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

FY 2006

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 manner; and minimize FPI's impact on private business and labor.

Message from the Board of Directors

It is our pleasure, as Federal Prison Industries' (FPI) Board of Directors, to present the Fiscal Year 2006 Annual Report to the Congress of the United States. 2006 is the fifth year of our tenure on the FPI Board of Directors, and we are very pleased with the FPI program's continued success providing job skills training to Federal inmates while minimizing any potential impact on private business and labor.

We are especially proud of the increased inmate participation in the FPI program during 2006. Unlike a normal business operation that seeks to maximize its profits, the FPI program utilizes labor-intensive manufacturing and service processes to employ the greatest practicable number of inmates. In 2006, 21,205 inmates in participated in the FPI program. This represents an increase of almost 2,000 inmates since 2004.

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 when compared to similar inmates without FPI program experience. Studies also show that the FPI program provides the greatest benefit to minority inmates, who are at greater statistical risk of recidivism.

While the number of inmates in the FPI program is increasing, so too is the Federal Bureau of Prisons' total inmate population. In 2006, only 18 percent of the Bureau's eligible inmates participated in the FPI program. The Board's goal is to increase the number of inmates afforded FPI work opportunities, thereby maximizing the FPI program's benefit to the criminal justice system, and our Nation as a whole. As a result of our commitment to this goal, the FPI program activated new factories at eight locations in 2006 – Hazelton, West Virginia, McCreary, Kentucky; Canaan, Pennsylvania; Williamsburg, South Carolina; Victorville, California; Coleman, Florida; Herlong, California; and Bennettsville, South Carolina.

By law, the FPI program must be self-funded. The Board takes its fiduciary responsibility seriously and is committed to ensuring that the FPI program generates revenues that are sufficient to cover its operating expenses. Although the Board is pleased with the 2006 financial results, we recognize the financial challenges which lay ahead. The program faces the prospect of decreased earnings in the future, as greater emphasis is placed on business groups (Fleet Management, Recycling, and Services) that generate smaller operating margins than our more traditional industries (Clothing/Textiles and Electronics).

The Bureau of Prisons has adopted an aggressive schedule for opening new institutions to accommodate its growing inmate population. The FPI program is actively planning new factories at several locations scheduled to open in 2007 and beyond. All costs associated with these factory activations are borne by the FPI program. Activation costs for each new factory can reach several million dollars. Cumulatively, the approaching activation costs are daunting. The FPI program must make wise use of its earnings to cover those costs.

The FPI program continues to generate most of its sales and earnings from its efforts in support of our Nation's military. The Clothing/Textiles and Electronics business groups have been particularly effective in meeting the needs of our military customers. We are proud of the FPI staff and inmates' commitment to providing the highest quality goods and services for the men and women in the Armed Services.

The Board recognizes the importance of preparing the corporation for the eventual end of the Iraq war, and the impact that decreased military sales will have on the FPI program. To that end, we are positioning the program to transition to a post-war environment.

Message from the Board of Directors

We are pleased with the FPI program's ability to successfully perform services for commercial, as well as military customers. At the Board's direction, FPI has positioned itself to provide "commercial services" that would otherwise be performed outside of the United States. We believe that repatriating products currently manufactured outside of the United States, for sale to commercial customers, is a potential growth opportunity for the FPI program. Authority for the FPI program to pursue this idea would require congressional legislation. It is the Board's hope that Congress will consider such an authority, as it would allow the FPI program to create additional inmate work opportunities without any negative impact on American workers.

The Board takes this opportunity to thank the Administration for its continued support and direction. We also thank all of the customers who express their confidence in the FPI program by selecting it as their vendor of choice.

One of the highlights for the Board of Directors in 2006 was our participation in a ceremony honoring former FPI Board member Dr. William E. Morgan. Dr. Morgan served on the FPI Board for 30 years, from 1966-1996. In recognition of Dr. Morgan's service, a building at FCI Englewood, Colorado was named in his honor. Several former members of the FPI Board of Directors participated in the ceremony, and we were pleased to help honor Dr. Morgan in this manner.

