U.S. Department of Justice

Federal Bureau of Prisons

Office of the Director

Washington, DC 20534

March 18, 2004

The President
The White House
Washington, DC 20500

Dear Mr. President:

In accordance with the Chief Financial Officers Act (CFO Act) of 1990, 31 U.S.C. §9106(b), please find enclosed a copy of Federal Prison Industries, Inc. (FPI) FY 2003 management report and independent financial audit. This report will also be made available via the Internet at www.unicor.gov.

If you should have any questions, or desire further information, please do not hesitate to contact me.

Respectfully,

Harley G. Lappin
Chief Executive Officer

Enclosure

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Report of Management

Responsibility for the integrity and objectivity of the financial information in this report rests with the management of Federal Prison Industries, Inc. The accompanying financial statements have been prepared to conform with United States generally accepted accounting principles (U.S. GAAP).

To ensure the integrity of financial data, FPI management maintains a system of internal accounting controls. The system provides reasonable assurance that transactions have management authorization and are properly recorded. It also safeguards, verifies, and maintains accountability of assets and permits preparation of financial statements that conform with U.S. GAAP. This system of internal controls is subject to periodic reviews by both management and FPI's independent auditors.

Internal accounting and administrative control systems have been reviewed and tested. Accordingly, FPI management provides the following assurances:

1. There are sufficient controls and security measures to compensate for any identified risks associated with the program/system and/or its environment,
2. The program/system is being operated in an effective manner and complies with applicable laws and regulations,
3. There is proper management of the program/system information, and
4. The program/system complies with management, financial, information resources management, accounting, budget and other appropriate standards.

The independent public accounting firm of PricewaterhouseCoopers LLP is retained to audit FPI's financial statements. The role of independent auditors is to provide an objective review of management's responsibilities to fairly report operating results, cash flows and financial position. The independent auditor's reports are presented on the following pages. The report on the fairness of the presentation of the financial statements is unqualified.

The independent auditor obtains an understanding of FPI's internal control sufficient to plan the audit and to determine the nature, timing, and extent of tests to be performed to form an opinion on the fairness of the presentation of the financial statements.

Although management may periodically adopt certain cost-effective recommendations made by the independent auditors to further strengthen FPI's system of internal control, management believes that FPI's internal and accounting control system is accomplishing its objectives.

Harley G. Lappin

Director, Federal Bureau of Prisons
Chief Executive Officer, Federal Prison Industries

Report of Independent Auditors

PRICEWATERHOUSECOOPERS

Inspector General
U.S. Department of Justice

PricewaterhouseCoopers LLP
1301 K St., N.W., Suite 800W
Washington DC 20005-3333
Telephone (202) 414-1000

Board of Directors
Federal Prison Industries, Inc.
U.S. Department of Justice

We have audited the accompanying balance sheets of Federal Prison Industries, Inc., a financial reporting component of the U.S. Department of Justice referred to herein as the FPI, as of September 30, 2003 and 2002, and the related statements of operations and cumulative results of operations, and cash flows, for the years then ended. These financial statements are the responsibility of the FPI's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements.* Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of FPI at September 30, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 11, 2003 on our consideration of the FPI's internal control and a report dated November 11, 2003 on its compliance with laws and regulations. Those reports are an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

PricewaterhouseCoopers LLP

November 11, 2003

Report of Independent Auditors on Internal Control

PRICEWATERHOUSECOOPERS

Inspector General
U.S. Department of Justice

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1301 K St., N.W., Suite 800W
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Board of Directors
Federal Prison Industries, Inc.
U.S. Department of Justice

We have audited the financial statements of the Federal Prison Industries, Inc., a financial reporting component of the U.S. Department of Justice referred to herein as FPI, as of September 30, 2003 and 2002, and for the years then ended, and have issued our report thereon dated November 11, 2003. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements.*

The management of FPI is responsible for establishing and maintaining accounting systems and internal control. In fulfilling this responsibility, estimates and judgments are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that: (1) transactions are properly recorded, processed, and summarized to permit the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America, and to safeguard assets against loss from unauthorized acquisition, use or disposition; (2) transactions are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and any other laws, regulations and government-wide policies identified in Appendix C of OMB Bulletin No. 01-02; and (3) transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by FPI management. Because of inherent limitations in any internal control, errors or fraud may nevertheless occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of FPI's financial statements, we obtained an understanding of the design of significant internal controls and whether they had been placed in operation, tested certain controls and assessed control risk in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements. We limited our control testing to those controls necessary to achieve the objectives described above and we did not test all controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982. Our purpose was not to provide an opinion on FPI's internal controls. Accordingly, we do not express such an opinion.

With respect to internal controls relevant to data that support reported performance measures, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal controls over reported performance measures. Accordingly, we do not provide an opinion on such controls.

We noted certain matters in FPI's internal controls that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the entity's ability to meet the internal control objectives described in the second paragraph. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control elements does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited or material to a performance measure or aggregation of related performance measures may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. The reportable condition below is not considered a material weakness.

