DEFENSE FINANCE AND ACCOUNTING SERVICE

WORKING CAPITAL FUND

FISCAL YEAR 2006
FINANCIAL REPORT

NOVEMBER 2006

UK &W Urbach Kahn & Werlin LLP
CERTIFIED PUBLIC ACCOUNTANTS

Table of Contents

Page

In Fiscal Year (FY) 2006, the Defense Finance and Accounting Service (DFAS) continued its endeavor to reform financial management, improve the quality of DFAS products and services, and reduce costs to customers. The DFAS efforts support the President's Management Agenda, the Department of Defense (DoD) transformation initiatives, and the men and women who defend America.

In FYs 2000 through 2006, 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) (OUSD (C)) and Chief Financial Officer (CFO), a Customer Advisory Forum, and an Audit Committee.

DESCRIPTION OF THE REPORTING ENTITY

DFAS is the finance and accounting arm of the DoD. DFAS' mission is to provide responsive, professional finance and accounting services. DFAS pays all DoD military and civilian personnel, retirees and annuitants, civilian employees of various federal agencies, major DoD contractors and vendors, and delivers accounting reports and financial information. DFAS employs more than 13,000 people throughout the United States and in the European and Pacific theaters of operations to serve this purpose. 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 similarly 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.

During FY 2006, DFAS established a Strategic Business Management (SBM) Deputate, responsible for Agency strategic planning; transformation initiatives within DFAS; standardization and integration of functional requirements; integration and the implementation of new operational systems architecture; and promulgating DoD accounting, finance, disbursing, and debt management policy to support the Department's goal toward achieving auditable financial statements.

As part of the SBM organization, the Transformation Directorate manages all Base Realignment and Closure (BRAC) 2005 planning and oversight activities for the Agency. During FY 2006, DFAS successfully closed sites in Lexington, KY; Oakland, CA; San Bernardino, CA; Seaside, CA; and San Antonio, TX; and transitioned work to the Enduring Sites in Indianapolis, IN; Cleveland, OH; Columbus, OH; Limestone, ME; and Rome, NY, all on schedule and within budget.

With oversight by the Transformation Directorate, the Agency began to integrate the major transformation initiatives impacting DFAS during 2006 and beyond. An inventory of approximately 50 initiatives was identified and program management information obtained.

The goal is to establish baseline information, key milestones, and interdependencies. In conjunction with the Business Transformation Agency Enterprise Transition Plan, DFAS is building an initial Integrated Master Schedule to provide a decisional tool for DFAS and DoD leaders to track DFAS costs, schedule, and performance, both individually and across initiatives.

DFAS was generally structured to support Army, Navy, Marine Corps, Air Force, and the Defense Agencies via departmental and field operating networks. Actions implementing the President's Management Agenda have added new customers from outside the DoD, including the Department of Energy, the Department of Veterans Affairs, the Environmental Protection Agency, and the Department of Health and Human Services.

DFAS' structure is designed to anticipate and meet customers' needs by assigning each major customer a dedicated Client Executive who fosters effective communications and builds partnerships that enhance customers' mission capabilities. Client Executives ensure the DFAS team understands the unique and diverse needs of each customer.

The following accomplishments highlight the magnitude of DFAS worldwide operations during fiscal year 2006:

- 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 $234 billion in Military Retirement and Medicare-Eligible Retiree Health Care funds
- Disbursed $455 billion to pay recipients
- Managed $13.5 billion in foreign military sales
- Accounted for 282 active DoD appropriations

TRANSFORMATION AND REORGANIZATION

DFAS focuses on being a trusted partner and a Center of Excellence for government finance and accounting. To achieve this vision, DFAS is pursuing continuous improvement in the delivery of finance and accounting services in support of the warfighter.

The DFAS transformation strategy is aligned with the DoD's transformation goals and objectives and with the President's Management Agenda. DFAS is transforming the finance and accounting business by modernizing and improving financial management and reducing personnel and operating costs while providing agile responses to the dynamic DoD environment.

The DFAS transformation strategy leverages and integrates competitive sourcing initiatives, BRAC opportunities to reduce excess capacity, performance-based management through the National Security Personnel System, and state-of-the-art technology. The ultimate objective of the organization is to optimize performance and continue to reduce costs.

DFAS will continue its transformation to offer best value to the warfighter, our customers, and the American taxpayer. To assist in accomplishing DFAS' transformation goal, DFAS has reorganized and replaced the three operational business lines (Military and Civilian Pay Services, Commercial Pay Services, and Accounting Services) with the following organizational structure:

1. Principal Deputy Director

2. Strategic Business Management
   - Policy and Performance
   - Transformation
   - Business Requirements and Integration

3. Operations
   - Indianapolis
   - Columbus
   - Cleveland
   - Denver
   - Kansas City
   - Standards and Compliance

Strategic Business Management

Established in April 2006, the SBM Deputate was created to focus on the Agency strategic goals of operational excellence, on-demand financial information, becoming a Center of Excellence, and attaining a highly professional workforce with indispensable skills and competencies. During FY 2006, DFAS made significant progress in several strategic areas. Specific results include:

- Develop and promulgate DoD and DFAS policy and procedures
- Analyze, report, and use performance metrics to drive "best business practices" and achieve high-quality results
- Integrate and standardize business rules, functional requirements and DFAS Operational Architecture
- Oversee and implement DoD-wide initiatives
- Develop DFAS Strategic Plan and Corporate Balanced Scorecard that links budget to the strategy
- Develop DFAS Human Capital Strategy
- Oversee all DFAS transformation efforts
- Institutionalize Lean6 methodology as the standard for driving and measuring performance
- Support the Military Services in achieving audit readiness
- Develop and maintain Agency-wide policies, programs and services in staffing, classification, employee relations, labor-management relations, incentive awards, benefits and training

Accomplishments/Initiatives

DFAS FY 2006 BRAC Site Closures Commence on Target

In 2006, DFAS sites at Lexington, KY; San Antonio, TX; San Bernardino, CA; Seaside, CA; and Oakland, CA closed on schedule and within budget. DFAS provided employee transition options that included paid relocation, priority placement with other agencies, early retirement incentives, and potential private sector employment opportunities. For sites closed in FY 2006, 35 percent of the employees accepted DFAS or other agency employment, 46 percent retired, and 19 percent were separated voluntarily or under a reduction in force (RIF) action.

For all FY 2006 site closures, workload transition to the Enduring Sites occurred while sustaining the quality of customer deliverables. This outcome was achieved through diligent project planning and execution by DFAS personnel and through the use of $41 million of BRAC Operations and Maintenance financing utilized in support of DFAS BRAC efforts.

DFAS Master Integration Contract Augments Transformation Mission Requirements

In May 2006, DFAS awarded a Blanket Purchase Agreement (BPA) to support DFAS Transformation mission requirements that exceed Agency status quo capacity or to augment skill sets through the use of contract labor. To ensure integration of the execution of DFAS strategic initiatives, DFAS has implemented a business model where the activities of multiple contractor teaming partners supporting Transformation are anchored and monitored through the leadership of a Master Integrator. Support from the DFAS BPA includes consulting services, program integration and project management, training support, augmentation of core mission area work, and logistics support functions required during DFAS Transformation and BRAC activities.

