide a maximum level of work for all qualified, able-bodied inmates;
- have operations similar to those found in private business;
- establish cooperative training ventures with the private sector; and
- provide low-cost construction, renovation, and repairs of facilities for government agencies and nonprofit organizations.

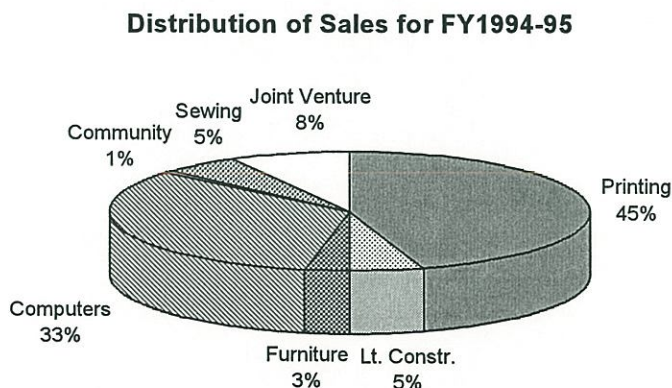
The primary purpose of the program is to employ inmates in real work situations. The Department of Public Safety has sought to address this mission by developing three classes of offender work programs: Community Work Industries, Traditional Industries, and Private Sector/Correctional Industries.

Community Work Industries programs are designed to provide services to the community at a reduced cost. Public agencies may hire an inmate to work on-site. The participating agency provides work supervision and pays the inmate a wage ranging from 50 cents per hour to the minimum wage.

The Traditional Industries Program provides goods and services to tax-supported agencies and certain nonprofit organizations. This program also gives inmates job training and work experience. Funds generated from the sale of the goods and services support program activities. Currently, the Traditional Industries Program concentrates on printing, computer hardware and services, furniture making and repair, sewing, and light construction. As can be seen in Exhibit 1.1, 78 percent of all Correctional Industries Program sales are from printing and computers.

The Private Sector/Correctional Industries Program allows private companies to set up manufacturing and services operations within correctional facilities or to employ offenders under the supervision of the Department of Public Safety at the site of the private company. Such arrangements are provided through joint venture contracts in which inmates' wages range from minimum wage (\$5.25) to prevailing wage (\$8.90). Inmates must pay federal and state taxes. Twenty percent of their wages are deducted and applied toward the cost of their incarceration, and another five percent of their wages are deducted and placed in a Victim Compensation Fund.

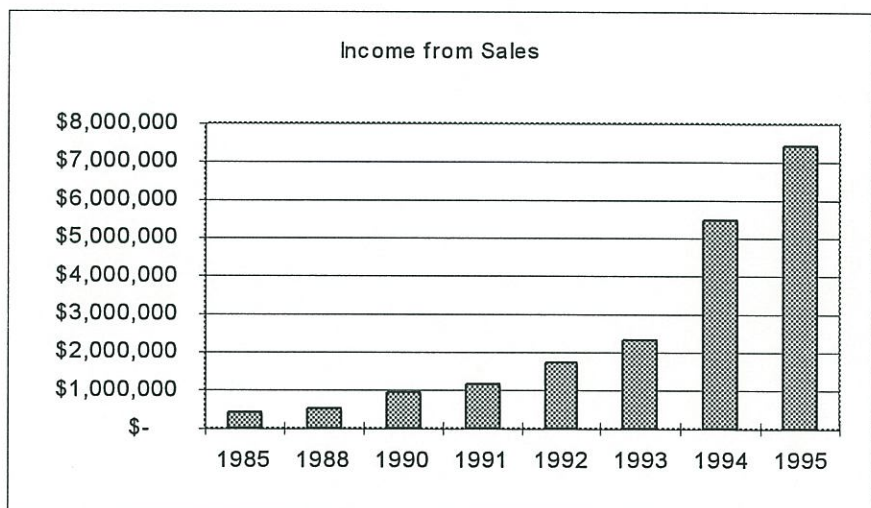
Exhibit 1.1 **Distribution of Correctional Industries Sales**



Source: Compiled by the Office of the Auditor from Correctional Industries records.

