

DEFENSE FINANCE AND ACCOUNTING SERVICE

WORKING CAPITAL FUND



FISCAL YEAR 2003 FINANCIAL REPORT

DECEMBER 2003

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**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2003**

MESSAGE FROM THE DFAS DIRECTOR

In Fiscal Year (FY) 2003, the Defense Finance and Accounting Service (DFAS) progressed toward meeting our goals of financial management reform, improving the quality of our products and services and reducing costs to customers. This drive toward becoming a world-class finance and accounting organization supports the President's Management Agenda as well as Defense transformation initiatives.

The DFAS team consistently provides responsive and professional finance and accounting services that support the men and women who defend America. We deliver pay and entitlements in reliable, easy-to-use ways to allow the men and women serving America to focus on their mission not on their money. We keep the Defense industry ready, willing and able to provide equipment, services and materiel through on-time, on-target delivery of financial management and accounting services. The DFAS team's customer focus is delivering results as evidenced by improved customer satisfaction scores recorded by an independent, annual customer survey. We provide timely, accurate business intelligence to Defense decision-makers. In the wake of September 11th and wars in Afghanistan and Iraq, DFAS is providing the nation an innovative, trusted finance and accounting partner.

In FYs 2000 through 2003, DFAS received unqualified audit opinions on its financial statements. DFAS has built an effective, accountable management structure with clearly defined, measurable goals. Our progress is charted and regularly reported to our stakeholders. Our programs and initiatives are guided by the Under Secretary of Defense (Comptroller) and Chief Financial Officer, a performance plan with the Defense Resources Board (DRB), a Board of Advisors, and an Audit Committee.

DESCRIPTION OF THE REPORTING ENTITY

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

As a Defense Working Capital Fund (DWCF) activity, DFAS operates similarly to a private sector business, obtaining revenue by charging customers fixed prices for products and delivered 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. DFAS has little flexibility in setting or adjusting prices in the year of execution, and DFAS operations are subject to DoD, Executive Branch and Legislative Branch oversight.

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DFAS prices are established with its customers and the American taxpayer's best interests in mind. DFAS delivers finance and accounting services worldwide from a Headquarters in Arlington, Virginia, five DFAS major sites located in Cleveland, Ohio; Columbus, Ohio; Denver, Colorado; Indianapolis, Indiana; and Kansas City, Missouri; and 20 field sites. DFAS was generally structured to support Army, Navy, Marine Corps, Air Force and Defense Agencies via departmental and field operating networks. Progress in the President's Management Agenda has recently added new customers from outside DoD including the Departments of Energy, Veteran Affairs, and Health and Human Services.

Organized by major business line beginning in FY 2001, DFAS now provides better service to our customers and has increased the organization's competitive value. This business-oriented structure benefits our customers by: (1) focusing DFAS executive talent on each individual client's needs; (2) identifying clear accountability for each DFAS business service; and (3) improving the value of products and services delivered. The success of this approach shows in the magnitude of DFAS worldwide operations this past year:

- Paid 5.9 million DoD military members, civilian personnel, retirees and annuitants
- Disbursed \$416 billion in DoD funds
- Recorded 121 million DoD accounting transactions
- Accounted for \$13 billion in DoD foreign military sales
- Processed 12.3 million DoD contractor invoices
- Managed \$197.4 billion in DoD military retirement and health benefits funds
- Made 6.8 million DoD travel payments
- Accounted for 279 active DoD appropriations

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

Financial Operations

The Financial Operations business area is composed of the Military and Civilian Pay Services, Commercial Pay Services, and Accounting Services Business Lines. 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.

Information Services

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

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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 its customers.

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

DFAS Performance Plan

DFAS has a Performance Plan that measures performance objectives for DFAS in fiscal years 2003 through 2009. Performance objectives in the plan provide focus for continued achievement of the DFAS mission of providing responsive, professional finance and accounting services for the people who defend America. For FY 2003, DFAS had a total of eleven performance metrics and met seven of them. For example, DFAS met the metrics for timeliness of Accounting reports to customers, reduction of aged in-transit, reduced number of direct billing hours (DBH), reduced unit cost for commercial payments, minimized overage of commercial payments, pay entitlements calculations processed accurately and reduced unit costs for military and civilian pay services.

In the Accounting Services business line, which is responsible for accounting and reporting the transactions of the Military Departments and Defense Agencies, a significant performance metric is the reduction in negative unliquidated obligations (NULOs). A NULO occurs when a payment is made against a particular obligation document and the amount of that payment is greater than the amount of the obligation previously recorded in the official accounting system. NULOs have been a chronic problem for DoD. The performance metric is to reduce DoD NULOs by 25 percent of the September 2002, goal of \$251 million. DFAS has made steady and dramatic progress in reducing the amount of NULOs. At the end of FY 2003, DoD NULOs were \$125 million, which is \$65 million below the goal of \$190 million.

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Another significant performance metric for Accounting Services is unmatched disbursements (UMD). UMDs occur when payments are made and the payment documents have been received by an accounting office; but have not been matched to the correct detail obligation. The performance metric is to reduce DoD UMDs by 25 percent of the September 2002 goal of \$1,374 million. At the end of FY 2003, DoD UMDs were \$854 million, which is \$178 million below the goal of \$1,032 million.

An in-transit disbursement occurs when a payment is made, but it has not yet been received or processed by the applicable accounting office for recordation against the corresponding obligation. The performance metric for in-transits is to reduce DoD in-transits by 10 percent of the September 2002 goal of \$369 million. At the end of FY 2003, DoD in-transits were \$95 million, \$237 million below the goal of \$332 million.