Technical and security design and implementation of the SAP financial application need improvement.

The remainder of this report discusses the reportable condition in more detail. Our recommendations for corrective action and status of prior year findings and recommendations are also provided.

PricewaterhouseCoopers LLP

November 11, 2003

Detailed information concerning the reportable conditions noted in Federal Prison Industries, Inc., internal control report can be obtained from the Department of Justice, Office of Inspector General for Audit, Office of Policy and Planning, 1425 New York Avenue, NW, Suite 5000, Washington, DC 20530 and from the Internet site at www.unicor.gov.

Report of Independent Auditors on Compliance with Laws and Regulations

PRICEWATERHOUSECOOPERS

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U.S. Department of Justice

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Telephone (202) 414-1000

Board of Directors
Federal Prison Industries, Inc.
U.S. Department of Justice

We have audited the financial statements of the Federal Prison Industries, Inc., a financial reporting component of the U.S. Department of Justice referred to herein as FPI, as of September 30, 2003 and 2002, and have issued our report thereon dated November 11, 2003 for the years then ended. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements.*

Compliance with laws and regulations applicable to the FPI is the responsibility of management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the FPI's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, the objective of our audits of the financial statements was not to provide an opinion on overall compliance with such provisions and, accordingly, we do not express such an opinion.

The results of our tests of compliance disclosed no instances of noncompliance with laws and regulations that are required to be reported under Government Auditing Standards or OMB Bulletin No. 01-02.

This report is intended solely for the information and use of the U.S. Department of Justice Office of the Inspector General, the management of the Department of Justice, the OMB, and Congress. This report is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

November 11, 2003

Balance Sheets

Federal Prison Industries, Inc.

September 30 **(DOLLARS IN THOUSANDS)**	**2003**	**2002**
ASSETS		
Current:		
Cash and cash equivalents	$ 187,416	$ 108,247
Accounts receivable, net	65,562	92,883
Inventories, net	146,702	141,847
Other assets	1,890	2,025
Total current assets	*401,570*	*345,002*
Property, plant and equipment, net	116,381	127,202
TOTAL ASSETS	*$ 517,951*	*$ 472,204*
LIABILITIES AND UNITED STATES GOVERNMENT EQUITY		
Current:		
Accounts payable	$ 48,020	$ 44,824
Deferred revenue	126,481	83,834
Accrued salaries and wages	7,268	6,988
Accrued annual leave	8,329	8,065
Other accrued expenses	10,077	12,669
Total current liabilities	*200,175*	*156,380*
FECA actuarial liability	7,932	7,935
Note payable to United States Treasury	20,000	20,000
Total Liabilities	*228,107*	*184,315*
United States Government Equity		
Initial capital	4,176	4,176
Cumulative results of operations	285,668	283,713
Total United States Government Equity	*289,844*	*287,889*
TOTAL LIABILITIES AND UNITED STATES GOVERNMENT EQUITY	*$ 517,951*	*$ 472,204*

The accompanying notes are an integral part of these financial statements

Statements of Operations and Cumulative Results of Operations

Federal Prison Industries, Inc.

Fiscal years ended September 30

(DOLLARS IN THOUSANDS)	**2003**	**2002**
REVENUE:		
Net sales	$ 666,763	$ 678,655
Other revenue	55,100	38,207
Total revenue	*721,863*	*716,862*
COST OF REVENUE:		
Cost of sales	598,625	603,014
Cost of other revenue	55,958	41,497
Total Cost of Revenue	*654,583*	*644,511*
GROSS PROFIT	*67,280*	*72,351*
OPERATING EXPENSES:		
Sales and marketing	6,983	8,788
General and administrative	72,193	66,529
Total operating expenses	*79,176*	*75,317*
LOSS FROM OPERATIONS	*(11,896)*	*(2,966)*
Interest income	1,941	1,409
Interest expense	(63)	(172)
Other income, net	11,973	10,819
Net income	*1,955*	*9,090*
Cumulative results of operations, beginning of fiscal year	283,713	274,480
Donated property reclasssified to cumulative results of operations	—	143
CUMULATIVE RESULTS OF OPERATIONS, END OF FISCALYEAR	*$ 285,668*	*$ 283,713*

The accompanying notes are an integral part of these financial statements

Statements of Cash Flow

Federal Prison Industries, Inc.

