A meeting of the Federal Prison Industries, Inc. (FPI) Board of Directors was held on August 14, 2023, via teleconference.

IN ATTENDANCE:

Donald R. Elliott, Vice Chairman
Lee Lofthus, Member
Dee Reardon, Member

QUORUM: A quorum was present.

ALSO IN ATTENDANCE:

William W. Lothrop, Acting Deputy Director, Federal Bureau of Prisons
Patrick T. O'Connor, Chief Executive Officer, FPI
Marianne Cantwell, General Counsel, FPI
Edward Porras, Chief Financial Officer, FPI
James Mitchell, General Manager, FPI
Valery Logan, Executive Assistant, FPI

Mr. Elliott opened the meeting.

I. Chief Executive Officer's Report

Mr. O'Connor provided the Board with an update. He has visited 21 factories this fiscal year. Mr. O'Connor also attended the BOP's Executive Staff meeting and the American Correctional Association Congress in Philadelphia.

Mr. O'Connor discussed business developments. The chip shortage has been a challenge for FPI. U.S. Customs and Border Protection (CBP) recognizes the issue, and it is affecting anyone counting on vehicles from Ford or GM. CBP has committed millions for fleet business next year and we are expecting millions more before the end of the year, so we have a year's worth of backlog just in the Fleet Solutions Group (FSG).

Mr. Elliott asked if FPI knew when the chip shortage challenge would be over. Mr. O'Connor stated there is no way to know. All we keep hearing is they hope it is resolved in the coming year.

Mr. O'Connor stated that the cost control and pricing efforts put in place are showing results as it relates to the inflation challenges FPI has faced. FPI has been profitable three out of the last four months, which has reduced the loss that we had through December by about 66%.

There was a customer visit on June 28 to FCC Beaumont for a discussion about a new optical laboratory. We are in talks to open a laboratory in Beaumont. The company would bring some of their own equipment and staffing. They are committing to put in an American Board of Optometry Certification Program. The contract negotiations are underway and hope to close in the next 30 days.

We also had customer visit on August 7 at FCC Petersburg for 3D printing for life size mannequins. The company is looking to add about 20 3D printers and run a multi-shift operation.

Mr. O'Connor provided an update on FPI's challenges. In regards to inflation, it has had a major affect on FPI, especially late last year and earlier this year, because we were shipping a lot of product that had been priced three to five years earlier when inflation was not an issue. We have been working diligently on both pricing and working on overhead and general and administrative expenses.

Mr. Elliott stated that he knows FPI has been talking to vendors about pricing and it sounds as if FPI has made some progress. Is FPI 20% through that process or more? Mr. O'Connor responded that FPI was 100% for the first time through but we have to keep passing back through it. In today's environment, it has to be more constant than when we were at one or two percent inflation. Mr. O'Connor noted that cost control and pricing efforts are showing results. We have been profitable six out of ten months this year. We are on an upward trend.

Mr. O'Connor provided an update on FPI's key performance indicators (KPIs):

KPI 1.0, Mission: We are ahead of plan and just below this time last year for number of full-time inmates employed. We are still well below our goal on the percentage of inmates within three years of release because of how drastically this pool of inmates was reduced by First Step Act and COVID-related releases. These releases have led to significant turnover, which is having a negative affect on FPI because we are spending so much time training inmates and getting defects that we're having to go back and fix before shipping.

Mr. Elliott asked: As we look at FPI's mission, and given the current environment, are we making the impact that our mission hopes it will make if people are only in the program for a couple months here and there? Are they really learning skill sets and being prepared for release as we had hoped? Mr. O'Connor responded that it makes it more difficult. If they are not working in FPI for very long, they are not going to learn as much. We have not had a good way to tell how long they will be in. The Bureau of Prisons (BOP) is getting more into the groove of figuring out how to apply time credits and hopefully as that becomes more automated, we will have better visibility into who we are hiring. It is a balance. Mr. Elliott and Mr. Lofthus emphasized the need for data to assess the impact of FPI on recidivism.

