UNITED STATES GENERAL ACCOUNTING OFFICE
DALLAS REGIONAL OFFICE
ROOM 500, 1512 COMMERCE STREET
DALLAS, TEXAS 75201

OCT 19 1971

Mr. Hal R. Hopkins
Superintendent
Federal Prison Industries, Inc.
Federal Correctional Institution
Texarkana, Texas 75501

Dear Mr. Hopkins:

We have completed an examination of the financial statements of Federal Prison Industries, Inc. (FPI), Texarkana, Texas, for the fiscal year ended June 30, 1971. The examination was made pursuant to the Government Corporation Control Act (31 U.S.C. 841).

Our review, which was completed in September 1971, was made in accordance with generally accepted auditing standards and included such tests of accounting records and financial transactions as we considered necessary in view of the nature and volume of transactions and the effectiveness of internal controls. Since internal auditors had not made a review since November 1969, we gave special attention to the internal controls exercised by FPI, Texarkana.

Our findings included several deficiencies which we believe indicate a need for improvement by FPI in the administration and review of its accounting functions. We were unable to ascertain the accuracy and reliability of the June 30, 1971, Inventory Certificates because of the numerous deficiencies we found in the accounting for inventories. The inventories were reported to be $95,692. The deficiencies were discussed with you and institution officials at the conclusion of our review. Details are presented below for your consideration and appropriate action.

Need for improvement in accounting for and internal control over inventories

Our examination of fiscal year 1971 inventory records for the tire reconditioning factory and furniture factory and discussions with FPI employees disclosed deficiencies in the procedures for taking annual physical inventories, writing off variances found between inventory records and the physical inventories, and making adjustment to inventory control accounts in the general ledger. At the time of our review, signficiant variances between the inventory records and the physical inventory existed for several items of raw materials and supplies. In addition, we found a lack of internal control over the receipt and storage of materials. In our opinion these deficiencies, discussed further below, indicate a need for improvement by FPI in its accounting for and internal control over inventories.

Based on our review and discussions with FPI employees, we found that physical inventories were taken, but, contrary to acceptable procedures for taking physical inventories, receipts and issues of materials were continued without proper controls and employees responsible for taking the physical inventories had access to balances shown on stock records. In order to provide proper control and assure accurate counts, we believe that physical inventories should be taken when receipts and issues can be properly controlled and, ideally, when production is at a minimum, and by employees who do not have access to stock record balances.

Variances between physical inventory counts and stock record balances were written off without adequate verification of the inventory counts and a determination that all receipts and issues had been posted. For example, over $1,800 was written off the stock record balance of finished goods for the tire reconditioning factory to make it agree with the results of the physical inventory. FPI employees advised us that no further verification of the finished goods inventory was made in this instance. We were also advised that because of the lack of time, only two or three items of raw materials and supplies were recounted to verify the accuracy of the physical inventories.

The write-off of variances between inventory counts and stock records is an acceptable procedure for making inventory adjustments. However, we believe that items showing substantial variances should be recounted and a determination made that all receipts and issues have been posted prior to adjustment to assure the accuracy of the inventory records.

The general ledger control account for the tire reconditioning factory finished goods was further reduced by more than $1,100 in order to make the ledger agree to the total of individual stock record balances. FPI employees advised us that the reasons for the differences between the general ledger and the stock record balances were not determined prior to the write-off. We believe that inventory adjustments should not be made until the reasons for the differences have been determined, to the extent practicable, and that such adjustments should be properly supported.

We found that variances between the inventory records and the physical inventory existed for 15 of 22, or 68 percent, of the items included in our test count of raw materials and supplies. The deficiencies cited above could be a contributing factor to some of the differences we found. In addition, the FPI business manager advised us that some of these variances existed because inmates (1) failed to record issues from the storerooms, (2) recorded some issues incorrectly, or (3) did not record items returned to the storerooms. In our opinion the warehouse should be more closely controlled, and stock record clerks should be more carefully supervised in order to assure accurate recording of inventory transactions.

In our review of internal controls we noted that the storekeeper who was responsible for the receipt of materials had access to purchase orders showing quantities ordered, unit prices, and total costs, at the time material was received. Good internal control requires that independent counts be made of merchandise received. We suggest that quantities be omitted from the storekeeper's copy of the purchase order to help assure that such counts are made.

Our review disclosed that several raw material items were stored in open spaces in the factories where proper control could not be exercised by the storekeeper. We also found that lockable storerooms were not always locked in the absence of the storekeeper. These practices indicate a further lack of internal control and should be corrected.

In our opinion, the deficiencies discussed above do not represent sound accounting practices or good internal control and warrant special consideration.

