DEFENSE FINANCE AND ACCOUNTING SERVICE

ANNUAL FINANCIAL STATEMENTS

FISCAL YEAR 2000

March 1, 2001

DEFENSE FINANCE AND ACCOUNTING SERVICE ANNUAL FINANCIAL STATEMENTS FISCAL YEAR 2000

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DEFENSE FINANCE AND ACCOUNTING SERVICE

OVERVIEW

SUMMARY OF THE DEFENSE FINANCE AND ACCOUNTING SERVICE

As of September 30, 2000

Description of the Reporting Entity

The reporting entity is the Defense Finance and Accounting Service (DFAS). DFAS is the finance and accounting arm of the Department of Defense (DoD). It pays all major DoD contracts and vendors, its 5.4 million military and civilian personnel, retirees and annuitants, and operates the department's 76 major finance and accounting systems. DFAS delivers finance and accounting services worldwide from a Headquarters in Arlington, Virginia, 7 DFAS centers located in Cleveland, Ohio; Columbus, Ohio (2); Denver, Colorado; Indianapolis, Indiana (2); and Kansas City, Missouri; 19 Operating Locations (OPLOCs), and a satellite office in Japan.

Summary

Fiscal Year (FY) 2000 marked a major milestone, as DFAS was the first DoD operational entity to receive an "unqualified audit opinion" on its financial statements. This is particularly significant since we are only in our second year of being audited by Deloitte & Touche (D&T), an independent public accounting firm. This demonstrates that DFAS can provide world class finance and accounting service to its DoD customers, and can assist customers in achieving favorable audit opinions in the future.

Prior to the establishment of DFAS, financial management within DoD was conducted independently by the Components--Army, Navy, Air Force, Marine Corps, and Defense Agencies. Each component developed financial management processes and tailored business practices to its particular mission. As Defense missions required greater integration, DoD components required greater interoperability in terms of missions, functions, and systems. The lack of integration and standardization took a toll. DoD components developed increasingly complex business practices to link their financial systems and left them prone to error and unable to meet demands in a timely and efficient manner.

In response to these challenges, on January 16, 1991, the Secretary of Defense chartered DFAS as the leading agent for DoD financial management reform. DFAS was charged with standardizing and streamlining finance and accounting operations and information that will produce data that is accurate, comprehensive, and timely. This effort included the standardization and consolidation of all DoD finance and accounting systems and operations. DFAS has taken this responsibility seriously, moving forward in every area of financial management during the past 10 years.

As a Defense Working Capital Fund (DWCF) activity, DFAS operates predominantly as a commercial business, obtaining revenue by charging customers fixed prices for its services. DFAS sets its rates annually based on anticipated workload and estimated costs calculated to offset any prior year gains or losses, keeping customers and ultimately the

American taxpayer's best interests in mind. These principals are evident in the Agency's mission and vision statements.

Mission and Vision

DFAS Mission:
"Provide responsive, professional finance and accounting services to the Department of Defense"

DFAS is proud to serve those who serve. The DFAS Mission and Vision emphasize our commitment to the men and women of the Armed Forces who depend on us for financial services. Our roadmap for financial reform, improved service, and reduced costs is producing results. A customer-focused vision ensures continuous improvement and a partnership approach to long-lasting financial reform within DoD.

DFAS Vision:
In support of this mission, the leadership and employees of the DFAS community have adopted a vision to be the:

- ***World-class provider of finance and accounting services, with strong corporate identity,***
- ***A trusted, innovative financial advisor,***
- ***An employer of choice, providing a progressive and professional work environment, and***
- ***Competitive, best value to customers***

- As the DoD agent for financial management reform, DFAS is committed to providing world-class finance and accounting service to our customers.
- All components are charged with putting the customer first while striving to find innovative ways to reduce costs and demonstrate that we provide competitive services.
- At the same time, we recognize our people as one of our most valuable resources. We dedicated $23 million for the training and professional development of our employees to ensure that they are well-trained professionals in this increasing high technology environment.
- We use a deliberate approach in the development and deployment of new systems and the transition of business practices that will enhance our productivity and customer service. At the same time we continue to evaluate our business lines and support service functions as potential candidates for outsourcing.

Defense Business Evolution

In FY 2000, DFAS took a major step forward in building a strong corporate identity that reflects our sincere concern to meet customer and organizational needs. As a result, the Agency began the organizational transition from a geographically centered Agency to a customer-centric organization referred to as the Defense Business Evolution (DBE). These organizational changes, while relatively small, represented a significant change in direction; a serious commitment on our part to place customer needs first. At the same time, these changes addressed the DoD challenge to reduce the cost of finance and accounting operations as a function of combat support. It is anticipated that this evolutionary change will be completed in FY 2001.

Business Operations

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

Financial Operations. The Financial Operations business area is composed of Payment Operations, Commercial Payment Operations, and Accounting Services. In addition to these components, 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.

- **Payroll Operations** is charged with providing timely and accurate pay services to active-duty military members, reservists, National Guard members, civilian personnel, retirees, and annuitants. It is responsible for debt and claims management, garnishments, and certain bankruptcies (e.g., Chapter 13), and responsive, quality travel services. Its focus is strengthening client/customer partnerships, meeting the challenges of outside competitors, integrating customer input into operations, and offering value enhanced services to customers.

- **Commercial Payment Operations** provides payments for most commercial invoices and payments to DoD contractors that provide businesses and services to DoD components (Services and Agencies). Commercial Payment is split into three different payment operations, Contract Pay, Vendor Pay, and Transportation Pay.

- **Accounting Services** provides budgetary and proprietary accounting support for all DoD Military Department and Defense Agencies with a goal of providing accurate and timely financial statements with the requisite information to assist senior managers in making resource-related decisions.

Information Services. This business area, led by the Agency's Chief Information Officer, serves as the component for DoD's future finance and accounting application systems strategy and architecture. It provides planning, policy, architectural guidance, and the supporting infrastructure systems. Within this business area, DFAS also implements business practice changes and Web-based and enabling technology to transition to a paperless environment.

Financial Condition

On the financial side, DFAS received an “unqualified audit opinion” on its financial statements. This demonstrates that we have the capability to provide world class finance and accounting service to our DoD customers. It also forms a firm base for us to assist customers in achieving favorable audit opinions in the future. Equally important, we have demonstrated that we can balance revenue and expenses. As a DoD agency, this ability is critical to the assurance that all DoD resources are properly allocated to the Department’s primary mission – combat and combat readiness. DFAS also received an unqualified opinion on the Military Retirement Fund for the eighth consecutive year

Measuring Performance

On the management side, DFAS moved forward with bold, new initiative to demonstrate its commitment to the needs of its customers. DFAS Indianapolis was realigned to provide a senior executive and supporting staff in direct support of the Army’s Operating and Sustaining Forces. This gave or Army customers a direct link to a senior executive to address their requirements and resolve issues along Army command and control lines. At the same time, DFAS Columbus was reorganized into three cohesive operations focusing on contract payments, accounting and financial services, and support services. This transformation provided a senior executive to oversee contract pay operations and address government and private sector partner inquiries. We provided a senior manager for both accounting and financial services and support services to support customer financial operations and provide renewed emphasis on accurate and timely payments to customers.