Finally, we extend a special appreciation to our former colleague, Dr. Paul R. Corts, who resigned from the FPI Board of Directors in May, 2006. During his tenure on the FPI Board, Dr. Corts was a tireless advocate of the FPI program, and he provided great leadership within the Administration on issues related to the FPI program. We thank Paul 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

Represents Agriculture

Donald R. Elliott, Vice Chairman

Represents Industry

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 2006 Annual Report.

Corrections is inherently a "people profession." The Bureau of Prisons manages an ever-growing and incredibly diverse inmate population. In order to ensure our correctional institutions continue to operate in a safe and efficient manner, we must successfully manage the federal inmates in our custody.

One of the greatest threats to an institution's safe and efficient operation is inmate idleness, which increases the risk of violence, escapes, and other disruptions. Idle inmates also require more supervision, which increases the cost of prison management to taxpayers. The Bureau of Prisons has a variety of programs to keep inmates constructively occupied, and prepare them for their release. However, the Bureau's most important correctional program is Federal Prison Industries.

The FPI program is not about warehousing inmates, and merely keeping them occupied. Almost every inmate in the Bureau's custody will be released at some point. Many of these inmates have not held a job outside of prison. As I have emphasized during my tenure as Director of the Bureau, 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.

The federal inmate population, now over 194,000 inmates, is expected to exceed 217,000 by 2011. Inmates coming into the Bureau's custody are increasingly more dangerous and aggressive offenders. These are precisely the type of inmates most in need of the job skills training and work experience provided by the FPI program.

Because the FPI program does not receive any appropriated funding, its value to the Bureau of Prisons is that much greater. Our other programming (for example, education, vocational training, parenting assistance, substance abuse classes, recreation) is paid by taxpayer funds. In contrast, the FPI program operates in a self-sustaining manner. Not only does the FPI program provide an essential prison management function while simultaneously preparing inmates for their eventual release, it does so without restricting the Bureau's financial resources.

This year, I took the unusual step of formally requesting that the Department of Justice's Office of Inspector General conduct an independent review of FPI's electronics recycling program. I made this request not because I harbored any doubts about the recycling operation. Rather, I sought to put an end to what I believe is misguided criticism of an extremely successful and well-administered program. The FPI program's recycling operations employ more than 1,000 inmates at seven factories de-manufacturing electronic equipment. Since 2002, the FPI program's recycling activities have prevented more than 190 million pounds of electronic waste from ending up in landfills. In performing these recycling activities, the FPI program ensures that inmates and staff are provided with a safe working environment and that all phases of e-waste recycling are rigorously inspected and supervised for Occupational Safety and Health Administration (OSHA) and Environmental Protection Agency (EPA) compliance, as well as compliance with all applicable local and state regulations.

Despite these measures, misinformation about the FPI program's recycling operations persists. On this subject, I wish to be very clear: the continued safety and health of inmates and staff is a top priority of the Bureau of Prisons and the FPI program. At my invitation, the FPI Board of Directors held one of its FY 2006 meetings at FCI Texarkana, site of an FPI recycling factory. The Board saw first hand how FPI's recycling factories operate, and spoke extensively with institution safety officials and a state environmental official about the manner in which FPI ensures all appropriate health and safety measures are followed. I look forward to the results of the Department's review.

As CEO, I continue to be impressed by the degree to which the FPI program supports small businesses. During FY 2006, FPI purchased more than $552 million worth of raw materials, supplies, equipment, and services from private sector businesses. More than 70 percent of those purchases were from small businesses, including

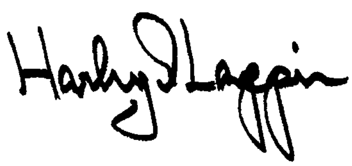
Message from the Director and Chief Executive Officer

businesses owned by women, minorities, and those who are disadvantaged.

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.

I wish to take this opportunity to express my particular appreciation to Steve Schwalb, who has announced his retirement from the Bureau of Prisons. Steve has served as the Chief Operating Officer for Federal Prison Industries since December, 1993. Steve's efforts have been a primary reason the FPI program has been successful in meeting its challenging mission. Steve's service to the Bureau of Prisons, and especially to Federal Prison Industries, is greatly appreciated, and he will be deeply missed.

