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

FY 2005

ANNUAL REPORT

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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 2005 Annual Report to the Congress of the United States. By any measure, 2005 was an outstanding year for the FPI program. While the "business" side of FPI's operations remained strong, we are most proud of FPI's *program* accomplishments.

We are committed to fulfilling FPI's mission to employ and provide job skills training to the greatest practicable number of inmates in the Federal Bureau of Prisons. In FY 2005, 18 percent of eligible inmates participated in the FPI program. We are encouraged that, after a three-year decline, the number of inmates participating in the FPI program increased in FY 2005. We are committed to continue efforts to increase the number of FPI work opportunities especially in light of the opening of new prisons and the growing inmate population.

We believe that the FPI program provides the greatest benefit to our criminal justice system when we maximize the number of inmates that receive job training and work experience by participating in the FPI program. With this goal in mind, we are pleased to announce that in FY 2005, FPI began operations at new Bureau of Prisons institutions located in Big Sandy, Kentucky; Gilmer, West Virginia; and Yazoo City, Mississippi. The FPI program also activated new factories at existing Bureau institutions located at the Federal Correctional Complex (FCC) Petersburg,Virginia; FCC Terre Haute, Indiana; and, FCI Tucson, Arizona.

Research has shown that inmates who participate in the FPI program are less likely to commit crimes and more likely to be employed after release than similar inmates without the FPI program experience. Studies also show that the FPI program provides the greatest benefit to minority inmates, who are often at greater risk for recidivism.

The Board takes great pride in FPI's continued outstanding service to our customers – particularly our Nation's military. In August, 2005, the Board of Directors, along with Chief Executive Officer Harley Lappin, accepted the *Supporting the Warfighter* award from the Defense Supply Center Philadelphia (DSCP). The award recognizes the outstanding work of FPI's Clothing and Textiles Business Group in support of DSCP's mission. FPI is a long-time supplier of numerous items to DSCP, including combat uniforms, cold weather clothing, ammunition bags, and canteen covers. During the last two years, the FPI program has delivered more than $200 million worth of orders to DSCP without a single delinquency. In making the award presentation, the DSCP Deputy Commander remarked that FPI's performance was the best he had seen in his 30 years of Federal procurement experience.

The Board would like to recognize the manner and speed with which the FPI program and its staff assisted in the relief efforts of Hurricanes Katrina and Rita. In response to an urgent request from the Department of Homeland Security, the FPI Fleet Management and Vehicular Components Business Group delivered more than 100 vehicles to assist in the Hurricane Katrina recovery efforts. Displaying their typical willingness to go "above and beyond," FPI staff drove the vehicles in "convoy-fashion" to the Gulf region, arriving just days after the storm hit and providing immediate assistance to law enforcement officers and the relief effort.

During FY 2005, *PROJECT GREEN-FED*, a pilot project in partnership with the Arkansas Department of Environmental Quality (ADEQ) was launched. Located at FCI Texarkana, *PROJECT GREEN-FED* offers all Arkansas residents a cost-effective, environmentally sound, computer recycling program that meets the Environmental Protection Agency's guidelines for material management. By dialing a toll-free number, Arkansas residents who wish to recycle computer equipment will receive a box, packing material, instructions, and a return label at no charge. Once the equipment is packed, the box is picked up from their home at no cost and delivered to FPI's recycling factory at FCI Texarkana. Feedback from both Arkansas

Message from the Board of Directors

residents and the ADEQ has been exceptional. We anticipate building on the success of this pilot and partnering with others to extend this program to households throughout the country.

The Board continues to emphasize our primary goal of economic competitiveness while minimizing our reliance on mandatory source. We have directed the corporation to continue to focus on growing our Fleet Management and Vehicular Components, Recycling, and Services Business Groups. FPI's work in these business areas is "non-mandatory," reducing our reliance on traditional industries, such as office furniture, textiles, and electronics. We are encouraged that in 2005, the FPI program granted 99.7 percent of all waiver requests received, and 100 percent of all electronics and textiles-related waivers – a clear indicator that FY 2005 sales were not driven by FPI's mandatory source status, but by our ability to meet our customers' needs successfully.

FPI's continuing effort to reduce our impact on the private sector and American workers is evidenced by our work providing services to commercial customers that would otherwise be performed outside the United States. This repatriation of work goes beyond having no negative impact on American workers as we create inmate jobs, and actually spawns additional jobs for domestic private sector employees through the FPI program's related purchases of supplies and services from U.S. enterprises.