In August 2006, DFAS and contract partners implemented a web-based project management capability where DFAS BRAC activities were piloted within the tool. This tool enabled a critical capability for viewing, reporting, and monitoring key business events across multiple DFAS locations during BRAC planning and implementation actions.

DFAS Corporate Electronic Document Management System

DFAS envisions delivering document imaging, storage and retrieval capabilities to all Operational/Mission areas at all DFAS sites by FY 2009. We have since accelerated the delivery of the Corporate Electronic Document Management System by implementing this system in phases. DFAS has initiated document preparation during July and August at Norfolk, VA, Dayton, OH and Denver, CO in anticipation of scanning the documents prior to workload transferring to Enduring Sites. Imaging will eliminate the need to ship and store hard-copy documents.

Defense Integrated Military Human Resource System (DIMHRS)

DFAS was tasked to orchestrate an extremely aggressive project schedule for implementing DIMHRS. We began working with the other DoD stakeholders to identify the current status.

By the end of August 2006, some 5,701 DIMHRS requirements were reviewed, with 1,742 anomalies identified (552 referred to Services for action, 979 resolved in Army review, and 211 referred by memo to the DIMHRS Enterprise Program Management Office (EPMO)).

Linking Cost Savings

DFAS continues linking cost-savings initiatives, such as BRAC, Accounting Enterprise Resource Planning (ERP) Systems, and A-76 High Performing Organizations to the dollar, and work year reductions in the DFAS FY 2007 President's Budget and the FY 2008 Program Objective Memorandum (POM)/Budget Estimate Submission (BES) to better identify the impact of these initiatives and to ensure all planned budget reductions are met.

Blue Book

The DFAS Publication 7900.4G, *A Guide to Federal Requirements for Financial Management Systems*, otherwise known as the "Blue Book", is being revised. At the end of August 2006, five of 16 chapters had been updated. The target date for completion is first quarter FY 2007.

OPERATIONS

Standards and Compliance Accomplishments

In FY 2006, DFAS made progress in several critical operational areas in support of the key strategic targets. Specific results include:

- Through continued application of the Balanced Scorecard and innovative initiatives, DFAS achieved significant results in improving operational performance. Results include: Reduced within-timeframe Suspense Account balances from $922 million to $541 million. Additionally, in-transit disbursements and collections overage balances were reduced from $300 million to $292 million. Overage negative unliquidated obligations (NULOs) were reduced to zero balances for all customers, except those covered by an OUSD (C) waiver.

- In an effort to reduce the number of incorrect invoices requiring rework, the Customer Service Office expanded its interactions with contractors. The "expanded" Quarterly Open House now hosts double the number of vendors who could previously attend. The Open House's Electronic Commerce (EC) workshop encourages enhanced EC participation as it decreases the possibility of keying errors and duplicate payments. Customer Service also hosts a Semi-Annual Defense Industry Leaders Conference and various DFAS Roadshows. During both, they work with our partners and other Government Agencies to develop more efficient and accurate processes. Customer Service also participated in 10 Federal Government Receivables and Research Bureau (FGRRB) conferences during the year. The FGRRB is a nationally recognized organization specializing in the training, education and dissemination of material to its members who do business with the U.S. Federal Government. This training increases customer awareness and knowledge, ultimately reducing the number of incorrect invoices submitted. The Customer Service Call Center was also enhanced, due to centralization of the Air Force Integrated Accounts Payable

System (IAPS) workload, which provided a single source for contractor/vendor telephone inquiries.

- Continued to increase Government-only access to the web-based Electronic File Room (EFR) at the Columbus Center. The EFR provides users with an efficient, convenient method for retrieving documents (contracts not available on Electronic Document Access (EDA); modifications; invoices; vouchers; and DoD/DFAS forms) stored in the Electronic Document Management (EDM) system. The EFR's security features are superimposed with EDAs. Work is underway to ensure the same level of EFR availability is provided to all customers. This initiative received the DoD Value Engineering Award.

- Continued the roll-out of the Contractor Debt System (CDS)-Lite within the Accounts Payable network. The CDS-Lite is a system used to manage all debts, including those referred to the Debt Management Office (DMO) for further collection efforts. User understanding of CDS-Lite has increased internal controls and reduced risks by standardizing data, reducing manual data input, in addition to providing greater workload visibility and better reporting capabilities. The data contained in CDS-Lite are drop-list and table-driven, reducing the chances of erroneous input and increasing data accuracy. Debts forwarded from Accounts Receivable CDS-Lite to Debt Management can be sent and imported electronically, thus eliminating the risk of keying errors, loss of government funds, erroneous and invalid debts, and potential loss of interest.

- The Debt Collection Improvement Act (DCIA) of 1996 authorized a centralized program for offset of Federal payments, including contract and vendor payments, to collect delinquent non-tax debts owed to the Federal government. To implement this, the Department of Treasury created the Treasury Offset Program (TOP). The Taxpayer Relief Act of 1997 authorized the Internal Revenue Service (IRS) to continuously levy up to 15 percent (since modified to 100 percent via the American Jobs Creation Act of 2004) of certain Federal payments, including contract and vendor payments. To implement this authority, the Federal Payment Levy Program (FPLP) was created. The FPLP uses the TOP system to match delinquent tax debts with Federal payments. In December 2002, DFAS Columbus joined the TOP process by matching and collecting debts (both tax and non-tax) on behalf of the Department of Treasury. Since implementation of the TOP program there were 7,608 collections totaling $62.7 million.

- June 2006 marked the workload transfer for the Intra-Governmental Payment and Collection System (IPAC), Travel Accounting and Vendor Pay to DFAS Columbus. The San Bernardino workload transitioned to Columbus and is in a production environment as of June 1, 2006. Accounting Operations is working closely with the Columbus Program Management Office in preparation for the DFAS Dayton workload transfer. A phased-in workload transition began in July and will continue through December 2006.

- Through tighter internal controls at all levels, DFAS closed 1,650 Army, Navy and Air Force cases to exceed the Foreign Military Sales (FMS) case closure target of 1,500 by 150 (10 percent). DFAS refunded $17 million to foreign customers by "final-closing" over 350 cases, thereby freeing customer funds for future FMS sales.

- Partnered with foreign governments, commercial banks, and DoD Components to introduce best banking practices to Security Assistance accounting that reduced processing time from days to hours and increased interest earned by foreign customers while tightening cash controls. The banking practices have reduced per-transaction processing costs by 29 percent, from $35 to $25. The FMS banking initiatives include expanding on-line wire transfer of customer funds by DFAS-Denver staff on FMS cases, modification of system capabilities to implement automated controls to account for multiple customer interest-bearing accounts, and the extension of commercial accounts to more customers.

- Implemented the Compensating Control Tool, which is a reconciliation database that reconciles Navy-to-Navy transactions while comparing disbursement/collection in the Defense Cash Accountability System (DCAS) to the Standard Accounting and Reporting System (STARS). The output from these processes is used to develop root cause solutions for problem transactions.

- Released programming in STARS to receive and process a property interface file from the Defense Property Accountability System (DPAS). This programming is the first of a two-phase property reporting project. Phase I meets current Audited Financial Statement (AFS) requirements to report non-military equipment property balances for the Department of the Navy. This release posts property to a general ledger trial balance, produces a CFO-style report for AFS, and provides for property reporting by command and activity. Phase II of this project is expected to balance property postings back to funding sources for financial control.

