DEFENSE FINANCE AND ACCOUNTING SERVICE

WORKING CAPITAL FUND

FISCAL YEAR 2005 FINANCIAL REPORT

NOVEMBER 2005

UK &W Urbach Kahn & Werlin LLP
CERTIFIED PUBLIC ACCOUNTANTS

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DEFENSE FINANCE AND ACCOUNTING SERVICE
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2005

In fiscal year (FY) 2005, the Defense Finance and Accounting Service (DFAS) continued its endeavors to reform financial management, improve the quality of DFAS products and services, and reduce costs to customers. These efforts support the President's Management Agenda, the Department of Defense (DoD) transformation initiatives, and the men and women who defend America.

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

For FYs 2000 through 2005, DFAS received unqualified audit opinions on its financial statements. DFAS has built an effective, accountable management structure with clearly defined and 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)), the 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 for the people who defend America. DFAS pays all 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. The information in this document, and the accompanying financial statements and footnotes are the responsibility of DFAS management.

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

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

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

DFAS' organization 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.

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

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

The following accomplishments highlight the magnitude of DFAS worldwide operations during fiscal year 2005:

- Paid 5.9 million military members, civilian personnel, retirees and annuitants
- Made 6.9 million travel payments
- Paid 14.1 million commercial invoices
- Processed 127.3 million accounting transactions
- Managed $234 billion 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 appropriations

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

<u>Financial Operations</u>

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

<u>Information Technology</u>

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

PERFORMANCE GOALS, OBJECTIVES AND RESULTS

DFAS is a customer-focused, strategy-based and metrics-driven organization. The DFAS Strategic Plan drives DFAS operations 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 five strategic targets that address the critical issues facing our customers and our core capabilities. Those targets are:

- Pay service members what they are entitled to on the scheduled pay date
- Implement electronic commerce for all commercial pay processing
- Support the Department's efforts to achieve an unqualified audit opinion
- Deliver client unique business intelligence
- Retain, recruit, and train a DFAS work force capable of developing and implementing the DFAS strategic plan

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 DFAS Balanced Scorecard serves as operational and financial performance indices to effectively and efficiently manage our business operations. Performance objectives in the Balanced Scorecard focus on continued achievement of the DFAS mission of providing responsive, professional finance and accounting services for the people who defend America. Our business lines 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. Business line employees are kept apprised of Balanced Scorecard measures and any corrective actions necessary to achieve established goals. The Balanced Scorecard, along with key indicator reports and performance measurement indicators are used to monitor the overall health of the organization.

In FY 2005, DFAS made progress in several critical financial and operational areas in support of the key strategic targets. Specific results include:

Military and Civilian Pay Services:

- myPay customers increased to 3.2 million from 2.9 million. Users now have improved SmartDocs capabilities as well as several other enhancements. SmartDocs is an electronic system whereby DFAS employees automatically receive electronic notification of their biweekly Civilian Pay via e-mail delivery.

- The Electronic Commerce Office implemented new procedures, including a process control checklist, for processing interrupted transaction transfers between myPay (our automated payment information system) and the payroll systems. The implementation of these procedures significantly reduces the likelihood of duplicate payments from the payroll system in the event that data transfers are interrupted due to system or network problems.

- The Army Reserve Components Mobilization/Demobilization Pay Services product line's data mining efforts prevented nearly $3 million in overpayments. Automated pre-loading of entitlements in-theater resulted in 800,000 transactions input timely, significantly reducing the risks associated with manual input. Also, as a direct result of automated data reconciliation, over 1,400 pay accounts were corrected prior to mobilization or demobilization.

- Military Pay Operations established procedures to identify soldiers deployed in support of Iraqi Freedom with an Estimated Time of Separation (ETS) date within 90 days. A special query was created and the results were forwarded to the soldier's command office for appropriate actions. As a result of this query, potential hardship was minimized or eliminated because soldiers were retained on the system rather than being deleted.

Accounting Services:

- Accounting Services established a Strategic Financial Improvement Office to support the DoD CFO in developing a Financial Improvement and Audit Readiness plan. The plan outlines steps for establishing sound internal controls and producing accurate and timely financial and performance information for decision makers. This office and its network counterparts assisted each of our clients in developing comprehensive, strategic and integrated improvement plans. In addition, the office developed a monthly reporting template and a Client Executive certification process to track critical actions for the accounting and reporting networks. The latter resulted in the completion of more than 100 critical financial improvement actions.

- Through continued application of the Balanced Scorecard and innovative initiatives, DFAS achieved significant results in improving operational performance. Results include: reduced Suspense Account Overage balances from $1,688 million to $120 million and within timeframe Suspense Account balances from $1,826 million to $922 million, a 50% reduction from FY 2004. Intransit disbursement and collections overage balances were reduced from $502 million to $300 million. Overage negative unliquidated obligations (NULOs) were reduced to zero balances for all customers except those covered by an OUSD (C) waiver.

- Conversion of the Standard Accounting and Reporting System (STARS) Headquarters Command Module to Major Command Reporting was completed in April. This allows use of the United States Standard General Ledger (USSGL)-conforming account balances to produce required monthly budget execution reports. It initiates use of the latter's journal voucher module for processing of accounting adjustments within regulatory requirements.

- The Accounting Systems Office assisted with the design and development of functional changes and improvements to the Defense Cash Accountability System (DCAS) which replaces the legacy Financial Reporting System (FRS). This is a step forward toward reaching the goal of posting expenditure transactions within 15 days as well as improving the accuracy of transactional data passed to the accounting systems. It also assists with reconciliation of U.S. Treasury and DFAS accounting records. It reduces unsupported undistributed disbursements in support of the Department of the Navy's Financial Improvement Plan.

- Security Assistance Accounting (SAA) upgraded its internal controls for precluding Foreign Military Sales (FMS) disbursements without Expenditure Authority (EA) by adding another approval layer when adjustments are required prior to processing a payment. If the EA is not approved, it is subject to drawdown, without exception, until receipt of funds.

- The Denver Center's Centralized Disbursing Office closed six of its field sites and consolidated the workload at the central site. This enabled the Disbursing Officer to standardize operations within the network, ensuring that policies, procedures and public law are uniformly applied.

Commercial Pay Services:

- Commercial Pay Business Line (CBPL) reduced over-aged invoices to a record low of 1.87% for FY 2005. Interest penalties have also reduced from $343 of interest dollars paid per million in FY 2001 to $139 per million in FY 2005. These accomplishments were the result of improved technology and increased use of Electronic Commerce.

- Wide Area Work Flow (WAWF) usage has increased dramatically over the fiscal year. Invoices created increased by 153%, while receiving reports created increased by 53%. Overall, the CPBL has increased electronic invoices received to 71% and electronic receiving reports received to approximately 66%. The CPBL has also increased electronic contracts received to 59% from 48% and electronic modifications to 33% from 19%.

- 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. It also participated in 15 Federal Government Receivables and Research Bureau (FGRRB) conferences, an increase of ten over the previous year. FGRRB is a nationally recognized organization specializing in the training, education and dissemination of material to its members who do business with the US Federal Government. The CPBL routinely supports FGRRB's conferences by providing speakers for Contract Pay Operations, Customer Service, and EC Initiatives. This training increases customer awareness and knowledge, ultimately reducing the number of incorrect invoices submitted.

