U.S. Department *of* Justice
Federal Prison Industries, Inc.

FY 2004

ANNUAL REPORT

TABLE OF CONTENTS

1 Table of Contents/ Mission Statement
2 Message from the Board of Directors
4 Message from the Director
5 Management Discussion and Analysis
12 Report of Independent Auditors
13 Report of Independent Auditors on Internal Control
18 Report of Independent Auditors on Compliance and Other Matters
19 Balance Sheets
20 Statements of Operations and Cumulative Results of Operations
21 Statements of Cash Flow
22 Notes to Financial Statements (Dollars in Thousands)

Mission Statement

It is the mission of Federal Prison Industries, Inc. (FPI) to employ and provide job skills training to the greatest practical number of inmates confined within the Federal Bureau of Prisons; contribute to the safety and security of our Nation's Federal correctional facilities by keeping inmates constructively occupied; produce market-quality goods for sale to the Federal Government; operate in a self-sustaining matter; and minimize FPI's impact on private business and labor.

Message from the Board of Directors

It is our pleasure to present Federal Prison Industries' (FPI) Fiscal Year 2004 Annual Report.

2004 is the third year of our tenure as FPI's Board of Directors. Each of us accepted our positions with the inherent responsibility of finding a balance between maintaining sufficient work opportunities for federal inmates and minimizing adverse effects on the private sector. We believe the FPI program's performance in 2004 shows that such a balance can be achieved.

During our tenure, we have initiated several administrative measures to ensure the FPI program fulfills its statutory mandate to limit competition with private industry and free labor. These initiatives include:

* Eliminating the FPI program's status as a mandatory source of federal supply for purchases valued at $2,500 or under;
* Granting all requests to waive FPI's mandatory source when FPI is unable or unwilling to meet the price of a comparable product offered by a private vendor;
* Waiving mandatory source for all products where the FPI program's share of the federal market is 20 percent or higher;
* Terminating the business practice commonly referred to as "pass-through" in which the FPI program would purchase finished goods from its private sector partners for resale if circumstances prevented FPI from fulfilling an order;
* Ensuring that inmates in the FPI program do not have access to sensitive or personal information of any kind (such as credit card numbers, medical records, social security numbers, credit reports, or other personal information); and,
* Requiring all products made by the FPI program to have at least 20 percent of their value added by inmate labor.

These initiatives, coupled with recent legislative efforts modifying application of the FPI program's mandatory source, have had the effect of reducing the level of impact on the private sector (particularly in the FPI program's traditional industries of textiles and office furniture), and simultaneously steering the FPI into a more competitive mode of operations.

For Fiscal Year 2004, FPI's sales were temporarily inflated as FPI responded to war surge requirements from the Department of Defense. Despite these temporarily elevated sales levels, we would note that the number of inmates participating in the FPI program has decreased by more than 3,000 in the last three years. For a correctional program whose primary mission is to provide job skills training and work experience to the greatest number of inmates possible, this is a disappointing trend, especially considering the fact that the number of inmates in the Bureau of Prisons grew by more than 23,000 during this same three year period.

The Board has made clear its objective to move the FPI program in the direction of operating with less reliance on mandatory source. Toward that end, FPI has made continued progress in the areas of Fleet Management and Vehicular Components, Recycling, and Services. All of FPI's work in these business areas is "non-mandatory." To reduce impact on the private sector, FPI has focused on providing to commercial companies, services that would otherwise be performed outside the United States. This repatriation of work goes beyond having no negative impact on American workers, and actually creates jobs for domestic employees through the FPI program's related purchases of supplies and services.

Message from the Board of Directors

The challenges facing the FPI program are significant: smaller federal budgets, increased competition from private suppliers, and the need to identify work opportunities for a growing number of federal inmates. However, we accept these challenges and commit to leading the FPI program to continued success.

The Board would like to take this opportunity to thank the Administration for its support and direction.

We would also like to thank the many customers who express their confidence in the FPI program by selecting it as their vendor of choice. We appreciate the outstanding work of the staff throughout the corporation in meeting the multiple and growing demands. Finally, it is appropriate that we also recognize the inmates who participate in the FPI program, for their contributions toward meeting our customers' needs.

The Board of Directors for Federal Prison Industries

Kenneth R. Rocks, Chairman
Represents Labor

David D. Spears, Vice Chairman
Represents Agriculture

Dr. Paul R. Corts
Represents the Attorney General

Donald R. Elliott
Represents Industry

Audrey J. Roberts
Represents Retailers and Consumers

Departure from the Board

On January 3, 2004, Diane K. Morales resigned from the FPI Board of Directors as the Secretary of Defense representative. For her service on the Board, and her support of the Program, we thank her.

Message from the Director

It is my pleasure, as Director of the Federal Bureau of Prisons, and as Chief Executive Officer of Federal Prison Industries, Inc. (FPI), to join with FPI's Presidentially-appointed Board of Directors in presenting the corporation's Fiscal Year 2004 Annual Report.

2004 was a special year for us, as it marked the FPI program's 70th Anniversary. Whether it was supporting our Nation's military effort, supplying the varied requirements of federal civilian agencies, or serving as the Bureau of Prisons' most important correctional management program, FPI continued its history of fulfilling its mission.

