

# DEFENSE FINANCE AND ACCOUNTING SERVICE

## WORKING CAPITAL FUND



## FISCAL YEAR 2002 FINANCIAL REPORT

DECEMBER 2002

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**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
MANAGEMENT'S DISCUSSION AND ANALYSIS  
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2002**

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**MESSAGE FROM THE DFAS DIRECTOR**

In Fiscal Year (FY) 2002, the Defense Finance and Accounting Service (DFAS) continued to make great progress towards meeting our goal of financial management reform. However, our priorities and our programs have been altered by the sobering events of September 11, 2001. While we continue to pursue financial management reform, our number one priority is to provide complete, unfettered support to the men and women protecting our nation, particularly those men and women who are in harm's way.

In FY's 2000, 2001 and 2002, DFAS received unqualified audit opinions on its financial statements. These are significant and noteworthy accomplishments, but as recent events in the private sector demonstrate, our organization must also have an effective, accountable management structure with definitive goals, objectives and targets for its operations. An organization must also have timely progress reporting and independent oversight. As shown in the paragraphs that follow, DFAS has built an effective, accountable management structure. Our performance goals are clearly defined, measurable, and our progress toward meeting those goals is 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's mission is to provide responsive, professional finance and accounting services for the people who defend America. DFAS pays all major DoD contracts and vendors, its 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 similar to a private business, obtaining revenue by charging customers fixed prices for its services. DFAS sets its prices or rates annually, two years in advance, based on anticipated workload and estimated costs calculated to offset any prior year gains or losses. However, unlike a private business, DFAS has little flexibility in setting or adjusting its prices in the year of execution, and DFAS operations are subject to DoD, Executive Branch and Legislative Branch oversight. Also unlike a private business, 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 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.

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Effective October 2000, DFAS shifted from a Service oriented geographical focus to a business line focus to better serve its customers and increase its competitive value. This change benefited customers by: (1) focusing DFAS executive talent on each individual customer's needs; (2) identifying clear accountability for each DFAS business service; and (3) improving the "value" of business services. The following summarizes the magnitude of DFAS worldwide operations:

- Paid 5.7 million DoD military members, civilian personnel, retirees and annuitants
- Disbursed \$346.6 billion in DoD funds
- Recorded 124 million DoD accounting transactions
- Accounted for \$12.5 billion in DoD foreign military sales
- Processed 11.2 million DoD contractor invoices
- Managed \$176 billion in DoD military retirement trust fund assets
- Made 7.3 million DoD travel payments
- Accounted for 267 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, 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**

The Information Services business area 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 DFAS's information technology infrastructure.

**PERFORMANCE GOALS, OBJECTIVES, AND RESULTS**

DFAS is a strategy-based organization committed to becoming a world-class provider of finance and accounting services for its customers. The Strategic Plan is an integral part of what is done at DFAS everyday. Our DFAS strategy includes four areas: customers, quality, systems and processes, and people. With the strategy clearly in mind and present at every operational level, DFAS continues to strengthen customer partnerships, improve quality, and reduce costs. DFAS looks for innovative solutions to maximize the potential of technology to meet customers' needs. DFAS strives to be a world-class organization by measuring itself against others in the industry. It is through the continued commitment to strong partnerships, highest quality, operational effectiveness and a skilled workforce that DFAS will achieve its vision and provide world-class, cost-effective services for its customers.

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DFAS's strategy is supported by performance metrics to measure the impact on strategic goals. The metrics are captured and progress reported in the DFAS Performance Plan and the Balanced Scorecard.

**DFAS Performance Plan**

DFAS has a performance plan with the DRB. The purpose of the plan is to document performance objectives for DFAS in fiscal years 2002 through 2007. Performance objectives in the plan are designed to provide focus for continued achievement of the DFAS mission to provide responsive, professional finance and accounting services for the people who defend America. For FY 2002, DFAS had a total of 34 performance metrics and met 30 of them. For example, DFAS met the metrics for negative unliquidated obligations, unmatched disbursements, in-transit disbursements, processing voucher payments, and reworking commercial invoices.

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 80 percent of the September 1998 baseline of \$1.3 billion. DFAS has made steady and dramatic progress in reducing the amount of NULOs. At the end of FY 2002, DoD NULOs were \$122 million, a reduction of 90 percent from the baseline. By comparison, at the end of FY 2001, the amount was \$205 million, an 84 percent reduction from the baseline.

Another significant performance metric for Accounting Services is unmatched disbursements (UMD). A UMD occurs when a payment is 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 80 percent of the September 1998 baseline of \$6.9 billion. At the end of FY 2002, DoD UMDs were \$858 million, a reduction of 88 percent from the baseline. By comparison, at the end of FY 2001, the amount was \$1.04 billion, an 85 percent reduction from the baseline.

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 80 percent of the September 1998 baseline of \$1.8 billion. At the end of FY 2002, DoD in-transits were \$156 million, a reduction of 92 percent from the baseline. By comparison, at the end of FY 2001, the amount was \$230 million, an 88 percent reduction from the baseline.

The performance in the Commercial Pay Services business line shows similar improvement. For example, in FY 2002, the percentage of DoD paid voucher payments that were processed accurately and the volume of "reworked" commercial invoices exceeded the corporate goals for those metrics.

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**Balanced Scorecard**

DFAS has adopted the Balanced Scorecard methodology, developed by leading industry experts, to align the organization with its mission and vision and to measure progress. The Balanced Scorecard is not an end in itself but an important tool for measuring progress and service delivery success against DFAS's strategy. The scorecard provides four perspectives on strategy execution: customer perspective, financial perspective, internal business process perspective, and growth and learning perspective. For example, under the customer perspective, DFAS has established a goal of improving client or customer satisfaction, as measured in annual customer surveys, by five percent in each dimension. In the internal business process perspective, one of DFAS's goals is to implement 20 new best business practices per year.

**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's financial condition is sound. DFAS received consecutive unqualified opinions on its financial statements from an independent Certified Public Accounting firm in FY's 2000, 2001 and 2002.

**SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE**

In FY 2002, DFAS implemented the time and attendance module of its new financial management system known as "e-Biz." The new system is a commercial off-the-shelf software product, and will replace several legacy systems. The remaining e-Biz modules are scheduled for fielding in FY 2003. This new system will provide a single source solution for DFAS financial management from the development of budgetary requirements, the management of time and attendance, and the formulation and development of financial statements.

Beginning in FY 2003, the Defense Departmental Reporting System (DDRS) will be used to produce DFAS's budgetary reports and financial statements. DDRS is designed to facilitate DFAS's ability to meet the new accelerated reporting schedule and the quarterly reporting requirements for financial statements. Both e-Biz and DDRS address DFAS's financial management requirements from funds allocation through financial statement delivery.