The performance in the Commercial Pay Services business line shows similar improvement. At the end of FY 2003, total interest paid was \$29.2 million, a reduction of 13 percent from the baseline. In addition, interest paid per million dropped 53%, from \$343 dollars per million in FY 2001 to \$160 dollars per million in FY 2003.

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 United States 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 2003.

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DEFENSE FINANCE AND ACCOUNTING SERVICE
MANAGEMENT'S DISCUSSION AND ANALYSIS
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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 collective knowledge to assist all of our customers to implement sound financial management practices and move the Department forward with true financial management reform.

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

POSSIBLE FUTURE EFFECTS ON EXISTING EVENTS AND CONDITIONS

While DFAS has a record of success, it must continue to move forward in improving operational excellence and to anticipate changes in customer needs and the financial landscape. To this end, DFAS has begun a transformation journey of evaluating every business line and product line to determine that the optimal mix of products and services are delivered in best possible way. This transformation journey allow the DFAS team to be more competitive in how it serves the men and women who defend America. Early milestones of this journey in FY 2003, include recommending DFAS conduct an A-76 cost comparison for its Marine Corps Accounting Services and pursuing a High Performing Organization for its Vendor Pay operations. In FY 2004, DFAS will conduct business case analyses of the remaining Accounting Services as well as some support services.

To help eliminate waste and create more value from within, DFAS is also adopting a "lean" thinking approach. "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.

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

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	<u>2003</u>	<u>2002</u>
ASSETS		
Intragovernmental:		
Collections and Disbursements Clearing	\$ -	\$ -
Accounts Receivable (Note 2)	15,812	80,963
Total Intragovernmental	\$ 15,812	\$ 80,963
With the Public:		
Accounts Receivable (Note 2)	\$ 5,539	\$ -
General Property, Plant and Equipment (Note 3)	898,773	948,010
Other Assets	19	242
TOTAL ASSETS	\$ 920,143	\$ 1,029,215
LIABILITIES		
Intragovernmental:		
Accounts Payable	\$ 83,245	\$ 63,229
Other Liabilities (Note 4 and 5)	14,684	14,211
Total Intragovernmental	\$ 97,929	\$ 77,440
With the Public:		
Accounts Payable	\$ 118,412	\$ 126,545
Actuarial FECA Liability (Note 5 and 6)	46,855	45,628
Accrued Payroll and Benefits (Note 4)	32,924	24,066
Accrued Unfunded Annual Leave (Note 4 and 5)	50,837	50,838
TOTAL LIABILITIES	\$ 346,957	\$ 324,517
NET POSITION		
Cumulative Results of Operations	\$ 573,186	\$ 704,698
TOTAL NET POSITION	\$ 573,186	\$ 704,698
TOTAL LIABILITIES AND NET POSITION	\$ 920,143	\$ 1,029,215

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
 DEFENSE FINANCE AND ACCOUNTING SERVICE
 CONSOLIDATED STATEMENTS OF NET COST
 FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	<u>2003</u>	<u>2002</u>
PROGRAM COSTS		
Intragovernmental Gross Costs	\$ 426,191	\$ 509,983
(Less: Intragovernmental Earned Revenue)	<u>(1,470,282)</u>	<u>(1,545,482)</u>
Intragovernmental Net Costs	\$ (1,044,091)	\$ (1,035,499)
Gross Costs With the Public	\$ 1,310,733	\$ 1,231,756
(Less: Earned Revenue From the Public)	<u>(1,096)</u>	<u>(27,495)</u>
Net Costs With the Public	\$ 1,309,637	\$ 1,204,261
NET COST OF OPERATIONS	<u>\$ 265,546</u>	<u>\$ 168,762</u>

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	<u>2003</u>	<u>2002</u>
Cumulative Results of Operations		
BEGINNING BALANCES	\$ 704,698	\$ 706,621
Budgetary Financing Sources		
Appropriations Received	-	400
Other Budgetary Financing Sources	1,442	-
Other Financing Sources		
Transfers-In/Out Without Reimbursement	58,468	97,674
Imputed Financing Sources (Note 7)	74,124	68,765
Total Financing Sources	134,034	166,839
Net Cost of Operations	265,546	168,762
ENDING BALANCES	\$ 573,186	\$ 704,698

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
COMBINED STATEMENTS OF BUDGETARY RESOURCES
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	<u>2003</u>	<u>2002</u>
BUDGETARY RESOURCES		
Budget Authority:		
Appropriations Received	\$ -	\$ 400
Contract Authority	124,437	189,051
Unobligated Balance:		
Beginning of Period	1,007,716	928,295
Net Transfers, Actual	625	2,100
Spending Authority from Offsetting Collections:		
Earned:		
Collected	1,698,573	1,754,411
Receivable from Federal Sources	(50,521)	(12,759)
Change in Unfilled Customer Orders:		
Without Advance from Federal Sources	25,986	(35,144)
Subtotal	<u>1,674,038</u>	<u>1,706,508</u>
Permanently not Available	<u>(987,867)</u>	<u>-</u>
Total Budgetary Resources	\$ 1,818,949	\$ 2,826,354
STATUS OF BUDGETARY RESOURCES		
Obligations Incurred:		
Reimbursable	\$ 1,782,763	\$ 1,818,638
Total Obligations Incurred	1,782,763	1,818,638
Unobligated Balance:		
Apportioned	<u>36,186</u>	<u>1,007,716</u>
Total Status of Budgetary Resources	\$ 1,818,949	\$ 2,826,354
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS		
Obligated Balance, Net - Beginning of Period	\$ 195,608	\$ 171,591
Obligated Balance, Net - End of Period:		
Accounts Receivable	(58,038)	(108,559)
Unfilled Customer Orders	(57,050)	(31,064)
Undelivered Orders (Note 9)	88,804	88,617
Accounts Payable (Note 9)	278,458	246,614
Outlays:		
Disbursements	1,750,732	1,842,525
Collections	(1,698,573)	(1,754,411)
Subtotal	<u>52,159</u>	<u>88,114</u>
Net Outlays	\$ 52,159	\$ 88,114