- The Vendor Pay Product Line increased 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 Electronic Document Management (EDM) system. The EFR's security features are superimposed with EDA's. Work is underway to ensure the same level of EFR availability is provided to all customers. This initiative received the DoD Value Engineering Award.

- The Vendor Pay Product Line initiated the roll out of the Contractor Debt System (CDS)-Lite. CDS-Lite is a system used by the Contract Pay Product Line 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, providing greater workload visibility, and better reporting capabilities. The data contained in CDS-Lite is drop list and table driven, reducing the chance of erroneous input and increasing data accuracy. Debts forwarded from Accounts Receivable (CDS-Lite) to Debt Management (CDS) 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.

Information Technology:

- A Computerized Accounts Payable System-Windows (CAPS-W) 6.5 upgrade improved internal controls by decreasing risk due to human error in selecting the wrong banking information. This version validates vendor registration and validates EFT remit-to data at invoice entry, vendor maintenance, pre-certification, Electronic Data Interchange (EDI), EDI 810 interface and certification. It provides reasonable assurance that most current banking information is available for entitlement processing.

- EDM introduced new functionality for the indexing documents and the efficient handling of rejects from other electronic systems. It sets the stage for data mapping. There is now an automated process between EDM and the WAWF system that identifies all receiving reports that require processing. The automated process significantly reduces the time spent reviewing documents that were in each system separately, including attempts to locate those that matched.

- MyInvoice recently replaced the Vendor Pay Inquiry System (VPIS). It improves customer service by adding necessary security (user-id and password required for log-on), providing an option for vendors to sign up to receive an e-mail payment notification (which provides a link to MyInvoice), and providing payment adjustment information, as well as voucher remarks from the entitlement systems. Additionally, MyInvoice provides an additional 30 days of invoice payment history, after which the data is archived for future use. Also the invoice/payment data is being used to satisfy other program/reporting requirements, thereby eliminating duplicate efforts.

- The Application Control Language (ACL) program was revised to include all CAPS-W payments regardless of amount. This reduces or eliminates manual prepayment examination steps and Certifying Officer hand-written signatures. It provides the latter with reasonable assurance payments are valid. This program revision received the DoD Value Engineering Award.

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 Office of Management and Budget (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 2005.

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

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

- DFAS provided support to the Transformation Systems Office (TSO) for the Defense Business Management Modernization Program (BMMP). Under BMMP, the TSO developed the DoD Business Enterprise Architecture (BEA) that prescribes how the Department's business systems and business processes will interact. DFAS also supported TSO in the development of a transition plan that will guide systems development, acquisition, upgrade, deployment and other changes for all financial management systems and other business systems to be consistent with the BEA.

- To support and secure accomplishment of the many initiatives imperative for operational continuance and improvement, DFAS assigned a senior responsible official for each initiative. DFAS established a process of reporting and evaluating material weaknesses at the Executive Steering Group (ESG) level. The ESG conducts a final corporate review of material weaknesses prior to submission to the Director. This mirrors guidance provided by revisions to OMB Circular A-123 for tightening management/internal controls throughout the Federal Government. DFAS reduced the number of IT internal control findings in FY 2005 from 23 to 8.

- DFAS implemented an ePortal database repository designed to record and maintain the inventory of assessable units, to report the accomplishment of assessable unit evaluations and to report material weaknesses and milestone updates throughout the year. By making all accessible units' internal control documentation available on-line, the DFAS staff is able to share information. This increased the entire DFAS community's appreciation for how dependent the Agency is on the accuracy and reliability of each other's data, the control process and the resulting actions taken or not taken. After being granted access, our audit community recognized it as a first-of-a-kind effort. The documentation significantly reduced the auditors' timelines for performing audits and becoming familiar with business practices and processes. This provided a better foundation for discussing materiality of identified audit findings and to a great extent improved communication during many audits.

- DFAS developed and implemented a High-Risk Management program which included a database for tracking high risks. The database assists managers in considering the likelihood and potential severity of impact of an event's occurrence. Based on internally-developed risk rating criteria, a risk matrix provides the total risk assessment in risk levels of critical, high or monitor. The criteria applied are based on the following definition: "A risk is a probable future event not mitigated through regular business activity that may result in adverse impacts on cost, schedule, or technical resources necessitating special attention or intervention if it occurred." The desired outcome is an environment wherein all employees realize risk management is part of their daily performance and not just a stand-alone program. The goal is to shift from being reactive to proactive in identifying risks and taking appropriate mitigation action, thereby avoiding crisis problem solving. Monthly business line meetings focus on the status of risk abatements, the identification of new risks, funds and/or resources required to mitigate the risks and the establishment of plans of action and milestones. High-Risk is monitored as part of our Balanced Scorecard reviews.

- Representatives of the Internal Review and Plans & Strategy directorates began discussions focused on the feasibility of combining each of the current, singularly-focused management control, risk and audit programs' data into one database – and how to provide easy ePortal access to all employees.

- The Columbus and Indianapolis Center Disbursing offices participated in a successful Emergency Response and Relocation tabletop exercise in March. This was the first time a disbursing-related tabletop exercise occurred between centers. Participants demonstrated a detailed level of applied knowledge on the roles and responsibilities necessary for the exercise. The centers clearly displayed they would be able to respond to an emergency situation and effectively move personnel as directed by our Relocation Plan with minimal customer impact.

- The Vendor Pay Product Line established "virtual teams" within its network. The teams' primary responsibility is to support other Vendor Pay sites during workload peaks and EDM implementation. They access both the EDM and related entitlement systems from their home location thereby enabling virtual processing. These teams increase operating efficiency and save resources during peak workload periods and help maintain better control of the workload within the network.

- An Improper Payment Online Database (IPOD) was developed for the consolidated management reporting of business line erroneous payments (overpayments, underpayments and duplicate payments). The application is a data repository for erroneous payments and accepts entries from various sources. A future enhancement will be the monthly reporting of all erroneous payment activity, to include investigations, to the Commercial Pay Services Business Line Director.

- The DFAS Chief Information Officer (CIO) established an Investment Review Board (IRB) process in accordance with the FY 2005 Ronald W. Reagan National Defense Authorization Act (NDAA). The FY 2005 NDAA established the Defense Business Systems Management Committee and the Department's Business Mission Area (BMA) IRBs. The new DoD process required Components such as DFAS to establish their own investment review processes and governance structure to support transformation initiatives, and to designate a headquarters level approval authority assigned accountability for business system investments and who will act as the Pre-Certification Authority for business system modernization/enhancement investments, submitting requests over $1 million to the appropriate BMA IRB for certification. Towards that end, the DFAS CIO was designated the Pre-Certification Authority and the ESG serves as the component-level IRB for DFAS. In addition, the ESG established the Investment Review Working Group, with representation from each operational business line and all directorates involved in the review work to conduct the detailed examinations required for certifying investments. As a direct result of DFAS areas working together, pooling expertise, and providing mutual support to meet very tight deadlines with quality results, in the first Financial Management BMA, DFAS programs were 75% of those reviewed by OSD in the first review opportunity, with DFAS having had three times as many programs clearing staff review as any other agency or service.

