Message from the Director

I am pleased to present the Fiscal Year (FY) 2001 financial statements for the Defense Logistics Agency (DLA). These statements provide the Agency's financial results and highlight some of our key accomplishments during the year.

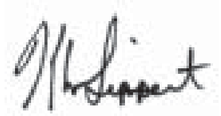
DLA is the Defense Department's combat logistics support agency. In FY 2001, we managed approximately 4.5 million items, including supplying all the Department's needs for fuel, food, clothing, and medical supplies, and approximately 90 percent of its needs for weapon system repair parts and industrial support consumable items.' Through the combination of DLA-managed and military service-owned items warehoused in DLA facilities, we filled over 80 percent of the Department's total requisitions for supplies and materiel. We also managed the reutilization and disposal of approximately $13.4 billion in DoD property that was no longer needed by its current holders. We met our responsibilities to support the combat readiness and sustainment of the war-fighter and continued to make great strides in delivering goods and services with greater efficiency. But more can and will be done. We are revising our Agency-wide strategic plan, and implementing a comprehensive business plan, to more clearly define our expectations and measure our progress in providing best value logistics solutions to America's war-fighters—the right item, at the right time, in the right place, at the right price.

Our objectives include developing a national inventory strategy to improve supply readiness, reducing excess capacity and related infrastructure costs, reducing our cost recovery rate, implementing our Business Systems Modernization initiative, adopting commercial business practices, and improving the accuracy and usefulness of our financial and performance data. We will achieve these objectives by streamlining and modernizing our core business processes, investing in new business systems and training our workforce to meet the challenges of the 21st Century. We will also challenge ourselves through a series of public/private competitions and, when appropriate, enter into commercial joint ventures. These strategies will allow us to reduce inventory levels, further integrate our supply chain, and optimize our processes for distribution, reutilization, document automation and production, and logistics information services. In FY 2002 we will also intensify our customer focus commitment by further tailoring logistics solutions to meet specific customer requirements.

We are also committed to improving the reliability and timeliness of our financial and performance data. Improved financial and performance data will

demonstrate our financial stewardship to customers and other stakeholders, and will enhance justification and management of resources needed to achieve our logistics transformation objectives and day-to-day readiness support performance goals.

During FY 2001, we marked the 40th anniversary of the establishment of DLA. We look back with pride and an overall sense of accomplishment. DLA has changed and adapted over the last 40 years to become the Department's primary provider of combat logistics support solutions to America's Armed Forces around the clock and—around the world, in times of peace, national emergencies and war. DLA touches the lives of all of America's soldiers, sailors, airmen, and marines and those they protect and defend. We take this responsibility—and the related requirements for judicious stewardship of required financial resources—very seriously. We will continue to improve our responsiveness and resource management in FY 2002 and the years to come.



KEITH W. LIPPERT
Vice Admiral, SC, USN
Director

Message from the Comptroller

I am pleased to present the fiscal year 2001 financial statements. During the year, we continued our contract with Deloitte and Touche LLP for the audit of our working capital fund consolidated financial statements. Our Audit Committee remains actively involved in overseeing the contract and is monitoring the contractor's performance. Our intent in hiring an external audit firm is to work with them to help bring DLA up to commercial standards, improve the accuracy and timeliness of our financial and management performance data, and to demonstrate financial stewardship to our customers and stakeholders.

Despite the disclaimer of opinion, we made significant progress during the year by addressing some of our long-standing deficiencies and putting in place long-term action plans to obtain complete, accurate, timely, and reliable data. For example, the results of our FY 2001 inventory sample demonstrated that the quantity balances of our materiel stored at the distribution depots were highly accurate. We also made great strides in creating an environment that allows the Agency to undergo an external audit by establishing cross-functional teams comprised of subject matter experts from our Primary Level Field Activities. The teams worked directly with the auditors to provide the required audit data. We will institutionalize these processes and streamline them in future years. Our Audit Committee, which includes senior DLA executives and representatives from the Defense Finance and Accounting Service and the DoD Inspector General, continues to deal with emerging audit issues and concerns as they arise.

Many of the problems identified by the auditors can be attributed to the myriad of archaic automated systems and business practices that were not designed to accomplish our diverse missions and functions on an enterprise-wide basis. They were not designed - nor are they sufficiently flexible - to comply with the current Federal accounting and system standards. We are on schedule to implement our Business Systems Modernization (BSM) initiative. BSM is our principal long-term strategy for complying with the Federal Financial Management Requirements and improving the accuracy

and reliability of the data in our supply management financial statements. In the meantime, DLA is developing corporate-wide solutions to the audit issues; building the business processes and internal controls needed to demonstrate the financial stewardship of our working capital fund and the integrity of our financial records; and deploying the financial rules and tools to enable our workforce to do their jobs effectively. Our revised compliance plan continues to focus on issues identified by the annual commercial audits and establishes plans of actions and milestones to correct outstanding issues.

The Agency remains strongly committed to employing business processes that will demonstrate our financial stewardship and thereby ensure confidence in our ability to support our customers in peace and war.

Linda J. Furiga
Comptroller

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DESCRIPTION OF THE REPORTING ENTITY

The Defense Logistics Agency (DLA) is a combat support agency of the Department of Defense (DoD). The Under Secretary of Defense for Acquisition, Technology, and Logistics provides oversight and staff direction to DLA. We support DoD missions and objectives through our involvement in the full range of military operations, from our participation in multi-national forces engaged in large-scale combat contingencies to localized humanitarian assistance efforts. Our reach extends from the home front to the frontlines and from mess halls to foxholes. Our overarching mission is to provide best value logistics solutions to meet the needs of America's Armed Forces around the clock and around the world, in times of peace, national emergency, and war. The United States national defense strategy has never been more dependent on the availability of DLA efforts than it is today. Our armed forces cannot effectively deploy for contingencies, emergencies or war without us. Hence, DLA is fundamental to the success of the national security strategy, as well as DoD corporate goals, by helping to shape the combat support environment and enhance the readiness of our troops through focused logistics.

We provide the Military Departments and other authorized customers with centralized management of the logistics information, energy, consumable spare parts, food, medical supplies, and clothing that they use to prepare for deployment and to sustain operations. We are also responsible for receiving, issuing, and distributing most DoD materiel; and we manage DoD programs to reutilize, transfer, donate or sell surplus and excess DoD materiel and to dispose of hazardous materiel and waste. As secondary missions, DLA manages the DoD document automation and production services and the National Defense Stockpile.

Our mission has evolved and grown over the past 40 years to an extent that if our forces fight with it, wear it, eat it, or burn it as fuel, we probably buy it, warehouse and distribute it, and/or arrange for its reuse, sale or disposal after the owner no longer needs it.

Our Vision

Right Item, Right Time, Right Place, Right Price.
Every Time...Best Value Solutions For America's Warfighters

Agency Strategic Goals

We are actively engaged in the revolution of DoD business affairs, including significant advances in the technological sophistication, speed, and mobility of our armed forces. Our 2002-2007 Strategic Plan provides a road map to our logistics transformation. The plan supports the tenets of "focused logistics," as contained in the FY 2001 DoD Logistics Strategic Plan (http://www.acq.osd.mil/log/lsp/lsp.htm) and the Goals for Defense Agencies in the Quadrennial Review. Our strategic plan reflects the changes we anticipate in the logistics requirements on the 21st century battlefield. It outlines our goals to facilitate the transformation of DLA into a smaller, more agile, combat support agency.

Agency Strategic Goals and Strategies

In FY 01, DLA began implementing a management tool, Balanced Scorecard (BSC), which identifies DLA corporate strategies, measures, targets and initiatives. BSC will track progress on DLA transforming strategies. Our FY 02 report will discuss this methodology as it relates to four quadrants of the Corporate BSC (Customer, Internal Process, Learning and Growth, and Financial) and DLA's Lead Center concept.

Our FY 2002-2007 Strategic Plan identifies DLA's four strategic goals:

Strategic Goals

- Consistently provide responsive, best-value supplies and services to our customers.
- Structure internal processes to deliver customer outcomes effectively and efficiently.
- Ensure our workforce is enabled and empowered to deliver and sustain logistics excellence.
- Manage DLA resources for best customer value.

We will achieve these strategic goals through a series of integrated enterprise-wide strategies.

Goal 1. Provide responsive, best value supplies and services consistently to our customers.

Strategy 1.1. Focus, manage, and measure logistics support by customer segment based on customer requirements.
Strategy 1.2. Negotiate and honor performance agreements with our customers.
Strategy 1.3 Ensure seamless logistics support to customer segments throughout the customer's transition to and from peace and war.

Goal 2. Structure internal processes to deliver customer outcomes effectively and efficiently.

Strategy 2.1. Improve supply chain effectiveness.
Strategy 2.2. Improve business processes.
Strategy 2.3. Leverage industry.
Strategy 2.4. Develop and implement a best value enterprise information technology (IT) environment.

Goal 3. Ensure our workforce is enabled and empowered to deliver and sustain logistics excellence.