Harley G. Lappin



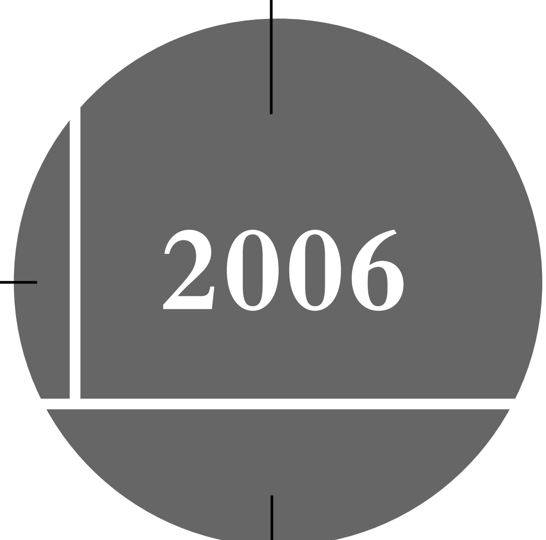
Director, Federal Bureau of Prisons
Chief Executive Officer, Federal Prison Industries

FPI FY 2006 Annual Report "Year at a Glance" Data

Inmate Workers:	**21,205**
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:	**108**
Distribution of FPI's revenues:	
Staff salaries:	**18**%
Inmate pay:	**5%**
Purchase of materials, supplies, equipment and services:	**77%**

77%
Purchase of materials and supplies from vendors and other general and administrative expenses

5%
Inmate pay (used to meet financial obligations and for commissary purchases of products that are supplied by local vendors)



18%
Staff salaries

100% returned to the private sector

Industrial Programs, Location, Inmate Employment and Net Sales

(as of September 30, 2006)

	Clothing and Textiles	Electronics	Fleet Management	Industrial Products	Office Furniture	Recycling	Services
	Atlanta GA Beaumont TX Big Sandy KY Butner NC Dublin CA Edgefield SC Fort Dix NJ Greeneville IL Hazelton WV Jesup GA Lee VA Manchester KY Miami FL Oakdale LA Pollack LA Ray Brook NY Safford AZ Sandstone MN Seagoville TX Terre Haute IN Waseca MN Yazoo City MS	Beaumont TX Big Spring TX Danbury CT Fairton NJ Lexington KY Lompoc CA Loretto PA Marion IL McKean PA Memphis TN Otisville NY Oxford WI Phoenix AZ Rochester MN	Bastrop TX Beaumont TX Estill SC Gilmer WV Herlong CA La Tuna TX Terre Haute IN Three Rivers TX Victorville CA	Butner NC Cumberland MD El Reno OK Leavenworth KS Lewisburg PA Lompoc CA Pekin IL Talladega AL Terminal Island CA Texarkana TX	Allenwood PA Ashland KY Beckley WV Coleman FL Florence CO Forrest City AR Milan MI Schuylkill PA Sheridan OR	Atwater CA Elkton OH Fort Dix NJ Lewisburg PA Marianna FL Texarkana TX Tucson AZ	Alderson WV Bryan TX Canaan PA Carswell TX Dublin CA Elgin FL Elkton OH El Paso TX Fort Dix NJ Leavenworth KS Marianna FL McCreary KY Montgomery AL Morgantown WV Petersburg VA Sandstone MN Tallahassee FL Williamsburg SC
Inmates Employed:*	**6,542**	**3,348**	**2,058**	**1,793**	**3,336**	**1,047**	**2,775**
Net Sales:**	**$152.7**	**$233.2**	**$125.9**	**$49.6**	**$118.2**	**$10.2**	**$27.8**

* There are an additional 306 inmates working in Customer Service and Product Support. The total number of inmates who worked in Federal Prison Industries as of September 30, 2006 was 21,205.

** 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 2006, 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 108 factories located at 79 prison locations that employed 21,205 inmates representing approximately 15% of the of total number of inmates housed in BOP facilities as of September 30, 2006. 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, preferred source basis.

