



ACI

Annual Report - 2010

BUILDING PRODUCTS • REBUILDING LIVES

Mission Statement

To create opportunities for inmates to develop marketable job skills, civility and good work habits through successful enterprises that produce quality products and services for our customers.

Vision

To operate successful business enterprises that help inmates acquire demand occupation job skills and experience.



Core Values

Who We Are:

We are a unique self-funded business within the Arizona Department of Corrections.

We are Honest, Hardworking, and Dependable.

We have the Highest Ethical Standards and we always seek to do the right thing.

We enjoy our work and celebrate our achievements.

What We Do:

We employ inmates so they can learn and be productive.

We provide a safe and secure environment for all of our workers.

We strive to constantly improve.

We are accountable for our actions, our team.

We make a difference EVERY DAY.

How We Do It:

We provide a positive learning experience for all of our workers.

We balance our home and business life.

Our quality is the best – if we find out it's not, we fix it. If someone does it better, we learn from their ideas.

Everyone is passionately involved in making the customer happy.

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ARIZONA CORRECTIONAL INDUSTRIES

Annual Report – FY 2010

Dear Director Ryan:

A year ago in the 2009 annual report, we reflected on the impact of the recession and difficulties that all businesses faced in responding to one of the most challenging fiscal crises in the past 80 years. Despite these tumultuous times, we were able to report that we had not only survived – but thrived in FY 2009. Now, just a year later, I am extremely pleased to report that fiscal year 2010 was another year of great accomplishments with record revenue and earnings. ACI's revenues increased in sales by 3.7% to \$33,153,815 and net income was \$3,450,133.

In alignment with our mission, we continue to strive to keep inmates employed while providing them the opportunity to gain marketable job skills. In FY 2010, inmates worked a total of 1,116,875 hours in ACI Owned & Operated programs. In addition, inmates provided 2,079,731 hours of work to our Private Sector partners. A grand total of 3,196,606 hours were worked which is an average of 1,663 inmates employed full or part-time.

There are several critical areas that laid the foundation for ACI's success as it relates to growth and sustainability:

- *Recognizing our social responsibility to the citizens of Arizona and the inmates that we train for their return to society.*
- *Our commitment to quality products and services.*
- *Strong financial performance that positively contributes to our success as a fully non-appropriated business, as well as the positive impact on the State of Arizona's economy.*

As you are aware, ACI work programs are invaluable to the State of Arizona and our positive impact includes:

- *Based on demand for raw materials and services generated by ACI, the Arizona State University WP Carey School of Business – Seidman Research Institute Study, estimates the economic impact to the state was \$186,424,774 and resulted in the creation of 1,774 jobs in the private sector.*
- *Inmate deductions totaling \$2,607,111 continue to support many funds and programs.*
- *Retention funds earned by the inmate workers assist them upon their release.*

ACI employs 69 full-time and 4 part-time staff. Unique for Correctional Industries, ACI also employs 63 Industry Program Specialist (IPS) which replaced Correctional Officers, so that officers could return to institutional duties, while ACI fully covers the costs of security for work programs. The staff of ACI has sustained the highest revenue in relation to the number of full time employees amongst Correctional Industries in the nation.

In closing, we sincerely appreciate your leadership and support as ACI staff endeavor to achieve the Arizona Department of Corrections (ADC) mission of providing structured programming designed to support inmate accountability and successful community reintegration while being ever cognizant of our responsibility to serve and protect the people of Arizona.

Sincerely,

William Branson
CEO/General Manager

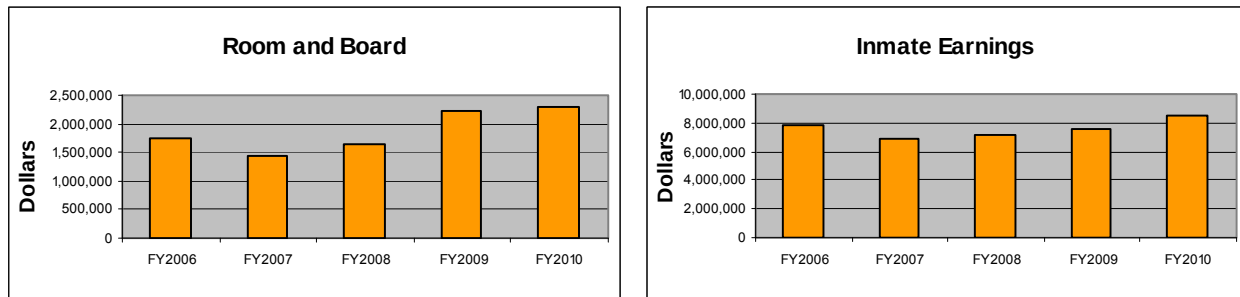
Effect & Impact to the State Economy

The constructive use of inmate time and labor has a direct and positive impact on the State budget. The employment of state employees as ACI workers, as well as the employment of inmates contributes to the tax base and the economy of our communities. Inmate wage deductions go to the state general fund, victim and court restitution, and family support. As the State of Arizona faces budget shortfalls and high unemployment rates, ACI provides a steady source of revenue and new job opportunities. These contributions come from two areas: actual raw materials and services that ACI purchases from Arizona businesses and consumer expenditures generated as a result of ACI related employment.

According to the Arizona State University, WP Carey School of Business – Seidman Research Institute, the financial contributions ACI made to the State's economy in FY 2010 was \$186,424,774. *More significant is the creation of an estimated 1,774 jobs for the State of Arizona.* The specific impact of the Correctional Industries Partnership with the Private Sector is difficult to estimate due to the lack of information available on privately held companies; therefore, the financial information is not public so estimates by the WP Carey School of Business are estimated from available data.

Inmate Deductions

Inmate wages offset the tax burden of room and board and contribute to the General Fund. In Fiscal Year 2010, inmate deductions to the General Fund were nearly 2.3 million dollars. Over the past five fiscal years, the General Fund has received \$9.3 million through inmate deductions. Below, the first chart reflects contributions to the General Fund for Room and Board. The second chart shows the total wages paid to ACI inmates over the last five fiscal years; a noteworthy \$38,143,183.