Correctional Industries Program records indicate that in FY1987-88, 20 inmates working in two print shops generated combined sales of \$550,000. Inmate employment almost tripled to 56 in FY1990-91 and sales doubled to \$1,182,494. The program continued to expand and in FY1993-94 sales of products and services soared to \$5,500,000. Some 350 inmates were employed. In FY1994-95, sales increased to \$7,400,000. Exhibit 1.2 summarizes the sales growth from 1985 to 1995.

Exhibit 1.2
Growth of Correctional Industries Sales



Source: Compiled by Office of the Auditor from Correctional Industries records

Objectives of the Audit

The objectives of this audit were to:

1. Ascertain whether procurement statutes, rules, exemptions and practices of the Correctional Industries Program result in cost-effective procurement for state government.
2. Make recommendations as appropriate.

Scope and Methodology

The scope of the audit encompassed the purchasing practices of the Correctional Industries Program and its sales of goods and services to state agencies. The audit covered the period from July 1994 to May 1996.

Fieldwork included interviews with Correctional Industries Program managers and officials from departments or offices that had purchased goods or services from the program. We also reviewed laws, policy and procedure manuals, and previous audits as appropriate. We reviewed a sample of purchases made by the Correctional Industries Program to determine whether those purchases were in compliance with applicable laws and/or policies and whether they were cost effective. Using these two criteria, we also reviewed a sample of purchases made by other state agencies from the program.

Our work was performed from January 1996 through May 1996 in accordance with generally accepted government auditing standards.

Chapter 2

Correctional Industries' Procurement Practices

State agencies are always charged with responsible and efficient use of state resources and acquisition of goods and services at the lowest possible price, but fiscal austerity adds urgency to underlying policy. While the primary goal of the Correctional Industries Program is to teach inmates real world job skills, the program also can reduce the cost of government by manufacturing goods and providing services to other state agencies at a lower cost than those agencies can find in the private sector. In accomplishing this task, the program must operate within the spirit and the letter of the statutes that define its purpose and govern the State's procurement process.

Summary of Findings

We found that the procurement of goods and services through the Correctional Industries Program has violated the spirit of the law and has increased the cost of goods purchased by the State. Specifically, we found that:

1. The Correctional Industries Program practice of reselling goods manufactured by others promotes the circumvention of the Hawaii Public Procurement Code.
2. Forcing state agencies to procure printing services from Correctional Industries is inefficient and unnecessary.

State Agencies Circumvent The Hawaii Public Procurement Code

The Hawaii Public Procurement Code allows state agencies under certain circumstances to purchase goods or services from Correctional Industries without first seeking bids or quotes from private sector vendors. We found that some state agency purchases from the program circumvented the law, resulting in a waste of public moneys.

Agencies are obligated to operate under purchasing constraints

The Legislature, in enacting Chapter 354D, HRS, the Hawaii Correctional Industries law, intended the Correctional Industries Program to carry out its mission free from as many impediments as possible. One of the "impediments" is the public bidding requirements of the Hawaii Public Procurement Code (and its predecessor code). The Correctional Industries law exempts the Correctional Industries Program from those bidding requirements but the exemptions are constrained in two ways: (1) only those purchases by the Correctional Industries Program used in the manufacture of goods or to provide services to state

agencies are exempt from bidding and (2) the goods and services sold to state agencies must be manufactured and provided through Correctional Industries' training programs. The Correctional Industries Program affirms these two constraints. The constraints were established to accommodate the differing goals of the procurement and the correctional industries laws.

The Hawaii Public Procurement Code is intended to obtain the best products and services for government at the lowest prices. Open competition is the means to achieve that goal. State and county agencies are required to buy goods and services as openly and competitively as possible. Any exemptions are specific and reflect an attempt to balance the interests of a program and the overall interests of government.

One purchasing practice that melds open competition with cost effectiveness is the use of the "price list." Rather than each office or agency individually trying to buy the most commonly needed goods and services according to the competition requirements of the procurement code, the State Procurement Office solicits bids from vendors for the price at which state agencies may obtain a given item or service. The prices are obtained according to the competition requirements of the procurement code. While the price list does not guarantee the lowest price for each purchase, it accomplishes overall efficiency by eliminating the costs that would be required if solicitation of bids or quotes were done on an item-by-item basis. As each agency needs the goods or services, it must buy from the price list vendors. That requirement to buy from the price list vendors is contained in Hawaii Administrative Rules, Section 3-121-6(c) and restated in the governor's budget execution policy, with some exemptions permitted. Some agencies need not buy from the price list, but they must otherwise comply with the procurement code's competition requirements.