DFAS also established a Board of Advisors (BOA). The BOA will consist of 14 members: 5 DoD senior civilian leaders, 5 General/Flag rank officers, and 4 senior managers from private sector firms. In addition, the Military Department’s Assistant Secretaries for Financial Management will be invited as observers. The first meeting of the BOA is planned for the Spring of 2001.

On the operational side, DFAS has a performance contract with the Defense Management Council (DMC). The DMC is the executive oversight council representing DoD customers. The contract prescribes the DMC’s understanding of our customers’ desired results and our commitment to achieve those results, recognizing that both parties want the highest possible level of quality and efficiency. Currently, the DFAS performance contract is designed to be the premier benchmark for codifying senior management, office, and employee goals to improve efficiencies and reduce cost.

For Fiscal Year (FY) 2000, DFAS had a total of 57 performance measures. Of those 50 were within DFAS control. DFAS met 48 of 50 contract performance deliverables within its control, to include cost, timeliness and accuracy goals. The two remaining deliverables are no longer applicable and require no further action to improve performance. The 7 goals that are outside DFAS direct control will require a collaborative effort with our customers, and we are spearheading a concerted effort to achieve those goals.

Some of the DFAS most noteworthy business operations accomplishments include:

- Reducing aged intransits by 86 percent. An aged in-transit disbursement occurs when a payment is made and reported to the U.S. Department of Treasury, but the payment has not been posted to the general ledger. In FY 1998, the in-transit balance was $1.8 billion. In FY 2000, that number was reduced to $257 million. This 86 percent reduction was achieved by re-engineering our entitlement and accounting systems to better enable the electronic transmission of financial data. This allows for increased timeliness and more accurate recording of transactions.

- Reducing unmatched disbursements (UMD) by 82 percent. A UMD occurs when a payment cannot be matched to the actual commitment/ obligation document recorded. UMDs are an outgrowth of the in-transit process and can result when different systems do not communicate at the time of the payment. In FY 1998, the UMD balance was $7.4 billion. In FY 2000, the UMD figure has been reduced 82 percent to $1.3 billion.

- Reducing negative unliguidated obligations (NULOs) by 77 percent. A NULO occurs when a payment made against a particular obligation document is greater than the amount of the obligation funds that is recorded in the official accounting system. In FY 1998, the NULO balance was $1.3 billion. In FY 2000, NULOs were $294 million, a 77 percent reduction.

- Completing 3 accounting operations-related competitive sourcing (OMB Circular A-76) studies, examining a total of 306 workyears. In all 3 cases, we won the competition and implemented the Most Efficient Organization (MEO) with total savings of 88 workyears (approximately 28 percent) and $4.8 million.

- Announcing three new competitive sourcing studies, examining 1,610 positions. The goal is to study over 5,000 finance and accounting positions within the next seven years. As a program, the A-76 studies have been very successful. To date, our competitive sourcing studies have examined 1,319 positions in six business areas and resulted in saving 530 workyears and more than $28 million.

Future Initiatives

Initiatives for FY 2001 and beyond include the implementation of a “Business-of-DFAS dashboard” that will be a method assessing the daily health of the organization and reviewing performance. Once operational, this web-based system will provide our entire network, as well as our customers, full visibility of our performance. With this and other on-going initiatives, we expect to maintain forward momentum aggressively pursuing beneficial business practice changes and continuing efforts to partner with our customers.

This iterative process culminates in a balanced scorecard that determines how well we meet customer satisfaction, quality and responsiveness goals, and how our performance impacts the achievement of our long-term strategic vision. The Balanced Scorecard is a strategic and tactical management tool for performance measurement that integrates internal and external perspectives and uses both short- and long-term performance indicators. It translates strategy into action, facilitates organizational learning, and communicates the organization vision.

All of the aforementioned accomplishment and our ongoing initiatives will move DFAS further up the path to improved service, and closer to our vision of becoming a world-class finance and accounting service provider.

DEFENSE FINANCE AND ACCOUNTING SERVICE

PRINCIPAL STATEMENTS

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATED BALANCE SHEET
AS OF SEPTEMBER 30, 2000
(IN THOUSANDS)

ASSETS	
Intragovernmental:	
Collections and disbursements, clearing (Note 2)	$ -
Accounts receivable (Note 3)	105,084
Other assets (Note 4)	15
Total intragovernmental	105,099
Accounts receivable (Note 3)	54
General property, plant and equipment, net (Note 5)	869,991
Other assets (Note 4)	10,057
TOTAL ASSETS	$ 985,201
LIABILITIES	
Intragovernmental:	
Accounts payable	$ 80,854
Other liabilities (Note 6)	14,612
Total intragovermental	95,466
Accounts payable	88,996
Military retirement benefits and other employment - related actuarial liabilities (Note 7)	41,526
Other liabilities (Note 6)	72,642
Total liabilities	298,630
NET POSITION	
Cumulative results of operations	686,571
Total net position	686,571
TOTAL LIABILITIES AND NET POSITION	$ 985,201

See notes to financial statements.

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATED STATEMENT OF NET COST
FOR THE YEAR ENDED SEPTEMBER 30, 2000
(IN THOUSANDS)

PROGRAM COST:	
Intragovernmental	$ 669,608
With the public	1,065,538
Total program cost	1,735,146
Less: Earned revenues	(1,701,636)
Net program costs	33,510
COSTS NOT ASSIGNED TO PROGRAMS	
Less: Earned revenues not attributable to programs	-
NET COST OF OPERATIONS	$ 33,510

See notes to financial statements.

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
FOR THE YEAR ENDED SEPTEMBER 30, 2000
(IN THOUSANDS)

NET COST OF OPERATIONS	$ 33,510
Financing sources (other than exchange revenues):	
Imputed financing (Note 7)	70,512
Transfers-in	38,417
(Transfers-out)	114,734
Other	(21,676)
Total financing sources (other than exchange revenues)	201,987
NET RESULTS OF OPERATIONS	168,477
PRIOR PERIOD ADJUSTMENTS (Note 8)	(36,126)
NET CHANGE IN CUMULATIVE RESULTS OF OPERATIONS	132,351
INCREASE (DECREASE) IN UNEXPENDED APPROPRIATIONS	-
CHANGE IN NET POSITION	132,351
NET POSITION, BEGINNING OF THE PERIOD	554,220
NET POSITION, END OF THE PERIOD	$ 686,571

See notes to financial statements.