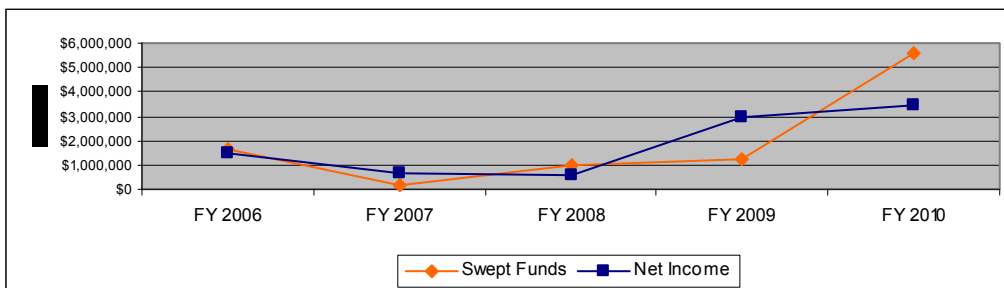
During the current fiscal year other inmate deductions supported the Victim's Compensation Fund (\$11,150), Dependent Support (\$55,575), Court Ordered Restitution (\$97,750), Alcohol Abuse and Treatment Fund (\$64,132), Transition Fee (\$75,266), Miscellaneous Deductions such as disciplinary restitution (\$12,332), as well as inmates paying Arizona State Tax (\$11,440). Additionally, qualified deductions go to the inmate's personal retention fund; a fund made available to the inmate for emergency situations while incarcerated and given to them in its entirety upon release as a foundation for their future. This is in addition to any personal savings that the inmate earned.

ACI Fund Transfers

ACI experienced a very good year; however, the decision to sweep ACI funds creates an unnecessary threat to the sustainability of the organization. Specifically, ACI has on three occasions (2006, 2008 and 2010) had more money swept to balance the General Fund than ACI realized in net income. As a non-appropriated entity of state government, ACI must manage a balance between growing or creating a business and employing more inmates, or work within the constraints of limited cash flow due to fund sweeps. If ACI employs more inmates in private sector jobs, that means a greater contribution to the State's General Fund. Any inmate working in a private sector partnership has 30% of their earnings deducted for room and board, which goes directly to the State General fund. In FY 2010, that was \$2.3 million. If ACI could retain its earnings, create more inmate jobs, the contribution could be doubled to over \$4 million annually. ACI can maximize their contributions to the state's economy by employing

more inmates, creating more indirect purchases for Arizona businesses, and contributing to the Arizona job market by generating a need for even more jobs.

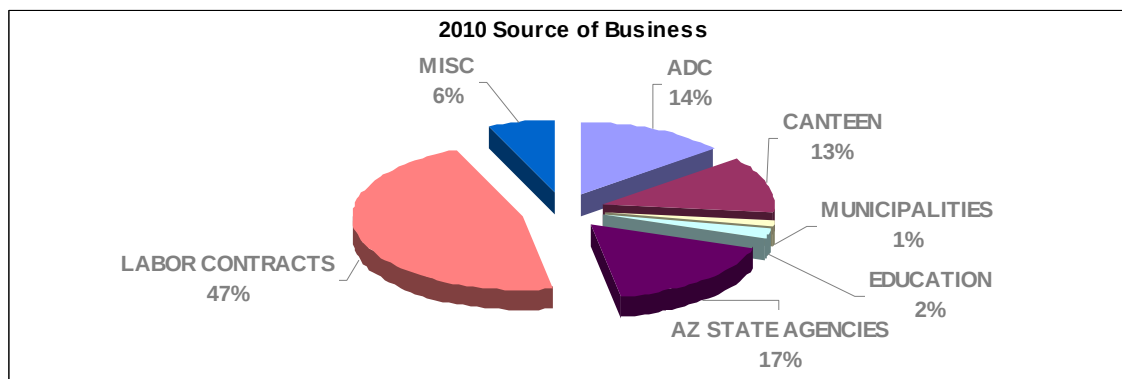
Below, the chart shows both net and swept funding for the last five fiscal years:



Source of Business

ACI has two revenue sources: Labor Contracts and Owned and Operated businesses. The first is Labor Contracts which in this fiscal year accounted for 43.9% of ACI's Total Revenue, and 48.1% of ACI's Net Income. Equally important, the Labor Contracts resulted in 65.1% of the Total Inmate Hours worked. The second source of revenue is ACI's Owned and Operated businesses. Owned and Operated was 56.1% of Total Revenue, and 51.9% of ACI's Net Income. The Inmate Hours worked for the Owned and Operated businesses was 34.9% of the Total Hours worked.

Additionally, ACI tracks sales by type of customer. The six key categories are: the Department of Corrections, Arizona State Agencies, Municipalities, Education (Schools, Colleges, and Universities), Labor Contracts, and General (private sector, not Labor Contracts). The chart below shows the sector growth for the last fiscal year.



Top Performers

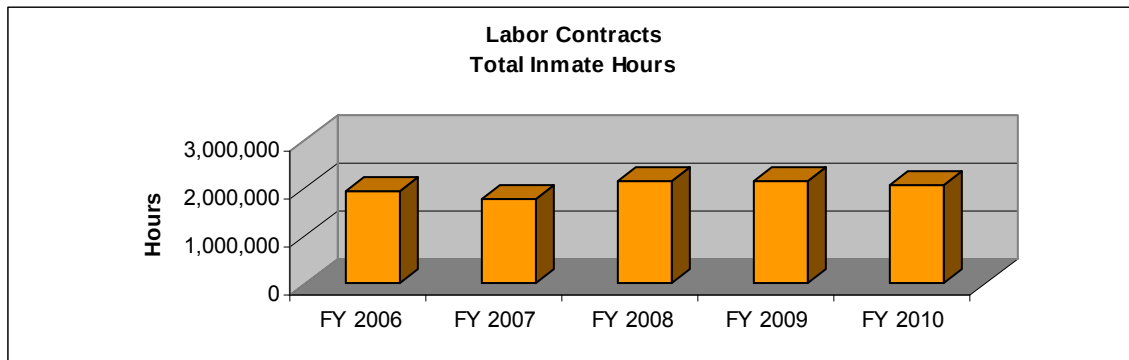
An overview follows of ACI's top performing cost centers that highlight their achievements, to include a five year profile of the Inmate Labor hours.