FPI processes all 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, 2006 and September 30, 2005, FPI had established allowance for bad debt in the amount of $2.05 million and $3.14 million on accounts receivable balances of $46.09 million and $57.30 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 72 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.

Analysis of Financial Statements

Investments

FPI's investment balance as of September 30, 2006 increased by 9.4% in comparison to September 30, 2005 and was 102.0% greater than September 30, 2004. The significant increase in investments in fiscal year 2006 is due to a decrease in accounts receivable of $10 million which is a result of enhanced collection efforts, and earnings of $17 million which are a direct result of the continued surge demand by the DOD for products manufactured by the Electronics Business Group.

Accounts Receivable

FPI's accounts receivable balance as of September 30, 2006 decreased by 18.7% in comparison to September 30, 2005 and was 41.7% less than September 30, 2004. The decrease in accounts receivable in fiscal year 2006 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 increased by 50.4% in fiscal year 2006 compared to fiscal year 2005 and 13.5% compared to fiscal year 2004. The increase in inventories is attributable to the Fleet Management and Vehicular Components and the Electronics Business Segments. The Fleet Management and Vehicular Components Business Segment experienced an increase in customer demand for vehicles from the Department of Homeland Security. The Electronics Business Group experienced an increase in customer demand in support of DOD efforts late in the fiscal year.

Deferred Revenue

Deferred Revenue increased 71.3% in fiscal year 2006 compared to fiscal year 2005, and 125.0% compared to fiscal year 2004. The increase in deferred revenue in fiscal year 2006 is due to customer advances received from the Department of Homeland Security. The customer advances increased by 71.3% in fiscal year 2006 compared to fiscal year 2005 and 125% in comparison to fiscal year 2004.

Revenue

Revenues for fiscal year 2006 decreased by 7.2% from fiscal year 2005 and 12.0% compared to fiscal year 2004. The decrease in revenue in fiscal year 2006 is due primarily to a decline in sales in the Electronics and Office Furniture Business Segments. The Electronics Business Segment's sales are attributable to the continuance of DOD surge. Sales from DOD were 23% lower than fiscal year 2005, representing a decline in the surge of customer demand, and 9.4% lower than fiscal year 2004 levels. The Furniture Business Group sales were 18.6% lower than fiscal year 2005 and 19.4% lower than fiscal year 2004 levels.

Cost of Revenue

The cost of revenue in fiscal year 2006 remained constant from fiscal year 2005 and decreased 2.6% from fiscal year 2004. The decline in cost of revenue is associated with the lower level in sales experienced in fiscal year 2006. Additionally, the Corporation experienced increased cost in purchased raw materials, employee salaries and utilities that is also reflective in the decrease in cost of revenue. The Corporation has also continued its efforts to control cost and better utilize materials and resources in the manufacturing of its products and the providing of its services.

Business Segments

In fiscal year 2006, 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 for the fiscal years ended September 30, 2006 and 2005 for each of its current business segments is presented for comparative purposes:

Business Segment	Fiscal Year	
Clothing and Textiles	**2006**	**2005**
Sales	$152,728	$155,390
Earnings	$20,631	$23,253
Electronics		
Sales	$233,182	$287,009
Earnings	$62,743	$94,515
Fleet Management		
Sales	$125,869	$90,797
Earnings	($6,376)	($5,775)
Industrial Products		
Sales	$49,591	$58,520
Earnings	($1,537)	($1,405)
Office Furniture		
Sales	$118,179	$139,773
Earnings	($3,353)	$2,866
Recycling		
Sales	$10,230	$9,024
Earnings	$1,715	$1,430
Services		
Sales	$27,765	$24,883
Earnings	($2,567)	($539)
Corporate Total		
Sales	$717,544	$765,396
Earnings	$71,256	$114,345

Management Discussion and Analysis

(c o n t i n u e d)

Liquidity and Capital Resources

FPI's cash from operations was $67 million in fiscal year 2006 compared to $158 million in fiscal year 2005. The change is attributed to an increase in inventories of $ 63 million in support of increased demand in the Fleet and Vehicular Components Business segment and the Electronics Business segment late in the fiscal year, an increase of $75 million in customer advances received from the Department of Homeland Security, and a decrease in net income of $ 47 million due to reduced sales for the Electronics and Office Furniture Business segments. While surge demand from the DOD continued during fiscal year 2006, sales levels were lower than that of fiscal year 2005.