During the past year, our Nation has faced many challenges, with the greatest perhaps being Operation Iraqi Freedom. The FPI program's continued ability to support our military's needs ensures that the men and women in uniform have the materials, equipment, and services necessary to carry out their mission. In particular, I wish to recognize FPI's outstanding performance in the areas of Electronics and Clothing/Textiles. During this time of war, the FPI program has received numerous requests from our military customers to increase production, modify an item's design or specifications, and reduce delivery times. I am extremely proud of the manner in which FPI staff and inmates stepped up and met these requests. The quality and reliability of FPI as a supplier during this time of war is best symbolized by our military customers' eagerness to use the FPI program as their supplier of choice.

The financial impact on FPI from the war in Iraq cannot be overstated. Virtually all of FPI's electronics sales, and the vast majority of FPI's clothing/textiles sales are in support of the Department of Defense's war effort. FPI's increased sales and earnings in those two business areas are a direct result of increased wartime demand. However, if not for this increased demand, and the resulting increases in sales and earnings, the FPI program would have actually lost money during Fiscal Year 2004.

The FPI program receives no appropriations. Thus, for the FPI program to finance the significant costs associated with activating so many new factories, the corporation must draw upon its earnings. Ensuring there is enough capital available to fund the upcoming factory activations will be a continuing challenge going forward.

FPI is the Bureau of Prisons' most important correctional management program. The federal inmate population, now over 181,000 inmates, is expected to reach 215,000 by 2010. Those inmates coming into BOP's custody are increasingly more dangerous and aggressive offenders. To keep pace with this increase in the inmate population, the BOP began the process of activating nine new institutions during FY 2004 and hopes to activate an additional four during the next three years. Virtually all of these inmates will be released back into our neighborhoods at some point, and they will need the job skills training and work experience provided by the FPI program.

When discussing new factories and earnings, it is easy to lose sight of the fact that FPI is not really a business. Rather, the FPI program is an integral component of the federal criminal justice system. FPI's real output is inmates who are more likely to return to society as law-abiding taxpayers because of the job skills training and work experience they received in the FPI program. The products manufactured and services provided by FPI are integral by-products of the job training program.

I'd like to take this opportunity to thank the FPI Board of Directors for all of their efforts on behalf of the program. I'd also like to express my sincere appreciation to the outstanding FPI staff for their tireless efforts to fulfill an extremely challenging mission.

On the occasion of the FPI program's 70th Anniversary, I am hard-pressed to think of a time during its history when FPI was more successful at both meeting the increasingly complex needs of its customers, while continuing to provide inmates with the job skills training and work experience that benefit all of us.

Harley G. Lappin
Director, Federal Bureau of Prisons
Chief Executive Officer, Federal Prison Industries

Management Discussion and Analysis

General

Mission

It is the mission of Federal Prison Industries, Inc. (FPI) to employ and provide job skills training to the greatest practicable number of inmates confined within the Federal Prison System, to contribute to the safety and security of our federal correctional facilities by keeping inmates constructively occupied, to provide inmates with work experience, training and skills, to produce market-priced quality goods for sale to the federal government, to operate in a self-sustaining manner and minimize FPI's impact on private business and labor.

Organizational Structure of Federal Prison Industries, Inc.

FPI is a wholly owned government corporation created by Congress in 1934. FPI is authorized to operate industries in federal correctional institutions and disciplinary barracks (18 U.S.C. § 4121 to § 4129). The Director of the Federal Bureau of Prisons (BOP), who has jurisdiction over all federal correctional institutions, is the Chief Executive Officer.

In fiscal year 2004, FPI operated in eight business areas: Clothing & Textiles, Electronics, Fleet Management & Vehicular Components, Graphics, Industrial Products, Office Furniture, Recycling Activities, and Services. FPI has industrial operations at 102 factories located at 71 prison locations that employed 19,337 inmates representing approximately 13% of the of total number of inmates housed in BOP facilities as of September 30, 2004. Factories are operated by FPI supervisors and managers, who train and oversee the work of inmates. The factories utilize raw material and component parts purchased from the private sector to produce finished goods. Orders for goods and services are obtained through marketing and sales efforts managed by FPI staff. Services are provided on a non-mandatory, preferred source basis.

FPI processes customer orders through a centralized customer service center at the Lexington, Kentucky facility. In addition, FPI performs product development, testing and costing at its facility in Englewood, Colorado.

Financial Structure

FPI operates as a revolving fund and does not receive an annual appropriation. The majority of revenues are derived from the sale of products and services to other federal departments, agencies, and bureaus. Operating expenses such as the cost of raw materials and supplies, inmate wages, staff salaries, and capital expenditures are applied against these revenues resulting in operating income or loss, which is reapplied toward operating costs for future production. In this regard, FPI makes capital investments in buildings and improvements, machinery, and equipment as necessary in the conduct of its industrial operation.

While FPI does business with the majority of federal departments, agencies and bureaus, FPI's largest federal government customers include the Department of Defense (DOD), the Department of Homeland Security (DHS), the Department of Justice (DOJ), the Social Security Administration (SSA), and the General Services Administration (GSA).