Labor Contracts

The ACI Labor Contract Division (LCD) manages 17 Private Sector Contracts, one (1) Prison Industry Enhancement Certification Programs (PIECP), and one (1) Inter-Government Agreement. There are 15 private sector locations within the Prison Complex, and 13 offsite locations.

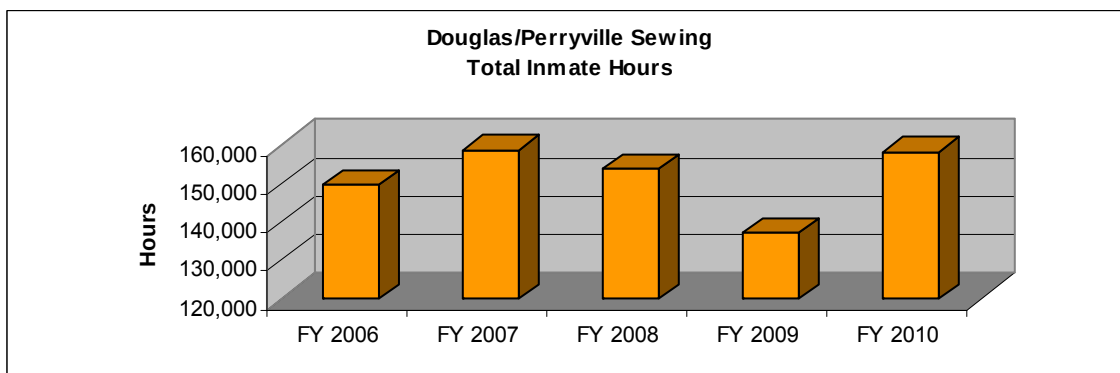
The Labor Contract Division includes 4 staff and employs 1,042 inmates. LCD's primary function falls into four areas. First, seek out new partnerships that will employ inmates. Secondly, the Labor Contract Division has responsibility to conduct periodic compliance surveys with each partnership, and to insure that security procedures are being followed. Third, handle day-to-day operations that interface between the labor partner and the prison complex staff. This includes security issues, staffing issues, facility problems, and helping to improve the partner's operation. Fourth, manage the hiring and management process of the IPS personnel that provide security and in some cases transportation to the worksite.

Partnerships include semi-truck and trailer refurbishing, agricultural, business to business call centers, trailer manufacturing, modular building construction, auto detailing, and food processing. Prison labor is well-suited for high volume, repetitive work that requires an understanding of current quality processes and high levels of customer service. The majority of the positions are considered unskilled labor, and are not easily filled by the private sector workforce.



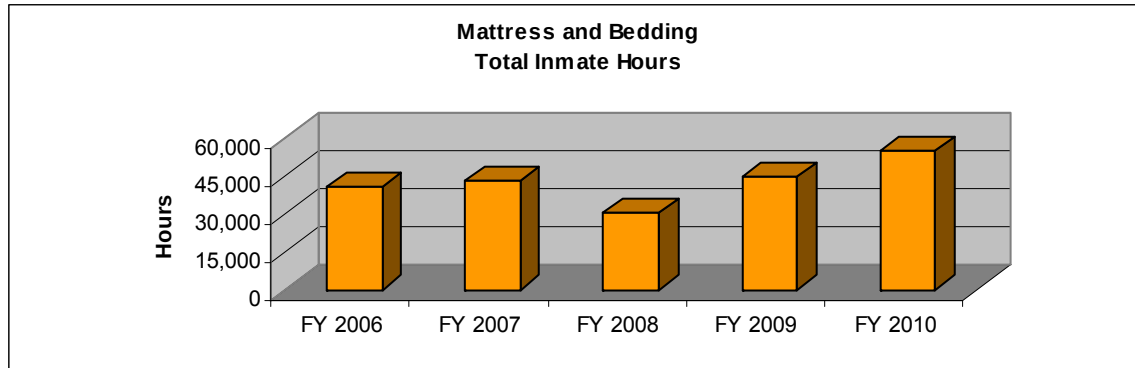
Douglas and Perryville Sewing Shops

ACI has two sewing shops, one at the Prison Complex in Douglas, and a second shop at the Perryville Complex in Goodyear, Arizona. The shops focus on clothing products for the Arizona Department of Corrections and the Private Prisons that house Arizona inmates. The sewing shops provide jobs for 90 male and 27 female inmates. During the twelve months in this fiscal year, the shops produced 207,000 inmate briefs; 174,600 T-Shirts, and over 90,000 pants. In addition to inmate clothing, sheets, pillow cases, wash cloths and towels were produced. Over 60,000 towels were delivered to Arizona Prisons for inmate use. The Perryville sewing operation will be moving to a larger facility in the Spring of 2011, which will employ 15-20 more female inmates. During the last month of the fiscal year, a third Sewing Shop was opened to compliment the current shops by producing belts, laundry bags, pillow cases, sheets and towels.



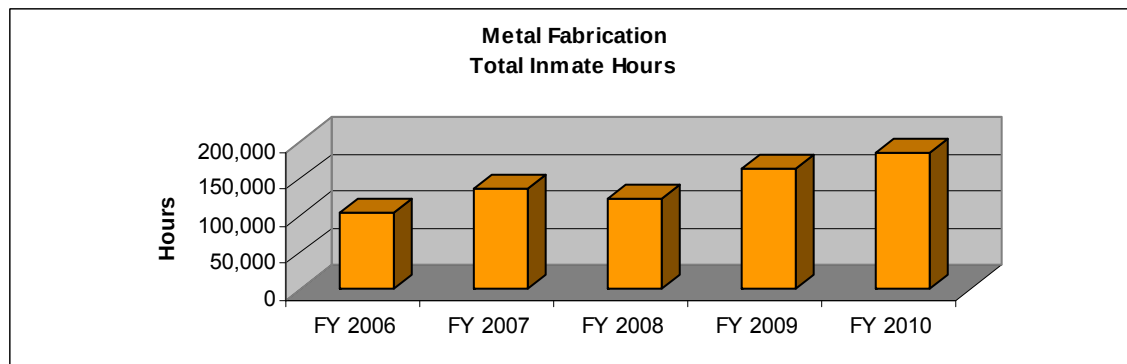
Mattress and Bedding Shop

The Mattress shop relocated in 2010, combining with the upholstery operation. This increased their space to 10,000 sq ft. Inmate mattresses are manufactured to meet strict institutional requirements; in 2009 the Department of Corrections changed to a green mattress that is made from 100% recycled material. Since the product does not rely on petroleum by-products, this recycled mattress also saved the Department of Corrections, over \$425,000 for mattresses. Arizona State Universities became interested in a green product for their students – ACI now manufactures a green dormitory mattress that is being sold to student housing throughout Arizona. Mattresses can take up a lot of valuable landfill, but by partnering with an Arizona company, **ACI will lead the way in green manufacturing for State institutions.**