POSSIBLE FUTURE EFFECTS ON EXISTING EVENTS AND CONDITIONS

DFAS must continue to anticipate changes in customer needs, the financial landscape and the Defense mission. DFAS' transformation journey includes evaluating every business line and product line to determine the optimal mix of products and services delivered in the best possible way. Since beginning the process in March 2003, DFAS has completed ten Business Case Analyses (BCAs) and nine recommended streamlining operations prior to competition with private industry. Two organizations have been streamlined and the remaining seven are in progress. One BCA recommended a competition under the guidelines of OMB Circular A-76. In FY 2006, DFAS will conduct business case analyses of the remaining functions.

To help eliminate rework and create more value from within, DFAS continues to build a culture of excellence through the adaptation and development of “Lean6”, which combines “Lean Thinking”, and "Six Sigma." "Lean Thinking" focuses on customer-defined value, mapping the value stream, ensuring value flows through the process, allowing the customer demand to pull value from the process, and relentlessly pursuing perfection. "Six Sigma" provides rigorous tools and techniques for eliminating error and waste while improving quality and productivity of DFAS processes and systems.

Like all Defense agencies, DFAS will support and implement the pending decisions of Base Realignment and Closure (BRAC) 2005, which will eliminate excess infrastructure capacity and present another transformation opportunity for the Agency. The Secretary of Defense submitted his recommendations to the Base Closure and Realignment Commission on May 13, 2005. The Commission recommended the closure of 19 DFAS locations and the consolidation of the Agency's workload from these locations at the Cleveland, Columbus, Indianapolis, Rome, and Limestone locations. This major consolidation will allow DFAS to restructure facilities and operations to achieve the Agency's strategic vision to be the best value provider of finance and accounting services to the people who defend America. The list, approved by the President, is awaiting Congressional action. If approved, BRAC implementation can begin in January 2006 and all BRAC actions must be completed by November 2011.

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

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2005 AND 2004

Dollars In Thousands	2005	2004 (Restated)
ASSETS		
Intragovernmental:		
Collections and Disbursements Clearing	$ -	$ -
Accounts Receivable (Note 2)	120,822	21,837
Total Intragovernmental	120,822	21,837
With the Public:		
Accounts Receivable (Note 2)	1,422	595
General Property, Plant and Equipment (Notes 3 and 11)	789,619	894,593
Other Assets	92	75
TOTAL ASSETS	**$ 911,955**	**$ 917,100**
LIABILITIES		
Intragovernmental:		
Accounts Payable	$ 88,131	$ 55,520
Other Liabilities (Notes 4 and 5)	17,854	13,660
Total Intragovernmental	105,985	69,180
With the Public:		
Accounts Payable	85,349	118,281
Actuarial FECA Liability (Notes 5 and 6)	41,631	42,328
Accrued Payroll and Benefits (Notes 4 and 5)	93,581	94,049
TOTAL LIABILITIES	**326,546**	**323,838**
NET POSITION		
Cumulative Results of Operations (Note 11)	585,409	593,262
TOTAL NET POSITION	**585,409**	**593,262**
TOTAL LIABILITIES AND NET POSITION	**$ 911,955**	**$ 917,100**

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, 2005 AND 2004

Dollars In Thousands	2005	2004 (Restated)
PROGRAM COSTS		
Intragovernmental Gross Costs	$ 518,916	$ 455,279
Less: Intragovernmental Earned Revenue	(1,612,244)	(1,726,441)
Intragovernmental Net Costs	(1,093,328)	(1,271,162)
Gross Costs With the Public (Note 11)	1,199,312	1,269,879
Less: Earned Revenue From the Public	(1,370)	(1,809)
Net Costs With the Public	1,197,942	1,268,070
NET COST OF OPERATIONS	**$ 104,614**	**$ (3,092)**

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, 2005 AND 2004

Dollars In Thousands	2005	2004 (Restated)
Cumulative Results of Operations		
Beginning Balances	$ 593,262	$ 573,186
Prior Period Adjustment (Note 11)	-	67,726
BEGINNING BALANCES, as adjusted	**593,262**	**640,912**
Budgetary Financing Sources		
Transfers-In/Out Without Reimbursement	301	-
Other Budgetary Financing Sources	-	13,357
Other Financing Sources		
Transfers-In/Out Without Reimbursement	16,241	(142,773)
Imputed Financing Sources (Note 7)	80,219	78,674
Total Financing Sources	**96,761**	**(50,742)**
Net Cost of Operations (Note 11)	**104,614**	**(3,092)**
ENDING BALANCES	**$ 585,409**	**$ 593,262**

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, 2005 AND 2004

Dollars In Thousands	2005	2004
BUDGETARY RESOURCES		
Budget Authority:		
Contract Authority	$ 50,615	$ 111,144
Unobligated Balance:		
Beginning of Period	177,153	36,186
Net Transfers, Actual	300	500
Spending Authority from Offsetting Collections:		
Earned:		
Collected	1,664,454	1,897,222
Receivable from Federal Sources	104,553	(29,904)
Change in Unfilled Customer Orders:		
Advance Received	4,111	-
Without Advance from Federal Sources	11,262	2,476
Subtotal	1,784,380	1,869,794
Recoveries of Prior Year Obligations	80,353	31,820
Permanently Not Available	(121,178)	(115,376)
Total Budgetary Resources	**$ 1,971,623**	**$ 1,934,068**
STATUS OF BUDGETARY RESOURCES		
Obligations Incurred:		
Reimbursable	$ 1,764,608	$ 1,756,915
Total Obligations Incurred	1,764,608	1,756,915
Unobligated Balance:		
Apportioned	207,015	177,153
Total Status of Budgetary Resources	**$ 1,971,623**	**$ 1,934,068**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS		
Obligated Balance, Net - Beginning of Period	$ 249,751	$ 252,174
Obligated Balance, Net - End of Period:		
Accounts Receivable	(132,687)	(28,135)
Unfilled Customer Orders from Federal Sources	(70,789)	(59,526)
Undelivered Orders (Note 9)	73,925	106,598
Accounts Payable (Note 9)	262,488	230,814
Outlays:		
Disbursements	1,685,254	1,754,945
Collections	(1,668,565)	(1,897,222)
Subtotal	16,689	(142,277)
Net Outlays	**$ 16,689**	**$ (142,277)**

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, 2005 AND 2004

Dollars In Thousands	2005	2004 (Restated)
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated:		
Obligations Incurred	$ 1,764,608	$ 1,756,915
Less: Spending Authority From Offsetting Collections	(1,864,733)	(1,901,614)
Net Obligations	(100,125)	(144,699)
Other Resources:		
Transfers In/Out Without Reimbursement	16,241	(142,773)
Imputed Financing Sources (Note 7)	80,219	78,674
Total Resources Used to Finance Activities	**(3,665)**	**(208,798)**
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	48,029	(15,375)
Resources that Fund Expenses Recognized in Prior Periods	(48,882)	(10,330)
Resources that Finance the Acquisition of Assets	(74,082)	(49,059)
Other	(16,241)	142,773
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**(91,176)**	**68,009**
Total Resources Used to Finance the Net Cost of Operations	**(94,841)**	**(140,789)**
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Other	-	2,812
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in Future Periods	**-**	**2,812**
Components Not Requiring or Generating Resources:		
Depreciation and Amortization (Note 11)	120,453	129,349
Revaluation of assets or liabilities (Note 11)	45,151	15,139
Other (Note 10)	33,851	(9,603)
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	**199,455**	**134,885**
Total Components of Net Cost of Operations That Will Not Require or Generate Resources or Generate Resources In the Current Period	**199,455**	**137,697**
NET COST OF OPERATIONS (Note 11)	**$ 104,614**	**$ (3,092)**

