unicor

We're life changing.

# FEDERAL PRISON INDUSTRIES, INC.

## Fiscal Year 2012
## Annual Management Report
## November 15, 2012

We are pleased to present the Fiscal Year 2012 Annual Management Report to the Congress of the United States. This report includes the Federal Prison Industries, Inc.'s (FPI's) financial statements, Management's Discussion and Analysis, Office of the Inspector General Commentary and Summary, and the independent auditors' reports on the corporation's financial statements, internal controls, compliance and other matters. FPI received an unqualified audit opinion on its financial statements and they were free of material weaknesses.

FPI was established by statute and Executive Order in 1934, to provide opportunities for educational and work-related experiences to federal inmates. FPI's mission is to protect society and reduce crime by preparing inmates for successful reentry through job training.

FPI is the Bureau of Prisons' (BOP's) most important reentry program, currently providing valuable job skills training and work experience to approximately 13,000 federal inmates. FPI directly supports the BOP's correctional mission by keeping inmates productively occupied and by enhancing the likelihood of their successful reentry into society. Inmates who participate in the FPI program are less likely to engage in disruptive behavior, a benefit which contributes significantly to the safe and secure management of prisons, thereby reducing operating costs. Additionally, inmates participating in the FPI program are 24% less likely to return to a life of crime, resulting in reduced future enforcement and incarceration costs.

FPI is a program with proven lasting benefits, including a reduction in government spending on crime prevention and prosecutions; a positive impact on the U.S. economy through purchases of raw materials from private-sector suppliers throughout the country; and the staff salaries spent in the communities with a FPI presence. This is achieved, without an additional burden to the taxpayer.

As a self-sustaining federal government corporation, FPI utilizes the funds generated by the sales of goods and services to fund this significant re-entry program. However, the FPI program has been greatly impacted by several factors, including the challenging economic times; increased competition for government business; reduced discretionary spending by government agencies; and legislation affecting FPI's status. As a result, in recent years, FPI's business and consequently the program has incurred substantial losses and inmate employment levels have dropped precipitously. FPI continues to seek to minimize its losses and more narrowly tailor its operations to meet customer requirements.

During fiscal year 2012, FPI received legislative authority to participate in the Prison Industries Enhancement Certification Program (PIECP) and to manufacture products that would otherwise be produced outside of the United States, as approved by FPI's Board of Directors. With the passage of these authorities, FPI's Board has approved 14 pilot programs for repatriated products. FPI anticipates these pilot projects will assist in further reducing its losses.

As demonstrated throughout FPI's 78 years of existence, The Board of Directors, senior management, and staff will continue to respond to challenges and focus on improving the overall performance of the corporation. FPI appreciates the outstanding contributions and dedication of its staff as well as the exceptional leadership provided by its Board of Directors during these challenging times.

Charles E. Samuels, Jr.
Chief Executive Officer

Mary M. Mitchell
Chief Operating Officer

# U.S. Department of Justice
# Federal Prison Industries, Inc.
# Management's Discussion and Analysis
# (Unaudited)

## Mission

It is the mission of Federal Prison Industries, Inc. (FPI) to protect society and reduce crime by preparing inmates for successful reentry through job training.

## 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 penal and 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. General management of FPI is provided by the Chief Operating Officer who also serves as an Assistant Director for the BOP.

In fiscal year 2012, FPI operated in six business segments: Clothing and Textiles, Electronics, Fleet and Industrial Products, Office Furniture, Recycling, and Services. FPI has industrial and service operations at 81 factories located at 63 prison facilities representing approximately 8% of the work eligible inmate population as of September 30, 2012. 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. Some products and all services are provided on a non-mandatory, preferred source basis.

FPI processes primarily all customer orders and invoicing through a centralized customer service and accounts receivable center at Lexington, Kentucky. Vendor payments are processed at a centralized accounts payable center at the Butner, North Carolina facility.

## 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.

FPI sells products and services to 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 financial statements, which have been prepared in accordance 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. 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. Sales returns are primarily replaced with like items and are recorded as they occur.

Revenue is recognized on multiple element (numerous stages of product delivery, set up, and installation) 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.

**Allowance for doubtful accounts receivable:** The allowance for doubtful accounts is based upon an analysis of several factors including payment trends, historical write off experience, credit quality for non-governmental 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. As part of their analysis, customer accounts determined to be unlikely to be paid are recorded as a charge to bad debt expense in the income statement and the allowance account is increased. When it becomes certain that a customer account will not be paid, the receivable is written off by removing the balance from accounts receivable.

As of September 30, 2012 and September 30, 2011, FPI had established an allowance for bad debt in the amount of $.52 million and $.66 million on accounts receivable balances of $26.66 million and

$47.34 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.