We suggested that a complete physical inventory, taken in accordance with acceptable inventory procedures, be performed in the near future in order to establish the accuracy of inventory records. We further suggested that adequate internal controls be instituted over the inventories to prevent a recurrence of the deficiencies discussed. You concurred with these suggestions and promised to take corrective action. We would appreciate your comments and a report on the results of the physical inventory.

Inadequate basis for distribution of manufacturing costs to jobs in the furniture factory

Our examination of cost of sales for the furniture factory disclosed that the basis of allocating labor costs to individual jobs on monthly job analyses was inadequate. Monthly labor variances, which resulted from differences between standard and actual labor costs, were allocated on an equal basis to each unit produced by the various jobs. Because labor costs are not the same for different type items, this basis of allocating the labor variance could significantly distort the charges to the various jobs. Furthermore, overhead costs are distributed to the individual jobs as a percentage of labor costs. Therefore any misstatements of labor costs for the jobs will result in additional misstatements of job costs. Misstatements of overhead costs could be substantial. For example, overhead rates averaged 496 percent of labor costs during the last 6 months of fiscal year 1971.

If the costs allocated to the individual jobs are inaccurate, then the value of job analyses as a production management tool is essentially lost. We believe that to assure accurate costs for individual jobs, any distribution of labor variance should be proportionate to the standard labor costs established for each type of furniture, or by any other equitable basis which FPI can establish.

At the conclusion of our review, you acknowledged this deficiency and agreed to establish an acceptable basis for distributing labor and overhead costs to the jobs produced by the furniture factory.

Compliance with FPI Washington instructions

FPI treated the cost for relocation of the tire reconditioning factory as a capital improvement; whereas instructions by the FPI Washington office required that the cost be accumulated as a deferred charge and amortized over 24 months. This treatment resulted in a minor overstatement of the buildings and improvements account and an understatement of the expenses charged for the period.

Overstatement of accounts payable and unliquidated obligations

Our examination disclosed that accounts payable at June 30, 1971, were overstated by $2,637 because of errors in computing contingent annual leave payable. Increases and decreases in contingent annual leave payable for employees who transferred from FPI during the year were not considered when making the computation. In addition, incorrect balances for the beginning of the year were used on computing the increase in contingent annual leave payable for fiscal year 1971.

The FPI business manager promised to correct these errors and to establish a procedure which will provide for accurate computations of contingent annual leave payable.

Unliquidated obligations were overstated by $5,413 because of errors in reporting open FPI purchase orders.

As corrective action has already been taken or promised concerning these matters, we are making no recommendations at this time.

Other deficiencies noted

Our review disclosed several other deficiencies which we believe further indicate a need for improvement by FPI in the administration and review of its accounting functions. These matters are summarized briefly below.

--We found several instances where inmates made incorrect postings to the general ledger or misclassified expenditures. These errors were not detected by accounting personnel in the business office.

--In two instances, accounts payable by FPI were allowed to remain outstanding for 2 and 6 months after the vendors' invoices had been received.

--Incorrect posting of accruals for the month of June 1971, to the Reserve For Transportation account resulted in an overstatement of that account and an understatement of the Accrued Accounts Payable account amounting to $4,263. The Transportation Register was not reconciled to the general ledger, therefore this error was not detected. Because both of these accounts are subsidiary to the overall Accounts Payable account the error does not affect the total of the account. However, it does illustrate the need to reconcile subsidiary records to the general ledger.

--Errors made in the preparation of Standard Form 225, Report on Obligations, resulted in an understatement on that report of net unpaid obligations amounting to $43,309.

--Although not occurring during the period covered by our review, we were informed that during the months of July and August 1971, that due to deficient filing procedures established by the business office for the tire reconditioning factory, all documents related to an unknown number of orders were lost after the completed reconditioned tires were shipped to FPI customers. FPI followed a practice of accumulating all copies of all documents in a single folder until the tires were shipped, at which time the folder was forwarded to the business office for recording and billing. Some of these folders disappeared before any documents could be removed. As a result, FPI does not know who to invoice, or the value involved. We do not know the value of the tires, but were informed by the Shop Foreman that he believed it to be substantial.

- - - -

We wish to acknowledge the courtesies and cooperation shown our representatives during the review. We would appreciate your comments and advice as to any further action taken on the matters discussed herein.

Copies of this letter are being sent to the Assistant Attorney General for Administration, Department of Justice; the Commissioner of Industries, Federal Prison Industries, Inc.; and the Warden, Federal Correctional Institution, Texarkana, Texas.

Sincerely yours,

W. H. Sheley, Jr.
Regional Manager