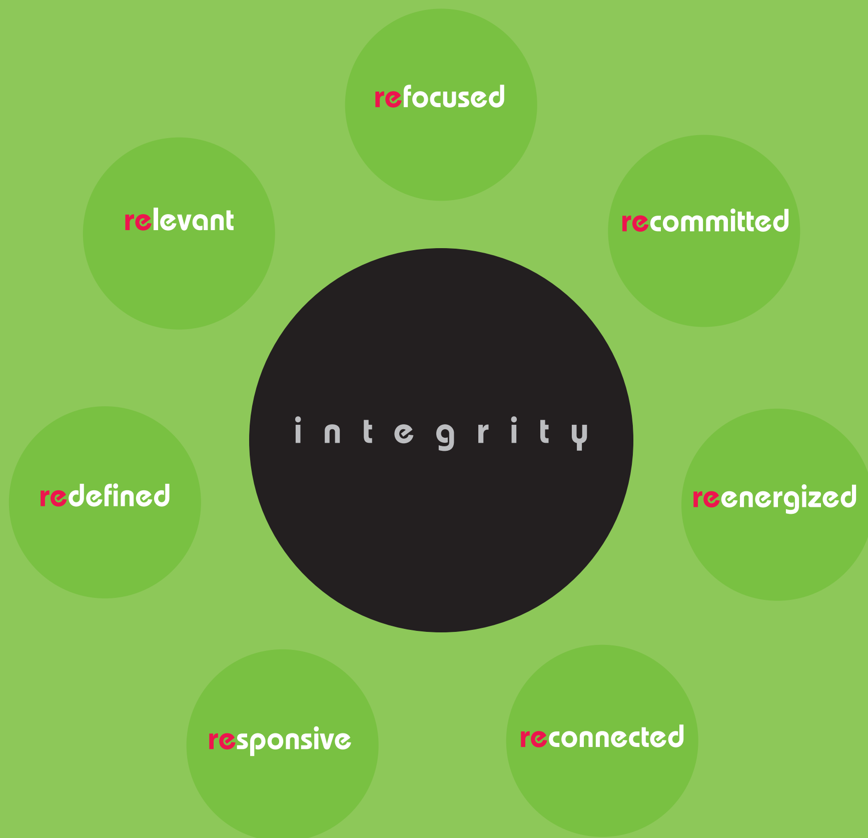
ANNUAL REPORT 2007

unicor

FEDERAL PRISON INDUSTRIES, INC.

unicor

contents


refocused
relevant
recommitted
integrity
redefined
reenergized
responsive
reconnected

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-priced quality goods for sale to the Federal Government; operate in a self-sustaining manner; and minimize FPI's impact on private business and labor.

integrity...

the connection to our past, present and future

As we continue to educate Federal Government agencies, customers, and the private sector about the true merits of Federal Prison Industries, Inc. (FPI), more widely known by its trade name UNICOR — and why it was created in 1934 — we are confident that they will ultimately recognize that purchasing from UNICOR is truly an investment in all our futures. • A civilized society sees prison work for its rehabilitative potential. UNICOR inherently teaches the true value of earning a paycheck; it represents a "fresh start" for a brighter future. One might say that UNICOR is life-changing. • What better way to put federal procurement dollars to work! Simply put, it's the right thing to do.

It is our pleasure, as Federal Prison Industries Board of Directors, to present the Fiscal Year 2007 Annual Report to the Congress of the United States.

In May, 2007, President Bush filled the three vacancies on the FPI Board. Jack Bell, Deputy Under Secretary of Defense for Logistics and Material Readiness, was appointed to represent the Secretary of Defense. Frank Gale, National Sergeant-At-Arms for the Fraternal Order of Police, was appointed to represent Labor. Lee Lofthus, Assistant Attorney General for Administration, was appointed to represent the Attorney General.

When assessing the performance of the FPI program, or any correctional program, it is important to remember that inmates are sentenced to prison *as* punishment, not *for* punishment. An inmate s ability to successfully re-integrate into the community upon release depends on the correctional programming opportunities that he or she receives while incarcerated. The FPI program plays a crucial role in creating these opportunities.

To quote Harley Lappin, Director of the Bureau of Prisons and CEO for the FPI program, Corrections is inherently a people profession. This is particularly true of Federal Prison Industries.

Many of the inmates working in FPI have never before held a steady job. Working in FPI affords inmates the opportunity to acquire a basic work ethic, interact with supervisors and work colleagues, and experience the importance of reporting to their jobs on time and ready to work. The significance of this should not be overlooked. A recent survey by the National Association of Manufacturers asked employers their reasons for rejecting job applicants. The most common reply was inadequate basic employability skills attendance, timeliness, work ethic, etc.

In addition to gaining a sense of self-worth and dignity by participating in the FPI program, inmates learn marketable job skills. This is true whether they work on the factory floor or in an administrative job utilizing computer and business skills. Unlike typical business operations that seek to maximize profits, FPI utilizes labor-intensive manufacturing and service operations, employing the greatest practicable number of inmates. In FY 2007, the number of inmates working in FPI increased to 23,152.

While the Board is committed to maximizing FPI s positive social impact through increased inmate participation, we are equally committed to minimizing the potential negative impact that our program may have on private business and free labor. We are proud to report that more than 77 percent of FPI s revenue is used to purchase raw materials, supplies, equipment, and services from private vendors. In FY 2007, approximately 70 percent of FPI s purchases

2007 Board of Directors
(left to right)

David S. Spears, Chairman
Donald R. Elliott, Vice Chairman
P. Jackson Bell
Franklin G. Gale
Audrey J. Roberts
Lee J. Lofthus

were from small businesses, including firms owned by women, minorities, and those who are disadvantaged. This is more than three times the Small Business Administration goal for federal agencies.

By law, the FPI program must operate in a self-sustaining manner. The Board takes this fiduciary responsibility seriously. We are committed to ensuring that FPI s revenues are sufficient to cover all operating expenses. Although FY 2007 was a financially successful year, the Board realizes there will be financial challenges in the years ahead.

FPI s current revenue and earnings are most heavily reliant upon its electronics and clothing/textiles products. Both business groups supply a variety of items to the Department of Defense. We are proud of the outstanding manner in which FPI continues to exceed the requirements of our military customers. However, we recognize the importance of preparing for the eventual end of the Iraq war, and of the impact that decreased military requirements will have on our organization. While the demand for some FPI products is expected to decrease, the federal inmate population and the demand for FPI jobs continues to grow.

We continue to be impressed with the Services Business Group s ability to successfully perform work for commercial customers. As part of our strategic plan, FPI s commercial services team is focusing on potential opportunities outside the United States. We believe that repatriating services currently performed outside the United States, for sale to commercial customers, is a potential growth opportunity for FPI. Working towards such an authority would provide the FPI program new opportunities for increased inmate employment without negative impact on American workers.

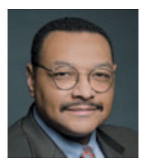
In closing, the Board thanks the Administration for its continued support of the FPI program. We wish to take this opportunity to recognize and thank Steve Schwalb, who retired after serving as FPI s Chief Operating Officer for more than 13 years, for his service and dedication to FPI. Finally, we extend a warm welcome to Paul M. Laird, who was named Chief Operating Officer for FPI in April, 2007. Paul has more than 20 years experience in the Bureau of Prisons, having served in a variety of leadership positions, including Warden at two institutions. He is an exceptionally capable leader, and we look forward to working with him in the years ahead.

