

**DEFENSE CONTRACT  
AUDIT AGENCY**



**FY 2007  
ANNUAL FINANCIAL STATEMENTS**



**DEFENSE CONTRACT AUDIT AGENCY**  
**DEPARTMENT OF DEFENSE**  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

CFA 400.2.1

November 13, 2007

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)

ATTENTION: Director, Financial Reporting and Analysis

SUBJECT: Fiscal Year (FY) 2007 Annual Audited Financial Statements

Attached are the FY 2007 Audited Financial Statements, as well as the Independent Auditor's Opinion, Notes to Financial Statements, Management Discussion and Analysis, and the Management Representations and Legal Liability Letters for the Defense Contract Audit Agency.

This package is submitted in accordance with the FY 2007 Financial Statement and Performance and Accountability Report Schedule.

My point of contact is Sandra Anderson at (703) 767-2245.

A handwritten signature in black ink, reading "Philip Anderson", is positioned above the printed name.

J. Philip Anderson  
Assistant Director, Resources

Attachments:  
As stated



**DEFENSE CONTRACT AUDIT AGENCY**  
**DEPARTMENT OF DEFENSE**  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BELVOIR, VA 22060-6219

OFFICE OF THE DIRECTOR

November 2, 2007

Leonard G. Birnbaum and Company  
Certified Public Accountants  
Washington Office  
6285 Franconia Road  
Alexandria, Virginia 22310-2510

Dear Mr. Leiper:

This letter is in connection with your audits of the Defense Contract Audit Agency's (DCAA) balance sheet as of September 30, 2007, and 2006, and the related statements of net costs, changes in net position, and budgetary resources for the years then ended for the purposes of (1) expressing an opinion as to whether the financial statements are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America, (2) reporting on the entity's internal control as of September 30, 2007, (3) reporting whether the Agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level as of September 30, 2007, and (4) testing for compliance with applicable laws and regulations.

Certain representations in this letter are described as being limited to matters that are material. For purposes of this letter, matters are considered material if they involve \$237,000 or more. Items also are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, the following representations were made to you during your audits, are as of the date of your auditor's report, and pertain to the period covered by the financial statements. These representations update the representations we provided in conjunction with your audit of the financial statements as of and for the year ended September 30, 2006.


1. We are responsible for the fair presentation of the financial statements in conformity with accounting principles generally accepted in the United States of America.
2. The financial statements are fairly presented in conformity with accounting principles generally accepted in the United States of America.
3. We have made available to you, all:
  - a. financial records and related data;
  - b. minutes of meetings of the Audit Committee or summaries of actions of recent meetings for which minutes have not been prepared; and

- c. cycle memos and flow charts of DCAA financial processes and systems.
- 4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements or disclosed in the notes to the financial statements.
- 5. DCAA has no capital equipment and our offices are located either in Federal space or commercially leased space managed by General Services Administration or the Corps of Engineers.
- 6. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
- 7. There are no:
  - a. possible violations of laws or regulations whose effect should be considered for disclosure in the financial statements or as a basis for recording a loss contingency;
  - b. material liabilities or gain or loss contingencies that are required to be accrued or disclosed, that have not been accrued or disclosed; or
  - c. unasserted claims or assessments that are probable and must be disclosed that have not been disclosed.
- 8. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
- 9. No material events or transactions have occurred subsequent to September 30, 2007, that have not been properly recorded in the financial statements or disclosed in the notes.
- 10. All intraentity transactions and balances have been appropriately identified and eliminated for financial reporting purposes, unless otherwise noted. All intragovernmental transactions and balances have been appropriately recorded, reported, and disclosed. Through Defense Finance and Accounting Service (DFAS) we have reconciled intragovernmental transactions and balances with the appropriate trading partners for the four fiduciary transactions identified in the U.S. Treasury's *Intragovernmental Fiduciary Transactions Accounting Guide*, and other intragovernmental asset, liability, and revenue amounts as required by the applicable Office of Management and Budget (OMB) Circular.
- 11. There has been no material fraud (intentional misstatements or omissions of amounts or disclosures in financial statements and misappropriation of assets that could have a material effect on the financial statements) or any fraud involving management or employees who have significant roles in internal control.

12. Except for information provided to you as part of your audit of the FY 2007 financial statements concerning Statement on Auditing Standards 99, dated May 3, May, 11 and August 6, 2007, we have no knowledge of any allegations of fraud or suspected fraud affecting the Agency received in communications from employees, former employees, regulators or others.
13. We are responsible for establishing and maintaining internal control.
14. Pursuant to the Federal Managers' Financial Integrity Act, we have assessed the effectiveness of DCAA's internal control in achieving the following objectives:
  - a. Reliability of financial reporting – transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with generally accepted accounting principles, and the assets are safeguarded against loss from unauthorized acquisition, use, or disposition;
  - b. Compliance with applicable laws and regulation – transactions are executed in accordance with: (i) laws governing the use of budget authority and other laws and regulations that could have a direct and material effect on the financial statements, and (ii) any other laws, regulations, and government-wide policies identified by the OMB in Appendix C of OMB's Audit Bulletin; and
  - c. Reliability of performance reporting – transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.
15. Those controls in place on September 30, 2007, provide reasonable assurance that the foregoing objectives are met. There have been no changes to internal control subsequent to September 30, 2007, or other factors that might significantly affect it.
16. The Defense Finance and Accounting Service is responsible for implementing and maintaining financial management systems for DCAA that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, the United States Standard General Ledger at the transaction level and the DoD Financial Management Regulation as prescribed by the DoD Comptroller.
17. We have presented through DFAS a reconciliation of the financial information in DCAA's Statement of Budgetary Resources (SBR) and DCAA's year-end Reports on Budget Execution and Budgetary Resources (SF 133s). The information presented on DCAA's SBR agrees with the information submitted on DCAA's year-end SF 133s in all material respects. This information will be used as input for the fiscal year 2007 actual column of the Program and Financing Schedules reported in the fiscal year 2009 Budget of the U.S. Government. Such information is supported by the related financial records and related data.

Leonard G. Birnbaum and Company

18. We are responsible for the DCAA's compliance with applicable laws and regulations, and are currently unaware of any instances of noncompliance.
19. We have identified and disclosed to you all laws and regulations that have a direct and material effect on the determination of financial statement amounts.



J. Philip Anderson  
Assistant Director, Resources  
Defense Contract Audit Agency



April G. Stephenson  
Deputy Director  
Defense Contract Audit Agency

Enclosure  
a/s



## DEFENSE LEGAL SERVICES

GENERAL COUNSEL  
Defense Contract Audit Agency  
8725 John J. Kingman Road, Suite 2135  
Fort Belvoir, VA 22060-6219

DL 240

October 29, 2007

Leonard G. Bimbaum and Company  
6285 Franconia Road  
Alexandria, VA 22310

### REFERENCES:

- (a) Interoffice Memorandum from Assistant Director, Resources, Defense Contract Audit Agency (DCAA), dated October 15, 2007
- (b) Statement of Federal Financial Accounting Standard (SFFAS) No. 5, "Accounting for Contingencies," December 1995, as amended by SFFAS Number 12, and Interpretation Number 2 of SFFAS Numbers 4 and 5
- (c) American Bar Association Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975)

This letter responds to reference (a) which requests that I provide information involving matters with respect to which I have been engaged and to which I have devoted substantive attention on behalf of DCAA in the form of legal consultation or representation where the amount of potential loss exceeds \$1,000,000. Reference (a) requests that a response be provided including matters that existed as of September 30, 2006 through at least October 29, 2007. Reference (a) further requests information concerning unasserted claims and assessments and requests confirmation that legal counsel are disclosing material loss contingencies as defined in reference (b).

As General Counsel of DCAA, I advise you as follows in connection with your examination of the DCAA concerning matters that existed as of September 30, 2006 and from the period September 30, 2006 through October 29, 2007.

As General Counsel of DCAA, I have supervisory authority with respect to claims and litigation made against DCAA. In such capacity, I or one of the lawyers over whom I exercise general supervision would have reviewed litigation and claims threatened or asserted involving DCAA.

### Known Claims, Litigation, and Assessments

Subject to the foregoing, and to the last paragraph of this letter, I advise you that, for the period ending September 30, 2006, and from that date through October 29, 2007, neither I nor any of the lawyers over whom I exercise general supervision have given substantive attention to, or represented, DCAA in connection with any known litigation, claim, or assessment of \$1,000,000 or more made against DCAA.

Leonard G. Birnbaum and Company

Unasserted Claims and Assessments

Information is also requested concerning unasserted claims and assessments that this office considers probable of assertion and, if asserted, would have a reasonable possibility of an unfavorable outcome. I have interpreted this request to refer to unasserted claims and assessments which, if asserted, have a reasonable possibility of resulting in a material unfavorable outcome where materiality is defined as \$1,000,000 or more.