Critical Accounting Policies

The following discussion and analysis of FPI's financial condition, results of operations, liquidity and capital resources are based upon FPI's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. These generally accepted accounting principles require FPI management to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses. In this regard, FPI management evaluates the estimates on an on-going basis, including those related to product returns, bad debt, inventories, long-lived assets, and contingencies and litigation. FPI bases its estimates upon historical experience and various other assumptions that FPI believes are reasonable under the circumstances. The actual results may differ from these estimates when assumptions or conditions change.

FPI believes that some of its accounting policies involve complex or higher degrees of judgment than its other accounting policies. The following accounting policies have been identified by FPI management as being critical and therefore requires more significant estimates or reliance on a higher degree of judgment on the part of FPI management.

Revenue recognition: Revenue is generally recognized when 1) delivery has occurred or services have been rendered, 2) persuasive evidence of an arrangement exists, 3) there is a fixed or determinable price, and 4) collectibility is reasonably assured. Revenue from contracts that specify a customer acceptance criteria is 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 (numerous stages of product delivery, set up, and installation) 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.

Allowance for doubtful accounts receivable: The allowance for doubtful accounts is based upon several factors including payment trends, historical write off experience, credit quality for non-governmental accounts and specific analysis of collectibility of an account. During the course of time, these factors may change which will cause the allowance level to adjust accordingly.

When a customer account is determined to be unlikely to be paid, a charge is recorded to bad debt expense in the income statement and the allowance account is increased. When it becomes certain that the account will not be paid the receivable is written off by removing the balance from accounts receivable and reducing the allowance account.

As of September 30, 2004 and September 30, 2003, FPI had established allowance for bad debt in the amount of $3.45 million and $4.98 million on accounts receivable balances of $79.04 million and $70.54 million, respectively.

Inventory Valuation: FPI maintains its inventory primarily for the manufacture of goods for sale to its customers. FPI's inventory is composed of three categories: Raw Materials, Work in Process, and Finished Goods. These categories are generally defined by FPI as follows: Raw Materials consist of materials that have been acquired and are available for the production cycle, Work in Process is composed of materials that have moved into the production process and have some measurable amount of labor and overhead added by FPI, Finished Goods are materials with FPI added labor and overhead that have completed the production cycle and are awaiting sale to customers.

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 allowance for administrative expenses. FPI values its finished goods 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.

Program Values

FPI's mission is to employ and provide job skills training to the greatest practicable number of inmates in BOP facilities necessary to ensure the safe and secure operation of such institutions, and in doing so, to produce market priced, quality goods in a self-sustaining manner that minimizes the potential impact on private business and labor.

The goal of FPI is to reduce undesirable inmate idleness by providing a full-time work program for inmate populations (goal of approximately 25 percent of "work eligible" inmates). Many of the inmates do not have marketable skills. FPI provides a program of constructive industrial work and services wherein job skills can be developed and work habits acquired.

As with most governmental programs, the real value of the entity is not readily measured in dollars and cents and is not always contained in the financial reports. FPI has existed as an effective correctional program for 70 years. In the course of the years, FPI has positively impacted the lives of countless inmates and staff members that reside and work in the Bureau of Prisons and the surrounding local communities in which we live.

FPI's greatest success is impossible to quantify: the extent to which it has prevented inmate unrest that would have been costly in lives as well as dollars. This success is obscured by the snarl of contentiousness over programs for inmates and sales to the Federal Government. In the face of an escalating inmate population and an increasing percentage of inmates with histories of violence, FPI's programs have helped ease tension and avert volatile situations, thereby protecting lives and Federal property. Prisons without meaningful activities for inmates are dangerous prisons, and dangerous prisons are expensive prisons. The work and education programs of FPI have played an essential role in protecting lives, preserving stability and saving money in America's Federal prisons.