The Board of Directors for Federal Prison Industries

David D. Spears, Chairman
Represents Agriculture

Donald R. Elliott, Vice Chairman
Represents Industry

P. Jackson Bell
Represents the Secretary of Defense



Franklin G. Gale
Represents Labor

Lee J. Lofthus
Represents the Attorney General

Audrey J. Roberts
Represents Retailers and Consumers

integrity

message from the director and chief executive officer

I am honored, as Director of the Federal Bureau of Prisons, and as Chief Executive Officer of Federal Prison Industries, Inc., to join with FPI s Board of Directors in presenting the Fiscal Year 2007 Annual Report.

By every measure, 2007 was another successful year for the FPI program. The Corporation s revenues and earnings remain strong. We continue to receive outstanding feedback from our customers and partners in the private sector. And perhaps most importantly, the number of inmates participating in the program continues to increase. By the end of the year, there were 23,152 inmates working in FPI.

In 2007, we launched a corporate-wide branding initiative that emphasized redefining the FPI program. We have used the words re-focused, re-energized, and re-committed, to emphasize that the FPI program remains dedicated to successfully fulfilling its mission.

The term *re-entry* is of particular importance to me. Each year more than 45,000 inmates are released from the Bureau of Prisons into our communities. Many factors influence whether these men and women have a successful re-entry into their communities, but one of the most important is their ability to get a job. This is where the FPI program plays an important role.

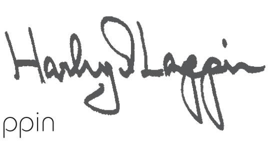
While the FPI program produces products and performs services, its real output is the inmates who are more likely to re-enter society as law-abiding taxpayers because of the job skills training and work experience they received in FPI. Rigorous research has found that inmates who participate in the FPI program are 24 percent less likely to return to crime and 14 percent more likely to be employed than similar inmates without experience in the FPI program.

In addition to the substantial contribution FPI makes to enhancing public safety by reducing recidivism, FPI also greatly assists in ensuring the safe and orderly operation of federal prisons by keeping inmates constructively occupied. Inmates in the FPI program are significantly less likely to be involved in misconduct as compared to inmates not working in FPI. Further, the Bureau of Prisons does not select only those inmates who are more likely to succeed to work in FPI. In fact, the opposite is true. The FPI program is focused on serious offenders, those confined in medium and high security institutions. Approximately 76 percent of inmates in the FPI program are convicted of drug trafficking, weapons, or violent offenses. Many of these inmates have never before held a steady job. Their experience in the FPI program teaches them a basic work ethic along with specific job skills.

By statute, the FPI program must operate in a self-sustaining manner. The FPI program must pay for all its costs and operating expenses (including wages for both staff and inmates) with the revenues it generates; no funds are appropriated by the Congress either directly or through the Bureau of Prisons. Thus, unlike other inmate programs, (such as education, vocational training, parenting assistance, recreation and substance abuse classes), FPI provides inmates meaningful work assignments and valuable training at no cost to the Bureau of Prisons. The FPI program provides an essential prison management function and prepares inmates for release without burdening the Bureau s limited resources.

The Bureau of Prisons Executive Staff recently revised the agency s core values to focus on three principles: correctional excellence, respect, and integrity. I am very proud of the manner in which the FPI program staff personify these values, both in their roles as correctional workers and in their roles working to fulfill FPI s demanding mission. To the FPI program staff, I extend my sincere thanks for your outstanding efforts throughout the year.

I congratulate P. Jackson Bell, Franklin G. Gale, and Lee J. Lofthus on their selection by President Bush to serve on the FPI Board of Directors. I thank the entire FPI Board for their continued leadership. I also wish to express my sincere appreciation to the Administration for its continued support of both the Bureau of Prisons and the FPI program. Finally, I wish to recognize former Attorney General Alberto Gonzales for his unfailing support of both the Bureau and the FPI program. His efforts on behalf of the Department of Justice are greatly appreciated.



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

UNICOR Welcomes Chief Operating Officer, Paul M. Laird

Effective April 1, 2007, Paul M. Laird became UNICOR s 14th Chief Operating Officer following the retirement of his predecessor, Steve Schwalb, who had served in this capacity since 1993.

Mr. Laird s career with the Federal Bureau of Prisons began in 1988, at FCI Phoenix, AZ. Since then, it has included varied positions and spanned five states, in addition to the District of Columbia. Mr. Laird s other duty stations include MDC Los Angeles, CA; FCI Dublin, CA; FCI Tucson, AZ; and USP Florence, CO. In 2001, Mr. Laird was named Warden at FCC Coleman, FL. He served in that position until 2004, at which time he was appointed Senior Deputy Assistant Director in the Bureau of Prisons Correctional Programs Division. In 2005, Mr. Laird was appointed Warden at the Metropolitan Detention Center in Brooklyn, NY, where he served for two years before assuming his new role with UNICOR.

Mr. Laird brings a solid understanding of business principles, extensive corrections experience, and a commitment to sound public policy. These skills will serve the organization well, particularly in view of the potential legislative challenges, ahead.

Although this is Mr. Laird s first direct engagement with UNICOR, he is no stranger to the program. Beyond its tremendous societal benefits, Mr. Laird s longstanding corrections career allowed him to experience, first hand, the important role UNICOR plays in the safe and efficient operations of the Bureau s facilities.

Mr. Laird serves in two capacities: as the Bureau of Prisons Assistant Director for Industries, Education and Vocational Training, and as UNICOR s Chief Operating Officer.

Integrity... the word most frequently used by customers to describe UNICOR . It s a powerful statement of who we are and cuts to the heart of our core compass.

The dictionary defines integrity as:

- adherence to a code; especially of moral value;
- an unimpaired condition; soundness;
- a state of being complete; undivided

Integrity... connects us with our past, present and future.

It can be said that UNICOR is truly a program with heart and soul. The work and life skills federal inmates acquire unleash a potential most never knew they had. Low self-esteem is replaced with self-confidence and a positive outlook, inspiring inmates to succeed after years of struggle.

The United States secures more inmates, per capita, than any other country. More than 2.3 million inmates occupy state/federal prisons as well as local jails. More than 600,000 inmates are released annually, with the unrealistic expectation that they will easily adapt to an outside world they haven t known for 5, 10, 15 or more years, in some cases.

The social assimilation and disorientation faced by offenders can seem insurmountable. Think of them:

- the stigma of having spent years in prison;
- potential employers fears of incurring liabilities;
- legal obstacles associated with securing drivers licenses, loans, housing, etc.
- a return to an unwelcome environment, such as dysfunctional households and impoverished neighborhoods

Our Core Connection

• Adherence to a code; especially of moral value

In 1934, President Franklin D. Roosevelt, by authority of Congress, ordered the creation of Federal Prison Industries more widely recognized as UNICOR.

Throughout most of its 73 year history, the UNICOR program has fueled often heated debate over the value of providing jobs to inmates, which might otherwise be made available domestically, within the private sector.

But what has been generally overlooked in this debate are the residual, lasting benefits of the program, including the safety and security of our Nation s correctional facilities, the viability of our communities, a reduction in government spending, and the positive programmatic impact upon the economy.

UNICOR represents an incredible investment in developing human potential. The reality is that 98% of all inmates will, one day, be released from prison. Some will become our neighbors.

Years of professional research supports the strong correlation between employment and reduced crime levels. Inmates who have participated in vocational training and work/life skills programs such as UNICOR are 24% less likely to return to a life of crime, and 14% more likely to obtain employment and socially adapt than those offenders who did not take full advantage of similar programs and experience.

Our Inner Core Strength

• An unimpaired condition; soundness

UNICOR s societal benefits are far-reaching, extending well beyond the confines of prison. For every inmate who commits an offense, other people suffer. Because

financial assistance from offenders has a tremendous healing and restorative power for crime victims, UNICOR requires that participating inmates pay one-half of their earnings toward crime victim restitution, court-ordered fines, and for child and family support.