Subject to the last paragraph of this letter, I advise you that neither I nor any of the lawyers over whom I exercise general supervision have given substantive attention to, or represented, DCAA in connection with any unasserted claims or assessments which, if asserted, would constitute a material loss contingency within the scope of clause (a) of Paragraph 5 of reference (c).

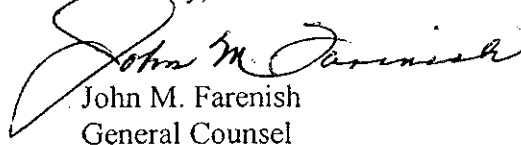
Representation Concerning Disclosure

Subject to the last paragraph of this letter, and consistent with the last sentence of Paragraph 6 of reference (c), this will confirm that whenever, in the course of performing legal services for DCAA with respect to a matter recognized to involve an unasserted possible material claim or assessment against DCAA that may call for financial statement disclosure, I or one of the lawyers over whom I exercise general supervision have formed a professional conclusion that DCAA must disclose, or consider disclosure, concerning such possible claim or assessment, the lawyer forming such professional conclusion will so advise DCAA and will consult with DCAA financial managers concerning the question of such disclosure and the applicable requirements of reference (b).

Limitation on This Response

This response is limited by, and made in accordance with, the ABA Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975) (reference (c)). Without limiting the generality of the foregoing, the limitations set forth in such Statement on the scope and use of this response (paragraphs 2 and 7) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of reference (c) and the accompanying Commentary (which is an integral part of this Statement). In addition, we do not interpret reference (a) to require or authorize the release of information subject to the attorney-client privilege or the work product doctrine, and in responding to reference (a) we have provided no information subject to that privilege or doctrine. Moreover, the information set forth herein is as of October 29, 2007, and I expressly disclaim any undertaking to advise you of changes which may be brought to my attention or to the attention of the lawyers over whom I exercise general supervision after the date of this letter.

Sincerely,



John M. Farenish  
General Counsel

Copy furnished: C



# **DEFENSE CONTRACT AUDIT AGENCY**



## **MANAGEMENT DISCUSSION AND ANALYSIS**

## Message from the Director

I am pleased to present the Defense Contract Audit Agency's (DCAA) Management's Discussion and Analysis (MD&A) for Fiscal Year 2007. The report summarizes the Agency's mission, organization, programmatic achievements, financial status, and business priorities for Fiscal Year 2007.



In support of the National Interest, we are dedicated to providing timely and responsive audits, reports, and financial advisory services to Department of Defense contracting officers and other customers. Our aim is to be **THE** audit organization with the foremost reputation for competence, integrity, and customer satisfaction by: creating an environment of teamwork, open communication, trust, and mutual respect, and developing highly qualified employees dedicated to the concept of continuous improvement.

As of September 2007, DCAA employed an all civilian workforce comprised of 3,937 full time equivalent professional contract auditors and administrative support personnel. Approximately 35 percent of DCAA's audit workforce are Certified Public Accountants (CPAs); 99 percent have bachelor's degrees; and 26 percent have advanced degrees.

DCAA is also committed to organizational excellence and sound financial management. I am pleased to report that for FY 2007, DCAA received an unqualified "clean" audit opinion on its financial statements for the seventh consecutive year. This audit result indicates that DCAA's financial statements are a reliable reflection of the agency's financial position.

As required by Section 1116(e) of Title 31 of the U.S.C., the financial and performance information contained in this report is complete and reliable, and DCAA is in substantial compliance with the requirements of the Federal Managers' Financial Integrity Act (FMFIA) and Federal Financial Management Improvement Act (FFMIA).

A handwritten signature in black ink that reads "William H. Reed". The signature is fluid and cursive, with the first and last names being more prominent.

William H. Reed  
Director

# **Defense Contract Audit Agency Management's Discussion and Analysis**

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## **OVERVIEW OF DCAA**

### **Mission**

More than 40 years of professional audit experience with complex, high dollar government contracts has made the Defense Contract Audit Agency (DCAA) *the* audit organization with the foremost reputation for competence, integrity, and customer satisfaction.

DCAA is a worldwide, single mission Agency dedicated to providing timely and responsive audits, reports, and financial advisory services to the Department of Defense (DoD) contracting officers and other customers. DCAA's primary customers are contracting officers in the Army, Navy, Air Force, and Defense Contract Management Agency (DCMA). However, the Agency also performs, on a reimbursable basis, contract audit services for the majority of other Federal agencies.

The majority of DCAA's workload is driven by statutory and regulatory requirements designed to ensure that the government meets its fiduciary responsibilities to the public when awarding and administering contracts. In this capacity, DCAA supports the oversight and internal control responsibilities of the Office of the Secretary of Defense, the DoD Inspector General (IG), the Government Accountability Office (GAO), and the Congress.

### **Organization and Structure**

DCAA was established in 1965 by then Secretary of Defense Robert S. McNamara, who determined that Department of Defense contract audit functions would be more effective and efficient if performed by a single organization. The Agency operates under the direction, authority, and control of the Under Secretary of Defense (Comptroller). A member of the Senior Executive Service, the Director of DCAA, is appointed by the Secretary of Defense.

The Agency is organized into six major components: a Headquarters and five regions. The Headquarters is located at the Andrew T. McNamara Headquarters Complex, Ft. Belvoir, VA. Principal elements of Headquarters are the Director, Deputy Director, Executive Officer, Special Assistant for Quality, General Counsel, and the Assistant Directors for Operations, Policy and Plans, and Resources.

Regional offices are located in Smyrna, GA; Lowell, MA; Irving, TX; La Mirada, CA; and Philadelphia, PA. The regions direct and administer the accomplishment of the DCAA audit mission for assigned geographical areas; manage personnel and resources assigned to the regions; and direct the operation of Field Audit Offices (FAOs) within their region. Principal elements of regional offices are the Regional Director, Deputy Regional Director, Special Assistant to the Regional Director for Quality, Regional Audit Managers, Regional Special Programs Manager, and Regional Resources Manager. During fiscal year (FY) 2007, the five

regional offices provided oversight and management for more than 340 FAOs and suboffices located throughout the United States and overseas.

An FAO is identified as either a branch office or a resident office. A resident office is established at a contractor's location when the amount of audit workload justifies the assignment of a permanent audit and support staff. A branch office is established at a strategically situated location within the region, and is responsible for performing all contract audit services within the assigned geographical area, exclusive of contract audit services performed by a resident or liaison office within the area. Regional Directors establish suboffices as extensions of FAOs when required to furnish contract audit service more economically. A suboffice is dependent on its parent FAO for release of audit reports and other administrative support.

The Agency has established liaison offices at DoD and some non-DoD procurement or contract administration offices to provide effective communication and coordination among procurement, contract administration, and contract audit elements. In addition, financial advisors are stationed at selected procurement offices to improve the quality of information for decision-makers by providing confidence about the reliability and relevance of financial information.

DCAA assists acquisition personnel by evaluating contractor submitted forward pricing proposals; providing contracting officers with accounting and financial advisory services useful to "could cost" and "should cost" assessments and negotiations; verifying the propriety and acceptability of costs charged by contractors to flexibly priced government contracts; and deterring contractors' inefficient practices which, if not detected and corrected, could lead to excessive costs and contract prices.

The Defense Contract Audit Institute (DCAI) in Memphis, TN provides specialized contract audit training for DCAA's audit staff. In addition, DCAI's trained instructors provide contract audit training segments in courses and seminars offered by other DoD and non-DoD agencies.

As of September 2007, DCAA employed an all civilian workforce comprised of 3,937 full time equivalent professional contract auditors and administrative support personnel. Approximately 35 percent of DCAA's audit workforce is Certified Public Accountants (CPAs); 99 percent have bachelor's degrees and 26 percent have advanced degrees.

### **THE DEFENSE CONTRACT AUDIT AGENCY STRATEGIC PLAN**

During 2006, DCAA added a number of Objectives to its Strategic Plan (first prepared in 1990), to reflect continued support for the goals set out in the DoD Quadrennial Review (QDR) which implements the Government Performance and Results Act (GPRA); as well as metrics associated with the President's Management Agenda and the DoD's implementation of these initiatives and programs. DCAA's Strategic Plan defines the mission, goals, objectives, strategies, and performance measures for DCAA. The goals provide a framework for supporting the aforementioned DoD initiatives and each strategic plan objective includes metrics to measure performance against the plan. The plan, which is available to the public at DCAA's web site, (<http://www.dcaa.mil>), is reviewed and updated continuously by DCAA's Executive Steering Committee.