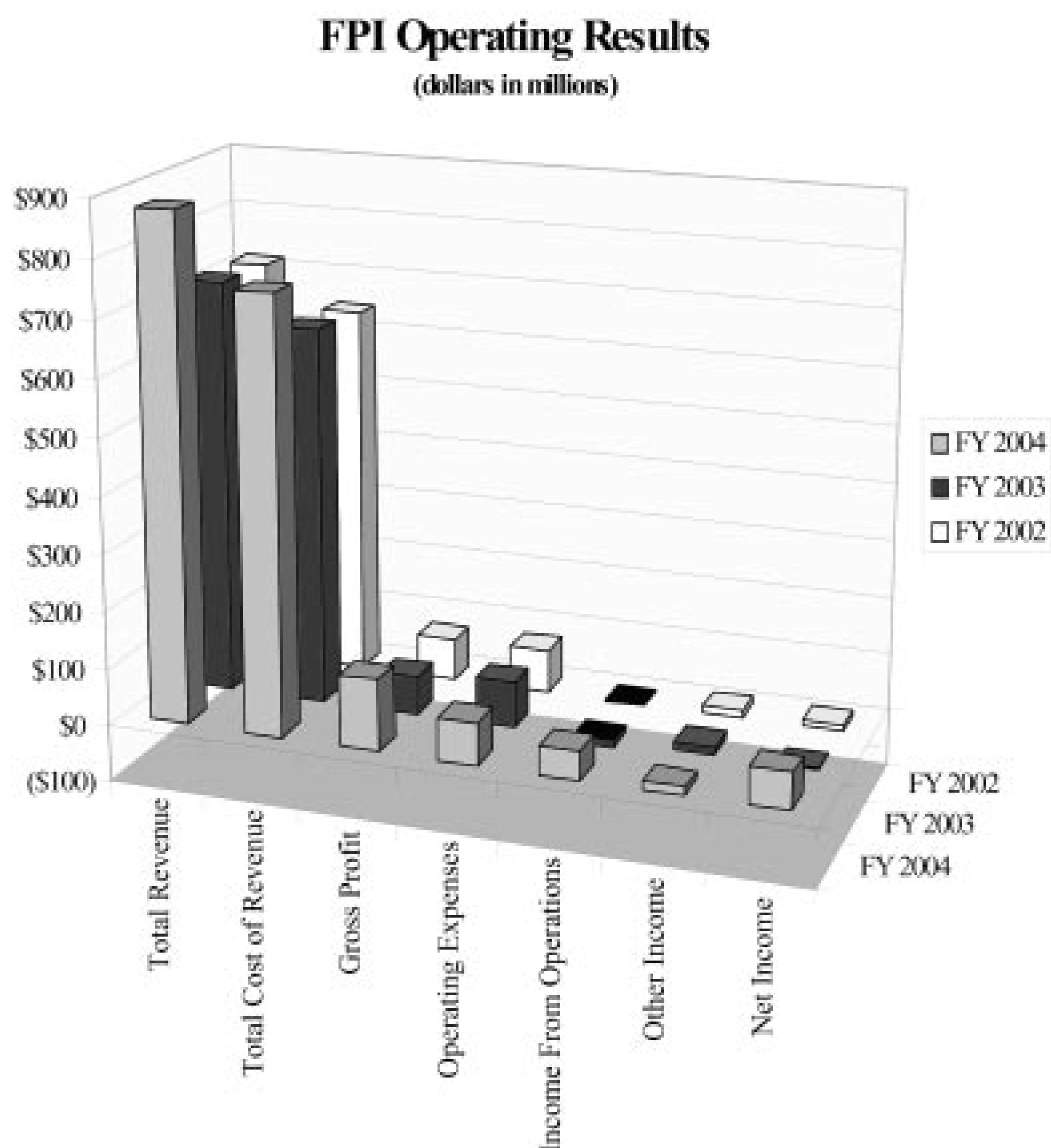
At the same time, FPI has met its other goal of offering opportunities for inmates who want to take the personal responsibility for rehabilitating themselves. Most inmates eventually will be returned to society; industrial and educational programs can help them to steer clear of criminal activity after release. FPI plays a vital role in management of inmates, and also improves the likelihood that inmates will remain crime-free upon their release from BOP custody. A comprehensive study conducted by the BOP demonstrated that FPI provides inmates with an opportunity to develop work ethics and skills, contributes substantially to lower recidivism and increases job - related success of inmates upon release.

This study, recognized as one of the most comprehensive studies on recidivism, indicates that inmates involved in FPI work programs and educational programs are substantially less likely to return to prison. The impact on the lives of people who live in the communities in which these inmates will return is immeasurable. Countless lives are spared the devastating impact of continued criminal activity.

Since coming into existence in the 1930s, FPI has been a reliable defense supplier, especially in times of surge demands. FPI has received a number of awards for its outstanding performance as a supplier to the DOD.

Results of Operations

The following chart provides the results of operations in comparative bar graph format for the current and the two previous fiscal years.



Management Discussion and Analysis

(c o n t i n u e d)

Revenues for fiscal year 2004 increased by 21.8% from fiscal year 2003 and were 22.7% greater than fiscal year 2002. The significant increase in revenue in fiscal year 2004 is due primarily to the Electronics and the Clothing and Textiles Business Groups increased sales in support of the DOD surge demand. It is anticipated that revenues will return to the more "normal" level, as reflected in fiscal years 2003 and 2002 upon the conclusion to the current war efforts.

Cost of Revenue

The cost of revenue in fiscal year 2004 decreased as a percentage of total revenue to 86%, down 5% from fiscal year 2003 and 4% from fiscal year 2002. This decrease is attributable to two main factors. First in June 2003, FPI implemented aggressive measure to cut costs at the operations and corporate level. These measures resulted in a decrease of overhead at the operational level by $6.2 million in fiscal year 2004 when compared to fiscal year 2003. Secondly, the number of factories that operate at a loss at the plant level was significantly reduced in fiscal year 2004. FPI management focused on factories that had traditionally lost money at the operations level and implemented corrective action plans to either turn the plant to profitability or to significantly reduce the level of losses. The impact of these corrective actions plans was a $13.6 million reduction in plants with losses when compared to fiscal year 2003. The overall impact on FPI cost due to containment and control efforts was $22.9 million in fiscal year 2004.

Management at FPI plans to continue its efforts to reduce cost and further reduce the number of unprofitable plants in fiscal year 2005.

Operating Expenses

The Selling, General and Administrative (SG&A) expenses for FPI decreased by $5.3 million when compared to fiscal year 2003. This reduction of SG&A is again reflective of the aggressive actions in regards to controlling, monitoring and reducing costs FPI management has initiated.