Work, in itself, does not reform an inmate. Rather, the opportunities presented from having worked and earned a paycheck enable the inmate to own up to his/her responsibilities. Without employment options, inmates would be unable to compensate victims, provide for their own families, or satisfy legal obligations. And inmate wages cannot be replaced by other revenue sources to provide such restitution. In Fiscal Year 2007, approximately $2.7 million was directed toward satisfying these obligations by inmates in UNICOR.

Coming Full Circle

• A state of being complete; undivided

The UNICOR program is especially compelling because it operates without cost to taxpayers. Even its managing Board of Directors serves without compensation. This means that funding which would otherwise be spent on correctional programs in the absence of UNICOR is available for other critical education, health and social services needs.

Beyond its fundamental mission, UNICOR works in tandem with other Bureau of Prisons components, such as the Inmate Transition Branch (ITB), to bring the program full circle. The ITB is the mortar which reinforces the work and social skills inmates acquire in UNICOR, by helping improve their prospects of obtaining meaningful jobs, upon release.

Thanks to the time and business acumen of more than 8,000 corporate recruiters, representatives from educational and community service agencies, and private citizen volunteers, approximately 700 mock job fairs in 114 federal prisons, involving 26,000 inmate participants have been held to date. These events focus on strengthening inmates employment interview skills, resume development, and compiling employment folders complete with documentation required by prospective employers.

One of the more challenging obstacles faced by former offenders when seeking jobs is the fear prospective employers have of incurring liability. In cooperation with the ITB, UNICOR launched a federal bonding program which provides $5,000 theft insurance to employers who hire former federal inmates who have worked in UNICOR. The insurance is offered at no cost to the employer, has a zero-dollar deductible, and covers the first six months of the former offender s employment (thereafter, the employer may opt to continue coverage at commercial rates).

In his introductory message, Bureau of Prisons Director, Harley Lappin, mentions the branding initiative UNICOR recently launched to relay the connection between *what* we do and *why* we do it. It cuts to the very core of who we are.

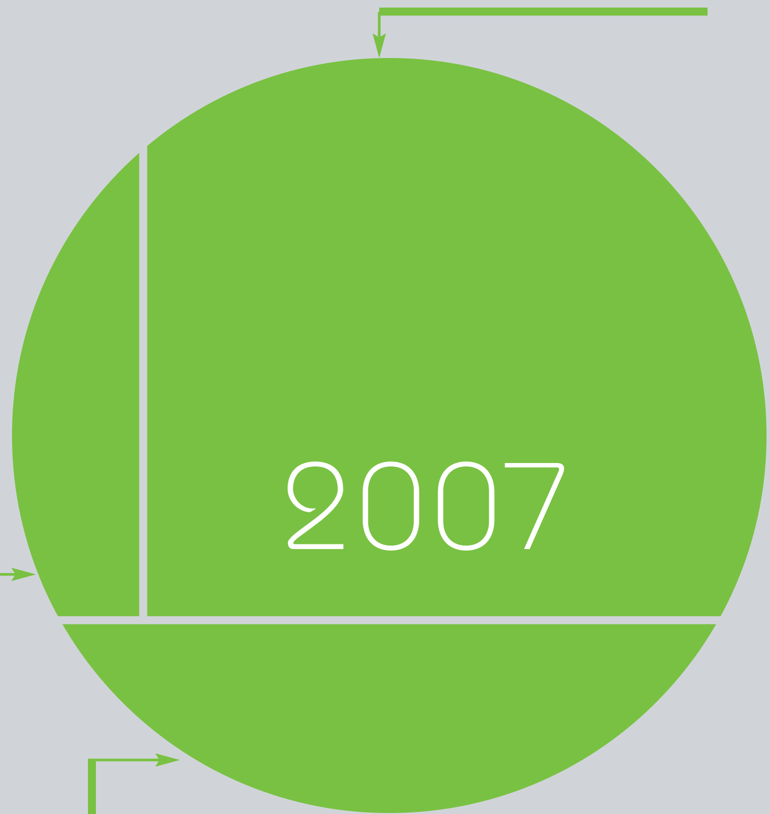
In recent years, UNICOR has faced increased challenges in light of legislative changes and widening competition. New procurement procedures outlined in the Federal Acquisition Regulation have impacted how Department of Defense and civilian agencies, alike, do business with us. As a result, an increasing percentage of all UNICOR purchases now come from services and other non-mandatory source items.

Today s survival of the fittest environment necessitates that UNICOR discover the key which will ensure that our customers will continue to want to do business with us, despite the competition s lure. We believe that reconnecting to our roots by sharing our unique story, is the perfect start.

Fiscal Year 2007 Recap

- Inmate Workers: 23,152
- Percent of Eligible (medically able/ sentenced) Population Employed: 18%
- Employment Goal: 25%
- Inmate Pay Rates: 23 cents to $1.15 per hour
- Factories: 110 factories at 79 locations
- Distribution of FPI's Revenues:*

77.4%
purchase of materials and supplies from private sector vendors



4.8%
inmate pay (some of which is used to meet financial obligations and for commissary purchases of products that are supplied by local vendors)

17.8%
staff salaries

100% returned to the private sector

Fiscal Year 2007 Comparison

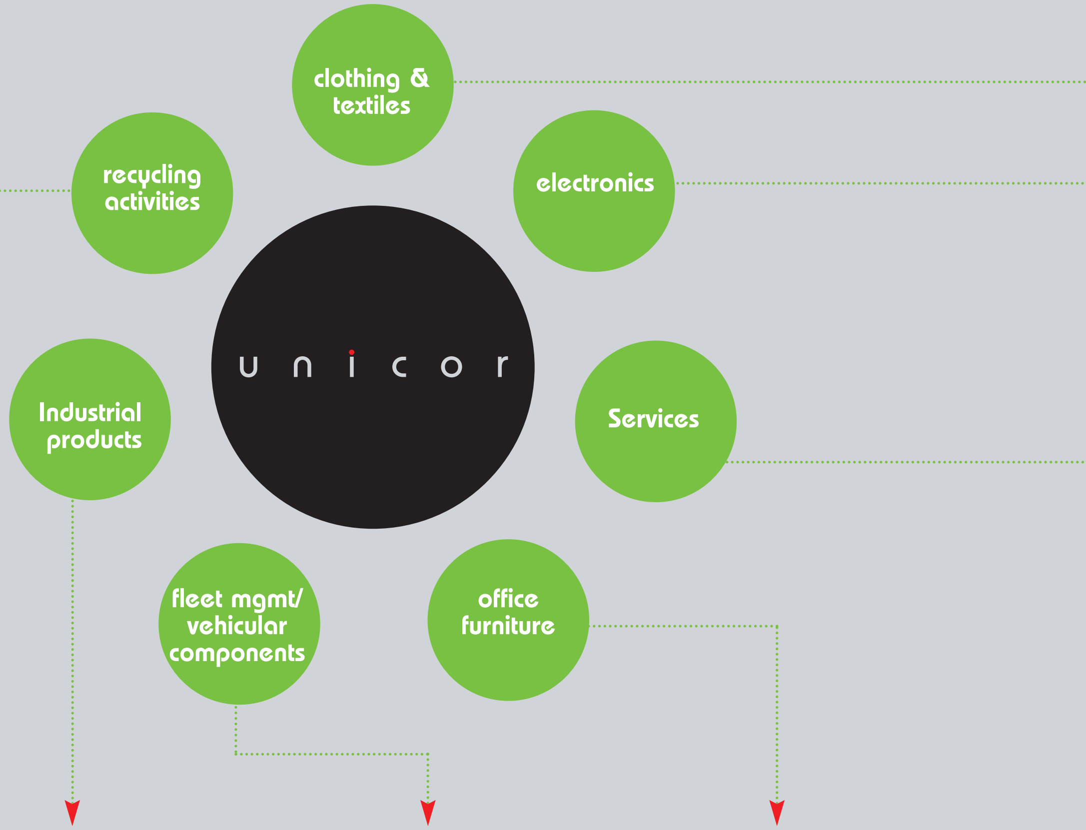
Millions of dollars	2006	2007
Net sales	$717.5	$852.7
Net income	$17.2	$45.8
Sales dollars spent on purchases from private sector	$462.9	$538.9
*Inmates employed	21,205	23,152