The Board is keenly aware of the future challenges facing the FPI program. The Federal inmate population continues to grow, requiring the FPI program to generate additional inmate work opportunities. In order to finance the construction and activation of future factories, the corporation must generate sufficient earnings from its sales for future capitalization. The increased war-time demand for military items supplied by the FPI program is key to generating the earnings necessary to transition successfully further into non-mandatory business areas, while continuing to fulfill our statutory obligation to operate in a self-sustaining manner.

The Board thanks the Attorney General and the Administration for providing continued support and direction. The Board also thanks all of the customers who express their confidence in our program by selecting FPI as their vendor of choice.

Finally, we extend a special appreciation to our former colleague, Kenneth R. Rocks, who resigned as Chairman of the FPI Board of Directors at the end of FY 2005. During his three years as Board Chairman, Ken provided outstanding leadership and vision for the FPI program. We thank Ken for his service on behalf of the staff and inmates in Federal Prison Industries.

The Board of Directors for Federal Prison Industries

David D. Spears, Chairman of the Board
Represents Agriculture

Donald R. Elliott, Vice Chairman
Represents Industry

Paul R. Corts
Represents the Attorney General

Audrey J. Roberts
Represents Retailers and Consumers

Message from the Director and Chief Executive Officer

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 Fiscal Year 2005 Annual Report.

I take great pride in the FPI program's accomplishments. FPI remains the Bureau of Prisons' most important correctional program. Since becoming Director in 2003, I have visited every Bureau institution. Whenever I enter an FPI factory, I see first-hand the vital role it plays. As I have repeatedly emphasized, although the FPI program produces products and performs services, its 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.

As Director of the Bureau of Prisons, I am keenly aware of FPI's importance as a correctional management program. It contributes significantly to reducing inmate idleness (problematic in itself by increasing the risk of violence, escapes, and other disruptions). Idle inmates also require more supervision, which increases the cost of prison management to taxpayers.

Because the FPI program receives no appropriations, its value to the Bureau of Prisons is that much greater. Other programming is paid for out of taxpayer funds. Operating in a self-sustaining manner, the FPI program provides an essential prison management function, without encumbering the Bureau's financial resources.

The FPI program directly benefits the inmates who participate. However, it also helps those inmates repay their debt to society. In FY 2005, inmates who worked in the FPI program contributed more than $2.7 million of their earnings toward meeting their financial obligations, e.g., court-ordered fines, child support, and/or restitution. Many inmates also contributed to the support and welfare of their families by sending home a portion of their earnings.

As CEO, I continue to be impressed by the degree to which the FPI program supports small businesses. During FY 2005, FPI purchased more than $412 million worth of raw materials, supplies, equipment, and services from private sector businesses. Approximately 60 percent of those purchases were from small businesses, including businesses owned by women, minorities, and those who are disadvantaged.

At the end of FY 2005, the federal inmate population was almost 188,000. By 2010, it is expected to reach 215,000. The Bureau is nearing completion of an aggressive construction schedule during which it will have activated 16 new institutions in five years. Inmates entering the Bureau's custody are increasingly more dangerous and aggressive offenders. Virtually all of these inmates will be released back into our neighborhoods at some point, and they will benefit from the job skills training and work experience provided by the FPI program.