Business Segments

In fiscal year 2004, FPI's businesses were 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. 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. For fiscal year 2005, the Graphics business segment will be reported under Industrial Products for Signs, Office Furniture Business segment for accessories, Services business segment for print, and Textiles business segment for specialty products. FPI's net sales and gross profit for each business segment for the fiscal years ended September 30, 2004, 2003 and 2002 is presented on the next page:

Management Discussion and Analysis

(continued)

Business Segment	Fiscal Year		
Electronics	**2004**	**2003**	**2002**
Sales	$255,171	$152,357	$132,662
Earnings	$80,143	$38,576	$27,353
Fleet Management			
Sales	$129,068	$123,272	$99,054
Earnings	$517	$3,355	($301)
Graphics			
Sales	$23,681	$23,658	$26,006
Earnings	$2,692	$2,943	$783
Industrial Products			
Sales	$45,846	$36,759	$27,782
Earnings	($194)	($3,510)	($9,545)
Office Furniture			
Sales	$140,935	$151,996	$217,852
Earnings	($1,878)	($2,205)	$22,342
Recycling Activities			
Sales	$10,004	$8,083	$3,359
Earnings	$2,818	$4	($229)
Services			
Sales	$13,550	$12,239	$12,210
Earnings	$789	$729	$2,509
Clothing and Textiles			
Sales	$184,465	$158,399	$159,730
Earnings	$35,540	$25,344	$28,473
Corporate Total			
Sales	$802,720	$666,763	$678,655
Earnings	$120,427	$65,236	$71,385

Liquidity and Capital Resources

FPI's cash from operations was $791 thousand in fiscal year 2004 compared to $81.8 million in fiscal year 2003. The change is attributed to the increase in deferred revenue (advances from customers) in fiscal year 2003 of $42 million that coupled with a significant decrease in customer receivables accounts for the majority of the cash provided by operations. This is contrasted with fiscal year 2004 in which deferred revenue decreased by $46 million as product was produced and shipped against the customer advance. In addition, strong earnings in fiscal year 2004 of $64 million resulted in a cash balance that decreased only slightly.

FPI does have a long term note outstanding with the U.S. Treasury (face value of $20 million). This note carries a lump sum maturity date of September 30, 2008. FPI has internally established reserve of cash to retire the debt. This reserve is fully funded. FPI plans to invest $8.3 million in fiscal year 2005 toward the replacement or repair of existing building or machinery. In addition, FPI plans to invest $15.6 million in equipment and $13.9 million toward building improvements for newly activated plants.

Market Risk Disclosures

FPI does not receive appropriated funding for operations and must maintain itself through the results of operations. Historically, FPI operates on a very low margin. The margins are much below those of non-governmental corporations of similar size and longevity. FPI has been able to sustain itself on the thin margins, while funding activation of new factories to meet the inmate employment demand caused by the unprecedented growth in the number of inmates in the BOP. The growth demands of the BOP are expected to continue for the foreseeable future.

In FPI's Annual Reasonable Assurance Report for Fiscal Year 2003, we included a "program concern." The concern noted that FPI faces challenges in maintaining the delicate balancing act between maintaining a 'self-sufficient' fiscal position and providing adequate inmate employment for the unprecedented growth in the Bureau of Prisons' inmate population. While the operating results for FY04 exceeded our estimates due to DoD surge demands and aggressive cost containment, the expected cost of activations at new institutions over the next four years exceeds the cash reserve we currently have set aside for those costs. Additionally, on-going challenges remain to some of the FPI program's underlying policies and operating activities (for example, mandatory source preference provided to FPI) that have sustained our ability to be self-sufficient. We are cautiously optimistic but recognize that addressing the "program concern" going forward will require continued vigilance by FPI and BOP management, and support by public policy makers.

Given FPI's low margin of operation, the above issues challenge FPI's ability to maintain its self sufficient status. This was reported as a "program concern" in the Federal Managers Financial Integrity Act Report, Section II for Fiscal Year 2004.

Conclusion

FPI looks forward to the challenges and opportunities that it will face in the future. While we expect the continuing war effort will provide another year of excellent work opportunities for our inmates, that situation will not last indefinitely. We need to remain conservative in our spending patterns. We will be carefully monitoring our SG&A levels while funding selective initiatives and investing in new growth opportunities. As stated in the "Market Risk Disclosure", we are cautiously optimistic but recognize that addressing the "program concern" going forward will require continued vigilance by FPI and BOP management, and support by public policy makers.

Report of Independent Auditors

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 accompanying balance sheets of the Federal Prison Industries, Inc. ("FPI"), a financial reporting component of the U.S. Department of Justice, as of September 30, 2004 and 2003, 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, 2004 and 2003, 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 October 22, 2004, on our consideration of the FPI internal control and a report dated October 22, 2004, on compliance and other matters for the year ended September 30, 2004. Those reports are 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 audits.

