DEPARTMENT OF AUDITS AND ACCOUNTS

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March 17, 2010

The Honorable Jack Hill
Chairman
Senate Appropriations Committee
234 State Capitol
Atlanta, Georgia 30334

Dear Senator Hill:

In your request dated May 21, 2009, you asked us to review the operations of Georgia Correctional Industries (GCI) across the following dimensions:

- Assess GCI's surpluses and shortfalls over the past 10 years, including determining if revenues from products and services have declined, and if so, what policy changes may improve GCI's profits;
- Assess service quality of the license plate program including whether GCI is providing a sufficient number and quality of license plates in a timely fashion to the Department of Revenue and possible private sector alternatives;
- Examine Food and Farm operations and possible private sector alternatives, including reasons for anticipated shortfalls and ways to address the shortfalls; and
- Examine GCI's governance model and best practices for governance including models used by other states.

In discussions with Carolyn Bourdeaux last spring, it was determined that the time and resources necessary to fully address these questions would reduce our ability to complete the Senate Appropriations Committee's requests for higher-priority special examinations. Once those higher-priority examinations were completed, however, we determined that we could provide some limited information and analysis about GCI that would be immediately relevant to the Committee; namely, an analysis and review of several factors that have had a significant impact on GCI's overall profitability and reserves. This letter contains the results of this review. In anticipation of this information meeting your needs, we are considering our work on GCI to be complete.

GCI History and Purpose

Georgia Correctional Industries was created by the General Assembly in 1960 as a public corporation. However, operations did not officially begin until 1966 when GCI took over seven industries that were being operated by the Georgia Department of Corrections (GDC). GCI is a non-profit, self-supporting

organization that derives most of its income from sales of its products. As a public corporation, GCI is given more flexibility to make operational decisions and to determine how funds will be used. By law, GCI can maintain a reasonable reserve for future operations, but is authorized to return any remaining profits to the state treasury. GCI is administratively attached to GDC and the Commissioner of GDC serves as the chief executive officer of the Board of Correctional Industries.

The correctional industries operation has multiple objectives. In addition to generating profits in order to be financially self-supporting, correctional industries operations seek to provide vocational skills to inmates, and to provide quality, low-cost products and services to the public sector market-place. While there have been no studies that specifically evaluate GCI's impact on inmates, general research indicates that inmates that participate in work programs are less likely to be rearrested and are more likely to obtain employment after their release from prison. In addition, work programs (like those provided by GCI) reduce prisoner idleness and provide prison administrators with an effective management tool that can lead to reductions in misconduct. Since GCI uses inmate labor, it is only allowed to sell its products to government entities such as state agencies, universities, and county jails.

GCI operates 19 industries at 15 prison locations. These industries include: sign reclamation, license plates, shoes/boots, garments (four locations), optical goods, printing services, wood furniture, upholstered furniture, institutional furniture, panels (office cubicles), road signs, embroidery, mattress, paint, interstate road signs, and janitorial chemicals. GCI reported that, as of January 2010, approximately 1,400 inmates per day were assigned to work in GCI facilities. In addition, GDC transferred its Food and Farm operations to GCI in January 2009. Personnel from GDC indicated that the anticipated benefits of this transfer included increased flexibility in purchasing and the ability to generate revenue to offset the cost of feeding the inmate population. (It should be noted that state law specifically allows the sale of unprocessed agricultural products produced on state property to the general public.) According to GCI and GDC personnel, the Food and Farm Program has six farms (with approximately 4,000 inmates assigned to work on these farms) and provides approximately 43% of the food that is served in Georgia's prisons. (Two of the six farms are located near state prisons and the remaining four are located at four separate prisons.)

Factors Impacting GCI Profitability and Reserves

Over a period of more than forty years, GCI has built up its cash reserves, reaching a high of $19 million in fiscal year 2004. In recent years, several factors external to GCI's normal operations have significantly impacted its profitability and its cash reserves. Specifically, the General Assembly required that some of GCI's reserve funds be transferred to the State Treasury and that credits be given to subsidize license plate operations at the Department of Revenue (DOR). In addition, GDC started charging GCI for correctional officers that supervise inmates at work and transferred its Food and Farm operations to GCI which resulted in GCI subsidizing the cost of Food and Farm in fiscal year 2009.