Fiscal years ended September 30 **(DOLLARS IN THOUSANDS)**	**2003**	**2002**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 1,955	$ 9,090
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,773	12,404
Loss on disposal of property, plant and equipment	1,748	278
Changes in:		
Accounts receivable	27,321	(4,520)
Inventories	(4,855)	(1,080)
Other assets	136	(190)
Accounts payable and accrued expenses	1,145	7,001
Deferred revenue	42,647	38,657
NET CASH PROVIDED BY OPERATING ACTIVITIES	*81,870*	*61,640*
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property, plant and equipment	(2,593)	(7,771)
Construction-in-progress of plant facilities	(200)	(19)
Construction reimbursement from Bureau of Prisons	92	—
NET CASH USED IN INVESTING ACTIVITIES	*(2,701)*	*(7,790)*
NET INCREASE IN CASH	79,169	53,850
CASH AND CASH EQUIVALENTS, BEGINNING OF FISCAL YEAR	108,247	54,397
CASH AND CASH EQUIVALENTS, END OF FISCAL YEAR	$ 187,416	$ 108,247

The accompanying notes are an integral part of these financial statements

Note 1
Organization and Mission

Federal Prison Industries, Inc. (FPI) was established in 1934 by an act of the United States Congress. FPI operates under the trade name UNICOR, as a wholly owned federal government corporation within the Department of Justice, and functions under the direction and control of a Board of Directors, (the "Board"). Members of the Board are appointed by the President of the United States of America and represent retailers and consumers, agriculture, industry, labor, the Attorney General, and the Secretary of Defense. FPI's statutory mandate is to provide employment and training for inmates in the Federal Prison System while remaining self-sufficient through the sale of its products and services.

FPI's federal government customers include departments, agencies and bureaus such as the Department of Justice, the Department of Defense, the Department of Homeland Security, the Social Security Administration, and the General Services Administration. These and other federal organizations are required to purchase products from FPI, if its products meet the customer's price, quality, and delivery standards, under a mandatory source preference specified in FPI's enabling statute and the Federal Acquisition Regulation. FPI's source preference may, at some time, be impacted by legislative changes. Subsequent to the end of this fiscal year, the House of Representatives passed H.R. 1829, which if enacted, would eliminate FPI's source preference and require other operational changes. FPI is unable to predict the probability of enactment, or if enacted the impact of this, or other legislation until it is finalized.

As of September 30, 2003, FPI had industrial operations at 112 factories located at 71 facilities within the Federal Prison System; these factories employed 20,274 inmates representing approximately 16% of the total federal inmate population.

Note 2
Summary of Significant Accounting Policies

Basis of Presentation

FPI has historically prepared its external financial statements in conformity with accounting principles generally accepted in the United States of America (US GAAP), based on accounting standards issued by the Financial Accounting Standards Board (FASB), the private sector standards-setting body. The Federal Accounting Standards Advisory Board (FASAB) has been designated as the standards-setting body for federal financial reporting entities with respect to the establishment of US GAAP. FASAB has indicated, however, that accounting standards published by FASB may also be in accordance with US GAAP for those federal entities, including FPI, that have issued such financial statements in the past.

Use of Estimates

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Cash and Cash Equivalents

FPI considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. FPI limits its investment activities and cash equivalents to short-term overnight repurchase agreements with the Bureau of Public Debt of the United States Treasury. The market value of these overnight repurchase agreements is equivalent to cost.

Accounts Receivable / Concentration of Credit Risk

Financial instruments that potentially subject FPI to concentrations of credit risk consist primarily of accounts receivable. FPI sells products and services to various federal government departments, agencies and bureaus, as well as certain private sector companies, without requiring collateral. Accounts receivable consists of amounts due from those entities and is stated net of an allowance for doubtful accounts.

Notes to Financial Statements (Dollars in Thousands)

FPI routinely assesses the payment histories of its federal customers and the financial strength of its private sector customers and maintains allowances for anticipated losses as they become evident. In this regard, a significant amount of accounts receivable remained past due at September 30, 2003 and 2002. A majority of these past due items relate to billings to various entities within Department of Defense (DOD) who rely on the Defense Finance and Accounting Service (DFAS) to process vendor payments. Historically, customer payments processed through DFAS have generally taken longer to receive than payments from other federal and private sector customers. FPI believes that ultimately, a majority of its past-due accounts receivable are fully collectable. The amount due FPI from DOD for fiscal years ended September 30, 2003 and 2002 was $54,185 and $74,913 respectively.

While federal accounts receivable are normally fully collectable in accordance with federal law, FPI has established an allowance for future losses against its federal accounts receivable to account for potential billing errors related to pricing and customer discounts, as well as, instances of expired or cancelled funding from its federally appropriated customers. At September 30, 2003 and 2002, FPI's allowance for doubtful accounts is stated at approximately $4,977 and $5,034, respectively, of which approximately $4,329 and $4,447, respectively, represents the amounts allocated against federal accounts receivable.

Inventories

Inventories are valued at the lower of average cost or market value (LCM) and include materials, labor and manufacturing overhead. Market value is calculated on the basis of the contractual or anticipated selling price, less allowances. FPI values its finished good and sub-assembly items at a standard cost that is periodically adjusted to approximate actual cost.

FPI has established inventory allowances to account for LCM adjustments and excess and/or obsolete items that may not be utilized in future periods.