PricewaterhouseCoopers LLP

October 22, 2004

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

PricewaterhouseCoopers LLP
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We have audited the accompanying balance sheets of the Federal Prison Industries, Inc. ("FPI"), a financial reporting component of the U.S. Department of Justice, as of September 30, 2004 and 2003, and the related statements of net cost, of changes in net position and of financing, and the statements of budgetary resources for the years then ended and issued our report thereon dated October 22, 2004. 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.*

In planning and performing our audit, we considered FPI's internal control over financial reporting by obtaining and understanding of the agency's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated and combined financial statements and not to provide an opinion on the internal controls. We limited our control testing to those controls necessary to achieve the following OMB control objectives that provide reasonable, but not absolute assurance, that: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the 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 governing the use of budget authority, other 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 management. We did not test all internal controls relevant to the operating objectives broadly defined by the Federal Managers' Financial Integrity Act of 1982. Our purpose was not to provide an opinion on FPI's internal control. Accordingly, we do not express an opinion on internal control.

Report of Independent Auditors on Internal Control

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. Under standards issued by the American Institute of Certified Public Accountants (AICPA) and OMB, reportable conditions are matters coming to our attention, that in our judgment, should be communicated because they represent significant deficiencies in the design or operation of the internal control that, could adversely affect the agency's ability to meet the internal control objectives related to the reliability of financial reporting, compliance with laws and regulations, and the reliability of performance reporting previously noted. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors, fraud or noncompliance 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. We noted certain matters, discussed in the following paragraphs, involving the internal control and its operation that we consider to be a reportable condition. However, this reportable condition is not believed to be a material weakness. With respect to internal control relevant to data that support reported performance measures, we obtained an und erstanding 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 control over reported performance measures. Accordingly, we do not provide an opinion on such controls.

Technical & security design and implementation of the SAP financial application need improvement (Repeat Condition).

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

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

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We performed a general information technology (IT) and application controls review at the FPI by (1) documenting our understanding of the general controls environment; (2) Report of Independent Auditors on Internal Control evaluating the effectiveness of IT general and specific application controls at the FPI; and (3) updating the general controls tests related to the FY 2003 audit. Using guidance contained in the U.S. Government Accountability Office's (GAO), *Federal Information System Controls Audit Manual*, we evaluated the general controls as they apply to the financial management systems and the application controls associated with these systems. We also relied upon guidance issued by the DOJ Information Technology Security Staff, technical publications issued by the National Institute of Standards and Technology (NIST), and as established in OMB Circular No. A-130, *Management of Federal Information Resources*. The following conditions need to be addressed to improve the FPI's information system controls environment:

Our testing of the SAP application environment responsible for processing FPI's financial transactions indicated that while significant improvements were made on the weakness we identified in prior years, the following weaknesses continue to exist:

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 systemlevel 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. We also noted that there are developers with update access in production environment. The proposed strategy to restrict access was not fully implemented.

An excessive number of end- users were identified with access to sensitive transactions and segregation of duty conflicts within the purchasing, payables, sales, and receivables functions.

Excessive access to critical SAP functionality affects the integrity and reliability of production data, and increases the risk of erroneous or fraudulent transactions.

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 Report of Independent Auditors on Internal Control systems." In addition, this publication mentions the importance of incorporating logical controls into systems.

Recommendations

We recommend the FPI:

1. Review and restrict the assignment of system- level transactions that provide access to perform table maintenance and batch processing. (Repeat)

   Management's Response:
   Concur: The BOP agrees with the recommendation.

2. Implement the proposed strategy to restrict Application, Basis, and ERP personnel's access to the SAP production environment. (Repeat)

   Management's Response:
   Concur: The BOP agrees with the recommendation.

3. 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. Also, review the list of users with access to transactions with the segregation of duties conflict and sensitive transactions to ensure that access is appropriate. In addition, where sensitive transactions and transactions with segregation of duties conflicts are assigned to the users, ensure that adequate compensating controls are in place to mitigate risks. (Updated)

Management's Response:

Concur: The BOP agrees with the recommendation. The target date for implementation is September 30, 2005

Status of Prior Year Findings and Recommendations:

As mentioned in the previous section, we have reviewed the status of FPI's corrective actions with respect to findings and recommendations identified in the prior audit. The table below provides our assessment of the progress FPI has made in correcting the reportable conditions identified during that audit. The recommendations, which are still open, are included in the current year reportable cond ition. We also provide the Office of Report of Independent Auditors on Internal Control 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 2004:

Report	Status of Recommendations	Status
04-30 (2003)	Reportable Condition: Technical and security design and implementation of the SAP financial application need improvement Recommendations:	
	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.	Completed (a)
	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.	Completed
	3. Review and restrict the assignment of system- level transactions that provide access to perform table maintenance and batch processing.	In Process – combined with recommendation #1 of the current year reportable condition
#04-30	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	In Process – combined with recommendation #3 of the current year reportable condition

Report of Independent Auditors on Internal Control

(c o n t i n u e d)

Report	Status of Recommendations	Status
(2003)	identified that cannot be resolved, ensure that adequate compensating controls are in place to monitor access to sensitive transactions.	Completed (a)
	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.	Completed
	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.	In Process – combined with recommendation #2 of the current year reportable condition

(a) Reported as a reportable condition in fiscal year 2003 and modified to a management letter comment for fiscal year 2004.