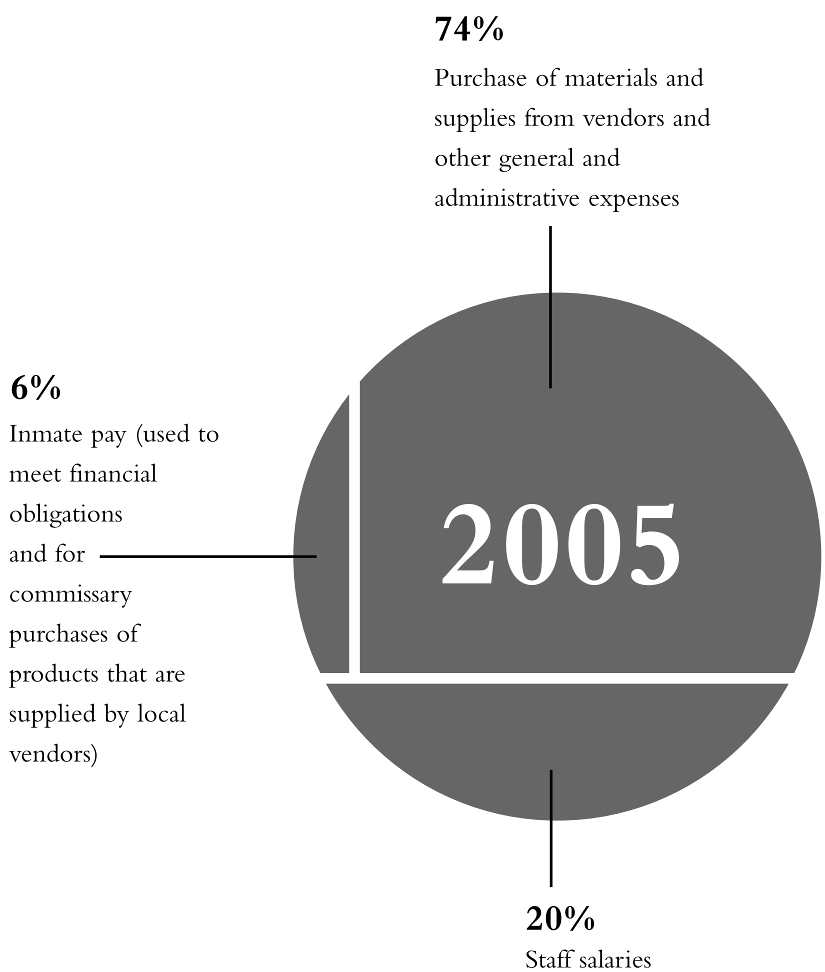
I am often asked "Is there anything the FPI program can do to further assist inmates after they are released?" Because the FPI program functions exclusively within Bureau of Prisons facilities, it has traditionally had no contact with ex-offenders once they are released. In 2005, with the approval of the Board of Directors, we initiated the "UNICOR Federal Bonding Program" to further assist inmates obtain employment post-release. FPI will fund the premiums to provide $5,000 bonding insurance to Federal inmates who participated in the FPI program during their incarceration. The reality of our world is that ex-offenders face many obstacles during their post-release job search. I believe the UNICOR Federal Bonding Program is an appropriate extension of both the Bureau's and the FPI program's effort to better prepare inmates for their eventual return to society.

I thank the FPI Board of Directors for their continued leadership on behalf of the program and extend my sincere appreciation to the outstanding FPI staff for their tireless efforts throughout the year. The FPI program is an example of the good that government can do.

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

FPI FY 2005 Annual Report "Year at a Glance" Data

Inmate Workers:	**19,720**
Percent of eligible (medically able/sentenced) inmate population employed:	**18%**
Employment goal:	**25%**
Inmate pay rates:	**$0.23 per hour-$1.15 per hour**
Factories:	**106**
Distribution of FPI's revenues:	
Staff salaries:	**20**%
Inmate pay:	**6%**
Purchase of materials, supplies, equipment and services:	**74%**



100% returned to the private sector

Industrial Programs, Location, Inmate Employment and Net Sales

(as of September 30, 2005)

	Clothing and Textiles	Electronics	Fleet	Industrial Products	Office Furniture	Recycling	Services
	Atlanta GA	Beaumont TX	Bastrop TX	Butner NC	Allenwood PA	Atwater CA	Alderson WV
	Beaumont TX	Big Spring TX	Beaumont TX	El Reno OK	Ashland KY	Elkton OH	Bryan TX
	Big Sandy KY	Danbury CT	Estill SC	Leavenworth KS	Beckley WV	Fort Dix NJ	Carswell TX
	Butner NC	Fairton NJ	Gilmer WV	Lewisburg PA	Coleman FL	Lewisburg PA	Dublin CA
	Cumberland MD	Lexington KY	La Tuna TX	Lompoc CA	Florence CO	Marianna FL	Elgin FL
	Dublin CA	Lompoc CA	Petersburg VA	Pekin IL	Forrest City AR	Texarkana TX	Elkton OH
	Edgefield SC	Loretto PA	Terre Haute IN	Talladega AL	McKean PA	Tucson AZ	El Paso TX
	Fort Dix NJ	Marion IL	Three Rivers TX	Terminal Island CA	Milan MI		Fort Dix NJ
	Greeneville IL	Memphis TN	Victorville CA	Texarkana TX	Schuylkill PA		Leavenworth KS
	Jesup GA	Otisville NY			Sheridan OR		Marianna FL
	Lee County VA	Oxford WI					McCreary KY
	Manchester KY	Phoenix AZ					Montgomery AL
	Miami FL	Rochester MN					Morgantown WV
	Oakdale LA						Petersburg VA
	Pollack LA						Sandstone MN
	Ray Brook NY						Tallahassee FL
	Safford AZ						
	Sandstone MN						
	Seagoville TX						
	Terre Haute IN						
	Waseca MN						
	Yazoo City MS						
Inmates Employed:*	**6,596**	**3,152**	**1,856**	**1,664**	**3,592**	**951**	**1,630**
Net Sales:**	**$155.4**	**$287.0**	**$90.8**	**$58.5**	**$139.8**	**$9.0**	**$24.9**

* There are an additional 279 inmates working in Customer Service and Product Support. The total number of inmates who worked in Federal Prison Industries as of September 30, 2005 was 19,720.