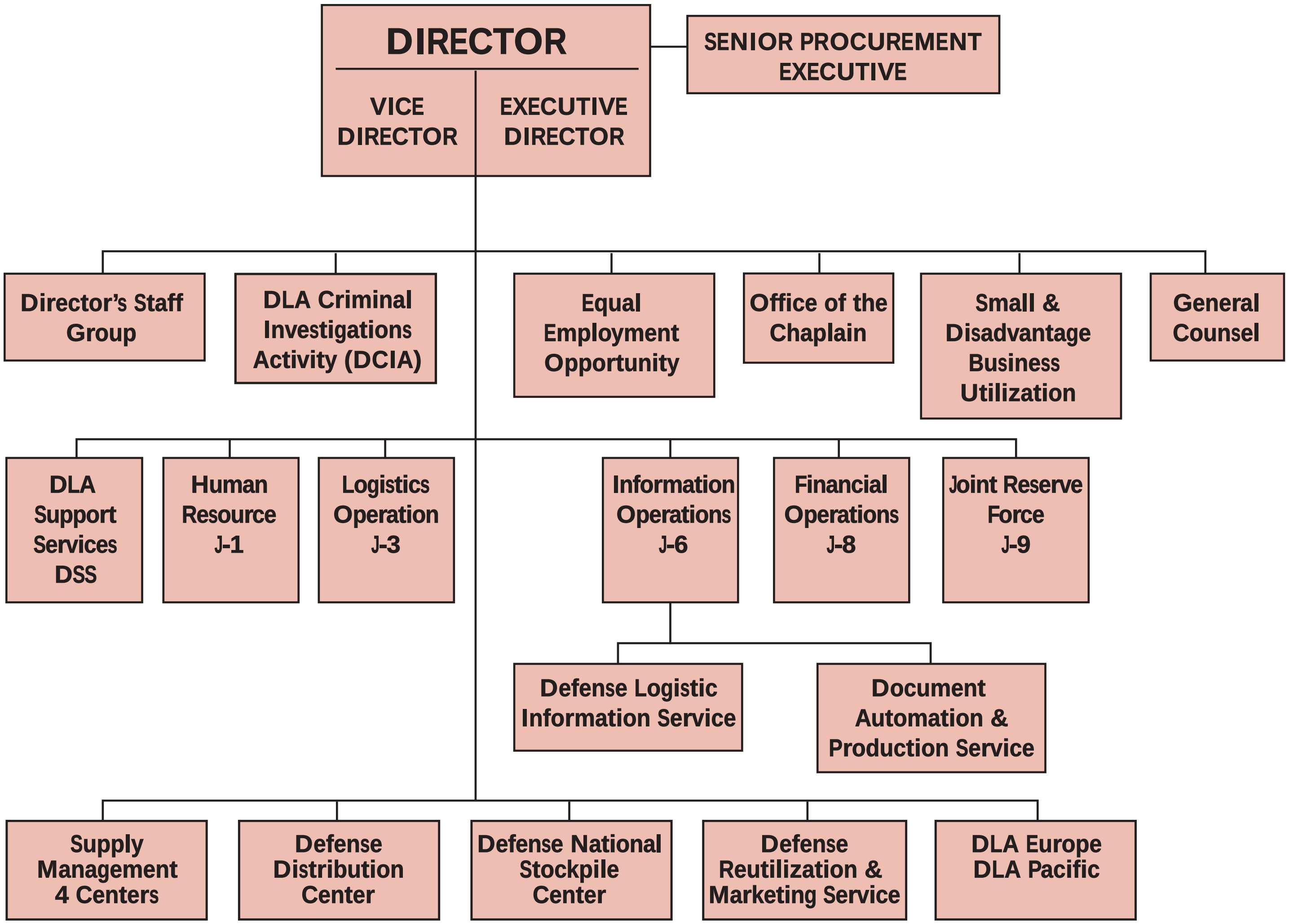
Strategy 3.1. Deliver the proper knowledge and skills to meet DLA's commitments to our customers.
Strategy 3.2. Create and manage a customer-focused corporate culture.
Strategy 3.3 Provide a quality work environment consistent with DLA values.

Goal 4. Manage DLA resources for best customer value.

Strategy 4.1. Resource DLA's operational strategies.
Strategy 4.2. Minimize total supply chain costs.
Strategy 4.3 Promote confidence in DLA's financial stewardship.

ORGANIZATION

DLA maintains a global presence with a workforce that exceeds 23,000 personnel. As part of our strategic planning process that started last year under DLA-21, we began a major organizational redesign effort to streamline and realign the DLA headquarters components. The reorganization will facilitate our conversion to an enterprise business model, which will allow us to develop and implement an improved set of corporate business processes and strategies. Organized as a single, integrated business enterprise it will best position us to focus on supply chain management, readiness, and contingency operations and thereby ensure that the warfighter is never unprepared from a logistics perspective. Our organizational structure during FY 01 is depicted below:



DLA's core functions are directed or supported by:

- Logistics Operations (J-3) provides focused logistics support to America's armed forces. J-3 is responsible for logistics and acquisition policy, supply chain management, development and application of DLA readiness and customer support efforts, business modernization, materiel disposition, and serves as the head of the logistics sector for the entire Department of Defense under the Presidentially-mandated Critical Infrastructure Protection (CIP) program. Logistics Operations encompasses supply management, distribution and reutilization and marketing.

- Information Operations (J-6) is DLA's knowledge broker and responsible for providing comprehensive, best practice technological support to the DLA Logistics Business Community resulting in high quality information systems, efficient, and economical computing, data management, electronic business, and telecommunication services. Information Operations encompasses oversight of two field activities: the Defense Logistics Information Service and the Document Automation and Production Service.

- Human Resources (J-1) mission entails developing a strategic approach and the requisite policies/programs related to human capital. J-1 is responsible for personnel staffing, employee relations, labor relations, training, executive development, career management, position classification, pay administration, manpower management, performance management, incentive awards, personnel management evaluation, certain worker/family support programs, management information, military personnel and manpower issues.

- Financial Operations (J-8) is the Agency's financial management process owner. J-8 is responsible for designing and implementing standard financial processes across the Agency, determining financial services' resource requirements and performance targets, and establishing financial core competency requirements. The Comptroller serves as the Agency's Chief Financial Officer and as the single spokesperson on financial management matters with external organizations.

- DLA Support Services (DSS) provides corporate policy and program support for Communications, Environmental and Safety, Installations, Strategic Planning, Security, Special Projects and Quality of Life (QOL) initiatives. Operational support is provided to the HQ Complex for facilities, security, health, protocol, QOL, the Information Technology contract support for the DLA Corporate activities, and the base contract support for DLA activities in the Washington, D.C. metropolitan area.

Activity Group Missions

The Defense-wide Working Capital Fund (DWCF) is the primary source of funds for DLA operations. During FY 01, DLA executed a total budget program of about $18.6 billion. The four DLA activity groups funded by the DWCF and included in these statements are Supply Management, Distribution, Reutilization and Marketing, and Document Automation and Production. Each year, DLA either obtains or returns funds to the DWCF and other DoD appropriations. These fund transfers are accounted for in these financial statements.

DLA also receives some direct appropriations (for purposes such as Military Construction), and manages the National Defense Stockpile Transaction Fund. These funds (and related financial events) are not accounted for in these financial statements.

The following business areas are financed by customer orders through the DWCF:

Supply Management. The Supply Management activity group provides customer support through management of logistics processes. This includes centralized management of logistics information, energy, consumable spare parts, food, pharmaceuticals, medical and surgical supplies, and clothing and textiles. Supply Management operates through four inventory control points located in Columbus, OH; Richmond, VA; Philadelphia, PA; and at Fort Belvoir, VA.

Distribution. The Distribution activity group provides a single, unified materiel distribution system for DoD. In addition to its primary mission of receiving, storing and issuing materiel worldwide; distribution depots perform other functions that include, but are not limited to, providing refrigerated storage, cylinder refurbishment, tent repair, medical unit assemblies, minor maintenance, and set assembly or disassembly. The Distribution activity group is under the control of the Defense Distribution Center in New Cumberland, PA and includes 22 subordinate distribution depots located throughout the United States, Europe and in the Pacific region.

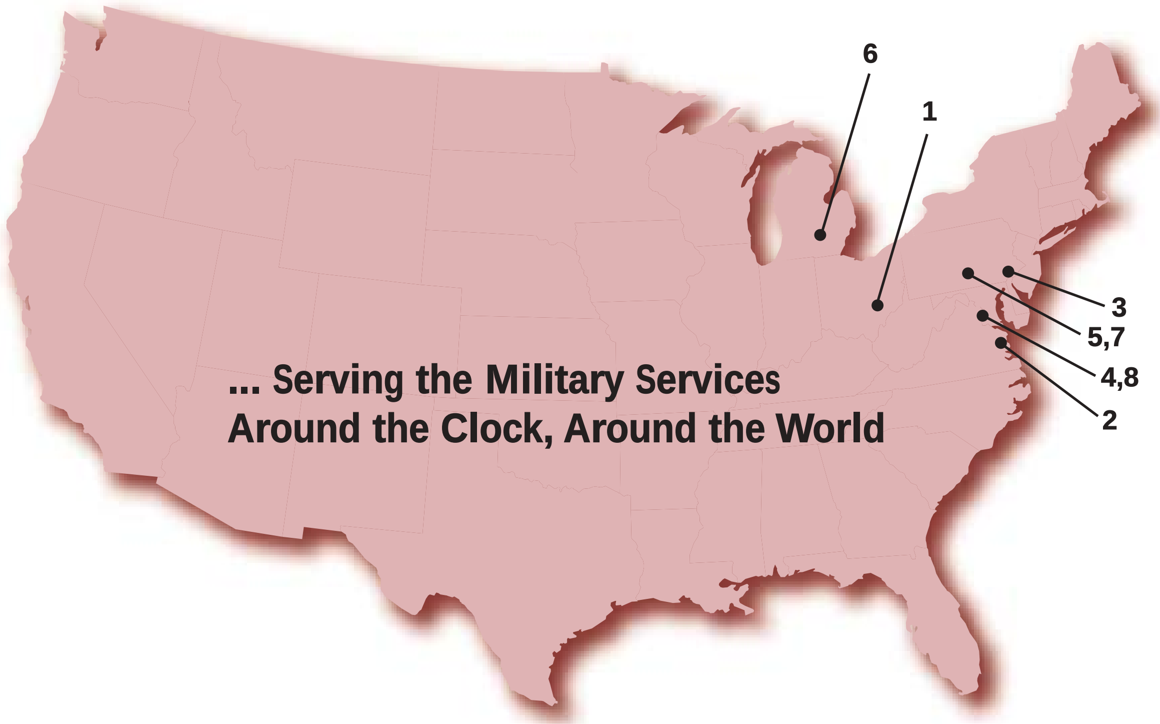
Reutilization and Marketing. The Reutilization and Marketing activity group supports and coordinates the reuse of excess and surplus property within DoD. Property not reutilized within DoD is available for transfer to other Federal agencies or for donation to authorized non-profit organizations, state governments, and local governments. Property not reused, transferred or donated is either sold to the public on a competitive basis or disposed of in an environmentally safe manner. A critical part of the Reutilization and Marketing activity group's mission is to arrange for the worldwide disposal of hazardous waste and materiel. The activity group accomplishes its mission from a headquarters in Battle Creek, MI and 94 Defense Reutilization and Marketing Offices located on military installations around the world.