The goal of the Correctional Industries Program is to develop inmates' marketable skills through its production of goods and services. The program is not a price list vendor and its goods and services are not on the state price list. But the procurement code, in allowing state agencies under cooperative purchasing agreements to purchase goods and services from the correctional program exempt from public solicitation, in effect permits the Correctional Industries Program to function as a price list vendor.

In recent years, however, state agencies have begun to purchase, without public solicitation, goods from Correctional Industries that are not produced by the training programs. Hawaii Administrative Rules, Section 3-128-7 allows state agencies to enter into cooperative purchasing agreements to obtain, without public solicitation, goods produced or services from the Correctional Industries Program. While

Procurement code is circumvented

the rule was intended to help the program achieve its goals, we found that the rule has turned into an opportunity for government agencies to circumvent the procurement code.

The Correctional Industries Program has allowed state agencies to purchase goods **through** the program without regard for the constraints upon its non-bid exemption. We found the program purchased items for agencies without benefit of bids or documented quotes, and simply resold the items to state agencies without using the items to manufacture goods or services. In other words, the program simply served as a pass-through or reseller of another company's products. In so doing, the program violated the exemptions it is granted from the procurement code. It also enabled agencies to avoid buying from the established price lists of the State Procurement Office or seeking public solicitations. Further, the program added an overhead charge to the goods, for the service of simply ordering the items for the state agencies, costing them unnecessarily. Finally, the agencies had no assurance that the Correctional Industries Program obtained the best prices for the items since it did not go out for competitive bids.

The State Procurement Office confirms that buying resale items from Correctional Industries does not exempt purchasing agencies from the requirements of competitive procurement. Procurement rules stipulate that state agencies may obtain goods or services from Correctional Industries without soliciting the private sector competitively only if the products are manufactured, assembled, constructed, or otherwise prepared and provided through the labor of Correctional Industry program participants. Such products as computer equipment, software, furniture, or other items that may have been provided by Correctional Industries as reseller of another company's products are not exempt from bidding.

We reviewed 26 invoices documenting the purchase of computer equipment. Approximately 65 percent of that equipment was simply resold to other state agencies. Correctional Industries staff confirmed that the computers were not used to train inmates in some manufacturing or service capacity. These computers included a popular brand whose manufacturer sells only fully assembled computers; those computers were simply transshipped through the Correctional Industries facility, but with a markup in price. And in at least one case, the equipment did not even physically pass through the Correctional Industries Program. An order costing Correctional Industries \$4,593 was shipped directly to the University of Hawaii's School of Architecture from the supplying vendor. Correctional Industries billed the school \$4,819, a \$226 markup, even when no inmates' hands had touched that equipment.

Despite a May 1995 memorandum from the Correctional Industries administrator to program staff regarding the necessity of adhering to the

code requirements, the pass-through sales of computer equipment have continued into the current year.

Agencies may not be expected to know whether their purchases from the Correctional Industries Program are produced by the program or are simply purchased by the program and resold to the agencies. Six out of seven agencies we interviewed that had purchased computers from the program had not sought bids or quotes for those purchases. Most of these agencies believed that they were either compelled to purchase items from the program or could purchase from the program without going through a competitive procurement process. In reality, only purchases of products *manufactured* by the Correctional Industries Program are exempt from the competitive procurement requirements of the code.

Although the program may not be in direct violation of a specific law by selling pass-through items, it promotes the circumvention of the Hawaii Public Procurement Code. Government agencies that improperly purchase from the Correctional Industries Program are in violation of the code. The cause of this dilemma appears to be an unanticipated conflict between the intent of Chapter 354D, HRS, and the intent of Chapter 103D, HRS. Chapter 354D provides Correctional Industries with as much freedom as possible to operate as an independent business. Chapter 103D is designed to ensure cost-effective purchasing and to promote competitive acquisition when possible. Competition is widely recognized as an effective method of insuring the best value for the price and protecting resources from waste, fraud, and inefficient use.