FPI Receives Unqualified Audit Opinion

The independent auditing firm of KPMG LLP was retained by the Department of Justice Inspector General Office to review and test FPI's internal accounting and administrative control systems for fiscal year (FY) 2007. The Board is pleased to announce that FPI has received an unqualified audit opinion for its FY 2007 financial statements.

integrity

industrial programs, locations, inmate employment and net



	recycling activities	industrial products	fleet management/ vehicular components	office furniture
	Atwater, CA Elkton, OH Fort Dix, NJ Leavenworth, KS Lewisburg, PA Marianna, FL Texarkana, TX Tucson, AZ	Butner, NC Cumberland, MD El Reno, OK Leavenworth, KS Lewisburg, PA Lompoc, CA Pekin, IL Talladega, AL Terminal Island, CA Texarkana, TX	Bastrop, TX Beaumont, TX Bennettsville, SC Estill, SC Gilmer, WV Herlong, CA La Tuna, TX Terre Haute, IN Three Rivers, TX Victorville, CA	Allenwood, PA Ashland, KY Beckley, WV Coleman, FL Florence, CO Forrest City, AR Milan, MI Schuylkill, PA
inmates employed*	961	1,708	2,396	3,541
net sales**	$11	$32.8	$156.4	$116.0

Some locations have multiple plants.

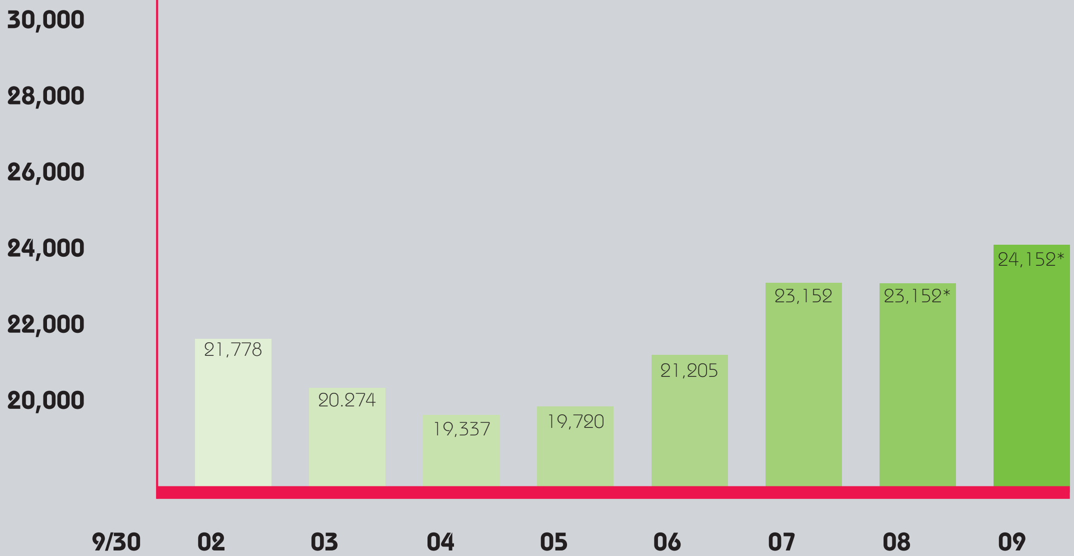
* There are an additional 306 inmates working in Customer Service and Product Support. The total number of inmates who worked for Federal Prison Industries as of September 30, 2007, was 23,152 (this includes 4,514 inmates employed in support positions).

** Dollars in millions

sales as of September 30, 2007

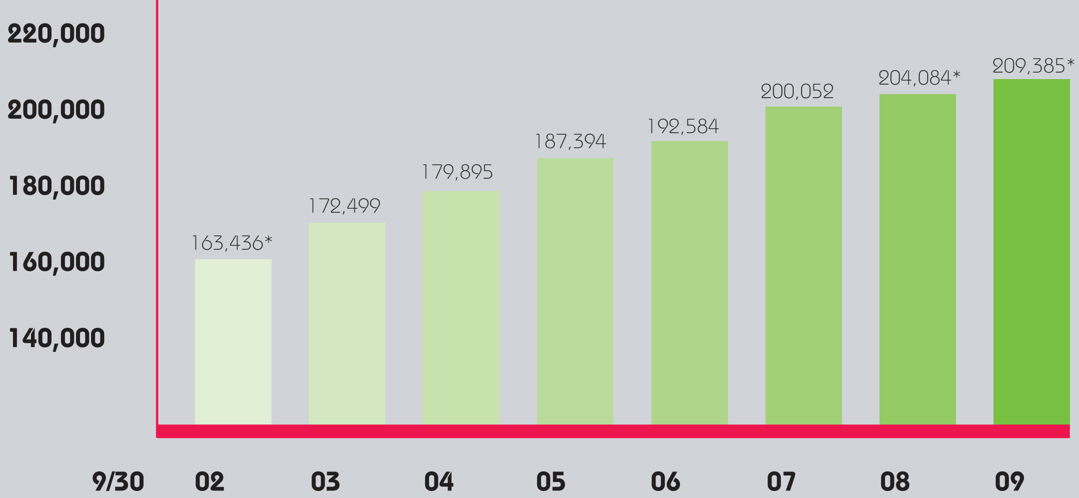
services	electronics	clothing & textiles	
Alderson, WV Bryan, TX Canaan, PA Carswell, TX Dublin, CA Eglin, FL Elkton, OH El Paso, TX Fort Dix, NJ Leavenworth, KS Marianna, FL McCreary, KY Montgomery, AL Morgantown, WV Petersburg, VA Sandstone, MN Sheridan, OR Tallahassee, FL Williamsburg, SC	Beaumont, 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	Atlanta, GA Beaumont, TX Big Sandy, KY Butner, NC Dublin, CA Edgefield, SC Fort Dix, NJ Greenville, IL Hazelton, WV Jesup, GA Leavenworth, KS Lee, VA Manchester, KY Miami, FL Oakdale, LA Pollock, LA Ray Brook, NY Safford, AZ Sandstone, MN Seagoville, TX Terre Haute, IN Waseca, MN Yazoo City, MS	
3,359	3,804	7,077	inmates employed*
$34.8	$326.3	$175.3	net sales**

Annual and Projected Inmate Job Requirements



Total jobs required for FY 2007 through FY 2009 = 8,000
Total institutions to be activated through FY 2009 = 17
*Projected

Annual Inmate Populations and Projections



* Projected

Business Group Milestones

110 factories, more than four million square feet of manufacturing, operations and servicing facilities, as well as its 23,152 inmate workers uniquely position UNICOR to take on the most challenging manufacturing and business solution challenges. Its seven distinct Business Groups are pleased to share some particularly noteworthy milestones from the past Fiscal Year.

Services Business Group

We're resourced!

The 100 millionth call!

Directory assistance calls handled by UNICOR s inmate tele-workers during the year exceeded 100 million. When UNICOR s first commercial call center opened in November, 2003, it employed 23 inmates. Today, UNICOR operates five directory assistance call centers and employs more than 1,600 inmate tele-workers at FPC Alderson, WV; FMC Carswell, TX; and FCIs Dublin, CA; Tallahassee, FL; and Williamsburg, VA.

The 100 millionth catalog!

