DEFENSE FINANCE AND ACCOUNTING SERVICE

WORKING CAPITAL FUND

FISCAL YEAR 2004
FINANCIAL REPORT

NOVEMBER 2004

UK &W Urbach Kahn & Werlin LLP
CERTIFIED PUBLIC ACCOUNTANTS

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MESSAGE FROM THE DFAS DIRECTOR

In Fiscal Year (FY) 2004, the Defense Finance and Accounting Service (DFAS) sharpened its focus on the needs of its customers and made significant strides toward fulfilling its vision of becoming a world-class finance and accounting organization. The agency progressed by working to reform financial management, improving the quality of DFAS products and services, and reducing costs to customers. These efforts support the President's Management Agenda, the Defense transformation initiatives, and the men and women who defend America.

The DFAS team is passionate and dedicated about serving our customers, from the men and women who depend on DFAS for finance and accounting services to the Defense decision makers who rely on DFAS for timely, accurate business intelligence. The men and women of DFAS proudly play a critical role in our national security. We recognize that as the threats against our nation grow and the needs of our customers expand, DFAS must anticipate and adapt to meet the mission needs of our customers and our country. DFAS delivers financial assurance which gives our customers the finance and accounting products, services and intelligence that will be on target, on time, every time.

In FYs 2000 through 2004, DFAS received unqualified audit opinions on its financial statements. DFAS has built an effective, accountable management structure with clearly defined, measurable goals. Our progress is charted and regularly reported to our stakeholders. Our programs and initiatives are guided by the Under Secretary of Defense (Comptroller) and Chief Financial Officer, a Board of Advisors, and an Audit Committee.

DESCRIPTION OF THE REPORTING ENTITY

DFAS is the finance and accounting arm of the Department of Defense (DoD). The DFAS mission is to provide responsive, professional finance and accounting services for the people who defend America. DFAS pays all military and civilian personnel, retirees and annuitants, civilian employees of various federal agencies, major DoD contracts and vendors, and delivers accounting reports and financial information. The information in this document, and the accompanying financial statements and footnotes are the responsibility of DFAS management.

As a Defense Working Capital Fund activity, DFAS operates similar to a private business, obtaining revenue by charging customers fixed prices for its services. DFAS sets its rates annually, two years in advance, based on anticipated workload and estimated costs calculated to offset any prior year gains or losses. Unlike private businesses, DFAS has little flexibility to adjust prices in the year of execution, and DFAS operations are subject to DoD, Executive Branch and Legislative Branch oversight.

DFAS exists to deliver world-class finance and accounting products and services to the men and women who defend America. DFAS employs more than 14,000 people throughout the United States and in the European and Pacific theaters of operations to serve this purpose.

DFAS delivers finance and accounting services worldwide from a Headquarters in Arlington, Virginia, five DFAS central sites located in Cleveland, Ohio; Columbus, Ohio; Denver, Colorado; Indianapolis, Indiana; and Kansas City, Missouri; and 20 field sites. DFAS was generally structured to support Army, Navy, Marine Corps, Air Force and Defense Agencies via departmental and field operating networks. Progress in the President's Management Agenda has recently added new customers (transition to be completed FY 2005) from outside the Department of Defense including the Department of Energy, Department of Veteran Affairs, Environmental Protection Agency, and Health and Human Services.

DFAS has built its organization to anticipate and meet our customers' needs by assigning each major customer a dedicated client executive to foster effective communication and build partnerships that enhance customers' mission capabilities. These client executives ensure the DFAS team understands the unique and diverse requirements of each customer.

DFAS' three operational business lines deliver the specific products and services that satisfy these needs:

- Military and Civilian Pay Services provide all aspects of pay to individuals – out of service debts, travel reimbursements and garnishments.
- Commercial Pay Services provide payment services to all contractors doing business with DoD.
- Accounting Services provide departmental and field-level accounting and disbursing services.

The magnitude of DFAS worldwide operations this past year consisted of:

- Paid 5.9 million military members, civilian personnel, retirees and annuitants
- Made 6.9 million travel payments
- Paid 12.6 million commercial invoices
- Processed 127.3 million accounting transactions
- Managed $226.5 billion Military Retirement and Medicare Eligible Retiree Health Care funds
- Disbursed $455 billion to pay recipients
- Managed $13.5 billion in Foreign Military Sales (reimbursed by foreign governments)
- Accounted for 282 active appropriations

DFAS has two distinct business areas, Financial Operations and Information Services.

Financial Operations

The Financial Operations business area is composed of six business lines, of which three are revenue producing (Military and Civilian Pay Services, Accounting Services and Commercial Pay Services) and the three others are support functions (Corporate Elements, Corporate Resources and Technology Services Organization). Inherent to these functions, DFAS is also responsible for safeguarding U.S. funds through delivery of payments and receipt of collections, providing prompt, accurate, and timely disbursing service, and reporting Disbursing Officer accountability to the Department of the Treasury.

Information Services

This activity functions as a fee-for-service operation. Organizations within this activity provide software development/modernization and systems maintenance support to Automated Information Systems. They also provide technical support in a number of system-related areas including the acquisition of information technology, systems implementation and support for DFAS' information technology (IT) infrastructure.

PERFORMANCE GOALS, OBJECTIVES AND RESULTS

DFAS is a customer-focused, strategy-based and metrics-driven organization. The DFAS Strategic Plan drives DFAS operations everyday to help DFAS achieve its vision of becoming a world-class finance and accounting organization that delivers the best value to our customers. Supporting this strategy, DFAS has identified five strategic targets that address the critical issues facing our customers and our core capabilities. Those targets include:

- Pay service members, civilians, retirees and annuitants what they are entitled to on the scheduled pay date
- Provide auditable financial statements by FY 2007
- Expand e-commerce for Commercial Pay by the end of FY 2005
- Develop a corporate capability to deliver unique business intelligence by FY 2005
- Recruit, train and retain a work force needed to develop and implement the DFAS strategy

DFAS turns its strategy into meaningful, measurable initiatives through the use of the Balanced Scorecard. Renewed each year, the Balanced Scorecard includes measures organized into four perspectives: customer, financial, internal, and growth and learning. At DFAS, every measure has an executive sponsor and measure expert to champion organizational progress in that area. Using the Balanced Scorecard to make the connection from DFAS' vision and strategic targets to individual performance and standards allows our employees to see how they contribute to the corporate goal everyday.

The DFAS Balanced Scorecard serves as operational and financial performance indices to effectively and efficiently manage our business operations. Performance objectives in the Balanced Scorecard focus on the continued achievement of the DFAS mission of providing responsive, professional finance and accounting services for the people who defend America.

In FY 2004, DFAS was able to reduce the time required to produce quarterly accounting reports for our customers from 45 to 21 days. By increasing the speed of these reports, DFAS accelerated its customers' ability to analyze and execute their budgets. While improving the timeliness of accounting reports, DFAS also made progress in several other critical financial and operational areas in support of the key strategic targets; such as:

Military and Civilian Pay Services Business Line:

- DFAS supported the mobilization and demobilization of more than 195,000 men and women for the war on terrorism.
- myPay customers have increased to 2.9 million participants and several enhancements were recently incorporated. Users can now interactively make changes for allotments and bonds. Continuing to add ePayroll customers will result in lower DoD costs for the myPay system.

Accounting Services Business Line:

FY 2004 was a challenging year with the Office of Management and Budget (OMB) mandated accelerated reporting dates for financial statements. DFAS met these dates and also achieved the 10 percent reduction goal for problem disbursements. Further, problem disbursements were no longer considered a material weakness by the Department, Chief Financial Officer.

- Reduced negative unliquidated obligations from $125 million at the end of FY 2003 to $95 million at the end of FY 2004.
- Reduced unmatched disbursements from $854 million in FY 2003, to $735 million at the end of FY 2004.

Within Commercial Pay services, DFAS made similar progress including:

- Lowering the percentage of overaged invoices from 3.66 percent at the end of FY 2003 to 2.55 percent at the end of FY 2004.
- Reducing the interest from $160 in FY 2003 to $130 in FY 2004 for every million dollars disbursed.

These improvements have been realized by the realignment of some functions/processes to centralized locations, due diligence in resolving aged transactions, and improved efficiencies of scale which translates into cost savings; passed along to our customers.

FINANCIAL CONDITION

The financial statements have been prepared to report the financial position and results of operations for DFAS, pursuant to the requirements of Title 31, United States Code, Section 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with accounting principles generally accepted in the United States of America and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

DFAS' financial condition is sound. DFAS received consecutive unqualified opinions on its financial statements from an independent Certified Public Accounting firm in FYs 2000 through 2004.

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

DFAS intends to continue development of a knowledge management environment to capture and share information in a network that is interactive, robust and responsive to the needs of DFAS and its employees. This will enable DFAS to leverage its lessons learned and its knowledge to assist all of our customers to implement sound financial management practices and move the Department forward with true financial management reform.

