



DEFENSE FINANCE AND ACCOUNTING SERVICE

WORKING CAPITAL FUND

FISCAL YEAR 2007 FINANCIAL REPORT

NOVEMBER 2007



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**DEFENSE FINANCE AND ACCOUNTING SERVICE
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007**

In Fiscal Year (FY) 2007, the Defense Finance and Accounting Service (DFAS) continued its endeavor to reform financial management, improve the quality of DFAS products and services, and reduce costs to customers. The DFAS efforts support the President's Management Agenda, the Department of Defense (DoD) transformation initiatives, and the men and women who defend America.

DESCRIPTION OF THE REPORTING ENTITY

DFAS' mission is to direct, approve, and perform finance and accounting activities for DoD. DFAS pays all DoD military and civilian personnel, retirees and annuitants, civilian employees of various federal agencies, major DoD contractors and vendors, and delivers accounting reports and financial information. DFAS employs approximately 13,000 people throughout the United States and in the European and Pacific theaters of operations to serve this purpose. The information in this document, and the accompanying financial statements and footnotes, are the responsibility of DFAS management.

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

In FY 2000 through FY 2007, DFAS received unqualified audit opinions on its financial statements. DFAS has built an effective, accountable management structure with clearly defined, measurable goals. Our progress is charted and regularly reported to our stakeholders. Our programs and initiatives are guided by the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) and Chief Financial Officer (CFO), a Customer Advisory Forum, and an Audit Committee.

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

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

DFAS is a customer-focused, strategy-based, and metrics-driven organization. The DFAS Strategic Plan drives daily operations to help achieve the Agency's vision of transforming with the Warfighter to remain the trusted financial partner for DoD. In refining its strategy for FY 2008 through 2013, DFAS outlined specific goals and objectives (depicted below).

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DFAS has adopted the Balanced Scorecard (BSC) (fiscal year 2007-2009 scorecard displayed below) as a management tool for tracking Agency-wide progress toward achieving its strategic objectives. The BSC enables DFAS to translate its strategy into quantifiable measures and targets by bringing together, in a single management report, various aspects of the Agency's competitive agenda: becoming customer oriented, shortening response time, improving quality, emphasizing teamwork, enhancing employee growth and satisfaction, and positioning DFAS for the future.

PERFORMANCE GOALS AND OBJECTIVES

DFAS is a customer-focused, strategy-based, and metrics-driven organization. The DFAS Strategic Plan drives DFAS operations every day to help DFAS achieve its vision of becoming a world-class finance and accounting organization that delivers the best value to our customers. Supporting this strategy, DFAS has identified the following goals and objectives that address the critical issues facing our customers and our core capabilities:

FY 2007 Strategic Plan Goals:

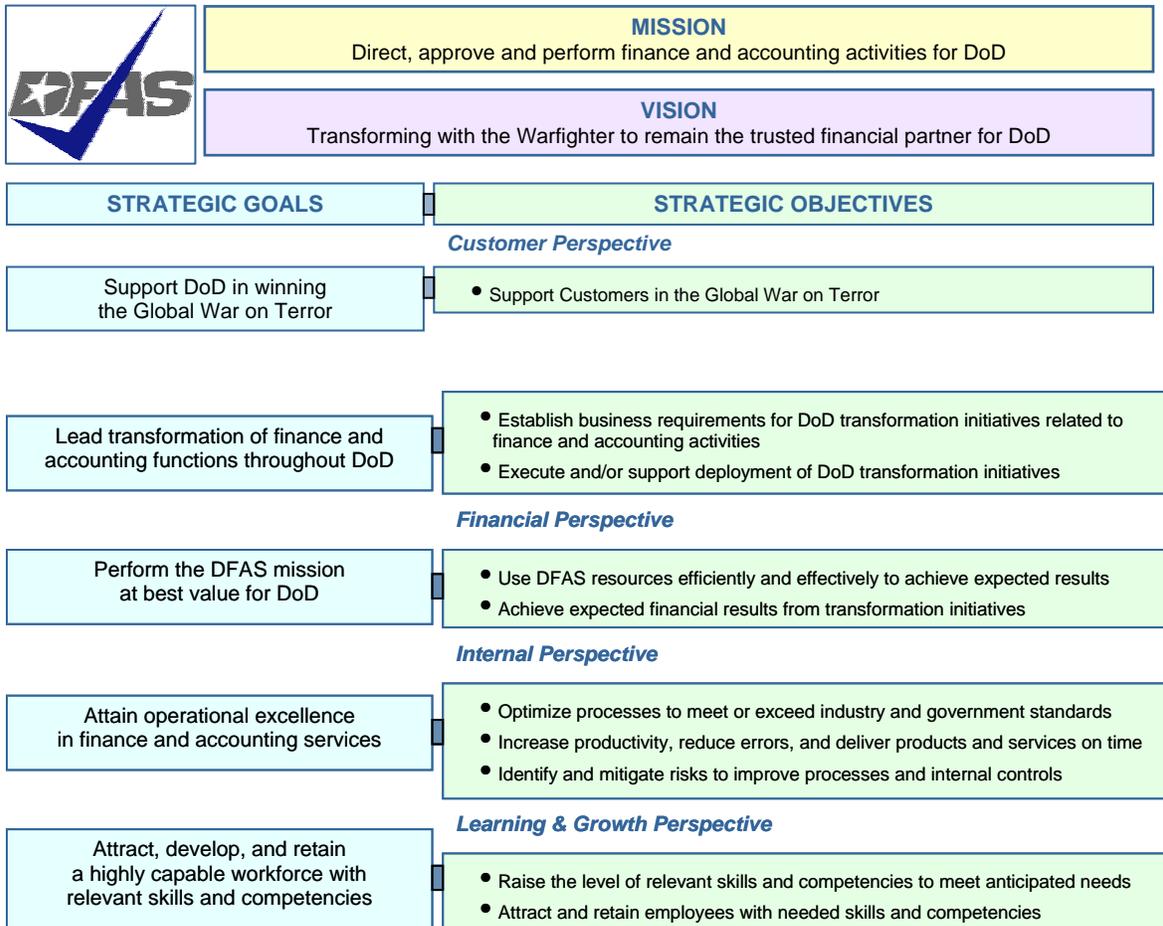
- Attain operational excellence in finance and accounting services
- Deliver financial information 'on demand' for decision makers
- Transform DFAS to become a Center of Excellence
- Attain a highly professional workforce with indispensable skills and competencies

FY 2007 DFAS Objectives:

- Provide instant access to comprehensive financial data
- Provide quality financial and timely advice
- Establish dynamic partnerships to execute Enterprise Resource Planning (ERP) solutions
- Implement 'best business practices' to increase productivity and reduce costs
- Integrate e-Solutions through state-of-the art technology
- Fulfill Base Realignment and Closure (BRAC) requirements
- Create Centers of Excellence and High Performance Organizations
- Execute National Security Personnel Systems requirements
- Re-shape workforce to meet mission needs

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DFAS STRATEGY 2008-2013



These goals and objectives will allow DFAS' leadership to examine the Agency's business from four important perspectives by providing answers to four basic questions:

- How do our customers see us? (customer perspective)
- Are our processes efficient and effective? (internal perspective)
- Can we continue to improve and create value? (learning and growth/innovation perspective)
- What is the impact of strategy execution on bottom-line resource management? (financial perspective)

DFAS turns its strategy into meaningful, measurable initiatives through the use of the BSC. Updated each year, the BSC includes measures organized into four perspectives: customer, financial, internal and growth and learning. At DFAS, every measure has an executive sponsor and 'measure expert' to champion organizational progress in that area. Using the BSC to make

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the connection from DFAS' vision and strategic targets to individual performance and standards allows our employees to see how they contribute to corporate goals.

The BSC, along with key indicator reports and performance measurement indicators, is used to monitor the overall health of the organization. It provides operational and financial performance indices to effectively and efficiently manage our business operations. Performance objectives in the BSC focus on continued achievement of the DFAS mission for providing responsive, professional finance and accounting services for the people who defend America. Our Deputy Directors continue to improve BSC reporting under its four perspectives. Success factors for each of its supporting measures are reviewed, compiled and analyzed monthly. Any out-of-tolerance conditions are reported to management, along with a plan of action and milestones, to mitigate the situation.

Customer and quality indices are used to evaluate the efficiency and effectiveness of operations. These indices provide management with real-time information to assist in identifying areas requiring improvement and/or modification. Employees are kept apprised of BSC measures and any corrective actions necessary to achieve established goals. Coupled with an extensive communications effort to ensure employee understanding, the BSC enables DFAS to avoid the perils of improvement in one area at the expense of another through a multidimensional approach to assessing the Agency's overall performance.