** Dollars in millions

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 2005, FPI operated in seven business segments: Clothing & Textiles, Electronics, Fleet Management & Vehicular Components, Industrial Products, Office Furniture, Recycling Activities, and Services. FPI has industrial operations at 106 factories located at 73 prison locations that employed 19,720 inmates representing approximately 14% of the total number of inmates housed in BOP facilities as of September 30, 2005. 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 nonmandatory basis.

FPI processes most 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 require 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 nongovernmental 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, 2005 and September 30, 2004, FPI had established allowance for bad debt in the amount of \$3.14 million and \$3.45 million on accounts receivable balances of \$57.30 million and \$79.04 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 costs may not be recovered 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 71 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.

One of FPI's greatest successes 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 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, and recognized as one of the most comprehensive studies on recidivism, 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. 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.

Management Discussion and Analysis

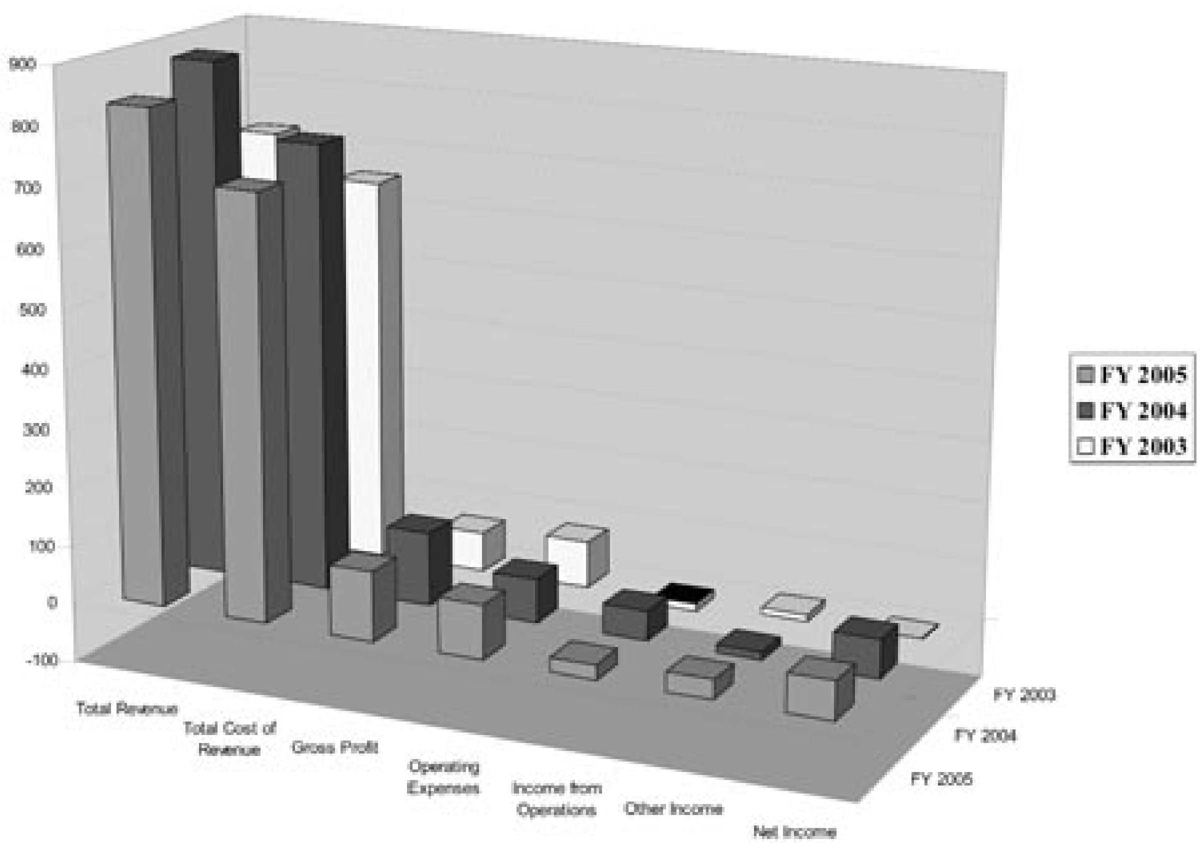
(c o n t i n u e d)

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.