Revenue Recognition

FPI sells a wide range of products and services to a diversified base of customers, primarily governmental departments, agencies and bureaus. Revenue is generally recognized when delivery has occurred or services have been rendered, persuasive evidence of an arrangement exists, there is a fixed or determinable price, and collectibility is reasonably assured. Revenue from contracts that require customer acceptance are not recognized until either customer acceptance is obtained, or upon completion of the contract. Provisions for anticipated contract losses are recognized at the time that they become evident.

Revenue is recognized on multiple element agreements for manufactured items when the product has been accepted by the customer. Revenue for services provided on behalf of FPI is recognized when the service provider presents a valid invoice including a customer acceptance or completion notice.

FPI records as other revenue the shipping and handling costs that have been billed to our customers. The cost of providing this service is recorded as a cost of other revenue.

Deferred revenue is comprised of customer cash advances, which have been paid to FPI prior to the manufacturing of goods, delivery of goods, or performance of services.

Other income is comprised primarily of imputed financing for retirement, health benefits and life insurance (Note 9).

Property, Plant and Equipment

Property, plant and equipment are stated at cost, net of an allowance for accumulated depreciation. Depreciation is computed using the straight-line method over the following estimated useful lives:

	Years
Machinery & Equipment	5 - 25
Computer Hardware	5 - 10
Computer Software	3 - 5
Building & Improvements	24 - 40

Upon retirement or disposition of property and equipment, the related gain or loss is reflected in the statement of operations. Repairs and maintenance costs are expensed as incurred.

Notes to Financial Statements (Dollars in Thousands)

Taxes
As a wholly-owned corporation of the federal government, FPI is exempt from federal and state income taxes, gross receipts tax, and property taxes.

Reclassifications
Certain fiscal year 2002 amounts in the accompanying financial statements and notes thereto have been reclassified to conform to our current year presentation.

Note 3
Accounts Receivable, Net

Accounts receivable, net consists of the following:

September 30	2003	2002
Intragovernmental billed receivables	$ 64,141	92,349
Private sector billed receivables	6,398	5,568
	70,539	***97,917***
Less allowance for doubtful accounts	4,977	5,034
Accounts receivable, net	***$ 65,562***	***$ 92,883***

Note 4
Inventories, Net

Inventories, net consist of the following:

September 30	2003	2002
Raw materials	$ 44,029	$ 46,229
Raw materials – vehicles	24,941	24,886
Work-in-process	21,774	31,546
Finished sub-assemblies	7,546	7,816
Finished goods	37,973	30,951
Finished goods – acceptance contracts	20,137	12,215
	156,400	***153,643***
Less inventory allowance	9,698	11,796
Inventories, net	***$146,702***	***$141,847***

$24,941 of FPI's fiscal year 2003 and $24,886 of FPI's fiscal year 2002 raw materials balance represents vehicles and component parts that have been purchased on behalf of the Customs and Border Protection and Bureau of Immigration and Customs Enforcement of the Department of Homeland Security (DHS) for retrofit services that are performed by FPI. As part of an interagency agreement, DHS provides advance funding to FPI to procure these vehicles. Revenue is recognized by FPI at the time of shipment of retrofitted vehicles to DHS.

$20,137 of FPI's fiscal year 2003 and $12,215 of FPI's fiscal year 2002 finished goods balance represents goods that have been shipped to customers or their agents, but for which revenue has not been recognized because of acceptance criteria within the customer contract. A majority of this amount consists of systems furniture installations in progress.

Note 5
Property, Plant and Equipment, Net

Property, plant and equipment, net consists of the following:

September 30	2003	2002
Machinery and equipment	$ 89,943	$ 91,296
Computer hardware	3,096	2,740
Computer software	5,965	6,806
Buildings and improvements	164,259	166,321
	263,263	***267,163***
Less accumulated depreciation	147,095	140,072
	116,168	***127,091***
Factory construction-in-progress	213	111
Property, plant and equipment, net	***$116,381***	***$127,202***

Depreciation and amortization expense approximated $11,773 and $12,404 for the fiscal years ended September 30, 2003 and 2002, respectively.

As of September 30, 2003, various projects were in progress for the construction of new industrial facilities and the renovation of existing facilities. In this regard, BOP, on behalf of FPI, is planning to invest approximately $17,105, provided from their fiscal year 2002 and 2003 building and facilities appropriations, during the next fiscal year for the construction of buildings and improvements. In addition, during the next fiscal year, FPI is planning to invest approximately $12,051 for the purchase and construction of property, plant, and equipment.