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF FINANCING
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	2003	2002
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated:		
Obligations Incurred	\$ 1,782,763	\$ 1,818,638
Less: Spending Authority From Offsetting Collections	(1,674,038)	(1,706,508)
Net Obligations	108,725	112,130
Other Resources:		
Transfers In/Out Without Reimbursement	58,468	-
Imputed Financing Sources (Note 7)	74,124	68,765
Total Resources Used to Finance Activities	241,317	180,895
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	26,020	12,003
Resources that Fund Expenses Recognized in Prior Periods	-	(1,107)
Resources that Finance the Acquisition of Assets	(59,347)	(171,615)
Other	(58,468)	-
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(91,795)	(160,719)
Total Resources Used to Finance the Net Cost of Operations	149,522	20,176
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Other	1,372	-
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in Future Periods	1,372	-
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	114,659	148,586
Other	(7)	-
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	114,652	148,586
Total Components of Net Cost of Operations That Will Not Require or Generate Resources or Generate Resources In the Current Period	116,024	148,586
NET COST OF OPERATIONS	\$ 265,546	\$ 168,762

The accompanying notes are an integral part of these statements

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

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 the Military and Civilian Pay, Commercial Pay Services, and Accounting Services Business Lines. 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.

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, systems implementation, and support for the DFAS information technology (IT) infrastructure.

**DEPARTMENT OF DEFENSE
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NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

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 Office of Management and Budget (OMB) Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, as amended, and the DoD Financial Management Regulation ("DoD FMR") Volume 6B, when applicable, which are 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.

**DEPARTMENT OF DEFENSE
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E. Collections and Disbursements Clearing Account

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

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

F. Accounts Receivable

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

G. General Property, Plant and Equipment

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

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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.

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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 are 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.

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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.

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Note 2. ACCOUNTS RECEIVABLE (IN THOUSANDS)

	2003			2002
	Gross Amount Due	Allowance for Uncollectible Accounts	Accounts Receivable, Net	Accounts Receivable, Net
Intragovernmental Receivable	\$ 15,812	N/A	\$ 15,812	\$ 80,963
Public Receivable	\$ 5,546	\$ 7	\$ 5,539	—
Total Accounts Receivable	\$ 21,358	\$ 7	\$ 21,351	\$ 80,963

The reduction in DFAS' billing rates and suspended work counts from fiscal year 2002 to 2003 contributed to the significant decrease in Intragovernmental accounts receivable. DFAS also increased its collection process, hence decreasing the accounts receivable balance. DFAS' public accounts receivable includes refunds receivable and advances to the military and civilian employees for their salary and the Federal Employee Health Benefits.

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

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

As of September 30, 2003:

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

As of September 30, 2002:

	Acquisition Cost	Accumulated Depreciation	Net Book Value	Useful Life (in years)
Buildings, Structures and Facilities	\$ 129,734	\$ 15,684	\$ 114,050	20 to 40
Leasehold Improvements	\$ 60,786	\$ 7,594	\$ 53,192	Lease Term
Equipment	\$ 246,637	\$ 193,646	\$ 52,991	5 to 10
Internal Use Software	\$ 820,633	\$ 555,622	\$ 265,011	2-5 to 10
Construction-In-Progress	\$ 462,766	—	\$ 462,766	N/A
Total General PP&E, Net	\$ 1,720,556	\$ 772,546	\$ 948,010	—

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

Note 4. OTHER LIABILITIES (IN THOUSANDS)

As of September 30, 2003:	Current	Non-Current	Total
Intragovernmental Other Liabilities			
Workers' Compensation	\$ 3,983	\$ 5,209	\$ 9,192
Employer Contributions and Payroll Taxes	5,492		5,492
Total Intragovernmental Other Liabilities	9,475	5,209	14,684
Other Liabilities With the Public			
Accrued Funded Payroll and Benefits	32,924		32,924
Accrued Unfunded Annual Leave	50,837		50,837
Total Other Liabilities With the Public	83,761		83,761
Total Other Liabilities	\$ 93,236	\$ 5,209	\$ 98,445
As of September 30, 2002:			
Intragovernmental Other Liabilities			
Workers' Compensation	\$ 4,348	\$ 4,699	\$ 9,047
Employer Contributions and Payroll Taxes	5,164		5,164
Total Intragovernmental Other Liabilities	9,512	4,699	14,211
Other Liabilities With the Public			
Accrued Funded Payroll and Benefits	24,066		24,066
Accrued Unfunded Annual Leave	50,838		50,838
Total Other Liabilities With the Public	74,904		74,904
Total Other Liabilities	\$ 84,416	\$ 4,699	\$ 89,115