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

The 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, and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

October 22, 2004

Report of Independent Auditors on Compliance and Other Matters

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Inspector General
U.S. Department of Justice

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

We have audited the accompanying balance sheets of the Federal Prison Industries, Inc. ("FPI"), a financial reporting component of the U.S. Department of Justice, as of September 30, 2004 and 2003, and the related statements of net cost, of changes in net position and of financing, and the statements of budgetary resources for the years then ended and issued our report thereon dated October 22, 2004. 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 compliance with laws and regulations. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws and regulations noncompliance with which could have a direct and material effect of 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. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to FPI. However, providing an opinion on compliance with those provisions was not an objective of our audits 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 discussed in the preceding paragraph exclusive of FFMIA, or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

Under FFMIA, we are required to report whether the agency's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed no instances in which the agency's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

The 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, and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

October 22, 2004

Federal Prison Industries, Inc.
Balance Sheets

September 30 **(DOLLARS IN THOUSANDS)**	**2004**	**2003**
ASSETS		
Current:		
Cash and cash equivalents	$ 183,833	$ 187,416
Accounts receivable, net	75,592	65,562
Inventories, net	165,718	146,702
Other assets	1,441	1,890
Total current assets	*426,584*	*401,570*
Property, plant and equipment, net	110,040	116,381
TOTAL ASSETS	*$ 536,624*	*$ 517,951*
LIABILITIES AND UNITED STATES GOVERNMENT EQUITY		
Current:		
Accounts payable	$ 47,810	$ 48,020
Deferred revenue	80,345	126,481
Accrued salaries and wages	8,352	7,268
Accrued annual leave	8,323	8,329
Other accrued expenses	10,726	10,077
Total current liabilities	*155,556*	*200,175*
FECA actuarial liability	7,650	7,932
Note payable to United States Treasury	20,000	20,000
Total Liabilities	*183,206*	*228,107*
United States Government Equity		
Initial capital	4,176	4,176
Cumulative results of operations	349,242	285,668
Total United States Government Equity	*353,418*	*289,844*
TOTAL LIABILITIES AND UNITED STATES GOVERNMENT EQUITY	*$ 536,624*	*$ 517,951*

The accompanying notes are an integral part of these financial statements

Federal Prison Industries, Inc.
Statements of Operations and Cumulative Results of Operations

Fiscal years ended September 30 **(DOLLARS IN THOUSANDS)**	**2004**	**2003**
REVENUE:		
Net sales	$ 802,720	$ 666,763
Other revenue	76,699	55,100
Total revenue	*879,419*	*721,863*
COST OF REVENUE:		
Cost of sales	678,866	598,625
Cost of other revenue	76,853	55,958
Total Cost of Revenue	*755,719*	*654,583*
GROSS PROFIT	*123,700*	*67,280*
OPERATING EXPENSES:		
Sales and marketing	6,573	6,983
General and administrative	67,307	72,193
Total operating expenses	*73,880*	*79,176*
INCOME (LOSS) FROM OPERATIONS	*49,820*	*(11,896)*
Interest income	1,818	1,941
Interest expense	(18)	(63)
Other income, net	11,954	11,973
NET INCOME	*63,574*	*1,955*
Cumulative results of operations, beginning of fiscal year	285,668	283,713
CUMULATIVE RESULTS OF OPERATIONS, END OF FISCAL YEAR	*$ 349,242*	*$ 285,668*

The accompanying notes are an integral part of these financial statements

Federal Prison Industries, Inc.
Statements of Cash Flows

Fiscal years ended September 30 **(DOLLARS IN THOUSANDS)**	**2004**	**2003**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 63,574	$ 1,955
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,664	11,773
Loss on disposal of property, plant and equipment	52	1,748
Changes in:		
Accounts receivable	(10,030)	27,321
Inventories	(19,016)	(4,855)
Other assets	448	136
Accounts payable and accrued expenses	1,235	1,145
Deferred revenue	(46,136)	42,647
NET CASH PROVIDED BY OPERATING ACTIVITIES	*791*	*81,870*
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property, plant and equipment	(4,280)	(2,593)
Construction-in-progress of plant facilities	(94)	(200)
Construction reimbursement from Bureau of Prisons	-	92
NET CASH USED IN INVESTING ACTIVITIES	*(4,374)*	*(2,701)*
NET (DECREASE) INCREASE IN CASH	(3,583)	79,169
CASH & CASH EQUIVALENTS, BEGINNING OF FISCAL YEAR	187,416	108,247
CASH AND CASH EQUIVALENTS, END OF FISCAL YEAR	$ 183,833	$ 187,416

The accompanying notes are an integral part of these financial statements

Fiscal Year 2004
Notes to Financial Statements
(Dollars in Thousands)

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.

As of September 30, 2004, FPI had industrial operations at 102 factories located at 71 facilities within the Federal Prison System; these factories employed 19,337 inmates representing approximately 13% 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, which management believes would include 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.

(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, 2004 and September 30, 2003. 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, net of allowances, from DOD for fiscal years ended September 30, 2004 and 2003 was $63,012 and $54,185 respectively.

While federal accounts receivable are normally fully collectible 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, 2004 and 2003, FPI's allowance for doubtful accounts is stated at approximately $3,446 and $4,977, respectively, of which approximately $3,102 and $4,329, 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.

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.