UNICOR s distribution program processed its 100 millionth catalog since operations began in 2001. Inmates are tasked to glue perfume samples inside catalogs, then package and mail them to customers. In 2001, the program employed 50 inmates. Today, the program operates at FPCs Alderson, WV and Bryan, TX, and the number of inmate workers has grown to more than 350.

Recycling Business Group

We recycle!

60,000 pounds of e-scrap processed through Green-Fed II!

UNICOR and the Arkansas Department of Environmental Quality (ADEQ) launched GREEN-FED II (the continuation of a 12 month pilot program established in 2006) with great success.

ADEQ s mission is to protect, enhance and restore the natural environment for the well-being of Arkansas, and the UNICOR Recycling Business Group is assisting the state fulfill its mission by providing a free, environmentally sound, EPA-compliant e-scrap recycling program to rural and urban Arkansas residents. To date, UNICOR Texarkana, TX has processed 60,000 pounds of e-scrap items through GREEN-FED II.

34,780,000 pounds of material recycled!

During the 2007 Fiscal Year UNICOR s seven recycling factories collectively recycled 34,780,000 pounds of material!

Office Furniture Business Group

We're renewed!

The 100,000th item of furniture sold!

UNICOR has worked diligently over the year to get the word out about its full range of exciting and innovative products specifically geared to today's flexible, high performance and healthy office environments, while providing cost-quality benefits and protecting the environment.

This past year, UNICOR's FEDFAST program, which guarantees shipment within 48 hours of order placement, sold its 100,000th item of furniture!

Fleet Management and Vehicular Components Business Group

We're responsive!

More than 4,300 law enforcement vehicles customized!

In support of Department of Homeland Security components including Border Patrol, ICE, and CBP, UNICOR Fleet factories at FCI Bastrop, TX, FCI LaTuna, TX, and FCI Three Rivers, TX, as well as USP Terre Haute, IN, customized and shipped over 4,300 law enforcement vehicles. They ranged from K-9 units to special detainee transport vehicles such as vans and busses. This relationship provided excellent training and skills development for more than 1,000 inmates!

Industrial Products Group

We're reliable!

1.7 million HVAC filters produced in FY 2007!

Clean air is essential to life and UNICOR's extensive range of filtration options provides the ultimate solution to help maintain clean, quality air, whether for airports, auditoriums, hospitals, maintenance facilities, office buildings, military installations, even spray/paint booths.

Given the Industrial Products Group's competitive pricing, years of experience and reputation for quality, customer demand for UNICOR's filtration production increased 25% over the previous year!

More than $5 million in items and parts produced at a single factory!

UNICOR's Pekin, IL factory had a record year producing a variety of industrial metal parts to meet a number of internal and external customers' needs. One example – "slide-in units" – were produced expressly for the Border Patrol to temporarily house detainees in anticipation of their hearings.

Electronics Business Group

We're recharged!

Historic high achieved!

UNICOR s Electronics Business Group plays a integral role in the supply of electronics and electrical products for the United States military in the U.S. and overseas. Electrical components are also provided for Homeland Security and other federal agencies, as well as for commercial applications. In FY 2007, the Electronics Business Group ranked number one in sales among all seven UNICOR Business Groups.

Clothing and Textiles Business Group

We react!

Ready When Duty Calls!

In light of the military s urgent needs, UNICOR clothing and textiles factories supplied 35,000 mattresses to Iraq in the past year. Approximately 2,000 inmate workers manufactured combat uniforms to support the war effort. Several types of technically-complicated ballistic vest carriers were also designed and, ultimately, worn by the Iraqi military.

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 2007, 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 110 factories located at 79 prison locations that employed 23,152 inmates representing approximately 16% of the total number of inmates housed in BOP facilities as of September 30, 2007. 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 General Services Administration (GSA), and the Social Security Administration (SSA).

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 U.S. generally accepted accounting principles. 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) collectability 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 and sales returns 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 collectability 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, 2007 and September 30, 2006, FPI had established an allowance for bad debt in the amount of $1.29 million and $2.05 million on accounts receivable balances of $69.55 million and $46.09 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 (at least monthly) adjusted to approximate actual cost. FPI has established inventory allowances to account for LCM adjustments and excess and/or obsolete items for costs that 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 all 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. 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

Cash and Investments

FPI s cash and cash equivalents balance as of September 30, 2007 increased by $38.7 million (9.2%) in comparison to September 30, 2006. The significant increase was primarily due to an increase in earnings of $28.5 million and an increase in cash advances of $12.7 million. Other significant factors include a $24.2 million increase in accounts receivable and a $13.3 million increase in accounts payable. These significant changes are a result of the continued surge demand from the DOD for product manufactured by the Electronics Business Group and by the DHS for retro-fitted vehicles by the Fleet Business Group

Accounts Receivable

The Accounts Receivable balance as of September 30, 2007 increased by $24.2 million (55.0%) in comparison to September 30, 2006. As of September 30, 2006, FPI had achieved a record low for outstanding receivables setting an unusually low target for comparison. Fourth quarter 2007 sales revenue exceeded $224 million and September 2007 sales revenues were $76.7 million. The increase in accounts receivable as of September 30, 2007 is reflective of current sales trends and represents an approximate days to collect ratio of 27 in comparison to a days to collect ratio of 26 as of September 30, 2006.

Inventory

Inventory decreased by $6.9 million (3.6%) in fiscal year 2007 compared to fiscal year 2006 and increased $63.0 million (50.4%) in 2006 compared to 2005. While inventories remained stable during 2007, they are reflective of the fiscal year 2006 and current demand for the Electronics and Fleet Business Groups products.

Accounts Payable

Accounts Payable increased $13.3 million (23.4%) in fiscal year 2007 compared to fiscal year 2006. The increase is primarily due to an increase in trade payables maintained in continued support of the Electronics Business Group and in support of an influx of customer orders for the Office Furniture Group during the fourth quarter of fiscal year 2007.

Revenue and Cost of Revenue

Revenue for fiscal year 2007 increased $184 million (23.6%) and cost of revenue increased $159 million (22.8%) compared to fiscal year 2006. The increase in revenue and cost of revenue in fiscal year 2007 is primarily due to the continued increase in the Electronics, Textiles and Fleet Business Groups production in support of ongoing DOD and DHS demand. Due to increased utilization of factory capacities, increase in direct costs were commensurate with the increase in revenues while overhead and general and administrative costs increased by only approximately 5% each.

Business Segments

In fiscal year 2007, 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 industrial income (earnings) at the Business Segment level consist of sales offset by cost of goods sold and under /over applied overhead. FPI s net sales and earnings for the fiscal years ended September 30, 2007 and 2006 for each of its current business segments is presented for comparative purposes:

Business Segment	**Fiscal Year**	
Clothing and Textiles	**2007**	**2006**
Sales	$ 175,271	$ 152,728
Earnings	$24,296	$20,631
Electronics		
Sales	$326,329	$233,182
Earnings	$77,826	$62,743
Fleet Management and Vehicular		
Sales	$156,364	$125,869
Earnings	$1,940	($6,376)
Industrial Products		
Sales	$32,804	$49,591
Earnings	($7,173)	($1,537)
Office Furniture		
Sales	$115,993	$118,179
Earnings	($2,465)	($3,353)
Recycling		
Sales	$11,183	$10,230
Earnings	$1,648	$1,715
Services		
Sales	$34,780	$27,765
Earnings	$714	($2,567)
Corporate Total		
Sales	$ 852,724	$717,544
Earnings	$96,787	$71,256

Liquidity and Capital Resources

FPI s cash provided by operations was $59 million in fiscal year 2007 compared to $67 million in fiscal year 2006. The change is attributable to a decrease in inventories of $7 million, an increase in accounts receivable of $24 million, an increase of $6 million in customer advances received from the Department of Homeland Security, an increase in accounts payable of $16, and an increase in net income of $28 million. Continued demand from the DOD and an increased demand from DHS during fiscal year 2007, were the major contributing factors to the increases in accounts receivable, accounts payable and net income.