A discussion of each of the factors impacting GCI's profitability and reserves is provided below. A summary of GCI's financial activity from fiscal years 2000 through 2009 is included as **Appendix A** and a timeline highlighting the factors we identified as impacting GCI's reserves and profitability (that is color keyed to the financial information in Appendix A) is included as **Appendix B**.

- **Transfers of Excess Reserves to the State Treasury**: GCI has transferred excess reserves to the state on two occasions in the last 10 years. In fiscal year 2001, GCI declared a surplus and

transferred $1,200,000 to the State Treasury. In fiscal year 2009, the General Assembly required that $5,000,000 be transferred from GCI's reserves to the State Treasury.

- **Subsidizing License Plate Program:** Historically, license plates for vehicles operating in the state were replaced on a five year cycle which resulted in periodic windfalls of sales and profits to GCI. However, in fiscal year 2004, the state stopped periodically replacing license plates and the General Assembly required that GCI give the Department of Motor Vehicle Services (DMVS) a credit of $4,583,792 for license plate purchases. This credit was used in fiscal years 2004 and 2005. In fiscal year 2009, the General Assembly required that GCI give the Department of Revenue (DOR) another credit of $2,895,700 for license plate purchases.[1] As a result of these credits, GCI essentially purchased materials for the plates, supplied the labor to produce the plates, and provided the finished plates at no cost to DMVS and DOR.

- **Reimbursing GDC for Correctional Officers**: GCI uses correctional officers provided by the Department of Corrections to supervise the inmates who participate in GCI's work program. Historically, GCI was not charged for the officers, which effectively resulted in GDC subsidizing GCI operations, inflating GCI's profits, and enabling it to retain additional reserves. However, in fiscal year 2003, GDC charged GCI $4,974 for correctional officers; in 2004, GDC did not charge GCI for officers; in 2005, GDC charged GCI approximately $1.2 million for officers; and, in 2006, GDC did not charge GCI for officers. Then, beginning in fiscal year 2007, GDC has consistently charged GCI $1,087,500 each year for correctional officer salaries and benefits (for 29 officers).

- **Subsidizing GDC's Food and Farm Operation**: GDC's Food and Farm Program, which is responsible for food production, processing, warehousing and preparation, was transferred to GCI in January 2009. GDC personnel indicated that the contract between GCI and GDC for Food and Farm services requires any profit be used strictly for Food and Farm and for GDC to reimburse GCI for any Food and Farm operating losses; however, our review found that there was no signed contract for fiscal year 2009. A contract for February 2009 through June 2010 (which was signed in January 2010) did not specify how Food and Farm Program profits or losses will be handled. After the review team pointed this out to GDC personnel, an amendment to the contract was signed in March 2010 that specifies that Food and Farm revenue can only be used for the Food and Farm Program; however, the amendment does not address how losses will be handled. GCI reported that its fiscal year 2009 losses of $3.7 million included Food and Farm losses of about $1.17 million. In addition, we identified another $582,700 in accrued annual leave liability that GCI incurred when Food and Farm employees transferred to GCI that GCI had not allocated to the Food and Farm Program. GCI reported that it has no intention to seek reimbursement from GDC for these losses. (GDC staff reported that GDC does not have a cash reserve for compensated absences that could be transferred to GCI; however, they indicated that GDC will reimburse GCI for any leave used by Food and Farm employees in the future.)