The following accomplishments highlight the magnitude of DFAS' worldwide operations during FY 2007:

- Processed 154.6 million pay transactions (5.9 million people)
- Made 6.9 million travel payments
- Paid 14.2 million commercial invoices
- Posted 57 million general ledger transactions
- Managed military retirement and health benefits funds (\$328 billion)
- Made approximately \$446 billion in disbursements to pay recipients
- Managed \$22.1 billion in foreign military sales (reimbursed by foreign governments)
- Account for 878 active DoD appropriations

TRANSFORMATION AND REORGANIZATION

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

The DFAS transformation strategy is aligned with the DoD's transformation goals and objectives and with the President's Management Agenda. DFAS transformation includes proactive planning for the future, emphasis on "best value" solutions, agility to address DoD and customer objectives, and employee participation.

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The DFAS transformation strategy leverages and integrates a large, complex portfolio of cross-cutting Agency level Transformation events, while ensuring other business functions have the proper oversight and control. The ultimate objective of the organization is to optimize performance and continue to reduce costs.

With oversight by the Transformation Directorate, Strategic Business Management Deputate (SBM), the Agency continues to integrate plans and project schedules for the major transformation initiatives impacting DFAS during 2007 and beyond. The executive leadership has validated an inventory of approximately 40 initiatives. Project management assessments were completed for each initiative, with the primary goals to validate baseline information and to monitor the achievement of key milestones and project outcomes. In conjunction with the DoD Business Transformation Agency (BTA) Enterprise Transition Plan, DFAS created an initial Transformation Integrated Master Schedule and governance process to support DFAS management of Transformation costs, schedules, and performance, both individually and across initiatives.

The Transformation Directorate also manages all BRAC 2005 actions for DFAS. BRAC legislation directed DFAS to close 20 sites within the continental United States and Hawaii, realign the functions performed in the Arlington, VA site, except for essential DFAS liaison staff, and migrate the functions into five Enduring Sites in Cleveland, OH; Columbus, OH; Indianapolis, IN; Limestone, ME; and Rome, NY. During FY 2007, DFAS successfully closed six (6) sites, bringing the total number of sites closed since June 2006 to eleven (11), all on schedule and within budget.

In FY 2007, Dayton, OH; Lawton, OK; Norfolk, VA; Ford Island, HI; St. Louis, MO; and Orlando, FL. closed on schedule and within budget. DFAS provided employee transition options that included paid relocation, priority placement with other agencies, early retirement incentives, and potential private sector employment opportunities. For sites closed in FY 2007, 50% of the employees accepted DFAS or other agency employment, 31% retired, and 19% were separated voluntarily or under a Reduction in Force (RIF) actions.

For all FY 2007 site closures, workload transition to the Enduring Sites occurred while sustaining the quality of customer deliverables. This outcome was achieved through diligent

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project planning and execution by DFAS personnel and through the use of \$64 million of BRAC Operations & Maintenance financing utilized in support of DFAS BRAC efforts.

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

1. Principal Deputy Director

- Business Intelligence
- Information and Technology
- Enterprise Management Services
- Internal Review
- Office of General Counsel
- Chief of Staff
- Equal Employment Opportunity

2. Strategic Business Management

- Policy and Performance Management
- Transformation
- Financial Management Center of Excellence
- Office of Strategy Management
- Human Resources

3. Operations

- Indianapolis
- Columbus
- Cleveland
- Denver
- Kansas City
- Standards and Compliance

PRINCIPAL DEPUTY DIRECTOR

Information and Technology

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

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Accomplishments/Initiatives:

- As a part of the Agency transformation initiative, in mid-FY 2005, all Agency operational applications were moved from the DFAS Business Lines (BLs) to the Chief Information Officer (CIO). FY 2006 was the first year that the DFAS CIO was directly responsible for managing all systems supporting operational requirements while fostering the execution of the DFAS BRAC and Transformation plans, concurrently. In addition, this initiative provided economies of scale in the operation and oversight of the Agency's applications; provided the capability to prioritize initiatives across BLs, and provided for system management standardization that will improve efficiency. Ultimately, this DFAS Transformation initiative enhanced operations, fostered consolidation and enabled DFAS to more readily support the Department's Financial Improvement plans.
- Technology Services Organization-Kansas City (TSO-KC) was transferred from the DFAS to the U. S. Marine Corps (USMC) at the end of FY 2006. The transfer of resources and functions was agreed to by USMC and DFAS, and approved by the OUSD(C). TSO-KC provides for application development, operation, maintenance of the family of systems represented by the Marine Corps Total Force System, the Standard Accounting, Budgeting and Reporting System, and the Reserve Order Writing System(s).
- In FY 2006, DFAS initiated action to merge the Information Services and Financial Operations Business Areas. Prior to this time, DFAS maintained two distinct working capital funds, one for financial operations activities and the other for software maintenance and development activities. Maintaining two distinct working capital funds required separate accounting, budgeting and reporting activities. Combining these funds into a single working capital fund eliminated unnecessary duplication. Workload related to the management of reimbursable activities between the two working capital funds has been reduced due to the timely processing of financial transactions. This efficiency was achieved by eliminating the lag time occurring between the two business areas, improving cash management. DFAS implemented this change in FY 2007 using a two phased approach which recognized FY 2007 as a transitional year and the complete elimination of the Information Services Business Area in FY 2008.
- The Desktop Management Initiative (DMI) is a DFAS business initiative to provide Managed Desktop Services to DFAS users worldwide and includes a Centralized Help Desk, Standard hardware, Standard Desktop Software, Standard Software Release Procedures across DFAS, Standard ordering processes for DMI items via the Web Ordering System (WOS), Technical Support based on Service Levels, and Industry Best Practice Technologies. It is intended to reduce total cost of desktop and help desk operations by standardizing service and equipment across the enterprise and to improve end user productivity and customer satisfaction. Prior to DMI implementation, the yearly cost of DFAS in-house desktop support was estimated at \$1,856 per seat by the Gartner Business Case Analysis. The current cost under DMI is \$1,441 per seat annually.
- To foster the Agency's transformation, the Director of I&T revised the DFAS Regulation 8430.1-R "Automated Information Systems (AIS)", and the DFAS Regulation 8500.1-R,

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"Information Assurance (IA)." The DFAS 8430.1-R was updated to incorporate Clinger-Cohen Act requirements and to clarify the delineation of duties among organizations within the AIS. The DFAS 8500.1-R was updated to implement the DoD IA Certification and Accreditation Process (DIACAP) and to move DFAS IT towards the use of stricter IA controls. Both DFAS regulations will be published before the end of the fiscal year. The remaining four DFAS IT regulations are scheduled to be updated during FY 2008. The DFAS 8400.1-R covering DFAS Infrastructure is currently under review. The Director of I&T has established the plan for an annual review to ensure DFAS IT policies evolve with the Agency.

- Using our existing agency Internal Review, Information Assurance (System Certification and Accreditation), Federal Manager's Financial Integrity Act (FMFIA) and like management control processes as a means to identify and categorize potential process issues, DFAS has created a "Proactive Audit Strategy" to address and potentially mitigate these issues as self-identified and corrected issues. Our goal is to improve our financial management processes by reducing and potentially eliminating repeat or duplicative audit findings.

ENTERPRISE MANAGEMENT SERVICES

Risk Management Office

The DFAS established the Strategic Risk Management Office (SRMO) under the Enterprise Management Services. The SRMO was established to facilitate a risk-based approach to strategic planning as overall risk portfolio, tolerance for specific risks and overall risk management capability are key inputs to strategy development and execution planning. In addition, SRMO provides a single point of accountability for the DFAS Enterprise Risk Management (ERM) program to insure a sustained and consistent focus on organizational acceptance, ERM process implementation and continuous improvement.

The SRMO is responsible for providing the DFAS Director and executive management a comprehensive assessment of risk exposure. To accomplish this, the SRMO ensures the following:

- Development and validation of risk measurement methodologies, valuation methodologies and qualitative and quantitative limits
- The DFAS ERM program is consistently applied throughout the Agency
- The alignment of DFAS' risk management capabilities with its strategic direction by integrating risk assessment with the strategic planning process
- Appropriate internal controls are in place and operating within the Agency

Accomplishments:

Improved Internal Control BSC Measures to focus on four major areas:

- Self-Identified Deficiencies

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- Material Weakness Milestones
- Assessable Unit Control Evaluations
- Audit Recommendations/Corrective Action Plans

Lead a robust "Check It" awareness campaign
Lead a robust internal control training program

Implemented Office of Management and Budget (OMB) Circular A-123, Appendix A for Internal Control over Financial Reporting which:

- Improved the process flowcharting, narratives, risk assessments, testing, and control analyses of the internal controls used to mitigate material misstatement of the financial reports.
- Identified process owners for specific financial statement line items
- Provided training and guidance to our subject matter experts
- Ensured appropriate testing of the controls and documenting of the test results
- Improvement of the Appendix A assessments for internal control effectiveness and documentation is on-going
- Introduced Taxonomy under the ERM Program

Initiatives

Future goals include:

- Development of a ERM dashboard that integrates the Agency's compliance programs
- Implementation of the Business Activity Monitoring tool with sophisticated analytics for pattern recognition, perceptive modeling, probabilistic evidential reasoning and temporal and state analysis capable of identifying sequences of concealment

Operational Risk Management Office

The Operational Risk Management Office (ORMO) provides an integrated approach to enterprise operational risk management. The ORMO provides discipline, structure, and increased accountability across the enterprise; streamlines project management processes; provides management with risk and risk mitigation visibility; and enables a culture of continuous process improvement within DFAS.