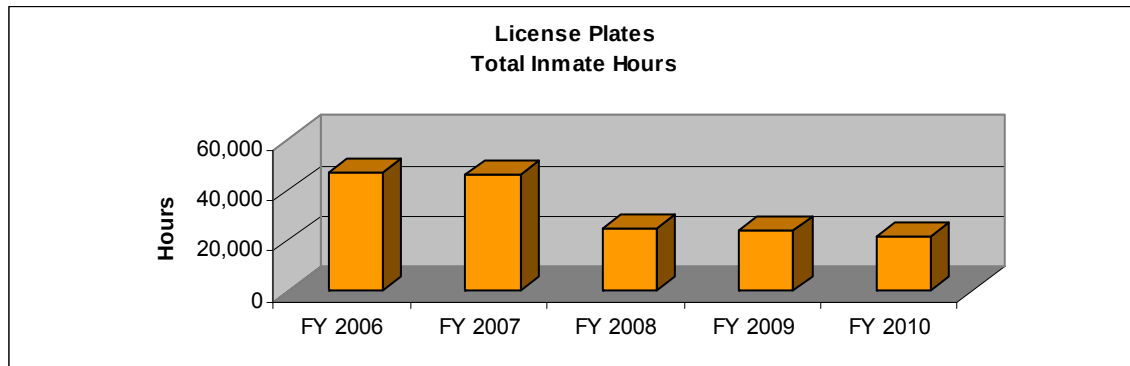
Metal Fabrication

ACI has developed a number of business partnerships with private sector companies to minimize the historical dependence on prison construction. The ideal product is metal sub-components and products used by the companies in daily operation, and not for resale. Metal fabrication competes equally with off-shore production, and is a very competitive option compared to foreign import products. High volume runs can be produced with excellent quality results. The Metal Fabrication operation has large presses for shaping metal, plasma cutters for detailed design work, and an experienced crew of nearly 100 male inmates who can meet product demands for even the largest jobs.



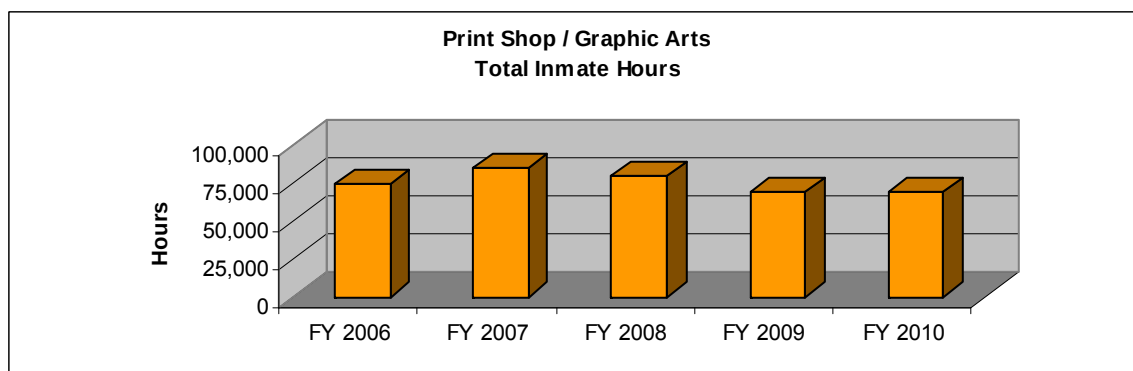
License Plates

ACI began manufacturing the new digital license plate in August 2007. The shop was relocated to ASPC Eyman to make room for an expanding metal fabrication operation. ACI maintains a just-in-time inventory for the Arizona Motor Vehicle Department. In 2010, over 750,000 license plates were produced. Arizona currently offers 177 different plates. In addition, Arizona citizens have the option of requesting a specialty license plate, or a personalized plate from the Motor Vehicle Department. Currently there are 24 different specialty plates available. Personalized plates are also produced by the License Plate facility, and in most cases are manufactured within 5 days after receipt of the order. License plate production has declined every year since 2006 levels due to a weaker demand for Arizona automobile registration.



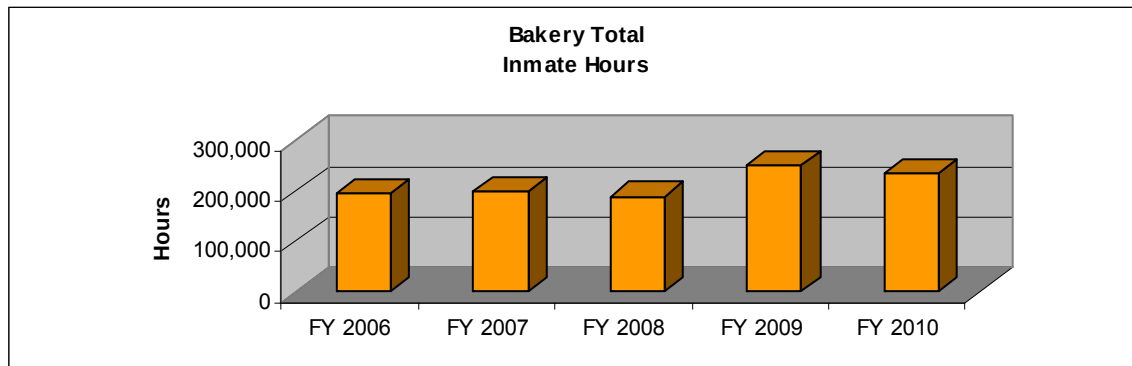
Printing and Graphic Arts

The Print Shop is a full-service facility that prints business cards, newsletters, forms, posters, letterhead, invitations, brochures, flyers, and more. The shop is able to work multiple shifts to handle any size job, but specializes on smaller jobs and quantities up to 500,000. ACI's Print Shop has a superweb four-color press, and four sheet-fed presses, including two Heidelberg press. In fiscal year 2010, the Print Shop produced materials for 36 Arizona State Agencies, 13 Cities or Towns, and 37 private companies or individuals, and 19 school districts. In business cards alone, the shop printed over 1,700 boxes of business cards for State employees; City, Town, and County employees; and also private sector employees. ACI is helping state agencies after the closure of the Arizona Department of Transportation (ADOT) and Arizona Department of Administration (ADOA) printing facilities due to budget restraints.