  It should be noted that Food and Farm expenses are ultimately paid with state appropriations. The Program is not intended to be a profit center for GCI, but is intended to be a mechanism to feed state inmates for the lowest possible cost. GDC reports that in fiscal year 2009, the average

[1] Responsibility for the issuance of license plates was transferred from the Department of Motor Vehicle Services to the Department of Revenue in 2005.

cost to feed an inmate in Georgia was $2.85 per day, which includes all costs associated with providing meals, such as farm costs, cafeteria labor in the facilities, additional food purchases, and maintenance and repair of equipment. In addition, GDC reported that it contracts out food service at two of its facilities, and, in fiscal year 2009, the contract cost per inmate was $3.029 per day. In comparison, interviews with corrections personnel in the contiguous states indicated that the average cost to feed an inmate was $2.85 for Alabama (whose Department of Corrections purchases food from a private vendor), $3.00 for Florida (whose DOC also purchases its food from a private vendor), and $4.04 for North Carolina (whose DOC purchases its food from the prison farm program).

Economic Factors Impacting GCI's Profitability and Reserves

We also identified several additional factors related to the recent downturn in the economy that have contributed to GCI's current financial situation.

- **Depressed Sales:** Economic constraints on state agencies and other government entities have had an impact on GCI's sales and its profitability. As its customers have experienced budget cuts and reductions in spending, GCI's sales have suffered. In fiscal year 2009, sales for GCI's core industries (not including the Food and Farm Program) were down about 13% from the prior year.

- **Reduced Interest Income:** For a number of years, GCI earned a significant amount of interest on its cash and investments; however, the reduction in GCI's cash, coupled with the drop in interest rates, resulted in its interest and other investment income falling $554,000 from fiscal year 2008 to 2009.

Future Profitability and Reserves

GCI ended fiscal year 2009 with about $7.17 million in cash and cash equivalents in its reserves. GCI reported that through January 2010 (the first seven months of fiscal year 2010) it had net losses of about $2.4 million (an average monthly loss of $343,200) and that its cash and cash equivalents had declined to about $1.75 million. (These figures do not include the impact of GCI's reimbursing GDC approximately $1 million for officers which has not yet been booked for the fiscal year.) A simple projection based on this average monthly loss indicates that GCI may exhaust its cash reserves in approximately five months unless it achieves significant improvements in its profitability. It should be noted that while this is a simple point-in-time projection, it indicates that GCI could experience cash flow problems in the future due to its reduced cash reserves.

GCI management indicated that it will take whatever steps may be necessary to ensure that GCI has adequate operating capital in the future. Specific steps that GCI plans to take include raising prices on products where the market will tolerate increases; cutting costs by adding furlough days for employees (along with maintaining vacancies); laying off employees and eliminating positions; and reducing inventories and raw material purchases. GCI also noted that it is launching two new industries and expects one new industry (Paint) to increase its sales revenue beginning in April and the other (interstate road signs) to generate increased sales within the next 24 months. In addition, GCI management indicated that it wants to expand its sales markets to include nonprofit and religious organizations; however, this will require a change in the law which GCI has not requested.

While GCI reported that the Food and Farm Program had losses of about $1.4 million as of January 31, 2010 (the first seven months of the fiscal year), it projects that the program will not end the fiscal year with an operating shortfall as a result of the following cost cutting measures and new sources of revenue that have been implemented.

- Increasing production of cash crops on the farms,
- Contracting with a private company to graze cattle on GDC/GCI land,
- Selling surplus egg production,
- Contracting with county jails to provide meals for their inmate populations,
- Selling food products to additional state agencies (generating savings for those agencies as well as profits for GCI), and
- Eliminating, maintaining vacancies, or combining Food and Farm Program positions.

A draft of this letter was provided to personnel at GCI and GDC for their review prior to release and they indicated that they agreed with the contents of this letter. If you have any questions about the information presented here, please do not hesitate to contact us.