- DFAS components submitted plans and schedules to correct disclosed material weaknesses in compliance with Office of Management and Budget (OMB) Circular A-123, Appendix A.

- Established the Military Pay Wounded in Action (WIA) Program that improved pay accuracy, reduced indebtedness and eliminated the pay account review backlog. As of September 2006, WIA cases have been reviewed, and less than one percent contained deployment related pay errors, and 12 percent require additional research.

Initiatives

- Improve field-level military pay timeliness
- Establish e-solutions capabilities that show measurable results
- Develop overarching reconciliation plans
- Improve Accounts Receivable and Accounts Payable processes and oversight
- Implement Wide Area Workflow at all sites
- Successfully implement BRAC
- DFAS is working with an outside contractor and the Navy Customers on the design and implementation of a cash reconciliation tool.
- Review and analyze requirements, establish goals and objectives, and develop a Military Pay Obligations Key Milestone Plan.

PERFORMANCE GOALS AND OBJECTIVES

DFAS is a customer-focused, strategy-based, and metrics-driven organization. The DFAS Strategic Plan drives DFAS operations every day 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 the following goals and objectives that address the critical issues facing our customers and our core capabilities:

FY 2007 Strategic Plan Goals:

- Attain operational excellence in finance and accounting services
- Deliver financial information "on demand" for decision makers
- Transform DFAS to become a Center of Excellence
- Attain a highly professional workforce with indispensable skills and competencies

FY 2007 DFAS Objectives:

- Provide instant access to comprehensive financial data
- Provide quality financial and timely advice
- Establish dynamic partnerships to execute ERP solutions
- Implement "best business practices" to increase productivity and reduce costs
- Integrate e-Solutions through state-of-the art technology
- Fulfill BRAC requirements
- Create Centers of Excellence and High Performing Organizations
- Execute National Security Personnel System requirements
- Re-shape workforce to meet mission needs

DFAS turns its strategy into meaningful, measurable initiatives through the use of the Balanced Scorecard. Updated 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 corporate goals.

The Balanced Scorecard, along with key indicator reports and performance measurement indicators, is used to monitor the overall health of the organization. It provides operational and financial performance indices to effectively and efficiently manage our business operations. Performance objectives in the Balanced Scorecard focus on continued achievement of the DFAS mission for providing responsive, professional finance and accounting services for the people who defend America. Our Deputy Directors continue to improve Balanced Scorecard reporting under its four perspectives. Success factors for each of its supporting measures are reviewed, compiled and analyzed monthly. Any out-of-tolerance conditions are reported to management, along with a plan of action and milestones, to mitigate the situation. Customer and quality indices are used to evaluate the efficiency and effectiveness of operations. These indices provide management with real-time information to assist in identifying areas requiring improvement and/or modification. Employees are kept apprised of Balanced Scorecard measures and any corrective actions necessary to achieve established goals.

Information and Technology

The Information and Technology Directorate (I&T) oversees the implementation of Department of Defense IT policies, facilitates an integrated Enterprise Architecture, monitors and evaluates the performance of all information and technology investments and develops and maintains the Agency's operational, technical, infrastructure, and application systems architectures. The I&T Directorate oversees the provisioning of telecommunications, computing and software engineering services, manages the agency's information assurance program, and maintains the DFAS infrastructure system (e.g., Enterprise Local Area Network).

Accomplishments/Initiatives:

- As a result of the findings reported in the FY 2005 Audit, the e-Biz system management team established a permanent e-Biz Continuity of Operations Plans (COOP) site in Mechanicsburg, PA. They were able to successfully test and execute a COOP plan and continue to maintain site readiness in case of emergency. Service-Level Agreements and Memorandums of Agreement were updated to reflect commitments by all. System internal review processes, to include quarterly reviews of audit logs, user access, signed security access forms files and updated documentation, were formalized and instituted. The Configuration Control Board (CCB) was re-established to review and prioritize development initiatives for Reports, System Change Requests (SCRs) and Production Trouble Reports (PTRs). Formal Quarterly Software releases and test processes to deliver consistent and timely updates for e-Biz were initiated, and all users' manuals were updated to reflect the current systems configuration.

- The I&T Directorate re-established the CCB for the Defense Joint Military Pay System (DJMS) in April 2006. The Investment Review Board approved funding for three DJMS-Active projects and four DJMS-Reserve projects. Total projected savings over two years based on reduced manual workload for these projects is $2.723 million. The CCB for the DJMS met again in August of 2006. There were 18 new SCRs presented, nine for DJMS-Active Component (AC) and nine for DJMS-Reserve Component (RC). All projects were approved and work is being accomplished. Since the reinvigoration of DJMS, we have implemented 11 SCRs for DJMS-RC and nine for DJMS-AC. In addition, 17 PTRs were implemented for DJMS-RC and 41 for DJMS-AC.

- As part of the process to move the Defense Mil/Pay Office (DMO) Corporate Database and the Staging Database (SDB) from mainframe to a centralized mid-tier/web-enabled environment at Defense Enterprise Computing Center (DECC)-Mechanicsburg, DMO has completed its mid-tier infrastructure. The DMO has also established a platform for web-based transaction processing, SDB access and inquiry to military pay data. This capability will result in long-term information processing center savings and provide additional functionality to the customer.

- The DFAS I&T Directorate converted the Defense Joint Accounting System (DJAS) to the Standard Finance System (STANFINS). The elimination of DJAS will result in an annual operating cost reduction of approximately $2.7 million. An archiving capability based on the DJAS database will be sustained to support historical data inquiries.

- The DFAS accounting system, Standard Accounting, Budgeting and Reporting System (SABRS), became the first military Service accounting system to inherently contain and report Standard Financial Information Structure - compliant, detail-level data to DoD. This key accomplishment by the DFAS I&T Directorate supports the DoD goals outlined in the Financial Improvement and Audit Readiness Plan and better positions the Marine Corps to be the first military Service to achieve auditable financial statements.

- Cleveland received the OUSD (C) Financial Management Award for its innovative use of Telecommunications Technology in support of the DFAS-Cleveland Navy Military Pay and Military Reserve and Guard Pay operations through the use of Interactive Voice Response System (IVRS) applications and Voice Mail call routing processes. The use of existing DFAS-Cleveland Technology Services Organization Telecommunications technology provided a direct cost savings to DFAS, freeing up $160,000 in telephone equipment expenses, which was made available for use in the DFAS-Cleveland contact centers.

- The DFAS Enterprise Local Area Network (ELAN) group, in a bold departure from past technology refreshes, defined the ELAN requirements as functional specifications rather than technical specifications, and required industry to respond using best practices, Total Cost of Ownership (TCO) and least cost in the solution set with periodic reporting against anticipated results. The ELAN Reengineering Initiative (ERI) Phase 1 replaced all the servers, eliminated Novell as an operating system, consolidated backup, improved COOP capability for the least cost and provided the lowest TCO proposed by Industry, while offering better performance and more capacity and capability.

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 the 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 for FYs 2000 through FY 2006.