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 $11.4 million in fiscal year 2008 toward the replacement or repair of existing building or machinery. In addition, FPI plans to invest $4.6 million in equipment and $12.6 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.

FPI does not receive appropriated funding for operations and must maintain itself through the results of operations. Historically, FPI operates on a very low margin. The margins are much below those of non-governmental corporations of similar size and longevity. 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 Bureau of Prisons (BOP). The growth demands of the BOP are expected to continue for the foreseeable future.

The delicate balancing act between self sufficiency and growth creates sizable challenges for FPI. Additionally, FPI is faced with challenges that may impact this balance. These challenges include proposed changes to FPI s position as a supplier to the Federal Government (mandatory source provided to FPI), substantial increases in costs not controlled by FPI (health benefits, staff pay schedule increases), self-directed and externally imposed changes to the Federal market, and growth needs of the Bureau of Prisons.

FPI continues to meet its mission challenges of maintaining a self-sufficient fiscal position; providing adequate inmate employment levels for the Bureau of Prison s unprecedented growth; and maintaining an aggressive cost containment practice. FPI 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.

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 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 value going forward will require continued vigilance by FPI and BOP management, and support by public policy makers.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Financial Statements

Inspector General
U.S. Department of Justice

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

We have audited the accompanying balance sheet of the U.S. Department of Justice, Federal Prison Industries (FPI) as of September 30, 2007, and the related statement of operations and cumulative results of operation, and cash flows for the year 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 audit. The financial statements of FPI as of September 30, 2006, were audited by other auditors whose report dated October 27, 2006, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the FPI s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides 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 as of September 30, 2007, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP

November 5, 2007

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Compliance and Other Matters

Inspector General
U.S. Department of Justice

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

We have audited the balance sheet of the U.S. Department of Justice, Federal Prison Industries (FPI) as of September 30, 2007, and the related statements of net cost, changes in net position, and statement of budgetary resources (hereinafter referred to as financial statements) for the year then ended, and have issued our report thereon dated November 5, 2007. Our report stated that the financial statements are presented on a basis of accounting other than U.S. generally accepted accounting principles. The financial statements are for the purpose of consolidation into the financial statements of the U.S. Department of Justice. As discussed in Note 16 to the financial statements, FPI changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations in fiscal year 2007.

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. 07-04, Audit Requirements for Federal Financial Statements. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of FPI is responsible for complying with laws, regulations, and contracts applicable to FPI. As part of obtaining reasonable assurance about whether FPI s financial statements are free of material misstatement, we performed tests of FPI s compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including certain provisions referred to in the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to FPI. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph of this report, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported herein under Government Auditing Standards or OMB Bulletin No. 07-04.

Under OMB Bulletin No. 07-04 and FFMIA, we are required to report whether FPI s financial management systems substantially comply with: (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) 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 FFMIA disclosed no instances in which FPI s financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

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

KPMG LLP

November 5, 2007

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Internal Control

Inspector General
U.S. Department of Justice

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

We have audited the balance sheet of the U.S. Department of Justice, Federal Prison Industries (FPI) as of September 30, 2007, and the related statements of net cost, changes in net position, and statement of budgetary resources (hereinafter referred to as financial statements) for the year then ended, and have issued our report thereon dated November 5, 2007. Our report stated that the financial statements are presented on a basis of accounting other than U.S. generally accepted accounting principles. The financial statements are for the purpose of consolidation into the financial statements of the U.S. Department of Justice. As discussed in Note 16 to the financial statements, FPI changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations in fiscal year 2007.

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. 07-04, Audit Requirements for Federal Financial Statements. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of FPI is responsible for establishing and maintaining effective internal control. In planning and performing our fiscal year 2007 audit, we considered FPI s internal control over financial reporting by obtaining an understanding of FPI s internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in Government Auditing Standards and OMB Bulletin No. 07-04. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers Financial Integrity Act of 1982. The objective of our audit was not to express an opinion on the effectiveness of FPI s internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of FPI s internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph of this section and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects FPI s ability to initiate, authorize, record, process, or report financial data reliably in accordance with the basis of accounting described in Note 1 to the financial statements such that there is more than a remote likelihood that a misstatement of FPI s financial statements that is more than inconsequential will not be prevented or detected by FPI s internal control over financial reporting. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by FPI s internal control over financial reporting.

In our fiscal year 2007 audit, we consider the control deficiency, described in Exhibit I to be a significant deficiency in internal control over financial reporting. However, we believe that the significant deficiency described in Exhibit I is not a material weakness.

INTERNAL CONTROL OVER PERFORMANCE MEASURES

As required by OMB Bulletin No. 07-04 in our fiscal year 2007 audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management s Discussion and Analysis section, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether these internal controls had been placed in operation. We limited our testing to those controls necessary to report deficiencies in the design of internal control over key performance measures in accordance with OMB Bulletin No. 07-04. However, our procedures were not designed to provide an opinion on internal control over reported performance measures and, accordingly, we do not provide an opinion thereon. In our fiscal year 2007 audit, we noted no deficiencies involving the design of the internal control over the existence and completeness assertions related to key performance measures.

FPI s responses to the findings identified in our audit are presented in the Exhibit I. We did not audit FPI s response and, accordingly, we express no opinion on it.

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

KPMG LLP

November 5, 2007

EXHIBIT I

SIGNIFICANT DEFICIENCY

Improvements are Needed in the FPI s Financial Management Systems General Controls

During the fiscal year 2007 financial statement audit, we evaluated the general control environment and selected application controls. General controls are the structure, policies, and procedures that apply to FPI s overall computer operations. Application controls are the structure, policies, and procedures that apply to the FPI s separate application systems. The evaluation was performed using the U.S. Government Accountability Office s (GAO) *Federal Information System Controls Audit Manual* (FISCAM) and National Institute of Standards and Technology (NIST), Special Publication (SP) 800-53, *Recommended Security Controls for Federal Information Systems*, and as established by OMB Circular A-130, *Management of Federal Information Resources*.

We noted weaknesses in the following FISCAM general control areas: Logical Access Controls, Change Controls, and System Software.

Logical Access Controls Need Improvement

Enhance and Adhere to Network Access Removal Policies

Windows Active Directory lacks the capability to synchronize FPI s multiple domains and servers to ensure inactive user accounts are tracked in a centralized report. We identified two (2) General Support System (GSS) users with access at the time of testing and noted that FPI is not able to track inactive network accounts across multiple domains and servers. However, we noted no instances where separated FPI personnel or released inmates appeared to have Millennium access.

DOJ Information Technology Security (ITS) Standard — Access Control (AC) Control Family, Version 2.1, states: AC-02.05-01, Accounts for recently separated or terminated employees and for recently departed contractors have been locked, disabled, or deleted according to established procedures; including verifying that any organization-required documentation was completed.

FPI Network Access Control Procedures Section 9.0, *Access Monitoring* states, "Network access accounts are monitored by the System Administrators (SAs) routinely every thirty days. Accounts are scanned for recent activity. Any account that has not been accessed for thirty days will be placed on a list for deletion and the user’s supervisor will be contacted to determine the continuing need for the access. Network access activity will be routinely monitored to detect signs of possible intrusion or malicious intent. Internal, unannounced audits will be conducted semi-annually under the authority of the ISO and the CIO. Application account audits will be conducted on at least a yearly basis."

Weak controls for removing and monitoring inactive employee and contractor access to FPI’s information systems increase the risk of unauthorized access and may compromise or adversely affect the integrity and security of financially significant systems and data.