Notes to Financial Statements (Dollars in Thousands)

Note 6
Other Accrued Expenses

Other accrued expenses consist of the following:

September 30	2003	2002
Permanent change of station	$ 2,411	$ 1,662
Information systems	614	3,614
FECA liability – current portion	936	764
Materials in Transit	2,369	2,067
Financial Audit Expense	946	900
Utilities	1,290	1,768
Other expense	1,511	1,894
Other accrued expenses	***$ 10,077***	***$ 12,669***

Note 7
Note Payable to United States Treasury

Congress has granted FPI borrowing authority pursuant to Public Law 100-690. Under this authority, FPI has borrowed $20,000 from the Bureau of Public Debt of the United States Treasury (the Treasury) with an extended lump-sum maturity date of September 30, 2008. The funds received under this note have been internally restricted for use in the construction of plant facilities and the purchase of equipment. The note accrues interest, payable March 31 and September 30 of each fiscal year at 5.5% (the rate equivalent to the yield of United States Treasury obligations of comparable maturities which existed on the date of a note maturity extension, granted in fiscal year 1998). Accrued interest payable under the note is either fully or partially offset to the extent FPI maintains non-interest bearing cash deposits with the Treasury. In this regard, there is no accrual of interest unless FPI's daily cash balance on deposit with the Treasury is less than the unpaid principal balance of all note advances received, as determined by a monthly calculation performed by the Treasury. When FPI's daily cash balance is less than the unpaid principal balance of all note advances received, interest is calculated by the Treasury on the difference between these two amounts. The note agreement provides for certain restrictive covenants and a prepayment penalty for debt retirements prior to 2008. Additionally, the agreement limits authorized borrowing in an aggregate amount not to exceed 25% of FPI's net equity.

There was no interest expense related to this note for the fiscal years ended September 30, 2003 and 2002.

Note 8
Business Segments

FPI's businesses are organized, managed and internally reported as eight operating segments based on products and services. These segments are Clothing and Textiles; Electronics; Fleet Management and Vehicular; Graphics; Industrial Products; Office Furniture; Recycling; and Services. These segments represent virtually all of FPI's product lines. FPI is not dependent on any single product as a primary revenue source; however, it is dependent on the federal government market for the sale of its products. FPI's net sales for the fiscal years ended September 30, 2003 and 2002 for each of its business segments is presented for comparative purposes:

Net Sales

Fiscal year ended September 30	2003	2002
Business Segment		
Clothing and Textiles	$158,399	$159,730
Electronics	152,357	132,662
Fleet Management and Vehicular	123,272	99,054
Graphics	23,658	26,006
Industrial Products	36,759	27,782
Office Furniture	151,996	217,852
Recycling	8,083	3,359
Services	12,239	12,210
Net sales	***$666,763***	***$678,655***

Regulatory Compliance

FPI's ability to add or to expand production of a specified product is regulated by the Federal Prison Industries Reform Act ("the Act"). The Act provides specific guidelines to FPI regarding its methodology for evaluating and reporting new or expanded products, including requiring FPI to provide direct notice to trade associations and interested parties of such actions. Finally, publication of annual decisions of the FPI Board of Directors and semi-annual sales disclosures are mandated under the Act.

Note 9
Intra-Department of Justice (DOJ)/ Intragovernmental Financial Activities

FPI's financial activities interact with and are dependent upon those of DOJ and the federal government as a whole. The following is a discussion of certain intra-DOJ and intragovernmental activities and their relationship with FPI:

Relationship with the Federal Bureau of Prisons
FPI and the Federal Bureau of Prisons (BOP) have a unique relationship in that the nature of their respective missions requires the sharing of facilities and responsibilities relative to the custody, training and employment of federal inmates. The Director of the BOP serves as the Chief Executive Officer of FPI and the Chief Operating Officer of FPI serves as an Assistant Director of the BOP. The BOP provides land to FPI for the construction of its manufacturing facilities and both FPI and BOP share certain facilities, generally at no cost to FPI.

Self Insurance
In accordance with federal government policy, FPI is uninsured with respect to property damage, product liability, and other customary business loss exposures. Losses incurred are absorbed as a current operating expense or, if they are induced by factors related to FPI's relationship with the Federal Prison System, may be reimbursed by BOP. Certain other costs, principally relating to personal injury claims, are paid directly by the federal government.

Federal Employees Compensation Act
The Federal Employees Compensation Act (FECA) provides income and medical cost protection to cover federal civilian employees injured on the job, employees who have incurred a work-related occupational disease, and beneficiaries of employees whose death is attributable to a job related injury or occupational disease. The United States Department of Labor (DOL), which administers FECA, annually charges each federal agency and department for its applicable portion of claims and benefits paid in the preceding year. As of September 30, 2003 and September 30, 2002, the accrued FECA liability as charged to FPI, approximated $936 and $737, respectively.

DOL also calculates the liability of the federal government for future claims and benefits, which includes the estimated liability of death, disability, medical, and other approved costs. Future claims and benefits are determined from an actuarial extrapolation, utilizing historical benefit payment patterns and calculations of projected future benefit payments discounted to current value over a 23.5 year period. FPI's estimated future liability approximated $7,932 and $7,935 at September 30, 2003 and 2002, respectively.