(Dollars in Thousands)

Note 3
Accounts Receivable, Net

Accounts receivable, net consists of the following:

September 30	2004	2003
Intragovernmental billed receivables	$72,168	$64,141
Private sector billed receivables	6,870	6,398
	79,038	***70,539***
Less allowance for doubtful accounts	3,446	4,977
Accounts receivable, net	***$75,592***	***$65,562***

Note 4
Inventories, Net

Inventories, net consist of the following:

September 30	2004	2003
Raw materials	$54,217	$44,029
Raw materials – vehicles	24,131	24,941
Work-in-process	29,764	21,774
Finished sub-assemblies	8,178	7,546
Finished goods	39,089	37,973
Finished goods – acceptance contracts	23,994	20,137
	179,373	***156,400***
Less inventory allowance	13,655	9,698
Inventories, net	***$165,718***	***$146,702***

$24,131 of FPI's fiscal year 2004 and $24,941 of FPI's fiscal year 2003, 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.

$23,994 of FPI's fiscal year 2004 and $20,137 of FPI's fiscal year 2003 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	2004	2003
Machinery and equipment	$91,222	$89,943
Computer hardware	3,486	3,096
Computer software	5,965	5,965
Buildings and improvements	165,192	164,259
	265,865	***263,263***
Less accumulated depreciation	155,919	147,095
	109,946	***116,168***
Factory construction-in-progress	94	213
Property, plant and equipment, net	***$110,040***	***$116,381***

Depreciation and amortization expense approximated $10,664 and $11,773 for the fiscal years ended September 30, 2004 and 2003, respectively.

As of September 30, 2004, 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 $51,734, provided from their fiscal year 2002, 2003, 2004, and 2005 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 $23,936 for the purchase and construction of property, plant, and equipment.

Note 6
Other Accrued Expenses

Other accrued expenses consist of the following:

September 30	2004	2003
Materials in transit	$2,951	$2,369
Permanent change of station	1,571	2,411
FECA liability – current portion	1,135	936
Financial audit expense	928	946
Utilities	971	1,290
Warranty expense	728	192
Gain sharing accrual	600	0
Information systems	0	614
Other expense	1,842	1,319
Other accrued expenses	***$10,726***	***$10,077***

(Dollars in Thousands)

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, 2004 and 2003.

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 and services. For fiscal year 2005, the Graphics business segment will be reported under Industrial Products for Signs, Office Furniture Business segment for accessories, Services business segment for print, and Textiles business segment for specialty products. FPI's net sales for the fiscal years ended September 30, 2004 and 2003 for each of its business segments is presented for comparative purposes:

Net Sales

Fiscal year ended September 30	**2004**	**2003**
Business Segment		
Clothing and Textiles	$184,465	$158,399
Electronics	255,171	152,357
Fleet Management and Vehicular	129,068	123,272
Graphics	23,681	23,658
Industrial Products	45,846	36,759
Office Furniture	140,935	151,996
Recycling	10,004	8,083
Services	13,550	12,239
Net sales	***$802,720***	***$666,763***

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, 2004 and September 30, 2003, the accrued FECA liability as charged to FPI, approximated $1,135 and $936, 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 $7,650 and $7,932 at September 30, 2004 and 2003, 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 14 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 9 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 $24,494 and $24,314 for the fiscal years ended September 30, 2004 and 2003, respectively.

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 $8,342 and $7,910 for the fiscal years ended September 30, 2004 and 2003, respectively.

OPM also provides health care and life insurance benefits for FPI's retired employees. Based on the requirements of Statement of Federal Financial Accounting Standards 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 $6,303 and $5,583 during the fiscal years ended September 30, 2004 and 2003, respectively, were determined by OPM utilizing cost factors which estimate the cost of providing postretirement 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.

(Dollars in Thousands)

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	**2004**	**2003**
Salaries, wages and benefits	$37,809	$32,440
Permanent change of station expense	2,781	3,453
Purchases of minor equipment	557	1,283
Contract services	6,440	9,410
Bad debt expense	322	2,903
Credit card services	1,418	1,452
Travel	1,353	2,139
Customer Goodwill	502	1,241
Personal Computer Expense	477	710
Depreciation	2,691	3,246
Gain on Disposition of Assets	(61)	(7)
Loss on Disposition of Assets	52	1,748
Other Expense	9,456	9,604
Imputed pension costs (Note 9)	3,780	3,971
Imputed post-retirement health care and life insurance cost (Note 9)	6,303	5,583
Selling, general & administrative expenses	*$73,880*	*$79,176*

Other expense is comprised primarily of inmate wages, maintenance agreements, financial audit expenses, 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 2005 $231 fiscal year 2006, $162, fiscal year 2007, $124, fiscal year 2008, $86, and fiscal year 2009, $5. Rental expense approximated $1,113 and $1,025 for the fiscal years ended September 30, 2004 and 2003, 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 established an accrual for future commitment for "Minimum Buy" agreements that are not expected to meet minimum purchase requirements from customer orders at fiscal year end.

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	**2004**	**2003**
Congressional limitation on expenses	$3,429	$3,429
Expenses incurred subject to Congressional limitation	$1,214	$1,432

DEPARTMENT OF JUSTICE
FEDERAL BUREAU OF PRISONS

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