## PERFORMANCE GOALS, OBJECTIVES, AND RESULTS

The measures selected for inclusion in the DCAA Performance Plan highlight the most important actions for successful accomplishment of the DCAA mission and to support the President's and DoD's initiatives. Each measure in the Performance Plan can be linked to the President's Management Agenda (PMA) and the DoD Balanced Scorecard/Risk Management Framework. The measures are grouped based on the PMA's five general initiatives: Human Capital; Competitive Sourcing; Financial Management; E-Government; and Budget & Performance integration.

The DCAA Performance Plan sets performance goals for its two major product lines – forward pricing and incurred cost audits. Together, these audit categories account for approximately 75 percent of DCAA's direct audit workload. Forward pricing audits generally are performed on sole-source, fixed price contracts valued at more than \$650,000 and on flexibly priced contracts valued at more than \$10 million. Forward pricing audit efforts include, but are not limited to, price proposal audits, forward pricing rate reviews, contractor estimating system surveys, and "should cost" studies. Incurred cost audits are performed on cost claims submitted by contractors for reimbursement under flexibly priced contracts. Contractor claims are reviewed to determine if costs are acceptable and are in accordance with regulations and the terms of the Performance Plan. Selected Performance Plan goals versus actuals for FY 2007 were as follows:

	FY 2007 Goal	FY 2007 Actual
<b><i>Forward Pricing:</i></b>		
Achieve average audit cycle time of 30 days or less	30 days	28 days
Forward pricing audits accomplished within 60 days	99%	99%
<b><i>Incurred Cost:</i></b>		
Complete audits within 12 months of receipt at major contractors and corporate offices	99%	99%
Complete audits within 24 months of receipt for all other submissions	99%	99%

These goals were established to meet contracting officer needs for awarding and closing out contracting actions.

The Performance Plan also includes Agency-wide goals:

### **1. Achieve an Agency-wide average cost per direct audit hour of \$112.53.**

The cost per direct hour reports were developed to serve as a reporting tool used in measuring how well DCAA controlled costs. It is also used as a tool to assist in measuring DCAA's cost competitiveness. DCAA's cost per direct audit hour for FY 2007 was \$110.13, which is \$2.40 per hour less than the FY 2007 objective. The favorable variance is primarily due to two factors. First, certain computer equipment that was originally planned for purchase this fiscal year was actually purchased at the end of FY 2006. Second, there was a higher percentage

of employees at lower grade levels holding down the average labor cost per hour. DCAA's benchmarking cost per direct audit hour for FY 2007 was \$117.42. The rate calculation reflects DCAA's FY 2007 Operations and Maintenance (O&M) and Procurement funds plus \$28.4 million of imputed costs for post retirement benefits (i.e., pension, health insurance, and life insurance) using Office of Personnel Management's prescribed rates. GSA's FY 2007 Scheduled rates reflected a comparable labor rate for national accounting firms of \$160.69, which results in a DCAA rate that is approximately 27 percent lower than the composite national firm rate.

## **2. Obtain at least 90 percent of contractor submissions electronically.**

Since the inception of this metric in FY 2005, DCAA has steadily increased the level of accomplishment for this metric. The goal for FY 2007 was 90 percent and DCAA received 95 percent of contractors' submissions in an electronic format.

Savings to the government, as a result of contract audit services, far exceed the cost of DCAA operations. For example, in FY 2007, the Agency audited \$135 billion of incurred cost and 8,182 forward pricing proposals amounting to \$215 billion. Approximately \$2.4 billion in net savings were reported during the year. These savings are available to the Military Services' budgets for use on other high priority procurements. When compared to the \$453.2 million expended from the Agency's current year O&M funding, the return on taxpayers' investments in DCAA was approximately \$5.30 for each dollar invested.

## **FINANCIAL CONDITION**

DCAA has prepared its financial statements as part of DCAA's and DoD's overall goal to improve financial management in the Department and to provide accurate, reliable information that is useful in assessing Agency performance and allocating resources. This is DCAA's eleventh year of preparing financial statements, and the eighth year that an independent accounting firm has audited the statements.

Leonard G. Birnbaum and Company has been retained to examine the Agency's FY 2007 financial statements. Subjecting the financial statements to an independent audit enhances the reliability of the statements and aids the Agency in promoting improved accountability and stewardship over the public resources entrusted to DCAA. The auditor's report is based on an audit conducted in accordance with generally accepted auditing standards, Government Auditing Standards (issued by the Comptroller General of the United States), and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

**Financial Condition – Assets.** The Agency had total assets of \$50.0 million as of September 30, 2007. Fund Balance with Treasury (FBWT) of \$45.7 million and Accounts Receivable of \$4.0 million comprised 99.4 percent of this amount. In comparison, the Agency had total assets of \$44.9 million as of September 30, 2006. Fund Balance with Treasury of \$40.5 million and Accounts Receivable of \$4.0 million comprised 99.1 percent of this amount. The increase in FBWT of 12.8 percent is due to increased appropriations from DoD.

The reimbursable accounts receivable balances are continuously reviewed. The over-aged accounts have been analyzed, collections have been pursued, adjustments for erroneous billings have been made, and reversals of invalid account balances have been accomplished. DCAA is coordinating with DFAS Columbus to ensure that aged accounts receivable are reviewed in a timely manner and appropriate action taken.

**Financial Condition – Liabilities.** The Agency had total liabilities of \$63.3 million as of September 30, 2007. Accounts Payable were \$6.4 million, 10.0 percent of the total liabilities. Other Employment Actuarial Liabilities for workmen's compensation (FECA) were \$13.0 million, 21.0 percent of the total. Other Liabilities of \$43.9 million comprised the remaining 69.0 percent of the total. Unfunded Liabilities of \$26.8 million for annual leave, compensatory leave and credit hours earned show the net amount that employees have accrued, which will be paid from future funds as the leave is taken. The balance in the unfunded liability account was adjusted to reflect current pay rates as of September 30, 2007.

The following chart presents comparative data for total liabilities as of September 20, 2007 and September 30, 2006.

**Liability Comparisons**  
**\$ in millions**

	<b>FY 2007</b>	<b>FY 2006</b>	<b>% Change</b>
<b><i>Total Liabilities</i></b>			
Accounts Payable	\$6.4	\$8.3	(22.9%)
FECA Actuarial Liabilities	13.0	14.2	(8.5%)
Other Liabilities	43.9	43.3	1.4%
<b><i>Total</i></b>	<b>\$63.3</b>	<b>\$65.8</b>	<b>(3.8%)</b>
Unfunded Liabilities	\$26.8	\$26.5	1.0%

The decrease in accounts payable resulted when DCAA reversed accounts payable established for cancelled appropriations. Since the cancelled payables were based on unsupported undistributed disbursements and are not in the Agency's general ledger, it will not be reduced by a future bill.

The Statement of Changes in Net Position represents those accounting transactions that caused the net position of the balance sheet to change from the beginning of the reporting period. Various financing sources increase net position, including appropriations, revenue, and imputed financing from costs absorbed by others. DCAA's net cost of operations reduced net position.

**Financial Condition – Net Position.** The Agency's Net Position was a negative \$13.3 million as of September 30, 2007. This amount consisted of Unexpended Appropriations of \$26.2 million and a Cumulative Results of Operations of a negative \$39.5 million.

The following chart presents comparative data for the net position and results of operations as of September 20, 2006 and September 30, 2007.

**Change in Net Position and Cumulative Results of Operations**  
\$ in millions

	<b>FY 2007</b>	<b>FY 2006</b>	<b>% Change</b>
<b><i>Net Position:</i></b>	(\$13.3)	(\$21.0)	(36.7%)
Unexpended Appropriations	26.2	25.2	3.97%
Cumulative Results of Operations	(39.5)	(46.2)	(14.5%)
<b><i>Cumulative Results of Operations:</i></b>	(39.5)	(46.2)	(14.5%)
Net Cost of Operations	418.9	410.8	1.9%
Net Results of Operations	6.6	(.30)	(2300.0%)

**Results of Operations.** The results of operations are reported in the Consolidated Statements of Changes in Net Position. DCAA had financing sources of \$425.5 million and Net Cost of Operations of \$418.9 million. The net results of operations were \$6.6 million. The cumulative results of operations were a negative \$39.5 million. Total costs increased 1.18 percent and revenues decreased 4.4 percent over prior year.

**Budgetary Results**

The total current year budget authority for DCAA's operations was \$454.2 million with obligations of \$453.2 million. This represents an execution rate of 99.8 percent. Approximately 85 percent of DCAA's operating budget is for pay and benefits; the balance of funds covers the necessary support costs – travel, office space, telecommunications, infrastructure, and supplies and equipment. Funding for DCAA operations is made available from two sources: appropriated funds provide for audits of DoD contracts, reimbursable funding is provided (on a per hour basis) for performance of contract audits for numerous non-Defense agencies.