FPI Operating Results
(dollars in millions)



Analysis of Financial Statements

Investments

FPI's investment balance as of September 30, 2005 increased by 84.7% in comparison to September 30, 2004 and was 81.6% greater than September 30, 2003. The significant increase in investments in fiscal year 2005 is due to strong net earnings of $64 million which are a direct result of surge demand by the DOD for products manufactured by the Electronics business group, a decrease in accounts receivable of $21 million which is a result of enhanced collection efforts, and a decrease of total inventory by $40 million due mainly to less demand for retrofit vehicles by the Department of Homeland Security (DHS).

Accounts Receivable

FPI's accounts receivable balance as of September 30, 2005 decreased by 28.4% in comparison to September 30, 2004 and was 17.4% less than September 30, 2003. The decrease in accounts receivable in fiscal year 2005 is the result of enhanced collection efforts with the DOD and the expediting of payments processed through the Wide Area Workflow (WAWF). In addition, increased use of the Intergovernmental Payment and Collection (IPAC) system by FPI customers has also assisted in reduction of the open receivable balance.

Inventory

Inventory decreased 24.5% in fiscal year 2005 compared to fiscal year 2004 and 14.7% from fiscal year 2003. The decrease in inventories is primarily a result of inventory reductions in the Fleet Management & Vehicular Components business group and Electronics business group. The Fleet Management & Vehicular Components inventory is reduced due to less vehicles in inventory for DHS retrofit. This is a result of less demand by DHS for retrofit vehicles. The Electronics inventory is reflective of a utilization of a build up on raw goods in fiscal year 2004 for large orders that were processed and completed in fiscal year 2005.

Deferred Revenue

Deferred Revenue increased 31.4% in fiscal year 2005 compared to fiscal year 2004, but decreased 16.5% compared to fiscal year 2003. The increase in deferred revenue in fiscal year 2005 is due to advances received by the DHS during the last quarter of the fiscal year. Although the advances have been received, the actual impact on production for the Fleet Management & Vehicular Components business group will not occur until fiscal year 2006 due to raw materials order process times.

Revenue

Revenues for fiscal year 2005 decreased by 5.2% from fiscal year 2004 and were 15.5% greater than fiscal year 2003. The decrease in revenue in fiscal year 2005 is due primarily to a sales decline in the Textiles (primarily the result of a switch in product lines at the request of DOD) and Fleet Management & Vehicular Components (primarily a result of decrease demand from DHS for retrofit vehicles) business groups from their fiscal year 2004 levels. The Electronics business group continues to have exceptional sales due to the DOD surge demand for their goods. This business group's sales accounted for 34.4% of FPI's revenue in fiscal year 2005.

Cost of Revenue

The cost of revenue expressed as a percentage of total revenue in fiscal year 2005 remained constant in comparison to fiscal year 2004 and decreased 4.7% in comparison to fiscal year 2003. This is reflective of the continued efforts

Management Discussion and Analysis

(c o n t i n u e d)

by FPI to control costs and better utilize materials and resources in the manufacturing of its products and the providing of services.

Business Segments

In fiscal year 2005, FPI's businesses were organized, managed and internally reported as seven operating segments based on products and services. These segments are Clothing and Textiles; Electronics; Fleet Management and Vehicular; 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. FPI's net sales and gross profit (before G&A) for the fiscal years ended September 30, 2005 and 2004 for each of its current business segments is presented for comparative purposes:

Business Segment	Fiscal Year	
Clothing and Textiles	**2005**	**2004**
Sales	$155,390	$190,556
Earnings	$23,253	$36,018
Electronics		
Sales	$287,009	$255,171
Earnings	$94,515	$80,144
Fleet Management		
Sales	$90,797	$129,068
Earnings	($5,775)	$518
Industrial Products		
Sales	$58,520	$50,478
Earnings	($1,405)	($73)
Office Furniture		
Sales	$139,773	$140,935
Earnings	$2,866	($1,879)
Recycling		
Sales	$9,024	$10,004
Earnings	$1,430	$2,818
Services		
Sales	$24,883	$26,508
Earnings	($539)	$2,881
Corporate Total		
Sales	$765,396	$802,720
Earnings	$114,345	$120,427

FPI redefined its business segments from eight categories to seven in fiscal year 2005. FPI's net sales and gross profit (before G&A) for the fiscal year ended September 30, 2004 and 2003 for each of its previous business segments is presented for comparative purposes:

Business Segment	**Fiscal Year**	
Clothing and Textiles	**2004**	**2003**
Sales	$184,465	$158,399
Earnings	$35,540	$25,344
Electronics		
Sales	$255,171	$152,357
Earnings	$80,143	$38,576
Fleet Management		
Sales	$129,068	$123,272
Earnings	$517	$3,355
Graphics		
Sales	$23,681	$23,658
Earnings	$2,692	$2,943
Industrial Products		
Sales	$45,846	$36,759
Earnings	($194)	($3,510)
Office Furniture		
Sales	$140,935	$151,996
Earnings	($1,878)	($2,205)
Recycling		
Sales	$10,004	$8,083
Earnings	$2,818	$4
Services		
Sales	$13,550	$12,239
Earnings	$789	$729
Corporate Total		
Sales	$802,720	$666,763
Earnings	$120,427	$65,236