DFAS is providing support to the Defense Financial Management Modernization Program (DFMMP) Management Office. The DFMMP is developing a DoD-wide blueprint, an enterprise architecture that is consistent with the DoD Chief Information Officer's IT architecture that prescribes how the Department's financial and non-financial feeder systems and business processes will interact. The DFMMP office is also responsible for the control and oversight of systems development, acquisition, upgrade, deployment and other changes for all financial management and related non-financial business systems including their legacy systems.

POSSIBLE FUTURE EFFECTS ON EXISTING EVENTS AND CONDITIONS

DFAS must continue to transform to anticipate changes in customer needs, the financial landscape and the Defense mission. DFAS' transformation journey includes evaluating every business line and product line to determine the optimal mix of products and services delivered in the best possible way. Since beginning the process in March 2003, DFAS has completed nine Business Case Analyses (BCAs). Seven of the BCAs recommended streamlining operations prior to competition with private industry. Another recommended an OMB Circular A – 76 competition and one is still pending. In FY 2005, DFAS will conduct business case analyses of the remaining functions.

To help eliminate rework and create more value from within, DFAS continues to build a culture of excellence through the adaptation and development of "Lean Six", which combines "Lean Thinking" and "Six Sigma." "Lean Thinking" focuses on customer-defined value, mapping the value stream, ensuring value flows through the process, allowing the customer demand to pull value from the process, and relentlessly pursuing perfection. "Six Sigma" provides rigorous tools and techniques for eliminating error and waste while improving quality and productivity of DFAS processes and systems.

Like all Defense agencies, DFAS will support and implement the pending decisions of Base Realignment and Closure (BRAC) 2005, which will eliminate excess infrastructure capacity and present another transformation opportunity for DFAS. The Secretary of Defense will make his recommendations in May 2005. The list will not be final until after consideration by the BRAC Commission, the President and the Congress in December 2005. BRAC implementation actions may not begin prior to January 2006 and must be completed by January 2011.

Additional information about DFAS performance, programs and systems can be found on our Web site at http://www.dfas.mil.

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands	2004	2003
ASSETS		
Intragovernmental:		
Collections and Disbursements Clearing	$ -	$ -
Accounts Receivable (Note 2)	21,837	15,812
Total Intragovernmental	$ 21,837	$ 15,812
With the Public:		
Accounts Receivable (Note 2)	$ 595	$ 5,539
General Property, Plant and Equipment (Note 3)	841,640	898,773
Other Assets	75	19
TOTAL ASSETS	**$ 864,147**	**$ 920,143**
LIABILITIES		
Intragovernmental:		
Accounts Payable	$ 55,520	$ 83,245
Other Liabilities (Note 4 and 5)	13,660	14,684
Total Intragovernmental	$ 69,180	$ 97,929
With the Public:		
Accounts Payable	$ 118,281	$ 118,412
Actuarial FECA Liability (Note 5 and 6)	42,328	46,855
Accrued Payroll and Benefits (Note 4)	46,045	32,924
Deposit Funds and Suspense Accounts (Note 4)	66	-
Accrued Unfunded Annual Leave (Note 4 and 5)	47,938	50,837
TOTAL LIABILITIES	**$ 323,838**	**$ 346,957**
NET POSITION		
Cumulative Results of Operations	$ 540,309	$ 573,186
TOTAL NET POSITION	**$ 540,309**	**$ 573,186**
TOTAL LIABILITIES AND NET POSITION	**$ 864,147**	**$ 920,143**

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF NET COST
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands		2004		2003
PROGRAM COSTS				
Intragovernmental Gross Costs	$	455,279	$	426,191
(Less: Intragovernmental Earned Revenue)		(1,726,441)		(1,470,282)
Intragovernmental Net Costs	$	(1,271,162)	$	(1,044,091)
Gross Costs With the Public	$	1,255,106	$	1,310,733
(Less: Earned Revenue From the Public)		(1,809)		(1,096)
Net Costs With the Public	$	1,253,297	$	1,309,637
NET COST OF OPERATIONS	**$**	**(17,865)**	**$**	**265,546**

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands	2004	2003
Cumulative Results of Operations		
BEGINNING BALANCES	**$ 573,186**	**$ 704,698**
Budgetary Financing Sources		
Other Budgetary Financing Sources	13,357	1,442
Other Financing Sources		
Transfers-In/Out Without Reimbursement	(142,773)	58,468
Imputed Financing Sources (Note 7)	78,674	74,124
Total Financing Sources	**(50,742)**	**134,034**
Net Cost of Operations	**(17,865)**	**265,546**
ENDING BALANCES	**$ 540,309**	**$ 573,186**

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
COMBINED STATEMENTS OF BUDGETARY RESOURCES
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands		2004		2003
BUDGETARY RESOURCES				
Budget Authority:				
Contract Authority	$	111,144	$	124,437
Unobligated Balance:				
Beginning of Period		36,186		1,007,716
Net Transfers, Actual		500		625
Spending Authority from Offsetting Collections:				
Earned:				
Collected		1,897,222		1,698,573
Receivable from Federal Sources		(29,904)		(50,521)
Change in Unfilled Customer Orders:				
Without Advance from Federal Sources		2,476		25,986
Subtotal		1,869,794		1,674,038
Recoveries of prior year obligations		31,820		-
Permanently not Available		(115,376)		(987,867)
Total Budgetary Resources	**$**	**1,934,068**	**$**	**1,818,949**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred:				
Reimbursable	$	1,756,915	$	1,782,763
Total Obligations Incurred		1,756,915		1,782,763
Unobligated Balance:				
Apportioned		177,153		36,186
Total Status of Budgetary Resources	**$**	**1,934,068**	**$**	**1,818,949**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net - Beginning of Period	$	252,174	$	195,608
Obligated Balance, Net - End of Period:				
Accounts Receivable		(28,135)		(58,038)
Unfilled Customer Orders		(59,526)		(57,050)
Undelivered Orders (Note 9)		106,598		88,804
Accounts Payable (Note 9)		230,814		278,458
Outlays:				
Disbursements		1,754,945		1,750,732
Collections		(1,897,222)		(1,698,573)
Subtotal		(142,277)		52,159
Net Outlays	**$**	**(142,277)**	**$**	**52,159**

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF FINANCING
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands	2004	2003
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated:		
Obligations Incurred	$ 1,756,915	$ 1,782,763
Less: Spending Authority From Offsetting Collections	(1,901,614)	(1,674,038)
Net Obligations	(144,699)	108,725
Other Resources:		
Transfers In/Out Without Reimbursement	(142,773)	58,468
Imputed Financing Sources (Note 7)	78,674	74,124
Total Resources Used to Finance Activities	**(208,798)**	**241,317**
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but Not Yet Provided	(15,375)	26,020
Resources that Fund Expenses Recognized in Prior Periods	(10,330)	-
Resources that Finance the Acquisition of Assets	(49,059)	(59,347)
Other	142,773	(58,468)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**68,009**	**(91,795)**
Total Resources Used to Finance the Net Cost of Operations	**(140,789)**	**149,522**
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Other	2,812	1,372
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in Future Periods	**2,812**	**1,372**
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	125,801	114,659
Revaluation of assets or liabilities	3,914	-
Other (Note 10)	(9,603)	(7)
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	**120,112**	**114,652**
Total Components of Net Cost of Operations That Will Not Require or Generate Resources or Generate Resources In the Current Period	**122,924**	116,024
NET COST OF OPERATIONS	**$ (17,865)**	**$ 265,546**

The accompanying notes are an integral part of these statements

Note 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The Defense Finance and Accounting Service (DFAS), a component of the Department of Defense (DoD) was established in 1991 by the Secretary of Defense to reduce the cost of DoD finance and accounting operations and to reform financial management throughout DoD. The mission of DFAS is to provide responsive, professional finance and accounting services to the DoD. Over the past ten years, DFAS has consolidated 338 installation-level finance and accounting operations into twenty-six sites. Entity accounts consist of resources that the agency has the authority to use, or where management is legally obligated to use funds to meet entity obligations. The accompanying financial statements of DFAS include the activities of the following organizational components:

<u>Financial Operations</u>

The Financial Operations business area is composed of six business lines, of which three are revenue producing (Military and Civilian Pay Services, Accounting Services and Commercial Pay Services) and the three others are support functions (Corporate Elements, Corporate Resources and Technology Services Organization). Inherent to these functions, DFAS is also responsible for safeguarding U.S. funds through delivery of payments and receipt of collections, providing prompt, accurate, and timely disbursing service, and reporting Disbursing Officer accountability to the Department of the Treasury.

<u>Information Services</u>

This activity functions as a fee-for-service operation. Organizations within this activity provide software development/modernization and systems maintenance support to Automated Information Systems. Additionally, they provide overall technical support in a number of system-related areas including the acquisition of information technology, systems implementation, and support for the DFAS information technology (IT) infrastructure.