Bakery

The Bakery operation runs three, eight hour shifts, five days each week. This shop contracts with Canteen to supply baked good for all of the Arizona State Prisons. In addition, the Bakery is expanding to supply product for private prisons. The Bakery produces nearly 20 different products; wheat bread is the primary product. During the fiscal year, the bakery produced 62,421 sheet cakes, almost 2.7 million loaves of bread, and 11.5 million cookies. Recent capital improvements and expansion have helped increase efficiency and productivity. Further expansion will be required to accommodate a growing population. Transportation is provided by a private transportation company.



ACI Quality Program

Arizona Correctional Industries, a 2005 Arizona Quality Alliance Showcase Winner for Quality Programs, continues to make great strides in maintaining a quality program that meets industry standards while continuing to seek opportunities to improve, expand and aggressively achieve exceptional quality objectives as a correctional industry. ACI's Quality Program tracks several quality factors through data collection, such as Customer Satisfaction, Sampling, Rework, Returned Material Authorizations (RMA's), Daily Open and On-Time Reports and Manufacturing Performance Data (purchasing, cost accounting, customer service, retail outlet, accounts receivable/payable, cost accounting and inmate payroll). The information collected is instrumental in gauging successes, identifying trends and driving opportunities for continuous process improvements. Exceeding our customer's expectations through quality services and products is an essential part of our success. Below, the 2010 Fiscal Year Customer Satisfaction Results reflect an *overall approval rate of 99.53%* and an *average weighted rating of 9.16*:



Monthly customer surveys resulted in an overall approval rate of 99.53%. The average weighted rating was 9.16 for customer satisfaction on a scale of 1 to 10 (10 being the best).

As a member of the Arizona Quality Alliance (AQA), ACI applied and was approved for participation in a mentorship program with the Intel Corporation that began in January 2010. The Intel Corporate Quality group has established a “Skills-based Volunteering” Program comprised of Intel Quality employees who were matched with our organization based upon their experience, skill sets, and certifications. These volunteers provide mentoring and assist with training in quality skills and accomplishment of quality objectives. The Intel/AQA Mentoring Project endeavors to improve ACI’s Requests for Costs of Manufacture (RCOM) by reducing the time required to provide quotes for non-standard products and reduce processing time for Returned Material Authorizations (RMA).

Additionally, Intel has provided training on Lean Principles, RAPID (Recommenders, Agreeers, Performer, Inputs, Decider) decision making model a service mark of Bain & Company and OSIR (Objective-Status-Issues-Recommendations) project/problem solving tool. In the coming fiscal year, ACI Executive Team will attend an Intel facilitated Lean workshop focusing on uniformly administering the philosophy/culture throughout our organization.

Green Initiatives

It is becoming more and more important that businesses make environmentalism a part of their brand. ACI is making it a priority to strive to use environmentally friendly techniques to impact the environment and lessen harm while giving consumers and business owners what they need. In 2009, ACI attended the Greenbuild International Expo in Phoenix, AZ. Greenbuild 2009 was billed as a cutting edge exhibition on learning how green technology can grow your business. It showcased the latest in innovative products and services for all areas of green building.

Another step in ACI’s going green was to partner with companies that hold the highest distinction in lean manufacturing, such as 3M, Affordable Interior Systems (AIS), Bonded Logic, Environ biocomposite and CAF. ACI products are manufactured with recycled materials wherever possible. Greening the supply chain and educating suppliers are just two of the things that help to impact the world we live in.

ACI’s partnership with Bonded Logic, a leader in the manufacturing of thermal and acoustical products has resulted in a new line of environmentally friendly dormitory and institutional mattresses. The cotton cores of these mattresses are made from denim jeans and are fire retardant, cost effective, and comfortable. ASU and the Department of Corrections are currently using these new green products.

Reducing waste and material inventory management are both examples of cost cutting achieved through reuse or recycling rather than buying new. ACI works with agencies to refurbish chairs and wood furniture and to recycle items such as pallets, paper and even scrap materials. These “green” approaches to manufacturing are yet further samples of effectively limiting waste.

Regardless of the economic situation, agencies and political subdivisions that partner with ACI provide a mutually beneficial venture that helps us achieve our mission of public safety and reduced recidivism through successful collaborative efforts. The more creative and innovative measures that ACI can use to sustain ourselves during an economic downturn are in part dependent upon the continued positive relationships between ACI and our customers.

2010 ACI Recognition Awards

Platinum Award

Metal Fabrication
Mattress
Bakery

Gold Award

License Plates
Sewing Douglas
Wood Metal Refurbishing
Labor Contracts

Silver Award

Sewing Perryville

Bronze Award

Small Business Center
Printing and Graphic Arts
Sewing Florence
Sign Shop
Commodity Products
Farm

Employees of the Year

Bernie Bronson
Harley Maxson

Top Quality Performer

Bakery

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DEPARTMENT OF CORRECTIONS
ARIZONA CORRECTIONAL INDUSTRIES

FINANCIAL STATEMENTS

Year Ended June 30, 2010

ARIZONA CORRECTIONAL INDUSTRIES

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INDEPENDENT AUDITORS' REPORT

Members of the Arizona State Legislature
Arizona Correctional Industries
Charles L. Ryan, Director
Arizona Department of Corrections

We have audited the accompanying financial statements of the State of Arizona, Department of Corrections-Arizona Correctional Industries (ACI) Enterprise Fund, as of and for the year ended June 30, 2010, as listed in the table of contents. These financial statements are the responsibility of the ACI's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of 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 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 audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the ACI Enterprise Fund and do not purport to, and do not, present fairly the financial position of the State of Arizona, Department of Corrections, as of June 30, 2010, and the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the State of Arizona, Department of Corrections-Arizona Correctional Industries Enterprise Fund as of June 30, 2010, and the respective changes in financial position and cash flows, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