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	2006	2005
ASSETS		
Intragovernmental:		
Collections and Disbursements Clearing	$ -	$ -
Accounts Receivable	35,353	120,822
Total Intragovernmental	35,353	120,822
With the Public:		
Accounts Receivable	594	1,422
General Property, Plant and Equipment, Net (Note 2)	670,006	789,619
Other Assets	38	92
TOTAL ASSETS	**$ 705,991**	**$ 911,955**
LIABILITIES		
Intragovernmental:		
Accounts Payable	$ 59,607	$ 88,131
Other Liabilities (Note 3)	13,952	17,854
Total Intragovernmental	73,559	105,985
With the Public:		
Accounts Payable	85,364	85,349
Actuarial FECA Liability (Notes 4 and 5)	39,993	41,631
Accrued Payroll and Benefits (Note 3)	96,496	93,581
TOTAL LIABILITIES	**295,412**	**326,546**
NET POSITION		
Cumulative Results of Operations	410,579	585,409
TOTAL NET POSITION	**410,579**	**585,409**
TOTAL LIABILITIES AND NET POSITION	**$ 705,991**	**$ 911,955**

The accompanying notes are an integral part of these statements

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF NET COST
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	2006	2005
PROGRAM COSTS		
Intragovernmental Gross Costs	$ 528,567	$ 518,916
Less: Intragovernmental Earned Revenue	(1,617,180)	(1,612,244)
Intragovernmental Net Costs	(1,088,613)	(1,093,328)
Gross Costs With the Public	1,222,840	1,199,312
Less: Earned Revenue From the Public	(1,563)	(1,370)
Net Costs With the Public	1,221,277	1,197,942
NET COST OF OPERATIONS	**$ 132,664**	**$ 104,614**

The accompanying notes are an integral part of these statements

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	2006	2005
Cumulative Results of Operations		
Beginning Balances	$ 585,409	$ 593,262
Budgetary Financing Sources		
Appropriations Used	70	-
Transfers-In/Out Without Reimbursement	-	301
Other Financing Sources		
Transfers-In/Out Without Reimbursement	(133,970)	16,241
Imputed Financing Sources (Note 6)	91,734	80,219
Total Financing Sources	**(42,166)**	**96,761**
Net Cost of Operations	**132,664**	**104,614**
ENDING BALANCES	**$ 410,579**	**$ 585,409**

The accompanying notes are an integral part of these statements

DEFENSE FINANCE AND ACCOUNTING SERVICE
COMBINED STATEMENTS OF BUDGETARY RESOURCES
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands		2006		2005
BUDGETARY RESOURCES				
Unobligated Balance, Beginning of Period	$	207,015	$	177,153
Recoveries of Prior Year Unpaid Obligations		69,783		80,353
Budget Authority				
Appropriation		70		-
Contract Authority		51,156		50,615
Spending Authority from Offsetting Collections:				
Earned:				
Collected		1,865,137		1,664,454
Change in Receivables from Federal Sources		(91,524)		104,553
Change in Unfilled Customer Orders:				
Advance Received		(4,111)		4,111
Without Advance from Federal Sources		17,996		11,262
Subtotal		1,838,724		1,834,995
Nonexpenditure Transfers, Net, Anticipated and Actual		-		300
Permanently Not Available		(300,130)		(121,178)
Total Budgetary Resources	**$**	**1,815,392**	**$**	**1,971,623**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred:				
Reimbursable	$	1,724,185	$	1,764,608
Total Obligations Incurred		1,724,185		1,764,608
Unobligated Balance:				
Apportioned		91,207		207,015
Total Status of Budgetary Resources	**$**	**1,815,392**	**$**	**1,971,623**
CHANGE IN OBLIGATED BALANCE				
Obligated Balance, Net - Beginning of Period	$	132,937	$	249,751
Obligations Incurred, Net		1,724,185		1,764,608
Less: Gross Outlays		(1,705,095)		(1,685,254)
Less: Recoveries of Prior Year Unpaid Obligation		(69,783)		(80,353)
Change in Uncollected Customer Payments from Federal Sources		73,528		(115,815)
Obligated Balance, Net - End of Period:				
Unpaid Obligations		285,720		336,413
Less: Uncollected Customer Payments from Federal Sources		(129,948)		(203,476)
Total, Unpaid Obligated Balance, Net, End of Period		155,772		132,937
Net Outlays:				
Gross Outlays		1,705,095		1,685,254
Less: Offsetting Collections		(1,861,026)		(1,668,565)
Subtotal		(155,931)		16,689
Net Outlays	**$**	**(155,931)**	**$**	**16,689**

The accompanying notes are an integral part of these statements

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF FINANCING
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	2006	2005
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated:		
Obligations Incurred	$ 1,724,185	$ 1,764,608
Less: Spending Authority from Offsetting Collections	(1,857,281)	(1,864,733)
Net Obligations	(133,096)	(100,125)
Other Resources:		
Transfers In/Out Without Reimbursement	(133,970)	16,241
Imputed Financing Sources (Note 6)	91,734	80,219
Total Resources Used to Finance Activities	**(175,332)**	**(3,665)**
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	32,354	48,029
Resources that Fund Expenses Recognized in Prior Periods	(1,682)	(48,882)
Resources that Finance the Acquisition of Assets	(64,505)	(74,082)
Other	133,970	(16,241)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**100,137**	**(91,176)**
Total Resources Used to Finance the Net Cost of Operations	**(75,195)**	**(94,841)**
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Components Requiring or Generating Resources in Future Period:		
Increase in Annual Leave Liability	3,825	-
Other	365	-
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	4,190	-
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	128,086	120,453
Revaluation of Assets or Liabilities	74,932	45,151
Other	651	33,851
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	**203,669**	**199,455**
Total Components of Net Cost of Operations That Will Not Require or Generate Resources or Generate Resources In the Current Period	**207,859**	**199,455**
NET COST OF OPERATIONS	**$ 132,664**	**$ 104,614**

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 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:

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. Additionally, they provide overall technical support in a number of system-related areas including the acquisition of information technology (IT), systems implementation, and support for the DFAS IT infrastructure.

B. Basis of Presentation

The accompanying financial statements have been prepared to report the financial position, net cost and changes in net position of DFAS, together with budgetary resources and a reconciliation of net cost 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) Circular A-136, Financial Reporting Requirements, 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 separate 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 Intragovernmental 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, except for Real Property which is capitalized at $20,000 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. GENERAL PROPERTY, PLANT AND EQUIPMENT, NET (IN THOUSANDS)

As of September 30, 2006:

	Acquisition Cost	Accumulated Depreciation	Net Book Value	Useful Life (in years)
Buildings, Structures and Facilities	$ 238,990	$ 86,208	$ 152,782	20 to 40
Leasehold Improvements	122,996	20,128	102,868	Lease Term
Equipment	287,371	242,599	44,772	5 to 10
Internal-Use Software	1,279,363	910,274	369,089	2 to 10
Construction-In-Progress	495	-	495	N/A
Other	1,212	1,212	-	N/A
Total General PP&E, Net	**$ 1,930,427**	**$ 1,260,421**	**$ 670,006**	**-**

As of September 30, 2005:

	Acquisition Cost	Accumulated Depreciation	Net Book Value	Useful Life (in years)
Buildings, Structures and Facilities	$ 212,241	$ 44,665	$ 167,576	20 to 40
Leasehold Improvements	123,841	14,637	109,204	Lease Term
Equipment	268,696	235,700	32,996	5 to 10
Internal-Use Software	1,325,739	846,269	479,470	2 to 10
Construction-In-Progress	373	-	373	N/A
Other	892	892	-	N/A
Total General PP&E, Net	**$ 1,931,782**	**$ 1,142,163**	**$ 789,619**	**-**

DFAS reports both Internal-Use Software and Internal-Use Software in Development as a combined total for financial statement preparation purposes. Accumulated Depreciation is recorded for Internal-Use Software only. As software in development is deemed ready for use, the value of the asset is transferred into the Internal-Use Software account and depreciation commences.