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

DFAS is providing support to the Defense Financial Management Modernization Program 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**

No existing event and condition has altered the DFAS mission, which is to provide responsive, professional finance and accounting services for the people who defend America. In the future, DFAS will face many challenges including improving service delivery on an extended basis to deployed forces, meeting new requirements for security and information sharing, and meeting accelerated requirements for compiling and reporting financial information. It is unlikely that the financial information presented in these financial statements will be materially altered by those events.

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Additional information about DFAS performance, programs and systems can be found in the "The Defense Finance and Accounting Service Annual Report FY 2002" and on our website at <http://www.dfas.mil>.

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
CONSOLIDATED BALANCE SHEETS  
AS OF SEPTEMBER 30, 2002 AND 2001**

Dollars In Thousands	<u>2002</u>	<u>2001</u>
<b>ASSETS</b>		
Intragovernmental:		
Collections and Disbursements Clearing	\$ -	\$ -
Accounts Receivable	80,963	107,363
<b>Total Intragovernmental</b>	<b>\$ 80,963</b>	<b>\$ 107,363</b>
With the Public:		
Accounts Receivable	\$ -	\$ 30
General Property, Plant and Equipment (Note 2)	948,010	909,181
Other Assets	242	70
<b>TOTAL ASSETS</b>	<b>\$ 1,029,215</b>	<b>\$ 1,016,644</b>
<b>LIABILITIES</b>		
Intragovernmental:		
Accounts Payable	\$ 63,229	\$ 84,559
Other Liabilities (Notes 3 and 4)	14,211	12,881
<b>Total Intragovernmental</b>	<b>\$ 77,440</b>	<b>\$ 97,440</b>
With the Public:		
Accounts Payable	\$ 126,545	\$ 92,848
Actuarial FECA Liability (Notes 4 and 5)	45,628	46,654
Accrued Payroll and Benefits (Note 3)	24,066	21,389
Accrued Unfunded Annual Leave (Notes 3 and 4)	50,838	51,692
<b>TOTAL LIABILITIES</b>	<b>\$ 324,517</b>	<b>\$ 310,023</b>
<b>NET POSITION</b>		
Cumulative Results of Operations	\$ 704,698	\$ 706,621
<b>TOTAL NET POSITION</b>	<b>\$ 704,698</b>	<b>\$ 706,621</b>
<b>TOTAL LIABILITIES AND NET POSITION</b>	<b>\$ 1,029,215</b>	<b>\$ 1,016,644</b>

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, 2002 AND 2001**

Dollars In Thousands	<u>2002</u>		<u>2001</u>	
<b>PROGRAM COSTS</b>				
Intragovernmental Gross Costs	\$	509,983	\$	626,902
(Less: Intragovernmental Earned Revenue)		(1,545,482)		(1,664,152)
Intragovernmental Net Costs	\$	(1,035,499)	\$	(1,037,250)
Gross Costs With the Public	\$	1,231,756	\$	1,105,449
(Less: Earned Revenue From the Public)		(27,495)		(356)
Net Costs With the Public	\$	1,204,261	\$	1,105,093
<b>NET COST OF OPERATIONS</b>	<b>\$</b>	<b>168,762</b>	<b>\$</b>	<b>67,843</b>

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, 2002 AND 2001**

Dollars In Thousands	<u>2002</u>	<u>2001</u>
<b>Cumulative Results of Operations</b>		
<b>BEGINNING BALANCES</b>	<u>\$ 706,621</u>	<u>\$ 686,571</u>
<b>Budgetary Financing Sources</b>		
Appropriations Received	400	1,025
<b>Other Financing Sources</b>		
Transfers-In/Out Without Reimbursement	97,674	12,749
Imputed Financing Sources (Note 6)	<u>68,765</u>	<u>74,119</u>
<b>Total Financing Sources</b>	<b>166,839</b>	<b>87,893</b>
<b>Net Cost of Operations</b>	<u><b>168,762</b></u>	<u><b>67,843</b></u>
<b>ENDING BALANCES</b>	<u><b>\$ 704,698</b></u>	<u><b>\$ 706,621</b></u>

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, 2002 AND 2001**

Dollars In Thousands	<u>2002</u>	<u>2001</u>
<b>BUDGETARY RESOURCES</b>		
Budget Authority:		
Appropriations Received	\$ 400	\$ 1,025
Contract Authority	189,051	220,000
Unobligated Balance:		
Beginning of Period	928,295	685,273
Net Transfers, Actual	2,100	4,524
Spending Authority from Offsetting Collections Earned:		
Collected	1,754,411	1,854,848
Receivables from Federal Sources	(12,759)	(3,043)
Change in Unfilled Customer Orders:		
Without Advance from Federal Sources	(35,144)	(18,064)
Subtotal	<u>1,706,508</u>	<u>1,833,741</u>
<b>Total Budgetary Resources</b>	<b><u>\$ 2,826,354</u></b>	<b><u>\$ 2,744,563</u></b>
<b>STATUS OF BUDGETARY RESOURCES</b>		
Obligations Incurred		
Direct	\$ -	\$ (220,023)
Reimbursable	1,818,638	2,036,291
Total Obligations Incurred	<u>1,818,638</u>	<u>1,816,268</u>
Unobligated Balance:		
Apportioned	<u>1,007,716</u>	<u>928,295</u>
<b>Total Status of Budgetary Resources</b>	<b><u>\$ 2,826,354</u></b>	<b><u>\$ 2,744,563</u></b>
<b>RELATIONSHIP OF OBLIGATIONS TO OUTLAYS</b>		
Obligated Balance, Net - Beginning of Period	\$ 171,591	\$ 180,767
Obligated Balance, Net - End of Period:		
Accounts Receivable	(108,559)	(121,318)
Unfilled Customer Orders	(31,064)	(66,208)
Undelivered Orders (Note 8)	88,617	135,936
Accounts Payable (Note 8)	246,614	223,181
Outlays:		
Disbursements	1,842,525	1,846,552
Collections	(1,754,411)	(1,854,849)
Subtotal	<u>88,114</u>	<u>(8,297)</u>
<b>Net Outlays</b>	<b><u>\$ 88,114</u></b>	<b><u>\$ (8,297)</u></b>