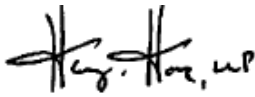
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Members of the Arizona State Legislature
Arizona Correctional Industries

In accordance with *Government Auditing Standards*, we have also issued our report dated October 2, 2010, on our consideration of the ACI Enterprise Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of that report 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



Casa Grande, Arizona
October 2, 2010

STATE OF ARIZONA
DEPARTMENT OF CORRECTIONS
ARIZONA CORRECTIONAL INDUSTRIES
STATEMENT OF NET ASSETS - ENTERPRISE FUND
June 30, 2010

ASSETS

Cash in bank and on hand	\$ 66,665
Cash and cash equivalents held by the State Treasurer	1,707,931
Accounts receivable (net of allowance for uncollectible of \$16,000)	4,818,837
Inventories	2,669,046
Prepaid expenses	<u>368,708</u>

TOTAL CURRENT ASSETS	<u>9,631,187</u>
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NONCURRENT ASSETS

Capital assets, not being depreciated	804,319
Capital assets, net of depreciation	<u>2,561,291</u>

TOTAL NONCURRENT ASSETS	<u>3,365,610</u>
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TOTAL ASSETS	<u>12,996,797</u>
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LIABILITIES

CURRENT LIABILITIES

Accounts payable	527,026
Accrued payroll and employee benefits	544,672
Accrued compensated absences	392,081
Deferred revenue	623,685
Other accrued liabilities	557,200
Short term debt	<u>95,785</u>

TOTAL CURRENT LIABILITIES	<u>2,740,449</u>
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NONCURRENT LIABILITIES

Long term debt	<u>132,662</u>
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TOTAL NONCURRENT LIABILITIES	<u>132,662</u>
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TOTAL LIABILITIES	<u>2,873,111</u>
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NET ASSETS

Invested in capital assets, net of related debt	3,137,163
Unrestricted	<u>6,986,523</u>

TOTAL NET ASSETS	<u><u>\$ 10,123,686</u></u>
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STATE OF ARIZONA
DEPARTMENT OF CORRECTIONS
ARIZONA CORRECTIONAL INDUSTRIES
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS -
ENTERPRISE FUND
Year Ended June 30, 2010

Sales	\$ 33,100,857
Cost of goods sold	<u>26,143,468</u>
GROSS PROFIT	<u>6,957,389</u>
OPERATING EXPENSES	
Selling	805,152
General and administrative	<u>2,692,946</u>
Total operating expenses	<u>3,498,098</u>
OPERATING INCOME	<u>3,459,291</u>
NONOPERATING REVENUES (EXPENSES)	
Investment earnings	29,526
Miscellaneous expense	(1,617)
Interest expense	<u>(37,067)</u>
TOTAL NONOPERATING REVENUES (EXPENSES)	<u>(9,158)</u>
INCOME BEFORE TRANSFERS	3,450,133
Transfers out to other State of Arizona funds	<u>(5,555,556)</u>
CHANGE IN NET ASSETS	(2,105,423)
NET ASSETS-BEGINNING OF YEAR	<u>12,229,109</u>
NET ASSETS-END OF YEAR	<u><u>\$ 10,123,686</u></u>

STATE OF ARIZONA
DEPARTMENT OF CORRECTIONS
ARIZONA CORRECTIONAL INDUSTRIES
STATEMENT OF CASH FLOWS
Year Ended June 30, 2010

CASH FLOWS FROM OPERATING ACTIVITIES	
Receipts from customers	\$ 30,728,658
Payments to suppliers for goods and services	(12,097,555)
Payments to employees	(8,113,778)
Payments to inmates	<u>(8,511,060)</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>2,006,265</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES	
Cash transfers to other funds	<u>(5,555,556)</u>
NET CASH USED BY NONCAPITAL FINANCING ACTIVITIES	<u>(5,555,556)</u>
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES	
Acquisition and construction of capital assets	(369,674)
Payments for debt	(80,617)
Interest payments on debt	<u>(38,684)</u>
NET CASH USED BY CAPITAL AND RELATED FINANCING ACTIVITIES	<u>(488,975)</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Interest received	<u>29,526</u>
NET CASH PROVIDED BY INVESTING ACTIVITIES	<u>29,526</u>
NET CHANGE IN CASH AND CASH EQUIVALENTS	(4,008,740)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>5,783,336</u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	<u><u>\$ 1,774,596</u></u>

See accompanying notes.

Reconciliation of operating income to net cash provided by operating activities:	
Operating income	\$ 3,459,291
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation	511,967
(Increase) decrease in:	
Accounts receivable	221,084
Inventories	691,506
Prepaid expenses	(281,408)
Increase (decrease) in:	
Accounts payable	(957)
Accrued payroll and employee benefits	(62,473)
Accrued compensated absences	60,538
Deferred revenue	(2,650,364)
Other accrued liabilities	57,081
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u><u>\$ 2,006,265</u></u>

STATE OF ARIZONA
DEPARTMENT OF CORRECTIONS
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NOTES TO FINANCIAL STATEMENTS
June 30, 2010

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting policies of the Department of Corrections-Arizona Correctional Industries (ACI) conform to generally accepted accounting principles applicable to governmental units adopted by the Governmental Accounting Standards Board (GASB). A summary of ACI's more significant accounting policies follows.

A. Reporting Entity

The ACI is accounted for as an enterprise fund of the State of Arizona that is controlled by the Department of Corrections. However, ultimate fiscal responsibility for ACI remains with the State of Arizona. ACI's financial information is presented in the *State of Arizona Comprehensive Annual Financial Report*.

B. Fund Accounting

ACI's accounts are maintained in accordance with the principles of fund accounting to ensure that limitations and restrictions on ACI's available resources are observed. The principles of fund accounting require that resources be classified for accounting and reporting purposes into funds in accordance with the activities or objectives specified for those resources. Each fund is considered a separate accounting entity, and its operations are accounted for in a separate set of self-balancing accounts that comprise its assets, liabilities, net assets, revenues, and expenses.

