

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

DEPARTMENT OF DEFENSE DEFENSE FINANCE AND ACCOUNTING SERVICE

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

Management's Discussion and Analysis

MANAGEMENT'S DISCUSSION AND ANALYSIS

FOR THE YEAR ENDED SEPTEMBER 30, 2001

DESCRIPTION OF THE REPORTING ENTITY

The reporting entity is the Defense Finance and Accounting Service (DFAS). DFAS is the finance and accounting arm of the Department of Defense (DoD). It pays all major DoD contracts and vendors, its 5.5 million military and civilian personnel, retirees and annuitants, and operates the Department's 65 major finance and accounting systems. DFAS delivers finance and accounting services worldwide from a Headquarters in Arlington, Virginia, five DFAS central sites located in Cleveland, Ohio; Columbus, Ohio; Denver, Colorado; Indianapolis, Indiana; and Kansas City, Missouri; and 20 field sites.

SUMMARY

In Fiscal Year (FY) 2001 DFAS took major strides to achieving true financial management reform. From receiving the first unqualified opinion on its financial statements for FY 2000, DFAS established definitive goals, objectives and management targets for its fiscal service operations. It implemented changes in business practices to align customer support by business and product lines and designated Senior Executives directly responsible for working with customers on the management of costs and the collection of revenue. DFAS became the only DoD operating entity to develop policies and procedures to implement Federal Accounting Standards Advisory Board (FASAB) Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software*. It initiated the development of a financial management guide to standardize Agency financial management practices, and increased the role of its Internal Review organization in evaluating financial management.

All of these actions are especially significant in that DFAS initiated them less than one year from receiving its first unqualified opinion on its financial statements for FY 2000. This is additional evidence that DFAS can provide world-class finance and accounting service to its DoD customers, and can leverage these accomplishments to assist customers in meeting their goals of achieving auditable financial statements in the future. In addition to performing its essential finance and accounting support to its DoD customers in FY 2001, DFAS:

- Provided the accounting support to the DoD Military Retirement Fund that received its 8th consecutive unqualified audit opinion.
- Provided the accounting support to the Defense Contract Audit Agency (DCAA) directly contributing to its achieving a favorable audit opinion on its FY 2001 financial statements.
- Provided technical guidance and support to the Department of Defense Internal Use Software (i.e., SFFAS No. 10) Working Group to facilitate DoD implementation of the new FASAB standard.

A summary of FY 2001 DFAS operational accomplishments is provided in the chart below.

FY 2001 Magnitude of Operations

- Paid 5.5 million military and civilian members, retirees and annuitants
- Disbursed \$299 billion
- Processed 100 million accounting transactions
- Accounted for \$13 billion in foreign military sales
- Paid 11 million contractors and vendor invoices
- Managed \$169 billion in retirement trust fund assets
- Paid 6.7 million travel payments
- Managed 231 active DoD appropriations

BACKGROUND

Prior to the establishment of DFAS, financial management within DoD was conducted independently by the Components--Army, Navy, Air Force, Marine Corps, and Defense Agencies. Each Component developed financial management processes and tailored business practices to its particular mission. As Defense missions required greater integration, DoD components required greater interoperability in terms of missions, functions, and systems. DoD Components developed increasingly complex business practices to link their financial systems. This effort left the systems prone to error and unable to meet customer demands in a timely and efficient manner.

In response to these challenges, on January 16, 1991, the Secretary of Defense chartered DFAS as the leading agent for DoD financial management reform. DFAS was charged with standardizing and streamlining finance and accounting operations and information to produce accurate, comprehensive, and timely data. This effort included the standardization and consolidation of DoD finance and accounting systems and operations. DFAS has taken this responsibility seriously, moving forward in every area of financial management during the past 10 years.

As a Defense Working Capital Fund (DWCF) activity, DFAS operates predominantly as a commercial 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, keeping customers and ultimately the American taxpayer's best interests in mind. These principles are evident in the Agency's mission and vision statements.

MISSION AND VISION

DFAS Mission:

“Provide responsive, professional finance and accounting services to those who defend America.”

DFAS is proud to serve those who serve. The DFAS Mission embodies our commitment to the men and women of the Armed Forces who depend on us for financial services. Our roadmap for financial reform, improved service, and reduced costs is producing results. A customer-focused vision ensures continuous improvement and a partnership approach to long-lasting financial reform within DoD.

DFAS Vision:

In support of this mission, the leadership and employees of the DFAS community have adopted a vision to provide best value and be the:

- ▶ ***World-class provider of finance and accounting services,***
 - ▶ ***A trusted, innovative financial partner,***
 - ▶ ***One organization, one identity, and***
 - ▶ ***An employer of choice, providing a progressive and professional work environment.***
-
- As the DoD agent for financial management reform, DFAS is committed to providing world-class finance and accounting services to our customers.
 - All DFAS organizations are charged with putting the customer first while striving to find innovative ways to reduce costs and demonstrate that we provide competitive services.
 - We are a strategy-based organization and use balanced scorecards to measure our progress in meeting our strategy and to ensure everyone is working to make our vision a reality.
 - At the same time, we recognize our people as one of our most valuable resources. We dedicate a significant portion of our annual budget for training and professional development of our employees to ensure that they can meet the challenges of the new high technology environment.

DFAS BUSINESS EVOLUTION

In FY 2001, DFAS completed the implementation of its DFAS Business Evolution (DBE) initiative begun in FY 2000. This new organizational structure shifted our focus away from geographic sites to the delivery of business line services: military and civilian pay, commercial pay, and accounting. This change has enabled DFAS to progressively improve internal operations, implement best business practices across business lines, and reduce costs.

Within the DBE structure, the Military and Civilian Pay Services Business Line Executive manages all aspects of payments to individuals - paychecks, travel reimbursements and garnishments.

The Commercial Pay Services Business Line Executive provides payment services to contractors, both large and small.

The Accounting Services Business Line Executive provides departmental and field level accounting, disbursing, and financial accounting services.

In addition, the DBE structure includes a Client Executive Corps devoted to anticipating and fulfilling the needs of our customer. They provide single points of contact for DFAS services.

Appointment of executives to lead DFAS end-to-end business processes has done much to increase accountability and to provide a link for customers. At the same time, these changes have facilitated cooperation between DFAS and its customers on the customers' Enterprise Resource Planning (ERP) tools, systems initiatives, as well as workload and revenue collection processes.

BUSINESS OPERATIONS

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

Financial Operations - The Financial Operations business area is composed of Military and Civilian Pay Business Line, Commercial Pay Services Business Line, and Accounting Services Business Line. Inherent in these functions, DFAS is also responsible for safeguarding U.S. funds through delivery of payments and receipt of collections, providing prompt, accurate, and timely disbursing service, and reporting Disbursing Officer accountability to the Department of the Treasury.

- *Military and Civilian Pay Business Line* is charged with providing timely and accurate pay services to active-duty military members, reservists, National Guard members, civilian personnel, retirees, and annuitants. It is responsible for debt and claims management, garnishments, and certain bankruptcies, and responsive, quality travel services. Its focus is strengthening client/customer partnerships, meeting the challenges of outside competitors, integrating customer input into operations, and offering value enhanced services to customers.
- *Commercial Pay Services Business Line* provides payments for most commercial invoices and payments to DoD contractors that provide businesses and services to DoD Components (Military Services and Defense Agencies). The Commercial Services Business Line is split into three different payment operations, Contract Pay, Vendor Pay, and Transportation Pay.
- *Accounting Services Business Line* provides budgetary and proprietary accounting support for all DoD Military Department and Defense Agencies with a goal of providing accurate and timely financial statements with the requisite information to assist senior managers in making resource-related decisions.

Information Services - This business area, led by the Agency's Chief Technology Officer, serves as the proponent for DoD's future finance and accounting application systems strategy and architecture. It provides planning, policy, architectural guidance, and the supporting infrastructure systems. Within this business area, DFAS also implements business practice changes and Web-based and enabling technology to transition to a paperless environment.

FINANCIAL CONDITION

DFAS's financial condition is sound. DFAS received consecutive unqualified opinions on its financial statements from an independent public accounting firm in FY 2000 and 2001. In addition, DFAS leveraged its lessons learned from previous audits, as well as its efforts during the FY 2001 cycle, to assist a number of customers in improving the accuracy and presentation of their financial statements.