Retirement
Substantially all of FPI's civilian employees are covered under either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). For employees covered under CSRS (those employees hired prior to January 1, 1984), FPI contributes approximately 7.0 percent (for normal retirement) or 7.5 percent (for hazardous duty retirement) of each employee's salary. CSRS covered employees do not have Federal Insurance Contributions Act (FICA) withholdings and, thus, are not fully eligible to receive Social Security benefits. For employees covered under FERS, (generally those employees hired on or after January 1, 1984) FPI contributes 10.7 percent (for normal retirement) or 22.7 percent (for hazardous duty retirement).

Under FERS, employees also receive retirement benefits from Social Security and, if applicable, benefits from a defined contribution plan (thrift). Under the thrift plan, an employee may contribute (tax deferred) up to 13 percent of salary to an investment fund. FPI then matches this amount up to 5 percent. Those employees, which elected to remain under CSRS after January 1, 1984, continue to receive benefits in place, and may also contribute (tax deferred) up to 8 percent of their salary to the thrift plan, but with no matching amount contributed by FPI.

CSRS and FERS are multi-employer plans. Although FPI funds a portion of pension benefits relating to its employees, and provides for the necessary payroll withholdings, it does not maintain or report information with respect to the assets of the plans, nor does it report actuarial data with respect to accumulated plan benefits or the pension liability relative to its employees. The reporting of such amounts is the responsibility of the United States Office of Personnel Management.

FPI's contribution to both plans was approximately $24,314 and $22,340 for the years ended September 30, 2003 and 2002, respectively.

Notes to Financial Statements (Dollars in Thousands)

Health Benefits and Life Insurance

FPI, through the Office of Personnel Management (OPM), offers health and life insurance plans under which premium costs for health care are shared between FPI and the employees. A substantial portion of life insurance premiums are paid for by employees. Amounts paid by FPI for health benefits approximated $7,910 and $6,727 for the fiscal years ended September 30, 2003 and 2002, respectively.

OPM also provides health care and life insurance benefits for FPI's retired employees. Based on the requirements of SFFAS No. 5, FPI must recognize an expense related to its share of the cost of such post-retirement health benefits and life insurance on a current basis (while its employees are still working), with an offsetting credit to other income. Costs in this regard, which approximated $5,583 and $5,143 during the fiscal years ended September 30, 2003 and 2002, respectively, were determined by OPM utilizing cost factors which estimate the cost of providing post-retirement benefits to current employees. However, because of the offsetting credit, the recording of these costs has no impact on reported net income or cash flows.

Future post-retirement health care and life insurance benefit costs are not reflected as a liability on FPI's financial statements, as such costs are expected to be funded in future periods by OPM.

Note 10
Selling, General and Administrative Expenses

Selling, general and administrative expenses consist of the following:

Selling, general and administrative expenses

Fiscal years ended September 30	**2003**	**2002**
Salaries, wages and benefits	$ 32,440	$ 29,714
Permanent change of station expense	3,453	1,901
Purchases of minor equipment	1,283	974
Contract services	9,410	9,388
Bad debt expense	2,903	4,957
Credit card services	1,452	1,733
Travel	2,139	2,020
Customer Goodwill	1,241	1,039
Personal Computer Expense	710	1,864
Depreciation	3,246	2,883
Gain or Loss on Disposition of Assets	1,741	194
Other Expense	9,604	10,482
Imputed pension costs (Note 9)	3,971	3,025
Imputed post-retirement health care and life insurance cost (Note 9)	5,583	5,143
Selling General and Administrative Expenses	$ 79,176	$ 75,317

Other expense is comprised primarily of inmate wages and certain sales and marketing expenses. Contract services consist primarily of consulting and sales and marketing fees. Salaries, wages and benefits are shown net of the imputed financing offsetting credit (Note 9).

Note 11
Commitments and Contingencies

Legal Contingencies

FPI is involved in various legal actions, including administrative proceedings, lawsuits, and claims. In the opinion of the organization's legal counsel, these suits are without substantial merit and should not result in judgments, which in the aggregate would have a material adverse effect on the organization's financial statements.

Lease Commitments

FPI leases certain facilities, machinery, vehicles and office equipment under noncancelable operating lease agreements that expire over future periods. Many of these lease agreements provide FPI with the option (after initial lease term) to either purchase the leased item at the then fair value or to renew the lease for additional periods of time. Future commitments for the next five years and thereafter are as follows: fiscal year 2004 $406, fiscal year 2005, $163, fiscal year 2006, $127, fiscal year 2007, $67, fiscal year 2008, $55, and fiscal years after 2008, $25. Rental expense approximated $1,025 and $1,640 for the fiscal years ended September 30, 2003 and 2002, respectively.

Product Warranty

FPI offers its customers a promise of an "Escape Proof Guarantee" on the products it manufactures. FPI Management has analyzed the historical pattern of sales returns and the adequacy of the sales returns and allowances. In this regard, Management has established an estimate of future returns related to current period product revenue.