Since 1999, DCAA's work-year levels had been fairly constant at approximately 4,000 workyears. However, as a result of the cumulative effect of several years of unfunded pay raises, beginning in FY 2004, workyears began declining. DCAA executed 3,941 workyears in FY 2004, 3,942 workyears in FY 2005, 3,867 workyears in FY 2006, and 3,937 workyears in FY 2007. We are working with the Department to achieve a workyear level of 3,999 for FYs 2008 through 2013. Projected audit requirements are commensurate with planned changes in DoD procurement levels, departmental acquisition streamlining initiatives, and required effort to complete audits of prior year contract expenditures. Staffing levels also reflect incorporation of previous QDR recommendations and related DoD initiatives.



## **SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE**

The DCAA financial statements are prepared by Defense Financial and Accounting Service (DFAS) based on data input into the Defense Business Management System (DBMS), a legacy accounting system. The DoD legacy accounting systems were developed to track budget execution, not to capture the information necessary to create financial statements. It was not until the Chief Financial Officers (CFO) Act of 1990 that CFOs of executive departments and agencies were required to prepare (and have audits of) annual financial statements.

The Federal Financial Management Improvement Act of 1996 required, among other things, that the audit reports state whether the Agency financial management systems comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The DoD and DFAS have developed long-term strategies to replace the many non-compliant accounting systems such as DBMS. However, until such time as the systems are replaced, DCAA is committed to implementing processes that support the accuracy and auditability of DCAA financial statements.

The DCAA system of accounting and administrative internal management controls is adequate to ensure that transactions are executed in accordance with budgetary and financial laws and other requirements, are consistent with the purposes authorized, and are recorded in accordance with Federal accounting standards. Reasonable assurance is provided that assets are properly acquired, used, and safeguarded to deter theft, accidental loss or unauthorized disposition, and fraud.

### **Management Assurances**

In FY 2007, DCAA reported an unqualified statement of assurance. The Agency has in place a rigorous system of internal accounting and administrative controls to ensure effective management of the Agency's resources. This system provides the reasonable assurance required to certify that the objectives of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 are achieved. The FMFIA requires federal agencies to assess the effectiveness of internal controls for program, operational, and administrative areas as well as accounting and financial management. The DCAA Executive Officer oversees the Agency's management control program. Individual assurance statements from each Headquarters Principal Staff Element and Regional Director serve as the primary basis for the Agency's assurance that management controls are adequate. The statements are based on information from various sources such as the managers' own knowledge of day-to-day operations and controls, program reviews, management initiated evaluations, and audits, reviews, and investigations performed by the DoDIG and/or the GAO.

DCAA continued to evaluate its system of internal accounting and administrative controls in effect during the fiscal year ending September 30, 2007 in accordance with the guidance in OMB Circular No. A-123, *Management's Responsibility for Internal Control*. The objectives of the system of internal accounting and administrative controls of DCAA are to provide reasonable assurance that:

1. The obligations and costs are in compliance with applicable laws.
2. Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation.
3. Revenues and expenditures applicable to Agency operations are properly recorded and accounted for to permit the preparation of reliable accounting, financial and statistical reports and to maintain accountability over the assets.

In FY 2007, DCAA reported an unqualified statement of assurance on internal control over financial reporting. During the fiscal year, DCAA and DFAS tested the effectiveness of key business process internal controls which significantly affect financial reports. Documentation in the form of process narratives and flowcharts was developed. Separate tests were conducted to assess the effectiveness of our internal controls. Risk assessments were either low or moderate with no material weaknesses in internal controls. No material weaknesses were found in the design or operation of the internal controls over DCAA's financial reporting.

The Senior Assessment Team (SAT) provided oversight, accountability and an assessment as to whether there is reasonable assurance that DCAA's internal controls are in place, operating effectively, and being used for financial reporting. The SAT, established in December 2006, is composed of senior leadership-level representatives to indicate DCAA's top down commitment to the accomplishment of the action plans. The SAT is maintaining complete records of the assessment documentation to explain significant decisions made in identifying material business processes, results of the assessments, internal control test plans, and in determining if material weaknesses exist which are to be reported outside of DCAA.

The evaluation of management controls extends to each executive, manager, supervisor, auditor and administrative employee in the Agency, and every responsibility and activity undertaken by DCAA is subject to financial, administrative and operational controls. Furthermore, the concept of reasonable assurance recognizes that (1) the cost of management controls should not exceed the benefits expected to be derived and (2) the benefits consist of reductions in the risks of failing to achieve the stated objectives. The expected benefits and related costs of control procedures should be addressed using estimates and managerial judgment. Moreover, errors or irregularities may occur and not be detected because of inherent limitations in any system of internal accounting and administrative control, including those limitations resulting from resource constraints, congressional restrictions, and other factors.

In addition, DCAA has implemented internal controls that provide reasonable assurance that performance data and metrics are reliable and relevant. Procedures are in place that control access to DCAA's Management Information System (DMIS). Access to DMIS is controlled through use of security tables that require login identifications and passwords. These login procedures control the level of access to the information system. Point-of-data entry edit checks, numerous data accuracy queries run throughout the year, and specific quarterly reviews performed by Headquarters, the Regions and FAOs assure performance data and metrics are not significantly misstated for the period.

In addition to the built-in data entry edit checks to prevent certain data input errors, other rigorous data accuracy queries are run after the data is entered to ensure performance data and

metrics are accurate and reliable. These queries focus on data relationships to highlight significant amounts that, if erroneous, could materially affect reported statistics for the period. The Agency maintains consistent and constant oversight of DMIS from data entry through transaction processing and reporting.

### **IMPROPER PAYMENTS INFORMATION ACT REPORTING**

The Improper Payments Information Act of 2002, as implemented by OMB, requires federal agencies to review annually all programs or activities and identify those that may be susceptible to significant erroneous payments. Within DCAA, no programs or activities were identified where payments met OMB's criteria for "significant" erroneous payments. DFAS determines entitlement for DCAA payments and their FY 2007 survey will include any improper payments for DCAA. Because DFAS reports by site and system, DCAA will not be identified specifically by number and amount of improper payments.

### **LIMITATIONS OF THE FINANCIAL STATEMENTS**

DCAA's financial statements are prepared by DFAS in conjunction with DCAA. The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515 (b). While the statements have been prepared from the books and records of the entity in accordance with generally accepted accounting principles for Federal entities and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. One implication of this is that the liabilities cannot be liquidated without legislation that provides resources to do so.

DEFENSE CONTRACT AUDIT AGENCY  
FINANCIAL STATEMENTS  
AND  
INDEPENDENT AUDITOR'S REPORT  
FOR THE YEARS ENDED  
SEPTEMBER 30, 2007 AND 2006

Leonard G. Birnbaum and Company, LLP  
6285 Franconia Road  
Alexandria, VA 22310-2510  
(703) 922-7622

# DEFENSE CONTRACT AUDIT AGENCY

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INDEPENDENT AUDITOR'S REPORT

To the Director, Defense Contract Audit Agency:

We have audited the Defense Contract Audit Agency's (DCAA) Consolidated Balance Sheets, Consolidated Statements of Net Cost, Consolidated Statements of Changes in Net Position, and Combined Statements of Budgetary Resources (Principal Financial Statements) as of, and for the years ended, September 30, 2007 and 2006; we have considered internal control over financial reporting in place as of September 30, 2007 and 2006; and we have tested compliance with selected laws and regulations.

In our opinion, DCAA's 2007 and 2006 Principal Financial Statements are presented fairly in all material respects.

We found no material conflicts with DCAA's 2007 report on management controls prepared as required by the Federal Managers' Financial Integrity Act of 1982 (FMFIA).

Each of these conclusions is discussed in more detail below. This report also discusses the scope of our work.