While the achievement of unqualified opinions is a testimony to improved business practices and hard work, these efforts cannot be sustained without support from sound financial systems. DFAS recognizes the need for a sound financial management system to support its internal financial management efforts. In June 2001, DFAS made the contract award of its Business Management Redesign (BMR) initiative. This new system is intended to provide a single source solution for Agency financial management from the development of budgetary requirements, the management of time and attendance and the formulation and development of financial statements. The system is scheduled to be implemented incrementally beginning in FY 2002, with completion scheduled by the end of FY 2003.

MEASURING PERFORMANCE

DFAS is a strategy-based organization committed to becoming a world-class provider of finance and accounting services for its customers. The DFAS strategy is supported by performance metrics to measure the impact of strategic goals. In addition, DFAS has adopted the Balanced Scorecard methodology, developed by leading industry experts, to align the organization with the mission and vision and to measure progress. The Balanced Scorecard is not an end in itself but an important tool for measuring progress and service delivery success against the DFAS strategy.

DFAS continued to refine its performance measures to improve service delivery to customers. DFAS completed implementation of DBE and provided business managers for each business line and client executives to facilitate customer support. The benefit of these changes is already evident. Using revenue collection, as a measure of improved performance, DFAS only had \$19 million in outstanding accounts receivable at the end of FY 2001. This can be compared to the over \$60 million in outstanding accounts receivable at the end of FY 2000. Of the \$19 million in outstanding accounts receivable for FY 2001, over \$13 million was collected during the first quarter of FY 2002. This turnaround in performance is due in large measure to the DBE reorganization and the Agency's work in demonstrating its support to the customer.

DFAS held its inaugural meeting of the Board of Advisors (BOA). The BOA consists of 14 members: 5 DoD senior civilian leaders, 5 General/Flag rank officers, and 4 senior managers from private sector firms. In addition, the Military Department's Assistant Secretaries for Financial Management serve as observers.

On the operational side, DFAS has a performance contract with the Defense Resources Board (DRB). The DRB is the executive oversight board representing DoD customers. The contract prescribes the DRB's understanding of our customers' desired results and our commitment to achieve those results, recognizing that both parties want the highest possible level of quality and efficiency. Currently, the DFAS performance contract is designed to be the premier benchmark for consolidating senior management, office, and employee goals to improve efficiencies and reduce cost.

For FY 2001, DFAS had a total of 47 performance measures. Of those, 45 were internal to DFAS. DFAS met all 45 of 45 contract performance deliverables, to include cost, timeliness and accuracy goals. The two goals that are external to DFAS will require a collaborative effort with our customers, and we are spearheading a concerted effort to achieve those goals. In FY 2000 there were a total of 57 performance measures, with 50 internal to DFAS. In the case of FY 2000, DFAS met all 50 that were within its internal purview.

Some of the DFAS noteworthy business operations accomplishments include:

Reduced aged in-transits by 88 percent from the FY 1998 baseline. An aged in-transit disbursement occurs when a payment is made and reported to the U.S. Department of Treasury, but the payment has not been posted to the general ledger. In FY 1998, the in-transit balance was \$1.8 billion. At the end of FY 2001, in-transits were \$230 million, an 88 percent reduction. This is an additional reduction of \$30 million, or 2 percent, from FY 2000.

Reduced unmatched disbursements (UMD) by 85 percent from the FY 1998 baseline. A UMD occurs when a payment cannot be matched to the actual commitment/obligation document recorded. UMDs are an outgrowth of the in-transit process and can result when different systems do not communicate at the time of payment. In FY 1998 the UMD balance was baselined at \$7.4 billion. In FY 2001, the baseline was revised to \$6.8 billion. UMD reductions in FY 2001 are reflected against the new baseline. At the end of FY 2001, UMDs were \$1 billion, an 85 percent reduction. This is a reduction of \$300 million from FY 2000, or an additional 4 percent.

Reduced negative unliquidated obligations (NULO) by 84 percent from the FY 1998 baseline. A NULO occurs when a payment made against a particular obligation document is greater than the amount of the obligation funds that is recorded in the official accounting system. In FY 1998, the NULO balance was \$1.3 billion. At the end of FY 2001, NULO was \$205 million, an 84 percent reduction. This is also a reduction of \$89 million or seven percent from FY 2000.

Completed the Military Retired and Annuitant Pay Competitive Sourcing (Office of Management and Budget Circular A-76) study that examined a total of 650 positions. ACS Government Services, Inc. won the competition and was awarded a contract on September 5, 2001. The contractor will be responsible for maintaining the retired and annuitant pay accounts and the associated computer systems. After allowing for transition and contract administration costs, DFAS expects to save \$9 million over the 10-year life of the contract.

Initiated the Security Assistance Accounting competitive sourcing study to evaluate 460 workyears. This cost comparison is scheduled for completion with a tentative decision in April 2002.

As a program, competitive sourcing has been very successful. DFAS has completed cost comparisons that examined nearly 1,300 positions in 6 business areas with a resulting annual savings of over \$30 million.

DFAS has established an FY 2002 goal to initiate cost comparison studies on at least seven percent of the positions available for competition on its Federal Activities Inventory Reform Act Inventory.

FUTURE INITIATIVES

DFAS is scheduled to begin implementation of its BMR system initiative in FY 2002. The first module to be fielded is the time and attendance module. The remaining modules are scheduled for fielding through FY 2002 and 2003.

DFAS is continuing to work on the development and implementation of a "Business-of-DFAS Dashboard" that will be a method of assessing the daily health of the organization and reviewing performance. Once fully operational, this web-based tool will provide our entire network, as well as our customers, full visibility of our performance. In addition DFAS is developing operational dashboards to provide customers near-real-time financial management information. These initiatives will enable the Agency to look inward at its performance and be able to assess customer support, while at the same time be able to advise customers on the status of their finances. Combined, these initiatives will help us maintain our momentum to improve business practices and demonstrate our sincere interest to partner with our customers.

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

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

**Consolidated and Combined Financial Statements
for the Years Ended September 30, 2001 and 2000,
and Independent Auditors' Reports**



INDEPENDENT AUDITORS' REPORT

To the Audit Committee and the Director,
Defense Finance and Accounting Service

We have audited the accompanying consolidated balance sheets of the Defense Finance and Accounting Service (DFAS) as of September 30, 2001 and 2000, and the related consolidated statements of net cost, consolidated statements of changes in net position, combined statements of budgetary resources, and combined statements of financing for the years then ended, collectively referred to as the financial statements. 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; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of DFAS as of September 30, 2001 and 2000, and its net cost, changes in net position, budgetary resources, and reconciliation of budgetary resources to net cost for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1.J. to the financial statements, DFAS adopted Statement of Federal Financial Accounting Standards No. 10, *Accounting for Internal Use Software*, effective October 1, 2000.

Our audits were conducted for the purpose of forming an opinion on the consolidated and combined financial statements taken as a whole. The consolidating and combining financial statement information on pages 26 to 32 is presented for the purpose of additional analysis of the consolidated and combined financial statements rather than to present the financial position, net cost, changes in net position, budgetary resources and reconciliation of budgetary resources to net cost of individual organizational components, and is not a required part of the consolidated and combined financial statements of DFAS. This consolidating and combining information is the responsibility of DFAS's management. Such consolidating and combining financial statement information has been subjected to the auditing procedures applied in our audits of the consolidated and combined financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the consolidated and combined financial statements taken as a whole.

To the Audit Committee and the Director of
Defense Finance and Accounting Service

The required supplementary information included on pages 1 to 7, and pages 33 to 36, is not a required part of the consolidated and combined financial statements but is supplementary information required by OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements* and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of the DFAS's management. 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 such information and we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 25, 2002, on our consideration of DFAS's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The image shows a handwritten signature in cursive script that reads "Deloitte & Touche LLP". The signature is written in dark ink and is positioned above the date.