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATED STATEMENT OF BUDGETARY RESOURCES
FOR THE YEAR ENDED SEPTEMBER 30, 2000
(IN THOUSANDS)

BUDGETARY RESOURCES:	
Budget authority	$ 222,921
Unobligated balance - beginning of period	446,442
Net transfers - prior year balance	(1,308)
Spending authority from offsetting collections and adjustments	1,877,993
Total budgetary resources	$ 2,546,048
STATUS OF BUDGETARY RESOURCES:	
Obligations incurred	$ 1,860,775
Unobligated balances - available	685,273
Total status of budgetary resources	$ 2,546,048
OUTLAYS:	
Obligations incurred	$ 1,860,775
Less: Spending authority from offsetting collections and adjustments	(1,877,993)
Obligated balance, net - beginning of period	312,774
Less: Obligated balance, net - end of period	(180,767)
Total outlays	$ 114,789

See notes to financial statements.

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATED STATEMENT OF FINANCING
FOR THE YEAR ENDED SEPTEMBER 30, 2000
(IN THOUSANDS)

OBLIGATIONS AND NONBUDGETARY RESOURCES:	
Obligations incurred	$1,860,775
Less: Spending authority for offsetting collections and adjustments	(1,877,993)
Financing imputed for cost subsidies	70,512
Less: Exchange revenue not in the entity's budget	(772)
Total obligations as adjusted and nonbudgetary resources	52,522
RESOURCES THAT DO NOT FUND NET COST OF OPERATIONS:	
Change in amount of goods, services, and benefits ordered but not yet received or provided - (increases)/decreases	63,508
Change in unfilled customer orders	(7,389)
Costs capitalized on the balance sheet - (increases)/decreases	(227,125)
Financing sources that fund costs of prior periods	(50,354)
Total resources that do not fund net cost of operations	(221,360)
COSTS THAT DO NOT REQUIRE RESOURCES:	
Depreciation and amortization	190,197
Total costs that do not require resources	190,197
FINANCING SOURCES YET TO BE PROVIDED	12,151
NET COST OF OPERATIONS	$ 33,510

See notes to financial statements.

DEFENSE FINANCE AND ACCOUNTING SERVICE

FOOTNOTES TO THE PRINCIPAL STATEMENTS

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

FOR THE YEAR ENDED SEPTEMBER 30, 2000

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

The Defense Finance and Accounting Service's (DFAS) financial statements report all activities of DFAS including Financial Operations and Information Services. The financial statements were prepared to meet the requirements of the Chief Financial Officer's (CFO) Act of 1990 and the Government Management Reform Act (GMRA) of 1994. While the statements have been prepared from the books and records of DFAS in accordance with the *Department of Defense Financial Management Regulation* ("DoDFMR") Volume 6B, as adapted from Office of Management and Budget (OMB) Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, as amended, the statements differ from 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 understanding that they are a component of the U.S. Government. These statements are in addition to the financial reports, also prepared by the Department of Defense (DoD) pursuant to OMB directives that are used to monitor and control DoD's use of budgetary resources.

DFAS's FY 2000 financial statements are presented in conformity with OMB Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, as amended by OMB Memoranda Nos. 99-03 and 00-05, Technical Amendments to OMB Bulletin No. 97-01.

B. Reporting Entity

DFAS 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 service to the DoD. Over the past ten years, DFAS has consolidated 338 installation-level finance and accounting operations into five DFAS centers and twenty operating locations. 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. DFAS entity accounts are 97X4930.005, Financial Operations (Code 5L) and Information Services (Code 5F40). The accompanying financial statements of DFAS include the activities of the following organizational components:

1. Financial Operations

   Financial Operations provides services for Commercial Payment Operations, General Accounting Services and Payroll Operations. Commercial Payment Operations provides payment services for invoice payments to contractors and vendors and travel payments to individuals. General Accounting Services provides accounting support services for the production of financial statements and reports and maintaining associated accounting systems and data. Payroll Operations provide payment services related to ensuring that all DoD employees receive compensation in a timely and accurate manner. Payroll operations make payroll payments to civilian personnel, active-duty military members, reservists, retirees and annuitants.

2. Information Services

This activity focuses on actions taken to bring DoD finance and accounting systems into compliance with the CFO Act.

C. Budgets and Budgetary Accounting

Budgetary accounting measures appropriation and consumption of Budget/Spending authority or other budgetary resources and facilitates compliance with legal constraints and controls over the use of federal funds. Under budgetary reporting principles, budgetary resources are consumed at the time of purchase. Assets and liabilities, which do not consume current budgetary resources, are not reported, and only those liabilities for which valid obligations have been established are considered to consume budgetary resources.

DFAS's major activities are funded through working capital funds. The DoD expanded the use of business-like financial management practices through the establishment of the Defense Business Operations Fund (DBOF) on October 1, 1991. On December 11, 1996, the DBOF became the Defense Working Capital Fund (DWCF). The DWCF operates with financial principles that provide improved cost visibility and accountability to enhance business management and improve the decision making process. The DWCF builds on revolving fund principles as used in industrial and commercial-type activities. DFAS and nine other activities are part of the DWCF.

D. Basis of Accounting

Under the authority of the CFO Act, the Federal Accounting Standards Advisory Board (FASAB) was established to recommend federal accounting standards to the Secretary of the Treasury, the Director of the OMB, and the Comptroller General. Seventeen Statements of Federal Financial Accounting Standards (SFFAS) and three Statements of Federal Financial Accounting Concepts (SFFAC) have been issued by the Director of OMB and the Comptroller General, some with deferred effective dates.

The accompanying financial statements have been prepared in accordance with SFFAS and related concepts. On October 19, 1999, the American Institute of Certified Public Accountants (AICPA) designated the FASAB as the accounting standard-setting body for federal government entities. As a result, accounting principles promulgated by FASAB are now considered Generally Accepted Accounting Principles (GAAP) for federal government entities. In the event the SFFASs do not address all of the transactions, the following hierarchy provides sources of accounting principles for the federal government: (1) Individual standards agreed to by the Director of the OMB, the Comptroller General, and the Secretary of the Treasury, and published by OMB and the General Accounting Office (GAO); (2) Interpretations related to SFFASs issued by OMB in accordance with the procedures outlined in OMB Circular A-134, *Financial Accounting Principles and Standards*; (3) Requirements contained in OMB's Form and Content Bulletin in effect for the period covered by the financial statements; and (4) Accounting principles published by other authoritative standard setting bodies and other authoritative sources.