Document Automation and Production. The Document Automation and Production Service (DAPS) activity group provides document automation and printing within the DoD. This mission encompasses electronic conversion, retrieval, output and distribution of digital and hardcopy information. Its focus is on enabling DAPS customers to transition from hardcopy to digital/electronic-based document management. DAPS manages its worldwide mission through a Headquarters, located in Mechanicsburg, PA, and a network of 80 major field locations and 185 smaller document automation facilities.

Information Services. This Activity Group was disestablished in FY 99; and while some residual financial transactions are recorded, no separate program or financial performance measures exist.

DLA DWCF ACTIVITY GROUP PRINCIPAL LOCATIONS

1. Defense Supply Center Columbus (DSCC)
2. Defense Supply Center Richmond (DSCR)
3. Defense Supply Center Philadelphia (DSCP)
4. Defense Energy Support Center (DESC)
5. Defense Distribution Center (DDC)
6. Defense Reutilization and Marketing Service (DRMS)
7. Document Automation and Production Service (DAPS)
8. Defense Logistic Agency Headquarters



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MANAGEMENT'S DISCUSSION AND ANALYSIS

Supply Management Activity Group

Defense Working Capital Fund

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Overview

The Supply Management Activity Group consists of four Inventory Control Points (ICPs), two Service Centers and other corporate activities. The ICPs are located in Columbus, Ohio; Richmond, Virginia; Philadelphia, Pennsylvania; and Fort Belvoir, Virginia. The Service Centers are the Defense Logistics Information Service (DLIS) and Defense Automatic Addressing Service Center (DAASC). The group's mission is to provide materiel and services to support peacetime and combat operations, combat preparedness and humanitarian aid. This includes integrated materiel management of nearly four million spare and repair parts supporting over 1,400 weapon systems. Supply Management also provides management of troop support items such as food, clothing and textiles, and medical supplies. In addition, the group purchases, manages, positions, and sells over 100 million barrels of fuel annually and provides centralized support to meet the energy needs of the military installations. Together, these commodities generated revenues of about $16.0 billion in FY 01 and are supported by over 10,000 personnel.

Mission

The mission of the Supply Management Activity Group is to provide customer support by managing logistics processes, to ensure that logistics support is provided to the Military Services worldwide at the right time, to the right place, and consistently at the best value in peacetime, emergency, and wartime scenarios. The support requirements are dynamic, and we continue to shift our approach in response to evolving changes in national priorities, requirements of the Military Services, technology, and the commercial marketplace. The primary logistics functions include:

- Supply-chain integration and inventory management.
- Transportation management (shared with the Distribution Activity Group).
- Technical management, which guarantees product quality and proper pricing of materiel.
- Procurement management, ensuring DoD gets the best value.
- Logistics data and information collection, management, and distribution, and providing for the integration and availability of this information.
- Logistics management process and processing of logistics and standard MILS transactions.

Strategic Goals

The long-term goals of the Supply Management Activity Group are consistent with the goals contained in the DLA Strategic Plan. These goals will be achieved through a series of supporting strategies and executed by the ICPs.

FY 01 Accomplishments

Partnership between DSCP and the Kentucky Logistics Operation Center in Lexington, Kentucky. This partnership provides a total clothing and textile supply chain solution to the Army National Guard Bureau (ANGB) that will improve logistics service for personalized clothing in all 50 states and the four American territories. It does so by consolidating the ANGB's inventories from storage locations throughout the states and territories into one central stockpile. Internet, e-mail, telephone, and fax ordering processes were set up to give soldiers faster turnaround and a simpler ordering process. Now a soldier can have clothing, complete with patches and nametapes sewn on, delivered to a designated site within ten days of ordering. This process simplifies operating procedures for the DSCP, is more efficient, and is expected to save the ARNG about $10 million annually. During FY 01, the program was further expanded to include the USMC Reserves and the Naval Reserves.

Partnership with the U.S. Army Office of the Surgeon General. This partnership completes the transition of Army medical treatment facilities and power projection platforms to DWCF support. It will allow these activities to comply with the Army's Single Stock Fund program. The transition also resulted in increased sales to DLA amounting to more than $107.5 million; and increased use of our more efficient centralized and electronically supported logistics programs, such as prime vendor deliveries. The Army benefited by decreasing its manual local purchase contracts and non-electronic credit card buys.

Boeing Fighter Contract. This is a performance-based contract supporting the F-15 aircraft and is expected to grow to cover items for the AV-8B and F/A-18 aircraft. The contract is a Direct Vender Delivery that takes advantage of Boeing's experience with managing parts to improve support for worldwide Navy, Marine, and Air Force customers. The contract will reduce customer wait time by filling all orders within two days for priority orders and within eight days for routine orders 95% of the time.

Ground Fuels Retail Billing and Capitalization. DESC developed processes for assuming the responsibility for end use billing associated with the capitalization of ground fuels from the military services. These efforts included the end use billing of all Air Force and some Army and Navy retail sites. Because of the significant increase in transaction volume that DESC will process and the far-reaching impact of this mission growth, it was determined that a phased approach should be utilized to complete the capitalization of all ground fuels stocks. The remaining Army and Navy sites will be completed by the end of FY 03; and this is a critical component of the Department's objective to consolidate DoD fuel inventories under DLA. This initiative, when completed, will significantly reduce or eliminate service fuel stock funds.

Program Performance Measures

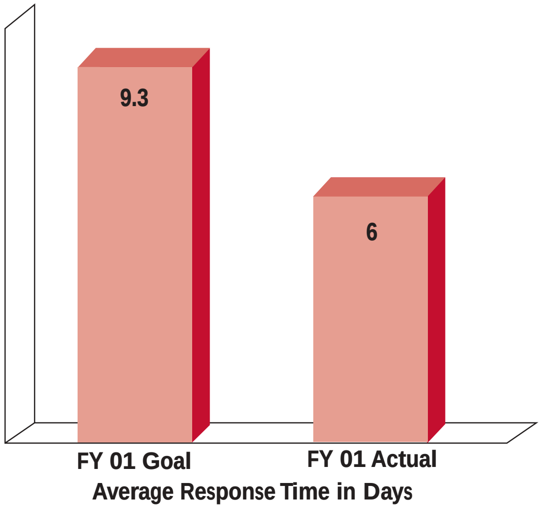
Customer Satisfaction Index This index measures the percentage of customers who responded to our periodic mail-out surveys that they were either "satisfied" or "very satisfied" with DLA's products and services. The overall satisfaction metric is a composite of how well (the customers' *perception)* the agency meets customer expectations in each of these areas. The goal for customer satisfaction in FY 01 was 83 percent.

During FY 01, DLA's Logistics Operations mailed out four waves of surveys: in November 2000, February 2001, May 2001, and August 2001. Each wave surveyed a different random sample of customers from the customer population for DLA's supply and service centers. During the year, 6,785 customers were surveyed and the results were:

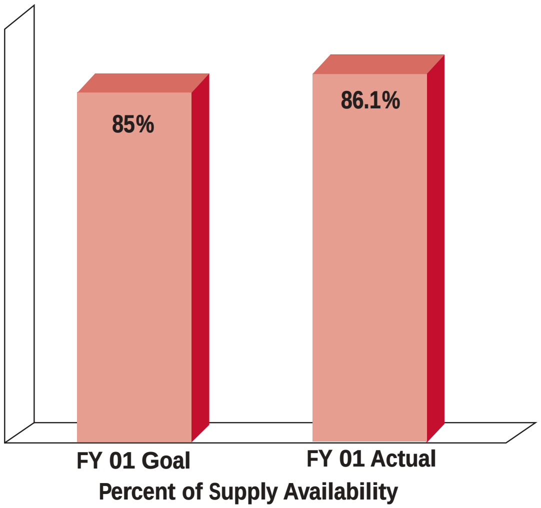
The overall average for the year was 77 percent; the last cycle's result (August 2001) was 76.8 percent. These results fall somewhat short of our overall goal for the year. Other performance metrics covered in this report, Logistics Response Time, Weapon System Supply Availability, and Product Conformance, detail progress made toward meeting customer expectations. However, the survey also identifies customer service factors such as effective information provided by DLA and responsiveness to calls and inquiries. The results of these surveys indicate there is room for improvement in these areas. We will continue to reinforce its current focus on customers, as specifically outlined in the DLA Strategic Plan, Balanced Scorecard and Customer Relationship Management initiative, to meet customer expectations in all areas identified by customers as important to them.

Logistics Response Time (LRT) This metric measures our response time and includes backorders and other delayed issues. If requisitioned materiel is not available from stock, it must be backordered and recorded as a delayed issue. Delayed issues represent a significantly longer response time than immediate issues. During FY 01, 96 percent of all requisitions were filled within an average response time of six days.

Logistics Response Time at 96 Percent Reliability



Weapons System Supply Availability



The following two metrics directly support the DLA Strategic Plan goal to consistently provide responsive, best value supplies and services to our customers.

Product Conformance This performance metric measures the number of National Stock Numbers (NSNs) that passed random testing for critical and major defects or characteristics, divided by the number of total NSNs tested. Currently, this indicator applies to construction, electronics, industrial and general supplies. DLA has consistently achieved a product conformance result exceeding 90 percent. In FY 01, we met our goal of 96 percent.

Weapons System Supply Availability This performance metric measures our capability to ensure that weapon systems supplies are available when needed. During FY 01, we exceeded our goal of 85 percent.

Financial Performance Measure

DLA measures the effectiveness of program budgeting and execution with unit cost performance measures. The following table depicts the Supply Management unit cost results for the fuel commodity and the composite non-energy commodities:

	FY 01 Goal	FY 01 Actual
Cost per Barrel of Fuel	$ 43.03	$ 41.27
Composite Non-Energy Cost per Dollar of sales	$ 1.03	$ 1.07

The cost per barrel of fuel includes the acquisition cost of a barrel of petroleum products in addition to operations costs for fuel services, transportation, and overhead. The actual cost per barrel was lower than our goal due to a lower than expected per barrel costs of petroleum ($37.64 vs. $37.74) and per barrel costs of operations ($3.63 vs. $5.29).