***Thousands of dollars
are wasted***

By circumventing competition in purchasing computer equipment from the Correctional Industries Program, state agencies have wasted thousands of dollars. Much of the equipment sold by the program is simply passed through from supplying vendors. Yet Correctional Industries charged purchasing state agencies from 11 percent to 37 percent more than supplying vendors had charged. For example, Correctional Industries sold a computer and a printer to Konawaena High School, charging \$3,230. The supplying vendor had charged Correctional Industries \$2,374 for these items. The school paid \$856, or 36.1 percent, more than it would have had it purchased directly from the supplying vendor.

Since the Correctional Industries Program received no special discounts from the vendors, purchasing through Correctional Industries was not in the best interest of the State. Agencies should be able to order directly from the vendors through a competitive process and save themselves the overhead charges of the Correctional Industries Program.

A change in the law is required

The sale of computers and related equipment has so far been the most obvious illustration of an unanticipated consequence of the differing goals of the procurement code and the Correctional Industries statute. A change in the latter law is in order. That would clarify the current situation and prevent further proliferation of the belief that anything can be purchased without competition as long as Correctional Industries does the ordering. Section 354D-6, HRS, should be amended to prohibit the Correctional Industries Program from simply reselling another company's products without inmates' labor on those products; its product sales should be limited to those goods that it actually manufactures or changes in some way. This amendment will help ensure compliance with the Hawaii Public Procurement Code.

Forcing State Agencies to Purchase All Printing Services From Correctional Industries Is Unnecessary

Chapter 354D, HRS, requires state agencies to acquire certain goods and services from the Correctional Industries Program unless they receive a waiver from doing so. The specific goods and services are identified by the public safety director in consultation with other state agencies. Currently, printing has been so identified. This requirement is costly and inefficient. Since most state agencies are likely to continue to use Correctional Industries' governmental printing services because of the program's competitive pricing, the requirement is no longer necessary.

The waiver request process is cumbersome

Section 354D-6(d), HRS, requires the Director of Public Safety or a representative to consult with the directors of the various agencies to identify goods or services that the Correctional Industries Program may produce or provide. Unless a specific exemption is granted by the administrator of the program, these goods and services shall be provided by the Correctional Industries Program. This type of required purchasing has a long history, dating back to the Prison-Made Goods Act of 1963. The intent of these provisions was to provide the program with a market sufficient to guarantee the income needed to carry out its mission.

Currently, printing is the only service that the Correctional Industries Program and the directors of the various agencies have determined must be purchased from the program. When an agency decides that it needs printing services, it either mails or faxes a request that fully describes its need. The agency may even submit a sample of the finished product. The program then determines whether it can perform the job; if so, it estimates a timeframe and cost. If the program cannot perform the work or if the agency needs the work done more quickly or believes that it can acquire the printing at a better price from another vendor, then the agency may submit a written request for a waiver. Upon receiving the request, a clerk at the Correctional Industries Program fills out a waiver form and submits it to the administrator for approval. If the

administrator, acting for the public safety director, approves the waiver, it is signed and returned to the agency. The agency submits the waiver to the Department of Accounting and General Services (DAGS) when requesting payment for the printing services performed by the selected vendor. DAGS will not pay for printing done by vendors other than the Correctional Industries Program unless a waiver is provided with the request for payment. If the administrator does not approve the waiver, the agency is notified that it must use Correctional Industries for the printing service.

Hundreds of work hours are wasted

The Correctional Industries Program issues hundreds of printing waivers every year. In FY1994-95 it issued 772 waivers for individual printing jobs. During the same period, it also issued at least 61 blanket waivers. A blanket waiver covers an entire class of printing jobs—from one to many individual printing jobs for up to one year. We ascertained that, not counting approval time, program staff spend about twenty minutes to process a waiver. Taking the number of waivers processed and assuming that the requesting agency uses a similar amount of time to process its request, we estimated conservatively that 556 work hours were used in FY1994-95 to process printing waivers. This is equivalent to an employee working full-time for three and one half months just to process waivers. The forced purchase of printing from the Correctional Industries Program is unnecessary. This use of work hours is costly and inefficient and serves no legitimate purpose.