Mr. O'Connor noted that the BOP conducted a study recently, the MITRE study, showing there was no impact on recidivism. He expressed his opinion that MITRE was not qualified to conduct the study, but they were in a position where they owed the BOP some work. However, the California penal system put out a very detailed study by the University of California that was more in line as the older study showing that working for correctional industries significantly reduced recidivism. Mr. O'Connor explained that he put together a report for the U.S. Justice Department outlining the last four or five reports done across the country, and they all showed a 19-25% reduction in recidivism except for the MITRE study.

Ms. Cantwell added that the Prep Study is the name of the study conducted on FPI years ago. It was an in-depth 14-year analysis conducted by the BOP. It concluded that inmates who worked for FPI were 24% less likely to recidivate. We tried to work over the years with the BOP to have them do it again, but it is very time intensive. The MITRE study was flawed because they were looking at data that wasn't in depth and data that was like apples and oranges.

Mr. Elliott reemphasized the importance or having empirical evidence of effectiveness. Mr. O'Connor agreed that we need to have another study done. He noted that conducting these studies took a number of years to gather the data and complete. It is not something that can be done quickly, even within a fiscal year.

KPI 2.0, Financial Perspective: We are very similar to last year's sales level and that is with losing about $3 million a month in FSG. Our net income last year at this time was -$15.7 million. We are still negative right now but we are at 2.5 million, which is half of where we were at the beginning of the calendar year. Our gross margin is down about 4% for the year, but we seem to be heading in the right direction for this month.

Mr. Lofthus asked how this can be if FPI has been profitable six out of the ten months this year. Is that profitable after Central Office overhead expenses have been applied? Mr. O'Connor responded that it is after overhead expenses have been applied. The thing that hurt us was the huge loss of $5 million just in the month of November, which put us behind and we have been digging out of that hole since.

KPI 3.0, Customer Perspective: FPI is slightly behind target, but significantly higher than last year's actual for on-time delivery. We have cut our backlog by 57%. We have improved delinquencies by 25%. We have done a very good job at making the deliveries and getting things back on-line as far as the customer is concerned.

KPI 4.0, Internal Perspective: Our defect rate is higher than it was last year. We have tracked this down to a couple specific factories that are making complex clothing and textile items and have a high turnover rate. While our recorded defect rate is high, that defect is not getting out to the customer. Everything that comes out of the plants goes through detailed inspection as well as DLA inspection prior to shipment. However, it is increasing expenses for rework.

Mr. Elliott asked what the rework is costing us. Mr. O'Connor responded that he does not have a figure on that yet. We are not generally scrapping entire garments. It is more of going back and resetting a pocket. Sometimes, it is just a matter of trimming excess thread. It can be very quick, but it counts as a defect.

Inventory turns are about the same as last year. Mr. O'Connor explained that because of the wide differences in our product lines, he wants to come up with a better measure for the coming year, such as finished goods inventory turns. Some areas have very high raw materials costs so it is throwing the calculations way off. It would be better to have them by business group or product/service category.

Lost hours were higher than we had hoped for, but they are still at a tremendous reduction from last year. This is basically because we are backing off the COVID protocols and everyone is getting used to keeping facilities filled and running again. The Wardens and Regional Directors (RDs) have done a good job at working with us on that. Mr. O'Connor puts out a weekly report to the Wardens and RDs on which operations are up and which are down. Typically we have had no more than two facilities down on Friday mornings for the past six weeks. We were at above

90% inmate staffing and dropped just below at 89% this past week. We are running about 10% more inmates on a regular basis that we were last year.

Mr. Elliott asked what we missed last year to be so far off on lost hours. Mr. O’Connor responded that our first budget was much closer to our actual lost hours for this year, but we were asked to go back and sharpen the pencils so we changed the probabilities on some things.

KPI 5.0, Learning and Growth Perspective: Our number of open staff vacancies is higher than we anticipated in the budget but it is on target with what we want to do to get overhead costs down. We have been on a hiring freeze for non-direct positions. If you are not out in the field making products, we haven’t been hiring except in the most dire circumstances so that we can get the overhead costs down. Our time to fill is extremely good at 25 days. The number of staff trained has surpassed our target. We have trained all our staff and then some. Recordable injuries are almost non-existent.