B. Basis of Presentation

The accompanying financial statements have been prepared to report the financial position, net costs and changes in net position of DFAS, together with budgetary resources and a reconciliation of net costs to budgetary obligations as required by the Chief Financial Officer's (CFO) Act of 1990 and amended by the Government Management Reform Act (GMRA) of 1994, and are in accordance with accounting principles generally accepted in the United States of America (GAAP). GAAP for Federal financial reporting entities recognize the Federal Accounting Standards Advisory Board (FASAB) as the standards-setting body designed to establish these principles for these entities. The financial statements have been prepared from the books and records of DFAS in accordance with the Office of Management and Budget (OMB) Bulletin No. 01-09, *Form and Content of Agency Financial Statements,* as amended, and the DoD Financial Management Regulation (DoD FMR) Volume 6B, when applicable, as summarized in these notes.

C. Basis of Accounting

Transactions are recorded on an accrual and a budgetary basis of accounting. Under the accrual basis, revenues are recorded when earned and expenses are recorded when incurred, regardless of when cash is exchanged. Under the budgetary basis, however, funds availability is recorded based upon legal considerations and constraints. As a result, certain line items on the proprietary financial statements may not equal similar line items on the budgetary financial statements.

D. Revenues and Other Financing Sources

Revenue is recognized when earned and services have been rendered. Revenue is generated by sales of accounting and finance services to the DFAS customers through a reimbursable order process. The majority of services rendered by DFAS are provided to other DoD agencies.

E. Collections and Disbursements Clearing Account

DFAS, as a working capital fund, does not have a Fund Balance with Treasury (FBWT) account. Instead, a collections and disbursements clearing account is maintained by DFAS to account for its collections and disbursements activity.

The Defense Working Capital Fund (DWCF) is subdivided at the Department of Treasury (Treasury) into five subnumbered Treasury accounts. It is at the subnumbered account level that the FBWT exists for the DWCF. DFAS and nine other DWCF activities operate under one Defense subnumbered Treasury account. As a result, DFAS does not have an individually identifiable balance. The collections, disbursements, and cash transfers applicable to DFAS' operations are recorded in DFAS' financial records during the fiscal year. The collections and disbursements and current-year cash transfers are recorded as financing sources transferred out without reimbursement via cumulative results of operations to the DWCF subnumbered Treasury account at year-end.

F. Accounts Receivable

Intragovernmental Accounts Receivable consists of amounts due from other DoD and other Federal agencies for reimbursable work performed on behalf of DFAS' customers. An allowance for uncollectible accounts was not established because all of the Accounts Receivable are due from other Federal agencies, and are deemed to be fully collectible.

G. General Property, Plant and Equipment

General Property, Plant and Equipment (PP&E) are carried at historical acquisition cost plus capitalized improvements. General PP&E assets are capitalized at cost if the acquisition is $100,000 or more and has a useful life of two or more years. All General PP&E is depreciated based on the historical cost using the straight-line method over the estimated useful lives of the assets, which range from 2 to 40 years. Normal repairs and maintenance are charged to expense as incurred.

Title 10, United States Code, prohibits DoD agencies from owning property, therefore DoD has implemented the recognition criteria of Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant and Equipment*, to report the financial position of its member agencies. As implemented by DoD regulations, ownership of an asset is not a prerequisite to asset recognition. DoD FMR Volume 4, Chapter 6, states that legal ownership usually, but not always, is the determinant factor when determining which DoD component recognizes a particular General PP&E asset for accounting and reporting purposes in financial statements. Asset recognition may also be based on the "Preponderance of Use" principle. This concept recognizes that member DoD agencies that gain the most benefit by virtue of space usage should capitalize the asset as General PP&E on their balance sheet.

H. Contingencies and Commitments

DFAS is a party in various administrative proceedings, legal actions, and claims brought against it. In the opinion of DFAS management and legal counsel, the ultimate resolution of these proceedings, actions, and claims will not materially affect the financial position or results of operations of DFAS.

I. Federal Employee Compensation Benefits

Workers' Compensation is comprised of two components: (1) the accrued liability which represents monies owed for claims incurred through the current fiscal year; and (2) the actuarial liability for approved compensation cases beyond the current year.

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered 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. Claims incurred for benefits for DFAS employees under FECA are administered by the Department of Labor (DOL) and are ultimately paid by DFAS.

Future workers' compensation estimates were generated from an application of actuarial procedures developed by DOL to estimate the liability for FECA benefits. The liability for future workers' compensation benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases. The liability is determined utilizing historical benefit payment patterns related to a specific period to estimate the ultimate payments related to the period.

J. Pensions, Other Retirement Benefits, and Other Post-Employment Benefits

Each employing Federal agency is required to recognize its share of the cost and imputed financing of providing pension and post-retirement health benefits and life insurance to its employees, effective with fiscal years beginning after September 30, 1996, as required by SFFAS No. 5, *Accounting for Liabilities of the Federal Government*. Factors used in calculation of these pension and post-retirement health and life insurance benefit expenses were provided by the Office of Personnel Management (OPM) financial management letters regarding cost factors for pension and other retirement benefits expense.

DFAS civilian employees participate in the Civil Service Retirement System (CSRS) and Federal Employees Retirement System (FERS), while military personnel are covered by the Military Retirement System (MRS). Employees and personnel covered by FERS and MRS also have varying coverage under Social Security. DFAS funds a portion of the civilian and military pensions. The assets, funded actuarial liability, and unfunded actuarial liability for the military personnel are reported in the DoD Military Retirement Fund. The actuarial liability for the military retirement health benefits is recognized in the DoD Agency-wide statements.

K. Annual, Sick and Other Accrued Leave

Military and civilian leave is accrued as earned and the accrued amounts are reduced for actual leave taken and increased for leave earned. The balances for accrued leave are adjusted monthly to reflect changes. The balances for military and civilian leave at the end of the fiscal year reflect current pay rates for the leave that is earned but not taken. Sick and other types of non-vested leave are expensed as taken. To the extent budget resources are not available to fund annual leave earned but not taken; funding will be obtained from future financing sources.

L. Interest on Late Payments

DFAS, on occasion, incurs interest penalties on late payments. All such interest penalties are paid to the respective vendor in accordance with the guidelines mandated by the Prompt Payment Act, Public Law, 97-177, as amended.

M. Use of Estimates

The preparation of financial statements requires management to make certain estimates and assumptions that affect the reported amount of assets and liabilities, at the date of the financial statements, and the amount of revenues and costs reported during the period. Actual results could differ from those estimates.

Note 2. ACCOUNTS RECEIVABLE (IN THOUSANDS)

	2004			2003
	Gross Amount Due	**Allowance for Uncollectible Accounts**	**Accounts Receivable, Net**	**Accounts Receivable, Net**
Intragovernmental Receivable	$ 21,837	N/A	$ 21,837	$ 15,812
Public Receivable	$ 601	$ 6	$ 595	$ 5,539
Total Accounts Receivable	**$ 22,438**	**$ 6**	**$ 22,432**	**$ 21,351**

Note 3. GENERAL PROPERTY, PLANT AND EQUIPMENT, NET (IN THOUSANDS)

As of September 30, 2004:

	Acquisition Cost	Accumulated Depreciation	Net Book Value	Useful Life (in years)
Buildings, Structures and Facilities	$ 215,979	$ 37,289	$ 178,690	20 to 40
Leasehold Improvements	$ 2,755	$ 1,307	$ 1,448	Lease Term
Equipment	$ 253,492	$ 227,398	$ 26,094	5 to 10
Internal Use Software	$ 1,357,653	$ 723,200	$ 634,453	2-5 to 10
Construction-In-Progress	$ 955	—	$ 955	N/A
Other	$ 892	$ 892	—	N/A
Total General PP&E, Net	**$ 1,831,726**	**$ 990,086**	**$ 841,640**	**—**

As of September 30, 2003:

	Acquisition Cost	Accumulated Depreciation	Net Book Value	Useful Life (in years)
Buildings, Structures and Facilities	$ 138,164	$ 19,341	$ 118,823	20 to 40
Leasehold Improvements	$ 60,786	$ 10,872	$ 49,914	Lease Term
Equipment	$ 251,353	$ 210,948	$ 40,405	5 to 10
Internal Use Software	$ 1,315,608	$ 626,693	$ 688,915	2-5 to 10
Construction-In-Progress	$ 716	—	$ 716	N/A
Total General PP&E, Net	**$ 1,766,627**	**$ 867,854**	**$ 898,773**	**—**

Note 4. OTHER LIABILITIES (IN THOUSANDS)

As of September 30, 2004:	**Current**	**Non-Current**	**Total**
Intragovernmental Other Liabilities			
Workers' Compensation	$ 4,086	$ 5,015	$ 9,101
Employer Contributions and Payroll Taxes	4,559	-	4,559
Total Intragovernmental Other Liabilities	8,645	5,015	13,660
Other Liabilities With the Public			
Accrued Funded Payroll and Benefits	46,045	-	46,045
Deposit Funds and Suspense Accounts	66		66
Accrued Unfunded Annual Leave	47,938	-	47,938
Total Other Liabilities With the Public	94,049	-	94,049
Total Other Liabilities	**$ 102,694**	**$ 5,015**	**$ 107,709**