Respectfully,



Russell W. Hinton
State Auditor

RWH/co

cc: Lieutenant Governor Casey Cagle
Senator Tommie Williams, President Pro Tempore
Senator Chip Rogers, Senate Majority Leader
Senator Greg Goggans, Vice Chair, Senate Appropriations Committee
Senator Tim Golden, Secretary, Senate Appropriations Committee
Representative Timothy Bearden, Vice Chair, House Governmental Affairs Committee
Representative Terry Barnard, Chairman, House State Institutions and Property Committee
Representative Alan Powell, Member, House Appropriations Committee
Members of the State Board of Corrections
Brian Owens, Commissioner, Department of Corrections
Becky East, Director, Division of Administration, Department of Corrections
Jerry Watson, Executive Director, Georgia Correctional Industries
Carolyn Bourdeaux, Director, Senate Budget and Evaluation Office

Appendix A

GCI Financial Information[1]

Fiscal Years 2000 - 2009

	Description	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
PROFIT AND LOSS INFORMATION	**Operating Revenues:**										
	Core GCI Industries Sales	$ 24,518,219	$ 28,300,046	$ 34,605,116	$ 33,716,640	$ 26,212,152	$ 26,042,160	$ 25,970,000	$ 25,959,000	$ 27,896,000	$ 24,249,777 [4]
	Less: License Plate Credit to DMVS					$ (2,242,772)	$ (2,341,020)				
	Plus: Food & Farm Program Sales	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 12,450,223
	Total Sales	**$ 24,518,219**	**$ 28,300,046**	**$ 34,605,116**	**$ 33,716,640**	**$ 23,969,380**	**$ 23,701,140**	**$ 25,970,000**	**$ 25,959,000**	**$ 27,896,000**	**$ 36,700,000**
	Operating Expenses:										
	Personal Services	$ 7,490,000	$ 7,354,726	$ 7,543,853	$ 8,002,049	$ 7,591,410	$ 7,333,606	$ 7,279,000	$ 7,574,000	$ 8,151,000	$ 9,770,000
	Services & Supplies	$ 15,619,291	$ 17,603,501	$ 20,024,029	$ 19,576,607	$ 15,916,584	$ 16,305,932	$ 16,876,000	$ 16,797,500	$ 18,333,500	$ 27,730,500
	Depreciation	$ 1,382,418	$ 1,433,732	$ 1,648,536	$ 1,974,040	$ 2,088,490	$ 2,078,530	$ 2,037,000	$ 1,884,000	$ 1,754,000	$ 1,845,000
	Payments for Corrections Officer Salaries	$ -	$ -	$ -	$ 4,974	$ -	$ 1,178,100	$ -	$ 1,087,500	$ 1,087,500	$ 1,087,500
	Operating Income (Loss)	**$ 26,510**	**$ 1,908,087**	**$ 5,388,698**	**$ 4,158,969**	**$ (1,627,103)**	**$ (3,195,028)**	**$ (222,000)**	**$ (1,384,000)**	**$ (1,430,000)**	**$ (3,733,000)** [3]
	Nonoperating Adjustments:										
	Interest & Other Investment Income	$ 431,859	$ 595,509	$ 370,674	$ 239,076	$ 192,332	$ 395,816	$ 679,000	$ 938,000	$ 702,000	$ 148,000 [4]
	Other (including Loss on Inventory)	$ 49,852	$ 267,757	$ (401,862)	$ (768,669)	$ 146,606	$ 272,310	$ 294,000	$ 309,000	$ 397,000	$ 307,000
	Transfers In (Food Service Inventory)										$ 5,019,000 [5]
	Transfers Out (Remittance to State Treasury)										$ (5,000,000)
	Transfers Out (Credit to DOR for License Plates)										$ (2,896,000)
	Net Income	**$ 508,222**	**$ 2,771,352**	**$ 5,357,511**	**$ 3,629,375**	**$ (1,288,166)**	**$ (2,526,902)**	**$ 751,000**	**$ (137,000)**	**$ (331,000)**	**$ (6,155,000)**
BALANCE SHEET INFORMATION	Net Assets (Beginning of Year - July 1)	$ 25,225,474	$ 26,879,644	$ 28,450,996	$ 33,808,507	$ 37,437,882	$ 36,149,716	$ 33,623,000	$ 34,374,000	$ 34,237,000	$ 33,906,000
	Plus: Net Income (see above)	$ 508,222	$ 2,771,352	$ 5,357,511	$ 3,629,375	$ (1,288,166)	$ (2,526,902)	$ 751,000	$ (137,000)	$ (331,000)	$ (6,155,000)
	Contributed Capital [2]	$ 1,145,948	$ (1,200,000)	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
	Net Assets (End of Year - June 30)	**$ 26,879,644**	**$ 28,450,996**	**$ 33,808,507**	**$ 37,437,882**	**$ 36,149,716**	**$ 33,622,814**	**$ 34,374,000**	**$ 34,237,000**	**$ 33,906,000**	**$ 27,751,000**
	June 30 Net Assets in Cash & Cash Equivalents	$ 7,995,981	$ 9,758,716	$ 14,717,463	$ 18,274,159	$ 19,142,422	$ 16,480,126	$ 18,282,000	$ 18,287,000	$ 15,760,000	$ 7,170,000
	Current Liabilities	$ (1,662,509)	$ (1,075,148)	$ (1,986,719)	$ (1,797,667)	$ (861,620)	$ (603,399)	$ (727,000)	$ (462,000)	$ (929,000)	$ (1,494,000)
	Other Current Assets (Inventories)	$ 11,213,408	$ 10,493,175	$ 10,819,327	$ 10,152,243	$ 8,151,269	$ 8,602,666	$ 8,752,000	$ 9,699,000	$ 11,981,000	$ 13,655,000
	Capital and Building	$ 9,332,764	$ 9,274,253	$ 10,258,437	$ 11,235,223	$ 10,084,399	$ 9,524,269	$ 8,521,000	$ 7,291,000	$ 7,723,000	$ 9,522,000
	Noncurrent Liabilities	$ -	$ -	$ -	$ (426,077)	$ (366,753)	$ (380,848)	$ (454,000)	$ (578,000)	$ (629,000)	$ (1,102,000)
	Total Net Assets (June 30)	**$ 26,879,644**	**$ 28,450,996**	**$ 33,808,507**	**$ 37,437,882**	**$ 36,149,717**	**$ 33,622,814**	**$ 34,374,000**	**$ 34,237,000**	**$ 33,906,000**	**$ 27,751,000**