Raw material inventory value is based upon moving average cost. Inventories are valued at the lower of average cost or market value (LCM) and include materials, labor and manufacturing overhead. Market value is calculated on the basis of the contractual or anticipated selling price, less allowance for administrative expenses. FPI values its finished goods and sub-assembly items at a standard cost that is periodically adjusted to approximate actual cost. FPI has established inventory allowances to account for LCM adjustments and obsolete items that may not be utilized in future periods.

## Program Values

It is FPI's vision to protect society, reduce crime, aid in the security of the nation's prisons and decrease taxpayer burden, by assisting inmates with developing vital skills necessary for successful re-entry to society. Through the production of market-priced quality goods and services, FPI provides job training and work opportunities to inmates, while minimizing impact on private industry and labor.

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

FPI has existed as an effective correctional program for 78 years. Over the course of these years, FPI has positively impacted countless staff and inmate lives. 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. FPI work and education programs provide meaningful activities for inmates, thereby playing an essential role in the operation of safe, secure and less costly prisons.

At the same time, FPI provides opportunities for inmates who want to take the personal responsibility for rehabilitating themselves. More than 95 percent of inmates eventually will be returned to society; industrial and educational programs can help them to steer clear of criminal activity after release. Participation in FPI programs 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 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.

## Analysis of Financial Statements

### Cash and Investments

Cash and Cash Equivalents increased $9.0 million during the year. A $20.5 million reduction in Accounts Receivable along with successful cost containment measures resulted in an increase in FPI (non-advance) cash of $31.1 million during fiscal year 2012. A reduction in Inventories of $4.7 million also positively affected the cash balance in fiscal year 2012. These positive impacts were offset by a decrease in Cash Advances of $22.1 million. FPI's cash advances are primarily for the purchase of inventory in support of the Fleet and Industrial Products vehicle retrofitting operation. The primary customer for these operations is the Department of Homeland Security; advances fluctuate throughout the year as they receive appropriations.

### Accounts Receivable

The Accounts Receivable balance decreased $20.5 million during fiscal year 2012. The Accounts Receivable balance of $26.1 million as of September 30, 2012, represents 57.9 percent of September's total revenues. FPI's average days to collect for fiscal year 2012 were approximately 27. The Accounts Receivable balance over sixty days old represented only 4.5 percent of the total balance as of September 30, 2012. Decreases in Accounts Receivable are related to a reduction in sales and increased collection efforts.

### Inventory

Inventory decreased by $4.7 million during fiscal year 2012. FPI continued to place an increased emphasis on inventory reduction during fiscal year 2012. The Electronics and Office Furniture business segments were the primary contributors to the reduction with decreases of $7.2 and $11.1 respectively. The Electronics segment decrease can be attributed to the decrease in solar panel and cable product group inventories totaling $2.3 million and $4.6 million respectively. The decrease in Office Furniture business segment can be attributed to a decrease of $7.2 million in Finished Goods at Customer as of September 30, 2012, compared to September 30, 2011. Offsetting increases resulted for Fleet and Industrial Products and Clothing and Textiles business segments. The increases for the Fleet and Industrial Products business group can be attributed to the cyclical nature of the Retrofit product line. Increases for Clothing and Textiles are due to significantly increased backlog in the fourth quarter.

## Liabilities

Total Liabilities decreased $4.8 million during fiscal year 2012 as a result of an Advances Payable decrease of $4.8 million. This decrease is attributable to a change in customer advances payable on hand as a result of a decrease in customer contracts.

## Revenue, Cost of Revenue and Net Loss

Total Revenue decreased by $201.9 million while total cost of revenue decreased by $175.4 million. The decrease in revenue resulted primarily from the decrease in sales revenue of $139.3 million, a reduction in corresponding freight collections of $9.7 million, a decrease in service revenue generated by way of the Economy Act of $13 million, and sales of raw material solar cells during fiscal year 2011 totaling $32.7 million for which no comparable activity occurred during fiscal year 2012. The largest business segments showing a decrease in sales were Fleet and Industrial Products with $94.6 million, Clothing and Textiles with $24.1 million, Office Furniture with $13.4 million, and Electronics with $8.6 million. The Recycling and Services business segments had modest offsetting increases of $0.3 million and $1.1 million in sales respectively. Despite capacity reductions and cost containment efforts, FPI's gross profit percentage decreased from 7.7% in fiscal year 2011 to 6.2% in fiscal year 2012 as the result of underutilized capacity in the electronics and Fleet and Industrial Products business segments. The Net Loss increased $26.4 million in fiscal year 2012 compared to fiscal year 2011. Factory Earnings were $30.3 million lower in fiscal year 2012 than the previous fiscal year.