Minimum Buy Agreements

FPI is obligated under certain "Minimum Buy" purchase agreements to procure a specified minimum quantity of raw materials. These agreements are generally related to the Clothing and Textiles and Electronics business groups. FPI has sufficient orders from customers at fiscal year end to satisfy the minimum purchase requirements.

Congressional Limitation on Administrative Expenses

Congress has imposed an annual spending limit on certain administrative expenses relating to FPI's central office management. These costs include salaries for management personnel, travel expenses and supplies. The following is a comparison of actual expenses to the limitation imposed:

Congressional limitation on administrative expenses

Fiscal years ended September 30	2003	2002
Congressional limitation on expenses	$ 3,429	$ 3,429
Expenses incurred subject to		
Congressional limitation	$ 1,432	$ 1,254

Report of Independent Auditors on Internal Control

PRICEWATERHOUSECOOPERS

Inspector General
U.S. Department of Justice

Board of Directors
Federal Prison Industries, Inc.
U.S. Department of Justice

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We have audited the financial statements of the Federal Prison Industries, Inc., a financial reporting component of the U.S. Department of Justice referred to herein as FPI, as of September 30, 2003 and 2002, and for the years then ended, and have issued our report thereon dated November 11, 2003. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of FPI is responsible for establishing and maintaining accounting systems and internal control. In fulfilling this responsibility, estimates and judgments are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control are to provide management with reasonable, but not absolute, assurance that: (1) transactions are properly recorded, processed, and summarized to permit the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America, and to safeguard assets against loss from unauthorized acquisition, use or disposition; (2) transactions are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and any other laws, regulations and government-wide policies identified in Appendix C of OMB Bulletin No. 01-02; and (3) transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by FPI management. Because of inherent limitations in any internal control, errors or fraud may nevertheless occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of FPI's financial statements, we obtained an understanding of the design of significant internal controls and whether they had been placed in operation, tested certain controls and assessed control risk in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements. We limited our control testing to those controls necessary to achieve the objectives described above and we did not test all controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982. Our purpose was not to provide an opinion on FPI's internal controls. Accordingly, we do not express such an opinion.

With respect to internal controls relevant to data that support reported performance measures, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal controls over reported performance measures. Accordingly, we do not provide an opinion on such controls.

We noted certain matters in FPI's internal controls that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the entity's ability to meet the internal control objectives described in the second paragraph. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control elements does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited or material to a performance measure or aggregation of related performance measures may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. The reportable condition below is not considered a material weakness.

> Technical and security design and implementation of the SAP financial application need improvement.

The remainder of this report discusses the reportable condition in more detail. Our recommendations for corrective action and status of prior year findings and recommendations are also provided.

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Technical and security design and implementation of the SAP financial application need improvement

Our testing of the SAP application environment responsible for processing FPI's financial transactions identified improvements needed to strengthen the design and implementation of its information security program. Specifically, we identified the following weaknesses:

- The SAP security strategy does not include specific strategies and policies that address the control of high-risk SAP security identification (ID) profiles and transactions, security re-certifications, and various security administration procedures.
- High-risk and/or vendor-supplied profiles have been assigned to user IDs. These user IDs allow users to process system and database updates across all functional and technical areas, which may not be detected in a timely manner.
- An excessive number of end-users had the ability to perform activities, such as table maintenance and batch processing through system-level transactions. The use of system-level transactions for these activities allows a user to bypass inherent controls that are built into the related business process transactions and could impact system performance.

- An excessive number of end-users were also identified with access to sensitive transactions and segregation of duty conflicts within the purchasing, payables, sales, and receivables functions.
- Some security administration procedures were not consistently followed to ensure that visibility and control over user access were properly monitored and addressed. For example, procedures have not been consistently implemented for monitoring unused user IDs, maintaining user access to reflect reengineered roles and to comply with the access requested on the user request form, and ensuring site security administrators cannot maintain their own access privileges.
- Password controls have not been fully addressed, such as populating the table of easily guessable passwords and properly setting the system parameter to control deletion of the powerful "SAP*" ID.
- Segregation of duties issues exist with respect to SAP Patch Teams who perform business configuration and programming. Specifically, the Teams have update access to both development and production environments.

Implementation of inconsistent security practices and configurations may lead to unauthorized access and/or modification, possibly causing corruption of the SAP financial application and production data through unauthorized, inadvertent, or malicious actions.

OMB A-130, Appendix III, *Security of Federal Automated Information Resources*, requires agencies to implement the practice of least privilege whereby user access is restricted to the minimum necessary to perform his or her job function; and enforce a separation of duties so that steps in a critical function are divided among different individuals. It also emphasizes the importance of management controls – such as individual accountability requirements, separation of duties enforced by access controls, and limitation on the processing privileges of individuals – to prevent and detect inappropriate or unauthorized activities.