We recommend that FPI:

1. Monitor all separated user s IS accounts to ensure they are locked, disabled, or deleted from the system in accordance with FPI policy. *(New)*

Management Response:
FPI concurs with the recommendation.

2. Develop, implement, and monitor procedures for tracking inactive accounts. (New)

Management Response:
FPI concurs with the recommendation.

Weaknesses in Reviewing Audit Logs

NetPro application has been implemented to maintain audit logs of access/security violations on the FPI network. However, FPI has not implemented policies and procedures to review the security audit logs that contain the network administrator's account management activities. In addition, FPI Management stated that SAP Millennium security logs are reviewed, but evidence of the reviews is not documented or maintained consistently.

DOJ ITS Standard, Audit Accountability (AU) Control Family, version 2.0, control number AU-02 Auditable Events states: The information system generates audit records for specific events (for example, account logon events, account management events, directory service access events, object access failures, policy change failures, privilege use failures, and system events).

DOJ ITS Standard, AU Control Family, version 2.0, control number AU-06 Audit Monitoring, Analysis, and Reporting states: The organization regularly reviews/analyzes audit records for indications of inappropriate or unusual activity, investigates suspicious activity or suspected violations, reports findings to appropriate officials, and takes necessary actions.

Without reviewing security audit logs, there is increased risk that FPI management may not be able to identify access violations in a timely manner. Without independent reviews of account management activities performed by administrators, there is increased risk that FPI management may not be able to identify inappropriate account management activities in a timely manner.

We recommend that FPI:

3. Implement policies and procedures to review the SAP Millennium and General Support System (Active Directory) security audit logs, including the documentation and review of FPI network administrator's account management activities. *(New)*

Management Response:
FPI concurs with the recommendation.

Change Controls Need Improvement

Adhere to System Development Life Cycle Methodology

Division chiefs do not consistently follow the finalized and approved system development life cycle (SDLC) methodology for infrastructure changes. We tested all Implemented or Closed TrackRecord changes for Infrastructure and ERP Systems (SAP operational and SAP nonoperational changes) that were created during FY 2007 and determined that:

- ¥ 8 of 23 changes did not have either the approval documented on the TrackRecord change tickets or a separate email approval, and
- ¥ 7 of 23 changes did not have any evidence testing was performed.

Additionally, upon inquiry of the Information Security Officer (ISO), we determined that System Support Staff test security updates and patches before they are approved for installation in Window Server Update Services; however, testing results for the patches are still not formally documented.

DOJ ITS Standard — Configuration Management (CM) Control Family, Version 1.0, states: CM-03.01-01, The component documents and controls changes to the information system. Appropriate component officials approve information system changes in accordance with component policies and procedures. The component assigns responsibility to specific parties and defines specific actions to ensure that configuration change control is implemented. The change control process involves the systematic proposal, justification, implementation, test/evaluation, review, and disposition of changes to the information system, including upgrades and modifications. The component includes emergency changes in the configuration change control process, including changes resulting from the remediation of flaws. The approvals to implement a change to the information system include successful results from a security analysis of the change.

NIST Federal Information Processing Standards Publication (FIPS PUB) 106: Guidelines on Software Maintenance states that: "The key to controlling changes to a system is the centralization of change approval and the formal requesting of changes."

Inadequate or inconsistently deployed development and implementation controls can lead to wasted resources (time, money, and staffing), unauthorized changes, and failure to meet business needs, as well as contributing to system security weaknesses.

We recommend that FPI:

4. Perform Infrastructure and ERP System changes in accordance with FPI and DOJ policies, including the appropriate approvals and documented testing evidence. *(New)*

Management Response:

FPI concurs with the recommendation.

System Software Needs Improvement

Default configuration settings within FPI s general and application environment

FPI management has not fully implemented policies and procedures and taken the appropriate actions to detect and prevent installation of systems with default configurations. Several instances of default installations of HP Insight Management console on the FPI General Support System (GSS) and the SAP application were identified. These systems had the default password of administrator . Hot Standby Router Protocol (HSRP) on Cisco routers with authentication data set at default settings was identified. Several passwords that did not meet the DOJ Information Technology Security Staff (ITSS) complexity rules or were configured with default settings were identified.

In addition, FPI has data traversing across the network un-encrypted.

DOJ ITS Standard — Configuration Management (CM) Control Family, Version 1.0, states: CM- 07.01-01, Prohibited or restricted functions, ports, protocols, and/or service are disabled or deactivated.

DOJ ITS Standard — Identification and Authentication (IA) Control Family, Version 2.0, states: IA-05.02-51, The password policies require that all passwords be at least eight characters in length.

DOJ ITS Standard also states, :IA-05.02-52, The password policies require that the passwords be composed of representatives of at least three of the following character sets: upper case characters, lower case letters, numeric characters, and special characters (for example: ~ ! @ # $ % ^ & * () _ + = - ' [ ] / ? > <).

By not changing the default passwords and configurations of software, there is an increased risk of unauthorized users accessing the configurations files, compromising the financial data, bypassing access controls without detection, and potentially affecting the availability, integrity, and confidentiality of the information passing through the network.

We recommend that FPI:

5. Implement policies and procedures to periodically scan the IS environment for default configurations and default passwords, make the appropriate changes, and update the applicable baseline configurations and documentation. (New)

Management Response:
FPI concurs with the recommendation.

6. Use a Secure Sockets Layer (SSL) wrapper to encrypt unsecured protocol (FTP, etc.) transmissions. (New)

Management Response:
FPI concurs with the recommendation.

integrity

Federal Prison Industries, Inc.
Balance Sheets

September 30, ***(Dollars in Thousands)***	**2007**	**2006**
Assets		
Current:		
Cash and cash equivalents	$ 417,090	$ 378,373
Accounts receivable, net	68,261	44,039
Inventories, net	181,223	188,088
Other assets	2,016	1,176
Total current assets	668,590	611,676
Property, plant and equipment, net	129,730	119,100
Total Assets	$ 798,320	$ 730,776

Liabilities and United States Government Equity

Current:		
Accounts payable	$ 70,450	$ 57,101
Deferred revenue	186,781	180,765
Accrued salaries and wages	10,412	9,177
Accrued annual leave	9,805	9,161
Note payable to United States Treasury	20,000	-
Other accrued expenses	9,495	9,533
Total current liabilities	306,943	265,737
FECA actuarial liability	10,465	9,916
Note payable to United States Treasury	-	20,000
Total Liabilities	317,408	295,653
United States Government Equity		
Initial capital	4,176	4,176
Cumulative results of operations	476,736	430,947
Total United States Government Equity	480,912	435,123
Total Liabilities and United States Government Equity	$ 798,320	$ 730,776

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)*	**2007**	**2006**
Revenue:		
Net sales	$ 852,724	$ 717,544
Other revenue	105,054	56,283
Total revenue	957,778	773,827
Cost of revenue:		
Cost of sales	748,615	637,551
Cost of other revenue	109,290	61,139
Total Cost of Revenue	857,905	698,690
Gross profit	99,873	75,137
Operating expenses:		
Sales and marketing	4,920	5,563
General and administrative	103,710	103,355
Total operating expenses	108,630	108,918
Income (loss) from operations	(8,757)	(33,781)
Interest income	17,849	15,083
Interest expense	(24)	(24)
Other income, net	36,721	35,959
Net income	45,789	17,237
Cumulative results of operations, beginning of fiscal year	430,947	413,710
Cumulative results of operations, end of fiscal year	$ 476,736	$ 430,947

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)***	**2007**	**2006**
Cash Flows From Operating Activities		
Net income	$ 45,789	$ 17,237
Adjustments to reconcile net income to net cash		
provided by operating activities:		
Depreciation and amortization	9,382	9,553
Loss on disposal of property, plant and equipment	128	1,626
Changes in:		
Accounts receivable	(24,222)	10,116
Inventories	6,865	(63,022)
Other assets	(841)	653
Accounts payable and accrued expenses	15,739	15,419
Deferred revenue	6,016	75,215
Net cash provided by operating activities	58,856	66,797
Cash Flows From Investing Activities		
Purchases of property, plant and equipment	(11,632)	(10,619)
Construction-in-progress of plant facilities	(8,507)	(11,796)
Net cash used in investing activities	(20,139)	(22,415)
Net (decrease) increase in cash	38,717	44,382
Cash and cash equivalents, beginning of fiscal year	378,373	333,991
Cash and cash equivalents, end of fiscal year	$ 417,090	$ 378,373

The accompanying notes are an integral part of these financial statements

Fiscal Year 2007
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 110 and 108 factories located at 79 and 79 prison facilities that employed 23,152 and 21,205 inmates representing approximately 16% and 15% of the total number of inmates housed in these BOP facilities as of September 30, 2007 and September 30, 2006, respectively.