Mr. O’Connor updated the Board on other current FPI projects. These include projects related to automating new accounting standards, proposal preparations, cycle counts, KPIs, third-party logistics, “order to cash” processes, Management Information Systems Branch (MISB) managed services, and marketing. We have been doing the conducting the Accounting Standards Codification (ASC) 606 revenue recognition rules manually for the last few years and it is a problem. It was flagged in our audit. We brought in a company to help us automate that process. In the coming year, our hope is that we are doing the 606 adjustment every month in real time.

Recently, the U.S. Government Accountability Office (GAO) did an audit of the U.S. Department of Defense (DoD) and how they purchase from FPI. From FPI’s point of view, it was a good report. The GAO did not find anything wrong. However, Mr. O’Connor explained that one thing he saw in the report that he did not like is that the percentage of work that we get from the DoD that we win from competitive bidding is low - about 16%. The rest is direct awards. Mr. O’Connor put a team together to identify how we can go after some of the larger projects that are out there. We have a tendency to working as subcontractors on the larger projects, rather than bidding ourselves. We are looking at an outside vendor to do a short-term project where we go after a couple specific projects and they teach our staff how to write better proposals.

Mr. Elliott asked when we lose bids whether we getting feedback on why we did not get the business. Mr. O’Connor responded that yes, sometimes we will get feedback on those and the government will tell us what areas we were deficient in. Mr. Elliott asked for confirmation that what is happening is that FPI loses a bid to another entity, and the organization that wins it subcontracts some of the work out to us. Mr. O’Connor responded in the affirmative. He noted that we have staff in some areas that feel it is easier to do it that way than to go through the proposal process. We have to redirect them to get the bid ourselves where we have higher margins. Mr. Elliott asked whether we are tracking the margin that we are losing by going through the current process rather than winning the business ourselves and if we know what the total impact has been in the past year in terms of dollars? Mr. O’Connor said no, but it is substantial.

II. Cycle Count Project

FPI continues to work with Lehigh University to transition warehouse cycle counting to a consumption-based method. Thirty-three factories are currently in the testing phase of the project. All factories are using the same process to generate counts to increase uniformity among operations. Very few issues have resulted from the testing and all have been resolved on a case-by-case basis. Creation of a new SAP role for FPI's Financial Management Branch (FMB) managers has increased count efficiencies by allowing FMB to solve issues by adjusting count frequencies per factory. Four to five new factories will be brought into the test group on a bi-weekly basis until all factories with inventory are using the consumption-based method.

Mr. Lofthus asked if this approach was presented to the auditors and if it is satisfactory for the audit. Mr. O'Connor responded that he kept them informed as to how it was going.

III. Third-Party Logistics Project

Jim Mitchell, General Manager of the Office Furniture Group (OFG) presented on the third-party logistics project. OFG had been using a company that went out of business in July. OFG has since started using a third-party logistics company that specializes in performing shipping and other logistics functions on behalf of other companies and only ships and provides real-time data and information. This change has resulted in a reduction of costs, and it helps FPI maximize production and avoid risk.

Mr. Elliott asked about the amount of cost savings. Mr. Mitchell responded that for fiscal year (FY) 2024, it should be approximately $2 million.

IV. Financial Review

Mr. Porras presented FPI's financial review. During July, FPI had a net income of $1.6 million. Cost of sales were lower than plan by $6 million. This is a 78% cost based on our sales. Our total expenses are lower than plan ($419,000). Our investment income had a gain of $576,000 and our other income had a gain of $60,000. FPI continues to make progress on improving the way we operate.

Year to date (YTD) FPI has a net loss of $2.5 million. We have reduced our losses from $7 million in February to $2.5 million in July. The major drivers are our cost of sales are lower than plan by $14 million. This is an 81% cost based on our sales. Our total expenses, which include under/over applied overhead, selling expenses, and general and administrative expenses (G&A), is higher than plan by $2.6 million. Under applied overhead is the major driver in our total expenses with $6 million not applied. Investment income had a gain of $3 million, which offset our operating losses.