According to National Institute of Standards and Technology (NIST) Special Publication NIST 800-12: *An Introduction to Computer Security*, "The Computer Security Act mandates that agencies develop computer security and privacy plans for sensitive systems." In addition, this publication mentions the importance of incorporating logical controls into systems.

Recommendations

We recommend FPI:

1. Review and update the existing SAP technical administration procedures and application level security design to ensure compliance with OMB A-130 and NIST 800-12.
2. Review and restrict the assignment of SAP-supplied and high-risk profiles in the production environment. Create custom profiles that restrict users to only the functionality needed to perform their specific job functions. In addition, implement monitoring controls to ensure that these procedures are followed.
3. Review and restrict the assignment of system-level transactions that provide access to perform table maintenance and batch processing.
4. Define segregation of duties conflicts at the transaction level to ensure that conflicts within a single role can be identified, in addition to conflicts among combined roles. Define all roles, including end-user and competency center roles with specific transaction codes, thereby reducing the risk of segregation of duties where transaction ranges are defined. Review the list of users with access to sensitive transactions to ensure that access is appropriate. In addition, where segregation of duties conflicts are identified that cannot be resolved, ensure that adequate compensating controls are in place to monitor access to sensitive transactions.
5. Take measures to ensure that existing procedures for providing visibility and control over user access is properly enforced. At a minimum, ensure that procedures have been fully implemented for monitoring and revoking unused IDs, providing guidelines for maintaining user access, and preventing site security administrators from maintaining their own access privileges.
6. Protect the powerful "SAP*" account by removing default profiles, locking the ID, and setting the system parameter to prevent the use of a default password if the ID is deleted. In addition, ensure password controls are in place to eliminate easily guessable passwords.
7. Implement the proposed strategy to restrict Application, Basis, and ERP personnel's access to the SAP production environment.

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Status of Prior Year Findings and Recommendations:

As required by *Government Auditing Standards* and OMB Bulletin 01-02, we have reviewed the status of FPI's corrective actions with respect to findings and recommendations identified in prior audits. The table below provides our assessment of the progress FPI has made in correcting the reportable conditions identified during these audits. We also provide the Office of the Inspector General (OIG) report number where the condition remains open, our recommendation for improvement, and the status of the condition as of the end of fiscal year 2003:

Report	Reportable Condition	Status
No. 03-30	<u>Material Weakness</u>: **The FPI information security program management and controls require improvement.**	
	<u>Recommendations:</u>	
	1) Ensure the risk assessment, security and contingency plans are updated on a periodic basis.	Completed (a)
	2) Formally document and implement access control policies.	Completed (a)
	3) Revoke network access of all terminated employees upon their exit from FPI.	Completed (a)
	4) Implement a log monitoring policy and document all activity.	Completed (a)
	5) Enforce employee compliance with SDLC policies and procedures.	Completed
	6) Require that system change requests be accompanied with formal documentation.	Completed
	7) Ensure the contingency plan is update periodically to reflect the current operating environment.	Completed (a)
	8) Document and perform routine and unscheduled maintenance on servers with critical data.	Completed
	9) Enforce established policies and procedures for consistent and secure system configurations and provide guidance on specific technical issues such as standard server security.	Completed
No. 03-30	<u>Reportable Condition</u>: Improvements are needed in FPI's development and implementation of accounting policies to ensure financial statements are prepared in accordance with generally accepted accounting principles.	

Report	Reportable Condition	Status
	Recommendations:	
	10) Continue to present service, installation, and shipping revenue as a part of FPI's sales and present the related expenses as cost of goods sold.	Completed
	11) Evaluate current policies and procedures for revenue recognition to ensure they address the types of transactions encountered in the field.	Completed
	12) Continue to monitor and review existing order entry processes to identify and correct the root cause of errors arising from this process.	Completed (a)
	13) Develop a process of estimating the average delivery time of products by product line and geography, and based on this information prepare month-end closing entries to reverse the estimated amount of undelivered products with F.O.B. destination terms that have been recognized as revenue in the general ledger.	Completed
	14) Develop and implement policies and procedures to address the applicability of Staff Accounting Bulletin 101, including contracts with multiple elements, bill and hold arrangements, and other non-standard sales transactions.	Completed
	15) Ensure that those tasked with the responsibility of preparing FPI accounting policies and the GAAP financial statements monitor new accounting developments to ensure that FPI policies and procedures are updated in a timely manner as standards change.	Completed
	16) Eliminate the practice of shipping products to a customer's facility without a valid purchase order or sales contract from the customer.	Completed
	17) Establish a formal policy for accruing and monitoring warranty reserves in order to ensure the adequacy of financial statement accruals and disclosures.	Completed

(a) This recommendation has been modified during FY 2003 and is now considered a management letter comment.

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We also noted other less significant matters involving FPI's internal controls that we will communicate to management in a separate letter.

This report is intended solely for the information and use of the U.S. Department of Justice Office of the Inspector General, the management of the Department of Justice, FPI's Board of Directors, the OMB, and Congress. This report is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

November 11, 2003