Correctional Industries is competitive

The Correctional Industries Program no longer needs to invoke the statutory provisions requiring state agencies to make purchases from the Correctional Industries Program in relation to printing. In the past ten years, the program's income from sales has increased by 1,727 percent, reaching \$7.4 million in 1995. Forty-five percent of these sales, or \$3.3 million, can be attributed to printing.

The program's success in printing sales is well deserved. We selected ten invoices for correctional industries printing services. We went to three private sector vendors to solicit their prices for the same work. In almost every case, the charges by the program were less than the price estimates of the private sector printers. Additionally, we found that the program is well equipped with "state-of-the-art" printing equipment that can be matched perhaps by only one other vendor in the state.

All parties would benefit

The correctional industries administrator affirms that the printing program no longer needs the protection of the statutory provisions forcing agencies to purchase printing from the program. She agrees that the program should have only an opportunity to compete for state agencies' printing business.

The program's strength as a competitor in the printing market is well established. Printing vendors we interviewed stated that competing against the capability and pricing of the program is difficult. If agencies could select among all printing sources through an open competitive bidding process, private vendors might obtain a slightly greater share of the governmental printing business. The Correctional Industries Program would not suffer a substantial loss in revenues. The necessity of obtaining printing waivers from the program would be eliminated, preventing waste and unnecessary costs to the program itself and to state agencies. In short, it would appear that all parties would benefit if the public safety director were to remove printing from the forced purchasing provisions of the law.

Conclusion

The reselling activities of the Correctional Industries Program promote the circumvention of the Hawaii Public Procurement Code. Purchasing agencies, which may not be aware that the items being purchased are pass-through sales, violate the code when buying pass-through items without going through competitive procurement procedures. Finally the forced acquisition of printing services from Correctional Industries by state agencies is inefficient and no longer necessary. Correctional Industries is currently in a position to compete with private sector vendors in an open printing market.

Recommendations

1. We recommend that the Legislature amend Section 354D-6, HRS, to prohibit the Correctional Industries Program from acting essentially as a reseller of another company's products. Its product sales should be limited to those goods actually manufactured or produced by the program.
2. We recommend that the director of public safety remove printing services from goods and services that must be purchased from the Correctional Industries Program.

Response of the Affected Agency

Comments on Agency Response

On October 2, 1996, we transmitted a draft of this report to the Department of Public Safety. A copy of the transmittal letter to the department is included as Attachment 1. The department's response is included as Attachment 2.

The Department of Public Safety did not concur with our conclusions. The department provided information to clarify one point in our preliminary draft that has been incorporated in our final report. However, the department does not acknowledge the anomalies that have resulted from the passage of the correctional industries statute and the procurement code. It simply defends current practices.

Most of the department's response contains unsubstantiated information; we stand by our audit evidence. More importantly, the department characterizes our information and conclusions as "error," then misquotes, misinterprets, or challenges with flawed argument or information.

For example, the department claims the report says that the state price list offers the best prices for products. The report makes no such statement. A careful reading of the report would have shown that the price list reflects a balance between efficiency of acquisition and price. Furthermore, the example the department offers of how its higher price for an upgraded computer system would be to an agency's advantage is flawed. The example avoids the issue of how much an agency had available to spend; whether the price list items contained just what the agency needed (the agency might not need the particular capacity of Correctional Industries' offerings); whether the agency could have obtained a better price on any computer system had it gone out to bid, (since Correctional Industries does not); and whether the agency on its own could have ordered, from a private vendor, the same system being offered by Correctional Industries while saving a markup of as much as 37 percent.

In defense of the status quo, the department misuses the term "quotation" to mean its "written quotation...furnished to state agencies for review and approval." The procurement code is clear: the bids and documented quotations required apply to the original acquisition from the vendor. The department's "quotations" reflect the prices at which Correctional Industries would resell products to the agencies. And those prices have not been proven to reflect "considerable high volume discounts" as the department claims. Our evidence indicates that vendors would have charged agencies that ordered directly the same prices that they charged Correctional Industries.