## Business Segments

In fiscal year 2012, FPI's businesses were organized, managed and internally reported as six operating segments based on products and services. These segments are Clothing and Textiles; Electronics; Fleet and 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 consists 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, 2012 and 2011 for each of its current business segments is presented for comparative purposes:

| Business Segment | Fiscal Year | |
|---|---|---|
| **Clothing and Textiles** | **2012** | **2011** |
| Sales | $214,522 | $238,631 |
| Earnings | $20,642 | $34,035 |
| **Electronics** | | |
| Sales | $67,865 | $76,443 |
| Earnings | ($7,384) | ($7,391) |
| **Fleet and Industrial Products** | | |
| Sales | $138,551 | $233,144 |
| Earnings | $1,553 | $21,116 |
| **Office Furniture** | | |
| Sales | $142,371 | $155,819 |
| Earnings | $9,648 | $11,141 |
| **Recycling** | | |
| Sales | $15,563 | $15,276 |
| Earnings | $4,764 | $4,555 |
| **Services** | | |
| Sales | $27,242 | $26,110 |
| Earnings | $2,490 | ($1,447) |
| **Corporate Total** | | |
| Sales | $606,114 | $745,423 |
| Earnings | $31,713 | $62,009 |

FPI redefined its business segments from seven categories to six in fiscal year 2012. The Fleet Management and Vehicular Components and Industrial Products business segments were consolidated. As a result, net sales and earnings for fiscal year 2011 for Fleet Management and Vehicular Components and Industrial Products have been combined for comparative purposes.

**Possible Future Effects of Existing Events and Conditions**

As reported in fiscal years 2009 through 2011, FPI continues to face the negative impact of economic and legislative forces. In fiscal years 2013 and beyond, FPI faces the additional challenge of the shrinking federal budget, the resulting decline in discretionary spending and the ultimate impact of a decline in FPI sales. FPI continues to address these external challenges through aggressively pursuing new customers and new products, involvement in legislative initiatives, cost reductions, and strict measures to control cash.

During FY 2012, FPI encountered a decline in sales for the third consecutive year and experienced a net loss for the fourth consecutive year. FPI's net loss of $28.3 million during FY 2012 included $7.3 million in losses due to Property, Plant and Equipment (PP&E) write-offs related to capacity reductions announced in prior years. If the referenced PP&E losses were to be factored out, FPI net losses during FY 2012 would have been $21.0 million. In addition to capacity and overhead reductions, FPI continued to focus efforts towards maintaining minimal inventory on hand, collections of receivables and maintaining capital improvements at a minimum. Through its leaning efforts, FPI was able to increase its non-advance cash by $31.1 million.

The Consolidated and Further Continuing Appropriations Act of 2012 (P.L. 112-55) authorized FPI to participate in the Prison Industries Enhancement Certification Program (PIECP) and to manufacture products that would otherwise be produced outside of the United States, as approved by FPI's Board of Directors. Additionally, during FY 2012, FPI has placed renewed emphasis on the use of job sharing and half time inmate workers. This will allow for an increase in the number of inmates participating in the FPI program while reducing the per-inmate cost of employment.

As with any government entity, civilian salaries and benefits continue to be a significant portion of FPI’s overhead costs. In addition to the completion of the capacity reductions during FY 2012, FPI reduced staffing through attrition primarily in the Central Office. Included in the losses during the first three quarters of the year are salaries for staff that are no longer on the rolls or have fulfilled other vacated positions in the organization. Due to the finalization of all previously announced capacity reductions, FPI’s salary base leveled off during the fourth quarter of FY 2012. The combined effect of all staffing reductions resulted in a decline of $9.1 million in FPI’s salary base during FY 2012 which will provide a savings (including benefits) of approximately $13 million per year in future years. Additionally, in August 2012, FPI announced the realignment of its Central Office team to operate more efficiently in support of FPI’s current business environment. The realignment resulted in the reduction of six business segments to five while creating a new group whose primary purpose is to pursue new business opportunities in all product and service areas including repatriation and PIECP.

FPI projects a significant decline in sales for FY 2013 and will continue to take a proactive approach toward minimizing losses and operating at a level that is commensurate with its current sales load.

In December 2009, the Department of Justice, Office of the Inspector General, initiated an investigation regarding the manufacturing and quality procedures for some of the military helmets produced by FPI. This investigation is still ongoing. FPI has terminated production of helmets. FPI’s management is committed to ensuring FPI produces a quality product that meets the requirements of our customers.

# FEDERAL PRISON INDUSTRIES, INC.
# ANNUAL FINANCIAL STATEMENTS
# FISCAL YEAR 2012

## OFFICE OF THE INSPECTOR GENERAL
## COMMENTARY AND SUMMARY

This audit report contains the Annual Financial Statements of the Federal Prison Industries, Inc. (FPI) for the fiscal years (FY) ended September 30, 2012, and September 30, 2011. In accordance with the Government Corporation Control Act, as amended (31 U.S.C. §9105), and under the direction of the Office of the Inspector General (OIG), Cotton & Company LLP performed the FPI's audit in accordance with auditing standards generally accepted in the United States of America. The audit resulted in an unqualified opinion on the FY 2012 financial statements. An unqualified opinion means that the financial statements present fairly, in all material respects, the financial position and the results of the entity's operations in conformity with U.S. generally accepted accounting principles. For FY 2011, the FPI also received an unqualified opinion on its financial statements (OIG Report No. 12-06).