PRINCIPAL FINANCIAL STATEMENTS

In our opinion, DCAA's Principal Financial Statements, including the notes thereto, present fairly, in all material respects, the agency's financial position as of September 30, 2007 and 2006, and its net cost of operations, changes in net position, and use of budgetary resources, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

INTERNAL CONTROL

We considered DCAA's internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the Principal Financial Statements. We limited our consideration of internal control to those controls necessary to achieve the objectives described in the Office of Management and Budget's (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements*. We did not consider all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to ensuring efficient operations. Since DCAA's financial recording and reporting, including the compilation of its

financial statements, are performed by the Defense Finance and Accounting Service (DFAS), our consideration of internal control included those aspects of internal control of DFAS which were relevant to DCAA. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

The objectives of internal control are to provide management with reasonable, but not absolute, assurance that the following objectives are met:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over assets;
- funds, property, and other assets are safeguarded against loss from unauthorized acquisition, use, or disposition;
- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements and other laws and regulations that the OMB, Department of Defense (DoD) management, its Office of Inspector General (OIG), or DCAA management have identified as being significant and for which compliance can be objectively measured and evaluated; and
- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Our consideration of internal control would not necessarily disclose all matters of internal control over financial reporting that might be significant deficiencies. Under standards issued by the American Institute of Certified Public Accountants, a significant deficiency is a control deficiency, or a combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A material weakness is a significant deficiency, or combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the financial statements will not be prevented or detected. Our tests of internal control did not disclose any material weaknesses.

The DoD OIG has identified several design deficiencies in the processing of financial data, including the compilation of financial statements, by DFAS for other DoD entities. While some of these deficiencies are present in DFAS' processing of DCAA's financial data, DFAS and/or DCAA has implemented appropriate processes to mitigate the effect of these deficiencies.

We noted certain other issues related to internal control that we have communicated to DCAA's management in a separate letter dated November 2, 2007.

## COMPLIANCE WITH LAWS AND REGULATIONS

DCAA's management is responsible for complying with laws and regulations applicable to its operations. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of DCAA'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 07-04, *Audit Requirements for Federal Financial Statements*. Since DCAA's financial recording and reporting, including the issuance of financial statements, are performed by DFAS, we considered compliance with laws and regulations by DFAS, which were relevant to DCAA. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to DCAA. The objective of our audit of the Principal Financial Statements, including our tests of compliance with selected provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Reportable instances of noncompliance are failures to follow requirements, or violations of prohibitions in statutes or regulations, that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements or that sensitivity warrants disclosure thereof.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph disclosed no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* or OMB Bulletin 07-04.

## RESPONSIBILITIES AND METHODOLOGY

DCAA management has the responsibility for:

- ensuring that the Principal Financial Statements are prepared in conformity with accounting principles generally accepted in the United States of America;
- ensuring that effective internal control is established and maintained; and
- complying with laws and regulations.

Our responsibility is to express an opinion on the Principal Financial Statements based on our audit. Auditing standards generally accepted in the United States of America require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Financial Statements are free of material misstatement and presented fairly in accordance with accounting principles generally accepted in the United States of America. We considered DCAA's and DFAS' internal control for the purpose of expressing our opinion on the Principal Financial Statements and not to provide an opinion on internal control. We are also responsible for testing compliance with selected provisions of applicable laws and regulations that may materially affect the financial statements.



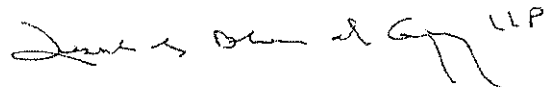
In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the Principal Financial Statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the Principal Financial Statements;
- obtained an understanding of the internal control over financial reporting;
- obtained an understanding of internal control over performance measures,
- tested, or obtained evidence of, compliance with selected provisions of laws and regulations that may materially affect the Principal Financial Statements; and
- performed other procedures as we considered necessary in the circumstances.

Our audit was conducted 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 OMB Bulletin 07-04. We believe that our audit provides a reasonable basis for our opinion.

The Management Discussion and Analysis and Required Supplementary Information are not a required part of the Principal Financial Statements, but are supplementary information required by OMB Circular A-136, *Financial Reporting Requirements*, Volume 6B of the Department of Defense Financial Management Regulation and the Federal Accounting Standards Advisory Board. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

This report is intended for the information of DCAA management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

A handwritten signature in dark ink, appearing to read "Leonard G. Birnbaum", followed by the letters "LLP" in a larger, bold font.

Leonard G. Birnbaum and Company, LLP

Alexandria, Virginia  
November 2, 2007

**DEFENSE CONTRACT  
AUDIT AGENCY**



**PRINCIPAL  
FINANCIAL STATEMENTS**

**Department of Defense**  
**Defense Contract Audit Agency**  
**CONSOLIDATED BALANCE SHEET**  
**(Amounts in Thousands)**  
**As of September 30,**

	<u>2007</u>	<u>2006</u>
<b>ASSETS</b>		
Intragovernmental Assets:		
Fund Balance with Treasury (Note 2)	\$ 45,652	\$ 40,483
Accounts Receivable (Note 3)	3,834	3,825
Total Intragovernmental Assets	49,486	44,308
Accounts Receivable, Net (Note 3)	202	125
Other Assets (Note 4)	262	458
<b>TOTAL ASSETS</b>	<u>49,950</u>	<u>44,891</u>
<b>LIABILITIES</b>		
Intragovernmental:		
Accounts Payable (Note 5)	1,921	787
Other Liabilities (Note 6)	4,803	5,001
Total Intragovernmental Liabilities	6,724	5,788
Accounts Payable (Note 5)	4,513	7,492
Employment-Related Benefits Liabilities (Note 5)	12,967	14,244
Other Liabilities (Note 6)	39,055	38,330
<b>TOTAL LIABILITIES</b>	<u>63,259</u>	<u>65,854</u>
<b>NET POSITION</b>		
Unexpended Appropriations (Note 7)	26,227	25,232
Cumulative Results of Operations	(39,536)	(46,195)
<b>TOTAL NET POSITION</b>	<u>(13,309)</u>	<u>(20,963)</u>
<b>TOTAL LIABILITIES AND NET POSITION</b>	<u>\$ 49,950</u>	<u>\$ 44,891</u>

**Department of Defense**  
**Defense Contract Audit Agency**  
**CONSOLIDATED STATEMENT OF NET COST**  
**(Amounts in Thousands)**  
**As of September 30,**

	<u>Incurred Costs</u>	<u>Forward Pricing</u>	<u>Other</u>	<u>Total 2007</u>	<u>Total 2006</u>
<b>PROGRAM COSTS</b>					
Gross Costs	\$ 238,966	\$ 114,268	\$ 120,905	\$ 474,139	\$ 468,615
(Less: Earned Revenue)	<u>(27,857)</u>	<u>(13,320)</u>	<u>(14,094)</u>	<u>(55,271)</u>	<u>(57,826)</u>
Net Program Costs	211,109	100,948	106,811	418,868	410,789
 Cost Not Assigned to Programs	-	-	-	-	-
Less: Earned Revenues Not Attributed to Programs	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
 Net Cost of Operations	<u>\$ 211,109</u>	<u>\$ 100,948</u>	<u>\$ 106,811</u>	<u>\$ 418,868</u>	<u>\$ 410,789</u>

**Department of Defense**  
**Defense Contract Audit Agency**  
**CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION**  
**(Amounts in Thousands)**  
**As of September 30,**

	<u>2007</u>	<u>2006</u>
<b>CUMULATIVE RESULTS OF OPERATIONS</b>		
Beginning Balances	\$ (46,195)	\$ (45,910)
Prior Period Adjustments	-	-
Beginning Balances, as adjusted	<u>(46,195)</u>	<u>(45,910)</u>
Budgetary Financing Sources		
Appropriations received	-	-
Appropriations transferred – in/out	-	-
Other adjustments (rescissions, etc.)	-	-
Appropriations used	397,083	382,358
Other Financing Sources		
Imputed Financing from costs absorbed by others	28,444	28,146
Total Financing Sources	<u>425,527</u>	<u>410,504</u>
Net Cost of Operations	<u>418,868</u>	<u>410,789</u>
Ending Balances	<u><u>(39,536)</u></u>	<u><u>(46,195)</u></u>
 <b>UNEXPENDED APPROPRIATIONS</b>		
Beginning Balances	25,232	16,416
Prior Period Adjustments	-	-
Beginning Balances, as adjusted	<u>25,232</u>	<u>16,416</u>
Budgetary Financing Sources		
Appropriations received	400,135	392,146
Appropriations transferred – in/out	(1,439)	65
Other adjustments (rescissions, etc.)	(618)	(1,037)
Appropriations used	<u>(397,083)</u>	<u>(382,358)</u>
Total Budgetary Financing Sources	995	8,816
Ending Balances	<u><u>26,227</u></u>	<u><u>25,232</u></u>
 Net Position	<u><u>\$ (13,309)</u></u>	<u><u>\$ (20,963)</u></u>

**Department of Defense**  
**Defense Contract Audit Agency**  
**COMBINED STATEMENT OF BUDGETARY RESOURCES**  
**(Amounts in Thousands)**  
**As of September 30,**