The composite unit cost for the non-energy commodities was over plan by $0.04. The actual unit cost for all non-energy commodities was higher than the goal primarily due to our efforts to increase supply availability by aggressively reducing backorders and pre-positioning stock at recruit sites and overseas locations.

Results

The FY 2001 Net Cost of Operation for Supply Management was a loss of $317.1 million. This loss includes elements of costs that are not intended for recovery, such as materiel transferred to DRMS ($279.8 million) and imputed costs ($62.0 million).

MANAGEMENT'S DISCUSSION AND ANALYSIS

Distribution Activity Group

Defense Working Capital Fund

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Overview

The Distribution Activity Group operates through the Defense Distribution Center and 22 subordinate distribution depots located throughout the United States and Europe and in the Pacific region. The group's mission is to manage the receipt, storage, and issue of DoD materiel. It may deliver that materiel to customers located on bases or to far-off ships, posts and repair facilities. The activity group also contracts with commercial sources to transport items from vendor-owned and DLA-owned warehouses directly to customers worldwide. Some distribution depots are highly automated facilities that were specifically designed to provide global support for general commodities. Others fill customer requirements on a regional basis, or provide global support for materiel that requires special equipment, facilities, or training. The distribution depots maintain the accountable inventory records and are responsible for preserving about $81 billion in DoD materiel (at selling price), representing over four million NSN's. They also process over 22 million receipt and issue transactions annually. In FY 01, this activity group generated revenues of $1.2 billion and was supported by about 8,300 personnel.

Mission

The mission of the Distribution Activity Group is the global distribution and warehousing of DoD materiel, including weapon systems parts, consumable items (such as medical, clothing, subsistence, electrical, industrial and general supplies), repairable spare parts, and end-items. It performs this mission by managing materiel and logistics information to enable a seamless, worldwide distribution network that provides effective and efficient support to the Commanders-in-Chief (CINCs), Military Services and others, in Theater and out, during war and peace. The distribution network ensures that America's warfighters receive competitively priced and best value distribution services by providing "around the clock - around the world," world-class service.

Strategic Goals

The strategic goals established by the Distribution Activity Group are consistent with those contained in the DLA Strategic Plan. These goals are achieved through a series of supporting strategies that will:

- Increase our reliability, response time, and value to our customers by continuously improving and reengineering business practices.
- Provide best-value solutions to our customers by continuously evaluating our activities and implementing changes, as necessary, to ensure efficient and effective distribution operations.
- Reduce under-utilized infrastructure by eliminating unnecessary storage capacity.

FY 01 Accomplishments

Infrastructure Cost Reduction through A-76 Cost Comparisons. In FY 98, we began the process of competing our depots with private industry. The goal of the competitions is to reduce operational costs either by reengineering existing depot business processes or privatizing the depots. Since its inception, six studies have been completed and four others are in progress. The Government has retained depot operations at one of the sites, while the other five have been contracted with private industry. The estimated net savings realized from the completed studies is in excess of $75 million.

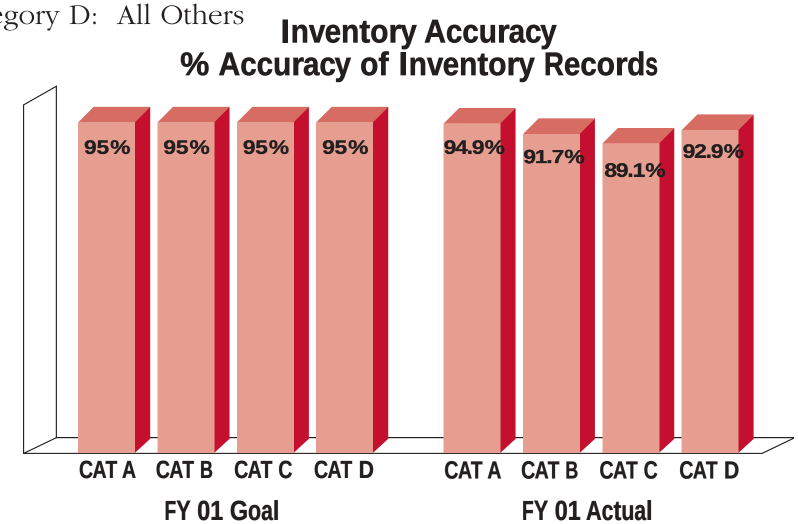
Inventory Quantities Sampling. In past years, we have been unable to demonstrate that either the quantity or cost data reported in our perpetual inventory records were accurate enough to support the dollar value reported in the inventory line of our financial statements. For DLA-owned materiel stored at the distribution depots, depot personnel are responsible for ensuring the accuracy of the recorded quantity balances and Inventory Control Point personnel are responsible for ensuring the accuracy of the recorded cost data. During FY 01, we implemented a sampling strategy to measure the impact that depot procedures and controls had on the overall dollar value accuracy of our inventory records. By adding an additional financial sample component (i.e., selecting more high dollar value items to count) to the existing quantity accuracy sampling that the depots had already planned to perform at year-end, we were able to design a sampling approach to give us a statistical estimate, at a 95% confidence interval, as to the accuracy of the DLA-owned items stored at the distribution depots. The sample was not designed to and did not validate the recorded cost data in the financial records.

The sample results showed that the recorded balances of the depot inventory records were within a precision range of +/- 2.06% at a 95% confidence interval, which would indicate that the financial records for the portion of DLA-owned inventory stored at the distribution depots would be reliable if the recorded cost data in those records could be supported. However, because the sample was not designed to validate the cost data of the records, we could not use the sample results to demonstrate the overall dollar accuracy of those records or to assert that the dollar value of the entire inventory balance included in the financial statements was accurate. Beginning in FY 02, we will devote additional resources to validating inventory cost data and continue to work towards taking the necessary actions to demonstrate the overall dollar and quantity accuracy of our inventory records.

Program Performance Measures

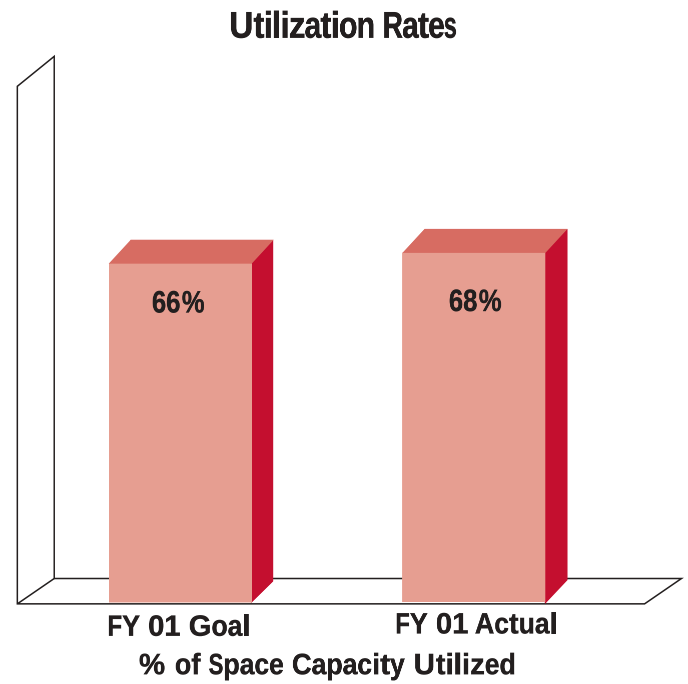
Inventory Record Accuracy. This performance metric measures the accuracy of inventory records using statistical sampling techniques, which are performed semi-annually. Starting in FY 99, DLA incorporated established DoD stratification and tolerance levels into the inventory sampling methodology. The DoD plan takes into consideration item characteristics such as dollar value, and provides a means to focus resources commensurate with the significance of the errors found. The FY 01 aggregate goal for inventory accuracy is 95 percent. Our record accuracy for the high dollar Category (A) is 94.9 percent; Category (B) is 91.7 percent; Category (C) 89.1 percent; and Category (D) is 92.9 percent.

Category A: Unit Price > $1,000
Category B: Unit of Issue Not Equal to Each OR On-Hand Balance > 50 AND Extended Dollar Value < $50,000 OR Activity > 50
Category C: On-Hand Balance < 50 AND Date of Last Inventory > 24 Months
Category D: All Others



The reasons we were unable to achieve our goal were due primarily to staff reductions and uncertainty caused by the ongoing and planned public-private competitions.

Storage Space Utilization. The goal of increasing space utilization ties directly to the goal in the DLA strategic plan to structure internal processes to deliver customer outcomes effectively and efficiently. In an effort to reduce infrastructure costs, we are evaluating our storage capacity and occupancy to identify improvements in space utilization and eliminate unnecessary space. This performance goal measures space occupancy. In FY 01, our space utilization rate was 68 percent, which exceeded our goal by 2 percent.



Financial Performance Measures

We measure the effectiveness of program budgeting and execution with unit cost performance measures. The following table depicts the Distribution unit cost results for processing, storage and reimbursable cost rates.

	FY 01 Goal	FY 01 Actual
Unit Cost - Total Composite Rate	$ 26.28	$ 25.40
Unit Cost - Covered Storage	$ .95	$ .85
Unit Cost - Reimbursable	$ 69.94	$ 62.07

The Unit Cost - Total Composite Rate measures all associated labor and non-labor processing costs to the number of receipt and issue line items processed.

The Unit Cost - Covered Storage measures all associated labor and non-labor storage costs to the cubic footage used.

The Unit Cost - Reimbursable measures all associated labor costs to the number of hours worked.

The total costs reductions in these three measures were due primarily to the rapid reductions in personnel (compared to those that were anticipated) from both on-going and planned A-76 studies, as well as reduced real property maintenance and depreciation costs.

Results

The FY 01 Net Cost of Operations, which includes costs not recovered by the Defense-wide Working Capital Fund (military construction depreciation and imputed expenses), reported a loss of $70.9 million. This bettered our planned loss of $117.6 million by $46.7 million.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Defense Reutilization and Marketing Activity Group

Defense Working Capital Fund

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Overview

The Defense Reutilization and Marketing Service (DRMS) coordinates the reuse of excess and surplus DoD property. Reutilization of excess materiel by DoD customers reduces the need to purchase materiel. In FY 01, materiel with an acquisition value of $13.4 billion was turned in to DRMS and $1.5 billion was reutilized within DoD. DRMS also oversees the demilitarization (DEMIL) and disposal of remaining property through transfers, donations, and sales; or its ultimate disposal as in the case with hazardous waste.