Cotton & Company LLP also issued Reports on Internal Control over Financial Reporting and on Compliance and Other Matters. For FY 2012, the auditors did not identify any significant deficiencies in the *Independent Auditors' Report on Internal Control over Financial Reporting*.

No instances of non-compliance or other matters that are required to be reported under *Government Auditing Standards* were identified during the audit in the FY 2012 *Independent Auditors' Report on Compliance and Other Matters*. Additionally, Cotton & Company LLP's tests disclosed no instances in which the FPI's financial management systems did not substantially comply with the *Federal Financial Management Improvement Act of 1996*.

The OIG reviewed Cotton & Company LLP's reports and related documentation and made necessary inquiries of its representatives. Our review, as differentiated from an audit in accordance with *Government Auditing Standards*, was not intended to enable us to express, and we do not express, an opinion on the FPI's financial statements, conclusions about the effectiveness of internal control, conclusions on whether the FPI's financial management systems substantially complied with the *Federal Financial Management Improvement Act of 1996*, or conclusions on compliance with laws and regulations. Cotton & Company LLP is responsible for the attached auditors' reports dated November 5, 2012, and the conclusions expressed in the reports.  However, our review disclosed no instances where Cotton & Company LLP did not comply, in all material respects, with auditing standards generally accepted in the United States of America.

Cotton & Company LLP
635 Slaters Lane
4th Floor
Alexandria, VA 22314

P: 703.836.6701
F: 703.836.0941
www.cottoncpa.com

**INDEPENDENT AUDITORS' REPORT ON FINANCIAL STATEMENTS**

Inspector General
United States Department of Justice

Chief Executive Officer
Board of Directors
Federal Prison Industries, Inc.
United States Department of Justice

We have audited the accompanying Balance Sheets of the Federal Prison Industries, Inc. (FPI), a component of the United States Department of Justice (DOJ), as of September 30, 2012 and 2011, and the related Statements of Operations and Cumulative Results of Operations, and Statements of Cash Flows for the years then ended. These financial statements are the responsibility of FPI's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audits 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 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. An audit also includes assessing the accounting principles used, and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the United States Department of Justice, Federal Prison Industries, Inc. as of September 30, 2012 and 2011, and the results of its operations and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Accounting principles generally accepted in the United States of America and OMB Circular No. A-136, *Financial Reporting Requirements,* require that the *Management's Discussion and Analysis* be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Federal Accounting Standards Advisory Board and OMB, who consider it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

In accordance with *Government Auditing Standards*, we have also issued our reports dated November 5, 2012, on our consideration of FPI's internal control over financial reporting and on our tests of its compliance with certain provisions of applicable laws and regulations. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audits.

COTTON & COMPANY LLP

Alan Rosenthal, CPA, CFE
Partner

November 5, 2012
Alexandria, Virginia

Cotton & Company LLP
635 Slaters Lane
4th Floor
Alexandria, VA 22314

P: 703.836.6701
F: 703.836.0941
www.cottoncpa.com

## INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Inspector General
United States Department of Justice

Chief Executive Officer
Board of Directors
Federal Prison Industries, Inc.
United States Department of Justice

We have audited the Balance Sheets of the Federal Prison Industries, Inc. (FPI), a component of the United States Department of Justice (DOJ), as of September 30, 2012 and 2011, and the related Statements of Operations and Cumulative Results of Operations, and Statements of Cash Flows for the years then ended, and have issued our report thereon dated November 5, 2012. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; 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*, as amended.

FPI's management is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our fiscal year 2012 audit, we considered FPI's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing 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 or on management's assertion on internal control included in *Management's Discussion and Analysis*. We limited our internal control testing to only 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*, such as controls relevant to ensuring efficient operations.

A deficiency in internal control 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the second paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. In our fiscal year 2012 audit, we did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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

COTTON & COMPANY LLP

Alan Rosenthal, CPA, CFE
Partner

November 5, 2012
Alexandria, Virginia

Cotton & Company LLP
635 Slaters Lane
4th Floor
Alexandria, VA 22314
P: 703.836.6701
F: 703.836.0941
www.cottoncpa.com

**INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND OTHER MATTERS**

Inspector General
United States Department of Justice

Chief Executive Officer
Board of Directors
Federal Prison Industries, Inc.
United States Department of Justice

We have audited the Balance Sheets of the Federal Prison Industries, Inc. (FPI), a component of the United States Department of Justice (DOJ), as of September 30, 2012 and 2011, and the related Statements of Operations and Cumulative Results of Operations, and the Statements of Cash Flows for the years then ended, and have issued our report thereon dated November 5, 2012. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; 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*, as amended.