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

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

Intragovernmental	2003	2002
Workers' Compensation	\$ 9,192	\$ 9,047
Total Intragovernmental	9,192	9,047
With the Public		
Actuarial FECA Liability	46,855	45,628
Accrued Annual Leave	50,837	50,838
Total With the Public	97,692	96,466
Total Liabilities Not Covered by Budgetary Resources	\$ 106,884	\$ 105,513
Total Liabilities Covered by Budgetary Resources	240,073	219,004
Total Liabilities	\$ 346,957	\$ 324,517

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Note 6. ACTUARIAL LIABILITY (IN THOUSANDS)

	Unfunded Actuarial Liability at September 30, 2003	Unfunded Actuarial Liability at September 30, 2002
Workers' Compensation	\$ 46,855	\$ 45,628
Total Actuarial Liability	\$ 46,855	\$ 45,628

The liability for future workers' compensation benefit (FECA) includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The Department of Labor provided an estimated actuarial liability for future workers' compensation benefits for the fiscal year ended September 30, 2003. DFAS' reported FECA liability is based on the DoD-Wide allocation worksheet, the bills received and the charge back report from July 1, 2002 to September 30, 2003.

Note 7. IMPUTED FINANCING SOURCES (IN THOUSANDS)

	2003	2002
Civilian Retirement	\$ 31,652	\$ 25,056
Civilian Health	42,335	43,571
Civilian Life Insurance	137	138
Total Imputed Financing Sources	\$ 74,124	\$ 68,765

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

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, 2003:

Fiscal Year	2003
2004	37,623
2005	38,940
2006	40,303
2007	41,714
2008	43,174
After 2008	44,685
Total Future Lease Payments	\$ 246,439

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

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

Under OMB Circular A-34, *Instructions on Budget Execution*, Federal agencies are to report budgetary information in the SBR based on budget terminology, definitions, and guidance issued. OMB Circular A-34 also states that the information on the SBR should be consistent with budget execution information reported in the President's Budget. Additionally, per Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources*, agencies are to provide financial statement footnote disclosure to explain significant differences between amounts presented in the SBR and amounts described as actual in the President's Budget. Because DFAS is a component of the DoD rather than a separate Federal agency as envisioned by OMB requirements, these analyses are difficult, however, an analysis of information reported in the SBR and the information reported in the September 30, 2003 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 2003 SF-133 was \$141,592, whereas the amount reported on the SBR was \$88,804, a difference of \$52,788. The amount reported for Accounts Payable on the fiscal year 2003 SF-133 was \$242,236, whereas the amount reported on the SBR was \$278,458, a difference of \$36,222.

The significant decrease in the available contract authority is due to the application of \$987,867 thousand in Unobligated balances to liquidate outstanding contract authority in the month of September 2003, as required by the National Defense Authorization Act of 2003.

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE**

**REQUIRED SUPPLEMENTARY INFORMATION
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2003**

(UNAUDITED)

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2003
(UNAUDITED)

Dollars In Thousands	
INTRAGOVERNMENTAL ASSETS	Accounts Receivable
Navy General Fund	\$ 4,534
Army General Fund	(23)
Air Force General Fund	470
Central Intelligence Agency	220
Armed Forces Retirement Home	3
United States Army Corps of Engineers	1,504
Other Defense Organizations General Funds	2,328
Other Defense Organizations Working Capital Funds	6,063
Army Working Capital Fund	164
Navy Working Capital Fund	350
Air Force Working Capital Fund	199
Total Intragovernmental Assets	\$ 15,812

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2003
(UNAUDITED)

Dollars In Thousands		
INTRAGOVERNMENTAL LIABILITIES	Accounts Payable	Other Liabilities
Department of Labor	\$ -	\$ 9,192
Navy General Fund	8,118	-
United States Postal Service	179	-
Department of the Treasury	234	-
Army General Fund	8,247	-
Office of Personnel Management	-	5,492
Department of Veterans Affairs	17	-
Government Printing Office	24	-
General Service Administration	7,892	-
Air Force General Fund	396	-
Department of Health and Human Services	163	-
National Archives and Records Administration	2	-
Independent Agencies	6	-
Other Defense Organizations General Funds	18,058	-
Other Defense Organizations Working Capital Funds	28,620	-
Army Working Capital Fund	386	-
Navy Working Capital Fund	8,537	-
Air Force Working Capital Fund	2,366	-
Total Intragovernmental Liabilities	\$ 83,245	\$ 14,684

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2003
(UNAUDITED)**

Dollars In Thousands	
INTRAGOVERNMENTAL REVENUE	Earned Revenue
Executive Office of the President	\$ 104
Department of Commerce	83
Navy General Fund	343,655
Department of State	18
Department of the Treasury	15
Army General Fund	499,691
Office of Personnel Management	106
Department of Veterans Affairs	21
General Service Administration	294
Central Intelligence Agency	220
Air Force General Fund	280,138
Department of Transportation	56
Armed Forces Retirement Home	46
Department of Energy	1,064
Department of Education	554
United States Army Corps of Engineers	2,588
Other Defense Organizations General Funds	118,003
Other Defense Organizations Working Capital Funds	118,324
Army Working Capital Fund	22,301
Navy Working Capital Fund	63,747
Air Force Working Capital Fund	19,254
Total Intragovernmental Revenue	\$ 1,470,282

NON - EXCHANGE REVENUE	Transfers - In	Transfers - Out
Other Defense Organizations General Funds	\$ 625	\$ -
Other Defense Organizations Working Capital Funds	-	57,843
Total Non - Exchange Revenue	\$ 625	\$ 57,843

**DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE**

**OTHER ACCOMPANYING INFORMATION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002**

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING BALANCE SHEETS
AS OF SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	Financial Operations	Information Services	Combined Total	Eliminations	2003 Consolidated	2002 Consolidated
ASSETS						
Intragovernmental:						
Collections and Disbursements Clearing	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Accounts Receivable (Note 2)	15,971	41,378	57,349	(41,537)	15,812	80,963
Total Intragovernmental	15,971	41,378	57,349	(41,537)	15,812	80,963
With the Public:						
Accounts Receivable (Note 2)	\$ 3,149	\$ 2,390	\$ 5,539	\$ -	\$ 5,539	\$ -
General Property, Plant and Equipment (Note 3)	894,663	4,110	898,773	-	898,773	948,010
Other Assets	18	1	19	-	19	242
TOTAL ASSETS	\$ 913,801	\$ 47,879	\$ 961,680	\$ (41,537)	\$ 920,143	\$ 1,029,215
LIABILITIES						
Intragovernmental:						
Accounts Payable	\$ 121,762	\$ 3,020	\$ 124,782	\$ (41,537)	\$ 83,245	\$ 63,229
Other Liabilities (Note 4 and 5)	13,047	1,637	14,684	-	14,684	14,211
Total Intragovernmental	134,809	4,657	139,466	(41,537)	97,929	77,440
With the Public:						
Accounts Payable	\$ 100,086	\$ 18,326	\$ 118,412	\$ -	\$ 118,412	\$ 126,545
Actuarial FECA Liability (Note 5 and 6)	44,512	2,343	46,855	-	46,855	45,628
Accrued Payroll and Benefits (Note 4)	29,380	3,544	32,924	-	32,924	24,066
Accrued Unfunded Annual Leave (Note 4 and 5)	45,321	5,516	50,837	-	50,837	50,838
TOTAL LIABILITIES	\$ 354,108	\$ 34,386	\$ 388,494	\$ (41,537)	\$ 346,957	\$ 324,517
NET POSITION						
Cumulative Results of Operations	\$ 559,693	\$ 13,493	\$ 573,186	\$ -	\$ 573,186	\$ 704,698
TOTAL NET POSITION	559,693	13,493	573,186	-	573,186	704,698
TOTAL LIABILITIES AND NET POSITION	\$ 913,801	\$ 47,879	\$ 961,680	\$ (41,537)	\$ 920,143	\$ 1,029,215

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF NET COST
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	Financial Operations	Information Services	Combined Total	Eliminations	2003 Consolidated	2002 Consolidated
PROGRAM COSTS						
Intragovernmental Gross Costs	\$ 587,516	\$ 15,349	\$ 602,865	\$ (176,674)	\$ 426,191	\$ 509,983
(Less: Intragovernmental Earned Revenue)	(1,437,593)	(209,363)	(1,646,956)	176,674	(1,470,282)	(1,545,482)
Intragovernmental Net Costs	\$ (850,077)	\$ (194,014)	\$ (1,044,091)	\$ -	\$ (1,044,091)	\$ (1,035,499)
Gross Costs With the Public	\$ 1,121,709	\$ 189,024	\$ 1,310,733	\$ -	\$ 1,310,733	\$ 1,231,756
(Less: Earned Revenue From the Public)	(1,097)	1	(1,096)	-	(1,096)	(27,495)
Net Costs With the Public	\$ 1,120,612	\$ 189,025	\$ 1,309,637	\$ -	\$ 1,309,637	\$ 1,204,261
NET COST OF OPERATIONS	\$ 270,535	\$ (4,989)	\$ 265,546	\$ -	\$ 265,546	\$ 168,762

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF CHANGES IN NET POSITION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	Financial Operations	Information Services	2003 Consolidated	2002 Consolidated
Cumulative Results of Operations				
BEGINNING BALANCES	\$ 701,083	\$ 3,615	\$ 704,698	\$ 706,621
Budgetary Financing Sources				
Appropriations Received	-	-	-	400
Other Budgetary Financing Sources	1,389	53	1,442	-
Other Financing Sources				
Transfers-In/Out Without Reimbursement	61,696	(3,228)	58,468	97,674
Imputed Financing Sources (Note 7)	66,060	8,064	74,124	68,765
Total Financing Sources	129,145	4,889	134,034	166,839
Net Cost of Operations	270,535	(4,989)	265,546	168,762
ENDING BALANCES	\$ 559,693	\$ 13,493	\$ 573,186	\$ 704,698

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
COMBINING STATEMENTS OF BUDGETARY RESOURCES
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	Financial Operations	Information Services	2003 Combined	2002 Combined
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations Received	\$ -	\$ -	\$ -	400
Contract Authority	123,746	691	124,437	189,051
Unobligated Balance:				
Beginning of Period	975,070	32,646	1,007,716	928,295
Net Transfers, Actual	625	-	625	2,100
Spending Authority from Offsetting Collections Earned:				
Collected	1,502,891	195,682	1,698,573	1,754,411
Receivable from Federal Sources	(64,202)	13,681	(50,521)	(12,759)
Change in Unfilled Customer Orders:				
Without Advance from Federal Sources	21,442	4,544	25,986	(35,144)
Subtotal	1,460,131	213,907	1,674,038	1,706,508
Permanently not Available	(937,969)	(49,898)	(987,867)	-
Total Budgetary Resources	\$ 1,621,603	\$ 197,346	\$ 1,818,949	\$ 2,826,354
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred:				
Reimbursable	\$ 1,584,580	\$ 198,183	\$ 1,782,763	\$ 1,818,638
Total Obligations Incurred	1,584,580	198,183	1,782,763	1,818,638
Unobligated Balance:				
Apportioned	37,023	(837)	36,186	1,007,716
Total Status of Budgetary Resources	\$ 1,621,603	\$ 197,346	\$ 1,818,949	\$ 2,826,354
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS:				
Obligated Balance, Net - Beginning of Period	\$ 217,196	\$ (21,588)	\$ 195,608	\$ 171,591
Obligated Balance, Net - End of Period:				
Accounts Receivable	(14,278)	(43,760)	(58,038)	(108,559)
Unfilled Customer Orders	(22,032)	(35,018)	(57,050)	(31,064)
Undelivered Orders (Note 9)	70,177	18,627	88,804	88,617
Accounts Payable (Note 9)	252,391	26,067	278,458	246,614
Outlays:				
Disbursements	1,558,278	192,454	1,750,732	1,842,525
Collections	(1,502,891)	(195,682)	(1,698,573)	(1,754,411)
Subtotal	55,387	(3,228)	52,159	88,114
Net Outlays	\$ 55,387	\$ (3,228)	\$ 52,159	\$ 88,114