The accompanying notes are an integral part of these statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

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

Financial Operations

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

Information Services

This activity functions as a fee-for-service operation. Organizations within this activity provide software development/modernization and systems maintenance support to Automated Information Systems. 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 costs and changes in net position of DFAS, together with budgetary resources and a reconciliation of net costs to budgetary obligations as required by the Chief Financial Officer's (CFO) Act of 1990 and amended by the Government Management Reform Act (GMRA) of 1994, and are in accordance with accounting principles generally accepted in the United States of America (GAAP). GAAP for Federal financial reporting entities recognize the Federal Accounting Standards Advisory Board (FASAB) as the standards-setting body designed to establish these principles for these entities. The financial statements have been prepared from the books and records of DFAS in accordance with the Office of Management and Budget (OMB) 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 for Intragovernmental Accounts Receivable because all amounts are due from other Federal agencies, and are deemed to be fully collectible.

G. General Property, Plant and Equipment

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

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

H. Contingencies and Commitments

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

I. Federal Employee Compensation Benefits

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

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian employees injured on the job, employees who have incurred a work-related occupational disease and beneficiaries of employees whose death is attributable to a job-related injury or occupational disease. Claims incurred for benefits for DFAS employees under FECA are administered by the Department of Labor (DOL) and are ultimately paid by DFAS.

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

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

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

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

K. Annual, Sick and Other Accrued Leave

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

L. Interest on Late Payments

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

M. Use of Estimates

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

NOTE 2. ACCOUNTS RECEIVABLE (IN THOUSANDS)

	2005			2004
	Gross Amount Due	**Allowance for Uncollectible Accounts**	**Accounts Receivable, Net**	**Accounts Receivable, Net**
Intragovernmental Receivable	$ 120,822	$ -	$ 120,822	$ 21,837
Public Receivable	1,428	(6)	1,422	595
Total Accounts Receivable	**$ 122,250**	**$ (6)**	**$ 122,244**	**$ 22,432**

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

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	2-5 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**	**-**

As of September 30, 2004 (Restated):

	Acquisition Cost	Accumulated Depreciation	Net Book Value	Useful Life (in years)
Buildings, Structures and Facilities	$ 215,979	$ 37,289	$ 178,690	20 to 40
Leasehold Improvements	123,593	7,852	115,741	Lease Term
Equipment	253,492	227,435	26,057	5 to 10
Internal-Use Software	1,335,713	762,563	573,150	2-5 to 10
Construction-In-Progress	955	-	955	N/A
Other	892	892	-	N/A
Total General PP&E, Net	**$ 1,930,624**	**$ 1,036,031**	**$ 894,593**	**-**

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.

During 2005, DFAS was notified by the Office of the Secretary of Defense (Comptroller) that certain additional properties occupied by DFAS may meet preponderance of use guidance under Financial Management Regulation Volume 4, Chapter 6, and may require reporting of such properties as assets on the balance sheet of DFAS. The Office of the Secretary of Defense (Comptroller) is in the process of determining the cost and accumulated depreciation amounts related to these properties, but has not completed its analysis. Accordingly, because DFAS lacks the necessary information to record these assets, no additional adjustments have been made to the financial statements as of September 30, 2005.

NOTE 4. OTHER LIABILITIES (IN THOUSANDS)

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 Funded 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**

As of September 30, 2004:	**Current**	**Non-Current**	**Total**
Intragovernmental Other Liabilities			
Workers' Compensation	$ 4,086	$ 5,015	$ 9,101
Employer Contributions and Payroll Taxes	4,559	-	4,559
Total Intragovernmental Other Liabilities	8,645	5,015	13,660
Other Liabilities With the Public			
Accrued Funded Payroll and Benefits	46,111	-	46,111
Accrued Unfunded Annual Leave	47,938	-	47,938
Total Other Liabilities With the Public	94,049	-	94,049
Total Other Liabilities	**$ 102,694**	**$ 5,015**	**$ 107,709**

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

Intragovernmental	**2005**	**2004**
Workers' Compensation	$ 8,854	$ 9,101
Total Intragovernmental	8,854	9,101
With the Public		
Actuarial FECA Liability	41,631	42,328
Accrued Annual Leave	-	47,938
Total With the Public	41,631	90,266
Total Liabilities Not Covered by Budgetary Resources	50,485	99,367
Total Liabilities Covered by Budgetary Resources	276,061	224,471
Total Liabilities	**$ 326,546**	**$ 323,838**

NOTE 6. ACTUARIAL LIABILITY (IN THOUSANDS)

	Unfunded Actuarial Liability at September 30, 2005		Unfunded Actuarial Liability at September 30, 2004	
Workers' Compensation	$	41,631	$	42,328
Total Actuarial Liability	**$**	**41,631**	**$**	**42,328**

The liability for future workers' compensation benefit (FECA) includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The Department of Labor provided an estimated actuarial liability for future workers' compensation benefits for fiscal year ended September 30, 2005. DFAS' reported FECA liability is based on the DoD-Wide allocation worksheet, the bills received, and the charge back report from July 1, 2004 to June 30, 2005.

NOTE 7. IMPUTED FINANCING SOURCES (IN THOUSANDS)

	2005		2004	
Civilian Retirement	$	29,089	$	30,490
Civilian Health		50,991		48,047
Civilian Life Insurance		139		137
Total Imputed Financing Sources	**$**	**80,219**	**$**	**78,674**

NOTE 8. LEASES (IN THOUSANDS)

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

The dollar amount of DFAS' operating lease commitments for future years consisted of the following at September 30, 2005:

Fiscal Year	**2005**
2006	$ 35,951
2007	37,641
2008	39,410
2009	41,262
2010	43,202
After 2010	45,232
Total Future Lease Payments	**$ 242,698**

NOTE 9. 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 Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources*, agencies are to provide financial statement footnote disclosure to explain significant differences between amounts presented in the 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, these analyses are difficult; however, an analysis of information reported in the Statement of Budgetary Resources and the information reported in the September 30, 2005 Report on Budget Execution (SF–133) was performed. This analysis identified significant differences related to Undelivered Orders and Accounts Payable due to DFAS adjustments, primarily related to additional accruals being posted to the financial statements. The amount reported for Undelivered Orders on the fiscal year 2005 SF–133 was $87 million, whereas the amount reported on the Statement of Budgetary Resources was $74 million, a difference of $13 million. The amount reported for Accounts Payable on the fiscal year 2005 SF–133 was $256 million whereas the amount reported on the Statement of Budgetary Resources was $262 million, a difference of $6 million.