ACI's financial transactions are recorded and reported as an enterprise fund, since its operations are financed and operated in a manner similar to private business enterprises, in which the governing body's intent is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges.

C. Basis of Presentation and Accounting

The financial statements include a statement of net assets; a statement of revenues, expenses, and changes in fund net assets; and a statement of cash flows.

A statement of net assets provides information about the assets, liabilities, and net assets of ACI at the end of the year. Assets and liabilities are classified as either current or noncurrent. Net assets are classified according to external restrictions or availability of assets to satisfy ACI's obligations. Invested in capital assets represents the value of capital assets, net of accumulated depreciation. Unrestricted net assets include all other net assets, including those that have been designated by management to be used for other than general operating purposes.

A statement of revenues, expenses, and changes in fund net assets provides information about ACI's financial activities during the year. Revenues and expenses are classified as either operating or nonoperating, and all changes in net assets are reported, including capital contributions and transfers. Operating revenues and expenses generally result from providing services, producing goods, and delivering

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June 30, 2010

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

goods in connection with ACI's ongoing operations. Other revenues used for operations, such as investment income, are not generated from operations and are considered to be nonoperating revenues. Operating expenses include the costs of sales and services, administrative expenses, and depreciation on capital assets.

A statement of cash flows provides information about ACI's sources and uses of cash and cash equivalents during the year. Increases and decreases in cash and cash equivalents are classified as either operating, noncapital financing, capital financing, or investing.

The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flows take place.

ACI follows generally accepted accounting principles and Interpretations issued on or before November 30, 1989; Accounting Principles Board Opinions; and Accounting Research Bulletins, unless those pronouncements conflict with or contradict GASB pronouncements.

D. Cash and Investments

For purposes of its statement of cash flows, ACI considers cash on hand, demand deposits, and cash on deposit with State Treasurer to be cash and cash equivalents.

E. Accounts Receivable

Accounts receivable are due from a variety of governmental and nongovernmental customers. The allowance for uncollectible accounts is based upon management's evaluation of the collectibility of the accounts.

F. Inventories

Inventories consist of raw materials, work-in-process, finished goods. Inventories are recorded as assets when purchased along with the costs of manufacturing the merchandise intended for sale to customers and expensed when sold. Inventories are stated at cost using the first-in, first-out method.

G. Capital Assets

Capital assets are reported at actual cost. Donated assets are reported at fair value at the time received. The capitalization thresholds are \$5,000 for all capital assets. Depreciation of such assets is charged as an expense against operations. These assets are depreciated over their estimated useful lives using the straight-line method. The estimated useful lives are as follows:

Land improvements and buildings	15 to 40 Years
Building improvements	10 to 40 Years
Equipment	3 to 15 Years

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NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

H. Investment Income

Investment income is composed of interest, dividends, and net changes in fair value of investments on ACI's portion of monies deposited with the State Treasurer.

I. Compensated Absences

Compensated absences consist of vacation leave earned by employees based on services already rendered. Employees may accumulate up to 320 hours of vacation if salaried or 240 hours if hourly depending on years of service, but any vacation hours in excess of the maximum amount that are unused at year-end are forfeited. Upon termination of employment, all unused and unforfeited vacation benefits are paid to employees. Accordingly, vacation benefits are accrued as a liability in the financial statements.

Employees may accumulate an unlimited number of sick leave hours. Generally, sick leave benefits provide for ordinary sick pay and are cumulative but are forfeited upon termination of employment. However, upon retirement, employees who have accumulated at least 500 hours of sick leave receive some benefit payments. Benefit payments vary based upon the number of sick hours accumulated, but cannot exceed \$30,000. ACI makes contributions to the State's Retiree Accumulated Sick Leave Fund for each employee, and the State makes benefit payments directly to the retired employees. Consequently, ACI has not accrued a liability for these sick leave benefits.

NOTE 2 DEPOSITS AND INVESTMENTS

Cash in bank and on hand-At June 30, 2010, cash on hand was \$1,000, the carrying amount of cash in bank was \$65,665, and the bank balance was \$65,731. ACI does not have a formal policy with respect to custodial credit risk. Arizona Revised Statutes (A.R.S.) stipulates that collateral is required for demand deposits and repurchase agreements at 102 percent of all deposits not covered by federal depository insurance. At June 30, 2010, ACI's bank balance was not exposed to custodial credit risk due to uninsured and uncollateralized accounts.

Cash and investment held by the State Treasurer-A.R.S. require state agencies' monies to be deposited with the State Treasurer, and further requires those deposits to be invested in various pooled funds. Cash on deposit with State Treasurer represent ACI's portion of those monies. ACI separately invested monies in the State Treasurer's Investment Pool 3 and interest earned from these separately invested monies is allocated monthly to ACI based upon the accounts average daily balance. The fair value of ACI's position in the pool approximates the value of ACI's pool shares. Those shares are not identified with specific investments and are not subject to custodial credit risk.

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NOTES TO FINANCIAL STATEMENTS
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NOTE 2 DEPOSITS AND INVESTMENTS (Continued)

At June 30, 2010, ACI's deposits with the State Treasurer were as follows:

	Carrying Amount	Balance with Treasurer
Cash deposits for operations	\$ 898,651	\$ 1,545,506
Cash deposits designated for investment	809,280	809,280
Total	<u>\$ 1,707,931</u>	<u>\$ 2,354,786</u>

Credit Risk

Credit risk is the risk that an issuer or counterparty to an investment will not fulfill its obligations. The State Treasurer's Investment Pool 3 is unrated.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. As of June 30, 2010, the State Treasurer's weighted average to maturity of its Investment Pool 3 is 0.58 years.