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, 2002 AND 2001**

Dollars In Thousands	2002	2001
<b>RESOURCES USED TO FINANCE ACTIVITIES</b>		
<b>Budgetary Resources Obligated</b>		
Obligations Incurred	\$ 1,818,638	\$ 1,816,268
Less: Spending Authority From Offsetting Collections	(1,706,508)	(1,833,741)
Net Obligations	112,130	(17,473)
<b>Other Resources:</b>		
Imputed Financing Sources (Note 6)	68,765	74,119
Exchange Revenue Not in the Entity's Budget	-	(1)
<b>Total Resources Used to Finance Activities</b>	<b>180,895</b>	<b>56,645</b>
<b>RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS</b>		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but Not Yet Provided	12,003	16,874
Resources that Fund Expenses Recognized in Prior Periods	(1,107)	(94)
Resources that Finance the Acquisition of Assets	(171,615)	(171,243)
<b>Total Resources Used to Finance Items Not Part of the Net Cost of Operations</b>	<b>(160,719)</b>	<b>(154,463)</b>
<b>Total Resources Used to Finance the Net Cost of Operations</b>	<b>20,176</b>	<b>(97,818)</b>
<b>COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD</b>		
Other	-	5,433
<b>Total Components of Net Cost of Operations That Will Not Require or Generate Resources in Future Periods</b>	<b>-</b>	<b>5,433</b>
<b>Components Not Requiring or Generating Resources</b>		
Depreciation and Amortization	148,586	160,228
<b>Total Components of Net Cost of Operations That Will Not Require or Generate Resources</b>	<b>148,586</b>	<b>160,228</b>
<b>Total Components of Net Cost of Operations That Will Not Require or Generate Resources In The Current Period</b>	<b>148,586</b>	<b>165,661</b>
<b>NET COST OF OPERATIONS</b>	<b>\$ 168,762</b>	<b>\$ 67,843</b>

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, 2002 AND 2001**

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**Note 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**A. Reporting Entity**

The Defense Finance and Accounting Service (DFAS), a component of the U.S. 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 (AIS). Additionally, they provide overall technical support in a number of system-related areas including the acquisition of information technology, systems implementation, and support for the DFAS information technology (IT) infrastructure.

**B. Basis of Presentation**

The accompanying financial statements have been prepared to report the financial position, net costs and changes in net position of DFAS, together with budgetary resources and a reconciliation of net costs to budgetary obligations as required by the Chief Financial Officer's (CFO) Act of 1990 and amended by the Government Management Reform Act (GMRA) of 1994, and are in accordance with accounting principles generally accepted in the United States of America (GAAP). GAAP for federal financial reporting entities recognize the Federal Accounting Standards Advisory Board (FASAB) as the standards-setting body designed to establish these principles for these entities. The financial statements have been prepared from the books and records of DFAS in accordance with 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.

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**C. Basis of Accounting**

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

**D. Revenues and Other Financing Sources**

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

**E. Collections and Disbursements Clearing Account**

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

The Defense Working Capital Fund (DWCF) is subdivided at the Department of Treasury into five subnumbered Treasury accounts. It is at the subnumbered account level that the FBWT exists for the DWCF. DFAS and nine other DWCF activities operate under one Defense subnumbered Treasury account. As a result, DFAS does not have an individually identifiable balance. The collections, disbursements, and cash transfers applicable to DFAS's operations are recorded in DFAS's 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's 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.

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NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS  
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**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.

Effective October 1, 2000, DFAS adopted SFFAS No. 10, *Accounting for Internal Use Software*, which requires a framework for identifying software development phases and processes to identify expenditures that should be capitalized for internal use software. This Standard is applicable for expenditures related to internally developed, contractor-developed, or commercial off-the-shelf software.

**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**

Worker's 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.

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NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS  
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

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

**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.

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS  
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

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**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.

**N. Reclassifications**

Certain balances in the FY 2001 financial statements have been reclassified to conform to the FY 2002 Departmental financial statement presentation requirements. The reclassifications had no material effect on total assets, liabilities, net position or the change in net position as previously reported.

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS  
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

**Note 2. GENERAL PROPERTY, PLANT AND EQUIPMENT, NET (IN THOUSANDS)**

**As of September 30, 2002:**

	<b>Acquisition Cost</b>	<b>Accumulated Depreciation</b>	<b>Net Book Value</b>	<b>Useful Life (in years)</b>
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
<b>Total General PP&amp;E, Net</b>	<b>\$ 1,720,556</b>	<b>\$ 772,546</b>	<b>\$ 948,010</b>	<b>—</b>

**As of September 30, 2001:**

	<b>Acquisition Cost</b>	<b>Accumulated Depreciation</b>	<b>Net Book Value</b>	<b>Useful Life (in years)</b>
Buildings, Structures and Facilities	\$ 128,812	\$ 11,900	\$ 116,912	20 to 40
Leasehold Improvements	\$ 51,303	\$ 4,651	\$ 46,652	Lease Term
Equipment	\$ 264,233	\$ 197,486	\$ 66,747	2-5 to 10
Internal Use Software	\$ 1,245,821	\$ 942,257	\$ 303,564	2-5 to 10
Construction-In-Progress	\$ 375,306	—	\$ 375,306	N/A
<b>Total General PP&amp;E, Net</b>	<b>\$ 2,065,475</b>	<b>\$ 1,156,294</b>	<b>\$ 909,181</b>	<b>—</b>

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS  
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

**Note 3. OTHER LIABILITIES (IN THOUSANDS)**

<b>As of September 30, 2002:</b>	<b>Current</b>	<b>Non-Current</b>	<b>Total</b>
Intragovernmental Other Liabilities			
Workers' Compensation	\$ 4,348	\$ 4,699	\$ 9,047
Employer Contributions and Payroll Taxes	5,164	-	5,164
<b>Total Intragovernmental Other Liabilities</b>	<b>9,512</b>	<b>4,699</b>	<b>14,211</b>
Other Liabilities With the Public			
Accrued Funded Payroll and Benefits	24,066	-	24,066
Accrued Unfunded Annual Leave	50,838	-	50,838
<b>Total Other Liabilities With the Public</b>	<b>74,904</b>	<b>-</b>	<b>74,904</b>
<b>Total Other Liabilities</b>	<b>\$ 84,416</b>	<b>\$ 4,699</b>	<b>\$ 89,115</b>

<b>As of September 30, 2001:</b>	<b>Current</b>	<b>Non-Current</b>	<b>Total</b>
Intragovernmental Other Liabilities			
Workers' Compensation	\$ 4,251	\$ 4,878	\$ 9,129
Employer Contributions and Payroll Taxes	3,752	-	3,752
<b>Total Intragovernmental Other Liabilities</b>	<b>8,003</b>	<b>4,878</b>	<b>12,881</b>
Other Liabilities With the Public			
Accrued Funded Payroll and Benefits	21,389	-	21,389
Accrued Unfunded Annual Leave	51,692	-	51,692
<b>Total Other Liabilities With the Public</b>	<b>73,081</b>	<b>-</b>	<b>73,081</b>
<b>Total Other Liabilities</b>	<b>\$ 81,084</b>	<b>\$ 4,878</b>	<b>\$ 85,962</b>

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS  
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

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

<b>Intragovernmental</b>	<b>2002</b>	<b>2001</b>
Workers' Compensation	\$ 9,047	\$ 9,129
Total Intragovernmental	9,047	9,129
<b>With the Public</b>		
Actuarial FECA Liability	45,628	46,654
Accrued Annual Leave	50,838	51,692
Total With the Public	96,466	98,346
Total Liabilities Not Covered by Budgetary Resources	\$ 105,513	\$ 107,475
Total Liabilities Covered by Budgetary Resources	219,004	202,548
<b>Total Liabilities</b>	<b>\$ 324,517</b>	<b>\$ 310,023</b>

**Note 5. ACTUARIAL LIABILITY (IN THOUSANDS)**

	<b>Unfunded Actuarial Liability at September 30, 2002</b>	<b>Unfunded Actuarial Liability at September 30, 2001</b>
Workers' Compensation	\$ 45,628	\$ 46,654
<b>Total Actuarial Liability</b>	<b>\$ 45,628</b>	<b>\$ 46,654</b>

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, 2002. DFAS's reported FECA liability is based on the DoD-Wide allocation worksheet, the bills received and the charge back report from July 1, 2001 to September 30, 2002.