NOTE 10. STATEMENT OF FINANCING

The objective of the Statement of Financing is to help users understand the difference between budgetary obligations incurred and net cost of operations reported. The Statement of Financing was expanded to further articulate and detail the relationship between net obligations from budgetary accounting and net cost of operation from proprietary accounting. In order to reconcile the Statement of Net Cost with the Statement of Financing, an increase of $34 million was included in the total shown on Components not Requiring or Generating Resources, Other, in the Statement of Financing. The difference consists of reversals of identified prior year adjustments to Accounts Payable for intra-DFAS eliminations, reclassification of negative payables, and audit adjustments.

NOTE 11. PRIOR PERIOD ADJUSTMENTS

Buildings

During 2005, it was determined that DFAS had completed construction of the Major General Emmett J. Bean Building, Indianapolis (Building 1) in August 2003, but the property had not yet been transferred to the WCF. During FY 2005, DFAS reported this asset transfer as a prior period adjustment in the WCF financial statements for approximately $114 million, resulting in a restatement of the FY 2004 WCF financial statements.

Internal-Use Software in Development

Additionally, DFAS misclassified the recording of PP&E between its Internal-Use Software in Development account and its Internal-Use Software account, resulting in the need to record significant depreciation adjustments to the fiscal year 2004 and 2005 financial statements to properly state PP&E, net cost, and net position balances.

The FY 2004 WCF financial statements were also restated to recognize approximately $22 million of Internal-Use Software in Development that were impaired or should have been terminated, of which approximately $11 million should have been recognized in FY 2004 and approximately $11 million should have been recognized prior to FY 2004. A restatement of approximately $39 million was also recorded to recognize depreciation of assets that were completed and should have been transferred from the Internal-Use Software in Development account to the Internal-Use Software account for capitalization, of which $3.5 million should have been recognized in FY 2004 and approximately $36 million should have been recognized prior to FY 2004.

Restatement of the financial statements for these errors affected the Balance Sheet, the Statements of Net Cost, Changes in Net Position, and Financing. The FY 2004 Statement of Changes in Net Position included a prior period adjustment of approximately $68 million. This included an approximately $53 million increase in PP&E and Cumulative Results of Operations on the Balance Sheet as of September 30, 2004. Gross Costs with the Public for FY 2004, as reported in the Statement of Net Cost, increased $15 million due to additional depreciation expense and revaluation of assets in connection with these adjustments. In the FY 2004 Statement of Financing, depreciation and amortization and revaluation of assets or liabilities increased by $3.5 million and $11.5 million, respectively, in connection with these adjustments.

DEFENSE FINANCE AND ACCOUNTING SERVICE

REQUIRED SUPPLEMENTARY INFORMATION
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2005

(UNAUDITED)

DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2005
(UNAUDITED)

Dollars In Thousands		
INTRAGOVERNMENTAL ASSETS		**Accounts Receivable**
Navy General Fund	$	11,302
Department of State		11
Army General Fund		98,230
General Services Administration		(187)
Air Force General Fund		448
Department of Homeland Security		2
Armed Forces Retirement Home		5
Department of Education		90
United States Army Corps of Engineers		1
Other Defense Organizations General Funds		4,750
Other Defense Organizations Working Capital Funds		4,676
Army Working Capital Fund		(156)
Navy Working Capital Fund		747
Air Force Working Capital Fund		903
Total Intragovernmental Assets	**$**	**120,822**

DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2005
(UNAUDITED)

Dollars In Thousands				
INTRAGOVERNMENTAL LIABILITIES		**Accounts Payable**		**Other Liabilities**
Department of the Interior	$	16	$	-
Department of Labor		-		8,854
Navy General Fund		539		3,612
Department of the Treasury		3,858		-
Army General Fund		2,635		-
Office of Personnel Management		1,582		4,889
Department of Veterans Affairs		2		-
General Services Administration		31,083		-
Air Force General Fund		3,098		7
Department of Transportation		373		-
Department of Homeland Security		150		-
Department of Health and Human Services		362		-
National Archives and Records Administration		1		-
Other Defense Organizations General Funds		1,585		-
Other Defense Organizations Working Capital Funds		31,229		-
Army Working Capital Fund		3,501		-
Navy Working Capital Fund		5,704		53
Air Force Working Capital Fund		2,413		439
Total Intragovernmental Liabilities	**$**	**88,131**	**$**	**17,854**

DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2005
(UNAUDITED)

Dollars In Thousands		
INTRAGOVERNMENTAL REVENUE		**Earned Revenue**
Executive Office of the President	$	148
Department of Commerce		69
Navy General Fund		386,403
Department of State		83
Army General Fund		575,615
Department of Veterans Affairs		2,036
General Services Administration		(282)
Air Force General Fund		15,180
Environmental Protection Agency		301
Department of Homeland Security		108
Armed Forces Retirement Home		(2)
Department of Energy		444
Department of Education		2,364
Independent Agencies		54
United States Army Corps of Engineers		3,044
Other Defense Organizations General Funds		403,620
Other Defense Organizations Working Capital Funds		115,276
Army Working Capital Fund		37,608
Navy Working Capital Fund		61,864
Air Force Working Capital Fund		8,311
Total Intragovernmental Revenue	**$**	**1,612,244**

NON - EXCHANGE REVENUE		Transfers - In		Transfers - Out
Other Defense Organizations Working Capital Funds	$	301	$	(16,241)
Total Non - Exchange Revenue	**$**	**301**	**$**	**(16,241)**

DEFENSE FINANCE AND ACCOUNTING SERVICE

OTHER ACCOMPANYING INFORMATION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2005 AND 2004

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING BALANCE SHEETS
AS OF SEPTEMBER 30, 2005 AND 2004

Dollars In Thousands	Financial Operations	Information Services	Combined Total	Eliminations	2005 Consolidated	2004 Consolidated (Restated)
ASSETS						
Intragovernmental:						
Collections and Disbursements Clearing	$ -	$ -	$ -	$ -	$ -	$ -
Accounts Receivable (Note 2)	118,904	13,189	132,093	(11,271)	120,822	21,837
Total Intragovernmental	118,904	13,189	132,093	(11,271)	120,822	21,837
With the Public:						
Accounts Receivable (Note 2)	1,203	219	1,422	-	1,422	595
General Property, Plant and Equipment (Notes 3 and 11)	787,586	2,033	789,619	-	789,619	894,593
Other Assets	89	3	92	-	92	75
TOTAL ASSETS	**$ 907,782**	**$ 15,444**	**$ 923,226**	**$ (11,271)**	**$ 911,955**	**$ 917,100**
LIABILITIES						
Intragovernmental:						
Accounts Payable	$ 96,478	$ 2,924	$ 99,402	$ (11,271)	$ 88,131	$ 55,520
Other Liabilities (Notes 4 and 5)	16,546	1,308	17,854	-	17,854	13,660
Total Intragovernmental	113,024	4,232	117,256	(11,271)	105,985	69,180
With the Public:						
Accounts Payable	71,658	13,691	85,349	-	85,349	118,281
Actuarial FECA Liability (Notes 5 and 6)	37,536	4,095	41,631	-	41,631	42,328
Accrued Payroll and Benefits (Notes 4 and 5)	83,669	9,912	93,581	-	93,581	94,049
TOTAL LIABILITIES	**305,887**	**31,930**	**337,817**	**(11,271)**	**326,546**	**323,838**
NET POSITION						
Cumulative Results of Operations (Note 11)	601,895	(16,486)	585,409	-	585,409	593,262
TOTAL NET POSITION	**601,895**	**(16,486)**	**585,409**	**-**	**585,409**	**593,262**
TOTAL LIABILITIES AND NET POSITION	**$ 907,782**	**$ 15,444**	**$ 923,226**	**$ (11,271)**	**$ 911,955**	**$ 917,100**