As of September 30, 2003:	**Current**	**Non-Current**	**Total**
Intragovernmental Other Liabilities			
Workers' Compensation	$ 3,983	$ 5,209	$ 9,192
Employer Contributions and Payroll Taxes	5,492	-	5,492
Total Intragovernmental Other Liabilities	9,475	5,209	14,684
Other Liabilities With the Public			
Accrued Funded Payroll and Benefits	32,924	-	32,924
Accrued Unfunded Annual Leave	50,837	-	50,837
Total Other Liabilities With the Public	83,761	-	83,761
Total Other Liabilities	**$ 93,236**	**$ 5,209**	**$ 98,445**

Note 5. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES (IN THOUSANDS)

Intragovernmental	**2004**	**2003**
Workers' Compensation	$ 9,101	$ 9,192
Total Intragovernmental	9,101	9,192
With the Public		
Actuarial FECA Liability	42,328	46,855
Accrued Annual Leave	47,938	50,837
Total With the Public	90,266	97,692
Total Liabilities Not Covered by Budgetary Resources	$ 99,367	$ 106,884
Total Liabilities Covered by Budgetary Resources	224,471	240,073
Total Liabilities	**$ 323,838**	**$ 346,957**

Note 6. ACTUARIAL LIABILITY (IN THOUSANDS)

	Unfunded Actuarial Liability at September 30, 2004	Unfunded Actuarial Liability at September 30, 2003
Workers' Compensation	$ 42,328	$ 46,855
Total Actuarial Liability	**$ 42,328**	**$ 46,855**

The liability for future workers' compensation benefit (FECA) includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The Department of Labor provided an estimated actuarial liability for future workers' compensation benefits for the fiscal year ended September 30, 2004. DFAS' reported FECA liability is based on the DoD-Wide allocation worksheet, the bills received and the charge back report from July 1, 2003 to September 30, 2004.

Note 7. IMPUTED FINANCING SOURCES (IN THOUSANDS)

	2004	2003
Civilian Retirement	$ 30,490	$ 31,652
Civilian Health	48,047	42,335
Civilian Life Insurance	137	137
Total Imputed Financing Sources	**$ 78,674**	**$ 74,124**

Note 8. LEASES (IN THOUSANDS)

DFAS has no capitalized leases. All DFAS leases are operating leases for rent, where DFAS is the lessee. The Consumer Price Index was used for future year projections as increases to the lease rental amounts.

The dollar amount of DFAS' operating lease commitments for future years consisted of the following at September 30, 2004:

Fiscal Year	2004
2005	32,143
2006	32,979
2007	33,837
2008	34,716
2009	35,619
After 2009	36,545
Total Future Lease Payments	**$ 205,839**

Note 9. STATEMENT OF BUDGETARY RESOURCES (SBR) RECONCILIATION (IN THOUSANDS)

Under OMB Circular A–34, *Instructions on Budget Execution*, Federal agencies are to report budgetary information in the SBR based on budget terminology, definitions, and guidance issued. OMB Circular A–34 also states that the information on the SBR should be consistent with budget execution information reported in the President's Budget. Additionally, per Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources*, agencies are to provide financial statement footnote disclosure to explain significant differences between amounts presented in the SBR and amounts described as actual in the President's Budget. Since DFAS is a component of the DoD rather than a separate Federal agency as envisioned by OMB requirements, these analyses are difficult, however, an analysis of information reported in the SBR and the information reported in the September 30, 2004 Report on Budget Execution (SF–133) was performed. This analysis identified significant differences related to Undelivered Orders and Accounts Payable due to DFAS adjustments, primarily related to additional accruals being posted to the financial statements. The amount reported for Undelivered Orders on the fiscal year 2004 SF–133 was $123,254, whereas the amount reported on the SBR was $106,598, a difference of $16,656. The amount reported for Accounts Payable on the fiscal year 2004 SF–133 was $221,437, whereas the amount reported on the SBR was $230,814, a difference of $9,377.

Note 10. STATEMENT OF FINANCING (SOF) (IN THOUSANDS)

The objective of the SOF is to make users understand the difference between budgetary and net cost of operations reported. The SOF was expanded to further articulate and detail the relationship between net obligations from budgetary accounting and net cost of operation from proprietary accounting. In order to reconcile the Statement of Net Cost with the SOF, an increase of $12,596 thousand has been included in Line 27d, Components Not Requiring or Generating Resources – Other, of the SOF. The difference consists of reversal of prior year adjustments to Accounts Payable for Level 3 eliminations, reclassification of negative Payables and audit adjustments

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

REQUIRED SUPPLEMENTARY INFORMATION
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2004

(UNAUDITED)

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2004
(UNAUDITED)

Dollars In Thousands		
INTRAGOVERNMENTAL ASSETS		**Accounts Receivable**
Department of Commerce	$	7
Navy General Fund		9,212
Army General Fund		197
General Service Administration		172
Air Force General Fund		162
Central Intelligence Agency		15
Armed Forces Retirement Home		22
Department of Education		91
United States Army Corps of Engineers		9
Other Defense Organizations General Funds		4,775
Other Defense Organizations Working Capital Funds		4,057
Army Working Capital Fund		1,469
Navy Working Capital Fund		1,114
Air Force Working Capital Fund		535
Total Intragovernmental Assets	**$**	**21,837**

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2004
(UNAUDITED)

Dollars In Thousands		
INTRAGOVERNMENTAL LIABILITIES	**Accounts Payable**	**Other Liabilities**
Department of Labor	$ -	$ 9,100
Navy General Fund	2,268	-
United States Postal Service	9	-
Department of the Treasury	2,001	-
Army General Fund	6,576	-
Office of Personnel Management	1,477	4,560
Department of Veterans Affairs	8	-
General Service Administration	9,326	-
Air Force General Fund	5,923	-
Department of Transportation	64	
Department of Health and Human Services	129	-
National Archives and Records Administration	11	-
Other Defense Organizations General Funds	2,859	-
Other Defense Organizations Working Capital Funds	14,785	-
Army Working Capital Fund	3,785	-
Navy Working Capital Fund	3,821	-
Air Force Working Capital Fund	2,478	-
Total Intragovernmental Liabilities	**$ 55,520**	**$ 13,660**

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2004
(UNAUDITED)

Dollars In Thousands		
INTRAGOVERNMENTAL REVENUE		**Earned Revenue**
Executive Office of the President	$	138
Department of Commerce		146
Navy General Fund		398,490
United States Postal Service		1
Department of the Treasury		459
Army General Fund		601,965
Social Security Administration		1
Department of Veterans Affairs		395
General Service Administration		957
Central Intelligence Agency		181
Air Force General Fund		329,835
Environmental Protection Agency		150
Homeland Security		111
Department of Health and Human Services		1,674
Armed Forces Retirement Home		38
Department of Energy		892
Department of Education		91
United States Army Corps of Engineers		2,840
Other Defense Organizations General Funds		156,770
Other Defense Organizations Working Capital Funds		121,927
Army Working Capital Fund		31,760
Navy Working Capital Fund		63,693
Air Force Working Capital Fund		13,927
Total Intragovernmental Revenue	**$**	**1,726,441**

NON - EXCHANGE REVENUE		Transfers - Out
Other Defense Organizations Working Capital Funds	$	142,773
Total Non - Exchange Revenue	**$**	**142,773**

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

OTHER ACCOMPANYING INFORMATION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING BALANCE SHEETS
AS OF SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands	Financial Operations	Information Services	Combined Total	Eliminations	2004 Consolidated	2003 Consolidated
ASSETS						
Intragovernmental:						
Collections and Disbursements Clearing	$ -	$ -	$ -	$ -	$ -	$ -
Accounts Receivable (Note 2)	18,178	12,139	30,317	(8,480)	21,837	15,812
Total Intragovernmental	18,178	12,139	30,317	(8,480)	21,837	15,812
With the Public:						
Accounts Receivable (Note 2)	$ 368	$ 227	$ 595	$ -	$ 595	$ 5,539
General Property, Plant and Equipment (Note 3)	838,847	2,793	841,640	-	841,640	898,773
Other Assets	71	4	75	-	75	19
TOTAL ASSETS	**$ 857,464**	**$ 15,163**	**$ 872,627**	**$ (8,480)**	**$ 864,147**	**$ 920,143**
LIABILITIES						
Intragovernmental:						
Accounts Payable	$ 62,451	$ 1,549	$ 64,000	$ (8,480)	$ 55,520	$ 83,245
Other Liabilities (Note 4 and 5)	11,811	1,849	13,660	-	13,660	14,684
Total Intragovernmental	74,262	3,398	77,660	(8,480)	69,180	97,929
With the Public:						
Accounts Payable	$ 100,760	$ 17,521	$ 118,281	$ -	$ 118,281	$ 118,412
Actuarial FECA Liability (Note 5 and 6)	37,707	4,621	42,328	-	42,328	46,855
Accrued Payroll and Benefits (Note 4)	40,663	5,382	46,045	-	46,045	32,924
Deposit Funds and Suspense Accounts (Note 4)	96	(30)	66	-	66	-
Accrued Unfunded Annual Leave (Note 4 and 5)	42,736	5,202	47,938	-	47,938	50,837
TOTAL LIABILITIES	**$ 296,224**	**$ 36,094**	**$ 332,318**	**$ (8,480)**	**$ 323,838**	**$ 346,957**
NET POSITION						
Cumulative Results of Operations	$ 561,240	$ (20,931)	$ 540,309	$ -	$ 540,309	$ 573,186
TOTAL NET POSITION	**561,240**	**(20,931)**	**540,309**	-	540,309	**573,186**
TOTAL LIABILITIES AND NET POSITION	**$ 857,464**	**$ 15,163**	**$ 872,627**	**$ (8,480]**	**$ 864,147**	**$ 920,143**