The DRMS headquarters is located in Battle Creek, MI; and its mission is accomplished through 94 Defense Reutilization and Marketing Offices (DRMOs) located on military installations throughout the world. DRMOs receive, classify, segregate, demilitarize, account for and report excess materiel for screening, lot categorization, merchandising and sale. The FY 01 mission was performed with almost 2,000 personnel, and generated revenues of $372 million.

Mission

The DRMS manages the reutilization, transfer, donation, and sale of military personal property, as well as disposal of hazardous waste items no longer needed for national defense. The goal is to maximize the financial return on the initial equipment investment and protect both valuable natural resources and the environment.

Strategic Goals

The long-term goals of the Reutilization and Marketing activity group are consistent with the goals contained in the DLA Strategic Plan. These goals are achieved through a series of supporting objectives and initiatives designed to improve and reengineer business practices to ensure efficient, effective, and best-value operational support.

FY 01 Accomplishments

Award of Commercial Venture 2. DRMS awarded its second Commercial Venture (CV2) contract to Surplus Acquisition Venture (SAV) in June 2001. SAV formed an independent entity, Government Liquidators (GL), which is responsible for the resale of all items purchased on the CV2 contract. The CV partner will handle all useable property sales in the Continental United States, excluding property that requires demilitarization (DEMIL) and hazardous property.

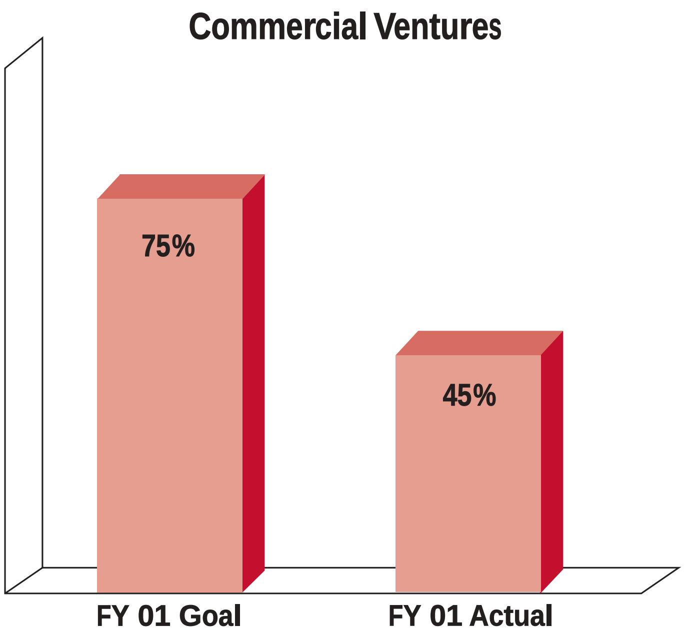
Recycling 2000 (R2000). R2000 is a country-by-country recycling and waste disposal initiative that was developed to implement an environmentally sound logistics program while transitioning to best commercial practices in partnership with industry. The overall goal is to improve business practices while meeting regulatory requirements through reengineered processes. More specifically, it seeks to decrease environmental program costs: by providing secondary containment and compliant disposal of scrap; by reducing the DRMO investment in the scrap program through improved efficiencies; and by avoiding the cost of infrastructure improvements. The first R2000 contract covers the disposal of solid waste from eight DRMOs located in Germany.

Recycling Control Point (RCP). In November 2000, RCP initiated a system upgrade referred to as Transition State 4, which immediately improved the efficiency and accuracy of RCP information. RCP shipments of depot located property that require DEMIL are moved directly to a Centralized DEMIL Center instead of to the co-located DRMO. This direct shipment results in less property handling and data input by DRMS employees.

Electronic Turn-in Document (ETID). The ETID project is designed to automate and simplify the turn-in process by eliminating hand-scribed/ typewritten disposal turn-in documents, improving data accuracy, and providing greater visibility of DoD excess property being turned in for disposal. ETID is easy to use, saves time for both generators and DRMS, and will become an important tool to meet upcoming financial and resource commitments. In FY 01, a prototype program was developed and deployed at seven DRMOs and eleven generators for a two-month pilot test. The pilot test was well received and successful, and generated much interest in expanding its use. As a result, the decision was made to make ETID available for wider use and to incorporate additional program enhancements to improve its functionality.

Program Performance Measures

Commercial Venture (CV) This measure, which is the percentage of property referred for sale to a CV, is an indicator of the degree to which DRMS has privatized the sales workload. The CV concept privatizes the marketing and resale of excess materiel on a shared-revenue basis. This partnership with industry has improved the net operating results by outsourcing the sales functions. The FY 01 goal was based on the expectation of a second commercial venture contract awarded in FY 00. However, we deferred the award of CV2 until June of FY 01 to ensure that the results of the first CV contract would favorably support a second contract. This delay prevented us from achieving the FY 01 percentage goal of 75 percent. However, in the last quarter of FY 01 (after award of CV2) the percentage of property sold via CV climbed to 69 percent and is expected to reach 75 percent in FY 02.



% of Property Referred for Sales to Commercial Ventures

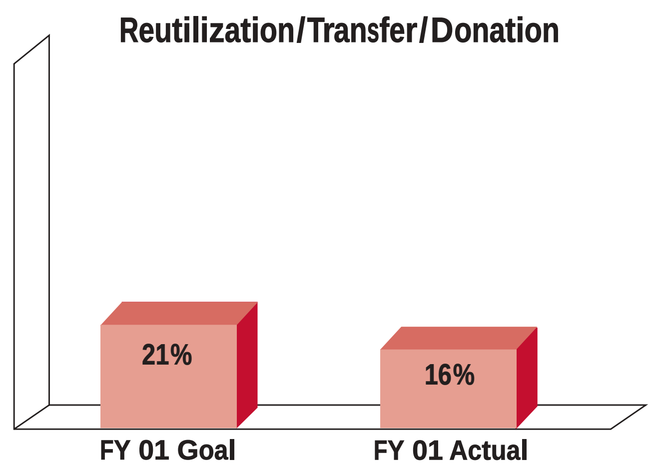
Reutilization/Transfer/Donation (R/T/D) This indicator represents the aggregate acquisition value of the property reutilized, transferred and donated, expressed as a percentage of acquisition value of all excess/surplus personal property received. The indicator applies to the available assets that are economically reused, thus preventing concurrent procurement of new assets. It addresses disposal via reutilization by another defense customer, transfer to another federal agency, or donation to eligible state and local governments or non-profit organizations. R/T/D dispositions, as a percentage of usable receipts, indicate compliance with federal regulations that mandate reuse through these cost avoidance programs as the first priority of disposal. In FY 01, the reutilization rate fell short of the goal for several reasons. First, early in FY 01 the General Services Agency placed a moratorium on transfers of computers to the Federal Prison Industries (FPI). FPI was a major customer for computers, requesting over $1 billion worth of transfers in FY 00. Additionally, in January 2001, DoD mandated the destruction of unclassified computer hard drives, which had a negative impact on R/T/D.

DRMS is facilitating the increase of R/T/D as a percentage of total receipts by:

- Implementing changes that will improve the information available on property in the inventory. This includes making photos and additional descriptive data mandatory for targeted classes of property.

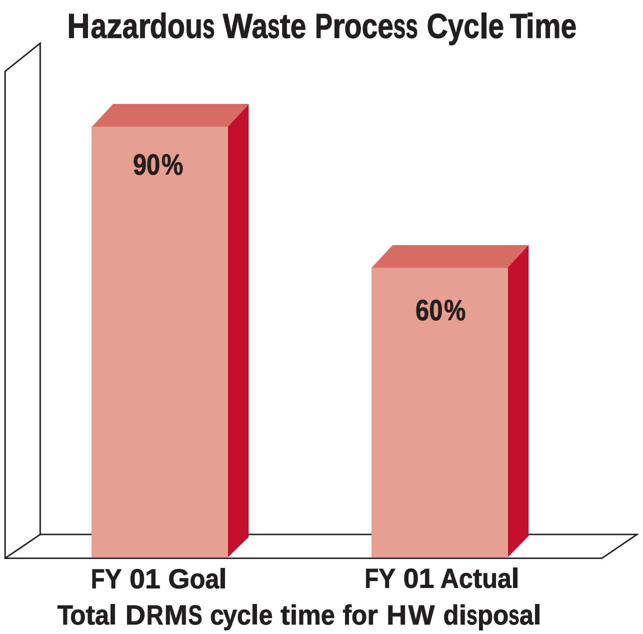
- Emphasizing the use of "want lists" for customers that are not already using them. These are static lists of NSNs that are automatically searched for in the DRMS inventory.

- Streamlining the screening and requisitioning process.



% of property R/T/D

Hazardous Waste Process Cycle Time: This measure monitors the duration of component processes and the total cycle time for hazardous waste disposal. We would violate Federal and/or State laws, if the total process exceeds 90 days. The incremental processes monitored are: accumulation, start date to receipt, receipt to input, input to delivery order, and delivery order to pickup. During FY 01, we complied with the 90-day goal by achieving a 60-day cycle time.



Financial Performance Measures

We measure the effectiveness of program budgeting and execution with unit cost performance measures. DRMS is measured on four unit cost goals: Reutilization/Transfer/Donation (R/T/D), Ultimate Disposal, Sales Proceeds and Abandonment & Destruction (A&D). The following table depicts the unit cost results for each category:

Financial Performance Measures	FY 01 Goal	FY 01 Actual
Cost/Dollar of Acquisition Value – Reutilization/Transfer/Donation (R/T/D)	$ 0.01753	$ 0.03423
Cost/Pound – Ultimate Disposal	$ 0.156	$ 0.159
Cost/Dollar – Sales Proceeds	$ 1.6087	$ 2.1188
Cost/Pounds – Abandonment & Destruction (A&D)	$ 0.084	$ 0.079

The FY 01 R/T/D actual unit cost was higher than planned because of the two policy changes discussed in the R/T/D measure above.