	<u>2007</u>	<u>2006</u>
<b>BUDGETARY RESOURCES</b>		
Budget Authority:		
Appropriations Received	\$ 400,135	\$ 392,146
Net Transfers Current Year Balance, Actual	61	(90)
Unobligated Balance – Beginning of Period	6,834	2,292
Net Transfers Prior-Year Balance, Actual	(1,500)	155
Spending Authority from Offsetting Collections		
Collected	55,289	63,223
Receivable from Federal Sources	(17)	(5,396)
Advance received	28	(7)
Recoveries of Prior Year Obligations	5,743	3,446
Permanently Not Available	(617)	(1,038)
<b>TOTAL BUDGETARY RESOURCES</b>	<u><u>465,956</u></u>	<u><u>454,731</u></u>
 <b>STATUS OF BUDGETARY RESOURCES</b>		
Obligations Incurred		
Direct	402,382	389,765
Reimbursable	55,578	58,130
Subtotal	457,960	447,895
Unobligated Balances - Apportioned	1,533	675
Unobligated Balances - Not Available	6,463	6,161
<b>TOTAL STATUS OF BUDGETARY RESOURCES</b>	<u><u>465,956</u></u>	<u><u>454,731</u></u>
 <b>RELATIONSHIP OF OBLIGATIONS TO OUTLAYS</b>		
Obligated Balance, Net – Beginning of Period	33,647	23,996
Less: Obligated Balance, Net – End of Period		
Accounts Receivable	(3,808)	(3,825)
Undelivered Orders	20,854	17,644
Accounts Payable	20,609	19,828
Outlays		
Disbursements	448,226	440,194
Collections	(55,316)	(63,215)
Net Outlays	<u><u>\$ 392,910</u></u>	<u><u>\$ 376,979</u></u>

# **DEFENSE CONTRACT AUDIT AGENCY**



## **NOTES TO THE PRINCIPAL FINANCIAL STATEMENTS**

## NOTES TO PRINCIPAL FINANCIAL STATEMENTS

### ORGANIZATION

The Defense Contract Audit Agency (DCAA) was established in 1965 by the Secretary of Defense Robert S. McNamara. The DCAA is a worldwide, single mission agency dedicated to providing timely and responsive audits and financial advisory services to the Department of Defense (DoD) contracting officers and other customers. The DCAA's primary customers are contracting officers in the Military Services, and the Defense Contract Management Agency. The Agency also performs, on a reimbursable basis, contract audit services for other federal agencies. The majority of DCAA's workload originates from statutory and regulatory requirements designed to ensure that the government meets its fiduciary responsibilities to the public when awarding and administering contracts.

The Agency is organized into six major components: a Headquarters and five regions. The Headquarters staff is responsible for the overall management of the Agency's operations, development of policies and plans, and allocation and accounting for the Agency's resources. The regions direct, manage and administer the personnel and resources allocated to their assigned geographical areas in the accomplishment of the DCAA's mission.

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Basis of Presentation

The accompanying principal financial statements present the financial activity and position of the DCAA in formats similar to the ones prescribed by the Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements* and the DoD Financial Management Regulation 7000.14R. This Circular is the central reference point for agency and government-wide financial reporting. The financial statements presented herein are in addition to financial reports prepared in accordance with OMB and the U.S. Treasury directives to monitor the status and control the use of budgetary resources.

The financial statements have been prepared from the accounting books and records of the DCAA and its accounting services provider, the Defense Finance and Accounting Service (DFAS), in accordance with DoD's accounting policies. DoD's accounting policies follow the generally accepted accounting principles (GAAP) for the federal government prescribed by the Federal Accounting Standards Advisory Board (FASAB). FASAB is designated by the American Institute of Certified Public Accountants as the official accounting standards-setting body for the federal government. Effective 4<sup>th</sup> Quarter, fiscal year (FY) 2006, DoD no longer publishes Consolidating/Combining financial statements.



## **Basis of Accounting**

For FY 2007 DCAA's financial management systems are unable to meet all of the requirements for full accrual accounting. Transactions are recorded using financial (accrual) and budgetary bases of accounting. Budgetary and financial accounting information are complementary, but the types of information and timing of their recognition cause differences between the two bases of accounting. Budgetary accounting facilitates compliance with legal constraints and statutory controls over the use of federal funds. Financial accounting supports accrual accounting and financial reporting by accounting for assets, liabilities, net position, revenues, and expenses to show actual financial position and net costs of operations. Under accrual accounting, exchange revenues are recognized when earned and operating expenses are recognized when incurred, without regard to the receipt or payment of cash.

The DoD has undertaken efforts to determine the actions required to bring its financial and nonfinancial feeder systems and processes into compliance with GAAP. One such action is the current revision of its accounting systems to record transactions based on the U.S. Standard General Ledger. Until all of the financial and nonfinancial feeder systems and processes are updated to collect and report financial information as required by GAAP, DCAA's financial data will be derived from budgetary and proprietary transactions, transactions from nonfinancial feeder systems, and accruals made for major items such as payroll expenses, accounts payable, and Federal Employee Compensation Act liability.

## **Revenues and Other Financing Sources**

The DCAA receives allotments of Operation and Maintenance and Procurement funds from the Office of Management and Budget through the Department of Defense to execute their mission and report on resource usage. The DCAA no longer receives new appropriations of Research, Development, Test and Evaluation (RDT&E) funds. In addition, when authorized, these appropriations are supplemented by revenues generated by sales of services to other Federal agencies on a reimbursable order basis. The DCAA recognizes revenue as a result of costs incurred or services performed on behalf of other Federal Agencies and the public. Full cost pricing is DCAA's standard policy for services provided as required by the OMB Circular A-25, Transmittal Memorandum # 1, User Charges, and Statement of Federal Financial Accounting Standards Number 4, *Managerial Cost Accounting Standards for the Federal Government*. Under the reimbursable order process, DCAA recognizes revenue when earned.

## **Accounting for Intragovernmental Transactions**

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

Most DoD and other Federal accounting systems do not capture accounts receivable or accounts payable data to identify the corresponding buying or selling agency. However, the DCAA's accounting systems capture trading partner data at the transaction level. The Defense Finance & Accounting Service (DFAS) reviews expenses at the transaction level by trading partner to ensure expenses are properly identified. Any potential error in intragovernmental accounts receivable or accounts payable and the corresponding revenue or expense is not material to the DCAA's financial statements.

The U.S. Treasury Financial Management Service is responsible for eliminating transactions between DoD and other Federal Agencies. The U.S. Treasury Financial Manual, provides guidance for reporting and reconciling intragovernmental balances. While DCAA is unable to fully reconcile intragovernmental transactions with all of its nonDoD federal partners, DCAA is able to reconcile balances pertaining to Federal Employees' Compensation Act transactions with the Department of Labor, and benefit program transactions with the Office of Personnel Management (OPM).

### **Fund Balance with Treasury**

The DCAA receives its spending authorizations as allotments from DoD appropriations. The DoD reconciles Fund Balance with Treasury at the agency-wide level. As such, what is presented on the DCAA's balance sheet is not reconcilable with account balances maintained by the U.S. Treasury.

### **Accounts Receivable**

Intragovernmental accounts receivable are due primarily from other non-DoD Federal agencies for services performed on a reimbursable basis. The DCAA does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intergovernmental Business Rules published in the Treasury Financial Manual <http://www.fms.treas.gov/tfm/vol1/07-03.pdf>. Nonfederal accounts receivable are due predominantly from employees. The DCAA established an allowance for uncollectible accounts due from the public by determining the estimated percentage of debts based on the age of the receivable.

### **Advances and Prepayments**

Payments in advance of the receipt of goods and services are recorded as advances or prepayments and reported as assets on the balance sheet. Advances and prepayments are recognized as expenditures when the related goods and service are received.

### **Lease Agreements**

The DCAA does not have any capital leases. Leases that do not transfer substantially all of the benefits or risks of ownership are classified as operating leases and recorded as expenses, as

payments are made over the lease term. The DCAA has operating leases on office space that expire at various times. The lease terms depend on individual contracts and locations.

### **Other Assets**

Other assets represent payments of salary and travel advances made to civilian employees to defray anticipated business expenses while on official travel.

### **Accounts Payable**

Intragovernmental accounts payable are amounts owed to other federal agencies for goods and services received but unpaid at the end of the year. Similarly, nonfederal accounts payable represent amounts owed to the public for goods and services received but unpaid at the end of the year.

### **Other Employment-Related Benefits Liabilities**

Other Employment-Related Benefits Liabilities represent the estimated actuarial liability, as determined by the U.S. Department of Labor (Labor), for future workers' compensation benefits payable under the Federal Employees Compensation Act (FECA).