FPI's management is responsible for complying with laws, regulations, and contract agreements applicable to the FPI. As part of obtaining reasonable assurance about whether FPI's fiscal year 2012 financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contract agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including the provisions referred to in Section 803(a) of the *Federal Financial Management Improvement Act of 1996* (FFMIA). 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, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 07-04.

Under FFMIA, we are required to report whether FPI's financial management systems substantially comply with federal financial management system requirements; applicable federal accounting standards; and application of the United States Standard General Ledger at the transaction level based upon U.S. generally accepted accounting principles issued by the Financial Accounting Standards Board, as applicable to the FPI in accordance with the provisions of the Government Corporation Control Act of 1945 (31 U.S.C. §9101 to 9110) and Statement of Federal Financial Accounting Standards No. 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*. 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 requirements described in the preceding paragraph.

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

COTTON & COMPANY LLP

Alan Rosenthal, CPA, CFE
Partner

November 5, 2012
Alexandria, Virginia

# Federal Prison Industries, Inc.

**Balance Sheets**

| ***As of September 30,*** ***(DOLLARS IN THOUSANDS)*** | **2012** | **2011** |
|---|---|---|
| **Assets** | | |
| Current: | | |
| Cash and cash equivalents | $ 300,544 | $ 291,510 |
| Accounts receivable, net | 26,141 | 46,680 |
| Inventories, net | 129,254 | 133,934 |
| Other assets | 828 | 2,582 |
| **Total current assets** | 456,767 | 474,706 |
| Property, plant and equipment, net | 87,631 | 102,775 |
| **Total Assets** | $ 544,398 | $ 577,481 |
| **Liabilities and United States Government Equity** | | |
| Current: | | |
| Accounts payable | $ 43,595 | $ 42,192 |
| Deferred revenue | 94,892 | 99,669 |
| Accrued salaries and wages | 9,610 | 10,620 |
| Accrued annual leave | 8,133 | 8,892 |
| Other accrued expenses | 7,474 | 9,681 |
| **Total current liabilities** | 163,704 | 171,054 |
| FECA actuarial liability | 18,920 | 16,403 |
| **Total Liabilities** | 182,624 | 187,457 |
| United States Government Equity | | |
| Initial capital | 4,176 | 4,176 |
| Cumulative results of operations | 357,598 | 385,848 |
| Total United States Government Equity | 361,774 | 390,024 |
| **Total Liabilities and United States Government Equity** | $ 544,398 | $ 577,481 |

The accompanying notes are an integral part of these financial statements.

## Federal Prison Industries, Inc.

### Statements of Operations and Cumulative Results of Operations

| ***For the fiscal years ended September 30,*** ***(DOLLARS IN THOUSANDS)*** | **2012** | **2011** |
|---|---|---|
| Revenue: | | |
| Net sales | $ 606,114 | $ 745,423 |
| Other revenue | 92,043 | 154,654 |
| Total revenue | 698,157 | 900,077 |
| Cost of revenue: | | |
| Cost of sales | 566,410 | 683,928 |
| Cost of other revenue | 88,756 | 146,642 |
| Total Cost of Revenue | 655,166 | 830,570 |
| Gross profit | 42,991 | 69,507 |
| Operating expenses: | | |
| Sales and marketing | 5,916 | 7,237 |
| General and administrative | 101,938 | 105,103 |
| Total operating expenses | 107,854 | 112,340 |
| Loss from operations | (64,863) | (42,833) |
| Interest income | 138 | 191 |
| Interest expense | (1) | (3) |
| Other income, net | 36,476 | 40,835 |
| Net loss | (28,250) | (1,810) |
| Cumulative results of operations, beginning of fiscal year | 385,848 | 387,658 |
| Cumulative results of operations, end of fiscal year | $ 357,598 | $ 385,848 |

The accompanying notes are an integral part of these financial statements.

# Federal Prison Industries, Inc.

**Statements of Cash Flows**

| ***For the fiscal years ended September 30,*** ***(DOLLARS IN THOUSANDS)*** | **2012** | **2011** |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net loss | $ (28,250) | $ (1,810) |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 10,067 | 10,469 |
| Loss on disposal of property, plant and equipment | 7,549 | 4,985 |
| Changes in: | | |
| Accounts receivable | 20,539 | (12,674) |
| Inventories | 4,680 | 69,397 |
| Other assets | 1,755 | 1,109 |
| Accounts payable and accrued expenses | (56) | (2,531) |
| Deferred revenue | (4,777) | (98,549) |
| Net cash provided by (used in) operating activities | 11,507 | (29,604) |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchases of property, plant and equipment | (2,384) | (1,334) |
| Construction-in-progress of plant facilities | (89) | - |
| Net cash used in investing activities | (2,473) | (1,334) |
| Net increase (decrease) in cash and cash equivalents | 9,034 | (30,938) |
| Cash and cash equivalents, beginning of fiscal year | 291,510 | 322,448 |
| Cash and cash equivalents, end of fiscal year | $ 300,544 | $ 291,510 |

The accompanying notes are an integral part of these financial statements.