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF NET COST
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2005 AND 2004

Dollars In Thousands	Financial Operations	Information Services	Combined Total	Eliminations	2005 Consolidated	2004 Consolidated (Restated)
PROGRAM COSTS						
Intragovernmental Gross Costs	$ 617,383	$ 54,621	$ 672,004	$ (153,088)	$ 518,916	$ 455,279
Less: Intragovernmental Earned Revenue	(1,584,990)	(180,342)	(1,765,332)	153,088	(1,612,244)	(1,726,441)
Intragovernmental Net Costs	(967,607)	(125,721)	(1,093,328)	-	(1,093,328)	(1,271,162)
Gross Costs With the Public (Note 11)	1,073,514	125,798	1,199,312	-	1,199,312	1,269,879
Less: Earned Revenue From the Public	(1,361)	(9)	(1,370)	-	(1,370)	(1,809)
Net Costs With the Public	1,072,153	125,789	1,197,942	-	1,197,942	1,268,070
NET COST OF OPERATIONS	**$ 104,546**	**$ 68**	**$ 104,614**	**$ -**	**$ 104,614**	**$ (3,092)**

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF CHANGES IN NET POSITION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2005 AND 2004

Dollars In Thousands	Financial Operations	Information Services	2005 Consolidated	2004 Consolidated (Restated)
Cumulative Results of Operations				
Beginning Balances	$ 614,192	$ (20,930)	$ 593,262	$ 573,186
Prior Period Adjustment (Note 11)	-	-	-	67,726
BEGINNING BALANCES, as adjusted	**614,192**	**(20,930)**	**593,262**	**640,912**
Budgetary Financing Sources				
Transfers-In/Out Without Reimbursement	301	-	301	-
Other Budgetary Financing Sources	-	-	-	13,357
Other Financing Sources				
Transfers-In/Out Without Reimbursement	19,732	(3,491)	16,241	(142,773)
Imputed Financing Sources (Note 7)	72,216	8,003	80,219	78,674
Total Financing Sources	**92,249**	**4,512**	**96,761**	**(50,742)**
Net Cost of Operations (Note 11)	**104,546**	**68**	**104,614**	**(3,092)**
ENDING BALANCES	**$ 601,895**	**$ (16,486)**	**$ 585,409**	**$ 593,262**

DEFENSE FINANCE AND ACCOUNTING SERVICE
COMBINING STATEMENTS OF BUDGETARY RESOURCES
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2005 AND 2004

Dollars In Thousands	Financial Operations	Information Services	2005 Combined	2004 Combined
BUDGETARY RESOURCES				
Budget Authority:				
Contract Authority	$ 50,132	$ 483	$ 50,615	$ 111,144
Unobligated Balance:				
Beginning of Period	183,637	(6,484)	177,153	36,186
Net Transfers, Actual	300	-	300	500
Spending Authority from Offsetting Collections				
Earned:				
Collected	1,485,108	179,346	1,664,454	1,897,222
Receivable from Federal Sources	101,200	3,353	104,553	(29,904)
Change in Unfilled Customer Orders:				
Advance Received	4,111	-	4,111	-
Without Advance from Federal Sources	12,962	(1,700)	11,262	2,476
Subtotal	1,603,381	180,999	1,784,380	1,869,794
Recoveries of Prior Year Obligations	68,045	12,308	80,353	31,820
Permanently Not Available	(119,769)	(1,409)	(121,178)	(115,376)
Total Budgetary Resources	**$ 1,785,726**	**$ 185,897**	**$ 1,971,623**	**$ 1,934,068**
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred:				
Reimbursable	$ 1,574,403	$ 190,205	$ 1,764,608	$ 1,756,915
Total Obligations Incurred	1,574,403	190,205	1,764,608	1,756,915
Unobligated Balance:				
Apportioned	211,323	(4,308)	207,015	177,153
Total Status of Budgetary Resources	**$ 1,785,726**	**$ 185,897**	**$ 1,971,623**	**$ 1,934,068**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS:				
Obligated Balance, Net - Beginning of Period	$ 228,459	$ 21,292	$ 249,751	$ 252,174
Obligated Balance, Net - End of Period:				
Accounts Receivable	(119,512)	(13,175)	(132,687)	(28,135)
Unfilled Customer Orders	(54,316)	(16,473)	(70,789)	(59,526)
Undelivered Orders (Note 9)	49,561	24,364	73,925	106,598
Accounts Payable (Note 9)	235,523	26,965	262,488	230,814
Outlays:				
Disbursements	1,509,399	175,855	1,685,254	1,754,945
Collections	(1,489,219)	(179,346)	(1,668,565)	(1,897,222)
Subtotal	20,180	(3,491)	16,689	(142,277)
Net Outlays	**$ 20,180**	**$ (3,491)**	**$ 16,689**	**$ (142,277)**

DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF FINANCING
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2005 AND 2004

Dollars In Thousands	Financial Operations	Information Services	2005 Consolidated	2004 Consolidated (Restated)
RESOURCES USED TO FINANCE ACTIVITIES				
Budgetary Resources Obligated:				
Obligations Incurred	$ 1,574,403	$ 190,205	$ 1,764,608	$ 1,756,915
Less: Spending Authority From Offsetting Collections	(1,671,424)	(193,309)	(1,864,733)	(1,901,614)
Net Obligations	(97,021)	(3,104)	(100,125)	(144,699)
Other Resources				
Transfers In/Out Without Reimbursement	19,732	(3,491)	16,241	(142,773)
Imputed Financing Sources (Note 7)	72,216	8,003	80,219	78,674
Total Resources Used to Finance Activities	**(5,073)**	**1,408**	**(3,665)**	**(208,798)**
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	51,194	(3,165)	48,029	(15,375)
Resources that Fund Expenses Recognized In Prior Periods	(43,030)	(5,852)	(48,882)	(10,330)
Resources that Finance the Acquisition of Assets	(73,380)	(702)	(74,082)	(49,059)
Other	(19,732)	3,491	(16,241)	142,773
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	**(84,948)**	**(6,228)**	**(91,176)**	**68,009**
Total Resources Used to Finance the Net Cost of Operations	**(90,021)**	**(4,820)**	**(94,841)**	**(140,789)**
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD				
Other	-	-	-	2,812
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in Future Periods	**-**	**-**	**-**	**2,812**
Components not Requiring or Generating Resources:				
Depreciation and Amortization (Note 11)	118,938	1,515	120,453	129,349
Revaluation of Assets or Liabilities (Note 11)	45,160	(9)	45,151	15,139
Other (Note 10)	30,469	3,382	33,851	(9,603)
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	**194,567**	**4,888**	**199,455**	**134,885**
Total Components of Net Cost of Operations That Will Not Require or Generate Resources In The Current Period	**194,567**	**4,888**	**199,455**	**137,697**
NET COST OF OPERATIONS (Note 11)	**$ 104,546**	**$ 68**	**$ 104,614**	**$ (3,092)**