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF NET COST
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands	Financial Operations	Information Services	Combined Total	Eliminations	2004 Consolidated	2003 Consolidated
PROGRAM COSTS						
Intragovernmental Gross Costs	$ 566,854	$ 30,924	$ 597,778	$ (142,499)	$ 455,279	$ 426,191
(Less: Intragovernmental Earned Revenue)	(1,675,335)	(193,605)	(1,868,940)	142,499	(1,726,441)	(1,470,282)
Intragovernmental Net Costs	$ (1,108,481)	$ (162,681)	$ (1,271,162)	$ -	$ (1,271,162)	$ (1,044,091)
Gross Costs With the Public	$ 1,097,533	$ 157,573	$ 1,255,106	$ -	$ 1,255,106	$ 1,310,733
(Less: Earned Revenue From the Public)	(1,809)	-	(1,809)	-	(1,809)	(1,096)
Net Costs With the Public	$ 1,095,724	$ 157,573	$ 1,253,297	$ -	$ 1,253,297	$ 1,309,637
NET COST OF OPERATIONS	**$ (12,757)**	**$ (5,108)**	**$ (17,865)**	**$ -**	**$ (17,865)**	**$ 265,546**

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF CHANGES IN NET POSITION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands	Financial Operations	Information Services	2004 Consolidated	2003 Consolidated
Cumulative Results of Operations				
BEGINNING BALANCES	**$ 559,693**	**$ 13,493**	**$ 573,186**	**$ 704,698**
Budgetary Financing Sources				
Other Budgetary Financing Sources	12,420	937	13,357	1,442
Other Financing Sources				
Transfers-In/Out Without Reimbursement	(94,092)	(48,681)	(142,773)	58,468
Imputed Financing Sources (Note 7)	70,463	8,211	78,674	74,124
Total Financing Sources	**(11,209)**	**(39,533)**	**(50,742)**	**134,034**
Net Cost of Operations	**(12,757)**	**(5,108)**	**(17,865)**	**265,546**
ENDING BALANCES	**$ 561,241**	**$ (20,932)**	**$ 540,309**	**$ 573,186**

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
COMBINING STATEMENTS OF BUDGETARY RESOURCES
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands	Financial Operations	Information Services	2004 Combined	2003 Combined
BUDGETARY RESOURCES				
Budget Authority:				
Contract Authority	$ 110,100	$ 1,044	$ 111,144	$ 124,437
Unobligated Balance:				
Beginning of Period	37,023	(837)	36,186	1,007,716
Net Transfers, Actual	500	-	500	625
Spending Authority from Offsetting Collections				
Earned:				
Collected	1,672,012	225,210	1,897,222	1,698,573
Receivable from Federal Sources	4,034	(33,938)	(29,904)	(50,521)
Change in Unfilled Customer Orders:				
Without Advance from Federal Sources	19,320	(16,844)	2,476	25,986
Subtotal	1,695,366	174,428	1,869,794	1,674,038
Recoveries of prior year obligations	31,820	-	31,820	-
Permanently not Available	(115,376)	-	(115,376)	(987,867)
Total Budgetary Resources	**$ 1,759,433**	**$ 174,635**	**$ 1,934,068**	**$ 1,818,949**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred:				
Reimbursable	$ 1,575,795	$ 181,120	$ 1,756,915	$ 1,782,763
Total Obligations Incurred	1,575,795	181,120	1,756,915	1,782,763
Unobligated Balance:				
Apportioned	183,637	(6,484)	177,153	36,186
Other available	1	(1)	-	-
Total Status of Budgetary Resources	**$ 1,759,433**	**$ 174,635**	**$ 1,934,068**	**$ 1,818,949**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS:				
Obligated Balance, Net - Beginning of Period	$ 286,259	$ (34,085)	$ 252,174	$ 195,608
Obligated Balance, Net - End of Period:				
Accounts Receivable	(18,313)	(9,822)	(28,135)	(58,038)
Unfilled Customer Orders	(41,352)	(18,174)	(59,526)	(57,050)
Undelivered Orders (Note 9)	83,701	22,897	106,598	88,804
Accounts Payable (Note 9)	204,423	26,391	230,814	278,458
Outlays:				
Disbursements	1,578,420	176,525	1,754,945	1,750,732
Collections	(1,672,012)	(225,210)	(1,897,222)	(1,698,573)
Subtotal	(93,592)	(48,685)	(142,277)	52,159
Net Outlays	**$ (93,592)**	**$ (48,685)**	**$ (142,277)**	**$ 52,159**

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF FINANCING
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2004 AND 2003

Dollars In Thousands	Financial Operations	Information Services	2004 Consolidated	2003 Consolidated
RESOURCES USED TO FINANCE ACTIVITIES				
Budgetary Resources Obligated:				
Obligations Incurred	$ 1,575,795	$ 181,120	$ 1,756,915	$ 1,782,763
Less: Spending Authority From Offsetting Collections	(1,727,186)	(174,428)	(1,901,614)	(1,674,038)
Net Obligations	(151,391)	6,692	(144,699)	108,725
Other Resources				
Transfers In/Out Without Reimbursement	(94,092)	(48,681)	(142,773)	58,468
Imputed Financing Sources (Note 7)	70,463	8,211	78,674	74,124
Total Resources Used to Finance Activities	**(175,020)**	**(33,778)**	**(208,798)**	**241,317**
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS				
Change In Budgetary Resources Obligated for Goods, Services and Benefits Ordered but Not Yet Provided	5,743	(21,118)	(15,375)	26,020
Resources that Fund Expenses Recognized In Prior Periods	(10,016)	(314)	(10,330)	-
Resources that Finance the Acquisition of Assets	(48,936)	(123)	(49,059)	(59,347)
Other	94,092	48,681	142,773	(58,468)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**40,883**	**27,126**	**68,009**	**(91,795)**
Total Resources Used to Finance the Net Cost of Operations	**(134,137)**	**(6,652)**	**(140,789)**	**149,522**
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD				
Other	-	2,812	2,812	1,372
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in Future Periods	**-**	**2,812**	**2,812**	**1,372**
Components not Requiring or Generating Resources:				
Depreciation and Amortization	123,693	2,108	125,801	114,659
Revaluation of Assets or Liablities	4,852	(938)	3,914	
Other (Note 10)	(7,165)	(2,438)	(9,603)	(7)
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	**121,380**	**(1,268)**	**120,112**	**114,652**
Total Components of Net Cost of Operations That Will Not Require or Generate Resources In The Current Period	**121,380**	**1,544**	**122,924**	**116,024**
NET COST OF OPERATIONS	**$ (12,757)**	**$ (5,108)**	**$ (17,865)**	**$ 265,546**

The accompanying notes are an integral part of these statements

Urbach Kahn & Werlin LLP
CERTIFIED PUBLIC ACCOUNTANTS

INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

Office of the Director and Audit Committee
United States Department of Defense
Defense Finance and Accounting Service

We have audited the accompanying Consolidated Balance Sheets of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense (DoD), as of September 30, 2004 and 2003, and the related Consolidated Statements of Net Cost, Changes in Net Position, and Financing, and the Combined Statements of Budgetary Resources for the years then ended. These financial statements are the responsibility of the management of DFAS. 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. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DFAS as of September 30, 2004 and 2003, and its net costs, changes in net position, combined budgetary resources, and reconciliation of budgetary obligations to net cost for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The information in the Management's Discussion and Analysis and Required Supplementary Information, as listed in the accompanying Table of Contents, is not a required part of the financial statements, but is supplementary information required by the Federal Accounting Standards Advisory Board and OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information.

INDEPENDENT AUDITOR'S REPORT
ON THE FINANCIAL STATEMENTS, CONTINUED

The Other Accompanying Information, as listed in the accompanying Table of Contents, is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, is fairly presented in all material respects in relation to the basic financial statements taken as a whole for the fiscal years ended September 30, 2004 and 2003.