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 $13.9 million in fiscal year 2007 toward the replacement or repair of existing building or machinery. In addition, FPI plans to invest $6.6 million in equipment and $13.9 million toward building improvements for newly activated plants.

Possible Future Effects of Existing Events and Conditions

FPI's Recycling Business Group is involved in the disassembly of components that may contain heavy metals. FPI management is committed to operating its recycling program in a manner that is safe and fully compliant with all applicable laws and regulations. Toward this end, FPI has established standard operating procedures, sought input from regulatory agencies such as OSHA and EPA, and contracted for testing, inspection and technical advice with private companies with appropriate expertise. Allegations have been made that FPI recycling activities were noncompliant and reviews have been conducted to address these allegations. Although the reviews concluded that FPI's current operations are operating safely and in compliance with applicable regulations and standards, concerns continue to be raised about FPI's past practices. To proactively address the matter, FPI has requested that the Department of Justice's Office of Inspector General conduct a comprehensive review of both past and present practices, and that review is currently underway.

The FPI does not receive appropriated funding for operations and must maintain itself through the results of operations. Historically, the FPI operates on very low margins. The margins are much below those of non-governmental corporations of similar size and longevity. The 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 during fiscal years 2003 and 2004 is no longer at a level of concern for the program. FPI continues to meet its mission challenges of maintaining a 'selfsufficient' fiscal position; providing adequate inmate employment levels for the Bureau of Prison's unprecedented growth; and maintaining an aggressive cost containment practice. The corporation continues to balance its self sufficiency as well as the inmate growth in the work force. The financial condition has improved and the corporation's cash reserves 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.

Management Discussion and Analysis

(c o n t i n u e d)

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 "Possible Future Effects of Existing Events and Conditions", 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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McLean, VA 22102-4261
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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, 2006 and 2005, and the related statements of net cost, of changes in net position, of financing, and of budgetary resources 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. 06-03, *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, 2006 and 2005, and its net cost of operations, changes in net position, budgetary resources and financing for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis (MD&A) and Required Supplementary Information (RSI) are not required parts of the financial statements but are supplementary information required by the Federal Accounting Standards Advisory Board and OMB Circular A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the MD&A and RSI. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the financial statements of the FPI taken as a whole. The Other Accompanying Information is presented for purposes of additional analysis and is not a required part of the finiancial statements. Such information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Report of Independent Auditors

PRICEWATERHOUSECOOPERS

In accordance with *Government Auditing Standards*, we have also issued a report dated October 27, 2006, on our consideration of the FPI internal control and a report dated October 27, 2006, on its compliance and other matters for the year ended September 30, 2006. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and of compliance and the results of that testing, and not to provide an opinion of the internal control over financial reporting or on compliance. 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 27, 2006

Report of Independent Auditors on Internal Control

PRICEWATERHOUSECOOPERS

Inspector General
U.S. Department of Justice

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

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We have audited the 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, 2006, 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 27, 2006. 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. 06-03, *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 controls, 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. 06-03, Appendix E, that could have a direct and material effect on the financial statements; 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

Report of Independent Auditors on Internal Control

(c o n t i n u e d)

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 as defined above.

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. 06-03. 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.

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

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

PricewaterhouseCoopers LLP

October 27, 2006

Report of Independent Auditors on Compliance and Other Matters

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Inspector General
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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, 2006, 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 27, 2006. 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. 06-03, *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. 06-03, 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.

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 of compliance disclosed no instances of noncompliance with laws and regulations or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03 and no instances of substantial noncompliance that are required to be reported under FFMIA.