Accomplishments

Established the Project Management Center of Excellence:

- Developed and implemented management standards
- Assessed DFAS transformation initiatives' compliance with established standards, and consulted project managers to comply with standards
- Established a project management community within DFAS
- Delivered project management and earned value management training to more than 440 project managers

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- Deployed a project server that provides a central repository and management tool for all DFAS projects and initiatives

Fostered a continuous process improvement culture wherein DFAS employees are empowered to improve business processes:

- Benchmarked DFAS Green Belt and Black Belt training with industry leaders
- Achieved open degree accreditation for Black Belt training
- Delivered Green Belt training to more than 1300 employees
- Trained 11 additional Black Belts
- Certified 56 Green Belts and Black Belts
- Facilitated the completion of 56 process improvement projects, generating an estimated savings of \$19 million
- Conceived and implemented a plan to achieve Deputy Secretary of Defense Continuous Process Improvement/Lean Six Sigma Goals

STRATEGIC BUSINESS MANAGEMENT

The SBM Deputate focuses on the Agency strategic goals of operational excellence, on-demand financial information, becoming a Center of Excellence, and attaining a highly professional workforce with indispensable skills and competencies. During FY 2007, DFAS made significant progress in several strategic areas. SBM's mission is to:

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

Accomplishments/Initiatives:

During FY 2007, DFAS made significant progress in several areas. Specific results include:

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Policy/Strategic Management:

- Published nearly 50 DoD Financial Management Regulation chapters and numerous DoD and DFAS policies.
- Developed a plan to update DoD Financial Management Regulation chapters at least every two years to support the Deputy Secretary of Defense's objective to keep DoD regulations current.
- Updated DFAS' Strategic Plan to more closely link to the DoD's strategic priorities.
- Utilized the FY 2007 BSC to analyze performance, drive best business practices, achieve high-quality results, and accomplish strategic goals.
- Recognized in an article by the Harvard Business School of Publishing for DFAS' use of the BSC to transform into a more effective organization.

Expanded DoD-wide cash management tools, such as the International Treasury Services system and FedLine Advantage to improve EFT payments and processing, as well as debit and stored value card programs to reduce the amount of disbursing officer cash on-hand and minimize risk of loss/theft.

Financial Management Center of Excellence (FMCOE)

In July 2007, the Financial Management Center of Excellence (FMCOE) was established within SBM. This new organization has the mission to develop and integrate standard finance and accounting business practices across DoD. To achieve the given mission, the FMCOE has established the following five goals:

1. Accelerate System Delivery
2. Reduce Risks Associated with System Delivery
3. Standardize Finance and Accounting Practices in DoD
4. Optimize Costs of Providing Finance & Accounting Services
5. Improve Financial Management

This organization has as its core, a Shared Services Directorate that develops standard products, such as requirements, test scenarios, and system interfaces that can be shared across systems initiatives. Using these standard products, project teams working on initiatives for the Office of the Secretary of Defense (OSD), the Military Departments, and Defense Agencies can quickly supply solutions to their customers while simultaneously driving standardization across the DoD enterprise. Improved business processes supported with state of the art technologies will enable the financial community to reduce the cost of accounting and financial services, and enable financial managers to leverage, real-time financial information for decision making.

Accomplishments:

Defense Integrated Military Human Resource System (DIMHRS)

DIMHRS will provide an integrated, multi-component, personnel and pay system supporting Army and Air Force service components. It will collect, store, pass, process, report and deliver

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timely and accurate pay and benefits, through the use of a single, comprehensive record of service. The integration, self-service, and technological enhancements will facilitate more than a 65% reduction in the DFAS military pay staff support.

DIMHRS Integration Office (DDIO) Sets New Implementation Strategy for DIMHRS

Following a detailed review, the DDIO used the results of the "DFAS After DIMHRS" analysis and the subsequent Business Process Change Review to move into the next phase of the program. DDIO adheres to the Lean 6 strategy and supports the governance structure that places the ownership, responsibility, and accountability for affecting the required business change with those within DFAS who have the authority to do so. DDIO will remain engaged with the process guiding, monitoring and supporting those involved. DDIO staff will be assigned as change agents to assist the 93 change teams that are being set up to manage the change, the teams being lead by appropriate representatives from the Operations and Systems areas. DDIO will also be providing tools to assist the Change Teams to monitor and report status via a database that will ultimately link to an online Executive Dashboard.

Defense Travel System (DTS)

On April 28, 2007 DTS implemented a DFAS championed change to require mandatory electronic funds transfer (EFT) information in DTS. All DTS payments are now via EFT, except for rare, separately-justified exceptions. This change eliminates the 4000-5000 checks issued per month from DTS, positively influences DoD performance toward meeting the OMB goal of 99% EFT payments, and eliminates traveler payment delays when Treasury checks are lost in the mail.

General Funds Enterprise Business System (GFEBs)

GFEBs is the U.S. Army web-based, ERP solution that will enable compilation and sharing of accurate, up-to-date resource management data across the Army. It will leverage commercial, off-the-shelf business enterprise software, supply standardized, real time finance data and information, and empower leadership to make strategic business decisions that have a direct and positive impact on the war fighter.

On May 1, 2007, GFEBs began the Design Phase. The Design Phase was scheduled from May 1, 2007, through September 30, 2007. During this phase, the team further refined the Business Process Designs to the detailed level, identified which applications supported the target business processes and the relationship between them, and developed functional design of reports, interfaces, conversions, extensions, forms, and workflow as needed. DFAS supports the Army in partnering in this initiative.

Defense Enterprise Accounting Management System (DEAMS)

DEAMS is a web-based, financial management ERP initiative that will transform business and financial management processes and systems to provide accurate, reliable, and timely business information to support effective business decision making for U.S. Transportation Command, U.S. Air Force, and the DFAS. DEAMS is being deployed in two increments, with several

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spirals and waves. Increment 1 (TRANSCOM), Spiral 1 (Commitment Accounting), Wave 1 (4 units on Scott AFB) was deployed July 27, 2007.

The DEAMS Functional Management Office (FMO) was also working on Spiral 2 Functional Design during this fiscal year. Spiral 2 is broken into 24 Capability Groups, scheduled to be completed by February 2008. DFAS has partnered with the DEAMS Program Management Office to provide support for all components relating to core financial processes as it pertains to blueprinting, requirements definition, interfaces, testing, training, and implementation strategies.

Standard Financial Information Structure (SFIS)

The Defense Departmental Reporting System-Budgetary (DDRS-B) Implementation of the Standard Financial Information Structure (SFIS) took effect on May 1, 2007. In DDRS-B Standard Fiscal Code (SFC) values are replaced with SFIS data elements and existing trial balance data are cross walked to SFIS data elements. No change is required to monthly data DDRS receives from DFAS systems. This implementation provides the DoD standard attributes for financial management (FM) and external reporting. The strategy leverages COTS capabilities and integrates existing operational capabilities into the "Transitional State" and "Target Solution."

DFAS Corporate Electronic Document Management System (CEDMS)

During FY 2007, DFAS began implementing the Corporate Electronic Document Management System (CEDMS) to deliver document imaging, storage, and retrieval capabilities to all Operational/Mission areas at all DFAS sites. DFAS managed successful completion of system development, completed user acceptance testing, and implemented CEDMS at the following DFAS sites: Denver, CO; Rome, NY; Charleston, SC; San Diego, CA; Kansas City, MO; Columbus, OH; Pensacola Naval Air Station, FL; Rock Island, IL; and Omaha, NE. As of September 30, 2007, these sites have scanned over 4.2 million pages of various document types into CEDMS. DFAS directly supported Global War on Terrorism (GWOT) by implementing CEDMS for Army Units in Kuwait as well as initiating implementation in Iraq. The contract for the next release of CEDMS was awarded during FY 2007, and DFAS initiated a long-term CEDMS strategic plan to further support DFAS goals and objectives.