### **Other Liabilities**

Intragovernmental other liabilities primarily represent amounts related to the reimbursement to Labor for FECA payments. Nonfederal other liabilities are primarily accrued funded payroll and benefits, and the unfunded liability for annual leave, compensatory time and credit hours earned but not taken. The unfunded liability for these accrued amounts is reduced as leave is taken and reflects current pay rates. Sick and other types of nonvested leave are expensed as taken.

### **Net Position**

Net position consists of unexpended appropriations and cumulative results of operations. Unexpended appropriations include the amount of unobligated allotments which have not been rescinded or withdrawn and amounts obligated but for which liabilities for payments had not been incurred at the end of the year.

Cumulative results of operations represent the accumulated difference between (1) financing sources and revenues and (2) expenses since the inception of the DCAA.

### **Management's Use of Estimates**

The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

## Contingencies and Other liabilities

The DCAA recognizes contingent liabilities on an annual basis when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. The DCAA's loss contingencies may arise as a result of uncollectible receivables, pending or threatened litigation, or other possible claims and assessments.

## Significant Events

Beginning 4th Quarter, FY 2007 DoD began presenting the Statement of Financing (SOF) as a note in accordance with the OMB Circular A-136. The SOF will no longer be considered a basic statement and is now referred to as "Reconciliation of Net Cost of Operations to Budget."

## 2. ASSETS

The DCAA's assets are classified as entity or nonentity. Entity assets are resources that the DCAA has the authority and the legal obligation to use. Nonentity assets are held by the DCAA, but are not available for use in its operations. Entity assets include accounts receivable, other assets and account balances with Treasury comprised of appropriated funds and cash collected for reimbursable audit work.

As of September 30, (Amounts in Thousands)	2007			2006
	Nonentity	Entity	Total	Total
<b>Intragovernmental Assets:</b>				
Fund Balance with Treasury	-	\$ 45,652	\$ 45,652	\$ 40,483
Accounts Receivable, Net	-	3,834	3,834	3,825
Total Intragovernmental Assets	-	\$ 49,486	\$ 49,486	\$ 44,308
<b>Nonfederal Assets:</b>				
Accounts Receivable, Net	\$ -	\$ 202	\$ 202	\$ 125
Other Assets	-	262	262	458
Total Nonfederal Assets	\$ -	\$ 464	\$ 464	\$ 583
<b>Total Assets</b>	\$ -	\$ 49,950	\$ 49,950	\$ 44,891

### 3. ACCOUNTS RECEIVABLE

As of September 30, (Amounts in Thousands)	2007			2006
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net	Accounts Receivable, Net
<b>Intragovernmental Receivables:</b>	\$ 3,834	\$ N/A	\$ 3,834	\$ 3,825
<b>Nonfederal Receivables (From The Public):</b>	219	(17)	202	125
<b>Total Accounts Receivable:</b>	<u>\$ 4,053</u>	<u>\$ (17)</u>	<u>\$ 4,036</u>	<u>\$ 3,950</u>

The DCAA has established an allowance for uncollectible accounts due from the public by applying a predetermined percentage of loss for each age group to the monthly receivable. Nonfederal Receivables represent receivables due from the public for audit work, and amounts due from employees for Federal Employee Health Benefit premiums paid by DCAA while employees were in a leave without pay status.

### 4. OTHER ASSETS

Other Assets consist of advances to employees to offset expenses related to official temporary duty travel or relocation.

### 5. LIABILITIES

DCAA's liabilities are classified as covered by budgetary resources or not covered by budgetary resources.

As of September 30, (Amounts in Thousands)	2007			2006
	Covered By Budgetary Resources	Not Covered By Budgetary Resources	Total	Total
<b>Intragovernmental Liabilities:</b>				
Accounts Payable	\$ 1,921	\$ -	\$ 1,921	\$ 787
Other	1,929	2,874	4,803	5,001
Total Intragovernmental Liabilities	3,850	2,874	6,724	5,788
<b>Nonfederal Liabilities:</b>				
Accounts Payable	4,513	-	4,513	7,492
Benefits and Other Employment-Related Actuarial Liabilities	-	12,967	12,967	14,244
Other Liabilities	12,283	26,772	39,055	38,330
Total Nonfederal Liabilities	16,796	39,739	56,535	60,066
<b>Total Liabilities</b>	<u>\$ 20,646</u>	<u>\$ 42,613</u>	<u>\$ 63,259</u>	<u>\$ 65,854</u>

## 6. OTHER LIABILITIES

As of September 30, (Amounts in Thousands)	2007			2006
	Current Liability	Noncurrent Liability	Total	Total
<b>Intragovernmental:</b>				
Resources Payable to Treasury	\$ -	\$ -	\$ -	\$ -
Accounts Payable –				
Canceled Appropriations	-	-	-	-
FECA Reimbursement to the				
Department of Labor	1,278	1,596	2,874	3,157
Other Liabilities	1,929	-	1,929	1,844
Total Intragovernmental				
Other Liabilities	3,207	1,596	4,803	5,001
<b>Nonfederal:</b>				
Accrued Funded Payroll				
And Benefits	12,245	-	12,245	11,791
Deposit Funds and				
Suspense Accounts	-	-	-	-
Accrued Unfunded Annual				
Leave	26,772	-	26,772	26,529
Advances from Others	38	-	38	10
Total Nonfederal Other				
Liabilities	39,055	-	39,055	38,330
<b>Total Other Liabilities</b>	<b>\$ 42,262</b>	<b>\$ 1,596</b>	<b>\$ 43,858</b>	<b>\$ 43,331</b>

## 7. UNEXPENDED APPROPRIATIONS

As of September 30, (Amounts in Thousands)	2007	2006
<b>Unexpended Appropriations:</b>		
Unobligated, Available	\$ 1,533	\$ 675
Unobligated, Unavailable	6,463	6,161
Unexpended Obligations	18,231	18,396
<b>Total Unexpended Appropriations</b>	<b>\$ 26,227</b>	<b>\$ 25,232</b>

## 8. STATEMENT OF NET COST

The Statement of Net Cost reports DCAA's gross and net costs arrayed as between its two major product lines, forward pricing and incurred cost audits, and other work. The presentation of the two major product lines correlates to DCAA's performance standards/stretch goals as set forth in DCAA Director's Performance Plan with the DoD Comptroller.

<b>As of September 30,</b> (Amounts in Thousands)	<u><b>2007</b></u>	<u><b>2006</b></u>
Intragovernmental Costs	\$ 108,283	\$ 110,889
Public Costs	<u>365,856</u>	<u>357,726</u>
Total Costs	<u>\$ 474,139</u>	<u>\$ 468,615</u>
Intragovernmental Earned Revenue	\$ (55,216)	\$ (57,719)
Public Earned Revenue	<u>(55)</u>	<u>(107)</u>
Total Earned Revenue	<u>\$ (55,271)</u>	<u>\$ (57,826)</u>
<b>Net Cost of Operations</b>	<u><b>\$ 418,868</b></u>	<u><b>\$ 410,789</b></u>

### Disclosures Related to the Statement of Net Cost

The Consolidated Statement of Net Cost in the federal government is unique because its principles are driven on understanding the net cost of programs and/or organizations that the federal government supports through appropriations or other means. Intragovernmental costs and revenue are related to transactions between two reporting entities within the Federal Government. Public costs and revenue are exchange transactions made between the reporting entity and a nonfederal entity. The DCAA is able to compare its intragovernmental costs and revenues with the corresponding balances of its intragovernmental trading partners and disclose any material differences identified within the Department of Defense. In addition, this statement provides gross and net cost information that can be related to the amount of output or outcome for a given program and/or organization administered by a responsible reporting entity.

The amounts presented in the Consolidated Statement of Net Cost are based on budgetary obligations, accrual, and disbursing transactions. The information presented also includes data from non-financial feeder systems to capture payroll expenses.

## 9. STATEMENT OF CHANGES IN NET POSITION

As of September 30, (Amounts in Thousands)	2007	2006
<b>Prior Period Adjustment Increase (Decrease) to Net Position Beginning Balance</b>		
Errors and Omissions in Prior Year Accounting Reports	\$ -	\$ -
Total Prior Period Adjustment	\$ -	\$ -
<b>Imputed Financing</b>		
Civilian CSRS/FERS Retirement	\$ 9,344	\$ 10,227
Civilian Health	19,042	17,732
Civilian Life Insurance	58	56
Judgment Fund	-	131
Total Imputed Financing	\$ 28,444	\$ 28,146

### Imputed Financing:

The amounts remitted to the Office of Personnel Management (OPM) for Civilian Benefit Programs do not fully cover the DCAA's true cost of providing these future benefits to its employees. The DCAA calculates an "imputed financing cost" equal to the difference between the true cost of providing benefits and the contributions remitted.