Management Discussion and Analysis

Liquidity and Capital Resources

FPI's cash from operations was $158 million in fiscal year 2005 compared to $791 thousand in fiscal year 2004. The change is attributed to strong net earnings of $64 million which are a direct result of surge demand by the DOD for products manufactured by the Electronics business group, a decrease in accounts receivable of $21 million which is a result of enhanced collection efforts, and a decrease of total inventory by $40 million due mainly to less demand for retrofit vehicles by the DHS.

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 a reserve of cash to retire the debt. This reserve is fully funded.

FPI plans to invest $14.1 million in fiscal year 2006 toward the replacement or repair of existing building or machinery. In addition, FPI plans to invest $13.2 million in equipment and $20.7 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 very low net earnings margins. 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 despite 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.

The 'Program Concern' reported by FPI over the last two fiscal years (2003-2004) is no longer at a level of concern for the program. FPI continues to meet its mission challenges of maintaining a 'self-sufficient' fiscal position; providing adequate inmate employment levels for the BOP's unprecedented growth; and maintaining an aggressive cost containment practice. The Corporation continues to balance its self sufficiency as well as growth in the inmate work force.The financial condition has improved and the corporation's cash reverses are adequate to meet the forecasted needs of the Agency. We are optimistic about future growth in the program and anticipate a sufficient profit margin during post war times.

The fiscal condition of FPI is currently being driven by support for the war effort. However, once the surge demands subside, FPI expects to return to a fiscal position that is tentative and can be easily impacted by regulating authorities.

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 selling, general, and administrative expenses 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

PRICEWATERHOUSECOOPERS

Inspector General
U.S. Department of Justice

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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, 2005 and 2004, 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, 2005 and 2004, 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 24, 2005, on our consideration of the FPI internal control and a report dated October 24, 2005, on compliance and other matters for the year ended September 30, 2005. 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 24, 2005

Report of Independent Auditors on Internal Control

PRICEWATERHOUSECOOPERS

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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 sheet of the Federal Prison Industries, Inc. (FPI), a financial reporting component of the U.S. Department of Justice, as of September 30, 2005, and the related statements of net cost, of changes in net position and of financing, and the statement of budgetary resources for the year then ended and issued our report thereon dated October 24, 2005. We conducted our audit 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 an understanding of the FPI'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 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.

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 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 FPI'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 no matters involving the internal control and its operation that we consider to be material weaknesses.

With respect to internal control 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 control over reported performance measures. Accordingly, we do not provide an opinion on such controls.

Status of Prior Year Findings and Recommendations:

The table below provides our assessment of the progress FPI has made in correcting the reportable condition 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 2005:

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 restrict the assignment of system-level transactions that provide access to perform table maintenance and batch processing.	Completed
	2. Implement the proposed strategy to restrict Application, Basis, and ERP personnel's access to the SAP production environment.	Completed
	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. 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.	Partially Completed (a)

(a) This recommendation has been modified during FY 2005 and is now considered a management letter comment.

Report of Independent Auditors on Internal Control

(continued)

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 24, 2005

Report of Independent Auditors on Compliance and Other Matters

PRICEWATERHOUSECOOPERS

Inspector General
U.S. Department of Justice

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

PricewaterhouseCoopers LLP
1301 K St., N.W., Suite 800W
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We have audited the accompanying balance sheet of the Federal Prison Industries, Inc. (FPI), a financial reporting component of the U.S. Department of Justice, as of September 30, 2005, and the related statements of net cost, of changes in net position and of financing, and the statement of budgetary resources for the years then ended and issued our report thereon dated October 24, 2005. We conducted our audit 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 FPI'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 FPI'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 24, 2005

Federal Prison Industries, Inc.
Balance Sheets

September 30 **(DOLLARS IN THOUSANDS)**	**2005**	**2004**
ASSETS		
Current:		
Cash and cash equivalents	$ 333,991	$ 183,833
Accounts receivable, net	54,155	75,592
Inventories, net	125,066	165,718
Other assets	1,829	1,441
Total current assets	*515,041*	*426,584*
Property, plant and equipment, net	107,865	110,040
TOTAL ASSETS	*$ 622,906*	*$ 536,624*
LIABILITIES AND UNITED STATES GOVERNMENT EQUITY		
Current:		
Accounts payable	$ 43,921	$ 47,810
Deferred revenue	105,550	80,345
Accrued salaries and wages	8,953	8,352
Accrued annual leave	8,573	8,323
Other accrued expenses	9,068	10,726
Total current liabilities	*176,065*	*155,556*
FECA actuarial liability	8,955	7,650
Note payable to United States Treasury	20,000	20,000
Total Liabilities	*205,020*	*183,206*
United States Government Equity		
Initial capital	4,176	4,176
Cumulative results of operations	413,710	349,242
Total United States Government Equity	*417,886*	*353,418*
TOTAL LIABILITIES AND UNITED STATES GOVERNMENT EQUITY	*$ 622,906*	*$ 536,624*