DFAS Electronic Solutions Strategic Plan

DFAS views the linkage of finance with information technology as a value-adding strategic partnership, delivering the latest technology to the Department's financial transactions. DFAS aims to achieve success by expanding e-commerce initiatives. Implementing electronic commerce (EC) solutions that accelerate and target new and current e-commerce initiatives will generate an opportunity to reduce costs for the Department. Additionally, DFAS supports the Enterprise Transition Plan (ETP) emphasizing best value to the war fighter, our customers, and the American taxpayer by implementing electronic capabilities. In 2007, DFAS established the architecture for managing and coordinating the expansion/acceleration of several existing EC capabilities through the following plans and project charters:

- EC Communication Plan for Current and Existing Initiatives

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- EC Governance Plan
- Air Force Vendor Pay EC Strategic Plan
- Project Charters to expand/initiate EC Solutions for WAWF for Utility Payments, WAWF for Miscellaneous Pay, Increase use of SPS, WAWF and GPC, and the Automation of the Travel Debt Notification
- Lean 6 Diagnostic for Electronic Contractual Documents to MOCAS completed which resulted in – two Black Belts, four Green Belts and six Just-do-it assignments
- Incorporated EC initiatives in the FIAR Plan and AP Working Group efforts.

Standard Functional Requirements

The DFAS FMCOE mission is to develop standard, consistent and effective requirements for DoD Financial and Accounting systems and operations. The COE completed Functional Requirements Development Plans and applicable schedules for the seven core financial areas. These plans, to include resources required, will be used to accomplish a consolidated project plan for development of the standard (enterprise) functional requirements. The plans will also be provided to the Business Line Directors to support and identify numbers and dates that Subject Matter Experts (SMEs) will be requested to support requirement reviews.

Transformation Initiatives/Accomplishments:

DFAS Transformation Master Integrator Model

DFAS is using a Master Integrator model to anchor, monitor, and identify the linkages between Transformation events. The result of using this model is a Transformation Integrated Master Schedule (IMS) capability that documents agency initiatives from the project milestones, schedules, interdependencies, and critical paths perspectives. The outputs generated by this capability will enable DFAS to assess project maturity and complexity and provide an integrated, cross-initiative view to executives and stakeholders.

DFAS Master Integration Contract Augments Transformation Mission Requirements

In May 2006, DFAS awarded a Blanket Purchase Agreement to support DFAS Transformation mission requirements that exceed agency status quo capacity or to augment skill sets through the use of contract labor. To ensure integration of the execution of DFAS strategic initiatives, DFAS implemented a business model where the activities of multiple contractor teaming partners supporting Transformation are anchored and monitored through the leadership of a Master Integrator. The Master Integration Contract has successfully supported DFAS by providing consulting services, program integration and project management support, training, and augmentation of core mission area work. A new acquisition strategy is being planned and will be in place by FY 2008. It will augment the existing capabilities provided by the Master Integration Contract with multiple teaming partners.

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OPERATIONS

The Operations mission is to support the warfighting capability of the DoD by paying people and contractors correctly, recording financial events correctly, and producing timely and accurate reports on the financial condition of the DoD.

To achieve the given mission, Operations will continue to improve in paying people and vendors and properly recording and reporting accounting events in the book of official record by:

- Assuring the proper recording of payables and receivables from the entitlement systems into the accounting system, and
- Synchronizing the recording of accounting events with the reporting of the financial condition of the Military Departments and Defense Agencies.

Accomplishments

In FY 2007, DFAS made progress in several critical operational areas in support of the key strategic targets. Specific results include:

Wounded Warrior Program

- The Wounded Warrior Pay Management Team prepared and submitted over 1,500 Remission Packets for adjudication and input over 800 remission approvals over a two-week period which eliminated backlog and improved customer support.
- Developed and published a Wounded Warrior Entitlement booklet which uses scenarios to explain answers to typical questions on entitlements. In addition, DFAS published four tri-folds covering specific pay entitlement information: Savings Deposit Program; Deployment Entitlements; Travel Pay for Wounded Warriors; and Invitational Travel orders. Customer reaction to these documents was very positive.
- Provided entitlement information for Wounded Warrior on the DFAS website for easy access by customers.
- Established a central processing office to expeditiously process all Wounded in Action (WIA) and Killed in Action (KIA) travel claims for mobilized soldiers. This office also expedites Invitational Travel Orders for families of mobilized soldiers. Reduced turn-around time for Wounded Warrior travel vouchers to an average of three days or less. Phone inquiries are answered in less than one minute and all claims logged in within 24 hours. Two dedicated resources are available to travel immediately to assist members and families.
- Conducted gap analysis and increased specially trained Wounded Warrior Pay team staffing at critical field locations. This ensures face-to-face pay support to these special customers and their families within 72 hours of their arrival at medical treatment facilities. Improved travel advance capability for Wounded Warriors and families at Walter Reed Army Center and troops evacuated to Lundstuhl Regional Medical Center.

**DEFENSE FINANCE AND ACCOUNTING SERVICE
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007**

- Completed the 2007 National Defense Authorization Act audit of pay accounts for soldiers who were evacuated from a theater of operations for medical inpatient treatment between May 1, 2005, and April 30, 2006. Army submitted report to Congress on February 14, 2007.

Military Pay

- FY 2007 average for Military Pay timeliness improved to 93.2%, up from the monthly FY 2006 average of 90.4%. This represents a 2.8-percentage point (approximately 3.1 million additional timely transactions) improvement. This is the best performance since the inception of the OSD Personnel/Pay Council.
- Successfully implemented year-end changes to both military pay systems – Defense Joint Military Pay System and the Marine Corps Total Force System. Results were timely and accurate pay and tax statements and production savings of \$1.7 million.
- Successfully printed and distributed tax statements for all supported pay activities on time. The timely availability of these statements resulted in continued encouragement to use MyPay and the electronic statement. On January 24, 2007, MyPay had 25 million user hits -- a new record. This was 8 million more than the previous high reached earlier in January 2007.
- The MyPay team received the LTG Timothy J. Maude award for exceptional contributions that materially enhanced soldier welfare and/or family quality of life for significant numbers of the United States Army. The team implemented a variety of security features to protect soldiers' personal financial data when transmitting to their computer. This secure technology met or exceeded security requirements in private industry. These features allowed soldiers or their family members to make pay changes online and provided the capability to view pay, tax, saving deposit, and 1099 INT statements.

Other Initiatives:

- The Commerce and Industry Association of Caribou, Maine recognized DFAS Limestone as the 2006 Business of the Year.
- Implemented the DTS program change for mandatory EFT reimbursement for all payments on April 28, 2007. This will save over \$40K annually in paper check production costs.
- Developed formal requirements for a new Global War on Terror (GWOT) Disaster Relief reporting initiative, obtained necessary approvals to pursue development and testing of an automated, web-based application to create all required monthly and quarterly reports.
- Lead the GWOT PMO audit team, which is a top priority for the Director of DFAS and the OUSD(C). We provided timely and comprehensive audit summaries on the high visibility

**DEFENSE FINANCE AND ACCOUNTING SERVICE
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007**

GWOT audits. We initiated continuous communication with the DoD Office of Inspector General and the Government Accountability Office on GWOT audits during their fieldwork and obtained advanced intelligence on potential audit findings. We either mitigated or minimized the findings by proactively seeking and ensuring implementation of corrective actions with the Services prior to the issuance of the final report.

- Implemented the Audit Status Report, which will provide the most current status of audits in the fieldwork stage. The report will be forwarded to management on a bi-weekly basis. The goal is to have an update that is never more than two months old. The new ALO tracking tool identifies if current information is reported in Remedy, which is important to managing ongoing audits. We experienced material improvements when the report was implemented, as current information on audits in Operations improved from 36% to 61%. Ensured the "In Process Update" field in Remedy was updated for all S&C Finance Mission audits in the Fieldwork stage.
- Completed a system change request for Wide Area Work Flow to upgrade the current default on Fast Pay Invoices designation. This will allow the submission of a receiving report and the invoice simultaneously. Upon receipt of these documents, we will be able to pay them in accordance with Fast Pay Procedures and will save the AP Enduring Operations time and effort.
- Coordination between DFAS-Cleveland, Navy field sites, and the In-transit Advocate enabled DFAS-Cleveland to resolve a long-standing Interfund issue related to the charging of invalid accounting activities. This resulted in a \$20 million decrease to their over-aged in transit balance and enabled them to meet their March 2007 in transit Financial Operations Metric goal.
- Reviewed and provided to Indianapolis AFS department, the FY 2007, 2nd quarter, in transit, Unmatched Disbursements (UMD), and Negative Unliquidated Obligations (NULO) data to support Note 3 of the quarterly financial statements for our customers. In-transits reduced from \$12.3 billion to \$7.6 billion, UMDs were unchanged at \$1.8 billion, and NULOs reduced from \$373 million to \$128 million.
- Completed the project to standardize assessable units (AUs) in Operations which reduced reporting across the organization by over 250 AUs.
- Converted 9,284 Federal Emergency Management Agency employee payroll accounts into the Health and Human Services Defense Civilian Pay system (DCPS) database for the pay period beginning April 30, 2007. These are intermittent employees that are normally called to duty during a crisis. There were approximately 100 active accounts at the time of conversion and there were no payroll problems experienced during the first pay periods after conversion.
- Successfully converted approximately 1,900 Broadcast Board of Governors employee accounts to e-Payroll in June 2007.