Note 2
Summary of Significant Accounting Policies

Basis of Presentation

FPI has historically prepared its external financial statements in conformity with U.S. generally accepted accounting principles 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 allows certain government agencies, which FPI management believes would include FPI, to utilize FASB standards for Financial Statement presentations.

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, 2007 and September 30, 2006. 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 the fiscal years ended September 30, 2007 and 2006 was $46,850 and $25,063 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, 2007 and 2006, FPI s allowance for doubtful accounts is stated at approximately $1,293 and $2,052, respectively, of which approximately $1,164 and $1,847, 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 (at least monthly) 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 and sales returns are recognized at the time that they become evident.

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

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

Deferred revenue is comprised of customer cash advances, which have been paid to FPI prior to the manufacturing of goods, delivery of goods, or performance of services.
Other income is comprised primarily of imputed financing for retirement, health benefits and life insurance (Note 9).

Property, Plant and Equipment

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

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

Upon retirement or disposition of property and equipment, the related gain or loss is reflected in the statements 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,	**2007**	**2006**
Intragovernmental billed receivables	$ 56,194	$ 35,685
Private sector billed receivables	13,360	10,406
	69,554	46,091
Less allowance for doubtful accounts	1,293	2,052
Accounts receivable, net	$ 68,261	$ 44,039

Included in bad debt expense are $1,302 and $1,297, respectively, for the fiscal years ended September 30, 2007 and 2006.

Note 4

Inventories, Net

Inventories, net consist of the following:

As of September 30,	**2007**	**2006**
Raw materials	$ 44,071	$ 56,878
Raw materials — vehicles	42,577	30,831
Work-in-process	43,598	39,497
Finished sub-assemblies	9,463	7,905
Finished goods	34,692	50,130
Finished goods — acceptance contracts	18,764	15,937
	193,165	201,178
Less inventory allowance	11,942	13,090
Inventories, net	$ 181,223	$ 188,088

$42,577 of FPI s fiscal year 2007 and $30,831 of FPI s fiscal year 2006, 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 contracted 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.

$18,764 of FPI s fiscal year 2007 and $15,937 of FPI s fiscal year 2006 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. Included in the balances as of September 30, 2007 and 2006, respectively are $10,954 and $9,665 for systems furniture installations in progress and $6,516 and $3,993 for destination acceptance contracts shipped after the cutoff for revenue recognition.

Note 5

Property, Plant and Equipment, Net

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

As of September 30,	**2007**	**2006**
Machinery and equipment	$ 112,525	$ 107,142
Computer hardware	4,161	3,728
Computer software	8,595	5,965
Buildings and improvements	172,462	165,786
	297,743	282,621
Less accumulated depreciation	184,612	175,920
	113,131	106,701
Factory construction-in-progress	16,599	12,399
Property, plant and equipment, net	$ 129,730	$ 119,100

Depreciation and amortization expense approximated $9,382 and $9,553 for the fiscal years ended September 30, 2007 and 2006, respectively.

As of September 30, 2007, 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 $28,695 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,	**2007**	**2006**
Materials in transit	$ 102	$ 1,893
Permanent change of station	1,785	3,469
FECA liabilities — current portion	1,221	1,177
Financial audit expense	440	697
Utilities	373	929
Warranty expense	453	427
Gain sharing accrual	450	-
Other expense	4,671	941
Other accrued expenses	$ 9,495	$ 9,533

Included in other expense as of September 30, 2007 are accruals for Intra-Departmental agreements of $995 and accruals for vendor invoices of $2,009.

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, 2007 and 2006.

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, 2007 and 2006 for each of its business segments is presented for comparative purposes:

Net Sales

For the years ended September 30,	**2007**	**2006**
Business Segment		
Clothing and Textiles	$ 175,271	$ 152,728
Electronics	326,329	233,182
Fleet Management and Vehicular	156,364	125,869
Industrial Products	32,804	49,591
Office Furniture	115,993	118,179
Recycling	11,183	10,230
Services	34,780	27,765
Net sales	$ 852,724	$ 717,544

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 years ended September 30, 2007 and 2006, respectively.

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, 2007 and September 30, 2006, the accrued FECA liabilities as charged to FPI, approximated $1,221 and $1,178, 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 $10,465 and $9,916 at September 30, 2007 and 2006, 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 years ended September 30, 2007 and September 30, 2006. FPI contributed (for hazardous retirement) 23.8 percent for fiscal years ended September 30 2007 and September 30, 2006 (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 $15,500 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 approximated $29,062 and $26,881 for the fiscal years ended September 30, 2007 and 2006, respectively.

In addition, based upon requirements of Statement of Federal Financial Accounting Standard No. 5 (SFFAS No. 5), FPI must recognize its share of the cost of providing pension benefits to eligible employees utilizing cost factors determined by the OPM. Included in general and administrative expense is approximately $1,528 and $1,728 in the fiscal years ended September 30, 2007 and 2006, respectively, with an offsetting credit to imputed financing sources.

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 $9,926 and $9,269 for the fiscal years ended September 30, 2007 and 2006, 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 $7,992 and $7,149 during the fiscal years ended September 30, 2007 and 2006, 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,	**2007**	**2006**
Salaries, wages and benefits	$ 41,940	$ 39,999
Permanent change of station expense	1,969	5,614
Purchases of minor equipment	1,894	2,006
Contract services	9,565	9,181
Bad debt expense	(87)	98
Credit card services	1,005	1,153
Travel	2,502	2,590
Customer Goodwill	6,402	3,482
Personal Computer Expense	2,073	1,718
Depreciation	1,260	1,240
Gain on disposition of assets	(75)	-
Loss on Disposition of Assets	128	1,626
Other Expense	5,526	5,511
Imputed pension costs (Note 9)	1,528	1,728
Imputed post-retirement health care and life insurance cost (Note 9)	7,992	7,149
Imputed Operating Costs	25,008	25,823
Selling, general and administrative expenses	$ 108,630	$ 108,918

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 and management, 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 2008, $248, fiscal year 2009, $27, and fiscal year 2010, $10. Operating lease expense approximated $364 and $309 for the fiscal years ended September 30, 2007 and 2006, respectively.

Product Warranty

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

Changes in aggregate product warranty liability

Fiscal years ended September 30,	**2007**	**2006**
Balance at the beginning of the period	$ 427	$ 452
Accruals for warranties issued during the period	282	476
Settlements made (in cash or in kind) during the period	(256)	(501)
Balance at the end of the period	453	427

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

Fiscal years end September 30,	**2007**	**2006**
Congressional limitation on expenses	$ 2,477	$ 3,322
Expenses incurred subject to Congressional limitation	$ 2,241	$ 1,420

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