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)**	**2005**	**2004**
Revenue:		
Net sales	$ 765,396	$ 802,720
Other revenue	68,232	76,699
Total revenue	833,628	879,419
Cost of revenue:		
Cost of sales	653,027	678,866
Cost of other revenue	63,317	76,853
Total Cost of Revenue	716,344	755,719
Gross profit	117,284	123,700
Operating expenses:		
Sales and marketing	5,605	6,573
General and administrative	86,186	67,307
Total operating expenses	91,791	73,880
Income from operations	25,493	49,820
Interest income	5,824	1,818
Interest expense	(13)	(18)
Other income, net	33,164	11,954
Net income	64,468	63,574
Cumulative results of operations, beginning of fiscal year	349,242	285,668
Cumulative results of operations, end of fiscal year	$ 413,710	$ 349,242

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)**	**2005**	**2004**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 64,468	$ 63,574
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,487	10,664
Loss on disposal of property, plant and equipment	976	52
Changes in:		
Accounts receivable	21,437	(10,030)
Inventories	40,652	(19,016)
Other assets	(388)	448
Accounts payable and accrued expenses	(3,391)	1,235
Deferred revenue	25,205	(46,136)
Net cash provided by operating activities	*158,446*	*791*
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property, plant and equipment	(7,178)	(4,280)
Construction-in-progress of plant facilities	(1,110)	(94)
Net cash used in investing activities	*(8,288)*	*(4,374)*
Net (decrease) increase in cash	150,158	(3,583)
Cash and cash equivalents, beginning of fiscal year	183,833	187,416
Cash and cash equivalents, end of fiscal year	$ 333,991	$ 183,833

The accompanying notes are an integral part of these financial statements

Fiscal Year 2005
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.

FPI had industrial operations at 106 and 102 factories located at 73 and 71 prison facilities that employed 19,720 and 19,337 inmates representing approximately 14% and 13% of the total number of inmates housed in BOP facilities as of September 30, 2005 and September 30, 2004, respectively.

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, 2005 and September 30, 2004. A majority of these past due items relate to billings to various entities within Department of Defense (DOD) which 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, 2005 and 2004 was $37,077 and $63,012 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, 2005 and 2004, FPI's allowance for doubtful accounts is stated at $3,141 and $3,447, respectively, of which $2,827 and $3,102, 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, life insurance, and intra-departmental services provided by the BOP. (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:

As of September 30	2005	2004
Intragovernmental billed receivables	$50,592	$74,322
Private sector billed receivables	6,704	4,717
	57,296	***79,039***
Less allowance for doubtful accounts	3,141	3,447
Accounts receivable, net	***$54,155***	***$75,592***

Note 4
Inventories, Net

Inventories, net consist of the following:

As of September 30	2005	2004
Raw materials	$44,661	$54,217
Raw materials – vehicles	8,035	24,131
Work-in-process	26,889	29,764
Finished sub-assemblies	7,225	8,178
Finished goods	32,609	39,089
Finished goods – acceptance contracts	16,288	23,994
	135,707	***179,373***
Less inventory allowance	10,641	13,655
Inventories, net	***$125,066***	***$165,718***

$8,035 of FPI's fiscal year 2005 and $24,131 of FPI's fiscal year 2004, raw materials balance represents vehicles and component parts for use in the Fleet Management and Vehicular Components business group's retrofit product line. A majority of that inventory balance has 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.

$16,288 of FPI's fiscal year 2005 and $23,994 of FPI's fiscal year 2004 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:

As of September 30	2005	2004
Machinery and equipment	$96,934	$91,222
Computer hardware	3,548	3,486
Computer software	5,965	5,965
Buildings and improvements	165,632	165,192
	272,079	***265,865***
Less accumulated depreciation	165,351	155,919
	106,728	***109,946***
Factory construction-in-progress	1,137	94
Property, plant and equipment, net	***$107,865***	***$110,040***

Depreciation and amortization expense approximated $9,487 and $10,664 for the fiscal years ended September 30, 2005 and 2004, respectively.