NOTE 3. OTHER LIABILITIES (IN THOUSANDS)

As of September 30, 2006:	Current	Non-Current	Total
Intragovernmental Other Liabilities			
Workers' Compensation	$ 3,860	$ 5,315	$ 9,175
Employer Contributions and Payroll Taxes	4,777	-	4,777
Total Intragovernmental Other Liabilities	8,637	5,315	13,952
Other Liabilities With the Public			
Accrued Payroll and Benefits	96,496	-	96,496
Total Other Liabilities With the Public	96,496	-	96,496
Total Other Liabilities	**$ 105,133**	**$ 5,315**	**$ 110,448**

As of September 30, 2005:	Current	Non-Current	Total
Intragovernmental Other Liabilities			
Advances from Others	$ 4,111	$ -	$ 4,111
Workers' Compensation	3,836	5,018	8,854
Employer Contributions and Payroll Taxes	4,889	-	4,889
Total Intragovernmental Other Liabilities	12,836	5,018	17,854
Other Liabilities With the Public			
Accrued Payroll and Benefits	93,581	-	93,581
Total Other Liabilities With the Public	93,581	-	93,581
Total Other Liabilities	**$ 106,417**	**$ 5,018**	**$ 111,435**

NOTE 4. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES (IN THOUSANDS)

Intragovernmental	**2006**	**2005**
Workers' Compensation	$ 9,175	$ 8,854
Total Intragovernmental	9,175	8,854
With the Public		
Actuarial FECA Liability	39,993	41,631
Total With the Public	39,993	41,631
Total Liabilities Not Covered by Budgetary Resources	49,168	50,485
Total Liabilities Covered by Budgetary Resources	246,244	276,061
Total Liabilities	**$ 295,412**	**$ 326,546**

NOTE 5. ACTUARIAL LIABILITY (IN THOUSANDS)

	Unfunded Actuarial Liability at September 30, 2006		Unfunded Actuarial Liability at September 30, 2005	
Workers' Compensation	$	39,993	$	41,631
Total Actuarial Liability	**$**	**39,993**	**$**	**41,631**

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 provides an estimated actuarial liability for future workers' compensation benefits. DFAS' reported FECA liability is based on the DoD-Wide allocation worksheet, the bills received, and applicable charge back reports.

NOTE 6. IMPUTED FINANCING SOURCES (IN THOUSANDS)

	2006		2005	
Civilian Retirement	$	27,480	$	29,089
Civilian Health		52,779		50,991
Civilian Life Insurance		139		139
Building Space		11,336		-
Total Imputed Financing Sources	**$**	**91,734**	**$**	**80,219**

NOTE 7. LEASES

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.

After the Base Realignment and Closure (BRAC) 2005 announcement, DFAS formed a Transformation and BRAC organization which put together a list of sites closing and the projected dates of closure. These sites and projected closure dates were all approved by the Office of the Secretary of Defense. Based on the projected DFAS sites closing, anticipated operating lease costs have been reduced based on the closure date.

The dollar amount (in thousands) of DFAS' operating lease commitments for future years consisted of the following at September 30, 2006:

Fiscal Year	**2006**
2007	$ 34,808
2008	33,182
2009	29,834
2010	30,764
2011	31,933
After 2011	33,146
Total Future Lease Payments	**$ 193,667**

NOTE 8. STATEMENT OF BUDGETARY RESOURCES RECONCILIATION

Under OMB Circular A–11, *Preparing, Submitting, and Executing the Budget*, Federal agencies are to report budgetary information in the Statement of Budgetary Resources based on budget terminology, definitions, and guidance issued. OMB Circular A–11 also states that the information on the Statement of Budgetary Resources should be consistent with budget execution information reported in the President's Budget. Additionally, per SFFAS 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 Statement of Budgetary Resources 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, an analysis comparing the DFAS Statement of Budgetary Resources to the President's Budget is not possible; however, an analysis of information reported in the Statement of Budgetary Resources and the information reported in the September 30, 2006 Report on Budget Execution (SF–133) was performed. This analysis identified immaterial differences related to Unpaid Obligations due to DFAS adjustments, primarily related to additional accruals being posted to the financial statements.

DEFENSE FINANCE AND ACCOUNTING SERVICE

REQUIRED SUPPLEMENTARY INFORMATION
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2006

(UNAUDITED)

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2006
(UNAUDITED)

Dollars In Thousands	
INTRAGOVERNMENTAL ASSETS	**Accounts Receivable**
Navy General Fund	$ 15,830
Army General Fund	3,536
Air Force General Fund	2,501
Other Defense Organizations General Funds	2,441
Other Defense Organizations Working Capital Funds	7,548
Army Working Capital Fund	614
Navy Working Capital Fund	2,883
Total Intragovernmental Assets	**$ 35,353**

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2006
(UNAUDITED)

Dollars In Thousands		
INTRAGOVERNMENTAL LIABILITIES	**Accounts Payable**	**Other Liabilities**
Department of the Interior	$ 8	$ -
Department of Labor	-	9,175
Navy General Fund	1,199	-
Department of the Treasury	2,214	-
Army General Fund	3,838	-
Office of Personnel Management	1,674	4,777
Department of Veterans Affairs	3	-
General Services Administration	17,531	-
Air Force General Fund	5,786	-
Department of Transportation	479	-
Department of Homeland Security	603	-
Department of Health and Human Services	913	-
United States Postal Service	95	-
Other Defense Organizations General Funds	1,446	-
Other Defense Organizations Working Capital Funds	14,780	-
Army Working Capital Fund	4,525	-
Navy Working Capital Fund	3,765	-
Air Force Working Capital Fund	748	-
Total Intragovernmental Liabilities	**$ 59,607**	**$ 13,952**

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2006
(UNAUDITED)

Dollars In Thousands		
INTRAGOVERNMENTAL REVENUE		**Earned Revenue**
Executive Office of the President	$	160
Department of Commerce		75
Navy General Fund		362,494
Department of State		(11)
Army General Fund		603,022
Department of Veterans Affairs		2,058
General Services Administration		202
Air Force General Fund		296,417
Environmental Protection Agency		860
Department of Homeland Security		116
Armed Forces Retirement Home		(5)
Department of Energy		327
Department of Education		1,968
Independent Agencies		158
United States Army Corps of Engineers		3,308
Other Defense Organizations General Funds		136,321
Other Defense Organizations Working Capital Funds		111,322
Army Working Capital Fund		29,938
Navy Working Capital Fund		62,221
Air Force Working Capital Fund		6,069
United States Postal Service		1
Office of Personnel Management		7
Central Intelligence Agency		152
Total Intragovernmental Revenue	**$**	**1,617,180**