## Note 1. Organization and Mission

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

FPI's federal government customers include departments (percent of Revenue shown in parenthesis), agencies and bureaus such as the Department of Defense (52%), the Department of Homeland Security (15%), the Department of Justice (11%), the General Services Administration (6%), and the Social Security Administration (4%). These and other federal organizations are generally 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 has industrial and service operations at 81 and 88 factories located at 63 and 66 prison facilities that employed 13,369 and 14,200 inmates representing approximately 8% of the work eligible inmate population as of September 30, 2012 and September 30, 2011, respectively.

## Note 2. Summary of Significant Accounting Policies

### *Basis of Accounting*

FPI transactions are recorded on the accrual basis of accounting. Under the accrual basis, revenues are recorded when earned and expenses are recorded when incurred, regardless of when the cash is exchanged.

### *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 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 contingent 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, an insignificant amount of accounts receivable remained past due at September 30, 2012 and September 30, 2011. A significant portion 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, 2012 and 2011 was $14,525 and $27,399 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, 2012 and 2011, FPI's allowance for doubtful accounts is stated at approximately $519 and $660, respectively, of which approximately $98 and $131, respectively, represents the amounts allocated against federal accounts receivable.

*Inventories*

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.

Raw material inventory value is based upon moving average cost. Inventories are valued at the lower of average cost or market value (LCM) and include materials, labor and manufacturing overhead. Market value is calculated on the basis of the contractual or anticipated selling price, less allowance for administrative expenses. FPI values its finished goods and sub-assembly items at a standard cost that is periodically adjusted to approximate actual cost. FPI has established inventory allowances to account for LCM adjustments and obsolete items that may not be utilized in future periods.

*Advances to Vendors*

FPI generally does not offer advances to the public; however, where warranted, FPI will on occasion make an advance to a vendor upon their request. Historically, these advances have been insignificant and made primarily to the Industries for the Blind. Prior to issuing advances to a vendor, the Centralized Accounts Receivable section performs a review as though they were a public customer, to include performing a due diligence review to assess risk and a review of applicant financial statements. A letter of credit is obtained as needed based on the results of this review. The FPI Controller approves advances prior to their disbursement. Advances are reduced by offset to the vendor invoice as goods are delivered.

*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 collectability 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. Sales returns are primarily replaced with like items and are recorded as they occur.

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 through an outside company 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, installation costs for FPI products, and items procured for its customers as part of procurement services provided by the Marketing, Activation, Research, and Corporate Support Branch. 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 includes imputed financing for retirement, health benefits and life insurance (Note 8).

*Property, Plant and Equipment*

During 2012, FPI changed the capitalization criteria for General Property, Plant and Equipment. The capitalization threshold of purchased property, equipment, buildings and vehicles was increased from an initial cost of $5 thousand to $10 thousand. Property, plant and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the following estimated useful lives:

| | Years |
|---|---|
| Machinery & Equipment | 2 - 25 |
| Computer Hardware | 2 - 10 |
| Computer Software | 2 - 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.

*Reclassifications*

Certain fiscal year 2011 financial statement line items have been reclassified to conform with the current year presentation. The reclassifications had no material effect on total assets, liabilities, equity, cumulative results of operations or cash flows as previously reported.

(Dollars in Thousands)

**Note 3. Accounts Receivable, Net**

Accounts receivable, net consists of the following:

| ***As of September 30,*** | **2012** | **2011** |
|---|---|---|
| Intragovernmental billed receivables | $ 21,676 | $ 34,491 |
| Private sector billed receivables | 4,984 | 12,849 |
| | 26,660 | 47,340 |
| Less allowance for doubtful accounts | 519 | 660 |
| **Accounts receivable, net** | $ 26,141 | $ 46,680 |

FPI incurred bad debt expense of $564 and $(66), respectively, for the fiscal years ended September 30, 2012 and 2011.

**Note 4. Inventories, Net**

Inventories, net consist of the following:

| ***As of September 30,*** | **2012** | **2011** |
|---|---|---|
| Raw materials | $ 37,956 | $ 46,988 |
| Raw materials – vehicles | 27,871 | 17,500 |
| Work-in-process | 21,740 | 25,857 |
| Finished sub-assemblies | 5,503 | 6,138 |
| Finished goods | 42,955 | 35,206 |
| Finished goods – acceptance contracts | 19,645 | 29,510 |
| | 155,670 | 161,199 |
| Less inventory allowance | 26,416 | 27,265 |
| **Inventories, net** | $ 129,254 | $ 133,934 |

$27,871 of FPI's fiscal year 2012 and $17,500 of FPI's fiscal year 2011, 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.