January 25, 2002

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

**CONSOLIDATED BALANCE SHEETS
AS OF SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

ASSETS	2001	2000
Intragovernmental:		
Collections and disbursements, clearing (Note 2)	\$ -	\$ -
Accounts receivable (Note 3)	107,363	105,084
Other assets (Note 4)	<u>-</u>	<u>15</u>
Total intragovernmental	107,363	105,099
Accounts receivable (Note 3)	30	54
General property, plant, and equipment, net (Note 5)	909,181	879,881
Other assets (Note 4)	<u>70</u>	<u>167</u>
TOTAL ASSETS	<u>\$1,016,644</u>	<u>\$985,201</u>
 LIABILITIES		
Intragovernmental:		
Accounts payable	\$ 84,559	\$ 80,854
Other liabilities (Note 6)	<u>12,881</u>	<u>14,612</u>
Total intragovernmental	97,440	95,466
Accounts payable	92,848	88,996
Military retirement benefits and other employment - related actuarial liabilities (Note 7)	46,654	41,526
Other liabilities (Note 6)	<u>73,081</u>	<u>72,642</u>
Total liabilities	<u>310,023</u>	<u>298,630</u>
 NET POSITION		
Unexpended appropriations	-	-
Cumulative results of operations	<u>706,621</u>	<u>686,571</u>
Total net position	<u>706,621</u>	<u>686,571</u>
 TOTAL LIABILITIES AND NET POSITION	<u>\$1,016,644</u>	<u>\$985,201</u>

See notes to consolidated and combined financial statements.

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

**CONSOLIDATED STATEMENTS OF NET COST
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

	2001	2000
PROGRAM COST:		
Intragovernmental	\$ 626,902	\$ 669,608
With the public	<u>1,105,449</u>	<u>1,065,538</u>
Total program cost	1,732,351	1,735,146
Less: Earned revenues	<u>(1,664,508)</u>	<u>(1,701,636)</u>
Net program costs	<u>67,843</u>	<u>33,510</u>
NET COST OF OPERATIONS	<u><u>\$ 67,843</u></u>	<u><u>\$ 33,510</u></u>

See notes to consolidated and combined financial statements.

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

**CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

	2001	2000
NET COST OF OPERATIONS	<u>\$ 67,843</u>	<u>\$ 33,510</u>
Financing sources (other than exchange revenues):		
Appropriations used	1,025	-
Imputed financing (Note 7)	74,119	70,512
Transfers-in	56,327	38,417
(Transfers-out)	(43,578)	114,734
Other	<u>-</u>	<u>(21,676)</u>
Total financing sources (other than exchange revenues)	<u>87,893</u>	<u>201,987</u>
NET RESULTS OF OPERATIONS	20,050	168,477
PRIOR-PERIOD ADJUSTMENTS	<u>-</u>	<u>(36,126)</u>
NET CHANGE IN CUMULATIVE RESULTS OF OPERATIONS	20,050	132,351
INCREASE (DECREASE) IN UNEXPENDED APPROPRIATIONS	<u>-</u>	<u>-</u>
CHANGE IN NET POSITION	20,050	132,351
NET POSITION, BEGINNING OF THE PERIOD	<u>686,571</u>	<u>554,220</u>
NET POSITION, END OF THE PERIOD	<u>\$ 706,621</u>	<u>\$ 686,571</u>

See notes to consolidated and combined financial statements.

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

**COMBINED STATEMENTS OF BUDGETARY RESOURCES
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

	2001	2000
BUDGETARY RESOURCES:		
Budget authority	\$ 221,025	\$ 222,921
Unobligated balance - beginning of period	685,273	446,442
Net transfers - prior year balance	4,524	(1,308)
Spending authority from offsetting collections and adjustments	<u>1,833,741</u>	<u>1,877,993</u>
Total budgetary resources	<u>\$ 2,744,563</u>	<u>\$ 2,546,048</u>
STATUS OF BUDGETARY RESOURCES:		
Obligations incurred	\$ 1,816,268	\$ 1,860,775
Unobligated balances - available	<u>928,295</u>	<u>685,273</u>
Total status of budgetary resources	<u>\$ 2,744,563</u>	<u>\$ 2,546,048</u>
OUTLAYS:		
Obligations incurred	\$ 1,816,268	\$ 1,860,775
Less: Spending authority from offsetting collections and adjustments	(1,833,741)	(1,877,993)
Obligated balance, net - beginning of period	180,767	312,774
Less: Obligated balance, net - end of period	<u>(171,591)</u>	<u>(180,767)</u>
Total outlays	<u>\$ (8,297)</u>	<u>\$ 114,789</u>

See notes to consolidated and combined financial statements.

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

**COMBINED STATEMENTS OF FINANCING
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

	2001	2000
OBLIGATIONS AND NONBUDGETARY RESOURCES:		
Obligations incurred	\$ 1,816,268	\$ 1,860,775
Less: Spending authority for offsetting collections and adjustments	(1,833,741)	(1,877,993)
Financing imputed for cost subsidies (Note 7)	74,119	70,512
Less: Exchange revenue not in the entity's budget	<u>(1)</u>	<u>(772)</u>
Total obligations as adjusted and nonbudgetary resources	<u>56,645</u>	<u>52,522</u>
RESOURCES THAT DO NOT FUND NET COST OF OPERATIONS:		
Change in amount of goods, services, and benefits ordered but not yet received or provided - (increases)/decreases	34,937	63,508
Change in unfilled customer orders	(18,063)	(7,389)
Costs capitalized on the balance sheet - (increases)/decreases	(171,243)	(227,125)
Financing sources that fund costs of prior periods	<u>(94)</u>	<u>(50,354)</u>
Total resources that do not fund net cost of operations	<u>(154,463)</u>	<u>(221,360)</u>
COSTS THAT DO NOT REQUIRE RESOURCES:		
Depreciation and amortization	<u>160,228</u>	<u>190,197</u>
Total costs that do not require resources	<u>160,228</u>	<u>190,197</u>
FINANCING SOURCES YET TO BE PROVIDED	<u>5,433</u>	<u>12,151</u>
NET COST OF OPERATIONS	<u><u>\$ 67,843</u></u>	<u><u>\$ 33,510</u></u>

See notes to consolidated and combined financial statements.

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

**NOTES TO THE
CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000**

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

The financial statements of the Defense Finance and Accounting Service (DFAS) report all working capital fund activities of DFAS including Financial Operations and Information Services. The financial statements were prepared to meet the requirements of the Chief Financial Officer's (CFO) Act of 1990 and the Government Management Reform Act (GMRA) of 1994. While the statements have been prepared from the books and records of DFAS in accordance with the *Department of Defense Financial Management Regulation* ("DoD FMR") Volume 6B, as adapted from Office of Management and Budget (OMB) Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, the statements differ from 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 understanding that they are a component of the U.S. Government. These statements are in addition to the financial reports, also prepared by the Department of Defense (DoD) pursuant to OMB directives that are used to monitor and control DoD's use of budgetary resources.

B. Reporting Entity

DFAS 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-eight sites including satellite 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. DFAS entity accounts are 97X4930.005, Financial Operations (Code 5L) and Information Services (Code 5F40). The accompanying financial statements of DFAS include the activities of the following organizational components:

1. Financial Operations

Financial Operations provide services for Commercial Payment Operations, General Accounting Services and Payroll Operations. Commercial Payment Operations provide payment services for invoice payments to contractors and vendors and travel payments to individuals. General Accounting Services provide accounting support services for the production of financial statements and reports and maintaining associated accounting systems and data. Payroll Operations provide payment services related to ensuring that all DoD employees receive compensation in a timely and accurate manner. Payroll operations make payroll payments to civilian personnel, active-duty military members, reservists, retirees and annuitants.

2. Information Services

This activity functions as a fee-for-service operation. Organizations within this activity provide software development/modernization and systems maintenance support to over 100 Automated

Information Systems (AIS). Additionally, they provide overall technical support in a number of system-related areas including the acquisition of information technology, systems implementation, and support for the DFAS information technology (IT) infrastructure.

C. Budgets and Budgetary Accounting

Budgetary accounting measures appropriation and consumption of Budget/Spending authority or other budgetary resources and facilitates compliance with legal constraints and controls over the use of Federal funds. Under budgetary reporting principles, budgetary resources are consumed at the time of purchase. Assets and liabilities, which do not consume current budgetary resources, are not reported, and only those liabilities for which valid obligations have been established are considered to consume budgetary resources.