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS  
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

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**Note 6. IMPUTED FINANCING SOURCES (IN THOUSANDS)**

	<u>2002</u>		<u>2001</u>
Civilian Retirement	\$ 25,056	\$	26,484
Civilian Health	43,571		47,497
Civilian Life Insurance	138		138
<b>Total Imputed Financing Sources</b>	<b>\$ 68,765</b>	<b>\$</b>	<b>74,119</b>

**Note 7. 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 rate of 3.5% was used for future year projections as increases to the lease rental amounts.

The dollar amount of DFAS's operating lease commitments for future years consisted of the following at September 30, 2002:

<u>Fiscal Year</u>	<u>Total</u>
2003	\$ 38,495
2004	39,842
2005	41,236
2006	42,679
2007	44,173
<u>After 2007</u>	<u>45,719</u>
<b>Total Future Lease Payments</b>	<b>\$ 252,144</b>

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS  
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

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***Note 8. 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, 2002 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 2002 SF-133 was \$155,296, whereas the amount reported on the SBR was \$88,617, a difference of \$66,679. The amount reported for Accounts Payable on the fiscal year 2002 SF-133 was \$183,719, whereas the amount reported on the SBR was \$246,614, a difference of \$62,895.

***Note 9. SUBSEQUENT EVENT***

As described in Note 1, DFAS is part of the Defense Working Capital Fund, of which DFAS and nine other DWCF activities operate under one Defense subnumbered Fund Balance with Treasury account. On December 3, 2002, the DFAS Director for Corporate Resources was notified of a potential insufficiency of cash in the DWCF by the Comptroller of one of the other agencies within the DWCF, and the impact this potential insufficiency of funds may have on DFAS's operations in FY 2003.

DFAS management does not believe that this potential insufficiency of funds will significantly impact DFAS's financial operations.

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

**REQUIRED SUPPLEMENTARY INFORMATION  
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2002**

**(UNAUDITED)**

**DEPARTMENT OF DEFENSE**  
**DEFENSE FINANCE AND ACCOUNTING SERVICE**  
**SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY**  
**FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2002**  
**(UNAUDITED)**

<b>Dollars in Thousands</b>	
<b>INTRAGOVERNMENTAL ASSETS</b>	<b>Accounts Receivable</b>
Department of Commerce	\$ 5
Navy General Fund	2,888
Army General Fund	35,093
General Services Administration	11
Central Intelligence Agency	250
Air Force General Fund	4,411
Armed Forces Retirement Home	35
U.S. Army Corps of Engineers	5
Other Defense Organizations General Fund	25,389
Other Defense Organizations Working Capital Fund	7,893
Army Working Capital Fund	1,150
Navy Working Capital Fund	3,628
Air Force Working Capital Fund	205
<b>Total Intragovernmental Assets</b>	<b>\$ 80,963</b>

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY  
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2002  
(UNAUDITED)**

<b>Dollars in Thousands</b>		
<b>INTRAGOVERNMENTAL LIABILITIES</b>	<b>Accounts Payable</b>	<b>Other Liabilities</b>
Government Printing Office	22	-
Department of Agriculture	1,607	-
Department of the Interior	19	-
Department of Labor	108	9,047
Department of the Navy	6,067	-
U. S. Postal Service	11	-
Department of State	45	-
Department of the Treasury	212	-
Department of the Army	4,240	-
Office of Personnel Management	919	5,164
Department of Veterans Affairs	111	-
U. S. Equal Employment Opportunity Commission	14	-
General Services Administration	3,443	-
Department of the Air Force	5,188	-
Department of Health and Human Services	397	-
U. S. Army Corps of Engineers	22	-
Office of the Secretary of Defense - Defense Agencies	235	-
Other Defense Organizations Working Capital Funds	28,132	-
Army Working Capital Fund	353	-
Navy Working Capital Fund	10,718	-
Air Force Working Capital Fund	1,366	-
<b>Total Intragovernmental Liabilities</b>	<b>\$ 63,229</b>	<b>\$ 14,211</b>

DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY  
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2002  
(UNAUDITED)

<b>Dollars in Thousands</b>	
<b>INTRAGOVERNMENTAL REVENUE</b>	<b>Earned Revenue</b>
Department of Commerce	\$ 110
Navy General Fund	372,080
U.S. Postal Service	1
Department of the Treasury	98
Department of the Army	517,191
Department of Veterans Affairs	34
General Services Administration	29
Central Intelligence Agency	250
Air Force General Fund	295,143
Department of Transportation	121
Armed Forces Retirement Home	58
U.S. Army Corps of Engineers	2,843
Other Defense Organizations General Funds	119,023
Other Defense Organizations Working Capital Funds	113,617
Army Working Capital Fund	25,847
Navy Working Capital Fund	72,871
Air Force Working Capital Fund	26,166
<b>Total Intragovernmental Revenue</b>	<b>\$ 1,545,482</b>

<b>NON - EXCHANGE REVENUE</b>	<b>Transfers - In</b>	<b>Transfers - Out</b>
Other Defense Organizations General Funds	\$ 15,367	\$ -
Other Defense Organizations Working Capital Funds	-	82,307
<b>Total Non - Exchange Revenue</b>	<b>\$ 15,367</b>	<b>\$ 82,307</b>

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

**OTHER ACCOMPANYING INFORMATION  
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2002 AND 2001**

**DEPARTMENT OF DEFENSE  
DEFENSE FINANCE AND ACCOUNTING SERVICE  
CONSOLIDATING BALANCE SHEETS  
AS OF SEPTEMBER 30, 2002 AND 2001**