(Dollars in Thousands)

$19,645 of FPI's fiscal year 2012 and $29,510 of its fiscal year 2011 finished goods balance represents goods shipped to customers or their agents for unrecognized revenue due to acceptance criteria within the customer contract. The balances as of September 30, 2012 and September 30, 2011 are primarily systems furniture installations and destination acceptance contracts shipped after the cutoff date for revenue recognition.

Included in total inventories as of September 30, 2012 and September 30, 2011, is $11,558 and $16,345 in raw materials, work-in-process and finished goods in support of the solar panel product line respectively.

**Note 5. Property, Plant and Equipment, Net**

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

| ***As of September 30,*** | **2012** | **2011** |
|---|---|---|
| Buildings and improvements | $ 177,613 | $ 178,347 |
| Machinery and equipment | 100,098 | 104,052 |
| Computer hardware | 2,713 | 2,149 |
| Computer software | 6,519 | 6,506 |
| | 286,943 | 291,054 |
| Less accumulated depreciation | 199,312 | 188,279 |
| **Property, plant and equipment, net** | $ 87,631 | $ 102,775 |

Depreciation and amortization expense totaled $10,067 and $10,469 for the fiscal years ended September 30, 2012 and 2011, respectively. During fiscal year 2012, FPI invested $2,473 for the purchase and construction of property, plant and equipment. During fiscal years 2012 and 2011, FPI deactivated factories in an effort to reduce excess factory capacity. As a result of these deactivations, FPI incurred losses on property plant and equipment of $7,293 in fiscal year 2012, and $4,599 in fiscal year 2011.

(Dollars in Thousands)

**Note 6. Other Accrued Expenses**

Other accrued expenses consist of the following:

| *As of September 30,* | 2012 | 2011 |
|---|---|---|
| Materials in transit | $ 81 | $ 1,108 |
| Relocation travel expense | 1,268 | 1,053 |
| FECA liabilities – current portion | 1,981 | 1,942 |
| Financial audit expense | 573 | 530 |
| Telecommunication expense | 1,226 | 1,132 |
| Utilities | 779 | 936 |
| Warranty expense | 418 | 444 |
| Other expense | 1,148 | 2,536 |
| **Other accrued expenses** | $ 7,474 | $ 9,681 |

Included in other expense as of September 30, 2012 and September 30, 2011 are accruals for Intra-Departmental agreements of $774 and $622 and accruals for vendor invoices of $180 and $645, respectively.

**Note 7. Business Segments**

FPI's businesses are organized, managed and internally reported as six operating segments based on products and services. These segments are Clothing and Textiles; Electronics; Fleet and 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, 2012 and 2011 for each of its business segments is presented for comparative purposes:

(Dollars in Thousands)

***Net Sales***

| ***For the years ended September 30,*** | **2012** | **2011** |
|---|---|---|
| Business Segment | | |
| Clothing and Textiles | $ 214,522 | $ 238,631 |
| Electronics | 67,865 | 76,443 |
| Fleet and Industrial Products | 138,551 | 233,144 |
| Office Furniture | 142,371 | 155,819 |
| Recycling | 15,563 | 15,276 |
| Services | 27,242 | 26,110 |
| **Net sales** | $ 606,114 | $ 745,423 |

FPI redefined its business segments from seven categories to six in fiscal year 2012. The Fleet Management and Vehicular Components and Industrial Products business segments were consolidated. As a result, net sales for fiscal year 2011 for Fleet Management and Vehicular Components and Industrial Products have been combined for comparative purposes.

*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 8. 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 combined missions requires the sharing of facilities and responsibilities relative to the custody, training and employment of federal inmates. The Director of the BOP, who has jurisdiction over all federal penal correctional institutions, is the Chief Executive Officer (CEO). General management of

FPI is provided by the Chief Operating Officer who also 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 Managerial Cost Accounting Concepts a reasonable estimate of these costs as provided by the BOP is included in general expense and other income of FPI for the fiscal years ended September 30, 2012 and 2011, 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 of FPI 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, 2012 and September 30, 2011, the accrued FECA liabilities as charged to FPI, approximated $1,981 and $1,942, 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 $18,920 and $16,403 at September 30, 2012 and 2011, 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 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) 11.9 and 11.7 percent for fiscal years ended September 30, 2012 and September 30, 2011, respectively. FPI contributed (for hazardous retirement) 26.3 and 25.7 percent for fiscal years ended September 30, 2012 and September 30, 2011, respectively.