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, 2005 and 2004, and the related Consolidated Statements of Net Cost, Changes in Net Position, and Financing, and the Combined Statements of Budgetary Resources for the years then ended. These financial statements are the responsibility of the management of DFAS. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements,* as amended. These standards and OMB Bulletin No. 01-02 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above, revised as described in Note 11, present fairly, in all material respects, the financial position of the DFAS WCF as of September 30, 2005 and 2004, and its net costs, changes in net position, combined budgetary resources, and reconciliation of budgetary obligations to net cost for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As reported in Notes 3 and 11 to the financial statements, DFAS' fiscal year 2004 General Property, Plant and Equipment balance previously reported as $842 million should have been $895 million. This discovery was made during the current year. The financial statements have been restated to reflect this correction.

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 primarily 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 28, 2005 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 28, 2005

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 year ended September 30, 2005, and have issued our report thereon dated October 28, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements,* as amended.

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

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

INDEPENDENT AUDITOR'S REPORT
ON INTERNAL CONTROL, CONTINUED

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

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

1. DFAS did not have adequate controls over the recording of property, plant and equipment.

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

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

4. DFAS needs to make improvements in its financial reporting processes.

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

We also noted other less significant matters involving the internal control and its operation, which we have reported to the management of DFAS in a separate letter, dated October 28, 2005.

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 28, 2005

REPORTABLE CONDITION 1 (Material Weakness)

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

During fiscal year 2005, we continued to note internal control weaknesses related to the recording of property, plant and equipment (PP&E). As a result of these weaknesses, DFAS had to record significant internal and auditor proposed adjustments to the financial statements.

Internal-Use Software in Development

DFAS did not adequately monitor and support the status of software projects, as follows:

- 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 the Electronic Business Accounting and Management System (e-Biz), resulting in the need to record significant depreciation adjustments to the fiscal year 2004 and 2005 financial statements to properly state the PP&E, net cost, and net position balances.

  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 2005, but the effort was not completed by DFAS until year-end. As a result of this review, DFAS identified certain items that required adjustment. However, our audit testing identified significant additional items requiring further adjustment.

  Because DFAS had neither adequate documentation nor an effective quality control process over the recording of software projects, we developed a software questionnaire based on the requirements of Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software* in order to gather information related to software projects selected for testing. Additionally, we requested that program managers complete a certification form to confirm the reported cost and viability of the software projects.

- We identified errors related to the capitalization of software in the incorrect fiscal year, resulting in significant current and prior year adjustments to depreciation.

Buildings and Leasehold Improvements

During our auditability assessment of the General Fund conducted in 2005, we noted that DFAS had completed construction of the DFAS Indianapolis building in August 2003, but the property had not yet been transferred to the WCF. During fiscal year 2005, DFAS reported this asset transfer as a prior period adjustment in the WCF financial statements for $114 million.

General

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

REPORTABLE CONDITION 1 (Material Weakness), Continued

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).*

DoD Financial Management Regulation (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 1 (Material Weakness), Continued

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

1. A data clean-up of all transactions in the Internal-Use Software in Development account is performed and completed during the first six months of fiscal year 2006 to ensure all assets that have been completed are properly and timely transferred to the Internal-Use Software account for capitalization and to ensure that adequate documentation is maintained to support capitalized assets. Documentation should also be maintained to support procurement and utilization decisions regarding the identification of potential excess or impaired Internal-Use Software and other capitalized assets.

2. DFAS management perform quality control procedures related to the data clean-up effort for all Internal-Use Software in Development and Internal-Use Software documents as stated above, to ensure that the data clean-up achieves all of its desired objectives, and that all appropriate adjustments resulting from the data clean-up are validated for their propriety and completeness.

3. Once the data clean-up is completed, software projects are monitored by the program managers on an on-going 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.

4. 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 Accounting Standards requirements related to PP&E.

REPORTABLE CONDITION 2 (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 were made over the prior fiscal year, throughout fiscal year 2005, 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 or year-end, resulting in an overstatement of the UDO balance. Because DFAS did not have adequate controls over the UDO 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 UDO balance had to be performed by DFAS at year-end, resulting in the need to record significant adjustments to properly state the UDO balance. Additionally, there was a need to record a significant auditor proposed adjustment to the financial statements to properly state the UDO balance as of September 30, 2005.

The correction of the overstatements in the UDO budgetary balance necessitated related adjustments to correct significant understatements in the corresponding proprietary balances for accounts payable (A/P), and expenses at year-end. This lack of control surrounding UDO's and the corresponding proprietary accounts, and the extensive year-end corrective effort, is reflective of the same circumstances that occurred in fiscal years 2002, 2003 and 2004.

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

- Inadequate training of DFAS Business Line (BL) 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;

- Inadequate training of the BL personnel over the performance of Triannual reviews, related to the specific objectives stated in the DoD FMR and the DFAS Policy Memorandum 05-02 for ensuring that applicable proprietary and budgetary accounts were valid, accurate, and properly supported. In addition, there was inadequate 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 BL's were valid and properly supported; and

- Invalid UDO balances were being reported because DFAS did not commence the 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 (and even years) to commence reconciliation of contracts after the period of performance had expired.

Accounts Payable

Throughout fiscal year 2005, we identified errors related to the improper recording of disbursements, and aged accounts payable 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 accounts payable balances. We also noted duplicate payments were made on certain invoices and discounts were not properly taken or consistently applied when paying invoices, leaving invalid payable balances in e-Biz.

Additionally, we also noted instances where invoices were received and fully disbursed; however, an invalid payable 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 payable.

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,

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

status from contracting or procurement activities. 4. Records identifying the unliquidated obligations deobligated as a result of the review, the amount deobligated for each document, and the rationale for deobligation. 5. Deobligation documents or references to dated deobligation documents indicating the value and identity of documents deobligated…

DoD FMR, Volume 3, Chapter 8, states,

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

DFAS Policy Memorandum FY 05-02, *Tri-Annual Review*, states,

To ensure DFAS (internal) has sound financial records consistently throughout the year, reviews are to be conducted in accordance with the schedule below. The prompt and accurate recording of commitments, obligations and accrued expenditures in the agency's official accounting system, e-Biz…shall review open commitment, obligation and accrual/receipt (expense) transactions for timeliness, accuracy, and completeness. FO/FSOs and Accounting Operations will participate in joint reviews with the BL and Corporate Elements…

DFAS Business Line (BL) Executives/Corporate Element Directors and their staffs are responsible for conducting the reviews and will certify to the DFAS Chief Financial Offices (CFO) that the reviews have been conducted in accordance with this policy. Certifications to the CFO will be submitted based upon the financial records as of January 31, May 31, and September 30 of each fiscal year. Note though, that transactions greater than $50,000 and all abnormal balances will be reviewed each month…Director, Financial Management Office is responsible to oversee the Agency Tri-annual reviews to ensure an effective review program is in practice.