NOTE 3 INVENTORIES

Inventories consisted of the following at June 30, 2010:

Raw materials	\$ 1,964,372
Work in process	147,802
Finished goods	556,872
	<u>\$ 2,669,046</u>

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NOTE 4 CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2010, was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets, not being depreciated:				
Land	\$ 692,438	\$ -	\$ -	\$ 692,438
Construction in progress	111,170	111,881	(111,170)	111,881
Total capital assets not being depreciated	803,608	111,881	(111,170)	804,319
Capital assets, being depreciated:				
Land improvements	240,438	-	-	240,438
Building	804,012	-	-	804,012
Building improvements	894,866	54,110	-	948,976
Equipment	7,528,701	314,853	-	7,843,554
Total capital assets being depreciated	9,468,017	368,963	-	9,836,980
Less accumulated depreciation for:				
Land improvements	(239,451)	(399)	-	(239,850)
Building	(400,123)	(30,352)	-	(430,475)
Building improvements	(496,184)	(26,617)	-	(522,801)
Equipment	(5,627,964)	(454,599)	-	(6,082,563)
Total accumulated depreciation	(6,763,722)	(511,967)	-	(7,275,689)
Total capital assets, being depreciated, net	2,704,295	(143,004)	-	2,561,291
Capital assets, net	\$ 3,507,903	\$ (31,123)	\$ (111,170)	\$ 3,365,610

NOTE 5 CAPITAL LEASES

In September of 2007, ACI entered into a lease with a one dollar bargain purchase option for a four color superweb series 180 press system costing \$439,985. Monthly installments of \$10,106, including interest of 13.94%, are due through August 1, 2012. Minimum lease payments by year are:

Fiscal year ending June 30	Business-type Activities
2011	\$ 121,274
2012	121,274
2013	20,212
Total minimum lease payments	262,760
Less: amount representing interest	34,313
Present value of future minimum lease payments	228,447
Less: current portion	95,785
Noncurrent portion	\$ 132,662

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NOTE 5 CAPITAL LEASES (CONTINUED)

The following is an analysis of the leased asset included in capital assets:

Asset	Leased Asset
Equipment	\$ 439,985
Less accumulated depreciation	(151,245)
Total	<u>\$ 288,740</u>

NOTE 6 CHANGES IN LONG-TERM LIABILITIES

Long-term liabilities activity for the year ended June 30, 2010 was as follows:

	Beginning Balance	Additions	Reductions	Ending Balance	Due Within One Year
Compensated absences	\$ 331,543	\$ 129,808	\$ (69,270)	\$ 392,081	\$ 392,081
Capital leases	309,064	-	(80,617)	228,447	95,785
Long-term liabilities	<u>\$ 640,607</u>	<u>\$ 129,808</u>	<u>\$ (149,887)</u>	<u>\$ 620,528</u>	<u>\$ 487,866</u>

NOTE 7 TRANSFERS TO OTHER STATE FUNDS

During the year ended June 30, 2010, ACI transferred \$4,057,900 and \$1,481,826 to the State of Arizona's General Fund and Department of Corrections, respectively. ACI transferred \$15,830 to the Arizona Department of Corrections for prisoner instruction, such as vocational education and job training, as allowed by A.R.S. §41-1624.

NOTE 8 RELATED PARTY TRANSACTIONS

ACI employs inmates in its manufacturing, service, and agricultural operations for the sale of goods and services primarily to other state agencies and political subdivisions. During the year ended June 30, 2010, approximately \$4.5 million, \$3.0 million, and \$3.0 million of goods and services were sold to the Arizona Department of Corrections (ADC), Arizona Department of Transportation (ADOT), and all other state agencies, respectively. At June 30, 2010, ACI's accounts receivable balance included \$858,184, \$221,882, and \$114,483 due from the ADC, ADOT, and all other state agencies, respectively. ACI purchased approximately \$10.1 million of goods and inmate services from the ADC, \$12,048 of goods and services from ADOT, and \$82,675 of goods and services from other state agencies, respectively, for the year ended June 30, 2010.

STATE OF ARIZONA
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NOTE 9 RISK MANAGEMENT

ACI is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees and others; and natural disasters. ACI is a participant in the State's self-insurance program covering property, environment liability, and workers' compensation losses. In the opinion of ACI's management, any unfavorable outcomes from these risks would be covered by the State's self-insurance program. Accordingly, ACI has no risk of loss beyond adjustments to future years' premium payments to the State's self-insurance program. All estimated losses for unsettled claims and actions of the State are determined on an actuarial basis and are included in the *State of Arizona Comprehensive Annual Financial Report*.

NOTE 10 RETIREMENT PLAN

Plan Description-ACI contributes to a cost-sharing, multiple-employer defined benefit pension plan that covers general employees of the ACI administered by the Arizona State Retirement System. Benefits are established by state statute and generally provide retirement, death, long-term disability, survivor, and health insurance premium benefits. The System is governed by the Arizona State Retirement System Board according to the provisions of A.R.S. Title 38, Chapter 5, Article 2.

The System issues a comprehensive annual financial report that includes its financial statements and required supplementary information. A report may be obtained by writing the Arizona Retirement System, 3300 North Central Avenue, PO Box 33910, Phoenix, AZ 85067-3910, or calling (602) 240-2000 or 1-800-621-3778.

Funding Policy-The Arizona State Legislature establishes and may amend active plan members' and ACI's contribution rates. For the year ended June 30, 2010, active ASRS members and the ACI were each required by statute to contribute at the actuarially determined rate of 9.1 percent (8.6 percent retirement and 0.5 percent long-term disability) of the members' annual covered payroll. ACI's contributions to the ASRS for the years ended June 30, 2010, 2009, and 2008 were \$310,050, \$250,824, and \$225,888, respectively, which were equal to the required contributions for the year.

SUPPLEMENTARY INFORMATION



REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON
COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL
STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT
AUDITING STANDARDS

Members of the Arizona State Legislature

Charles L. Ryan, Director
Arizona Department of Corrections

We have audited the financial statements of the business-type activities of State of Arizona, Department of Corrections-Arizona Correctional Industries (ACI) Enterprise Fund (ACI), as of and for the year ended June 30, 2010, which collectively comprise ACI's basic financial statements and have issued our report thereon dated October 2, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered ACI'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 ACI's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of ACI's internal control over financial reporting.

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 a 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 first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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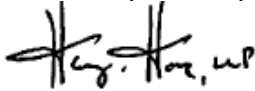
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Compliance and Other Matters

As part of obtaining reasonable assurance about whether ACI's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. 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 disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management, Members of the Arizona State Legislature, Arizona Department of Corrections, others within the entity, and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in black ink, appearing to read "Kay. Hae, CPA". The signature is stylized with a large, looped initial "K" and a trailing "CPA" at the end.

Casa Grande, Arizona
October 2, 2010