DFAS's major activities are funded through working capital funds. The DoD expanded the use of business-like financial management practices through the establishment of the Defense Business Operations Fund (DBOF) on October 1, 1991. On December 11, 1996, the DBOF became the Defense Working Capital Fund (DWCF). The DWCF operates with financial principles that provide improved cost visibility and accountability to enhance business management and improve the decision making process. The DWCF builds on revolving fund principles as used in industrial and commercial-type activities.

D. Basis of Accounting

Under the authority of the CFO Act, the Federal Accounting Standards Advisory Board (FASAB) was established to recommend Federal accounting standards to the Secretary of the Treasury, the Director of the OMB, and the Comptroller General.

In April 2000, the American Institute of Certified Public Accountants (AICPA) through Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*, as amended by SAS No. 91, *Federal GAAP Hierarchy*, established the following hierarchy of accounting principles for Federal governmental entities:

- FASAB Statements and Interpretations plus AICPA and Financial Accounting Standards Board (FASB) pronouncements if made applicable to Federal government entities by a FASAB Statement or Interpretation;
- FASAB Technical Bulletins and the following pronouncements if specifically made applicable to Federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position;
- AICPA Accounting Standards Executive Committee (ACSEC) Practice Bulletins if specifically made applicable to Federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB; and
- Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the Federal government.

E. Revenues and Other Financing Sources

Exchange revenue is generated by sales of accounting and finance services to DoD agencies through a reimbursable order process. Revenue is recognized to the extent the revenue is payable to DFAS from other DoD agencies. Revenue is recognized at the point the service is rendered. Imputed financing sources consist of imputed revenue for post-retirement benefits for DFAS employees as described in Note 1.P. In FY 2001, DFAS also received direct appropriations, which were used to offset energy costs.

F. Recognition of Expenses

For financial reporting purposes, DoD policy requires the recognition of operating expenses in the period incurred. Net increases or decreases in unexpended appropriations are recognized as a change in the net position.

G. Accounting for Intragovernmental Activities

DFAS, as an agency of the Federal Government, interacts with and is dependent upon the financial activities of the DoD and Federal Government as a whole. Therefore, these financial statements do not reflect the results of all financial decisions applicable to DFAS as though it was a stand-alone entity.

In order to prepare financial statements, transactions occurring between entities within the DoD or between two or more DoD agencies must be eliminated. For fiscal years (FY) 2001 and 2000, DFAS provided summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side and departmental accounting offices and in return, received this same type of information from them in order to properly eliminate the buyer-side activity.

H. Collections and Disbursements Clearing

DFAS, as a working capital fund, does not have a Fund Balance with Treasury (FWBT) 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) FWBT is subdivided at the Department of Treasury into five subnumbered Treasury accounts. It is at the subnumbered account level that the FWBT exists for the DWCF. DFAS and nine other DWCF activities operate under one Defense subnumbered Treasury account. As a result, DFAS does not have an individually identifiable balance. The collections, disbursements, and cash transfers applicable to DFAS's operations are recorded in DFAS financial records during the fiscal year. The collections and disbursements and current-year cash transfers are recognized as transfers to the DWCF subnumbered Treasury account at year-end.

The collection, disbursement, and current-year cash transfers balances are recorded as financing sources transferred out without reimbursement, and that account is later closed to cumulative results of operations.

I. Accounts Receivable

Intragovernmental Accounts Receivable consists of amounts due from other DoD and other Federal agencies. Accounts Receivable consists of claims receivable from other entities. Allowances for uncollectable accounts are based upon analysis of collection experience by fund type and are only applicable to receivables due from the public.

J. General Property, Plant and Equipment, Net

General Property, Plant and Equipment (PP&E) are valued at historical acquisition cost plus capitalized renovations or improvements. General PP&E assets are capitalized at cost if the acquisition is \$100,000 or more and has a useful life of two or more years. All General PP&E other than land, is depreciated on a straight-line basis. 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 more accurately 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." This

concept recognizes that member DoD agencies who gain the most benefit by virtue of space usage should capitalize the asset as General PP&E on their balance sheet.

Equipment is recorded at acquisition cost. In those instances where the original acquisition cost of General PP&E was not available, estimates have been used. Such estimates are based on either (1) the cost of similar assets at the time of acquisition or (2) the current cost of similar assets discounted for inflation to the time of acquisition.

Effective October 1, 2001, DFAS adopted SFFAS No. 10, *Accounting for Internal Use Software*, which requires a framework for identifying software development phases and processes to identify expenditures that should be capitalized for internal use software. This Standard is applicable for expenditures related to internally developed, contractor-developed, or Commercial Off the Shelf (COTS) software. The effect of adopting this standard was to increase program costs during the year ended September 30, 2001 by \$67,331 thousand.

K. Other Assets

Other assets include Advances, Prepayments, and Travel Advances.

L. Leases

Generally, lease payments are for the rental of equipment, space, and operating facilities and are classified as operating leases. Leases that do not transfer substantially all of the benefits or risks of ownership are classified as operating leases and recorded as expenses as payments are made over the lease terms.

M. Accounts Payable

Intragovernmental Accounts Payable consists of amounts owed to other DoD and Federal agencies. Accounts Payable consists of accounts payable with the public.

N. Accrued Leave

Military and civilian leave are accrued as earned and the accrued amounts are reduced as leave is taken. 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 nonvested 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.

O. Workers' Compensation Liability

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 and are ultimately paid by DFAS.

Future workers' compensation estimates were generated from an application of actuarial procedures developed by the Department of Labor 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 that period.

P. Pension, 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 the calculation of these pension and post-retirement health and life insurance benefit expenses were provided by the Office of Personnel Management (OPM) Financial Management Letters regarding *Cost Factors for Pension and other Retirement Benefits Expense*.

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

Q. Litigation

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

Most legal actions, other than contract claims, to which DFAS may be a named party, are covered by the provisions of the Federal Tort Claims Act and the provisions of Title 10, United States Code, Chapter 163, governing military claims. Since payments under these statutes are limited to amounts well below the threshold of materiality for claims payable from the agency's funds and payments will be from the permanent, indefinite appropriation "Claims, Judgments, and Relief Acts", these legal actions should not materially affect DFAS's operations.

R. Net Position

Net position consists of unexpended appropriations and cumulative result of operations. Unexpended appropriations represent amounts of authority, which are unobligated and have not been rescinded or withdrawn, and amounts obligated but for which neither legal liabilities for payment have been incurred nor actual payments made. DFAS does not have unexpended appropriations.

Cumulative results of operations represents the difference of an activity between expenses and other losses, and financing sources including appropriations used, revenue, and other gains. Beginning with FY 1998, this included the cumulative amount of donations and transfers of assets in and out without reimbursement. In addition, there is no longer a segregation of cumulative amounts related to investments in capitalized assets, such as PP&E, or a separate negative amount shown for future funding requirements. Cumulative results of operations for working capital funds represent the excess of revenues over expenses since fund inception, transfers of assets in and out without reimbursement since fund inception, less refunds to customers, and future funding requirements.

S. Undelivered Orders

DFAS is obligated for goods and services that have been ordered but not yet received (Undelivered Orders) as of September 30, 2001. DFAS has Undelivered Orders of \$136,005 thousand and \$170,926 thousand at September 30, 2001 and 2000, respectively. No liability for payment has been established in the financial statements because goods/services have yet to be delivered.

T. Pricing Policy

DFAS provides finance, accounting and information services to DoD agencies. The product lines available from DFAS include payroll and commercial payment processing as well as accounting and information services. Each year during the program budget formation and review process, a limited cost assessment is made by product or service line to assure that the rates charged to customers reflect the full cost to provide such services. The rate review process is an integral component to the development of customer service rates.

U. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

V. Reclassifications

Certain amounts and balances from the prior year have been reclassified to conform with the presentation of the current year.