E. Revenues and Other Financing Sources

Exchange revenue is generated by sales of accounting and finance services to DoD agencies through a reimbursable order process. Revenue is recognized to the extent the revenue is payable to DFAS from other DoD agencies. Revenue is recognized at the point the service is rendered. Imputed financing sources consist of imputed revenue for post-retirement benefits for DFAS employees as described in Note 1.O.

F. Accounting for Intragovernmental Activities

DFAS, as an agency of the federal government, interacts with and is dependent upon the financial activities of the DoD and federal government as a whole. Therefore, these financial statements do not reflect the results of all financial decisions applicable to DFAS as though the service was a stand-alone entity.

In order to prepare financial statements, transactions occurring between entities within the DoD or between two or more DoD agencies must be eliminated. For FY 2000, DFAS provided summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side and departmental accounting offices and in return, received this same type of information from them in order to properly eliminate the buyer-side activity.

G. Collections and Disbursements Clearing

DFAS, as a working capital fund, does not have a Fund Balance with Treasury (FWBT) 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) FWBT is subdivided at the Department of 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's operations are recorded in the DFAS financial records during the fiscal year. The collections and disbursements and current-year cash transfers are recognized as transfers to the DWCF subnumbered Treasury account at year-end.

The collection, disbursement, and current-year cash transfers balances are recorded as financing sources transferred out without reimbursement, and that account is later closed to cumulative results of operations.

H. Accounts Receivable

Accounts Receivable, Intragovernmental consists of amounts due from other DoD agencies. Accounts Receivable, Net - consists of claims receivable from other entities. Allowances for uncollectable accounts are based upon analysis of collection experience by fund type and are only applicable to receivables due from the public.

I. General Property, Plant and Equipment, Net

General Property, Plant and Equipment (PP&E) are valued at historical acquisition cost plus capitalized renovations or 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 other than land, is depreciated on a straight-line basis. Title 10, United States Code, prohibits DoD agencies from owning property, therefore DoD has implemented the recognition criteria of SFFAS No. 6, *Accounting for Property, Plant and Equipment*, to more accurately 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." This concept recognizes that member DoD agencies who gain the most benefit by virtue of space usage should capitalize the asset as General PP&E on their balance sheet.

Equipment is recorded at acquisition cost. In those instances where the original acquisition cost of General PP&E was not available, estimates have been used. Such estimates are based on either (1) the cost of similar assets at the time of acquisition or (2) the current cost of similar assets discounted for inflation to the time of acquisition.

J. Leases

Generally, lease payments are for the rental of equipment, space, and operating facilities and are classified as operating leases. Leases that do not transfer substantially all of the benefits or risks of ownership are classified as operating leases and recorded as expenses as payments are made over the lease terms.

K. Other Assets

Other Assets include Advances and Prepayments, Travel Advances and Non-Military Equipment Not in Use. Non-Military Equipment Not in Use represents the cost of equipment that would normally be classified as Property, Plant and Equipment if it were currently being utilized.

L. Accounts Payable

Accounts Payable-Intragovernmental consists of amounts owed to other DoD agencies. Accounts payable consists of accounts payable with the public.

M. Accrued Leave

Civilian annual leave and military leave are accrued as earned and the accrued amounts are reduced as leave is taken. The balances for accrued leave are adjusted monthly to reflect changes. The balances for annual civilian and military 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 nonvested 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.

N. Workers' Compensation Liability

Workers' Compensation is comprised of two components: (1) the accrued liability which represents money 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 and are ultimately paid by DFAS.

Future workers' compensation estimates were generated from an application of actuarial procedures developed by the Department of Labor 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 that period.

O. Pension, 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 the calculation of these pension and post-retirement health and life insurance benefit expenses were provided by the Office of Personnel Management (OPM) Financial Management Letter F-00-07, *2000 Cost Factors for Pension and other Retirement Benefits Expense*, to each agency to meet this requirement.

DFAS's 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.

P. Litigation

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

Most legal actions, other than contract claims, to which the Agency may be a named party, are covered by the provisions of the Federal Tort Claims Act and the provisions of Title 10, United States Code, Chapter 163, governing military claims. Since payments under these statutes are limited to amounts well below the threshold of materiality for claims payable from the Agency's funds and payments will be from the permanent, indefinite appropriation "Claims, Judgments, and Relief Acts", these legal actions should not materially affect DFAS's operations.

Q. Net Position

Net position consists of unexpended appropriations and cumulative result of operations. Unexpended appropriations represent amounts of authority, which are unobligated and have not been rescinded or withdrawn, and amounts obligated but for which neither legal liabilities for payment have been incurred nor actual payments made. DFAS does not have unexpended appropriations.

Cumulative results of operations represents the difference of an activity between expenses and other losses, and financing sources including appropriations used, revenue, and other gains. Beginning with FY 1998, this included the cumulative amount of donations and transfers of assets in and out without reimbursement. In addition, there is no longer a segregation of cumulative amounts related to investments in capitalized assets, such as PP&E, or a separate negative amount shown for future funding requirements. Cumulative results of operations for working capital funds represent the excess of revenues over expenses since fund inception, transfers of assets in and out without reimbursement since fund inception, less refunds to customers, and future funding requirements.

R. Undelivered Orders

DFAS is obligated for goods and services that have been ordered but not yet received (Undelivered Orders) as of September 30, 2000. The DFAS has Undelivered Orders of $170,926 thousand at fiscal year end. No liability for payment has been established in the financial statements because goods/services have yet to be delivered.

S. Pricing Policy

DFAS provides finance, accounting and information services to DoD agencies. The product lines available from DFAS include payroll and commercial payment processing as well as accounting and information services. Each year during the program budget formation and review process, a limited cost assessment is made by product or service line to assure that the rates charged to customers reflect the full cost to provide such services. DFAS, a working capital fund, does not receive any appropriated funding from the Congress; therefore, the rate review process is an integral component to the development of customer service rates.

T. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 2. COLLECTIONS AND DISBURSEMENTS CLEARING

Fund Type	
Appropriated Funds	$ -
Revolving Funds	-
Trust Funds	-
Other Fund Types	-
Total	$ -

NOTE 3. ACCOUNTS RECEIVABLE (IN THOUSANDS)

	Gross Amount	Allowance for Estimated Uncollectibles	Total
Entity Receivables:			
Intragovernmental	$105,084	$ -	$105,084
With the public - net	55	(1)	54

NOTE 4. OTHER ASSETS (IN THOUSANDS)

Intragovernmental:	
Other assets - advances and prepayments	$ 15
Total Intragovernmental	$ 15
Other assets:	
Non-military equipment not in use	$9,890
Advances - travel	167
Total other assets	$10,057

NOTE 5. GENERAL PROPERTY, PLANT AND EQUIPMENT, NET (IN THOUSANDS)

	Depreciation / Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation / Amortization)	Net Book Value
Major Asset Classes:					
Land	N/A	N/A	$ -	$ -	$ -
Buildings, Structures, and Facilities	S/L	20-40	153,855	(11,184)	142,671
Leasehold Improvements	S/L	Lease Term	2,199	(756)	1,443
ADP Software	S/L	2-5	1,150,378	(811,748)	338,630
Equipment	S/L	5-10	244,896	(179,898)	64,998
Construction-In-Progress	N/A	N/A	322,249	-	322,249
Total			$1,873,577	$(1,003,586)	$ 869,991

During FY 2000, DFAS adopted SFFAS No. 6, *Accounting for Property, Plant and Equipment*, retroactive to October 1, 1999. In accordance with the implementation guidance for SFFAS No. 6, ADP software, construction-in-progress, and equipment assets purchased on or before September 30, 1999, are recorded at estimated cost. The estimated cost is based on available historic supporting documents and the cost of similar assets at the time of acquisition.

The retroactive adoption of SFFAS No. 6 during FY 2000 resulted in a reduction of $13,842 thousand to previously recorded values, which is reported as a prior-period adjustment in the statement of changes in net position (see Note 8).

NOTE 6. OTHER LIABILITIES (IN THOUSANDS)

	Current Liability	Noncurrent Liability	Total
Other Liabilities Not Covered by Budgetary Resources:			
Intragovernmental:			
Workers' compensation	$ 3,517	$5,307	$ 8,824
Other liabilities	5,788	-	5,788
Total	$ 9,305	$5,307	$14,612
With the Public:			
Accrued funded payroll and benefits	$20,859	$ -	$20,859
Accrued unfunded annual leave	51,783	-	51,783
Total	$72,642	$ -	$72,642

NOTE 7. MILITARY RETIREMENT BENEFITS AND OTHER EMPLOYMENT-RELATED ACTUARIAL LIABILITIES (IN THOUSANDS)

Major Program Activities	Actuarial Present Value of Projected Plan Benefits	Actuarial Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Actuarial Liabilities
Pension and Health Benefits (1):				
Military Retirement Pensions	$ -	-	$ -	$ -
Military Retirement Health Benefits	-	-	-	-
Total	$ -		$ -	$ -
Other:				
Workers' Compensation (FECA)	$41,526	6.275%	$ -	$41,526
Total	$41,526		$ -	$41,526
Total	$41,526		$ -	$41,526

(1) Pension liabilities reported in the DoD Military Retirement Fund.

Workers' Compensation

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered federal civilian 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 and are ultimately paid by DFAS.

Future workers' compensation estimates were generated from an application of actuarial procedures developed by the Department of Labor 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 using a method that utilizes historical benefit payment patterns related to a specific incurred period to estimate the ultimate payments related to that period.

Consistent with past practice, these projected annual benefit payments have been discounted to present value using the OMB's economic assumptions for 10-year Treasury notes and bonds. Interest rate assumptions utilized for discounting were as follows:

6.275% in year 1,
6.30% in year 2, and thereafter

To provide more specifically for the effects of inflation on the liability for future workers' compensation benefits, wage inflation factors that include cost of living adjustments and medical inflation factors are also used to adjust the methodology's historical payment to the current year constant dollars. This methodology also includes a discounting formula to recognize the timing of actual compensation payments as thirteen payments per year instead of one lump sum per year. The projected number of years of benefits payments is 37 years.

The model's resulting projections were analyzed by DOL to ensure that the amounts were reliable. The analysis was based on three tests: (1) a comparison of the current year projections to the prior year projections, (2) a comparison of the prior year projected payments to the current year actual payments, excluding any new case payments that had arisen during the current year, and (3) a comparison of the current year actual payment data to the prior year actual payment data. Based on the outcome of this analysis, ad hoc adjustments were made by DOL to correct any abnormalities in the projections.

Pensions and Other Retirement Benefits

To calculate the liability for pensions and other retirement benefit costs, the "service cost" or normal cost is calculated. Service cost is defined as the actuarial present value of the benefits attributed by the pension plan's benefit formula to services rendered by employees during the accounting period. The amount of the service cost, less any employee contributions attributable to post-retirement benefits, is defined as pension expense for the entity.

Cost factors and imputed cost calculations provided by OPM Financial Management Letter F-00-07 dated September 30, 2000, were used to calculate the amount of additional expense to be recorded by DFAS.

The employee and employer contributions for health care and life insurance are attributed to the current period, and therefore, there is no offset to these service costs to calculate the other retirement benefit expense for the entity. These additional expenses represent the “subsidy” being made by OPM for employees’ retirement benefits. Based on the information provided by the OPM, DFAS determined that the imputed cost for the Pensions and Other Retirement Benefits for the year ended September 30, 2000 were:

Imputed Financing

CSRS/FERS Retirement	$23,826
Health	46,568
Life Insurance	118
Total	$70,512

NOTE 8. PRIOR-PERIOD ADJUSTMENTS (IN THOUSANDS)

Accounts payable	$(45,475)
Property, plant and equipment	16,923
Accounts receivable	(5,515)
Other	(2,059)
Total	$(36,126)

NOTE 9. OPERATING LEASES (IN THOUSANDS)

DFAS’s operating lease commitments for future years were estimated using data gathered from leases, General Services Administration bills, and InterService Support Agreements. The estimates for FY 2002 and beyond are based on a 3% inflation rate. The estimate for leases after 5 years includes only leases with defined expiration dates.

Future Payments Due:

Fiscal Year	
2001	$ 35,111
2002	35,939
2003	36,937
2004	38,118
2005	39,223
After 5 Years	36,281
Total Future Lease Payments	$221,609

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DEFENSE FINANCE AND ACCOUNTING SERVICE

FISCAL YEAR 2000
CONSOLIDATING FINANCIAL STATEMENT INFORMATION

FOR THE YEAR ENDED SEPTEMBER 30, 2000

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATING BALANCE SHEET INFORMATION
AS OF SEPTEMBER 30, 2000
(IN THOUSANDS)

ASSETS	Financial Operations	Information Services	Combined	Eliminations	Consolidated
Entity Assets					
Intragovernmental:					
Accounts receivable	$ 99,586	$ 31,654	$ 131,240	$(26,156)	$105,084
Other assets	15	-	15	-	15
Total intragovernmental	99,601	31,654	131,255	(26,156)	105,099
Accounts receivable	50	4	54	-	54
General property, plant and equipment, net	862,305	7,686	869,991	-	869,991
Other assets	10,051	6	10,057	-	10,057
Total entity assets	972,007	39,350	1,011,357	(26,156)	985,201
TOTAL ASSETS	$972,007	$ 39,350	$1,011,357	$(26,156)	$985,201