[1] For an explanation of the color coding, see Appendix B.

[2] $1.2 million was remitted to the State Treasury in FY 2001.

[3] $1.7 million of the Operating Income loss was due to the Food and Farm Program (includes $582,700 in accrued annual leave liability incurred when Food and Farm employees transferred to GCI).

[4] The poor economy contributed to lower sales and lower interest rates. Lower interest rates along with lower cash for investments resulted in lower interest income.

[5] This transfer in was from the acquisition of the Food & Farm Program.

Source: Financial Audits, Management Reports, Comprehensive Annual Financial Reports

Appendix B
Factors Impacting GCI's Profitability and Reserves

Fiscal Year	Transfer of GCI Reserves to the State Treasury	GCI Subsidizing License Plate Program	GCI Reimbursing GDC for Correctional Officers	GCI Subsidizing GDC for Food and Farm Program Losses	Poor Economy
2001	GCI remits $1.2 million of reserves to the State Treasury.				
2002		Last two years of higher GCI sales due to periodic (5 year) license plate replacements.			
2003			GCI pays GDC about $5,000 for Correctional Officers.		
2004		GCI required to give DMVS a $4.58 million credit for license plate production. DMVS uses $2.24 million of the credit in FY2004 and $2.34 million of the credit in FY2005.			
2005			GCI pays GDC about $1.2 million for Correctional Officers.		
2006					
2007			GCI pays GDC about $1.1 million for Correctional Officers.		
2008			GCI pays GDC about $1.1 million for Correctional Officers.		
2009	GCI remits $5 million of reserves to the State Treasury.	GCI required to give DOR a $2.9 million credit for license plate production.	GCI pays GDC about $1.1 million for Correctional Officers.	GCI absorbs about a $1.7 million loss for Food and Farm Program Operations.	GCI experiences lower sales and interest rates. (Lower interest rates and reduced cash for investments resulted in lower interest income.)

Source: GCI financial records, GDC financial records, Governor's Budget Reports, appropriations acts, budget tracking documents, interviews