NON - EXCHANGE REVENUE		**Transfers - In**		**Transfers - Out**
Other Defense Organizations Working Capital Funds	$	-	$	136,099
Other Defense Organizations General Funds		2,129		-
Total Non-Exchange Revenue	**$**	**2,129**	**$**	**136,099**

DEFENSE FINANCE AND ACCOUNTING SERVICE

OTHER ACCOMPANYING INFORMATION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING BALANCE SHEETS
AS OF SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	Information Services	Financial Operations	Combined Total	Eliminations	2006 Consolidated	2005 Consolidated
ASSETS						
Intragovernmental:						
Collections and Disbursements Clearing	$ -	$ -	$ -	$ -	$ -	$ -
Accounts Receivable	5,097	35,634	40,731	(5,378)	35,353	120,822
Total Intragovernmental	5,097	35,634	40,731	(5,378)	35,353	120,822
With the Public:						
Accounts Receivable	8	586	594	-	594	1,422
General Property, Plant and Equipment, Net (Note 2)	1,618	668,388	670,006	-	670,006	789,619
Other Assets	1	37	38	-	38	92
TOTAL ASSETS	**$ 6,724**	**$ 704,645**	**$ 711,369**	**$ (5,378)**	**$ 705,991**	**$ 911,955**
LIABILITIES						
Intragovernmental:						
Accounts Payable	$ 1,346	$ 63,639	$ 64,985	$ (5,378)	$ 59,607	$ 88,131
Other Liabilities (Note 3)	1,203	12,749	13,952	-	13,952	17,854
Total Intragovernmental	2,549	76,388	78,937	(5,378)	73,559	105,985
With the Public:						
Accounts Payable	14,010	71,354	85,364	-	85,364	85,349
Actuarial FECA Liability (Notes 4 and 5)	3,604	36,389	39,993	-	39,993	41,631
Accrued Payroll and Benefits (Note 3)	9,649	86,847	96,496	-	96,496	93,581
TOTAL LIABILITIES	**29,812**	**270,978**	**300,790**	**(5,378)**	**295,412**	**326,546**
NET POSITION						
Cumulative Results of Operations	(23,088)	433,667	410,579	-	410,579	585,409
TOTAL NET POSITION	**(23,088)**	**433,667**	**410,579**	**-**	**410,579**	**585,409**
TOTAL LIABILITIES AND NET POSITION	**$ 6,724**	**$ 704,645**	**$ 711,369**	**$ (5,378)**	**$ 705,991**	**$ 911,955**

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF NET COST
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	Information Services	Financial Operations	Combined Total	Eliminations	2006 Consolidated	2005 Consolidated
PROGRAM COSTS						
Intragovernmental Gross Costs	$ 27,985	$ 621,940	$ 649,925	$ (121,358)	$ 528,567	$ 518,916
Less: Intragovernmental Earned Revenue	(171,704)	(1,566,834)	(1,738,538)	121,358	(1,617,180)	(1,612,244)
Intragovernmental Net Costs	(143,719)	(944,894)	(1,088,613)	-	(1,088,613)	(1,093,328)
Gross Costs With the Public	147,667	1,075,173	1,222,840	-	1,222,840	1,199,312
Less: Earned Revenue From the Public	(32)	(1,531)	(1,563)	-	(1,563)	(1,370)
Net Costs With the Public	147,635	1,073,642	1,221,277	-	1,221,277	1,197,942
NET COST OF OPERATIONS	**$ 3,916**	**$ 128,748**	**$ 132,664**	**$ -**	**$ 132,664**	**$ 104,614**

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF CHANGES IN NET POSITION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	Information Services	Financial Operations	2006 Consolidated	2005 Consolidated
Cumulative Results of Operations				
Beginning Balances	$ (16,486)	$ 601,895	$ 585,409	$ 593,262
Budgetary Financing Sources				
Appropriations Used	-	70	70	-
Transfers-In/Out Without Reimbursement	-	-	-	301
Other Financing Sources				
Transfers-In/Out Without Reimbursement	(10,053)	(123,917)	(133,970)	16,241
Imputed Financing Sources (Note 6)	7,368	84,366	91,734	80,219
Total Financing Sources	**(2,685)**	**(39,481)**	**(42,166)**	**96,761**
Net Cost of Operations	**3,916**	**128,748**	**132,664**	**104,614**
ENDING BALANCES	**$ (23,087)**	**$ 433,666**	**$ 410,579**	**$ 585,409**

DEFENSE FINANCE AND ACCOUNTING SERVICE
COMBINING STATEMENTS OF BUDGETARY RESOURCES
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	Information Service	Financial Operations	2006 Combined	2005 Combined
BUDGETARY RESOURCES				
Unobligated Balance, Beginning of Period	$ (4,308)	$ 211,323	$ 207,015	$ 177,153
Recoveries of Prior Year Unpaid Obligations	22,229	47,554	69,783	80,353
Budget Authority				
Appropriation	-	70	70	-
Contract Authority	394	50,762	51,156	50,615
Spending Authority from Offsetting Collections				
Earned:				
Collected	180,232	1,684,905	1,865,137	1,664,454
Change in Receivables from Federal Sources	(7,749)	(83,775)	(91,524)	104,553
Change in Unfilled Customer Orders:				
Advance Received	-	(4,111)	(4,111)	4,111
Without Advance from Federal Sources	17,553	443	17,996	11,262
Subtotal	190,430	1,648,294	1,838,724	1,834,995
Nonexpenditure Transfers, Net, Anticipated and Actual	-	-	-	300
Permanently Not Available	(17,678)	(282,452)	(300,130)	(121,178)
Total Budgetary Resources	**$ 190,673**	**$ 1,624,719**	**$ 1,815,392**	**$ 1,971,623**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred:				
Reimbursable	$ 177,354	$ 1,546,831	$ 1,724,185	$ 1,764,608
Total Obligations Incurred	177,354	1,546,831	1,724,185	1,764,608
Unobligated Balance:				
Apportioned	13,319	77,888	91,207	207,015
Total Status of Budgetary Resources	**$ 190,673**	**$ 1,624,719**	**$ 1,815,392**	**$ 1,971,623**
CHANGE IN OBLIGATED BALANCE				
Obligated Balance, Net - Beginning of Period	$ 21,680	$ 111,257	$ 132,937	$ 249,751
Obligations Incurred, Net	177,354	1,546,831	1,724,185	1,764,608
Less: Gross Outlays	(170,166)	(1,534,929)	(1,705,095)	(1,685,254)
Less: Recoveries of Prior Year Unpaid Obligations, Actual	(22,229)	(47,554)	(69,783)	(80,353)
Change in Uncollected Customer Payments from Federal Sources	(9,806)	83,334	73,528	(115,815)
Obligated Balance, Net - End of Period:				
Unpaid Obligations	36,287	249,433	285,720	336,413
Less: Uncollected Customer Payments from Federal Sources	(39,454)	(90,494)	(129,948)	(203,476)
Total, Unpaid Obligated Balance, Net, End of Period	(3,167)	158,939	155,772	132,937
Net Outlays:				
Gross Outlays	170,166	1,534,929	1,705,095	1,685,254
Less: Offsetting Collections	(180,231)	(1,680,795)	(1,861,026)	(1,668,565)
Subtotal	(10,065)	(145,866)	(155,931)	16,689
Net Outlays	**$ (10,065)**	**$ (145,866)**	**$ (155,931)**	**$ 16,689**