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATING BALANCE SHEET INFORMATION
AS OF SEPTEMBER 30, 2000
(IN THOUSANDS)

LIABILITIES	Financial Operations	Information Services	Combined	Eliminations	Consolidated
Intragovernmental:					
Accounts payable	$ 100,653	$ 6,357	$ 107,010	$(26,156)	$ 80,854
Other liabilities	13,748	864	14,612	-	14,612
Total intragovernmental	114,401	7,221	121,622	(26,156)	95,466
Accounts payable	63,770	25,226	88,996	-	88,996
Military retirement benefit and other employment-related actuarial liabilities	39,450	2,076	41,526	-	41,526
Other liabilities	65,267	7,375	72,642	-	72,642
Total liabilities	282,888	41,898	324,786	(26,156)	298,630
NET POSITION					
Cumulative results of operations	689,119	(2,548)	686,571	-	686,571
Total net position	689,119	(2,548)	686,571	-	686,571
TOTAL LIABILITIES AND NET POSITION	$ 972,007	$39,350	$1,011,357	$(26,156)	$ 985,201

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATING STATEMENT OF NET COST INFORMATION
FOR THE YEAR ENDED SEPTEMBER 30, 2000
(IN THOUSANDS)

	Financial Operations	Information Services	Combined	Eliminations	Consolidated
PROGRAM COST:					
Intragovernmental	$ 829,541	$ 28,860	$ 858,401	$(188,793)	$ 669,608
With the public	851,703	213,835	1,065,538	-	1,065,538
Total program cost	1,681,244	242,695	1,923,939	(188,793)	1,735,146
Less: Earned revenues	(1,663,543)	(226,886)	(1,890,429)	188,793	(1,701,636)
Net program costs	17,701	15,809	33,510	-	33,510
NET COST OF OPERATIONS	$ 17,701	$ 15,809	$ 33,510	$ -	$ 33,510

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

CONSOLIDATING STATEMENT OF CHANGES IN NET POSITION INFORMATION
FOR THE YEAR ENDED SEPTEMBER 30, 2000
(IN THOUSANDS)

	Financial Operations	Information Services	Combined	Eliminations	Consolidated
NET COST OF OPERATIONS	$ 17,701	$ 15,809	$ 33,510	$ -	$ 33,510
Financing sources (other than exchange revenues)					
Imputed financing	63,715	6,797	70,512	-	70,512
Transfers-in	38,428	632	39,060	(643)	38,417
(Transfers-out)	111,234	2,857	114,091	643	114,734
Other	(21,676)	-	(21,676)	-	(21,676)
Total financing sources (other than exchange revenues)	191,701	10,286	201,987	-	201,987
NET RESULTS OF OPERATIONS	174,000	(5,523)	168,477	-	168,477
PRIOR-PERIOD ADJUSTMENTS	(30,947)	(5,179)	(36,126)	-	(36,126)
NET CHANGE IN CUMULATIVE RESULTS OF OPERATIONS	143,053	(10,702)	132,351	-	132,351
INCREASE (DECREASE) IN UNEXPENDED APPROPRIATIONS	-	-	-	-	-
CHANGE IN NET POSITION	143,053	(10,702)	132,351	-	132,351
NET POSITION - BEGINNING OF THE PERIOD	546,065	8,155	554,220	-	554,220
NET POSITION - END OF THE PERIOD	$ 689,118	$ (2,547)	$ 686,571	$ -	$ 686,571

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

COMBINING STATEMENT OF BUDGETARY RESOURCES INFORMATION
FOR THE YEAR ENDED SEPTEMBER 30, 2000
(IN THOUSANDS)

	Financial Operations	Information Services	Combined
BUDGETARY RESOURCES:			
Budget authority	$ 221,521	$ 1,400	$ 222,921
Unobligated balance - beginning of period	389,741	56,701	446,442
Net transfers - prior year balance	(1,308)	-	(1,308)
Spending authority from offsetting collections and adjustments	1,661,114	216,879	1,877,993
TOTAL BUDGETARY RESOURCES	$2,271,068	$ 274,980	$ 2,546,048
STATUS OF BUDGETARY RESOURCES:			
Obligations incurred	$1,643,010	$ 217,765	$ 1,860,775
Unobligated balances - available	628,058	57,215	685,273
TOTAL STATUS OF BUDGETARY RESOURCES	$2,271,068	$ 274,980	$ 2,546,048
OUTLAYS:			
Obligations incurred	$1,643,010	$ 217,765	$ 1,860,775
Less: Spending authority from offsetting collections and adjustments	(1,661,114)	(216,879)	(1,877,993)
Obligated balance, net - beginning of period	342,264	(29,490)	312,774
Less: Obligated balance, net - end of period	(212,274)	31,507	(180,767)
TOTAL OUTLAYS	$ 111,886	$ 2,903	$ 114,789

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

COMBINING STATEMENT OF FINANCING INFORMATION
FOR THE YEAR ENDED SEPTEMBER 30, 2000
(IN THOUSANDS)

	Financial Operations	Information Services	Combined
OBLIGATIONS AND NONBUDGETARY RESOURCES:			
Obligations incurred	$ 1,643,010	$ 217,765	$ 1,860,775
Less: Spending authority for offsetting collections and adjustments	(1,661,114)	(216,879)	(1,877,993)
Financing imputed for cost subsidies	63,715	6,797	70,512
Less: Exchange revenue not in the entity's budget	(772)	-	(772)
Total obligations as adjusted and nonbudgetary resources	44,839	7,683	52,522
RESOURCES THAT DO NOT FUND NET COST OF OPERATIONS:			
Change in amount of goods, services, and benefits ordered but not yet received or provided - (increases)/decreases	46,414	17,094	63,508
Change in unfilled customer orders	2,649	(10,038)	(7,389)
Costs capitalized on the balance sheet - (increases)/decreases	(226,028)	(1,097)	(227,125)
Financing sources that fund costs of prior periods	(44,965)	(5,389)	(50,354)
Total resources that do not fund net cost of operations	(221,930)	570	(221,360)
COSTS THAT DO NOT REQUIRE RESOURCES:			
Depreciation and amortization	183,249	6,948	190,197
Total costs that do not require resources	183,249	6,948	190,197
FINANCING SOURCES YET TO BE PROVIDED	11,543	608	12,151
NET COST OF OPERATIONS	$ 17,701	$ 15,809	$ 33,510