<b>Dollars In Thousands</b>	<b>Financial Operations</b>	<b>Information Services</b>	<b>Combined Total</b>	<b>Eliminations</b>	<b>2002 CONSOLIDATED</b>	<b>2001 CONSOLIDATED</b>
<b>ASSETS</b>						
Intragovernmental:						
Collections and Disbursements Clearing	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Accounts Receivable	78,284	30,109	108,393	27,430	80,963	107,363
<b>Total Intragovernmental</b>	<b>78,284</b>	<b>30,109</b>	<b>108,393</b>	<b>27,430</b>	<b>80,963</b>	<b>107,363</b>
With the Public:						
Accounts Receivable	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 30
General Property, Plant and Equipment (Note 2)	942,842	5,168	948,010	-	948,010	909,181
Other Assets	241	1	242	-	242	70
<b>TOTAL ASSETS</b>	<b>\$ 1,021,367</b>	<b>\$ 35,278</b>	<b>\$ 1,056,645</b>	<b>\$ 27,430</b>	<b>\$ 1,029,215</b>	<b>\$ 1,016,644</b>
<b>LIABILITIES</b>						
Intragovernmental:						
Accounts Payable	\$ 88,090	\$ 2,569	\$ 90,659	\$ 27,430	\$ 63,229	\$ 84,559
Other Liabilities (Note 3 and 4)	13,214	997	14,211	-	14,211	12,881
<b>Total Intragovernmental</b>	<b>101,304</b>	<b>3,566</b>	<b>104,870</b>	<b>27,430</b>	<b>77,440</b>	<b>97,440</b>
With the Public:						
Accounts Payable	\$ 109,138	\$ 17,407	\$ 126,545	\$ -	\$ 126,545	\$ 92,848
Actuarial FECA Liability (Notes 4 and 5)	43,347	2,281	45,628	-	45,628	46,654
Accrued Payroll and Benefits (Note 3)	21,174	2,892	24,066	-	24,066	21,389
Accrued Unfunded Annual Leave (Notes 3 and 4)	45,321	5,517	50,838	-	50,838	51,692
<b>TOTAL LIABILITIES</b>	<b>\$ 320,284</b>	<b>\$ 31,663</b>	<b>\$ 351,947</b>	<b>\$ 27,430</b>	<b>\$ 324,517</b>	<b>\$ 310,023</b>
<b>NET POSITION</b>						
Cumulative Results of Operations	\$ 701,083	\$ 3,615	\$ 704,698	\$ -	\$ 704,698	\$ 706,621
<b>TOTAL NET POSITION</b>	<b>701,083</b>	<b>3,615</b>	<b>704,698</b>	<b>-</b>	<b>704,698</b>	<b>706,621</b>
<b>TOTAL LIABILITIES AND NET POSITION</b>	<b>\$ 1,021,367</b>	<b>\$ 35,278</b>	<b>\$ 1,056,645</b>	<b>\$ 27,430</b>	<b>\$ 1,029,215</b>	<b>\$ 1,016,644</b>

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, 2002 AND 2001**

<b>Dollars In Thousands</b>	<b>Financial Operations</b>	<b>Information Services</b>	<b>Combined Total</b>	<b>Eliminations</b>	<b>2002 CONSOLIDATED</b>	<b>2001 CONSOLIDATED</b>
<b>PROGRAM COSTS</b>						
Intragovernmental Gross Costs	\$ 640,319	\$ 39,377	\$ 679,696	\$ 169,713	\$ 509,983	\$ 626,902
(Less: Intragovernmental Earned Revenue)	(1,511,668)	(203,527)	(1,715,195)	(169,713)	(1,545,482)	(1,664,152)
Intragovernmental Net Costs	\$ (871,349)	\$ (164,150)	\$ (1,035,499)	\$ -	\$ (1,035,499)	\$ (1,037,250)
Gross Costs With The Public	\$ 1,057,845	\$ 173,911	\$ 1,231,756	\$ -	\$ 1,231,756	\$ 1,105,449
(Less: Earned Revenue From the Public)	(27,357)	(138)	(27,495)	-	(27,495)	(356)
Net Costs With the Public	\$ 1,030,488	\$ 173,773	\$ 1,204,261	\$ -	\$ 1,204,261	\$ 1,105,093
<b>NET COST OF OPERATIONS</b>	<b>\$ 159,139</b>	<b>\$ 9,623</b>	<b>\$ 168,762</b>	<b>\$ -</b>	<b>\$ 168,762</b>	<b>\$ 67,843</b>

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, 2002 AND 2001

<b>Dollars In Thousands</b>	<b>Financial Operations</b>	<b>Information Services</b>	<b>2002 CONSOLIDATED</b>	<b>2001 CONSOLIDATED</b>
<b>Cumulative Results of Operations</b>				
<b>BEGINNING BALANCES</b>	\$ 716,611	\$ (9,990)	\$ 706,621	\$ 686,571
<b>Budgetary Financing Sources</b>				
Appropriations Received	400	-	400	1,025
<b>Other Financing Sources</b>				
Transfers-In/Out Without Reimbursement	81,652	16,022	97,674	12,749
Imputed Financing Sources (Note 6)	61,559	7,206	68,765	74,119
<b>Total Financing Sources</b>	<b>143,611</b>	<b>23,228</b>	<b>166,839</b>	<b>87,893</b>
<b>Net Cost of Operations</b>	<b>159,139</b>	<b>9,623</b>	<b>168,762</b>	<b>67,843</b>
<b>ENDING BALANCES</b>	<b>\$ 701,083</b>	<b>\$ 3,615</b>	<b>\$ 704,698</b>	<b>\$ 706,621</b>

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, 2002 AND 2001**

Dollars in Thousands	Financial Operations	Information Services	2002 Combined	2001 Combined
<b>BUDGETARY RESOURCES</b>				
Budget Authority:				
Appropriations Received	\$ 400	\$ -	\$ 400	\$ 1,025
Contract Authority	187,800	1,251	189,051	220,000
Unobligated Balance:				
Beginning of Period	892,752	35,543	928,295	685,273
Net Transfers, Actual	2,100	-	2,100	4,524
Spending Authority from Offsetting Collections				
Earned:				
Collected	1,558,263	196,148	1,754,411	1,854,848
Receivables from Federal Sources	(21,820)	9,061	(12,759)	(3,043)
Change in Unfilled Customer Orders:				
Without advance from Federal Sources	(22,457)	(12,687)	(35,144)	(18,064)
Subtotal	1,513,986	192,522	1,706,508	1,833,741
<b>Total Budgetary Resources</b>	<b>\$ 2,597,038</b>	<b>\$ 229,316</b>	<b>\$ 2,826,354</b>	<b>\$ 2,744,563</b>
<b>STATUS OF BUDGETARY RESOURCES</b>				
Obligations Incurred				
Direct	\$ -	\$ -	\$ -	(220,023)
Reimbursable	1,621,969	196,669	1,818,638	2,036,291
Total Obligations Incurred	1,621,969	196,669	1,818,638	1,816,268
Unobligated Balance:				
Apportioned	975,069	32,647	1,007,716	928,295
<b>Total Status of Budgetary Resources</b>	<b>\$ 2,597,038</b>	<b>\$ 229,316</b>	<b>\$ 2,826,354</b>	<b>\$ 2,744,563</b>
<b>RELATIONSHIP OF OBLIGATIONS TO OUTLAYS</b>				
Obligated Balance, Net - Beginning of Period:	\$ 181,294	\$ (9,703)	\$ 171,591	\$ 180,767
Obligated Balance, Net - End of Period:				
Accounts Receivable	(78,480)	(30,079)	(108,559)	(121,318)
Unfilled Customer Orders	(590)	(30,474)	(31,064)	(66,208)
Undelivered Orders (Note 8)	73,036	15,581	88,617	135,936
Accounts Payable (Note 8)	223,230	23,384	246,614	223,181
Outlays:				
Disbursements	1,630,344	212,181	1,842,525	1,846,552
Collections	(1,558,263)	(196,148)	(1,754,411)	(1,854,849)
Subtotal	72,081	16,033	88,114	(8,297)
<b>Net Outlays</b>	<b>\$ 72,081</b>	<b>\$ 16,033</b>	<b>\$ 88,114</b>	<b>\$ (8,297)</b>