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 27, 2006

Federal Prison Industries, Inc.
Balance Sheets

September 30, ***(Dollars in Thousands)***	**2006**	**2005**
Assets		
Current:		
Cash and cash equivalents	$ 378,373	$ 333,991
Accounts receivable, net	44,039	54,155
Inventories, net	188,088	125,066
Other assets	1,176	1,829
Total current assets	611,676	515,041
Property, plant and equipment, net	119,100	107,865
Total Assets	$ 730,776	$ 622,906

Liabilities and United States Government Equity

Current:		
Accounts payable	$ 57,101	$ 43,921
Deferred revenue	180,765	105,550
Accrued salaries and wages	9,177	8,953
Accrued annual leave	9,161	8,573
Other accrued expenses	9,533	9,068
Total current liabilities	265,737	176,065
FECA actuarial liability	9,916	8,955
Note payable to United States Treasury	20,000	20,000
Total Liabilities	295,653	205,020
United States Government Equity		
Initial capital	4,176	4,176
Cumulative results of operations	430,947	413,710
Total United States Government Equity	435,123	417,886
Total Liabilities and United States Government Equity	$ 730,776	$ 622,906

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)***	**2006**	**2005**
Revenue:		
Net sales	$ 717,544	$ 765,396
Other revenue	56,283	68,232
Total revenue	773,827	833,628
Cost of revenue:		
Cost of sales	637,551	653,027
Cost of other revenue	61,139	63,317
Total Cost of Revenue	698,690	716,344
Gross profit	75,137	117,284
Operating expenses:		
Sales and marketing	5,563	5,605
General and administrative	103,355	86,186
Total operating expenses	108,918	91,791
Income from operations	(33,781)	25,493
Interest income	15,083	5,824
Interest expense	(24)	(13)
Other income, net	35,959	33,164
Net income	17,237	64,468
Cumulative results of operations, beginning of fiscal year	413,710	349,242
Cumulative results of operations, end of fiscal year	$ 430,947	$ 413,710

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)*	**2006**	**2005**
Cash Flows From Operating Activities		
Net income	$ 17,237	$ 64,468
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,553	9,487
Loss on disposal of property, plant and equipment	1,626	976
Changes in:		
Accounts receivable	10,116	21,437
Inventories	(63,022)	40,652
Other assets	653	(388)
Accounts payable and accrued expenses	15,419	(3,391)
Deferred revenue	75,215	25,205
Net cash provided by operating activities	66,797	158,446
Cash Flows From Investing Activities		
Purchases of property, plant and equipment	(10,619)	(7,178)
Construction-in-progress of plant facilities	(11,796)	(1,110)
Net cash used in investing activities	(22,415)	(8,288)
Net (decrease) increase in cash	44,382	150,158
Cash and cash equivalents, beginning of fiscal year	333,991	183,833
Cash and cash equivalents, end of fiscal year	$ 378,373	$ 333,991

The accompanying notes are an integral part of these financial statements

Fiscal Year 2006
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 108 and 106 factories located at 79 and 73 prison facilities that employed 21,205 and 19,720 inmates representing approximately 15% and 14% of the total number of inmates housed in BOP facilities as of September 30, 2006 and September 30, 2005, 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.

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, 2006 and September 30, 2005. 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 period ended September 30, 2006 and 2005 was $25,063 and $37,077 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, 2006 and 2005, FPI's allowance for doubtful accounts is stated at approximately $2,052 and $3,141, respectively, of which approximately $1,847 and $2,827, 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).

(Dollars in Thousands)

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.

Note 3
Accounts Receivable, Net

Accounts receivable, net consists of the following:

As of September 30,	2006	2005
Intragovernmental billed receivables	$ 35,685	$ 50,592
Private sector billed receivables	10,406	6,704
	46,091	57,296
Less allowance for doubtful accounts	2,052	3,141
Accounts receivable, net	$ 44,039	$ 54,155

Note 4
Inventories, Net

Inventories, net consist of the following:

As of September 30,	2006	2005
Raw materials	$ 56,878	$ 44,661
Raw materials – vehicles	30,831	8,035
Work-in-process	39,497	26,889
Finished sub-assemblies	7,905	7,225
Finished goods	50,130	32,609
Finished goods – acceptance contracts	15,937	16,288
	201,178	135,707
Less inventory allowance	13,090	10,641
Inventories, net	$ 188,088	$ 125,066

$30,831 of FPI's fiscal year 2006 and $8,035 of FPI's fiscal year 2005, 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

(Dollars in Thousands)

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.