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF FINANCING
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2006 AND 2005

Dollars In Thousands	Information Services	Financial Operations	2006 Consolidated	2005 Consolidated
RESOURCES USED TO FINANCE ACTIVITIES				
Budgetary Resources Obligated:				
Obligations Incurred	$ 177,354	$ 1,546,831	$ 1,724,185	$ 1,764,608
Less: Spending Authority from Offsetting Collections	(212,265)	(1,645,016)	(1,857,281)	(1,864,733)
Net Obligations	(34,911)	(98,185)	(133,096)	(100,125)
Other Resources				
Transfers In/Out Without Reimbursement	(10,053)	(123,917)	(133,970)	16,241
Imputed Financing Sources (Note 6)	7,368	84,366	91,734	80,219
Total Resources Used to Finance Activities	**(37,596)**	**(137,736)**	**(175,332)**	**(3,665)**
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	31,045	1,309	32,354	48,029
Resources that Fund Expenses Recognized In Prior Periods	(535)	(1,147)	(1,682)	(48,882)
Resources that Finance the Acquisition of Assets	(584)	(63,921)	(64,505)	(74,082)
Other	10,053	123,917	133,970	(16,241)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**39,979**	**60,158**	**100,137**	**(91,176)**
Total Resources Used to Finance the Net Cost of Operations	**2,383**	**(77,578)**	**(75,195)**	**(94,841)**
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD				
Components Requiring or Generating Resources in Future Period:				
Increase in Annual Leave Liability	295	3,530	3,825	-
Other	-	365	365	-
Total components of Net Cost of Operations that will require or generate resources in future periods	**295**	**3,895**	**4,190**	**-**
Components not Requiring or Generating Resources:				
Depreciation and Amortization	1,095	126,991	128,086	120,453
Revaluation of Assets or Liabilities	129	74,803	74,932	45,151
Other	15	636	651	33,851
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	**1,239**	**202,430**	**203,669**	**199,455**
Total Components of Net Cost of Operations That Will Not Require or Generate Resources In The Current Period	**1,534**	**206,325**	**207,859**	**199,455**
NET COST OF OPERATIONS	**$ 3,917**	**$ 128,747**	**$ 132,664**	**$ 104,614**

INDEPENDENT AUDITOR'S REPORT ON THE FINANCIAL STATEMENTS

Director and Audit Committee
Defense Finance and Accounting Service

We have audited the accompanying Consolidated Balance Sheets of the Working Capital Fund (WCF) of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense, as of September 30, 2006 and 2005, 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. 06-03, *Audit Requirements for Federal Financial Statements*. These standards and OMB Bulletin No. 06-03 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of DFAS' internal control over financial reporting for the WCF. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of the DFAS WCF as of September 30, 2006 and 2005, and its net cost, 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 Circular No. A-136, *Financial Reporting Requirements*. 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 the information and express no opinion on it.

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 financial statements. This information has been subjected to the auditing procedures applied in the audits of the financial statements, and, in our opinion, is presented fairly, in all material respects, in relation to the financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued reports dated October 30, 2006 on our consideration of DFAS' internal control over financial reporting for the WCF, and on our tests of its compliance with certain provisions of applicable laws, regulations, and contracts for the WCF. 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 30, 2006

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL

Director and Audit Committee
Defense Finance and Accounting Service

We have audited the Working Capital Fund 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 years ended September 30, 2006 and 2005, and have issued our report thereon dated October 30, 2006. 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. 06-03, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audits, 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. 06-03 and *Government Auditing Standards*. 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 audits 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 the following two matters involving the internal control and its operation that we consider to be 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 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. 06-03. 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 30, 2006.

This report is intended solely for the information and use of the management of DFAS and DoD, 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 30, 2006

REPORTABLE CONDITION 1 (Material Weakness)

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

Undelivered Orders and Corresponding Proprietary Accounts

Even though improvements continued to be made over the prior fiscal years, throughout fiscal year 2006, DFAS did not timely deobligate aged or erroneous undelivered orders (UDO) balances, and did not properly monitor the estimation of accrued liabilities, where the goods or services had been provided prior to month-end. Because DFAS did not have adequate controls over the UDO balance throughout the fiscal year, we were unable to rely on the results of our interim audit testing. Consequently, an extensive examination of the items comprising the UDO balance had to be performed by DFAS during the last quarter of the fiscal year, which required unanticipated additional testing of the UDO account population at year-end. During the last quarter of the fiscal year, DFAS management took an increased active role ensuring the majority of accruals were properly posted in the Electronic Business Accounting and Management System (e-Biz).

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

- Insufficient training of DFAS Directorate Executive personnel regarding the monitoring of UDO balances, including timely deobligation of invalid or aged documents, proper recording of accruals, and the inconsistent application of all required policies and procedures throughout the organization;

- Insufficient training of the Directorate Executive personnel over the performance of Triannual reviews, related to the specific objectives stated in the DoD Financial Management Regulation (FMR) and the DFAS Regulation 7040.1R for ensuring that applicable proprietary and budgetary accounts were valid, accurate, and properly supported. In addition, there was ineffective quality control procedures performed by the Director of the Financial Management Office of the Office of Corporate Resources related to the performance of Triannual reviews to ensure that the transactions identified and certified by the Directorate Executive personnel were valid and properly supported; and

- Invalid UDO balances were being reported because DFAS did not commence contract reconciliations in a timely manner after the contract period ended as required by the Federal Acquisition Regulation (FAR). In some instances, it took DFAS more than six months to commence reconciliation of contracts after the period of performance (POP) had expired.

REPORTABLE CONDITION 1 (Material Weakness), Continued

Accounts Payable

Even though improvements continued to be made over the prior fiscal years, throughout fiscal year 2006, we identified errors related to the improper recording of disbursements, and aged accounts payable (A/P) that were not properly written off. Receipts were improperly posted either to incorrect document numbers or for incorrect amounts, either overstating or understating the related A/P balances. Because DFAS did not have adequate controls over the A/P balances throughout the fiscal year, we were unable to rely on the results of our interim audit testing. Consequently, an extensive examination of the items comprising the A/P balances had to be performed by DFAS during the last quarter of the fiscal year, which required unanticipated additional testing of the A/P account population at year-end.

Additionally, we noted instances where invoices were received and fully disbursed; however, an invalid A/P balance was reported because the estimated accruals were higher than the actual invoices but the original estimated accruals were not reversed when the invoice was received. Also, there were instances where disbursements were made exceeding the receipt amount available on the line of accounting, which created an invalid A/P.