In accordance with *Government Auditing Standards*, we have also issued reports dated October 28, 2004 on our consideration of DFAS' internal control over financial reporting, and on our tests of its compliance with certain provisions of applicable laws and regulations. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and, in considering the results of the audit, should be read in conjunction with this report.

Urbach Kahn & Werlin LLP

Washington, DC
October 28, 2004

Urbach Kahn & Werlin LLP
CERTIFIED PUBLIC ACCOUNTANTS

**INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL**

Office of the Director and Audit Committee
United States Department of Defense
Defense Finance and Accounting Service

We have audited the financial statements of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense, as of and for the year ended September 30, 2004, and have issued our report thereon dated October 28, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered DFAS' internal control over financial reporting by obtaining an understanding of DFAS' internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. 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 those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect DFAS' ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses or noncompliance may nevertheless occur and not be detected.

INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL, CONTINUED

However, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions, and, with respect to the first three items below, material weaknesses.

These conditions, detailed on the following pages, are summarized as follows:

1. DFAS did not have adequate controls over the recording of undelivered orders and corresponding proprietary accounts.

2. DFAS did not have adequate controls over its financial reporting processes.

3. DFAS did not have adequate controls over its information systems control environment related to e-Biz service continuity and DDRS segregation of duties.

4. DFAS needs to make improvements in its controls over the recording of property, plant and equipment

In addition, with respect to internal control related to performance measures reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

We also noted other less significant matters involving the internal control and its operation, which we have reported to the management of DFAS in a separate letter, dated October 28, 2004.

This report is intended solely for the information and use of the management of the United States Department of Defense, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Urbach Kahn & Werlin LLP

Washington, DC
October 28, 2004

REPORTABLE CONDITION 1 (Material Weakness)

DFAS DID NOT HAVE ADEQUATE CONTROLS OVER THE RECORDING OF UNDELIVERED ORDERS AND CORRESPONDING PROPRIETARY ACCOUNTS

Control Environment for Undelivered Orders and Corresponding Proprietary Accounts

DFAS did not properly monitor the estimation of accrued liabilities throughout the fiscal year, where the goods or services had been provided prior to month-end or year-end, and the deobligation of aged or erroneous obligations were not made, resulting in an overstatement of the undelivered orders (UDO) balance at September 30, 2004. Consequently, an extensive examination of the items comprising the UDO balance had to be performed, resulting in the need to record significant "On-Top" adjustments to the financial statements to properly state the UDO balance at year-end. The correction of the overstatements in the UDO budgetary balance necessitated related adjustments to correct significant understatements in the corresponding accounts payable (A/P), and expenses proprietary balances at year-end. This lack of control surrounding UDO and corresponding proprietary accounts, and the extensive year-end corrective effort is reflective of the same circumstances that occurred in fiscal years 2002 and 2003.

We have been provided information by DFAS management related to its Financial Management Improvement Plan (FMIP). The FMIP has been initiated to address the business process and systematic financial improvements needed to resolve DFAS' identified internal control weaknesses in the areas of rejected documents that affect unmatched disbursements, A/P, UDOs; property, plant and equipment, and eliminations. DFAS' FMIP includes prioritizing required improvements, assembling teams of process owners to study root causes of rejected documents, systems interfaces, and business process disconnects.

UDO and its corresponding proprietary accounts were misstated throughout the fiscal year and at year-end primarily due to the following:

- Inadequate training of DFAS Fiscal Service Office (FSO) and program personnel regarding the recording of accruals, the maintenance of proper documentation to support the methodology, and justification of accruals that were recorded, and the inconsistent application of all required policies and procedures throughout the organization;

- Inadequate training and quality control over the performance of Triannual reviews, which did not ensure that the specific objectives stated in the DoD Financial Management Regulation (FMR) and the DFAS Financial Management (FM) Desktop Guide were followed ensuring that applicable proprietary and budgetary accounts were valid, accurate, and properly supported. The Triannual review process should be regarded as a financial management tool to ensure that the appropriate internal controls are in place throughout the fiscal year related to the reporting of UDO, A/P and other related proprietary accounts; and

REPORTABLE CONDITION 1 (Material Weakness), Continued

- DFAS converted its accounting system from the Defense Business Management System (DBMS) to the Electronic Business Accounting and Management System (e-Biz) during fiscal year 2003. However, as a result of the system conversion, the policies and procedures regarding DFAS financial operations were not updated, specifically the FM Guide, as reported in our prior year audit. There are many references to DBMS and the concepts of how to process a transaction in the DBMS environment in the current version of the FM Guide. This information must be replaced by the e-Biz operation concepts in order to ensure that DFAS personnel have up to date information to process transactions properly in e-Biz.

Aged Accounts Payable

There were aged, invalid A/P balances at September 30, 2004 that were not properly written off prior to year-end. A significant "On-Top" adjustment to the financial statements was made to properly state the balance in A/P at year-end.

Undelivered Orders and Accounts Payable Year-end Cutoff

The September 30, 2004 trial balance and the subsidiary ledgers provided for UDO and A/P erroneously included certain fiscal year 2005 transactions. Consequently, the account balances for both UDO and AP were overstated on the originally provided trial balance as of September 30, 2004. DFAS had to re-generate the trial balance and subsidiary ledgers to exclude the fiscal year 2005 transactions, to properly state those balances on the year-end trial balance.

Statement of Federal Financial Accounting Standards No. 1, *Accounting for Selected Assets and Liabilities* states,

> *Accounts payable are amounts owed by a Federal entity for goods and services received from, progress in contract performance made by, and rents due to other entities…When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated.*

DoD FMR Volume 1, Chapter 2 states,

> *To support certifications of obligations…the foregoing verifications for obligated fund balances shall be made in a manner that shall ensure all of the files and balances are reconciled and validated at least once each fiscal year (not necessarily as of September 30). The work papers and records on which the determinations are based shall be retained in a form to facilitate audit and reconciliation for such periods as may be necessary…Data shall be edited, validated, and in some instances, computed before it is integrated into an accounting system...*
>
> *At a minimum, the following documentation shall be required to support the periodic verifications of unliquidated obligations: 1. An overall summary of the methodology, criteria, and rationale used to select unliquidated obligations for review, such as statistical sampling techniques, aging, and months past delivery date. 2. Mechanized or manual listings identifying the unliquidated obligations selected for review and the results of their review. 3. Annotated supply status reports and letters, memoranda, or records of telephone calls requesting delivery status from contracting or procurement activities. 4. Records identifying the unliquidated obligations deobligated as a result of the review, the amount deobligated for each document, and the rationale for deobligation. 5. Deobligation documents or references to dated deobligation documents indicating the value and identity of documents deobligated…*

DoD FMR, Volume 3, Chapter 8 states,

> *Triannual Reviews of Commitments and Obligations. Fund holders, with assistance from supporting offices, shall review commitment and obligation transactions for timeliness, accuracy, and completeness during each of the four month periods ending January 31, May 31, and September 30 of each fiscal year…The accounting office also shall provide listing(s) or automated media identifying accounts payable and accounts receivable which enable the funds holder to verify proprietary accounts (as well as budgetary accounts) and, thus, ensure that proprietary and budgetary accounts are valid, accurate and reconciled...All required deobligations, adjustments or corrections identified during the review shall be documented and processed within 10 working days of their identification by the responsible individuals.*

REPORTABLE CONDITION 1 (Material Weakness), Continued

DFAS FM Desktop Guide, *Triannual Reviews* states,

> *…Each UDO of $50,000.00 or more, over 30 days old must be reviewed. The review will determine if the recorded obligation amount is accurate… Identify UDOs of less than $50,000.00. A review may be conducted using acceptable statistical sampling techniques as is established by the Accounting Deputy Director (DFAS-AA/CA). The FSO [Fiscal Service Office] will de-obligate all line items from the above reports, which are identified as expiring funds.*

Recommendations

<u>Immediate Action</u>

Since the above "On-Top" adjustments that were made related to UDO, A/P and its corresponding proprietary accounts for fiscal year 2004 were only reported at the financial statement and not at the detailed trial balance level, DFAS needs to perform a complete data clean-up of all documents within its UDO and A/P subsidiary ledgers at the detailed trial balance level in order to ensure that its accounts are properly stated for periodic reporting and audit purposes in fiscal year 2005.

Accordingly, we recommend the DFAS Director and Audit Committee ensure that:

1. A data clean–up for all documents in the UDO and A/P subsidiary listings is completed to ensure that the balances are properly reported, with appropriate adjustments posted at the detailed trial balance level. The data clean-up must ensure that all UDO and A/P documents are reviewed, not just the ones identified for adjustment during the audit, for both a risk of overstatement and understatement, and are supported by proper documentation.

2. Quality control procedures are performed related to the data clean-up effort for all UDO and A/P documents as stated above, by either DFAS management or DFAS Internal Review to ensure that the data clean-up achieves all of its desired objectives, and that all appropriate adjustments resulting from the data clean-up are validated for their propriety and completeness.