The department's argument that its computer program adds value and relieves agencies of the problems of installing new equipment is belied by our evidence that 65 percent of its computer purchases were shipped complete by the vendor. Moreover, its unsubstantiated claim of a 13 percent charge for overhead is belied by our evidence of charges of 11 to 37 percent. Its claim that the private sector markup is more than 35 percent is irrelevant—that markup is already reflected in the price any purchaser pays for any equipment. The Correctional Industries markup is a markup on a markup. Our point is that the agencies should not have to pay Correctional Industries' markup when the equipment is not used to train inmates, which was the intent of the correctional industries statute.

Finally, the department's response on the issue of forced acquisition of printing services is in two parts: to retain its current advantages and acquire more over the private sector, and to deny that there are any problems with current practices. Correctional Industries' printing operations have achieved, to its credit, a very competitive position in the industry. It is already cost-competitive with the private sector. The removal of the waiver requirement would relieve both the program and the state agencies of unnecessary work. The volume of waivers approved indicates that state government alone generates more printing work than Correctional Industries can handle. The department's argument that it should be allowed to compete with the private sector for nongovernmental work is disingenuous—its costs of operation are grossly incomparable. Its claims on the costs of the waiver process are also disingenuous. During our audit, the waivers were being processed by an employee holding a clerk-steno II position, not an inmate. The department also did not acknowledge the costs to requesting agencies' administrators and employees in initiating, approving, and transmitting the waivers, which Correctional Industries approves routinely anyway.

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October 2, 1996

COPY

The Honorable George Iranon
Director
Department of Public Safety
919 Ala Moana Boulevard, Suite 400
Honolulu, Hawaii 96814

Dear Mr. Iranon:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Procurement Audit of the Correctional Industries Program*. We ask that you telephone us by Friday, October 4, 1996, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Friday, October 11, 1996.

The Governor, and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa
State Auditor

Enclosures

BENJAMIN J. CAYETANO
GOVERNOR



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October 15, 1996

Ms. Marion Higa
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OFF. OF THE AUDITOR
STATE OF HAWAII

Dear Ms. Higa:

My response to the **Procurement Audit of the Correctional Industries Program** is in two parts: the first responding to the report on Computer Operations and the second on Printing Services.

COMPUTER OPERATIONS

The report on Correctional Industries' Computer Operations is seriously flawed because it incorrectly describes the purchase of computers by Maui Community College. Many of the report's findings are based on this case. Because the research information is grossly incorrect, the merit of the recommendations is questionable.

Contrary to the report, the computer system sold to Maui Community College (MCC) was not shipped directly to MCC from the manufacturer. One component of the system, the computer monitors, were shipped directly to MCC but the rest of the system was assembled by Correctional Industries.

The order required installation and configuration of network cards, and testing of the 168-computer system. Once networked, the systems were sent from the shipping company warehouse to MCC. This was not a "pass-through" because value was added by the work of Correctional Industries.

Additional errors in the report:

1. **Error:** The State "price list" offers the best prices for products. (Page 6, second paragraph).

Fact: Correctional Industries can offer prices below the price list.

For example, an agency awards a contract for 20 systems of 486 DX-2 computers for \$2,500 each. However, the bid items have minimum memory capacity, small hard drives, and an inadequate video card for large spreadsheets and graphics. Upgrading these items would cost an additional \$1,050. Therefore, the systems total cost is actually \$3,550 each. By comparison, Correctional Industries can provide the agency a Pentium with the needed specifications for about \$3,000 (for a savings of \$550 per system, or a total savings of \$11,000).

2. **Error:** "The program purchased items for agencies without benefit of bids or documented quotes." (Page 7, first paragraph).

Fact: Correctional Industries procedures require staff to obtain the lowest price, best quality and optimal delivery for computer parts. A written quotation is furnished to state agencies for review and approval.

3. **Error:** "The computers were not used to train inmates in some manufacturing or service capacity." (Page 7, second paragraph).

Fact: Correctional Industries purchases computer component parts from the vendor in various degrees of assembly. Our policy of adding value includes installation of motherboards, add-in cards, software, etc. Whether the system requires full assembly or adding on components, all orders are normally handled by inmate worklines. Also, these worklines fully test and configure each system.