**DEFENSE FINANCE AND ACCOUNTING SERVICE
MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007**

- Implemented the Certified Payroll Professional certification for payroll operations employees at the DFAS payroll centers. The site serving the Army and Air Force began on an exam fee reimbursable basis in May 2007 and organizations servicing the Navy will begin in October 2007 with two certification classes per quarter.
- Cleared \$80 million in aged "Statement of Transaction to Detail" differences for our customers as chargeback packages were processed to DFAS-Indianapolis and DFAS-Cleveland in compliance with current standard operation procedures.

Initiatives:

- Improve field-level military pay timeliness
- Establish e-solutions capabilities that show measurable results
- Appoint Project Officers for each material weakness identified on the FY 2006 Statement of Assurance
- Focus on Hazardous Fire Pay problem occurrences during field site training
- Develop a policy for returning invoices with no Taxpayer Identification Number and coordinate with Site Directors and customers
- Develop compliance review check list for all of our mission areas
- Complete work on e-Biz (Electronic Business Accounting and Management System) codes related to direct/indirect coding and correct coding related to unassigned costs
- Establish a prepayment review and validation process

FINANCIAL CONDITION

The financial statements have been prepared to report the financial position and results of operations for DFAS, pursuant to the requirements of Title 31, United States Code, Section 3515(b).

While the statements have been prepared from the books and records of the entity in accordance with accounting principles generally accepted in the United States of America and the formats prescribed by the OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

DFAS' financial condition is sound. DFAS received consecutive unqualified opinions on its financial statements from an independent Certified Public Accounting firm in FY 2000 through FY 2007.

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

**DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2007 AND 2006**

Dollars In Thousands	<u>2007</u>	<u>2006</u>
ASSETS		
Intragovernmental:		
Collections and Disbursements Clearing Account	\$ -	\$ -
Accounts Receivable	9,188	35,353
Total Intragovernmental	9,188	35,353
With the Public:		
Accounts Receivable	675	594
General Property, Plant and Equipment (Note 2)	566,407	670,006
Other Assets	58	38
TOTAL ASSETS	\$ 576,328	\$ 705,991
LIABILITIES		
Intragovernmental:		
Accounts Payable	\$ 41,309	\$ 59,607
Other Liabilities (Note 3)	13,734	13,952
Total Intragovernmental	55,043	73,559
With the Public:		
Accounts Payable	63,462	85,364
Actuarial FECA Liability (Notes 4 and 5)	38,245	39,993
Accrued Payroll and Benefits (Note 3)	93,355	96,496
TOTAL LIABILITIES	250,105	295,412
NET POSITION		
Cumulative Results of Operations	326,223	410,579
TOTAL NET POSITION	326,223	410,579
TOTAL LIABILITIES AND NET POSITION	\$ 576,328	\$ 705,991

The accompanying notes are an integral part of these statements

**DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF NET COST
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

Dollars In Thousands	<u>2007</u>	<u>2006</u>
PROGRAM COSTS		
Intragovernmental Gross Costs	\$ 500,345	\$ 528,567
Less: Intragovernmental Earned Revenue	<u>(1,501,948)</u>	<u>(1,617,180)</u>
Intragovernmental Net Costs	(1,001,603)	(1,088,613)
Gross Costs With the Public	1,095,797	1,222,840
Less: Earned Revenue From the Public	<u>(1,875)</u>	<u>(1,563)</u>
Net Costs With the Public	<u>1,093,922</u>	<u>1,221,277</u>
NET COST OF OPERATIONS	<u>\$ 92,319</u>	<u>\$ 132,664</u>

The accompanying notes are an integral part of these statements

**DEFENSE FINANCE AND ACCOUNTING SERVICE
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

Dollars In Thousands	<u>2007</u>	<u>2006</u>
Cumulative Results of Operations		
Beginning Balances	\$ 410,579	\$ 585,409
Budgetary Financing Sources		
Appropriations Used	-	70
Other Financing Sources		
Transfers-In/Out Without Reimbursement	(69,042)	(153,876)
Imputed Financing Sources (Note 6)	82,294	91,734
Other	(5,289)	19,906
Total Financing Sources	7,963	(42,166)
Net Cost of Operations	92,319	132,664
ENDING BALANCES	\$ 326,223	\$ 410,579

The accompanying notes are an integral part of these statements

**DEFENSE FINANCE AND ACCOUNTING SERVICE
COMBINED STATEMENTS OF BUDGETARY RESOURCES
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

Dollars In Thousands	2007	2006
BUDGETARY RESOURCES		
Unobligated Balance, Beginning of Period	\$ 91,207	\$ 207,015
Recoveries of Prior Year Unpaid Obligations	72,066	69,783
Budget Authority		
Appropriation	-	70
Contract Authority	28,793	51,156
Spending Authority from Offsetting Collections:		
Earned:		
Collected	1,538,675	1,865,137
Change in Receivables from Federal Sources	(30,821)	(91,524)
Change in Unfilled Customer Orders:		
Advance Received	-	(4,111)
Without Advance from Federal Sources	(62,472)	17,996
Subtotal	<u>1,474,175</u>	<u>1,838,724</u>
Permanently Not Available	<u>(91,303)</u>	<u>(300,130)</u>
Total Budgetary Resources	<u>\$ 1,546,145</u>	<u>\$ 1,815,392</u>
STATUS OF BUDGETARY RESOURCES		
Obligations Incurred:		
Reimbursable	<u>\$ 1,532,529</u>	<u>\$ 1,724,185</u>
Total Obligations Incurred	1,532,529	1,724,185
Unobligated Balance:		
Apportioned	<u>13,616</u>	<u>91,207</u>
Total Status of Budgetary Resources	<u>\$ 1,546,145</u>	<u>\$ 1,815,392</u>
CHANGE IN OBLIGATED BALANCE		
Obligated Balance, Net - Beginning of Period	\$ 155,772	\$ 132,937
Obligations Incurred, Net	1,532,529	1,724,185
Less: Gross Outlays	(1,486,938)	(1,705,095)
Less: Recoveries of Prior Year Unpaid Obligation	(72,066)	(69,783)
Change in Uncollected Customer Payments from Federal Sources	93,292	73,528
Obligated Balance, Net - End of Period:		
Unpaid Obligations	259,244	285,720
Less: Uncollected Customer Payments from Federal Sources	(36,655)	(129,948)
Total, Unpaid Obligated Balance, Net, End of Period	<u>222,589</u>	<u>155,772</u>
Net Outlays:		
Gross Outlays	1,486,938	1,705,095
Less: Offsetting Collections	(1,538,675)	(1,861,026)
Subtotal	<u>(51,737)</u>	<u>(155,931)</u>
Net Outlays	<u>\$ (51,737)</u>	<u>\$ (155,931)</u>

The accompanying notes are an integral part of these statements

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

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

Financial Operations

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

Information Services

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

In fiscal year (FY) 2006, DFAS initiated action to merge the Information Services and Financial Operations Business Areas. Prior to this time, DFAS maintained two distinct working capital funds, one for financial operations activities and the other for software maintenance and development activities. Maintaining two distinct working capital funds required separate accounting, budgeting and reporting activities. Combining these funds into a single working capital fund eliminated unnecessary duplication. Workload related to the management of reimbursable activities between the two working capital funds has been reduced due to the timely processing of financial transactions. This efficiency was achieved by eliminating the lag time occurring between the two business areas, improving cash management. DFAS implemented this change in FY 2007 using a two phased approach which recognized FY 2007 as a transitional year and the complete elimination of the Information Services Business Area in FY 2008.

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

B. Basis of Presentation

The accompanying financial statements have been prepared to report the financial position, net cost and changes in net position of DFAS, together with budgetary resources and a reconciliation of net cost to budgetary obligations as required by the Chief Financial Officer's (CFO) Act of 1990 and amended by the Government Management Reform Act (GMRA) of 1994, and are in accordance with accounting principles generally accepted in the United States of America (GAAP). GAAP for Federal financial reporting entities recognize the Federal Accounting Standards Advisory Board (FASAB) as the standards-setting body designed to establish these principles for these entities. The financial statements have been prepared from the books and records of DFAS in accordance with the Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements*, and the DoD Financial Management Regulation (DoD FMR) Volume 6B, when applicable, as summarized in these notes.