Long-Term Resolution and Ongoing Internal Control Improvement

After the completion of the initial data clean-up of all UDO and A/P documents, DFAS needs to improve its internal controls related to the reporting of UDO, A/P and other related proprietary accounts, including those controls related to the recording of accruals and the performance of Triannual reviews in order to ensure that its accounts are properly stated throughout the fiscal year and at year-end.

Prior corrective action plans utilized by DFAS regarding the reporting of UDO, A/P and other related proprietary accounts have been unsuccessful, because DFAS management only focused on resolving problems with documents identified during the audit, not rectifying the root causes of the underlying business deficiencies. DFAS needs to ensure that the initiatives within its FMIP are long-term solutions to ensure that the deficiencies are prevented in the future. It is imperative that all personnel in the organization understand and embrace the ongoing effort to improve DFAS' internal controls in this critical area through continued direction by DFAS senior management.

Accordingly, we recommend the DFAS Director and Audit Committee ensure that:

3. Notification is sent by the DFAS Director through the Director of Corporate Resources to all personnel in the organization informing that there have been significant impediments related to the reporting of UDO, A/P and other related proprietary accounts that have not been resolved during the prior three fiscal years, and that immediate action is required by all personnel involved in the reporting of these accounts. The notification should also emphasize the following:

    - The criticality of resolving these impediments to the entire organization, not only from an audit risk perspective, but to accurately portray DFAS' financial position;

    - It is the responsibility of DFAS FSO, accounting operations, and program personnel that these accounts are properly stated, and that personnel from all of these offices must work together to ensure that the proper corrective actions are taken to improve the internal controls on an ongoing basis; and

    - The importance of ensuring that information is entered into e-Biz in a timely and accurate manner regarding the recording of accruals and the deobligation of funds, especially at month-end and year-end, in order for DFAS to meet the accelerated reporting requirements prospectively.

4. Additional training is provided for DFAS FSO and program personnel regarding the proper procedures for estimating and documenting accrued liabilities throughout the fiscal year. Specifically, the training should describe in detail, with illustrative examples, each manual and e-Biz related step that is necessary to estimate and properly document accrued liabilities on an ongoing basis, as well as reemphasize the FMR requirements related to the deobligation of funds.

REPORTABLE CONDITION 1 (Material Weakness), Continued

5. Aged UDO and A/P are continually monitored throughout the fiscal year to ensure the propriety of the account balances, and that adequate documentation is maintained that justifies why the remaining balance is proper and should not be written off.

6. The FMIP is monitored throughout the fiscal year to track the progress of all audit related findings from prior years, to ensure that the root causes related to all of the deficiencies are identified and resolved. Additionally, ensure that the FM Guide is updated to reflect current e-Biz business operations, and that the FM Guide is updated timely going forward to reflect any major changes in DFAS' financial operations.

7. The trial balance and all subsidiary ledgers are properly reconciled and reviewed at the end of each reporting period, to ensure that transactions are reported in the proper period.

REPORTABLE CONDITION 2 (Material Weakness)

DFAS DID NOT HAVE ADEQUATE CONTROLS OVER ITS FINANCIAL REPORTING PROCESSES

Eliminating Entries

DFAS made improvements in the financial reporting processes for making elimination entries during fiscal year 2004, specifically related to rejects. However, DFAS continued to perform a manual data call to identify trading partners, which caused errors between amounts coded between intragovernmental and public accounts payable and expense throughout the fiscal year and at year-end. There were vendors within e-Biz that were coded without a valid vendor code, or with a generic vendor code, which complicated the eliminations process and created a higher risk of error.

Due to the accelerated reporting timeframes, a fully coordinated and comprehensive review over eliminations did not take place prior to the preparation of the September 30, 2004 financial statements, which contributed to the errors in the classification of amounts between intragovernmental and public.

Financial Statement Preparation

Budgetary data was not in agreement with proprietary expenses and assets capitalized, causing a difference in the Net Cost of Operations on the Statement of Net Cost and Statement of Financing, which required an unsupported balancing adjustment of approximately $12 million to force the Net Cost of Operations on the September 30, 2004 Statement of Financing to equal to the Statement of Net Cost.

OMB Circular A-123, *Management Accountability and Control* states,

> *Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. The documentation for transactions, management controls, and other significant events must be clear and readily available for examination.*

DoD FMR Volume 1, Chapter 2 states,

> *Source data needed in an accounting system shall be entered only once and transferred to appropriate accounts or other segments of the system or its subsystems. Once data are entered into a system in a controlled environment, it is desirable that paper source documents not be transferred into other systems. If data is needed by both an accounting system and another administrative system, a determination shall be made as to which system shall retain the basic source document.*

REPORTABLE CONDITION 2 (Material Weakness), Continued

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

8. The eliminations capabilities in e-Biz are fully utilized, in order to minimize the risk of errors being created by the manual data call process that was used for fiscal year 2004.

9. Additional training is provided for DFAS personnel involved in the eliminations process in order to ensure that a thorough and complete understanding of e-Biz vendor codes, elimination reports, and financial statement reporting requirements is obtained.

10. A fully coordinated and comprehensive review over the financial reporting related to eliminations occurs during fiscal year 2005 to detect errors, prior to approving data for inclusion in the financial statements, including ensuring that all vendors that are established in e-Biz have a proper vendor and trading partner code identified.

11. Research is conducted to determine the root causes of the disconnect between the budgetary and proprietary data that caused the necessity for the balancing entry to force the Statement of Financing to equal the Statement of Net Cost.

REPORTABLE CONDITION 3 (Material Weakness)

DFAS DID NOT HAVE ADEQUATE CONTROLS OVER ITS INFORMATION SYSTEMS CONTROL ENVIRONMENT RELATED TO e-BIZ SERVICE CONTINUITY AND DDRS SEGREGATION OF DUTIES

DFAS made improvements within its information systems control environment during fiscal year 2004, including the final implementation of its accounting system, e-Biz. However, the following significant internal control weaknesses related to e-Biz and the Defense Departmental Reporting System (DDRS) were identified as of September 30, 2004.

e-Biz Control Weaknesses

- There was no alternate processing facility for e-Biz. The production and performance copies of e-Biz are both housed at the same site at the Defense Enterprise Computing Center (DECC) Columbus. Although major disruptions with long-term effects may be rare, they are required to be accounted for in a contingency plan. Thus, the contingency plan must include a strategy to recover and perform system operations at an alternative facility for an extended period of time. This is to mitigate the risk that if the system is damaged or destroyed, or the primary site is unavailable, necessary hardware and software will not be available at an alternative site. Consequently, the system will not be available to users and the system will not be operational. In the absence of a geographically-removed Contingency Plan/Continuity of Operations Plan site, the condition continues to pose an unmitigated risk to DFAS business operations should the primary (only) processing site in Columbus be rendered inoperative.

  We were notified on October 27, 2004 that DFAS management initiated an official memorandum to Defense Information Systems Agency management requesting that a Remote Disaster Recovery Site (RDRS) be set up to address the fact that no alternate processing site is in existence for the e-Biz system residing at DECC Columbus. DFAS management is requesting that the plan to implement this process be in place by November 12, 2004, and that the actual RDRS be instituted as soon as possible after the finalization of the plan.

- The principle of least privilege was not followed for user access to Oracle, the database supporting e-Biz. Profiles are not currently being used to limit access to only allow individuals system access necessary to perform job functions. The principle of least privilege states that access granted to a user should be set at the minimum level to perform job functions. Giving unnecessary privileges to users increases the risk of unauthorized changes in Oracle. Subsequently, there could be further occurrences of inappropriate access that remain unchecked. Combined with the lack of auditing, Oracle could be at high risk of inappropriate actions performed by unauthorized users.

REPORTABLE CONDITION 3 (Material Weakness), Continued

DDRS Control Weakness

Certain users had both the Headquarters Security Administrator (HQSA) and Journal Voucher (JV) Approver roles within the DDRS Audited Financial Statements module.

The HQSA is an Administrative role and JV Approver is a Functional User role within DDRS. This violates the principle of segregation of duties, since unauthorized and erroneous transactions may occur if proper procedures are not implemented to control and limit an employee's effective role within the system.