- CSRS and FERS – The cost factor for CSRS and FERS is the portion of gross pay from which withholdings are made. The FY 2007 cost factors for CSRS and FERS are 25% and 12% (respectively) of basic pay and constitute the total service cost for retirement. The difference between the service cost and contributions is the imputed cost for retirement.
- FEHB – The calculation for imputed costs for the 4<sup>th</sup> Quarter, FY 2007 looks at the actual enrollment in FEHB at three points in time: October 1, 2006, March 31, 2007 and September 30, 2007. A multiplier of one is used for the October and September enrollments and a multiplier of two for the March enrollment. The grand total applying the multiplier is then divided by four to derive the "constructed FEHB enrollment." The constructed FEHB enrollment is multiplied by the 4<sup>th</sup> Quarter, FY 2007 cost factor of \$1 thousand (rounded). This is the imputed cost for FEHB for 4<sup>th</sup> Quarter, FY 2007.
- FEGLI – The imputed cost for providing post-retirement FEGLI benefits is computed using a cost factor of .02% of basic pay for all employees covered by basic life insurance.



## 10. STATEMENT OF BUDGETARY RESOURCES

The Combined Statement of Budgetary Resources reports information on how budgetary resources were made available and their status as of September 30, 2006 and 2007. The budgetary resources section presents the total budgetary resources available to DCAA. For 2006 and 2007, DCAA received approximately \$392.1 million and \$400.1 million, respectively, in budget authority and spending authority from offsetting collections of \$57.8 million and \$55.3 million, respectively.

## 11. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

Beginning 4th Quarter, FY 2007 the Department of Defense (DoD) began presenting the Statement of Financing (SOF) as a note schedule in accordance with the Office of Management and Budget Circular A-136. The SOF will no longer be considered a basic statement and is now referred to as "Reconciliation of Net Cost of Operations to Budget."

As of September 30, (Amounts in Thousands)	2007	2006
<b>Resources Used to Finance Activities</b>		
<b>Budgetary Resources Obligated</b>		
Obligations incurred	\$ 457,960	\$ 447,895
Less: Spending Authority from Offsetting Collections and Recoveries	(61,043)	(61,266)
Net Obligations	\$ 396,917	\$ 386,629
<b>Other Resources</b>		
Imputed Financing from Costs Absorbed by Others	\$ 28,443	\$ 28,146
Net Other Resources Used to Finance Activities	\$ 28,443	\$ 28,146
Total Resources Used to Finance Activities	\$ 425,360	\$ 414,775
<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:		
Undelivered Orders	\$ (3,013)	\$ (3,948)
Unfilled Customer Orders	28	(7)
Resources that Fund Expenses Recognized in Prior Periods	(3,646)	(2,600)
Other - (Increases)/Decreases	\$ -	\$ -
Total Resources Used to Finance Items not Part of the Net Cost of Operations	(6,631)	(6,555)
Total Resources Used to Finance Net Cost of Operations	\$ 418,729	\$ 408,220

**Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period**

Increase in Annual Leave Liability	\$ 243	\$ 1,129
Other	\$ (104)	\$ 1,440
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period	<u>\$ 139</u>	<u>\$ 2,569</u>
<b>Net Cost of Operations</b>	<u><b>\$ 418,868</b></u>	<u><b>\$ 410,789</b></u>

Due to DoD financial system limitations, DCAA's budgetary data is not in agreement with proprietary expenses. These differences between budgetary and proprietary data are a previously identified deficiency for DoD.

The note schedule lines are presented as combined instead of consolidated due to intraagency budgetary transactions not being eliminated:

- Obligations Incurred
- Less: Spending Authority from Offsetting Collections and Recoveries
- Obligations Net of Offsetting Collections and Recoveries
- Less: Offsetting Receipts
- Net Obligations
- Undelivered Orders
- Unfilled Customer Orders

**12. LEASES**

The DCAA leases real property under operating leases. These leases expire in various years. Minimum rental payments under operating leases having remaining terms in excess of one year as of September 30, 2007 for each of the next 5 years and in aggregate are as follows: (Amounts in Thousands)

<u>Year Ended September 30</u>	<u>Operating Lease Amounts</u>
2008	9,606
2009	8,341
2010	6,961
2011	6,081
2012	4,612
2013 and thereafter	<u>7,323</u>
Total Minimum Future Lease Payments	<u>\$ 42,924</u>

Amounts reported as of September 30, 2007 for operating lease future payments represent amounts gathered from lease occupancy agreements.

**DEFENSE CONTRACT  
AUDIT AGENCY**



**REQUIRED SUPPLEMENTAL  
INFORMATION**

## Required Supplemental Information - Part A

## AT97 - Other Defense Organizations General Funds

## Under Secretary of Defense (Comptroller)

## DCAA - Defense Contract Audit Agency

Schedule, Part A DoD Intra-governmental Asset Balances. (\$Amounts in Thousands)	Treasury Index	Fund Balance with Treasury	Accounts Receivable	Loans Receivable	Investments	Other
Department of Agriculture	12		\$21			
Department of Commerce	13		\$15			
Department of the Interior	14		\$19			
Department of Labor	16		\$0			
United States Postal Service	18		\$50			
Department of State	19		\$64			
Department of the Treasury	20	\$45,651	\$45			
Office of Personnel Management	24		\$2			
Social Security Administration	28		\$1			
Nuclear Regulatory Commission	31		\$10			
Department of Veterans Affairs	36		\$23			
General Service Administration	47		\$33			
National Science Foundation	49		(\$29)			
Central Intelligence Agency	56		\$1			
Environmental Protection Agency	68		\$236			
Department of Transportation	69		\$254			
Homeland Security	70		\$302			
Agency for International Development	72		\$124			
Department of Health and Human Services	75		\$227			
National Aeronautics and Space Administration	80		\$715			
Department of Housing and Urban Development	86		\$19			
National Archives and Records Administration	88		\$8			
Department of Energy	89		\$683			
US Army Corps of Engineers	96		\$108			
Other Defense Organizations General Funds	97		\$905			
<b>Totals might not match reports.</b>	<b>Totals:</b>	<b>\$45,651</b>	<b>\$3,836</b>			

**Required Supplemental Information - Part B****AT97 - Other Defense Organizations General Funds****Under Secretary of Defense (Comptroller)****DCAA - Defense Contract Audit Agency**

Schedule, Part B DoD Intra-governmental entity liabilities.  (\$Amounts in Thousands)	Treasury Index	Accounts Payable	Debts/Borrowings From Other Agencies	Other
Department of the Interior	14	\$12		
Department of Labor	16			\$2,874
Department of State	19	\$65		
Department of the Treasury	20	\$3		
Army General Fund	21	\$24		
Office of Personnel Management	24	\$0		\$1,929
General Service Administration	47	\$839		
Air Force General Fund	57	\$10		
Homeland Security	70	\$33		
Department of Health and Human Services	75	\$0		
Other Defense Organizations Working Capital Funds	97-4930	\$936		
<b>Totals might not match reports.</b>	<b>Totals:</b>	<b>\$1,922</b>		<b>\$4,803</b>

**Required Supplemental Information - Part C****AT97 - Other Defense Organizations General Funds****Under Secretary of Defense (Comptroller)****DCAA - Defense Contract Audit Agency**

Schedule, Part C DoD Intra-governmental revenue and related costs.	Treasury Index	Earned Revenue
<b>(\$Amounts in Thousands)</b>		
Department of Agriculture	12	\$177
Department of Commerce	13	\$75
Department of the Interior	14	\$434
Department of Justice	15	\$33
Department of Labor	16	\$10
United States Postal Service	18	\$934
Department of State	19	\$792
Department of the Treasury	20	\$685
Army General Fund	21	\$9
Office of Personnel Management	24	\$18
Social Security Administration	28	\$50
Nuclear Regulatory Commission	31	\$100
Department of Veterans Affairs	36	\$256
General Service Administration	47	\$670
National Science Foundation	49	\$306
Securities and Exchange Commission	50	\$5
Central Intelligence Agency	56	\$1
Air Force General Fund	57	\$9
Environmental Protection Agency	68	\$1,369
Department of Transportation	69	\$2,807
Homeland Security	70	\$2,472
Agency for International Development	72	\$2,290
Department of Health and Human Services	75	\$3,892
National Aeronautics and Space Administration	80	\$17,809
Department of Housing and Urban Development	86	\$68
National Archives and Records Administration	88	\$11
Department of Energy	89	\$13,090
Independent Agencies	95	\$44
US Army Corps of Engineers	96	\$1,878
Other Defense Organizations General Funds	97	\$4,923
<b>Totals might not match reports.</b>	<b>Totals:</b>	<b>\$55,217</b>