C. Basis of Accounting

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

D. Revenues and Other Financing Sources

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

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

E. Collections and Disbursements Clearing Account

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

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

disbursements and current-year cash transfers are recorded as financing sources transferred out without reimbursement via cumulative results of operations to the DWCF subnumbered Treasury account at year-end.

F. Accounts Receivable

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

G. General Property, Plant and Equipment

General Property, Plant and Equipment (PP&E) are carried at historical acquisition cost plus capitalized improvements. General PP&E assets are capitalized at cost if the acquisition is \$100,000 or more except for real property that was revised to \$20,000 in FY 2006 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.

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

H. Contingencies and Commitments

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

I. Federal Employee Compensation Benefits

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

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

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

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

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

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

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

K. Annual, Sick and Other Accrued Leave

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

L. Interest on Late Payments

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

M. Use of Estimates

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

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

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

As of September 30, 2007:

	Acquisition Cost	Accumulated Depreciation	Net Book Value	Useful Life (in years)
Buildings, Structures and Facilities	\$ 187,455	\$ 72,079	\$ 115,376	20 to 40
Leasehold Improvements	121,933	25,660	96,273	Lease Term
Equipment	299,704	250,494	49,210	5 to 10
Internal-Use Software	1,294,642	989,282	305,360	2 to 10
Construction-In-Progress	38	-	38	N/A
Other	1,513	1,363	150	N/A
Total General PP&E, Net	\$ 1,905,285	\$ 1,338,878	\$ 566,407	-

As of September 30, 2006:

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

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

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

NOTE 3. OTHER LIABILITIES (IN THOUSANDS)

As of September 30, 2007:	Current	Non-Current	Total
Intragovernmental Other Liabilities			
Workers' Compensation	\$ 4,099	\$ 5,060	\$ 9,159
Employer Contributions and Payroll Taxes	4,575	-	4,575
Total Intragovernmental Other Liabilities	<u>8,674</u>	<u>5,060</u>	<u>13,734</u>
Other Liabilities With the Public			
Accrued Payroll and Benefits	93,355	-	93,355
Total Other Liabilities With the Public	<u>93,355</u>	<u>-</u>	<u>93,355</u>
Total Other Liabilities	<u>\$ 102,029</u>	<u>\$ 5,060</u>	<u>\$ 107,089</u>

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

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

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

Intragovernmental	<u>2007</u>	<u>2006</u>
Workers' Compensation	\$ 9,159	\$ 9,175
Total Intragovernmental	<u>9,159</u>	<u>9,175</u>
 With the Public		
Actuarial FECA Liability	38,245	39,993
Unfunded Compensatory Time and Credit Leave Liability	4,037	-
Total With the Public	<u>42,282</u>	<u>39,993</u>
Total Liabilities Not Covered by Budgetary Resources	51,441	49,168
Total Liabilities Covered by Budgetary Resources	<u>198,664</u>	<u>246,244</u>
Total Liabilities	<u>\$ 250,105</u>	<u>\$ 295,412</u>

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

NOTE 5. ACTUARIAL LIABILITY (IN THOUSANDS)

	Unfunded Actuarial Liability at September 30, 2007	Unfunded Actuarial Liability at September 30, 2006
Workers' Compensation	\$ 38,245	\$ 39,993
Total Actuarial Liability	\$ 38,245	\$ 39,993

The liability for future workers' compensation benefit (FECA) includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The Department of Labor provides an estimated actuarial liability for future workers' compensation benefits. DFAS' reported FECA liability is based on the DoD-Wide allocation worksheet, the bills received, and applicable charge back reports.

NOTE 6. IMPUTED FINANCING SOURCES (IN THOUSANDS)

	2007	2006
Civilian Retirement	\$ 23,989	\$ 27,480
Civilian Health	55,386	52,779
Civilian Life Insurance	133	139
Building Space	2,786	11,336
Total Imputed Financing Sources	\$ 82,294	\$ 91,734

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

NOTE 7. LEASES

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

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

The dollar amount (in thousands) of DFAS' operating lease commitments for future years consisted of the following at September 30, 2007:

Fiscal Year	2007
2008	\$ 29,831
2009	26,591
2010	26,969
2011	27,508
2012	28,058
After 2012	28,620
Total Future Lease Payments	\$ 167,577

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

NOTE 8. STATEMENT OF BUDGETARY RESOURCES RECONCILIATION

Under OMB Circular A-11, *Preparing, Submitting, and Executing the Budget*, Federal agencies are to report budgetary information in the Statement of Budgetary Resources based on budget terminology, definitions, and guidance issued. OMB Circular A-11 also states that the information on the Statement of Budgetary Resources should be consistent with budget execution information reported in the President's Budget. Additionally, per SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*, agencies are to provide financial statement footnote disclosure to explain significant differences between amounts presented in the Statement of Budgetary Resources and amounts described as actual in the President's Budget. Since DFAS is a component of the DoD rather than a separate Federal agency as envisioned by OMB requirements, these analyses are difficult; however, an analysis of information reported in the Statement of Budgetary Resources and the information reported in the September 30, 2007 Report on Budget Execution (SF-133) was performed. This analysis identified immaterial differences related to Unpaid Obligations due to DFAS adjustments, primarily related to additional accruals being posted to the financial statements.

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

NOTE 9. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET (IN THOUSANDS)

	<u>2007</u>	<u>2006</u>
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated:		
Obligations Incurred	\$ 1,532,529	\$ 1,724,185
Less: Spending Authority from Offsetting Collections and Recoveries	(1,517,448)	(1,857,281)
Net Obligations	<u>15,081</u>	<u>(133,096)</u>
Other Resources:		
Transfers In/Out Without Reimbursement	(69,042)	(153,876)
Imputed Financing Sources	82,294	91,734
Other	(5,289)	19,906
Total Resources Used to Finance Activities	<u>23,044</u>	<u>(175,332)</u>
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but Not Yet Provided:		
Undelivered Orders	(3,936)	18,468
Unfilled Customer Orders	(62,472)	13,886
Resources that Fund Expenses Recognized in Prior Periods	(4,726)	(1,682)
Resources that Finance the Acquisition of Assets	(29,635)	(64,505)
Other	74,331	133,970
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	<u>(26,438)</u>	<u>100,137</u>
Total Resources Used to Finance the Net Cost of Operations	<u>\$ (3,394)</u>	<u>\$ (75,195)</u>

**DEFENSE FINANCE AND ACCOUNTING SERVICE
NOTES TO THE FINANCIAL STATEMENTS
FOR THE FISCAL YEARS ENDED SEPTEMBER 30, 2007 AND 2006**

NOTE 9. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET (IN THOUSANDS), CONTINUED

	<u>2007</u>	<u>2006</u>
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Components Requiring or Generating Resources in Future Period:		
Increase in Annual Leave Liability	\$ 507	\$ 3,825
Other	2,666	365
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	<u>3,173</u>	<u>4,190</u>
Components Not Requiring or Generating Resources:		
Depreciation and Amortization	103,031	128,086
Revaluation of Assets or Liabilities	(10,689)	74,932
Other	198	651
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	<u>92,540</u>	<u>203,669</u>
Total Components of Net Cost of Operations That Will Not Require or Generate Resources In the Current Period	<u>95,713</u>	<u>207,859</u>
NET COST OF OPERATIONS	<u>\$ 92,319</u>	<u>\$ 132,664</u>

DEFENSE FINANCE AND ACCOUNTING SERVICE
REQUIRED SUPPLEMENTARY INFORMATION
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007
(UNAUDITED)

**DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007
(UNAUDITED)**

Dollars In Thousands	
INTRAGOVERNMENTAL ASSETS	Accounts Receivable
Executive Office of the President	\$ 6
Navy General Fund	122
Army General Fund	5,088
Department of Veteran Affairs	183
Air Force General Fund	17
Department of Homeland Security	7
Independent Agencies	47
Other Defense Organizations General Funds	890
Other Defense Organizations Working Capital Funds	106
Army Working Capital Fund	2,151
Navy Working Capital Fund	561
Air Force Working Capital Fund	10
Total Intragovernmental Assets	\$ 9,188

**DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007
(UNAUDITED)**

Dollars In Thousands		
INTRAGOVERNMENTAL LIABILITIES	Accounts Payable	Other Liabilities
Department of the Interior	\$ 8	\$ -
Department of Labor	-	9,159
Navy General Fund	257	-
United States Postal Service	318	-
Department of the Treasury	2,126	-
Army General Fund	1,887	-
Office of Personnel Management	929	4,575
Department of Veterans Affairs	5	-
General Services Administration	15,923	-
Air Force General Fund	5,800	-
Department of Transportation	253	-
Department of Homeland Security	280	-
Department of Health and Human Services	1,510	-
Other Defense Organizations General Funds	819	-
Other Defense Organizations Working Capital Funds	9,403	-
Army Working Capital Fund	161	-
Navy Working Capital Fund	1,459	-
Air Force Working Capital Fund	171	-
Total Intragovernmental Liabilities	\$ 41,309	\$ 13,734