The Sales Proceeds unit cost was higher than planned because of the lower quantity and quality of receipts, the exclusion of sales proceeds of $5 million pending protest filed, and a Departmental decision to return $.5 million to the U.S. Army for the sale of excess Industrial Plant Equipment.

The A&D unit cost was lower than planned due to the increase in the amount of lower quality property being turned in for disposal. More of this property is turned in as or downgraded to scrap resulting in larger volumes of property being disposed by the A&D process.

Results

The Reutilization and Marketing activity group showed a net gain of $46.1 million for FY 01. The primary factor for this gain was the recovery of prior year losses. These losses occurred based on a Departmental decision that directed the military services not to reimburse DRMS for its FY 00 Service Level Bills. Instead, the resulting FY 00 loss, $160.0 million, and the FY 99 loss, $31.5 million, were schedule for recovery in FY 01 and FY 02. In addition, the operating result was also negatively affected by a directed return of $.5 million in sales proceeds to the U.S. Army Watervliet Arsenal; and a delay in recording $5 million as a result of a protest filed by the National Association of Aircraft and Communications Systems.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Defense Automation and Production Service

Defense Working Capital Fund

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Overview

The Document Automation and Production Service (DAPS) manages its worldwide mission through a Headquarters, located in Mechanicsburg, Pennsylvania, and a network of 80 major field locations and 185 smaller document automation facilities. We are responsible for the DoD printing, duplicating and document automation programs; encompassing value-added conversion, electronic storage and output, and the distribution of hard copy and digital information. All DoD printing requirements, whether produced in-house or procured through the Government Printing Office (GPO), are forwarded to us to ensure compliance with DoD directives and the Federal Printing Program. The Congressional Joint Committee on Printing exercises oversight over all Federal printing, including our in-house capability. We manage a worldwide printing, duplicating and document automation production and procurement network. During FY 01, we earned $390.2 million in revenue; and employed 1,433 personnel at year-end, which represents an 8.7 percent end strength reduction from FY 00. Our customers are Air Force (18.1 percent), Navy (30.2 percent), Army (20.2 percent), Defense Agencies (22.8 percent) and non-DoD customers (8.7 percent).

Mission

The mission of DAPS is to provide best value document automation and management services in support of America's armed forces and Federal agencies, including the capture, management, access, distribution and output of digital and hardcopy information. We provide time sensitive, competitively priced, high quality products and services that are produced in-house or procured from commercial sources. DAPS is the recognized leader in document automation and the customer-preferred provider of automated digital and hardcopy information products and services. We are dedicated to the transition from paper to electronic-based document management and are an integral part of the DoD plan to transition into the age of electronic documents and commercial business practices.

Strategic Goals

DAPS is committed to the following goals:

- Serving as a major catalyst in transforming business by revolutionizing document automation services,
- Rapidly utilizing technology for agile, responsive, internal business solutions,
- Aggressively pursuing partnerships with government, industry and suppliers,
- Ensuring that our workforce is enabled to deliver and sustain world-class performance,
- Striving to reduce costs, simplify organizational structure, eliminate unnecessary facilities, and ensure that equipment and personnel are commensurate with the workload,
- Aligning our processes to focus on improving the quality of our products and services while meeting or exceeding our customers' delivery requirements.

FY 01 Major Accomplishments

- In March, U.S. Army Printing Facilities in the Republic of Korea transferred to DAPS. DAPS provides its traditional print output services, conversion to digital documents, as well as mobilization support for the Army.
- Established a memorandum of agreement (MOA) with the Department of the Navy, to act as the issuing agent for the Smart /Common Access Card Program. DAPS will provide this service for afloat and ashore units to include Active Duty, Selected Service Reservists, and Civilians.
- Signed an MOA with the National Institute of Health (NIH) to provide digital print document conversion services for NIH grant applications. Implementation will occur in two phases. Phase 1 began in March 2001 with DAPS subsuming part of the NIH's in-house printing operations. The second phase will begin in March 2002, completing the turnover of NIH print facility and related services. When fully implemented, this business segment should generate additional annual revenue in excess of $2.5 million.
- Agreed to provide and operate an Enterprise Document Management Service at 21 Defense Distribution Center (DDC)

sites. The service will improve document retrieval, automate indexing for shipping and receiving documents, and provide a single digital format and central database. DAPS will execute a multi-year deployment strategy to mitigate program and financial risk. When fully implemented the estimated annual revenue will exceed $5 million.

- Completed its first year of a focused campaign to obtain new business, primarily through new relationships with non-DoD Federal Executive Branch agencies. New revenue streams delivered through these efforts exceeded $9 million annually.

Program Performance Measures

Conversion to Digital Format This performance metric measures the number of pages (in millions) converted to digital format during the year. Conversions may be accomplished either in-house or by contract and includes hardcopy to digital, system output to digital and from one form of digital to another. Although our actual production of 61.3 million pages fell short by about 10 percent of the goal of 68.0 million pages converted, it still represented an increase of 32.7 percent from FY 00.

Customer Satisfaction This performance metric measures satisfied customers as the percentage of customers ranking DAPS performance from acceptable through high quality. We use a survey, professionally prepared and administered by an independent entity, to determine an overall customer satisfaction rating. The survey showed that we exceeded our goal of 93 percent customer satisfaction. The overall satisfaction rating expressed by DAPS customers was 94 percent. In addition, we initiated measurement of customer loyalty (likelihood to remain a customer of DAPS). The baseline results of this measure show 81 percent of customers are likely to remain a customer of DAPS as opposed to choosing another service provider.

Production Efficiency Factor This performance metric measures our production efficiency in terms of units produced per hour. The units are converted to standard hours earned. Employee time is captured by cost center as hours available. The employee hours available are divided into the hours earned to produce the production efficiency factor shown as a percentage. DAPS production efficiency was 92.7 percent for FY 01.

Product Rework There are two performance metrics to measure the quality of delivered products:

- **In-House Rework Percentage** This performance metric is calculated by dividing revenue lost from orders not accepted by the total in-house production revenue. During FY 01, we bettered our goal of 0.42 percent. The actual for FY 01 was 0.36 percent.

- **Commercial Rework Percentage** This performance metric is calculated by dividing problem jobs by total jobs submitted to GPO. During FY 01, GPO bettered the goal of 2.0 percent we established with them. The actual for FY 01 was 1.7 percent.

Financial Performance Measure

In addition to program performance measures, we measure the effectiveness of program budgeting and execution with a unit cost performance measure. It measures the total units produced relative to the total cost to produce those items.

	FY 01 Goal	FY 01 Actual
Unit Cost per In-House Production Unit	.0518	.0566

We did not achieve our unit goal due to the retention of fixed costs relative to the overall reduction in workload, the change in "work mix" with increased workload in document electronic conversion, and the occurrence of unanticipated one-time costs. The changes in workload reflect the transition of the Department from hardcopy to digital documents. The number of pages converted to digital format by DAPS in FY 01 increased 32.7 percent from FY 00, but hardcopy pages produced fell by 12.7 percent. This trend is expected to continue and result in decreases in total units.

Financial Conditions

DAPS projected a positive FY 01 Net Cost of Operations in excess of $16 million (including $7.1 million of imputed costs), but experienced a net operating loss of $6.7 million. This occurred primarily through reduced sales of more than $26 million.

It was during this period that we made a series of accounting adjustments totaling $7.3 million to reverse outstanding and invalid accounts payable due to the accumulation of unmatched disbursements that were not processed in prior fiscal years. These adjustments were reflected as a prior year adjustment via journal voucher and result in a reduction in negative accumulated operating result.

As first identified in FY 00, the Navy Inventory Control Point (NAVICP) determined that the management of the COG-I Forms program was not a core mission, and transferred the program to DAPS Philadelphia. The forms in inventory, valued at approximately $4.5 million, have assigned National Stock Numbers (NSNs), are identifiable through the Federal Acquisition Register, and are warehoused and issued at the Defense Depot, Susquehanna, PA.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Financial Condition

Defense Working Capital Fund

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Financial Condition

The financial statements report the financial position and results of operations for the DLA WCF pursuant to the requirements of the 31 U.S.C. 3515(b). While the statements have been prepared from DLA books and records, in accordance with the formats prescribed by the Office of Management and Budget, 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.

To the extent possible, the financial statements have been prepared in accordance with Federal accounting standards. At times, DoD is unable to implement all elements of the standards due to financial management systems limitations and continues to implement system improvements to address these limitations. The statements should be read with the realization that they are for a component of the U.S Government, a sovereign entity. One implication of this is that the liabilities cannot be liquidated without legislation that provides resources to perform the liquidation.

Defense-wide Working Capital Fund. The Defense-wide Working Capital Fund (DWCF) was created to establish a customer-provider relationship between the military operating forces and support organizations, in order to improve delivery of support services while reducing the cost of operations. The financial structure of the DWCF allows for the identification of the full cost of activity groups and facilitates performance measures to foster efficiency and productivity improvements. This enables the customer to make economical buying decisions using timely and accurate financial information in the decision-making process. DLA evaluates monthly financial reports and makes appropriate adjustments in budget execution during the year to ensure that the activity groups are consistent with budget execution targets. Additionally, the financial data is used as a baseline for future budget requests and to establish prices.

The DLA Working Capital Fund finished the year with total assets valued at about $12.0 billion, liabilities of about $2.6 billion, and a Net Operating Loss of about $.3 billion on program costs of about $17.8 billion and earned revenue of about $17.4 billion. It should be noted, however, that DLA imputed costs of more than $.1 billion reported in the financial statements, such as retirement costs, are not paid by the DWCF and therefore are not captured in the rates DLA charges its customers.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

Systems, Controls, and Legal Compliance

Defense Working Capital Fund

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Systems, Controls, and Legal Compliance

While matters regarding systems, management controls, and legal compliance are addressed in the following pages, they are more fully addressed in the FY 01 Annual Statement of Assurance.