> *In the absence of knowing the exact quantity and amount of the goods/services received, then 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 will be documented by use of the standard DFAS Accrual of Goods/Services Received form…All Accruals are required to 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 should be initiated on the standard DFAS Accrual of Goods/Services Received form and submitted to the servicing FO/FSO along with an 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.*

REPORTABLE CONDITION 2 (Material Weakness), Continued

Recommendations

Immediate Action

Since the above adjustments that were made related to UDO, A/P and its corresponding proprietary accounts for fiscal year 2005 were only reported at the financial statement level, DFAS needs to perform a complete data clean-up of all documents within the first six months of fiscal year 2006 within its UDO and A/P subsidiary ledgers at the document level in order to ensure that its accounts are properly stated for periodic reporting.

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

5. A data clean–up for all documents in the UDO and A/P subsidiary listings is completed within the first six months of fiscal year 2006 to ensure that the balances are properly reported, with appropriate adjustments posted at the document level. The data clean-up must ensure that all UDO and A/P documents are reviewed, not just the ones identified for adjustment during the audit, for both a risk of overstatement and understatement, and are supported by proper documentation.

6. DFAS management performs quality control procedures related to the data clean-up effort for all UDO and A/P documents as stated above, to ensure that the data clean-up achieves all of its desired objectives, and that all appropriate adjustments are validated for their propriety and completeness.

Long-Term Resolution and Ongoing Internal Control Improvement

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

Prior corrective action plans utilized by DFAS regarding the reporting of UDO, A/P and other related proprietary accounts have been unsuccessful, because DFAS management primarily focused on resolving problems with documents identified during the audit, not rectifying the root causes of the underlying business deficiencies. DFAS needs to ensure that the initiatives within its corrective action plans are long-term solutions to ensure that the deficiencies are prevented in the future.

REPORTABLE CONDITION 2 (Material Weakness), Continued

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

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

   - It is the responsibility of BL 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.

8. 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 BL's are valid and properly supported.

9. 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.

10. The Financial Management Improvement Plan is more closely monitored throughout the fiscal year to track the progress of all audit related findings from prior years, to ensure that the root causes related to all of the deficiencies are identified and resolved.

REPORTABLE CONDITION 3 (Material Weakness)

DFAS DID NOT HAVE ADEQUATE CONTROLS OVER ITS INFORMATION SYSTEMS CONTROL ENVIRONMENT RELATED TO e-BIZ SERVICE CONTINUITY

DFAS made significant improvements within its information systems control environment during fiscal year 2005. However, the following internal control weakness related to e-Biz was identified as of September 30, 2005.

As also reported in fiscal year 2004, there was no alternate processing facility for e-Biz. The production and performance copies of e-Biz are both housed at the same site at the Defense Enterprise Computing Center (DECC) Columbus. Although major disruptions with long-term effects may be rare, they should be accounted for in a contingency plan. Thus, the contingency plan must include a strategy to recover and perform system operations at an alternative facility for an extended period of time. This is to mitigate the risk if the system is damaged or destroyed or the primary site is unavailable, that necessary hardware and software will not be available at an alternative site. Consequently, the system will not be available to users and the system will not be operational. In the absence of a geographically-removed Contingency Plan/Continuity of Operations Plan site, the condition continues to pose an unmitigated risk to DFAS business operations should the processing site in Columbus be rendered inoperable.

During fiscal year 2005, management decided to move the alternate processing facility from DECC Columbus to DECC Ogden and DECC Mechanicsburg. This transfer is scheduled to be completed during the first quarter of fiscal year 2006.

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

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

REPORTABLE CONDITION 3 (Material Weakness), Continued

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

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

DoD Directive Number 8500.1, *Information Assurance*, states,

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

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

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

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

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

REPORTABLE CONDITION 3 (Material Weakness), Continued

Recommendation

We recommend the DFAS Director and Audit Committee ensure that:

11. The current plan to move the alternate processing facility for e-Biz from DECC Columbus to DECC Ogden and DECC Mechanicsburg is completed within the scheduled timeframe in the first quarter of fiscal year 2006.

REPORTABLE CONDITION 4

DFAS NEEDS TO MAKE IMPROVEMENTS IN ITS FINANCIAL REPORTING PROCESSES

Financial Statement Adjustments

As noted elsewhere in this report, DFAS made significant adjustments to the financial statements for fiscal years 2004 and 2005. The significant amount of adjustments is an impediment to DFAS management conducting thorough financial analyses at a detailed level, and it deters the generation of reliable and timely quarterly financial statements. Accurately recording accounting events in the general ledger at the transaction level, for interim periods as well as year-end, is essential for effective financial management.

As an example of the impact of these adjustments, we noted that budgetary data was not in agreement with proprietary expenses and assets capitalized, causing a difference in the Net Cost of Operations on the Statement of Net Cost and Statement of Financing, which required balancing adjustments of approximately $33 million. These balancing adjustments were necessary due to cumulative prior year and current year financial statement adjustments not being properly reflected in the detailed general ledger.

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

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

DoD FMR Volume 1, Chapter 2, states,

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

REPORTABLE CONDITION 4, Continued

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

12. All cumulative adjustments for fiscal year 2005 are entered into the general ledger in fiscal year 2006.

13. An evaluation is performed to identify the root causes for financial statement misstatements and develop a corrective action plan to ensure that all transactions are properly recorded in the general ledger timely.

Urbach Kahn & Werlin LLP
CERTIFIED PUBLIC ACCOUNTANTS

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 year ended September 30, 2005, and have issued our report thereon dated October 28, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements,* as amended.

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. 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and we did not test compliance with all laws, 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. 01-02.

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

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

Federal Financial Management Systems Requirements

As also reported in fiscal year 2004, DFAS' core financial management system, the Electronic Business Accounting and Management System (e-Biz), did not substantially comply with Federal financial management system requirements, including OMB Circulars A-127, *Financial Management Systems* and A-130, *Management of Federal Information Resources*, as they relate to information system security requirements. DFAS did not satisfy certain provisions of OMB Circular A-130, Appendix III, Section (3), which requires agencies to implement and maintain a program to assure that adequate security is provided for all agency information collected, processed, transmitted, stored, or disseminated in general support systems and major applications. Specifically, there was no alternate processing facility for e-Biz. The production and performance copies of e-Biz are both housed at the same site at the Defense Enterprise Computing Center (DECC) Columbus.

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

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

DoD Directive Number 8500.1, *Information Assurance,* states,

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

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

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

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

During fiscal year 2005, management decided to move the alternate processing facility from DECC Columbus to DECC Ogden and DECC Mechanicsburg. This transfer is scheduled to be completed during the first quarter of fiscal year 2006.

Specific conditions and recommended remedial actions attributable to the above instance of noncompliance are more fully described in our Independent Auditor's Report on Internal Control, dated October 28, 2005. The DFAS Office of Corporate Resources is responsible for the WCF financial management systems within DFAS.

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

This report is intended solely for the information and use of the management of 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 28, 2005