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) to an investment fund, up to $17,000 and $16,500 of salary for the fiscal years ended September 30, 2012 and September 30, 2011, respectively. FPI then matches this amount up to 4 percent, in addition to an automatic 1 percent 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 $17,000 of 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 $26,855 and $29,352 for the fiscal years ended September 30, 2012 and 2011, respectively.

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 $2,423 and $3,531 in the fiscal years ended September 30, 2012 and 2011, respectively, with an offsetting credit to other income on the Statements of Operations and Cumulative Results of Operations.

*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 $9,717 and $10,334 for the fiscal years ended September 30, 2012 and 2011, respectively.

OPM also provides health care and life insurance benefits for FPI's retired employees. FPI must recognize an expense related to its share of the cost of such post-retirement health benefits and life insurance on a current basis (while its employees are still working), with an offsetting credit to other income. Costs in this regard, which approximated $6,420 and $7,405 during the fiscal years ended September 30, 2012 and 2011, respectively, were determined by OPM utilizing cost factors used to estimate the cost of providing post-retirement benefits to current employees. However, because of the offsetting credit, which is reflected as other income on the Statements of Operations and Cumulative Results of Operations, the recording of these costs has no impact on reported net income or cash flows.

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

(Dollars in Thousands)

**Note 9. Sales and Marketing, General and Administrative Expenses**

Sales and marketing, general and administrative expenses consist of the following:

| ***Sales and marketing, general and administrative expenses*** ***Fiscal years ended September 30,*** | **2012** | **2011** |
|---|---|---|
| Salaries, wages and benefits | $ 42,986 | $ 46,491 |
| Permanent change of station expense | 1,657 | 1,350 |
| Purchases of minor equipment | 172 | 307 |
| Contract services | 9,270 | 9,787 |
| Bad debt expense | 564 | (66) |
| Credit card service fees | 970 | 897 |
| Travel | 1,487 | 1,721 |
| Personal computer expense | 1,458 | 2,290 |
| Accident compensation | 4,660 | 2,409 |
| Financial audit | 1,257 | 1,690 |
| Marketing | 1,550 | 1,793 |
| Depreciation | 2,122 | 2,056 |
| Net loss on disposition of assets | 7,516 | 4,984 |
| Telecommunication expense | 2,914 | 2,976 |
| Other expense | (4,290) | (2,745) |
| Imputed pension costs (Note 8) | 2,423 | 3,531 |
| Imputed post-retirement health care and life insurance cost (Note 8) | 6,420 | 7,405 |
| Imputed operating costs | 24,718 | 25,464 |
| **Sales and marketing, general and administrative expenses** | $ 107,854 | $ 112,340 |

Other expense is comprised primarily of inmate wages, maintenance agreements, and distributions to factory operations. FPI distributes certain General and Administrative expenses that benefit all locations to the individual factory levels. These charges include computer licenses and fees, civilian and inmate accident compensation, and check charges. These charges totaled $7.7 million for fiscal year 2012 and $8.1 million for fiscal year 2011. 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 8). Included in accident compensation for fiscal year 2012 is a $2.5 million increase in the actuarial FECA estimated liability.

(Dollars in Thousands)

## Note 10. Commitments and Contingencies

*Legal Contingencies*

FPI is party to various administrative proceedings, legal actions, and claims. The balance sheet includes an estimated liability for those legal actions where management and the Chief Counsel consider adverse decisions "probable" and amounts are reasonably estimable. Legal actions where management and the Chief Council consider adverse decisions reasonably possible and the amounts are reasonably estimable, should not result in judgments which would have a material, adverse effect on the organization's financial statements. Furthermore, there are cases where amounts have not been accrued or disclosed because the amounts of the potential loss cannot be estimated or the likelihood of an unfavorable outcome is considered remote.

*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. As of September 30, 2012, future capital lease payments due and future operating lease commitments total $93 and $39, respectively.

*Product Warranty*

FPI offers its customers a promise of an "Escape Proof Guarantee" on the products it manufactures. FPI has analyzed the historical pattern of warranty returns and the adequacy of the warranty returns and allowances. In this regard, FPI 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,*** | **2012** | **2011** |
|---|---|---|
| Balance at the beginning of the period | $ 444 | $ 451 |
| Accruals for warranties issued during the period | 349 | 353 |
| Settlements made (in cash or in kind) during the period | (375) | (360) |
| Balance at the end of the period | $418 | $ 444 |

*Minimum Buy Contracts*

FPI has entered into firm purchase commitments for solar panel materials totaling $5,012 to be delivered in fiscal year 2015.

*Congressional Limitation on Administrative Expenses*

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

| ***Congressional limitation on administrative expenses*** ***Fiscal years ended September 30,*** | **2012** | **2011** |
|---|---|---|
| Congressional limitation on expenses | $ 2,700 | $ 2,695 |
| Expenses incurred subject to Congressional limitation | $ 1,760 | $ 1,775 |