Systems

For most of its 40-year history, DLA operated its complex, worldwide logistics support mission with strong command and control lines along multiple business segments and programs. Over time, this led to "stovepipe" organizations that developed their own automated management (legacy) information systems and accounting processes. While these independently developed practices worked well to service the customer, they also produced a fragmented and very complex set of accounting processes and financial systems that often resulted in the use of different accounting methods and systems to account for essentially the same types of transactions.

The Defense Finance and Accounting Service (DFAS) prepared the FY 01 DLA financial statements from available finance, accounting, and feeder systems (such as acquisition, logistics, and personnel systems) and manual processes. Most of the automated systems were designed decades before the current Federal accounting standards were developed, making it difficult to collect the data needed to prepare financial statements that comply with Federal standards from the legacy systems. Additionally, there is often insufficient documentation available showing how financial transactions are processed through the systems, making it very difficult for auditors to audit the financial statements and for DLA to demonstrate a high level of internal controls and compliance with pertinent financial laws and regulations. Other data comes from DFAS systems that are neither linked with DLA systems nor can pass data easily among other DFAS systems. The system deficiencies and our plans to correct them are more fully addressed in our Chief Financial Officer (CFO) Compliance Plan.

DLA has a multitude of on going and planned efforts designed to fully assess its financial operations and to develop systems and processes that are fully integrated and compliant with Federal system and accounting requirements. Our approach is to chart a strategy that will result in long-term solutions to address the enormous challenges that lie ahead and, at the same time, make significant progress towards addressing the immediate problems preventing us from getting an opinion on our financial statements. Some of our major strategies include:

- Upgrade our logistics systems through the Business Systems Modernization (BSM) initiative. The BSM strategy will – at first – support the "supply/non-fuels" businesses by replacing our obsolete suite of mission critical automated systems with commercial-off-the-shelf enterprise resource planning software and advanced planning and scheduling systems. To help make the BSM initiative a success, we committed DLA-wide resources to build a dedicated team of financial and business process experts to help ensure that the new suite of systems will continuously furnish complete, accurate, timely, and reliable financial data.

- During FY 01, we contracted with a commercial sector audit firm to audit the DLA Consolidated Balance Sheet. This is part of an effort to establish a long-term partnership arrangement that will allow the auditors to work toward a complete audit and opinion on the financial statements and related processes and controls. Senior management is committed to working with the auditors to overcome all obstacles preventing us from receiving audit opinions on our financial statements as soon as possible. The DLA Audit Committee will provide oversight of the audit process and to make sure that corrective actions are implemented.

- The CFO Compliance Team will work with DoD, DFAS, and audit personnel to coordinate, document, and monitor DLA and DFAS actions aimed at resolving outstanding audit issues. The team will maintain a compliance plan that describes the specific actions and milestones to correct the deficiencies identified by the auditors; and update the plan as issues are resolved or as new issues are identified.

Management Controls

The system of internal accounting and administrative control of DLA, in effect during FY 01, was evaluated in accordance with the applicable federal guidance. The objectives of the system are to provide reasonable assurance that:

- Obligations and costs are in compliance with applicable laws.
- Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation.
- Revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of reliable accounting, financial, and statistical reports.
- Accountability over the assets is maintained.

The evaluation of management controls extends to every responsibility and activity undertaken by DLA and is applicable to financial, administrative, and operational controls. Furthermore, the concept of reasonable assurance recognizes that (1) the cost of management controls should not exceed the projected derived benefits; and (2) the benefits consist of reductions in the risks of failing to achieve the stated objectives. The expected benefits and related costs of control procedures should be addressed using estimates and managerial judgment. Moreover, errors or irregularities may occur and not be detected because of inherent limitations in any system of internal accounting and administrative control, including those limitations resulting from resource constraints, congressional restrictions, and other factors. Finally, projection of any evaluation of the system to future periods is subject to risk that procedures may be inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate. Therefore, statements of reasonable assurance are provided within the limits of the preceding description.

The evaluation was performed in accordance with the guidelines identified above. The results indicate that the system of internal accounting and administrative control of DLA in effect during FY 01, taken as a whole, complies with the requirement to provide reasonable assurance that the objectives were achieved. This position on reasonable assurance is within the limits described in the preceding paragraph.

The description of how the evaluation was conducted:

Progress Made Institutionalizing the Management Control (MC) Program. During FY 01 the status of the MC material weaknesses, as well as concerns was incorporated into the HQ DLA Internal Support Review process. The HQ business offices and Primary Level Field Activities (PLFAs) reported the status of weaknesses and concerns semi-annually. The Business Offices and PLFAs made similar progress in the expanded reporting of weaknesses and controls. Many established local websites for control managers to update status and get access to applicable regulations and procedures as well as sample assessment letters. In addition, the HQ DLA established a Risk Assessment Office, and the program managers meet frequently to discuss upcoming audits and development of a shared database.

Improvements to MC Program Coverage. Due to program expansion, DLA increased the number of offices required to submit letters of assurance, both at Headquarters and in the field. As such, the Defense Distribution Center (DDC) required depot commanders to submit letters, and the Defense Energy Supply Center (DESC) required all field offices to submit letters of assurance for FY 01, and at HQ, more business offices were included in the management control program.

DLA Developed Core Objectives to be Included in All Applicable Management Control Plans. In FY 02, DLA is required to link Management Control Plans to each control objective to the Balanced Scorecard program, DLA strategic goals, and General Accounting Office (GAO) High Risk Areas. In addition, DLA created a website for MC issues. This website will contain DLA directives and instructions, links to Office of Management and Budget (OMB), GAO, and PLFA sites, as well as all local guidance.

INDEPENDENT AUDITORS' REPORT

Defense Working Capital Fund

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Deloitte & Touche

Independent Auditor's Report

To the Audit Committee and the Director,
Defense LogisticsAgency

We were engaged to audit the accompanying consolidated balance sheets of the Defense Logistics Agency (DLA) working capital fund, as of September 30, 2001 and 2000, and the related consolidated statements of net cost, consolidated statements of changes in financial 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 DLA management.

As of September 30, 2001 and 2000, DLA accounting records did not provide sufficient evidential matter to support the recorded balances of inventory, aggregating approximately $9.6 billion and $9.5 billion, respectively, reflected on the consolidated balance sheets. The recorded value of inventory was derived from accounting records that did not permit us to extend our auditing procedures sufficiently to satisfy ourselves as to the recorded value of inventory.

During the years ended September 30, 2001 and 2000, DLA did not have the accounting records, systems and control procedures in place to accurately record the results of its activities, particularly the accuracy, completeness and cutoff of activity as of September 30, 2001 and 2000. It was not practicable to extend our auditing procedures sufficiently to satisfy ourselves as to the fair presentation of the balance sheet accounts as of those dates. Errors in these accounts would also materially affect the determination of the net cost, changes in net position, budgetary resources and reconciliation of budgetary resources to net cost for the years ended September 30, 2001 and 2000.

Accounting principles generally accepted in the United States of America require Federal entities to adopt Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software,* effective October 1, 2000, under which certain development costs of internal use software are capitalized. Although DLA had development projects related to internal use software underway during the year ended September 30, 2001, DLA did not adopt SFFAS No. 10. Thus the accompanying financial statements for the year ended September 30, 2001, reflect a departure from accounting principles generally accepted in the United States of America. The information needed to quantify the effects of this departure on the financial position, results of operations, and budgetary resources of DLA is not reasonably determinable from the accounts and records and the effect of such departure cannot be quantified.

Additionally, certain other information required by accounting principles generally accepted in the United States of America and Office of Management and Budget (OMB) Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, to be recorded or disclosed is not recorded or disclosed in the accompanying financial statements for the years ended September 30, 2001 and 2000. Such information includes the accrual of liabilities in accordance with SFFAS No. 5, *Accounting for Liabilities of the Federal Government,* and SFFAS No. 6, *Accounting for Property, Plant and Equipment*, (both as amended) arising from environmental damages and/or remediation. Such information also includes the nature and extent of DLA's leasing activities for real and personal property. The information needed to quantify the effects of these departures on the financial position, results of operations, and budgetary resources of DLA is not reasonably determinable from the accounts and records and the effects of such departures cannot be quantified.

Furthermore, because of the circumstances described in the preceding four paragraphs, we were unable to assess whether DLA's accounting principles were applied on a consistent basis.

Because of the matters discussed in the preceding paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements of DLA as of and for the years ended September 30, 2001 and 2000.

We were engaged to conduct an audit for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The additional consolidating financial statement information on pages 65-72 is presented for the purpose of additional analysis of the basic 2001 consolidated 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 the individual organizational components, and is not a required part of the basic 2001 consolidated financial statements. For the reasons discussed in the preceding paragraphs, we also are unable to express, and we do not express, an opinion on this additional consolidating financial statement information.

The required supplementary information on pages 1-40 and 77-84 and the required supplementary stewardship information on pages 73-76, are not a required part of the consolidated financial statements but are supplementary information required by the OMB Bulletin No. 01-09 and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of DLA's management. 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 31, 2002, on our consideration of DLA'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 engagement to perform an audit in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our engagement.

Deloitte & Touche LLP

January 31, 2002

Deloitte
Touche
Tohmatsu

CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

Defense Working Capital Fund

Department of Defense
Defense Logistics Agency
CONSOLIDATED BALANCE SHEETS
As of September 30, 2001 and 2000
(In Thousands)

	2001	2000
ASSETS		
INTRAGOVERNMENTAL		
Collections and Disbursements - Clearing (Note 2)	$ –	$ –
Accounts Receivable (Note 3)	692,660	846,981
Other Assets (Note 4)	240	528
Total Intragovernmental	$ 692,900	$ 847,509
Accounts Receivable (Note 3)	286,748	137,050
Inventory and Related Property (Note 5)	9,607,044	9,498,125
General Property, Plant and Equipment - net (Note 6)	1,216,122	938,649
Other Assets (Note 4)	235,604	524,055
TOTAL ASSETS	**$ 12,038,418**	**$ 11,945,388**
LIABILITIES (Note 7)		
INTRAGOVERNMENTAL		
Accounts Payable (Note 8)	$ 100,849	$ 191,151
Other Liabilities (Note 10)	188,053	229,618
Total Intragovernmental	$ 288,902	$ 420,769
Accounts Payable (Note 8)	1,865,469	1,762,550
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 11)	245,648	242,304
Environmental Liabilities (Note 9)	–	–
Other Liabilities (Note 10)	171,836	120,353
TOTAL LIABILITIES	**$ 2,571,855**	**$ 2,545,976**
NET POSITION		
Unexpended Appropriations	$ –	$ 1,556,200
Cumulative Results of Operations	9,466,563	7,843,212
Total Net Position	**$ 9,466,563**	**$ 9,399,412**
Total Liabilities and Net Position	**$ 12,038,418**	**$ 11,945,388**

See notes to the consolidated and combined financial statements.