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, 2002 AND 2001**

<b>Dollars In Thousands</b>	<b>Financial Operations</b>	<b>Information Services</b>	<b>2002 Consolidated</b>	<b>2001 Consolidated</b>
<b>RESOURCES USED TO FINANCE ACTIVITIES</b>				
<b>Budgetary Resources Obligated:</b>				
Obligations Incurred	\$ 1,621,969	\$ 196,669	\$ 1,818,638	\$ 1,816,268
Less: Spending Authority From Offsetting Collections	(1,513,986)	(192,522)	(1,706,508)	(1,833,741)
Net Obligations	107,983	4,147	112,130	(17,473)
<b>Other Resources:</b>				
Imputed Financing Sources (Note 6)	61,559	7,206	68,765	74,119
Less: Exchange Revenue Not In The Entity's Budget	-	-	-	(1)
<b>Total Resources Used to Finance Activities</b>	<b>169,542</b>	<b>11,353</b>	<b>180,895</b>	<b>56,645</b>
<b>RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS</b>				
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but Not Yet Provided	14,988	(2,985)	12,003	16,874
Resources that Fund Expenses Recognized in Prior Periods	(1,052)	(55)	(1,107)	(94)
Resources that Finance the Acquisition of Assets	(170,108)	(1,507)	(171,615)	(171,243)
<b>Total Resources Used to Finance Items Not Part of the Net Cost of Operations</b>	<b>(156,172)</b>	<b>(4,547)</b>	<b>(160,719)</b>	<b>(154,463)</b>
<b>Total Resources Used to Finance the Net Cost of Operations</b>	<b>13,370</b>	<b>6,806</b>	<b>20,176</b>	<b>(97,818)</b>
<b>COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD</b>				
Other	-	-	-	5,433
<b>Total Components of Net Cost of Operations That Will Not Require or Generate Resources in Future Periods</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>5,433</b>
<b>Components Not Requiring or Generating Resources:</b>				
Depreciation and Amortization	145,770	2,816	148,586	160,228
<b>Total Components of Net Cost of Operations That Will Not Require or Generate Resources</b>	<b>145,770</b>	<b>2,816</b>	<b>148,586</b>	<b>160,228</b>
<b>Total Components of Net Cost of Operations That Will Not Require or Generate Resources In The Current Period</b>	<b>145,770</b>	<b>2,816</b>	<b>148,586</b>	<b>165,661</b>
<b>NET COST OF OPERATIONS</b>	<b>\$ 159,140</b>	<b>\$ 9,622</b>	<b>\$ 168,762</b>	<b>\$ 67,843</b>

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 Sheet of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense (DoD), as of September 30, 2002, and the related Consolidated Statements of Net Cost, Changes in Net Position, and Financing, and the Combined Statement of Budgetary Resources for the year 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 audit. The financial statements of DFAS as of September 30, 2001 were audited by other auditors, whose report dated January 25, 2002, expressed an unqualified opinion on those statements.

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*. 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 audit provides 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, 2002, and its net costs, changes in net position, budgetary resources, and reconciliation of budgetary obligations to net cost for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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*, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures for the fiscal year ended September 30, 2002, 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 financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements, and, in our opinion, such information is fairly presented in all material respects in relation to the financial statements taken as a whole for the fiscal year ended September 30, 2002.

In accordance with *Government Auditing Standards*, we have also issued reports dated December 30, 2002, 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.



Washington, DC  
December 30, 2002

**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, 2002, and have issued our report thereon dated December 30, 2002. 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's internal control over financial reporting by obtaining an understanding of DFAS's 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's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses or noncompliance may nevertheless occur and not be detected.

## INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL, CONTINUED

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

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

1. DFAS did not have adequate controls over the recording of undelivered orders and corresponding proprietary accounts.
2. DFAS did not have adequate controls over its systems' security requirements.
3. DFAS did not have adequate management, operational and technical controls over its systems.
4. DFAS's financial reporting processes need improvement.

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 30, 2002.

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.

*Ulrich Kahn & Wulfin LLP*

Washington, DC  
December 30, 2002

## REPORTABLE CONDITION 1 (Material Weakness)

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

DFAS did not properly monitor the estimation of accrued liabilities, where the goods or services had been provided prior to September 30, 2002, resulting in an overstatement of the Undelivered Orders balance at year-end. Consequently, an extensive examination of the items comprising the Undelivered Orders balance had to be performed, resulting in the recording of a significant amount of “On-Top” adjustments to the financial statements to properly state the balance in Undelivered Orders at year-end. The correction of the overstatements in the Undelivered Orders budgetary balance necessitated related adjustments to correct significant understatements in the corresponding Accounts Payable, Property, Plant and Equipment and Expenses proprietary balances at year-end. Certain of these “On-Top” adjustments related to Accounts Payable and Expenses were not properly classified between intragovernmental or public on the financial statements, due to the fact that the adjustments were not posted until after the DoD eliminations process was completed.

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.*

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 *Financial Management Regulation* (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.*

## REPORTABLE CONDITION 1 (Material Weakness), Continued

### Recommendations

We recommend the DFAS Director and Audit Committee:

1. Ensure that DFAS's policies and procedures are followed regarding the estimation of accrued liabilities throughout the fiscal year, and the performance of Triannual reviews, including requiring that DFAS Fiscal Service Office (FSO) personnel and program officials review open obligations for unpaid invoices and receiving reports, and generate the necessary entries in the general ledger to properly record the estimation of accrued liabilities on a regular basis. Additionally, ensure that adequate supporting documentation is maintained for all estimated accruals performed by FSO personnel or program officials, which clearly documents the justification for the accrual estimate.
2. Provide additional training for DFAS FSO personnel and program officials regarding the proper procedures for estimating and documenting accrued liabilities and performing Triannual reviews. Such training should emphasize the necessity for DFAS personnel to identify key contacts within vendors to determine accruals with the public and to identify contacts within other federal agencies to determine interagency accruals.