DEFENSE FINANCE AND ACCOUNTING SERVICE

REQUIRED SUPPLEMENTARY INFORMATION

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
AS OF SEPTEMBER 30, 2000
(IN THOUSANDS)
(UNAUDITED)

INTRAGOVERNMENTAL ASSETS:

	Accounts Receivable	Other Assets
Navy General Fund	$ 28,729	$ -
Army General Fund	36,876	-
Air Force General Fund	8,754	15
Army Working Capital Fund	10,676	-
Navy Working Capital Fund	8,811	-
Air Force Working Capital Fund	467	-
ODO General Fund	4,693	-
ODO Working Capital Fund	5,881	-
Executive Office of the President AT (11)	48	-
Department of Agriculture AT (12)	31	-
United States Postal Service AT (18)	16	-
Department of the Treasury AT (20)	36	-
Social Security Administration AT (28)	7	-
General Services Administration AT (47)	1	-
Department of Transportation AT (69)	3	-
U.S. Army Corps of Engineers	55	-
Total Intragovernmental Assets	$105,084	$ 15

INTRAGOVERNMENTAL LIABILITIES:

	Accounts Payable	Other Liabilities
Navy General Fund	$ 16,867	$ -
Army General Fund	8,613	-
Air Force General Fund	2,149	-
Army Working Capital Fund	1,438	-
Navy Working Capital Fund	3,006	-
Air Force Working Capital Fund	1,571	-
ODO General Fund	2,186	-
ODO Working Capital Fund	39,759	-
Office of Personnel Management AT (24)	-	5,220
General Services Administration AT (47)	5,163	-
U.S. Army Corps of Engineers	102	-
Department of Labor	-	9,392
Total Intragovernmental Liabilities	$ 80,854	$14,612

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE

SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
AS OF SEPTEMBER 30, 2000
(IN THOUSANDS)
(UNAUDITED)

	Earned Revenues
INTRAGOVERNMENTAL REVENUES:	
Navy General Fund	$ 381,818
Army General Fund	580,558
Air Force General Fund	287,391
Army Working Capital Fund	26,786
Navy Working Capital Fund	93,455
Air Force Working Capital Fund	34,859
ODO General Fund	103,679
ODO Working Capital Fund	145,811
Executive Office of the President AT (11)	42,520
Department of the Treasury AT (20)	142
Social Security Administration AT (28)	69
General Services Administration AT (69)	2
U.S. Army Corps of Engineers	4,062
Department of Energy	42
Department of Transportation	442
Total Intragovernmental Revenues	$1,701,636

DEFENSE FINANCE AND ACCOUNTING SERVICE

Audit Opinion

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Deloitte & Touche

INDEPENDENT AUDITORS' REPORT

To the Audit Committee and the Director,
Defense Finance and Accounting Service

We have audited the accompanying consolidated balance sheet of the Defense Finance and Accounting Service (DFAS) as of September 30, 2000, and the related consolidated statements of net cost, changes in net position, budgetary resources, and financing for the year then ended, collectively referred to as the financial statements. 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, *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 accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of DFAS as of September 30, 2000, and its net cost, changes in net position, budgetary resources, and reconciliation of budgetary obligations to net cost for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating financial statement information on pages 18-24 is presented for the purpose of additional analysis of the consolidated financial statements rather than to present the financial position, net cost, changes in net position, budgetary resources and reconciliation of budgetary obligations to net cost of individual organizational components, and is not a required part of the consolidated financial statements of DFAS. This consolidating information is the responsibility of DFAS's management. Such consolidating financial statement information has been subjected to the auditing procedures applied in our audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the consolidated financial statements taken as a whole.

The required supplementary information on pages 25-27 is not a required part of the consolidated financial statements but is supplementary information required by the OMB Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, as amended. This supplementary information is the responsibility of the DFAS's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information and we do not express an opinion on it.

Deloitte
Touche
Tohmatsu

In accordance with *Government Auditing Standards*, we have also issued our report dated January 26, 2001, on our consideration of DFAS's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

January 26, 2001

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Audit Committee and the Director,
Defense Finance and Accounting Service

We have audited the consolidated financial statements of the Defense Finance and Accounting Service (DFAS) as of and for the year ended September 30, 2000, and have issued our report thereon dated January 26, 2001. 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.*

Internal Control over Financial Reporting

In planning and performing our audit, we considered DFAS's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving DFAS's internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operations of the internal control over financial reporting that, in our judgment, could adversely affect DFAS's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a condition 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

Reportable conditions noted are described in the following paragraphs and include significant departures from certain requirements of OMB Circular A – 127, *Financial Management Systems*, which incorporates by reference Circulars A – 123, *Management Accountability and Control*, and A – 130, *Management of Federal Information Resources*, among other requirements. We believe that the following reportable conditions are also material weaknesses.

1. During our audit of DFAS's consolidated financial statements, we identified deficiencies related to the internal control over the preparation, analysis, and monitoring of financial information to support the efficient and effective preparation of agency wide financial statements. Because of the deficiencies noted, we believe that DFAS's financial management system does not meet the requirements of an integrated financial management system as defined in OMB Circular A - 127, with respect to "consistent internal control over data entry, transaction processing and reporting." We also believe that DFAS is not in compliance with the system design requirements sufficient to comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury, and to monitor the financial management system to ensure integrity of financial data.

   As defined in OMB Circular A – 127, "a financial management system encompasses automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions." Such financial management systems shall be designed to provide for effective and efficient interrelationship between software, hardware, personnel, procedures, controls, and data contained within the systems. These integrated systems shall have the following characteristics: (1) common data elements; (2) common transaction processing; (3) consistent internal control over data entry, transaction processing and reporting; and (4) efficient transaction entry.

   With respect to system requirements in the area of financial reporting, OMB Circular A – 127 requires that an "agency financial management system shall be able to provide financial information in a timely and useful fashion to (1) support management's fiduciary role; (2) support the legal, regulatory and other special management requirements of the agency; (3) support budget formulation and execution functions; (4) support fiscal management of program delivery and program decision making; (5) comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury; and (6) monitor the financial management system to ensure integrity of financial data."

   Our assessment is based upon various factors noted during our audit. For example, we noted that:

   ◊ DFAS does not have a business practice to maintain records to record construction-in-progress (CIP) costs for building improvements for buildings owned through the "preponderance of use" criteria or leasehold improvements for facilities that DFAS leases from third parties. The information supporting the $50 million in additions and the related amount of depreciation, $1.5 million, was subsequently provided during the course of the audit.

◊ DFAS does not have a business practice nor is the current practice understood uniformly throughout the organization to monitor the usage of the Equipment Not In Use account. Amounts included in the account consisted of in - use items that had not been properly cleared from the account and items that did not meet the established capitalization threshold. During the audit, approximately $4.5 million was reclassified from the account based on additional analysis.