As of September 30, 2005, 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 $210 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.

Note 6
Other Accrued Expenses

Other accrued expenses consist of the following:

As of September 30	2005	2004
Materials in transit	$1,903	$2,951
Permanent change of station	2,030	1,571
FECA liability – current portion	1,249	1,135
Financial audit expense	789	928
Utilities	1,000	971
Warranty expense	452	728
Gain sharing accrual	500	600
Other expense	1,145	1,842
Other accrued expenses	***$9,068***	***$10,726***

(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, 2005 and 2004.

Note 8
Business Segments

FPI's businesses are organized, managed and internally reported as seven operating segments based on products and services. These segments are Clothing and Textiles; Electronics; Fleet Management and Vehicular; 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. FPI's net sales for the fiscal years ended September 30, 2005 and 2004 for each of its business segments is presented for comparative purposes:

Net Sales for the Fiscal years ended September 30	**2005**	**2004**
Business Segment		
Clothing and Textiles	$155,390	$190,556
Electronics	287,009	255,171
Fleet Management and Vehicular	90,797	129,068
Industrial Products	58,520	50,478
Office Furniture	139,773	140,935
Recycling	9,024	10,004
Services	24,883	26,508
Net sales	***$765,396***	***$802,720***

The FPI redefined its business segments from eight to seven in fiscal year 2005. The FPI's net sales for the fiscal year ended September 30, 2004 and 2003 for each of its previous business segments is presented for comparative purposes:

Net Sales for the fiscal years 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. In accordance with SFFAS Number 4, "Managerial Cost Accounting Standards and Concepts", as interpreted by FASAB Interpretation No. 6, implemented June 30, 2005, a reasonable estimate of these costs as provided by the BOP is included in general expense and other income for the fiscal year ended September 30, 2005. For fiscal year 2005, the estimate includes $10.3 million related to inmate workspace provided by the BOP and $10.8 million for services provided by the BOP.

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, 2005 and September 30, 2004, the accrued FECA liabilities as charged to FPI, approximated $1,249 and $1,135, 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 $8,955 and $7,650 at September 30, 2005 and 2004, 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 contributed 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 by the FERS, (generally those employees hired on or after January 1, 1984), FPI contributed (for normal retirement) 11.2 percent for fiscal year ending September 30, 2005, and 10.7 percent for the fiscal year ending September 30, 2004. FPI contributed (for hazardous retirement) 23.8 percent for fiscal year ending September 30, 2005, and 22.7 percent for the fiscal year ended September 30, 2004 (for hazardous 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 15 percent of salary to an investment fund. FPI then matches this amount up to 4 percent, in addition to an automatic 1% that is contributed for all FERS employees. 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 10 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 (OPM).

(Dollars in Thousands)

FPI's contribution to both plans was approximately $25,824, and $24,494 for the fiscal years ended September 30, 2005 and 2004, respectively.

Health Benefits and Life Insurance

FPI, through the 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 and life insurance approximated $8,846 and $8,517 for the fiscal years ended September 30, 2005 and 2004, 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 $6,706, and $6,303 during the fiscal years ended September 30, 2005 and 2004, respectively, were determined by OPM utilizing cost factors used to 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.

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	2005	2004
Salaries, wages and benefits	$37,170	$37,809
Permanent change of station expense	2,985	2,781
Purchases of minor equipment	2,595	557
Contract services	5,887	6,440
Bad debt expense	316	322
Credit card services	1,041	1,418
Travel	1,861	1,353
Customer goodwill	891	502
Personal computer expense	1,558	477
Depreciation	1,668	2,691
Gain on disposition of assets	(3)	(61)
Loss on disposition of assets	976	52
Other Expense	4,704	9,456
Imputed pension costs (Note 9)	2,297	3,780
Imputed post-retirement health care and life insurance cost (Note 9)	6,706	6,303
Imputed operating costs–BOP	21,139	–
Selling, general & administrative expenses	***$91,791***	***$73,880***

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.

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 capital and 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 operating lease commitments for the next five years and thereafter are as follows: fiscal year 2006 $301 fiscal year 2007, $43, fiscal year 2008, $17, fiscal year 2009, $11, and fiscal year 2010, $5. Rental expense approximated $289 and $1,113 for the fiscal years ended September 30, 2005 and 2004, respectively.

(Dollars in Thousands)

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.The amount of warranty expenses accrued as of September 30, 2005, is not material to the financial statements.

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, and are not material to the financial statements.

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	**2005**	**2004**
Congressional limitation on expenses	$3,429	$3,429
Expenses incurred subject to Congressional limitation	$1,102	$1,214

U.S. Department of Justice
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