## REPORTABLE CONDITION 2 (Material Weakness)

### DFAS DID NOT HAVE ADEQUATE CONTROLS OVER ITS SYSTEMS' SECURITY REQUIREMENTS

During fiscal year 2002, certain systems that support the processing of financial transactions did not have System Security Authorization Agreements (SSAA), security plans, or risk assessments. Additionally, certain systems were not authorized to process information because they were operating without accreditation or expired interim accreditations. The following specific issues were identified:

- SSAA's were not complete, or the system authorization had expired for the Standard Finance Redesign Subsystem-1 (SRD-1), Computerized Accounts Payable System (CAPS), and the Defense Disbursing Analysis Reporting System (DDARS).
- Security plans did not exist for SRD-1, CAPS, and DDARS, and was not complete for the Integrated Automated Travel System (IATS).
- Risk assessments did not exist for SRD-1, CAPS, and DDARS, and was not complete for IATS.

DoD Instruction 5200.40, *DoD Information Technology Security Certification and Accreditation Process* states,

*The SSAA is a living document that represents the formal agreement between the DAA [Designated Approving Authority], the CA [Certifying Authority], the user representative, and the program manager. The SSAA shall describe the applicable set of planning and certification actions, resources, and documentation required for the C&A [certification and accreditation]...Shall apply to the acquisition, operation and sustainment of any DoD system that collects, stores, transmits, or processes unclassified or classified information.*

DoD Instruction 5200.28 *Security Requirements for Automated Information Systems [AISs]* states,

*The accreditation of an AIS shall be supported by a certification plan, a risk analysis of the AIS in its operational environment, an evaluation of the security safeguards, and a certification report, all approved by the DAA.*

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

*Review the security controls in each system when significant modifications are made to the system, but at least every three years. The scope and frequency of the review should be commensurate with the acceptable level of risk for the system.*

## REPORTABLE CONDITION 2 (Material Weakness), Continued

Absent the formal, accountable authority to operate via the SSAA process, DoD systems may be subject to inconsistent or limited management oversight, increasing the risk of unprevented or undetected attack or misuse by both insiders and outsiders. Up-to-date SSAA's are vital to the proper implementation of controls over DFAS's critical infrastructure.

### Recommendations

We recommend the DFAS Director and Audit Committee:

3. Ensure that SSAA's are completed for all systems, and that all systems that support financial transactions have been accredited.
4. Ensure that all systems that support financial transactions have completed security plans and risk assessments that have been approved by management.

## REPORTABLE CONDITION 3 (Material Weakness)

### DFAS DID NOT HAVE ADEQUATE MANAGEMENT, OPERATIONAL AND TECHNICAL CONTROLS OVER ITS SYSTEMS

During fiscal year 2002, numerous instances of internal control weaknesses were identified in DFAS's management, operational and technical controls over the financial systems and general systems that support the financial statements. The following is a summary of the weaknesses that were identified:

#### Management Controls

Management controls focus on the management of the risks surrounding Information Technology (IT).

- The Defense Information Systems Agency (DISA) Defense Enterprise Computing Centers (DECC) Strategic Plan was not completed as of September 30, 2002.
- There were no policies and procedures for DDARS code movement between libraries.
- There was no enforcement of policies prohibiting personal software on the local area network (LAN).

#### Operational Controls

Operational controls address security methods focusing on mechanisms primarily implemented and executed by people (as opposed to systems). These controls are put in place to improve the security of a particular system (or group of systems). They often require technical or specialized expertise and often rely upon management activities as well as technical controls.

- Various weaknesses in the user account request and reconciliation processes for user accounts existed for the LAN, DDARS, SRD-1, and Mechanization of Contract Administrative Services (MOCAS) systems.
- Various weaknesses in the physical access controls existed at DFAS–Columbus, physical controls were lacking over workstations for CAPS and over logbooks with passwords for CAPS.
- Various environmental controls do not exist at the DFAS–Denver and Columbus server rooms. Additionally, there was a lack of emergency training for Columbus staff and deficiencies with the off-site storage of backup tapes for DFAS–Denver.

#### Technical Controls

Technical controls focus on security controls that the computer system executes. The controls can provide automated protection for unauthorized access or misuse, facilitate detection of security violations, and support security requirements for applications and data.

### REPORTABLE CONDITION 3 (Material Weakness), Continued

- Improperly configured settings for user's accounts were identified in DDARS, CAPS, the LAN, Oracle, Resource Analysis Decision Support System (RADSS), and the Access Control Facility 2 (ACF2).
- Security violation reporting and system auditing issues existed for DDARS, SRD-1, MOCAS, CAPS, the LAN and the Defense Business Management System (DBMS).
- There were improper account configurations that violated segregation of duty requirements for CAPS and SRD-1.

DFAS 8000.1-R *Information Management Corporate Policy* states the following regarding IT Identification and Authentication,

*DFAS Systems Administrators [SAs] will comply with the policy contained herein relative to the protection of password files, audit records, and the creation of user accounts. The SAs will also review the monthly security audit and ensure that the users change identified overage/weak passwords.*

DoD Instruction 5200.28 states,

*There shall be in place safeguards to ensure each person having access to an AIS (Automated Information System) may be held accountable for his or her actions on the AIS. There shall be an audit trail providing a documented history of Defense AIS use. The audit trail shall be of sufficient detail to reconstruct events in determining the cause or magnitude of compromise should a security violation or malfunction occur.*

*The safeguarding of information and AIS resources (against sabotage, tampering, denial of service, espionage, fraud, misappropriation, misuse, or release to unauthorized persons) shall be accomplished through the continuous employment of safeguards consisting of administrative, procedural, physical and/or environmental, personnel, communications security, emanations security, and computer security (i.e., hardware, firmware, and software), as required. The mix of safeguards selected shall achieve the requisite level of security or protection.*

Without well designed management, operational, and technical controls, weaknesses could lead to unauthorized access, loss of data integrity, or controls being inconsistently applied.

## REPORTABLE CONDITION 3 (Material Weakness), Continued

### Recommendations:

We recommend that the DFAS Director and Audit Committee:

5. Coordinate with DISA to ensure that the DECC Strategic Plan is completed in a timely manner.
6. Enforce policies and procedures for movement of code and software use.
7. Ensure policies and procedures are implemented, improved and enforced with respect to internal controls for the following:
  - Strengthening user account configurations;
  - Physical access controls over DFAS server rooms and workstations;
  - Environmental controls in the DFAS server rooms; and
  - Security violation reporting and review of systems.