The accompanying notes are an integral part of these statements

DEPARTMENT OF DEFENSE
DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATING STATEMENTS OF FINANCING
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2003 AND 2002

Dollars In Thousands	Financial Operations	Information Services	2003 Consolidated	2002 Consolidated
RESOURCES USED TO FINANCE ACTIVITIES				
Budgetary Resources Obligated:				
Obligations Incurred	\$ 1,584,580	\$ 198,183	\$ 1,782,763	\$ 1,818,638
Less: Spending Authority From Offsetting Collections	(1,460,131)	(213,907)	(1,674,038)	(1,706,508)
Net Obligations	124,449	(15,724)	108,725	112,130
Other Resources				
Transfers In/Out Without Reimbursement	61,696	(3,228)	58,468	-
Imputed Financing Sources (Note 7)	66,060	8,064	74,124	68,765
Total Resources Used to Finance Activities	252,205	(10,888)	241,317	180,895
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	24,522	1,498	26,020	12,003
Resources that Fund Expenses Recognized In Prior Periods	-	-	-	(1,107)
Resources that Finance the Acquisition of Assets	(58,544)	(803)	(59,347)	(171,615)
Other	(61,696)	3,228	(58,468)	-
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(95,718)	3,923	(91,795)	(160,719)
Total Resources Used to Finance the Net Cost of Operations	156,487	(6,965)	149,522	20,176
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD				
Other	1,303	69	1,372	-
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in Future Periods	1,303	69	1,372	-
Components not Requiring or Generating Resources:				
Depreciation and Amortization	112,745	1,914	114,659	148,586
Other	-	(7)	(7)	-
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	112,745	1,907	114,652	148,586
Total Components of Net Cost of Operations That Will Not Require or Generate Resources In The Current Period	114,048	1,976	116,024	148,586
NET COST OF OPERATIONS	\$ 270,535	\$ (4,989)	\$ 265,546	\$ 168,762

The accompanying notes are an integral part of these statements

**INDEPENDENT AUDITOR'S REPORT
ON THE FINANCIAL STATEMENTS**

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

We have audited the accompanying Consolidated Balance Sheets of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense (DoD), as of September 30, 2003 and 2002, and the related Consolidated Statements of Net Cost, Changes in Net Position, and Financing, and the Combined Statements of Budgetary Resources for the years then ended. These financial statements are the responsibility of the management of DFAS. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DFAS as of September 30, 2003 and 2002, and its net costs, changes in net position, combined budgetary resources, and reconciliation of budgetary obligations to net cost for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

**INDEPENDENT AUDITOR'S REPORT
ON THE FINANCIAL STATEMENTS, CONTINUED**

The Other Accompanying Information, as listed in the accompanying Table of Contents, is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, such information is fairly presented in all material respects in relation to the basic financial statements taken as a whole for the fiscal years ended September 30, 2003 and 2002.

In accordance with *Government Auditing Standards*, we have also issued reports dated December 1, 2003 on our consideration of DFAS's internal control over financial reporting, and on our tests of its compliance with certain provisions of applicable laws and regulations. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and, in considering the results of the audit, those reports should be read in conjunction with this report.

Ernst & Young LLP

Washington, DC
December 1, 2003

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

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

We have audited the financial statements of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense, as of and for the year ended September 30, 2003, and have issued our report thereon dated December 1, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered DFAS' internal control over financial reporting by obtaining an understanding of DFAS' internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

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

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL, CONTINUED

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

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

1. DFAS did not have adequate controls over the recording of undelivered orders and corresponding proprietary accounts.
2. DFAS did not have adequate controls over its financial reporting processes over eliminations.
3. DFAS needs to make improvements in its information systems control environment.

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 December 1, 2003.