**DEFENSE FINANCE AND ACCOUNTING SERVICE
SUPPLEMENTAL SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2007
(UNAUDITED)**

Dollars In Thousands	
INTRAGOVERNMENTAL REVENUE	Earned Revenue
Executive Office of the President	\$ 157
Department of Commerce	10
Navy General Fund	319,444
Army General Fund	558,199
Department of Veterans Affairs	3,662
Air Force General Fund	280,056
Environmental Protection Agency	1,915
Department of Homeland Security	125
Department of Health and Human Services	6,469
Department of Energy	992
Independent Agencies	750
United States Army Corps of Engineers	3,092
Other Defense Organizations General Funds	142,511
Other Defense Organizations Working Capital Funds	101,894
Army Working Capital Fund	29,529
Navy Working Capital Fund	46,660
Air Force Working Capital Fund	6,483
Total Intragovernmental Revenue	\$ 1,501,948

NON - EXCHANGE REVENUE	Transfers - Out
Army General Fund	\$ 74
Other Defense Organizations Working Capital Funds	51,733
Navy Working Capital Fund	17,235
Total Non-Exchange Revenue	\$ 69,042

**INDEPENDENT AUDITORS' REPORT
ON THE FINANCIAL STATEMENTS**

Director and Audit Committee
Defense Finance and Accounting Service

We have audited the accompanying Consolidated Balance Sheets of the Working Capital Fund (WCF) of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense, as of September 30, 2007 and 2006, and the related Consolidated Statements of Net Cost and Changes in Net Position, and the Combined Statements of Budgetary Resources for the years then ended. These financial statements are the responsibility of the management of DFAS. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting (internal control) as a basis for designing our audit procedures that are appropriate in the circumstances and to comply with OMB audit guidance, but not for the purpose of expressing an opinion on the effectiveness of DFAS' internal control for the WCF. Accordingly, we do not express an opinion on DFAS' internal control for WCF. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of the DFAS WCF as of September 30, 2007 and 2006, and its net cost, changes in net position, and combined budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The information in the Management's Discussion and Analysis and Required Supplementary Information, as listed in the accompanying Table of Contents, is not a required part of the financial statements, but is supplementary information required by the Federal Accounting Standards Advisory Board, OMB Circular No. A-136, *Financial Reporting Requirements*, and the Treasury Financial Manual. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

**INDEPENDENT AUDITORS' REPORT
ON THE FINANCIAL STATEMENTS, CONTINUED**

In accordance with *Government Auditing Standards*, we have also issued reports dated October 30, 2007 on our consideration of DFAS' internal control for the WCF, and on our tests of its compliance with certain provisions of applicable laws and regulations for the WCF. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and, in considering the results of the audit, should be read in conjunction with this report.

Urbach Kahn & Werlin LLP

Arlington, VA
October 30, 2007

**INDEPENDENT AUDITORS' REPORT
ON INTERNAL CONTROL**

Director and Audit Committee
Defense Finance and Accounting Service

We have audited the Working Capital Fund (WCF) financial statements of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense (DoD), as of and for the years ended September 30, 2007 and 2006, and have issued our report thereon dated October 30, 2007. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audits, we considered DFAS' internal control over financial reporting for the WCF (internal control) by obtaining an understanding of DFAS' internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 07-04 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audits was not to express an opinion on the effectiveness of DFAS' internal control. Consequently, we do not provide an opinion on the effectiveness of DFAS' internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects DFAS' 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 DFAS' financial statements that is more than inconsequential will not be prevented or detected by DFAS' internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies that results in a more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by DFAS' internal control.

Our consideration of the internal control was for the limited purpose described in the first paragraph and would not necessarily disclose all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified a deficiency in DFAS' internal control that we consider to be a significant deficiency.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL, CONTINUED

This condition, detailed on the following pages, is summarized as follows:

- DFAS needs to improve controls over the recording of accounts payable and undelivered orders.

With respect to the internal control objective relating to the performance measures reported in the Management's Discussion and Analysis, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether they have been placed in operation, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide an opinion on the effectiveness of DFAS' internal control over reported performance measures, and, accordingly, we do not provide an opinion on the effectiveness of DFAS' internal control over these reported performance measures.

We also noted other less significant matters involving DFAS' internal control, which we have reported to the management of DFAS in a separate letter, dated October 30, 2007.

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

Urbach Kahn & Werlin LLP

Arlington, VA
October 30, 2007

SIGNIFICANT DEFICIENCY

DFAS NEEDS TO IMPROVE CONTROLS OVER THE RECORDING OF ACCOUNTS PAYABLE AND UNDELIVERED ORDERS

DFAS continued to make improvements in its controls over the prior fiscal years related to the recording of accounts payable (A/P) and undelivered orders (UDO). However, throughout fiscal year 2007, we identified the following control deficiencies related to these business processes:

- DFAS' monitoring controls over the estimation of accrued liabilities, where the goods or services had been provided prior to month-end were not effective, including the following:
 - ✓ Estimated accruals were not consistently prepared on a monthly basis when services were received. For example, DFAS erroneously processed an estimated accrual in September 2007 that was meant to cover the service period from October 2006 – September 2007;
 - ✓ Accrual forms were created, but certain entries were not posted to e-Biz (Electronic Business Accounting and Management System) until the following month;
 - ✓ Estimated accruals were either not reversed for the full amount or not reversed at all, once the receiving report/invoice was recorded in e-Biz; and
 - ✓ Improper posting of receipts to incorrect document numbers or for incorrect amounts, causing the overstatement or understatement of A/P.
- Documentation supporting specific A/P and UDO balances did not contain complete or accurate information. Certain supporting documentation, including estimated accrual forms and disbursement vouchers had the incorrect document number, date, or amount, or were lacking the necessary information to sustain a proper audit trail.
- Aged or erroneous UDO balances were not deobligated timely.
- Invalid A/P balances were recorded because receipts were not fully reversed due to discounts taken on invoices.

SIGNIFICANT DEFICIENCY, CONTINUED

The control deficiencies for accounts payable and undelivered orders were primarily caused by the following:

- Insufficient training of Directorate Executive personnel regarding the proper recording of accruals and monitoring of UDO balances, including timely deobligation of invalid or aged documents, and the inconsistent application of required policies and procedures throughout the organization;
- Insufficient training of Directorate Executive personnel over the performance of triannual reviews related to the specific objectives stated in the DoD Financial Management Regulation (FMR) and DFAS Regulation 7040.1R, for ensuring that applicable proprietary and budgetary accounts were valid, accurate, and properly supported. In addition, there was ineffective monitoring and quality control procedures performed by the Director of Resource Management related to the performance of triannual reviews to ensure that the transactions identified and certified by the Directorate Executive personnel were valid and properly supported. A significant amount of the financial statement audit testing exceptions related to A/P and UDO should have been detected and resolved by DFAS personnel during the triannual review process; and
- Invalid UDO balances were recorded because DFAS did not commence contract reconciliations in a timely manner after the contract period ended, as required by the Federal Acquisition Regulation and DFAS regulations. In a number of instances, it took DFAS more than six months to commence reconciliation of contracts after the period of performance (POP) had expired.

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

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

DoD FMR Volume 1, Chapter 2, *General Financial Information, Systems and Requirements – Conceptual Framework*, states,

...As a minimum, the following documentation shall be required to support the periodic verifications of unliquidated obligations: 1. An overall summary of the methodology, criteria, and rationale used to select unliquidated obligations for review, such as statistical sampling techniques, aging, and months past delivery

SIGNIFICANT DEFICIENCY, CONTINUED

date. 2. Mechanized or manual listings identifying the unliquidated obligations selected for review and the results of their review. 3. Annotated supply status reports and letters, memoranda, or records of telephone calls requesting delivery status from contracting or procurement activities. 4. Records identifying the unliquidated obligations deobligated as a result of the review, the amount deobligated for each document, and the rationale for deobligation. 5. Deobligation documents or references to dated deobligation documents indicating the value and identity of documents deobligated...

DoD FMR, Volume 3, Chapter 8, *Budget Execution – Availability and Use of Budgetary Resources – Standards for Recording and Reviewing Commitments and Obligations*, states,

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

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

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

SIGNIFICANT DEFICIENCY, CONTINUED

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

To ensure DFAS (internal) has sound financial records consistently throughout the year, reviews are to be conducted in accordance with the schedule below. Prompt and accurate recording of commitments, obligations and accrued expenditures in e-Biz, is a vital part of proper financial reporting. BL and Corporate Elements, in conjunction with their servicing RI, and with assistance from supporting offices, shall review open commitment, obligation, and accrual/receipt (expense) transactions for timeliness, accuracy, and completeness. FO/FSOs and Accounting Operations participate in joint reviews with the BL and Corporate Elements, in a supporting role when applicable.