OMB Circular A-130, *Management of Federal Information Resources* states,

> *Agencies shall implement and maintain a program to assure that adequate security is provided for all agency information collected, processed, transmitted, stored, or disseminated in general support systems and major applications…"Adequate security" means security commensurate with the risk and magnitude of the harm resulting from the loss, misuse, or unauthorized access to or modification of information. This includes assuring that systems and applications used by the agency operate effectively and provide appropriate confidentiality, integrity, and availability, through the use of cost-effective management, personnel, operational, and technical controls.*

United States Code Title 10, Subtitle A, Part IV, Chapter 131, Section 2224, *Defense Information Assurance Program* states,

> *The Secretary of Defense shall carry out a program, to be known as the "Defense Information Assurance Program", to protect and defend Department of Defense information, information systems, and information networks that are critical to the Department and the armed forces during day-to-day operations and operations in time of crisis…The objectives of the program shall be to provide continuously for the availability, integrity, authentication, confidentiality, nonrepudiation, and rapid restitution of information and information systems that are essential elements of the Defense Information Infrastructure.*

REPORTABLE CONDITION 3 (Material Weakness), Continued

DoD Directive Number 8500.1, *Information Assurance* states,

> *…Information assurance requirements shall be identified and included in the design, acquisition, installation, operation, upgrade, or replacement of all DoD information systems in accordance with 10 U.S.C. Section 2224, Office of Management and Budget Circular A-130, Appendix III, DoD Directive 5000.1 (references (a), (j), and (k)), this Directive , and other IA-related DoD guidance, as issued.*

DoD Directive Number 8500.2, *Information Assurance Implementation* states,

> *A disaster plan exists that provides for the smooth transfer of all mission or business essential functions to an alternate site for the duration of an event with little or no loss of operational continuity. (Disaster recovery procedures include business recovery plans, system contingency plans, facility disaster recovery plans, and plan acceptance.)…An alternate site is identified that permits the restoration of all mission or business essential functions.*

OMB Circular A-123, *Management Accountability and Control* states,

> *Key duties and responsibilities in authorizing, processing, recording, and reviewing official agency transactions should be separated among individuals. Managers should exercise appropriate oversight to ensure individuals do not exceed or abuse their assigned authorities.*

DFAS Regulation 3020.26, *The Corporate Contingency Plan (CCP)* states,

> *A Business Continuity Plan (BCP) is a plan that outlines emergency operations including: provisions for the continuation of business operations from an alternative site in the event of a loss of access to the primary work site, provisions for conducting the business operation using an alternative method in the event of a loss of access to the primary automated system; and provisions for reconstituting the primary automated system at an alternative site and for reconfiguring network mapping to allow access to the system in the new location.*

REPORTABLE CONDITION 3 (Material Weakness), Continued

The DFAS System Access Control Policy and Standard Operating Procedures for DFAS Corporate Information Infrastructure states,

> *Functional user roles access the data and processes from within the application itself. An application administratives primary function is to set-up, update and administer the data values for the system to function and administer user account creation, update, expiration and password maintenance. No functional user shall have any administrative role capability. Conversely, no application administrator, system administrator or database administrator shall have any access to the functional capabilities within any of the applications.*

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

12. An adequate alternate processing facility for the e-Biz system is developed.

13. Policies and procedures for granting privileges and roles to users for Oracle are created to ensure that the rule of least privilege is followed. Furthermore, perform periodic reconciliation on accounts to ensure that roles that are no longer required are removed and review accounts to ensure that users do not have unauthorized roles.

14. A plan is developed to segregate the functions or place compensating controls for the HQSA and JV Approval roles within DDRS.

REPORTABLE CONDITION 4

DFAS NEEDS TO MAKE IMPROVEMENTS IN ITS CONTROLS OVER THE RECORDING OF PROPERTY, PLANT AND EQUIPMENT

The following internal control weaknesses related to the controls over the recording of property, plant and equipment (PP&E) were identified as of September 30, 2004:

- DFAS misclassified the recording of PP&E between general ledger account 1832, *Internal-Use Software in Development*, and general ledger account 1830, *Internal-Use Software* in e-Biz, resulting in the need to record significant "On-Top" adjustments to the financial statements to properly state the balances in the above categories at year-end. Additionally, DFAS did not maintain adequate documentation to support procurement and utilization decisions regarding the identification of potential excess or impaired internal use software.

- For certain capitalized assets tested, DFAS did not have adequate support for the acquisition cost, or improperly recorded the acquisition cost.

- DFAS improperly deferred recognizing depreciation expense until the month following an assets activation date, rather than the date of acquisition. This was due to the manner in which in the Defense Property Accountability System (DPAS) is programmed to set up and compute depreciation.

Statement of Federal Financial Accounting Standards (SFFAS) No. 6 *Accounting for Property, Plant and Equipment* states,

> *All general PP&E shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use.*

DoD FMR Volume 4, Chapter 6 states,

> *Documents that support the acquisition of General PP&E assets shall be retained by the DoD Component in accordance with the requirements contained in Volume 1, Chapter 9 of this regulation. Documentation shall be maintained in a readily available location, during the applicable retention period, to permit the validation of information pertaining to the asset such as the acquisition cost, acquisition date, cost of improvements, etc. Supporting documentation may include, but is not limited to, purchase invoices, sales and procurement contracts…and other such documentation generated independently of the entity in possession of the property…*

REPORTABLE CONDITION 4, Continued

…Entries to record financial transactions in accounting system general ledger accounts and/or the supporting subsidiary property accountability records and/or systems must: Include sufficient information indicating the physical quantity, location and unit cost of the PP&E. The property records shall be designed to be of maximum assistance in making procurement and utilization decisions, including decisions related to identifying potential excess PP&E that may be available for reuse, transfer to other DoD Components or made available for disposal in accordance with current DoD regulations and other regulatory requirements.

…Commencement of Depreciation. The event that triggers the calculation of depreciation is the date of receipt shown on the asset receiving document or the date installed and ready for use (regardless of whether it is actually used…Under the Month Available for Service Method, the month the asset was available for use, regardless of whether it was actually used, is the month used to commence the calculation of depreciation expense for the first year.

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

15. Internal Use Software is timely and properly transferred from the *Internal-Use Software in Development* general ledger account, to the *Internal Use Software* general ledger account in e-Biz throughout the fiscal year.

16. A management approved review is completed during the fiscal year, similar to the Triannual Review process, to ensure that adequate documentation is maintained to support the acquisition costs of capitalized assets, and to support procurement and utilization decisions regarding the identification of potential excess or impaired internal use software and other capitalized assets.

17. DFAS commences depreciation upon receipt or activation of assets, as required by the FMR.

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

Office of the Director and Audit Committee
United States Department of Defense
Defense Finance and Accounting Service

We have audited the financial statements of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense (DoD), as of and for the year ended September 30, 2004, and have issued our report thereon dated October 28, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of DFAS is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether DFAS' financial statements are free of material misstatement, we performed tests of DFAS' compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to DFAS.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph, exclusive of FFMIA, disclosed no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

Under FFMIA, we are required to report whether DFAS' financial management systems substantially comply with the Federal financial management system requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed an instance, described below where DFAS' financial management systems did not substantially comply with the first requirement discussed in the preceding paragraph related to Federal financial management system requirements.

Federal Financial Management Systems Requirements

DFAS' financial management system did not substantially comply with Federal financial management system requirements, including OMB Circulars A-127, *Financial Management Systems* and A-130, *Management of Federal Information Resources*, as they relate to information system security requirements. DFAS did not satisfy certain provisions of OMB Circular A-130, Appendix III, Section (3), which requires agencies to implement and maintain a program to assure that adequate security is provided for all agency information collected, processed, transmitted, stored, or disseminated in general support systems and major applications. Specifically, there was no alternate processing facility for the Electronic Business Accounting and Management System (e-Biz), DFAS' financial management system. The production and performance copies of e-Biz are both housed at the same site at the Defense Enterprise Computing Center Columbus.

United States Code Title 10, Subtitle A, Part IV, Chapter 131, Section 2224, *Defense Information Assurance Program* states,

> *The Secretary of Defense shall carry out a program, to be known as the "Defense Information Assurance Program", to protect and defend Department of Defense information, information systems, and information networks that are critical to the Department and the armed forces during day-to-day operations and operations in time of crisis…The objectives of the program shall be to provide continuously for the availability, integrity, authentication, confidentiality, nonrepudiation, and rapid restitution of information and information systems that are essential elements of the Defense Information Infrastructure.*

DoD Directive Number 8500.1, *Information Assurance* states,

> *…Information assurance requirements shall be identified and included in the design, acquisition, installation, operation, upgrade, or replacement of all DoD information systems in accordance with 10 U.S.C. Section 2224, Office of Management and Budget Circular A-130, Appendix III, DoD Directive 5000.1 (references (a), (j), and (k)), this Directive , and other IA-related DoD guidance, as issued.*

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS, CONTINUED

DoD Directive Number 8500.2, *Information Assurance Implementation* states,

> *A disaster plan exists that provides for the smooth transfer of all mission or business essential functions to an alternate site for the duration of an event with little or no loss of operational continuity. (Disaster recovery procedures include business recovery plans, system contingency plans, facility disaster recovery plans, and plan acceptance.)…An alternate site is identified that permits the restoration of all mission or business essential functions.*

Specific conditions and recommended remedial actions attributable to the above instance of noncompliance are more fully described in our Independent Auditor's Report on Internal Control, dated October 28, 2004. The DFAS Office of Corporate Resources is responsible for the financial management systems within DFAS.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of the United States Department of Defense, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Urbach Kahn & Werlin LLP

Washington, DC
October 28, 2004