Statement of Federal Financial Accounting Standards (SFFAS) 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,

> ...*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…*

REPORTABLE CONDITION 1 (Material Weakness), Continued

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.*

DFAS Regulation 7040.1R, Chapter 18, Section 4, states,

> *To ensure DFAS (internal) has sound financial records consistently throughout the year, reviews are to be conducted in accordance with the schedule below. Prompt and accurate recording of commitments, obligations and accrued expenditures in e-Biz, is a vital part of proper financial reporting. BL and Corporate Elements, in conjunction with their servicing RI, and with assistance from supporting offices, shall review open commitment, obligation, and accrual/receipt (expense) transactions for timeliness, accuracy, and completeness. FO/FSOs and Accounting Operations participate in joint reviews with the BL and Corporate Elements, in a supporting role when applicable.*
>
> *Certifications to the CFO are submitted based upon the financial records as of January 31, May 31, and September 30 of each fiscal year. Note, All transactions greater than $50,000 and all abnormal balances are reviewed each month…To support the CFO certification to OSD(C), the BL Executives/Corporate Element Directors likewise, provide a signed certification memorandum to the CFO within 21 calendar days following each of the same four month periods.*

DFAS 7040.1R, Chapter 9, Section 4, states,

> *In the absence of knowing the exact quantity and amount of the goods/services received, an estimated Accrual (i.e., an E* e-Biz transaction code) transaction is required to be initiated by the responsible program or financial management point of contact...require an accrual for that estimated time/materials to be initiated and input to e-Biz before the close of the month.*

> *The estimated accrual is documented by use of the DFAS Form 1414, Accrual of Goods/Services Received…All Accruals must be reversed at a point in time and replaced with an actual receipt (i.e., R* e-Biz transaction code) transaction…once the program or financial management POC receives information that establishes the exact quantity and amounts of goods/services, a (manual) Accrual Reversal is initiated on the DFAS Form 1414, and submitted to the servicing FO/TPA along with the actual Receipt document…*

DFAS Policy Memorandum 05-5, *Contract Reconciliation and Contract Closeout Procedures*, states,

> *Reviews are conducted to determine if there are undelivered orders (UDOs) or unobligated commitments and to ascertain whether the funds must be reconciled or deobligated via contract modification.*
>
> *Do not wait until the period of performance of all option years, delivery orders or calls are complete or the period of performance has ended before reconciling the contract, receiving reports, invoices, disbursements and their posting in the various electronic business systems. Contracts may be funded by multiple funding documents and in some cases the period of performance may encompass multiple years; therefore, it is important to continually review and reconcile each funding document. Reconciliation of one funding document may* [reveal] *posting errors of other funding documents on the same or different contract.*
>
> *The COR is the primary person responsible for…Conducting a complete review and reconciliation of the contract obligations, products and services received, invoices, and disbursements 60 days before the end of the performance period for service contracts, if not already being performed as a routine part of monitoring the contract; Initiating action to reconcile and/or begin closeout procedures within 60 days after the period of performance has passed, delivery has been made or the contract is physically complete. This is a follow-on to the initial review conducted 60 days prior to the end of the POP…*

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

1. The UDO and A/P subsidiary listings are continually monitored throughout the fiscal year to ensure that the balances are properly supported, with appropriate adjustments validated for their propriety and completeness. Additionally, aged UDO and A/P should be 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.

2. Contract review and reconciliation is performed in accordance with DFAS Policy Memorandum 05-5 to ensure expired obligations are closed out and deobligated timely. DFAS should also consider using a tickler file in e-Biz or in an offline file that is triggered during specific times during the POP of the obligation, such as 60 days prior to the expiration of the POP and when the POP ends on an obligation, which would provide timely notification for the reconciliation to begin.

3. Ongoing training is provided for DFAS Directorate Executive personnel regarding the proper procedures for estimating and documenting accrued liabilities throughout the fiscal year. Training is increasingly critical due to the changes in responsibilities emanating from Base Realignment and Closure. 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. The training should also emphasize the following:

    - It is the responsibility of Directorate Executives that these accounts are properly stated. However, all personnel within the organization 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.

4. The Triannual review process is 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. Additionally, monitoring and quality control of the Triannual process is performed by the Director of the Financial Management Office of the Office of Corporate Resources to ensure that the transactions identified and certified by the Directorate Executives are valid and properly supported.

REPORTABLE CONDITION 2 (Material Weakness)

DFAS DID NOT HAVE ADEQUATE CONTROLS OVER THE RECORDING OF PROPERTY, PLANT AND EQUIPMENT

Even though improvements were made over the prior fiscal years, throughout fiscal year 2006, DFAS did not have adequate controls over the recording of property, plant and equipment (PP&E).

Internal-Use Software

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 errors in depreciation expense. In response to prior year audit findings, DFAS performed an in-depth review of the Internal-Use Software in Development account. The review was scheduled to be completed by June 2006, but the effort was not entirely completed by DFAS until year-end. Because DFAS did not have adequate controls over the PP&E balances throughout the fiscal year, we were unable to rely on the results of our interim audit testing. Consequently, an extensive examination of the items comprising the Internal-Use Software in Development balance had to be performed by DFAS during the last quarter of the fiscal year, which required unanticipated additional testing of the Internal-Use Software in Development account population at year-end. During the last quarter of the fiscal year, DFAS management took an increased active role ensuring that completed Internal-Use Software in Development projects were properly capitalized as of year-end.

General

Adequate supporting documentation was not maintained to corroborate the acquisition cost or activation date of certain PP&E items recorded in the Defense Property Accountability System or e-Biz.

SFFAS No. 6, *Accounting for Property, Plant and Equipment,* states,

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

SFFAS No. 10, *Accounting for Internal-Use Software,* states,

> *Entities should capitalize the cost of software when such software meets the criteria for general property, plant, and equipment (PP&E).*

REPORTABLE CONDITION 2 (Material Weakness), Continued

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 (original documents and/or hard and electronic copies of original 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.*
>
> *…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.*
>
> *For each module or component of a software project, depreciation should begin when that module or component has been successfully tested. If the use of a module is dependent on completion of another module(s), the depreciation of that module should begin when both that module and the other module(s) have successfully completed testing.*

REPORTABLE CONDITION 2 (Material Weakness), Continued

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

5. Software projects are monitored by the program managers on an ongoing basis throughout the fiscal year to ensure the timely and proper transfer 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. The monitoring process should also include documented quality control oversight by senior management.

6. Ongoing training is provided for all applicable DFAS personnel regarding the proper procedures for recording PP&E transactions and maintaining proper documentation to support PP&E throughout the fiscal year. The training should reemphasize the FMR and Federal Financial Accounting Standards requirements related to PP&E. Training is increasingly critical due to the changes in responsibilities emanating from Base Realignment and Closure.

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

Director and Audit Committee
Defense Finance and Accounting Service

We have audited the Working Capital Fund (WCF) 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 years ended September 30, 2006 and 2005, and have issued our report thereon dated October 30, 2006. 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. 06-03, *Audit Requirements for Federal Financial Statements*.

The management of DFAS is responsible for complying with laws, regulations, and provisions of contracts applicable to DFAS. 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, regulations, and contracts, 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. 06-03, 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, regulations, and provisions of contracts applicable to the DFAS WCF.

The results of our tests of compliance with the laws, regulations, and contracts described in the preceding paragraph, exclusive of FFMIA, disclosed no instances of noncompliance with laws, regulations, and provisions of contracts that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03.

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 no instances where DFAS' financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

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

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

This report is intended solely for the information and use of the management of DFAS and DoD, 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 30, 2006