$15,937 of FPI's fiscal year 2006 and $16,288 of FPI's fiscal year 2005 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 consist of the following:

As of September 30,	2006	2005
Machinery and equipment	$ 107,142	$ 96,934
Computer hardware	3,728	3,548
Computer software	5,965	5,965
Buildings and improvements	165,786	165,632
	282,621	272,079
Less accumulated depreciation	175,920	165,351
	106,701	106,728
Factory construction-in-progress	12,399	1,137
Property, plant and equipment, net	$ 119,100	$ 107,865

Depreciation and amortization expense approximated $9,553 and $9,487 for the fiscal year ended September 30, 2006 and 2005, respectively.

As of September 30, 2006, various projects were in progress for the construction of new industrial facilities and the renovation of existing facilities. In addition, during the next fiscal year, FPI is planning to invest approximately $34,381 for the purchase and construction of property, plant, and equipment.

Note 6
Other Accrued Expenses

Other accrued expenses consist of the following:

As of September 30,	2006	2005
Materials in transit	$ 1,893	$ 1,903
Permanent change of station	3,469	2,030
FECA liabilities – current portion	1,177	1,249
Financial audit expense	697	789
Utilities	929	1,000
Warranty expense	427	452
Gain sharing accrual	–	500
Other expense	941	1,145
Other accrued expenses	$ 9,533	$ 9,068

(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 period ended September 30, 2006 and 2005.

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 period ended September 30, 2006 and 2005 for each of its business segments is presented for comparative purposes:

Net Sales

For the years ended September 30,	**2006**	**2005**
Business Segment		
Clothing and Textiles	$ 152,728	$ 155,390
Electronics	233,182	287,009
Fleet Management and Vehicular	125,869	90,797
Industrial Products	49,591	58,520
Office Furniture	118,179	139,773
Recycling	10,230	9,024
Services	27,765	24,883
Net sales	$ 717,544	$ 765,396

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, 2006.

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, 2006 and September 30, 2005, the accrued FECA liabilities as charged to FPI, approximated $1,178 and $1,249, 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 $9,916 and $8,955 at September 30, 2006 and 2005, 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 period ending September 30, 2006 and September 30, 2005. FPI contributed (for hazardous retirement) 23.8 percent for period ending September 30 2006 and September 30, 2005 (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).

FPI's contribution to both plans was approximately $26,881 and $25,824 for the periods ended September 30, 2006 and 2005, 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 $9,269 and $8,846 for the periods ended September 30, 2006 and 2005, 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 $7,149, and $6,706 during the period ended September 30, 2006 and 2005, 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.

(Dollars in Thousands)

Note 10
Selling, General and Administrative Expenses

Selling, general and administrative expenses consist of the following:

Selling, general and administrative expenses

Periods ended September 30,	**2006**	**2005**
Salaries, wages and benefits	$ 39,999	$ 37,170
Permanent change of station expense	5,614	2,985
Purchases of minor equipment	2,006	2,595
Contract services	9,181	5,887
Bad debt expense	98	316
Credit card services	1,153	1,041
Travel	2,590	1,861
Customer Goodwill	3,482	891
Personal Computer Expense	1,718	1,558
Depreciation	1,240	1,668
Gain on disposition of assets	-	(3)
Loss on Disposition of Assets	1,626	976
Other Expense	5,511	4,704
Imputed pension costs (Note 9)	1,728	2,297
Imputed post-retirement health care and life insurance cost (Note 9)	7,149	6,706
Imputed Operating Costs – BOP	25,823	21,139
Selling, general and administrative expenses	$ 108,918	$ 91,791

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 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 2007 $137, fiscal year 2008, $32, fiscal year 2009, $26, and fiscal year 2010, $10. Rental expense approximated $309 and $289 for the periods ended September 30, 2006 and 2005, respectively.

Notes to Financial Statements

(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.

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.

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

Periods end September 30,	**2006**	**2005**
Congressional limitation on expenses	$ 3,322	$ 3,429
Expenses incurred subject to Congressional limitation	$ 1,420	$ 1,102

U.S. Department of Justice
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