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

Urbach Kahn & Werlin LLP

Washington, DC
December 1, 2003

REPORTABLE CONDITION 1 (Material Weakness)

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

Control Environment for Undelivered Orders and Corresponding Proprietary Accounts

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

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

- Inadequate training of DFAS Fiscal Service Office (FSO) and program personnel regarding the recording of accruals, the maintenance of proper documentation to support the methodology and justification of accruals that were recorded, and the inconsistent application of all required policies and procedures throughout the organization;
- Inadequate training and quality control over the performance of Triannual reviews, which did not ensure that the specific objectives stated in the DoD Financial Management Regulation (FMR) and the DFAS Financial Management (FM) Desktop Guide were followed ensuring that applicable proprietary and budgetary accounts were valid, accurate and properly supported. The Triannual review process should be regarded as a financial management tool to ensure that the appropriate internal controls are in place throughout the fiscal year related to the reporting of UDO, A/P and other related proprietary accounts;

REPORTABLE CONDITION 1 (Material Weakness), Continued

- DFAS did not ensure that an effective corrective action plan was in place throughout the fiscal year to track the progress of the material weakness related to UDO from the prior year. FSO personnel from major DFAS sites were not advised of the necessity to better monitor and control UDO's during the fiscal year. In addition, DFAS did not initiate and document satisfactory corrective actions or provide detailed, comprehensive training related to the reporting of UDO at all major DFAS sites; and
- Internal DFAS policies and procedures that were contradictory to Federal accounting standards and the FMR were followed by certain FSO personnel, which erroneously required certain accruals related to capital purchases to not be posted at year-end until an invoice was received by the vendor, even though the goods had already been received by DFAS prior to year-end.

Aged Accounts Payable

There were aged, invalid A/P balances at September 30, 2003 that were not properly written off prior to year-end. A significant "On-Top" adjustment to the financial statements was made to properly state the balance in A/P at year-end.

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

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

DoD FMR Volume 1, Chapter 2 states,

To support certifications of obligations...the foregoing verifications for obligated fund balances shall be made in a manner that shall ensure all of the files and balances are reconciled and validated at least once each fiscal year (not necessarily as of September 30). The work papers and records on which the determinations are based shall be retained in a form to facilitate audit and reconciliation for such periods as may be necessary...Data shall be edited, validated, and in some instances, computed before it is integrated into an accounting system...

REPORTABLE CONDITION 1 (Material Weakness), Continued

As 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 FM Desktop Guide, *Tri-Annual Reviews* states,

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

REPORTABLE CONDITION 1 (Material Weakness), Continued

Recommendations

Immediate Action

Since the above “On-Top” adjustments that were made related to UDO, A/P and its corresponding proprietary accounts for fiscal year 2003 were only reported at the financial statement and not at the detailed trial balance level, DFAS will need to perform a complete data clean-up of all documents within its UDO and A/P subsidiary ledgers at the detailed trial balance level in order to ensure that its accounts are properly stated for quarterly reporting purposes in fiscal year 2004.

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

1. A data clean-up for all UDO and A/P documents is completed to ensure that the balances are properly reported, with appropriate adjustments posted at the detailed trial balance level. The data clean-up must ensure that all UDO and A/P documents are reviewed for both a risk of overstatement and understatement, and are supported by proper documentation.
2. Quality control procedures are performed related to the data clean-up effort for all UDO and A/P documents by either DFAS management or Internal Review 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 the completion of the initial data clean-up of all UDO and A/P documents, DFAS will need 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 and training methods utilized by DFAS regarding the reporting of UDO, A/P and other related proprietary accounts have been unsuccessful. It is imperative that all personnel in the organization understand and embrace the ongoing effort to improve DFAS' internal controls in this critical area through direction by DFAS senior management.

REPORTABLE CONDITION 1 (Material Weakness), Continued

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

3. Notification is sent by the DFAS Director through the Director of Corporate Resources to all personnel in the organization informing that there have been significant impediments related to the reporting of UDO, A/P and other related proprietary accounts that have not been resolved during the prior two fiscal years, and that immediate action is required by all personnel involved in the reporting of these accounts. The notification should also emphasize the following:
 - The criticality of resolving these impediments to the entire organization, not only from an audit risk perspective, but to increase DFAS funds availability;
 - It is both the responsibility of DFAS FSO and program personnel that these accounts are properly stated, and that personnel from all of these organizations 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 the Electronic Business Accounting and Management System (e-Biz) in a timely manner regarding the recording of accruals and the deobligation of funds, especially at month-end and year-end, in order for DFAS to meet the accelerated OMB reporting requirements going forward.
4. Additional training is provided for DFAS FSO and program personnel regarding the proper procedures for estimating and documenting accrued liabilities throughout the fiscal year. The training must be at an increased level of specificity than has been done in the past, and must be presented to all personnel involved in the reporting of UDO, A/P and other related proprietary accounts, not only members of management within those organizations. Specifically, the training should describe in detail, with illustrative examples, each 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 must also ensure that all DFAS personnel are following Federal accounting standards and DoD requirements consistently throughout the organization.
5. Additional training is provided for DFAS FSO and program personnel regarding the performance of Triannual reviews that reemphasizes the specific requirements of the FMR and DFAS FM Guide, and the importance of documenting that those requirements are met.

REPORTABLE CONDITION 1 (Material Weakness), Continued

6. DFAS FSO and program personnel review open obligations for receiving reports and unpaid invoices to generate the necessary entries in the general ledger to properly record the estimation of accrued liabilities on a regular basis throughout the fiscal year. Adequate supporting documentation should be maintained for all estimated accruals performed by FSO or program personnel, which clearly documents the justification for the accrual estimate.
7. Aged UDO and A/P are continually monitored throughout the fiscal year to ensure the propriety of the account balances, and that adequate documentation is maintained in the document folder that justifies why the remaining balance is proper and should not be written off.
8. An effective corrective action plan is in place throughout the fiscal year to track the progress of all audit related findings from prior years, and to initiate and document satisfactory corrective actions and detailed, comprehensive training related to audit related findings at all DFAS major sites on an ongoing basis.