◊ Accounts Payable recorded at September 30, 2000, as was the case at the end of September 30, 1999, included significant invalid amounts. Of the recorded amount of $313 million at year-end, DFAS identified and took write-offs of approximately $169 million. The write-off was performed by reviewing over 30,000 documents and performing the following procedures: (1) document review; (2) confirming with responsible parties throughout the organization issues requiring further review; and (3) journalizing the adjustments into the general ledger. Approximately $14 million related to capital transactions and $155 million related to non-capital transactions. Although a top - level adjustment of these accounts was recorded for purposes of the FY 1999 financial statements, DFAS did not initiate any substantive effort to record the adjustment at the individual document level until after September 30, 2000.

◊ Undelivered orders are not subjected to a continual review and assessment for validity. Approximately $47 million in undelivered orders were written off due to the accounts payable document review and focused review of stale or unusual undelivered order balances in object class accounts. In similar fashion to the accounts payable effort, the write-offs were performed by (1) document review; (2) confirming with responsible parties throughout the organization issues requiring further review; and (3) journalizing the adjustments into the general ledger.

◊ DFAS rendered services in excess of the Military Intradepartmental Purchase Request (MIPR) in the amount of $49.6 million during FY 2000. The unfunded expenses represent the continuation of normal services performed in excess of funded orders. These services were not initially recognized as customer receivables until funding for these costs was approved. An adjustment for $56.5 million [FY 2000 services subsequently funded based on FY 2001 Program Budget Decision (PBD) No. 416] was recorded.

◊ DFAS does not have a managerial cost accounting system that can draw from the general ledger activity in the Defense Business Management System (DBMS) on a real time basis. Therefore, DFAS is unable to get a snapshot picture of their full costs against the amount charged to their customers.

◊ Numerous adjustments were posted to the trial balances to correct or add data and to crosswalk DBMS general ledger accounts to U. S. Standard General Ledger (SGL) accounts. For report preparation purposes that information was input to the Defense Departmental Reporting System (DDRS). As discussed in the *"Framework for Federal Financial Management Systems"* issued by the Joint Financial Management Improvement Program (JFMIP), an agency's financial management system should include "the ability to ... facilitate the preparation of financial statements, and other financial reports in accordance with federal accounting and reporting standards." The responsibilities of agency level data stewardship exist at each level within the agency to insure that "the information contained within the systems is accurate, timely, consistent and useful."

◊ The Electronic Data Processing (EDP) systems utilized by DFAS are not fully compliant with OMB Circular A-127. The Circular requires that federal financial systems provide complete, reliable, consistent and useful information on a timely basis. Our procedures identified deficiencies in the design and operation of EDP controls that increase the risk of unauthorized access to and modification of sensitive data. This condition compromises the ability of the systems to provide reliable data.

We recognize that DFAS continues to undertake significant efforts to fully implement the reporting requirements of OMB Bulletin No. 97 – 01, *Form and Content of Agency Financial Statements*, as amended. While we believe DFAS has made significant progress toward meeting its planned reporting objectives, significant improvements are still required as the processes and infrastructure that support the preparation of the agency's consolidated financial statements are not yet mature.

2. DFAS provides services and acquires services from many Department of Defense (DoD) agencies and components as well as the government as a whole. The governmental entities and activities that do business with DFAS are referred to as trading partners. Transactions generated by these trading partner activities are an accounts receivable (DFAS as the seller) or an accounts payable (DFAS as the buyer). Presently, DoD and its component agencies do not have a standard key or code identifier in their business partner transactions to eliminate those transactions during the preparation of consolidated financial statements.

   At year-end, DFAS received seller information that could not be adequately reconciled to its accounts payable at year-end. Seller information could not be adequately reconciled due to the quality of the information provided and due to the time and resources that would be necessary to undergo such a process.

3. Our assessment of information systems at the computer processing locations used by DFAS disclosed deficiencies in the design and operation of the disaster recovery plans, environmental controls and backup procedures. Specifically, we noted disaster recovery plans that were not periodically tested in a timely manner; data centers that lacked specific environmental controls; a data center that did not maintain a redundant processing location to restore operations in the event of a disaster; and backup tapes that were not adequately stored offsite.

4. Our review of DFAS's information system security access controls and security policies and procedures in place disclosed deficiencies in the design and operation of information system access controls. Specifically, we noted the following control weaknesses:

- ◊ Lack of specific security procedures
- ◊ Inadequate security administration
- ◊ Inadequate password parameters
- ◊ Segregation of duties concerns between programming, security administration and user responsibilities
- ◊ Network security weaknesses
- ◊ Lack of firewalls in place
- ◊ Security software configuration weaknesses

5. The information system assessment included the application program change control and operating system change control procedures in place. Our review noted weaknesses in the application and operating system change control procedures, including: lack of application change approvals; lack of system software change control procedures; inadequate procedures for testing, approving and migrating system software changes; and inadequate system software change tracking procedures.

6. DFAS did not prepare the annual Section 4 report as required by the Federal Managers Financial Integrity Act (FMFIA). Management stated that the reason for not conducting an annual Section 4 report was that the DFAS legacy systems have been previously reported that they continue not to comply with federal financial management system requirements. DFAS is in the process of replacing the non-compliant legacy systems with migratory systems. This replacing process will take approximately 3-4 more years to complete the implementation.

Finally, with respect to the internal control related to performance measures reported in Management 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 control.

We plan to issue our separate report to you, also dated January 26, 2001, on our comments on DFAS's internal control.

Compliance

As part of obtaining reasonable assurance about whether DFAS's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described below.

1. The material weaknesses in internal control over financial reporting discussed above indicate that DFAS is not in full compliance with the requirements of OMB Circulars A – 123 and A – 127.

2. The material weakness discussed above indicate that DFAS in not in full compliance with the FMFIA.

3. The financial management systems utilized by DFAS do not comply substantially with the requirements for Federal financial management systems set forth in OMB Circular A – 130, in that they do not fully, efficiently and effectively support DFAS's efforts to:

   ◊ Prepare financial statements and other required financial and budget reports using information generated by the financial management systems;

   ◊ Provide reliable and timely financial information for managing current operations;

   ◊ Account for their assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and

   ◊ Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger.

   We believe these weaknesses, in the aggregate, result in significant departures from certain of the requirements of OMB Circulars A – 123, A – 127, and A – 130.

Distribution

This report is intended solely for the information and use of the Audit Committee, the management of the Defense Finance and Accounting Service, the DoD Inspector General and the DoD Under Secretary of Defense (Comptroller) and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

January 26, 2001