NOTE 2. COLLECTIONS AND DISBURSEMENTS CLEARING

Fund Type	2001	2000
Appropriated Funds	\$ -	\$ -
Revolving Funds	-	-
Trust Funds	-	-
Other Fund Types	-	-
	<u>-</u>	<u>-</u>
Total	<u>\$ -</u>	<u>\$ -</u>

NOTE 3. ACCOUNTS RECEIVABLE (IN THOUSANDS)

	Gross Amount	Allowance for Estimated Uncollectibles	2001 Total	2000 Total
Entity Receivables:				
Intragovernmental	\$ 107,363	\$ -	\$ 107,363	\$ 105,084
With the public - net	<u>31</u>	<u>(1)</u>	<u>30</u>	<u>54</u>
Total	<u>\$ 107,394</u>	<u>\$ (1)</u>	<u>\$ 107,393</u>	<u>\$ 105,138</u>

NOTE 4. OTHER ASSETS (IN THOUSANDS)

	2001	2000
Intragovernmental:		
Other assets - advances and prepayments	\$ -	\$ 15
Total Intragovernmental	<u>\$ -</u>	<u>\$ 15</u>
Other assets:		
Advances - travel	\$ 70	\$ 167
Total	<u>\$ 70</u>	<u>\$ 167</u>

NOTE 5. GENERAL PROPERTY, PLANT AND EQUIPMENT, NET (IN THOUSANDS)

	Depreciation/ Amortization Method	Service Life	Acquisition Value	(Accumulated Depreciation/ Amortization)	2001 Net Book Value	2000 Net Book Value
Major Asset Classes:						
Land	N/A	N/A	\$ -	\$ -	\$ -	\$ -
Buildings, Structures, and Facilities	S/L	20-40	128,812	(11,900)	116,912	103,459
Leasehold Improvements	S/L	Lease Term	51,303	(4,651)	46,652	40,655
ADP Software	S/L	2-5	1,245,821	(942,257)	303,564	338,630
Equipment	S/L	5-10	264,233	(197,486)	66,747	74,888
Construction-In-Progress	N/A	N/A	<u>375,306</u>	<u>-</u>	<u>375,306</u>	<u>322,249</u>
Total			<u>\$ 2,065,475</u>	<u>\$ (1,156,294)</u>	<u>\$ 909,181</u>	<u>\$ 879,881</u>

MILCON Transfers

There were \$24,140 thousand in Military Construction (MILCON) transfers received from the U.S. Army Corps of Engineers during FY 2001 for the improvement and construction of the Limestone, Omaha, Charleston, and Rome facilities. FY 2000 transfers totaled \$50,034 thousand.

NOTE 6. OTHER LIABILITIES (IN THOUSANDS)

	Current Liability	Noncurrent Liability	2001 Total	2000 Total
Other Liabilities Not Covered by Budgetary Resources:				
Intragovernmental:				
Workers' compensation	\$ 4,251	\$ 4,878	\$ 9,129	\$ 8,824
Other liabilities	<u>3,752</u>	<u>-</u>	<u>3,752</u>	<u>5,788</u>
Total	<u>\$ 8,003</u>	<u>\$ 4,878</u>	<u>\$ 12,881</u>	<u>\$ 14,612</u>
With the Public:				
Accrued funded payroll and benefits	\$ 21,389	\$ -	\$ 21,389	\$ 20,859
Accrued unfunded annual leave	<u>51,692</u>	<u>-</u>	<u>51,692</u>	<u>51,783</u>
Total	<u>\$ 73,081</u>	<u>\$ -</u>	<u>\$ 73,081</u>	<u>\$ 72,642</u>

NOTE 7. MILITARY RETIREMENT BENEFITS AND OTHER EMPLOYMENT-RELATED ACTUARIAL LIABILITIES (IN THOUSANDS)

Major Program Activities	Actuarial Present Value of Projected Plan Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	2001 Unfunded Actuarial Liabilities	2000 Unfunded Actuarial Liabilities
Pension and Health Benefits (1):					
Military Retirement Pensions	\$ -	-	\$ -	\$ -	\$ -
Military Retirement Health Benefits	<u>-</u>	-	<u>-</u>	<u>-</u>	<u>-</u>
Total	<u>\$ -</u>		<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Other:					
Workers' Compensation (FECA)	<u>\$ 46,654</u>	5.21 %	<u>\$ -</u>	<u>\$ 46,654</u>	<u>\$ 41,526</u>
Total	<u>\$ 46,654</u>		<u>\$ -</u>	<u>\$ 46,654</u>	<u>\$ 41,526</u>
Total	<u>\$ 46,654</u>		<u>\$ -</u>	<u>\$ 46,654</u>	<u>\$ 41,526</u>

(1) Pension liabilities reported in the DoD Military Retirement Fund.

Workers' Compensation

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian 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 and are ultimately paid by DFAS.

Future workers' compensation estimates were generated from an application of actuarial procedures developed by the Department of Labor for each Federal agency 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 using a method that utilizes historical benefit payment patterns related to a specific incurred period to estimate the ultimate payments related to that period. The amounts presented in the financial statements are an allocation to DFAS from the liability computed for DoD.

Consistent with past practice, these projected annual benefit payments have been discounted to present value using the OMB's economic assumptions for 10-year Treasury notes and bonds. For FY 2001, interest rate assumptions utilized for discounting were as follows:

5.210% in year 1; and
5.210% in year 2 and thereafter.

For FY 2000, interest rates assumptions utilized for discounting were as follows:

6.275% in year 1;
6.300% in year 2 and thereafter.

To provide more specifically for the effects of inflation on the liability for future workers' compensation benefits, wage inflation factors that include cost of living adjustments and medical inflation factors are also used to adjust the methodology's historical payment to the current year constant dollars.

The model's resulting projections were analyzed to ensure that the amounts were reliable. The analysis was based on two tests: (1) a comparison of the percentage change in the liability amounts by agency to the percentage change in the actual payments, and (2) a comparison of the ratio of the estimated liability to the actual payment of the beginning year calculated for the current projection to the liability-payment ratio calculated for the prior projection.

In prior years, the actuarial FECA balance was derived from the 1-year chargeback amount for the specific DoD entity in question. For FY 2001, a weighted average method was established to allocate the FECA liability.

Pensions and Other Retirement Benefits

To calculate the liability for pensions and other retirement benefit costs, the "service cost" or normal cost is calculated. Service cost is defined as the actuarial present value of the benefits attributed by the pension plan's benefit formula to services rendered by employees during the accounting period. The amount of the service cost, less any employee contributions attributable to post-retirement benefits, is defined as pension expense for the entity.

Cost factors and imputed cost calculations were provided by OPM Financial Management Letters regarding *Cost Factors for Pension and Other Retirement Benefits Expenses*, and used to calculate the amount of additional expense to be recorded by DFAS.

The employee and employer contributions for health care and life insurance are attributed to the current period, and therefore, there is no offset to these service costs to calculate the other retirement benefit expense for the entity. These additional expenses represent a "subsidy" being made by OPM for employees' retirement benefits. Based

on the information provided by the OPM, DFAS determined that the imputed costs for the Pensions and Other Retirement Benefits for the following fiscal years were:

Imputed Expenses:

	2001	2000
CSRS/FERS Retirement	\$ 26,484	\$ 23,826
Health	47,497	46,568
Life Insurance	<u>138</u>	<u>118</u>
Total	<u>\$ 74,119</u>	<u>\$ 70,512</u>

NOTE 8. OPERATING LEASES (IN THOUSANDS)

DFAS's operating lease commitments for future years were estimated using data gathered from leases, General Services Administration bills, and InterService Support Agreements. The estimates for FY 2001 and 2000 future payments are based on a 1.7% and 3%, respectively, Consumer Price Index rate. The estimate for leases after five years includes only leases with defined expiration dates.