Our sales YTD are $29 million below plan, and $8 million lower than forecasted levels. When comparing to our forecast, the major driver is that OFG sales missed its forecast by $11 million. Our revenues from services we provide to clients are higher than plan by $4 million.

FPI cost of sales is lower than planned by $14 million YTD. Our plan was $302 million and our actuals were $288 million. The main drivers are that the Clothing and Textiles Group (CTG) ended with a lower cost of sales than planned by $12 million and FSG ended with a lower cost of sales by $20 million due to lower sales.

Our G&A was under plan by $3 million. Mr. Elliott asked what FPI's method is for allocating G&A across the various business units. Mr. Porras stated that he will send the Board members the standard operating procedures that detail the methodology used for how they allocate G&A to each business group. Mr. Lofthus asked how the factories build G&A into their pricing. Mr. Porras said there is a percentage for each business group and he will send it to the Board.

To control G&A FPI has curtailed travel and is utilizing virtual capabilities whenever possible. We have implemented a "no new hiring" policy unless approved by the CEO. In the past 11 months, we have introduced nine corrective actions to improve our operations. We have 33 factories under the cycle count program testing phase. We continue to update our bills of material, cost rolls, and standard routings to improve our costs accuracy in production. We are in phase two of our revenue recognition implementation. We are updating our warehouse procedures policy which includes training implementation. The actual overhead costs at the factory level is 5.7 million under our plan. The applied overhead is under applied by 26.4 million. We take into consideration that not all locations applied overhead. The under applied overhead is adjusted each period using the Capitalization of Overhead Entry, adjusting our inventory.

Our selling expenses are lower than plan by $853,000. Accounts receivables are at $40 million and have kept steady since July of last year. Our inventory is at $130 million, down from $137 million.

Mr. Lofthus questioned the previously-made statement that FPI has been profitable six out of 10 months, when the data presented show an approximate loss of $15 million. He also commented that FPI has talked about updating prices, but that does not seem to be reflected in FPI's operating income. We would expect if products are priced accurately that we would not be losing an average of $1.5 million every month.

Mr. O'Connor responded that in November, FPI experienced a huge loss of over $5 million, even after the investment gain, which skews the data. When we change our prices, there are only a few items it affects immediately. Most of the items out there are on contracts that were let many months, if not years, ago. We have to have those flush through the system before the new pricing takes affect. We had some contracts where we were able to get customers not to exercise option years, otherwise, we would have been stuck with some of the pricing on some items for another year to get them to then take on a new price. Some of these products were priced 3-5 years ago when there was 1-2% inflation per year.

Mr. Lofthus asked about the mechanics of changing product prices. Mr. O'Connor stated that most of the contracts we had had economic price adjustment clauses in them but they had a 1-2% ceiling, which is how we got hurt. That is something we are looking at when we write new contracts. If we terminated some of these contracts because we can't supply, they go to the next person and we won't be able to look at that contract for three to five years because they are with someone else. When possible we have terminated in a way that prevented us from losing the future business. If we lose $1.5 million per month for three months on a product but then the new contract comes up we have an opportunity to price it at a profitable pricing. But if we terminated the other contract, we can't even bid on it. So then, we lose the opportunity to make money on it for five years. Mr. Elliott said that is assuming that they will accept the new pricing. Mr. Lofthus stated that at a future meeting they would like to look at this more.

V. Action Items/Legal Updates

Mr. Lofthus requested that, going forward, the Board meeting minutes more fully reflect the Board's questioning on various topics. Ms. Cantwell affirmed that FPI will try to incorporate more of that. She noted that we made it more general in saying that the Board members expressed their concerns about the projected loss and the seeming lack of a sense of urgency, but we can be more specific.

The Board unanimously approved the draft meeting minutes from the June Board meeting.

The Board approved the next scheduled meeting to be in person in Washington, DC on October 18, 2023.

The meeting adjourned.

Subsequent to the August Board meeting, the Board approved, via email, a resolution for funding to replace the roof at FPI's facility at FCI La Tuna.

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Patrick T. O'Connor, Chief Executive Officer