## REPORTABLE CONDITION 4

### DFAS'S FINANCIAL REPORTING PROCESSES NEED IMPROVEMENT

During fiscal year 2002, DFAS continued to take proactive measures to improve the internal controls surrounding its financial reporting processes, including commencing the implementation of a new financial management system "e-Biz". However, notwithstanding these advancements, certain weaknesses were identified related to DFAS's internal controls over the reporting of financial information that were primarily attributable to systems limitations.

#### **Financial Statement Adjustments**

For purposes of generating the fiscal year 2002 financial statements, DFAS posted numerous adjustments to the DBMS trial balances for corrections or changes to financial data and to conform the DBMS general ledger accounts to U.S. Standard General Ledger (SGL) accounts. The adjustments affected both the proprietary and budgetary accounts. Compounding the potential for error, a large number of "On-Top" adjustments to the financial statements were posted manually, and each adjustment was crosswalked to the financial statements, notes, Required Supplementary Information and Other Accompanying Information via the Defense Departmental Reporting System (DDRS).

This manual financial statement preparation process is an impediment to DFAS management conducting thorough financial analysis at a detailed level, and it deters the generation of reliable and timely quarterly financial statements, which are required by OMB beginning in fiscal year 2003. Additionally, the extensive processes required to produce the financial statements precludes the availability of perpetual financial statement data as a management and monitoring mechanism throughout the fiscal year. Developing regular and consistent accounting policies and procedures, including estimation methodologies, for interim periods as well as year-end are critical elements needed to facilitate shorter financial reporting and auditing timeframes anticipated by OMB.

#### **Property, Plant and Equipment (PP&E) Reporting**

For fiscal year 2002, DFAS used a property accountability system, the Defense Property Accountability System (DPAS), for tracking and reporting PP&E and the related depreciation. DPAS was not interfaced or integrated with the core financial management system (DBMS), to comply with financial management system reporting requirements issued by OMB.

## REPORTABLE CONDITION 4, Continued

Additionally, because of limitations in the design of DPAS, DFAS was unable to produce reconciled interim listings of current fiscal year PP&E acquisitions and disposals and the related depreciation. This resulted in an extensive amount of manual reconciliation procedures to be performed by DFAS that increased the risk of errors and omissions. Consequently, extensive testing of the year-end PP&E account balances had to be performed. DFAS's ability to produce reconciled listings of PP&E and the related depreciation on an interim basis, as well as at year-end are another critical element needed to facilitate accelerated financial reporting.

OMB Circular A-127 *Financial Management Systems* states,

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

*Financial management systems shall be designed to provide for effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems. Financial system designs shall eliminate unnecessary duplication of transaction entry. Wherever appropriate, data needed by the systems to support financial functions shall be entered only once and other parts of the system shall be updated through electronic means consistent with the timing requirements of normal business/transaction cycles.*

Joint Financial Management Improvement Program's *Framework for Federal Financial Management Systems* states,

*Financial management systems must process, track, and provide accurate, timely, internally consistent, and readily accessible information on financial activity in the most cost effective and efficient manner. These systems should not only support the basic accounting functions but must also be the vehicle for integrated budget, financial and performance information that managers use to make decisions on their programs.*

## REPORTABLE CONDITION 4, Continued

### Recommendations:

We recommend the DFAS Director and Audit Committee:

8. Review and refine the current systemic process of generating financial statements in an effort to improve the timeliness and usefulness of reporting. Focus should be placed on determining the underlying causes for the “On-Top” adjustments to the financial statements, including estimation methodologies, for interim periods as well as at year-end, in order to facilitate shorter financial reporting and auditing timeframes anticipated by OMB.
9. Determine if DPAS as an accountability system is the appropriate system for DFAS to utilize for its financial reporting of PP&E. Additionally, detailed PP&E listings of acquisitions and disposals, and the related depreciation are continually reviewed and reconciled by appropriate personnel to identify potential misstatements and errors, and to ensure consistency of accounting treatment.

**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, 2002, and have issued our report thereon dated December 30, 2002. 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 instances of noncompliance with the following laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, as described below.

As directed by the Office of the Secretary of Defense (OSD), DFAS did not prepare the annual Section 4 report, as required by the Federal Managers' Financial Integrity Act (FMFIA), which requires that any material weaknesses in the agency's systems of internal accounting and administrative control to be identified, and the plans and schedule for correcting any such weaknesses be described. DFAS has legacy systems, which continue to be reported as being non-compliant with Federal financial management system requirements. DFAS is in the process of replacing the non-compliant legacy systems with migratory systems.

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 instances, described below where DFAS's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

### **Federal Financial Management Systems Requirements**

DFAS's financial management systems 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. Although DFAS attempted to mitigate the effect of the internal control weaknesses related to its financial management systems with the implementation of manual processes and procedures (workarounds), these workarounds did not satisfy the provisions of OMB Circular A-127, Section 7 (b) which requires that consistent internal controls exist in integrated financial management systems. Accordingly, DFAS was not in compliance with this authoritative OMB guidance as of and for the year ended September 30, 2002.

### **Federal Accounting Standards**

DFAS did not have adequate financial statement reporting functionality within its accounting system of record, the Defense Business Management System (DBMS), to meet the financial reporting requirements of OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*.

Although DFAS attempted to mitigate the effect of the internal control weaknesses related to its financial management systems with the implementation of manual processes and procedures, these workarounds did not satisfy the provisions of OMB Circular A-127, Section 7 (d) which requires that agency financial management systems maintain accounting data to permit reporting in accordance with accounting standards recommended by the Federal Accounting Standards Advisory Board (FASAB) and issued by the Director of the OMB, and reporting requirements issued by the Director of the OMB and/or the Secretary of the Treasury.

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

Additionally, DFAS's financial management systems did not satisfy the provisions of OMB Circular A-127, Section 7 (e), which requires that the agency financial management systems provide financial information in a timely and useful fashion to (1) support management's fiduciary role; (2) support the legal, regulatory and other special management requirements of the agency; (3) support budget formulation and execution functions; (4) support fiscal management of program delivery and program decision making; (5) comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury; and (6) monitor the financial management system to ensure the integrity of financial data. Accordingly, DFAS was not in compliance with this authoritative OMB guidance as of and for the year ended September 30, 2002.

### **United States Government Standard General Ledger (SGL)**

DFAS's financial management systems did not substantially comply with the SGL at the transaction level, because transactions were not recorded in accordance with the SGL chart of accounts; reports produced by the systems provided financial information that could not be traced directly to SGL accounts; and transactions from feeder systems were not posted following SGL requirements.

Specific conditions and recommended remedial actions attributable to the above instances of noncompliance are more fully described in our Independent Auditor's Report on Internal Control, dated December 30, 2002. The DFAS Office of Corporate Resources is responsible for the financial management systems within DFAS.

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

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

*Charles Kahn & Werbin LLP*

Washington, DC  
December 30, 2002