Future Payments Due:

Subsequent Years	2001	2000
Year 1	\$ 34,248	\$ 35,111
Year 2	34,831	35,939
Year 3	35,423	36,937
Year 4	36,025	38,118
Year 5	36,637	39,223
After Year 5	<u>37,260</u>	<u>36,281</u>
Total Future Lease Payments	<u>\$ 214,424</u>	<u>\$ 221,609</u>

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

**Consolidating and Combining Financial Statement Information
for the Years Ended September 30, 2001 and 2000**

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

**CONSOLIDATING BALANCE SHEET INFORMATION
AS OF SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

ASSETS	Financial Operations	Information Services	Combined	Eliminations	2001 Consolidated	2000 Consolidated
Entity Assets						
Collections and disbursements, clearing	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Intragovernmental:						
Accounts receivable	107,010	21,018	128,028	(20,665)	107,363	105,084
Other assets	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>15</u>
Total intragovernmental	107,010	21,018	128,028	(20,665)	107,363	105,099
Accounts receivable	28	2	30	-	30	54
General property, plant and equipment, net	902,692	6,489	909,181	-	909,181	879,881
Other assets	<u>69</u>	<u>1</u>	<u>70</u>	<u>-</u>	<u>70</u>	<u>167</u>
Total entity assets	<u>1,009,799</u>	<u>27,510</u>	<u>1,037,309</u>	<u>(20,665)</u>	<u>1,016,644</u>	<u>985,201</u>
TOTAL ASSETS	<u>\$1,009,799</u>	<u>\$27,510</u>	<u>\$1,037,309</u>	<u>\$(20,665)</u>	<u>\$1,016,644</u>	<u>\$985,201</u>

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

**CONSOLIDATING BALANCE SHEET INFORMATION
AS OF SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

LIABILITIES	Financial Operations	Information Services	Combined	Eliminations	2001 Consolidated	2000 Consolidated
Intragovernmental:						
Accounts payable	\$ 100,469	\$ 4,755	\$ 105,224	\$ (20,665)	\$ 84,559	\$ 80,854
Other liabilities	<u>12,044</u>	<u>837</u>	<u>12,881</u>	<u>-</u>	<u>12,881</u>	<u>14,612</u>
Total intragovernmental	112,513	5,592	118,105	(20,665)	97,440	95,466
Accounts payable	71,450	21,398	92,848	-	92,848	88,996
Military retirement benefit and other employment-related actuarial liabilities	44,321	2,333	46,654	-	46,654	41,526
Other liabilities	<u>64,904</u>	<u>8,177</u>	<u>73,081</u>	<u>-</u>	<u>73,081</u>	<u>72,642</u>
Total liabilities	<u>293,188</u>	<u>37,500</u>	<u>330,688</u>	<u>(20,665)</u>	<u>310,023</u>	<u>298,630</u>
NET POSITION						
Unexpected appropriations	-	-	-	-	-	-
Cumulative results of operations	<u>716,611</u>	<u>(9,990)</u>	<u>706,621</u>	<u>-</u>	<u>706,621</u>	<u>686,571</u>
Total net position	<u>716,611</u>	<u>(9,990)</u>	<u>706,621</u>	<u>-</u>	<u>706,621</u>	<u>686,571</u>
TOTAL LIABILITIES AND NET POSITION	<u>\$ 1,009,799</u>	<u>\$ 27,510</u>	<u>\$ 1,037,309</u>	<u>\$ (20,665)</u>	<u>\$ 1,016,644</u>	<u>\$ 985,201</u>

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

**CONSOLIDATING STATEMENT OF NET COST INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

	Financial Operations	Information Services	Combined	Eliminations	2001 Consolidated	2000 Consolidated
PROGRAM COST:€						
Intragovernmental	\$ 757,373	\$ 47,668	\$ 805,041	\$ (178,139)	\$ 626,902	\$ 669,608
With the public	<u>918,550</u>	<u>186,899</u>	<u>1,105,449</u>	<u>-</u>	<u>1,105,449</u>	<u>1,065,538</u>
 Total program cost	 1,675,923	 234,567	 1,910,490	 (178,139)	 1,732,351	 1,735,146
Less: Earned revenues	<u>(1,625,714)</u>	<u>(216,933)</u>	<u>(1,842,647)</u>	<u>178,139</u>	<u>(1,664,508)</u>	<u>(1,701,636)</u>
 Net program costs	 <u>50,209</u>	 <u>17,634</u>	 <u>67,843</u>	 <u>-</u>	 <u>67,843</u>	 <u>33,510</u>
 NET COST OF OPERATIONS€	 <u><u>\$ 50,209</u></u>	 <u><u>\$ 17,634</u></u>	 <u><u>\$ 67,843</u></u>	 <u><u>\$ -</u></u>	 <u><u>\$ 67,843</u></u>	 <u><u>\$ 33,510</u></u>

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

**CONSOLIDATING STATEMENT OF CHANGES IN NET POSITION INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

	Financial Operations	Information Services	Combined	Eliminations	2001 Consolidated	2000 Consolidated
NET COST OF OPERATIONS	<u>\$ 50,209</u>	<u>\$ 17,634</u>	<u>\$ 67,843</u>	<u>\$ -</u>	<u>\$ 67,843</u>	<u>\$ 33,510</u>
Financing sources (other than exchange revenues):						
Appropriations used	1,025	-	1,025	-	1,025	-
Imputed financing	66,847	7,272	74,119	-	74,119	70,512
Transfers-in	55,704	50	55,754	573	56,327	38,417
(Transfers-out)	(45,875)	2,870	(43,005)	(573)	(43,578)	114,734
Other	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(21,676)</u>
Total financing sources (other than exchange revenues)	<u>77,701</u>	<u>10,192</u>	<u>87,893</u>	<u>-</u>	<u>87,893</u>	<u>201,987</u>
NET RESULTS OF OPERATIONS	27,492	(7,442)	20,050	-	20,050	168,477
PRIOR-PERIOD ADJUSTMENTS	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>(36,126)</u>
NET CHANGE IN CUMULATIVE RESULTS OF OPERATIONS	27,492	(7,442)	20,050	-	20,050	132,351
INCREASE (DECREASE) IN UNEXPENDED APPROPRIATIONS	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
CHANGE IN NET POSITION	27,492	(7,442)	20,050	-	20,050	132,351
NET POSITION - BEGINNING OF THE PERIOD	<u>689,119</u>	<u>(2,548)</u>	<u>686,571</u>	<u>-</u>	<u>686,571</u>	<u>554,220</u>
NET POSITION - END OF THE PERIOD	<u>\$ 716,611</u>	<u>\$ (9,990)</u>	<u>\$ 706,621</u>	<u>\$ -</u>	<u>\$ 706,621</u>	<u>\$ 686,571</u>

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

**COMBINING STATEMENT OF BUDGETARY RESOURCES INFORMATION
FOR THE YEAR ENDED SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

	Financial Operations	Information Services	2001 Combined	2000 Combined
BUDGETARY RESOURCES:				
Budget authority	\$ 218,425	\$ 2,600	\$ 221,025	\$ 222,921
Unobligated balance - beginning of period	628,058	57,215	685,273	446,442
Net transfers - prior year balance	4,524	-	4,524	(1,308)
Spending authority from offsetting collections and adjustments	<u>1,627,972</u>	<u>205,769</u>	<u>1,833,741</u>	<u>1,877,993</u>
TOTAL BUDGETARY RESOURCES	<u>\$ 2,478,979</u>	<u>\$ 265,584</u>	<u>\$ 2,744,563</u>	<u>\$2,546,048</u>
STATUS OF BUDGETARY RESOURCES:				
Obligations incurred	\$ 1,586,226	\$ 230,042	\$ 1,816,268	\$ 1,860,775
Unobligated balances - available	<u>892,753</u>	<u>35,542</u>	<u>928,295</u>	<u>685,273</u>
TOTAL STATUS OF BUDGETARY RESOURCES	<u>\$ 2,478,979</u>	<u>\$ 265,584</u>	<u>\$ 2,744,563</u>	<u>\$2,546,048</u>
OUTLAYS:				
Obligations incurred	\$ 1,586,226	\$ 230,042	\$ 1,816,268	\$ 1,860,775
Less: Spending authority from offsetting collections and adjustments	(1,627,972)	(205,769)	(1,833,741)	(1,877,993)
Obligated balance, net - beginning of period	212,274	(31,507)	180,767	312,774
Less: Obligated balance, net - end of period	<u>(181,294)</u>	<u>9,703</u>	<u>(171,591)</u>	<u>(180,767)</u>
TOTAL OUTLAYS	<u>\$ (10,766)</u>	<u>\$ 2,469</u>	<u>\$ (8,297)</u>	<u>\$ 114,789</u>