Certifications to the CFO are submitted based upon the financial records as of January 31, May 31, and September 30 of each fiscal year. Note, All transactions greater than \$50,000 and all abnormal balances are reviewed each month...To support the CFO certification to OSD(C), the BL Executives/Corporate Element Directors likewise, provide a signed certification memorandum to the CFO within 21 calendar days following each of the same four month periods.

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

Reviews are conducted to determine if there are undelivered orders (UDOs) or unobligated commitments and to ascertain whether the funds must be reconciled or deobligated via contract modification...Do not wait until the period of performance of all option years, delivery orders or calls are complete or the period of performance has ended before reconciling the contract, receiving reports, invoices, disbursements and their posting in the various electronic business systems. Contracts may be funded by multiple funding documents and in some cases the period of performance may encompass multiple years; therefore, it is important to continually review and reconcile each funding document. Reconciliation of one funding document may [reveal] posting errors of other funding documents on the same or different contract.

SIGNIFICANT DEFICIENCY, CONTINUED

The COR is the primary person responsible for...conducting a complete review and reconciliation of the contract obligations, products and services received, invoices, and disbursements 60 days before the end of the performance period for service contracts, if not already being performed as a routine part of monitoring the contract; Initiating action to reconcile and/or begin closeout procedures within 60 days after the period of performance has passed, delivery has been made or the contract is physically complete. This is a follow-on to the initial review conducted 60 days prior to the end of the POP...

Recommendations

We recommend the DFAS Director and Audit Committee ensure that:

1. Ongoing training is provided by DFAS management for Directorate Executive personnel regarding the proper procedures for estimating and documenting accrued liabilities throughout the fiscal year. Specifically, the training should describe in detail, with illustrative examples, each manual and e-Biz related step that is necessary to estimate and properly document accruals on an ongoing basis, as well as reemphasize the FMR requirements related to the timely deobligation of funds. The training should also emphasize:
 - The significance of recording accruals, disbursements, and deobligation of funds into e-Biz in a timely and accurate manner on a monthly basis;
 - Estimated accruals are recorded and reversed properly and timely on a monthly basis, throughout the entire life of the obligation; and
 - Supporting documentation must contain complete and accurate information, including the correct document number, date, and amount.
2. The triannual review process is regarded as a financial management tool to ensure that the appropriate internal controls are in place throughout the fiscal year related to the recording of A/P and UDO. This can be accomplished by ensuring:
 - Ongoing training is provided to Directorate Executive personnel over the performance of triannual reviews, related to the specific objectives stated in the DoD FMR and DFAS regulations for ensuring that applicable proprietary and budgetary accounts are valid, accurate, and properly supported. The training should emphasize the following:
 - ✓ Aged transactions are reviewed in detail to substantiate the propriety of the balances, including maintaining adequate supporting documentation as an audit trail of the triannual review testing;

SIGNIFICANT DEFICIENCY, CONTINUED

- ✓ Triannual review samples should be selected by Directorate Executive personnel using the A/P and UDO subsidiary ledgers (PC041 Reports). Testing should be performed with detailed and documented procedures. Adjustments for noted exceptions should be processed no later than 10 working days after the review has been completed, as required by the DoD FMR; and
- ✓ Monthly reviews of balances greater than \$50,000 are properly documented in accordance with DFAS regulations to support the conclusions regarding the propriety of the balances, including the posting of estimated accruals, estimated accrual reversals, and deobligations of aged and invalid balances.
- Enhanced monitoring and quality control of the triannual process is performed by the Director of Resource Management to ensure that the transactions identified and certified by the Directorate Executives are valid and properly supported. The monitoring should also emphasize that adequate documentation is maintained over the completeness of the triannual review testing.
- Aged UDO balances are continually monitored as part of the triannual review process throughout the fiscal year to ensure the propriety of the account balances, and adequate documentation is maintained that justifies why the remaining balance is proper and should not be written off, including:
 - ✓ Ongoing training is provided to Directorate Executive personnel regarding ensuring contract review and reconciliation is performed in accordance with DFAS Policy Memorandum 05-5 to ensure expired obligations are closed out and deobligated timely;
 - ✓ DFAS initiate the use of a tickler file in e-Biz or in an offline file that is triggered during specific times during the POP of the obligation, such as 60 days prior to the expiration of the POP and when the POP ends on an obligation, which would provide timely notification for the contract close-out reconciliation to begin; and
 - ✓ DFAS should separately identify and monitor UDO balances which are under review by the Defense Contract Audit Agency, as well as contracts that are in dispute with vendors, in order to streamline the triannual review and financial statement audit testing processes. This would also facilitate closing out these balances in a more timely manner.

**INDEPENDENT AUDITORS' REPORT ON
COMPLIANCE WITH LAWS AND REGULATIONS**

Director and Audit Committee
Defense Finance and Accounting Service

We have audited the Working Capital Fund (WCF) financial statements of the Defense Finance and Accounting Service (DFAS), a component of the United States Department of Defense (DoD), as of and for the years ended September 30, 2007 and 2006, and have issued our report thereon dated October 30, 2007. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

The management of DFAS is responsible for complying with laws and regulations applicable to DFAS. As part of obtaining reasonable assurance about whether DFAS' financial statements are free of material misstatement, we performed tests of DFAS' compliance with certain provisions of laws 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. 07-04, 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 the DFAS WCF.

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

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

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

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

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

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

Urbach Kahn & Werlin LLP

Arlington, VA
October 30, 2007



DEFENSE FINANCE AND ACCOUNTING SERVICE
1851 SOUTH BELL STREET
ARLINGTON, VA 22240-5291

Mr. Wayne Ference, CPA
Principal
Urbach Kahn & Werlin LLP
4250 N. Fairfax Drive, Suite 1020
Arlington, VA 22203

Dear Mr. Ference:

This letter is in response to the three draft Independent Auditor's Reports that you submitted to the Defense Finance and Accounting Service (DFAS) Audit Committee on October 30, 2007.

The Audit Committee would like to extend its thanks to you and your associates for performing the audit of the Fiscal Year 2007 DFAS Working Capital Fund Financial Statements. We commend you and your staff for the outstanding integrity, professionalism and diligence exhibited these last nine months. The reports are concise and definitive as to the areas requiring our attention in the coming year. We accept these reports as written, and will use them as the basis to advise and guide the DFAS management in improving its financial management processes, policies, and practices in order to continue rectifying the underlying causes that created the conditions you have identified.

The DFAS Financial Management Improvement Plan (FMIP) Team will address the conditions you identified in the past year and we look forward to the FMIP Team's continual updates as it addresses the issues presented in your FY 2007 audit reports.

Again, our utmost gratitude to you and your staff and we look forward to receiving the final FY 2007 DFAS Financial Statements Audit Report.

Sincerely,

A handwritten signature in black ink, reading "Kathleen M. Turco".

Kathleen Turco
Chairman
DFAS Audit Committee



**DEFENSE FINANCE AND ACCOUNTING SERVICE
ARLINGTON
1851 SOUTH BELL STREET
ARLINGTON, VA 22240-5291**

NOV - 7 2007

Mr. Wayne Ference, CPA
Principal
Urbach Kahn & Werlin LLP
4250 N. Fairfax Drive, Suite 1020
Arlington, VA 22203

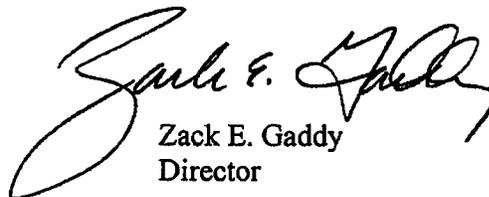
Dear Mr. Ference:

This letter is in response to the three draft Independent Auditor's Reports that you submitted to my office on October 30, 2007. Please extend my thanks to your staff for completing an audit of this magnitude in a relatively short period of time immediately following the end of the fiscal year. The dedication, integrity and knowledge of your staff are a credit to the professionalism for which your firm is known.

I concur with the conditions presented and the recommendations provided. The Defense Finance and Accounting Service has institutionalized a continuous improvement process that evaluates the results of our audit findings, performs root cause analysis and ensures corrective actions are completed.

Our Financial Management Improvement Plan office will incorporate your recommendations into our improvement process. My point of contact is Mr. Craig Fitzgibbons, (317) 510-1258 or email at craig.fitzgibbons@dfas.mil.

Sincerely,


Zack E. Gaddy
Director