REPORTABLE CONDITION 2 (Material Weakness)

DFAS DID NOT HAVE ADEQUATE CONTROLS OVER ITS FINANCIAL REPORTING PROCESSES OVER ELIMINATIONS

DFAS performed a manual data call to identify trading partners. Due to the accelerated reporting timeframes, a fully coordinated and comprehensive review over eliminations did not take place prior to providing the September 30, 2003 draft financial statements.

According to DFAS personnel, reviews were ongoing related to the following elimination entry-related errors on the draft financial statements:

- Amounts coded between intragovernmental and public
- Amounts coded between DFAS activities (Financial Operations and Information Services)
- Anomaly balances generated due to certain adjustments not being recorded

Corrections were made on subsequent versions of the financial statements, resulting in the recording of significant “On-Top” adjustments to the financial statements to properly state the balances in the above categories at year-end. Additionally, during fiscal year 2004, DFAS has initiated corrective actions in order to ensure that the eliminations capabilities in e-Biz are fully utilized.

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

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

DoD FMR Volume 1, Chapter 2 states,

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

REPORTABLE CONDITION 2 (Material Weakness), Continued

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

9. The eliminations capabilities in e-Biz are fully utilized, in order to minimize the risk of errors being created by the manual data call process that was used for fiscal year 2003.
10. Additional training is provided for DFAS personnel involved in the eliminations process in order to ensure that a thorough and complete understanding of e-Biz vendor codes, elimination reports, and financial statement reporting requirements is obtained.
11. A fully coordinated and comprehensive review over the financial reporting related to eliminations occurs during fiscal year 2004 to detect errors, and account balance anomalies, prior to approving data for inclusion in the draft financial statements.

REPORTABLE CONDITION 3

DFAS NEEDS TO MAKE IMPROVEMENTS IN ITS INFORMATION SYSTEMS CONTROL ENVIRONMENT

DFAS made significant improvements within its information systems control environment during fiscal year 2003, including the continued implementation of its new accounting system, e-Biz. However, the following internal control weaknesses related to e-Biz were identified as of September 30, 2003.

e-Biz Control Weaknesses

- The Contingency Plan/Continuity of Operations Plan (COOP) was not finalized.
- There were users that had both purchasing and accounts payable roles within e-Biz that violated segregation of duties.
- The principle of least privilege was not followed for Oracle and e-Biz user access. Least privilege is the practice of restricting a user's access to the minimum functions necessary to perform his or her job.
- The e-Biz project plan did not include detailed information about the different stages outlined in the project timeline, and was not up to date with the current status of e-Biz implementation.
- During the implementation of e-Biz, DFAS did not adhere to its preliminary test development strategies.
- We have identified other issues regarding the information systems control environment in a separate report entitled, *Improvements Needed in DFAS' Information Systems Control Environment Associated with Financial Management Systems*. Due to the sensitive nature of the specific findings and resulting recommendations, they are not repeated here.

e-Biz Report Production

DFAS did not utilize certain e-Biz standard financial reports for either management or audit requirements. To meet the needs of the DFAS organization, COGNOS Reporting database requirements were identified and were in the process of being developed. Consequently, DFAS created Ad hoc queries to meet both management and audit requirements where reports did not exist or were in development, including the monthly eliminations queries, and queries to produce the UDO and A/P summary reports by document number.

REPORTABLE CONDITION 3, Continued

DoD Directive 3020.26, *Continuity of Operations (COOP) Policy and Planning* states,

Develop, maintain and exercise emergency and business continuity plans to ensure that critical business operations continue with minimal impairment during any local or national emergency.

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

Federal Agencies provide adequate security for their computing systems. Adequate security includes not only logical controls, but also physical controls. Even the best logical controls over applications and data will be insufficient if the physical security protecting the computing resources is poor.

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

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

DoD FMR Volume 1, Chapter 2 states,

Financial management data shall be gathered and processed only when necessary to meet specific internal management needs or external requirements. Reports shall be tailored to specific user needs...Financial management data shall be recorded as soon as practicable after the occurrence of the event...Financial management information shall be reasonably complete and accurate, shall be verifiable and ordinarily be drawn from the official records and systems, and shall be no more detailed than necessary to meet the needs of management and external requirements...Accounting systems shall be capable of being adapted quickly to changing needs. Accounts shall be established and maintained at a level that enable data to be aggregated readily.

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

12. The COOP for e-Biz is completed and tested on a yearly basis.
13. A plan is developed to segregate the functions or place compensating controls for the purchasing and accounts payable roles within e-Biz.
14. Oracle security for e-Biz is configured to increase the database integrity.

REPORTABLE CONDITION 3, Continued

15. Policies and procedures for granting privileges and roles to users for Oracle/e-Biz are created to ensure that the rule of least access is followed. Furthermore, perform periodic reconciliation on accounts to ensure that roles that are no longer required are removed and review accounts to ensure that users do not have unauthorized roles.
16. Updated system documentation is maintained to ensure that adequate procedures and effective system maintenance is followed for the duration of the system's life.
17. Additional training is provided to DFAS personnel related to e-Biz standardized financial report production, in order to minimize the requirements to produce ad hoc queries from both a management and audit perspective.

**INDEPENDENT AUDITOR'S REPORT ON
COMPLIANCE WITH LAWS AND REGULATIONS**

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

We have audited the financial statements of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense, as of and for the year ended September 30, 2003, and have issued our report thereon dated December 1, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

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

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

Under FFMIA, we are required to report whether DFAS's 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.

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

The results of our tests disclosed no instances in which DFAS' financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

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

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

Urbach Kahn & Werlin LLP

Washington, DC
December 1, 2003