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

**COMBINING STATEMENT OF FINANCING INFORMATION
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)**

	Financial Operations	Information Services	2001 Combined	2000 Combined
OBLIGATIONS AND NONBUDGETARY RESOURCES:				
Obligations incurred	\$ 1,586,226	\$ 230,042	\$ 1,816,268	\$ 1,860,775
Less: Spending authority for offsetting collections and adjustments	(1,627,972)	(205,769)	(1,833,741)	(1,877,993)
Financing imputed for cost subsidies	66,847	7,272	74,119	70,512
Less: Exchange revenue not in the entity's budget	<u>-</u>	<u>(1)</u>	<u>(1)</u>	<u>(772)</u>
Total obligations as adjusted and nonbudgetary resources	<u>25,101</u>	<u>31,544</u>	<u>56,645</u>	<u>52,522</u>
RESOURCES THAT DO NOT FUND NET COST OF OPERATIONS:				
Change in amount of goods, services, and benefits ordered but not yet received or provided - (increases)/decreases	39,373	(4,436)	34,937	63,508
Change in unfilled customer orders	(6,826)	(11,237)	(18,063)	(7,389)
Costs capitalized on the balance sheet - (increases)/decreases	(168,714)	(2,529)	(171,243)	(227,125)
Financing sources that fund costs of prior periods	<u>-</u>	<u>(94)</u>	<u>(94)</u>	<u>(50,354)</u>
Total resources that do not fund net cost of operations	<u>(136,167)</u>	<u>(18,296)</u>	<u>(154,463)</u>	<u>(221,360)</u>
COSTS THAT DO NOT REQUIRE RESOURCES:				
Depreciation and amortization	<u>156,113</u>	<u>4,115</u>	<u>160,228</u>	<u>190,197</u>
Total costs that do not require resources	<u>156,113</u>	<u>4,115</u>	<u>160,228</u>	<u>190,197</u>
FINANCING SOURCES YET TO BE PROVIDED	<u>5,162</u>	<u>271</u>	<u>5,433</u>	<u>12,151</u>
NET COST OF OPERATIONS	<u>\$ 50,209</u>	<u>\$ 17,634</u>	<u>\$ 67,843</u>	<u>\$ 33,510</u>

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

**Required Supplementary Information for the Years
Ended September 30, 2001 and 2000 (Unaudited)**

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

**SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
AS OF SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)
(UNAUDITED)**

	2001		2000	
	Accounts Receivable	Other Assets	Accounts Receivable	Other Assets
INTRAGOVERNMENTAL ASSETS:				
Navy General Fund	\$ 32,654	\$ -	\$ 28,729	\$ -
Army General Fund	52,296	-	36,876	-
Air Force General Fund	2,163	-	8,754	15
Army Working Capital Fund	4,694	-	10,676	-
Navy Working Capital Fund	6,297	-	8,811	-
Air Force Working Capital Fund	1,174	-	467	-
ODO General Fund	4,190	-	4,693	-
ODO Working Capital Fund	2,374	-	5,881	-
Executive Office of the President AT (11)	-	-	48	-
Department of Agriculture AT (12)	-	-	31	-
United States Postal Service AT (18)	-	-	16	-
Department of the Treasury AT (20)	1,465	-	36	-
Social Security Administration AT (28)	-	-	7	-
General Services Administration AT (47)	14	-	1	-
Department of Transportation AT (69)	-	-	3	-
Armed Forces Retirement Home	27	-		
Independent Agencies	14	-		
U.S. Army Corps of Engineers	<u>1</u>	<u>-</u>	<u>55</u>	<u>-</u>
 Total Intragovernmental Assets	 <u>\$ 107,363</u>	 <u>\$ -</u>	 <u>\$ 105,084</u>	 <u>\$ 15</u>

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

**SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
AS OF SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)
(UNAUDITED)**

	2001		2000	
	Accounts Payable	Other Liabilities	Accounts Payable	Other Liabilities
INTERGOVERNMENTAL LIABILITIES:				
Navy General Fund	\$ 6,262	\$ -	\$ 16,867	\$ -
Army General Fund	7,565	-	8,613	-
Air Force General Fund	5,324	-	2,149	-
Army Working Capital Fund	224	-	1,438	-
Navy Working Capital Fund	20,071	-	3,006	-
Air Force Working Capital Fund	1,775	-	1,571	-
ODO General Fund	746	-	2,186	-
ODO Working Capital Fund	37,116	-	39,759	-
Office of Personnel Management AT (24)	684	3,753	-	5,220
General Services Administration AT (47)	2,859	-	5,163	-
U.S. Army Corps of Engineers	98	-	102	-
Executive Office of the President	4	-	-	-
Department of the Interior	540	-	-	-
Department of the Treasury	926	-	-	-
Department of Veterans Affairs	4	-	-	-
Department of Transportation	1	-	-	-
Department of Health and Human Services	356	-	-	-
Export-Import Bank of the United States	4	-	-	-
Department of Labor	-	9,128	-	9,392
	<u>-</u>	<u>9,128</u>	<u>-</u>	<u>9,392</u>
 Total Intragovernmental Liabilities	 <u>\$ 84,559</u>	 <u>\$ 12,881</u>	 <u>\$ 80,854</u>	 <u>\$ 14,612</u>

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

**SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
AS OF SEPTEMBER 30, 2001 AND 2000
(IN THOUSANDS)
(UNAUDITED)**

	2001	2000
	Earned Revenues	Earned Revenues
INTRAGOVERNMENTAL REVENUES:		
Navy General Fund	\$ 386,185	\$ 381,818
Army General Fund	551,831	580,558
Air Force General Fund	298,450	287,391
Army Working Capital Fund	29,528	26,786
Navy Working Capital Fund	88,028	93,455
Air Force Working Capital Fund	34,004	34,859
ODO General Fund	136,695	103,679
ODO Working Capital Fund	134,618	145,811
Executive Office of the President AT (11)	137	42,520
Department of the Treasury AT (20)	1,465	142
Social Security Administration AT (28)	-	69
General Services Administration AT (69)	24	2
U.S. Army Corps of Engineers	2,962	4,062
Department of Commerce	13	-
Department of Energy	-	42
Department of Veterans Affairs	13	-
Armed Forces Retirement Home	69	-
Selective Services System	11	-
Department of Transportation	119	442
Other	<u>356</u>	<u>-</u>
 Total Intragovernmental Revenues	 <u>\$1,664,508</u>	 <u>\$1,701,636</u>
	Transfers In	Transfers Out
NON-EXCHANGE REVENUES FOR FY 2001:		
ODO Working Capital Funds	\$ 31,279	\$ 43,578
ODO General Funds	<u>25,048</u>	<u>-</u>
 Total Non-exchange Revenues	 <u>\$ 56,327</u>	 <u>\$ 43,578</u>

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

**Independent Auditors' Report on Internal Control Over Financial
Reporting and Compliance Based Upon the Audit Performed in
Accordance with *Government Auditing Standards***

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Audit Committee and the Director,
Defense Finance and Accounting Service:

We have audited the consolidated and combined financial statements of the Defense Finance and Accounting Service (DFAS) as of and for the year ended September 30, 2001, and have issued our report thereon dated January 25, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

Internal Control over Financial Reporting

In planning and performing our audit, we considered DFAS's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving DFAS's internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operations of the internal control over financial reporting that, in our judgment, could adversely affect DFAS's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

Reportable conditions noted are described in the following paragraphs and include significant departures from certain requirements of OMB Circular A-127, *Financial Management Systems*, which incorporates by reference Circulars A-123, *Management Accountability and Control*, and A-130, *Management of Federal Information Resources*, among other requirements. We believe that the following reportable conditions are also material weaknesses.

1. During our audit of DFAS's consolidated and combined financial statements, we identified deficiencies related to the internal control over the preparation, analysis, and monitoring of financial information to

support the efficient and effective preparation of agency wide financial statements. Because of the deficiencies noted, we believe that DFAS's financial management system does not meet the requirements of an integrated financial management system as defined in OMB Circular A-127, with respect to "consistent internal control over data entry, transaction processing and reporting." We also believe that DFAS is not in compliance with the system design requirements sufficient to comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury, and to monitor the financial management system to ensure integrity of financial data.