Most computer components are manufactured outside of the United States and assembled domestically. Correctional Industries does not manufacture components; it does provide service training to inmates through the assembly, configuration and testing of machines in accordance with customers' specifications.

4. **Error:** "In some cases, the equipment did not even physically pass through the Correctional Industries program." (Page 7, second paragraph).

Fact: The only equipment that does not physically pass through Correctional Industries are monitors, which usually do not require additional handling, and may be shipped directly to the customer to save shipping costs. Over 95% of all equipment ordered does pass through Correctional Industries.

As previously explained, the report is incorrect in claiming that the entire Maui Community College order, dated August 3, 1995, was shipped directly to the College. The only items directly shipped were the monitors. For the rest of the computer system, Correctional Industries installed and configured network cards, and conducted system testing.

Correctional Industries charges about 13% for overhead, which pays for inmate and supervisor wages, transportation, sales and marketing, and administrative costs. Correctional Industries is self-supporting and does not receive state government subsidies. By comparison, the usual markup by the private sector is more than 35%.

Correctional Industries saved Maui Community College money on its order. The \$45,000 overhead charges paid by Maui Community College is less than the College would have paid for purchasing the component parts from two vendors plus networking and assembly charges.

In the case of the \$4,593 order to the University of Hawaii's School of Architecture, it was found that a Correctional Industries supervisor was not in compliance with operating policies. A management reorganization was implemented with the supervisor being removed from the operation. The new management of the computer operation has been trained and is fully adhering to Correctional Industries policies and procedures.

5. **Error:** "By circumventing competition in purchasing computer equipment from the Correctional Industries Program, state agencies have wasted thousands of dollars." (Page 8, third paragraph).

Fact: Correctional Industries provides services as part of its overhead charge that saves agencies expenses they would otherwise incur. The procurement code is not circumvented.

For example, if agencies purchased directly from vendors, they would entail added costs of purchasing network cards and software separately; installing these cards; troubleshooting and obtaining replacement parts for any malfunctioning components; and setting up and configuring their own network software. It is short-sighted to suggest that agencies could invest time and labor in these activities for every computer purchase at less cost than Correctional Industries.

6. **Error:** "Since the Correctional Industries Program received no special discounts from these vendors, purchasing through Correctional Industries was not in the best interest of the State." (Page 8, fourth paragraph).

Fact: As a major wholesale customer, Correctional Industries receives considerable high volume discounts and special handling consideration from vendors. By using these price discounts and inmate labor, Correctional Industries provides state agencies with the best value at the lowest price.

PRINTING SERVICES

The report's recommendation that the printing waiver requirement be removed to require Correctional Industries to directly compete with private sector vendors is flawed because it overlooks two fundamental differences between Correctional Industries and the private sector:

First, Correctional Industries' only customer is state government. It does not compete for non-government printing jobs because of the state law restricting its sales activities. Enabling the private sector to compete for state agency printing jobs while legally restricting the Correctional Industries' customer base imposes a disadvantage to Correctional Industries.

The fact that Correctional Industries is cost-competitive with the private sector while serving a limited clientele is a tribute to its innovative management and modern equipment. It should not be penalized for its sound operations by removal of the waiver requirement.

Second, Correctional Industries provides training and work-skills to inmates to prepare them for meaningful lives when they are released. Private vendors do not have this responsibility. Opening government printing to competition with the private sector may mean a loss in revenues to Correctional Industries and hamper its ability to offer training and employment to inmates.

Processing of waivers is done by inmate clerks receiving starting pay of 48 cents per hour and is part of their work skills training. Contrary to the report, the cost of processing waiver forms is minimal -- about \$266 annually.

Instead of wholesale removal of the requirement that state agencies purchase printing from Correctional Industries, the following are alternative suggestions:

1. Require state agencies considering the use of private sector printers to also obtain a printing bid from Correctional Industries;
2. Remove the statutory restriction imposed on Correctional Industries that restricts its sales to state government;
3. Make no changes. The report notes that Correctional Industries offers state agencies quality printing services at the lowest cost. Why try to fix something that isn't broken?

Aloha,



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Director