As defined in OMB Circular A-127, "a financial management system encompasses automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions." Such financial management systems shall be designed to provide for effective and efficient interrelationship between software, hardware, personnel, procedures, controls, and data contained within the systems. These integrated systems shall have the following characteristics: (1) common data elements; (2) common transaction processing; (3) consistent internal control over data entry, transaction processing and reporting; and (4) efficient transaction entry.

With respect to system requirements in the area of financial reporting, OMB Circular A-127 requires that an "agency financial management system shall be able to provide financial information in a timely and useful fashion to (1) support management's fiduciary role; (2) support the legal, regulatory and other special management requirements of the agency; (3) support budget formulation and execution functions; (4) support fiscal management of program delivery and program decision making; (5) comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury; and (6) monitor the financial management system to ensure integrity of financial data."

Our assessment is based upon various factors noted during our audit. For example, we noted:

- DFAS rendered services in excess of Military Interdepartmental Purchase Requests (MIPRs) in the amount of \$19 million during FY 2001. The unfunded expenses represent the continuation of normal services performed in excess of funded orders. These services were not initially recognized as customer receivables until funding for these costs was approved. As a result, an adjustment for \$19 million was made to the financial statements to record the customer receivables.
- DFAS does not have a managerial cost accounting system that can draw from the general ledger activity in the Defense Business Management System (DBMS) on a real time basis. Therefore, DFAS is unable to get a snapshot picture of their full costs against the amount charged to their customers.
- Accounts payable amounts related to certain vendors were miscoded between the intergovernmental (government) and nonfederal (public) classifications. Such miscodings were not caught through normal accounting processes or timely review procedures and would impact the elimination process at all levels. The miscodings resulted in an adjustment of \$8.6 million to the financial statements.
- Numerous adjustments were posted to the DBMS trial balances to correct or add data and to crosswalk DBMS general ledger accounts to U. S. Standard General Ledger (SGL) accounts. The adjustments made affect the integrity of both the proprietary and the budgetary accounts. For purposes of compiling the financial statements, the information from the crosswalk was inputted to the Defense Departmental Reporting System (DDRS). As discussed in the *Framework for Federal*

Financial Management Systems, issued by the Joint Financial Management Improvement Program (JFMIP), an agency's financial management system should include "the ability to . . . facilitate the preparation of financial statements, and other financial reports in accordance with federal accounting and reporting standards." The responsibilities of agency level data stewardship exist at each level within the agency to insure that "the information contained within the systems is accurate, timely, consistent and useful."

- DFAS receives fund transfers and direct appropriations, which are earmarked for special activities. In the current year, funds were provided in support of the Office of the Secretary of Defense (OSD) activities, website design, and reduction of excess utility costs. Our review found that DFAS did not account for obligations, disbursements, and expenses for each unique fund source (i.e., direct appropriation). For example, in order to determine the amounts consumed from \$4.3 million provided to DFAS from OSD, document level queries had to be performed.
- The Electronic Data Processing (EDP) systems utilized by DFAS are not fully compliant with OMB Circular A-127. The Circular requires that Federal financial systems provide complete, reliable, consistent, timely and useful financial management information. Our procedures identified deficiencies in the design and operation of EDP controls that increase the risk of unauthorized access to and modification of sensitive data. This condition compromises the ability of the systems to provide reliable data.

DFAS continues to undertake significant efforts to fully implement the reporting requirements of OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. While we believe DFAS has made significant progress toward meeting its planned reporting objectives, significant improvements are still required as the processes and infrastructure that support the preparation of the agency's consolidated and combined financial statements do not yet provide timely and effective reporting going forward.

2. DFAS provides services and acquires services from many Department of Defense (DoD) agencies and components as well as the government as a whole. The governmental entities and activities that do business with DFAS are referred to as trading partners. Transactions generated by these trading partner activities are an accounts receivable (DFAS as the seller) or an accounts payable (DFAS as the buyer). Presently, DoD and its component agencies do not have a standard key or code identifier in their business partner transactions to eliminate those transactions during the preparation of the financial statements.

In the current year, DFAS developed an interim method to enable them to reconcile accounts payable within DFAS (i.e., 5L and 5F) at year-end. Seller information was reconciled to information provided; however, an automated process is not in place.

3. Our assessment of information systems at the computer processing locations used by DFAS disclosed deficiencies in the design and operation of the disaster recovery plans, environmental controls and backup procedures. Specifically, we noted the following with respect to Disaster Recovery Plans (DRP):
 - Lack of documented or informally documented application-specific Disaster Recovery Plans (also referred to as Continuity of Operation Plans – COOP Plans);
 - Infrequent or no periodic testing of Disaster Recovery Plans;

- Issues with regard to the rotation of backup tapes to offsite facilities including the timing of rotation, location of offsite facilities, security of tapes during shipment to offsite facilities, and procedures for ensuring that all necessary backup tapes are at the offsite facility;
 - Inadequate or no periodic testing of backup tapes to verify reliability;
 - Data centers that lacked specific environmental controls; and
 - Data centers with single points of failure that could disrupt access to systems and data.
4. Our review of DFAS's information system security access controls and security policies and procedures in place disclosed deficiencies in the design and operation of information system access controls. Specifically, we noted the following control weaknesses:
- Weak password requirements;
 - Inadequate protection of internal network resources from Internet-based attacks;
 - Group accounts that permit users to access to systems without individual accountability;
 - Users with excessive access privileges;
 - Physical security weaknesses with respect to personnel access to data centers;
 - Insufficient or no monitoring of security violation and security audit logs;
 - Inadequate monitoring of inactive user accounts;
 - Infrequent or no periodic reviews of access privileges; and
 - Inadequate intrusion detection software.
5. The information system assessment identified weaknesses in operating system software change control procedures, including lack of system software change control procedures; inadequate procedures for testing, approving and migrating system software changes; and inadequate system software change tracking procedures. Segregation of incompatible duties does not exist at several information system processing centers/support locations. For instance, certain database administrators have the ability to promote changes to production environment; and at one location there was not an adequate segregation of programming duties, database administration duties, system administration duties, security administration duties, and technical support duties. Additionally, in the payroll area, certain supervisors, leads, and special purpose technicians at the Defense civilian payroll offices are able to change data originating from the HR system.
6. As directed by the Office of the Secretary of Defense (OSD), DFAS did not prepare the annual Section 4 report as required by the Federal Managers Financial Integrity Act (FMFIA). Such Section 4 reporting requirements are met at the OSD level through the Financial Management Improvement Plan (FMIP). Although Section 4 reporting requirements are intended for the department level, compliance requirements derivatively apply to DFAS because it is a DoD component. DFAS has legacy systems which had previously been reported on as not being in compliance with Federal financial management system requirements; they continue to not be in compliance. DFAS is in the process of replacing the

non-compliant legacy systems with migratory systems. This replacing process will take approximately 1-2 more years to complete the implementation.

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

Compliance

As part of obtaining reasonable assurance about whether DFAS's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described below.

1. The material weaknesses in internal control over financial reporting discussed above indicate that DFAS is not in compliance with the requirements of OMB Circulars A-123, A-127.
2. The material weakness discussed above indicate that DFAS is not in compliance with the FMFIA.
3. The financial management systems utilized by DFAS do not comply substantially with the requirements for Federal financial management systems set forth in OMB Circular A-127 in that they do not fully, efficiently, and effectively support DFAS's efforts to:
 - Prepare financial statements and other required financial and budget reports using information generated by the financial management systems;
 - Provide reliable and timely financial information for managing current operations;
 - Account for their assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and
 - Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger.
4. The material weakness discussed above indicate that DFAS is not in compliance with OMB Circular A-130, including subsection 8b(3)(b)(iii) and Appendix III, *Security of Federal Automated Information Resources*.

We believe these weaknesses, in the aggregate, result in significant departures from certain of the requirements of OMB Circulars A-123, A-127, and A-130.

Distribution

This report is intended solely for the information and use of the Audit Committee, the management of the Defense Finance and Accounting Service, the DoD Inspector General, and the DoD Under Secretary of Defense (Comptroller) and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

January 25, 2002