Department of Defense
Defense Logistics Agency
CONSOLIDATED STATEMENTS OF NET COST
For the years ended September 30, 2001 and 2000
(In Thousands)

	2001	2000
PROGRAM COSTS		
Intragovernmental	$ 987,535	$ 939,019
With the Public	16,874,366	14,959,433
Total Program Cost	$ 17,861,901	$ 15,898,452
Less: Earned Revenues	(17,512,563)	(14,194,501)
Net Program Costs	$ 349,338	$ 1,703,951
NET COST OF OPERATIONS	**$ 349,338**	**$ 1,703,951**

See notes to the consolidated and combined financial statements.

Department of Defense
Defense Logistics Agency
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the years ended September 30, 2001 and 2000
(In Thousands)

	2001	2000
NET COST OF OPERATIONS	$ 349,338	$ 1,703,951
FINANCING SOURCES (other than exchange revenues)		
Appropriations used	1,558,879	–
Imputed financing	122,539	110,858
Transfers-in	1,271,788	55
(Transfers-out)	(719,067)	(463,593)
Other	(128,858)	224,700
Total Financing Sources (other than exchange revenues)	$ 2,105,281	(127,980)
NET RESULTS OF OPERATIONS	**$ 1,755,943**	**(1,831,931)**
PRIOR PERIOD ADJUSTMENTS (Note 13)	(132,592)	174,896
NET CHANGE IN CUMULATIVE RESULTS OF OPERATIONS	$ 1,623,351	(1,657,035)
INCREASE (DECREASE) IN UNEXPENDED APPROPRIATIONS	**(1,556,200)**	**1,556,200**
CHANGE IN NET POSITION	$ 67,151	(100,835)
NET POSITION, BEGINNING OF THE PERIOD	9,399,412	9,500,247
NET POSITION, END OF THE PERIOD	**$ 9,466,563**	**$ 9,399,412**

See notes to the consolidated and combined financial statements.

Department of Defense
Defense Logistics Agency
COMBINED STATEMENTS OF BUDGETARY RESOURCES
For the years ended September 30, 2001 and 2000
(In Thousands)

	2001	2000
BUDGETARY RESOURCES		
Budget Authority	$ 1,857,346	$ 4,243,093
Unobligated Balance, Beginning of Period	1,426,506	204,595
Net Transfers, Prior-Year Balance	(915,300)	(292,300)
Spending Authority from Offsetting Collections	18,011,088	14,879,902
Adjustments	(1,267,195)	(113,415)
TOTAL BUDGETARY RESOURCES	**$ 19,112,445**	**$ 18,921,875**
STATUS OF BUDGETARY RESOURCES		
Obligations Incurred	$ 18,580,429	$ 17,495,370
Unobligated Balances - Available	532,016	1,426,505
TOTAL STATUS OF BUDGETARY RESOURCES	**$ 19,112,445**	**$ 18,921,875**
OUTLAYS		
Obligations Incurred	$ 18,580,429	$ 17,495,370
Less: Spending Authority From Offsetting Collections and Adjustments	(18,011,088)	(14,879,919)
Obligated Balance - Net, Beginning of Period	6,621,808	5,144,929
Less: Obligated Balance - Net, End of Period	(6,643,099)	(6,621,808)
TOTAL OUTLAYS	**$ 548,050**	**$ 1,138,572**

See notes to the consolidated and combined financial statements.

Department of Defense
Defense Logistics Agency
COMBINED STATEMENTS OF FINANCING
For the years ended September 30, 2001 and 2000
(In Thousands)

	2001	2000
OBLIGATIONS AND NONBUDGETARY RESOURCES		
Obligations Incurred	$ 18,580,429	$ 17,495,370
Less: Spending Authority for Offsetting Collections and Adjustments	(18,011,089)	(14,879,919)
Financing Imputed for Cost Subsidies	122,539	110,858
Less: Exchange Revenue Not in the Entity's Budget	–	1,305
Total Obligations as Adjusted and Nonbudgetary Resources	$ 691,879	$ 2,727,614
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	67,460	(1,419,093)
Change in Unfilled Customer Orders	73,778	121,534
Costs Capitalized on the Balance Sheet - (Increases)/Decreases	(443,876)	(15,557)
Financing Sources That Fund Costs of Prior Periods	(7,652)	30,628
Other - (Increases)/Decreases	(139,230)	139,439
Total Resources That Do Not Fund Net Costs of Operations	$ (449,520)	$ (1,143,049)
COSTS THAT DO NOT REQUIRE RESOURCES		
Depreciation and Amortization	$ 98,724	$ 120,089
Bad Debts Related to Uncollectable Non-Credit Reform Receivables	(1)	–
Loss on Disposition of Assets	(5,169)	(6,850)
Total Costs That Do Not Require Resources	$ 93,554	$ 113,239
FINANCING SOURCES YET TO BE PROVIDED	13,425	6,147
NET COST OF OPERATIONS	**$ 349,338**	**$ 1,703,951**

See notes to the consolidated and combined financial statements.

NOTES TO THE CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

Defense Working Capital Fund

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NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

The financial statements of the Defense Logistics Agency (DLA) report all working capital fund (WCF) activities of DLA including Supply Management, Distribution, Reutilizations and Marketing, and the Document Automation and Production Service. 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 DLA in accordance with the *Department of Defense Financial Management Regulation* ("DoDFMR") 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

DLA operates as a working capital fund. 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.

The DLA mission is to provide the best value logistics solution to meet the needs of America's armed forces around the clock and around the world, in times of peace, national emergency, and war. Support begins with joint planning for parts used in new weapons systems, extends through production and contract support, and concludes with the disposal of materiel that is obsolete, worn out, or no longer needed. DLA provides supply support, technical/logistics services and quality support to all branches of the military. The services it provides fall into the following activity groups: Supply Management, Distribution, Reutilization and Marketing (DRMS), and the Document Automation and Production Service (DAPS). Effective October 1, 2000, the Information Services business activity is no longer an independent entity. In the current year, residual amounts from Information Services were transferred to Supply Management.

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.

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:

- Federal Accounting Standards Advisory Board (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.

DLA has not implemented all requirements of generally accepted accounting principles for Federal government entities due to limitations of its financial management processes and systems, including non-financial feeder systems and processes. Reported values and information for DLA's major asset and liability categories are derived largely from non-financial feeder systems, such as acquisition, property, and logistic systems. These systems were designed to support reporting requirements that focused on asset accountability and funds control rather than to support preparation of financial statements in accordance with generally accepted accounting principles for Federal government entities. DLA has begun to implement process and system improvements to address the existing system and process limitations.

E. Revenues and Other Financing Sources

Exchange revenue is recognized when goods or services are provided and when inventory items are sold. Certain distribution activity group revenues are recognized based on the actual workload for the period. Revenue is not earned to offset costs incurred by the DRMS activity group's transfer and donation programs.

F. Recognition of Expenses

For financial reporting purposes, the DoD policy requires the recognition of operating expenses in the period incurred. Expenditures for capital and other long-term assets are not recognized as expenses when consumed in DLA operations. Certain expenses, such as annual and military leave earned but not taken, are financed in the period in which payment is made.

G. Accounting for Intragovernmental Activities

DLA, 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 DLA as though the agency was a stand-alone entity.

In order to prepare financial statements, transactions occurring between entities within the DLA or between DLA and other DoD agencies, and between other federal agencies, must be eliminated. For fiscal years (FY) 2001 and 2000, DLA 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. Transactions with Foreign Government and International Organizations

Each year, the DLA Components sell defense articles and services to foreign governments and international organizations, primarily under the provisions of the "Arms Export Control Act of 1976." Under the provisions of this Act, DLA has the authority to sell defense articles and services to foreign countries and international organizations, generally at no profit or loss to the U.S. Government.

I. Collections and Disbursements Clearing

DLA, as a working capital fund, does not have a Fund Balance with Treasury (FBWT) account. Instead, a collections and disbursements clearing account is maintained by DLA 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 FBWT exists for the DWCF. DLA and nine other DWCF activities operate under one Defense subnumbered Treasury account. As a result, DLA does not have an individually identifiable balance. The collections, disbursements, and cash transfers applicable to DLA's operations are recorded in the DLA 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.

J. Foreign Currency

DLA conducts a portion of its operations overseas within the DWCF. Any gains or losses incurred from foreign currency fluctuations are considered during the rate development process.

K. Accounts Receivable

Accounts Receivable, Intragovernmental consists of amounts due from DoD and other Federal agencies. Accounts Receivable, Net consists of claims receivable from other entities. The DLA does not recognize an allowance for estimated uncollectible amounts from another federal agency. For public accounts receivable, DLA does not anticipate material uncollectible amounts.

L. Inventory

Inventories are reported at approximate historical cost based on Latest Acquisition Cost (LAC) adjusted for holding gains and losses. The LAC method is used because inventory data is maintained in logistics systems designed for materiel management purposes. For the most part, these systems value inventory at LAC and the reported amounts must be adjusted. DLA uses a formula to estimate the approximate historical cost of DLA inventories.

Contracts for purchases of bulk fuels include an Economic Price Adjustment (EPA) clause, which is indexed to the Bureau of Labor Statistics, U.S. Department of Labor's "Producer Price Index."

M. General Property, Plant, and Equipment, Net

General Property, Plant and Equipment (PP&E) are generally 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 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 that 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, SFFAS No. 10, *Accounting for Internal Use Software,* 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. DLA did not adopt this standard.

N. Other Assets

Other assets include Advances, Prepayments, Outstanding Contract Financing Payments, and Travel Advances.

O. Leases

Lease payments are for rental of equipment and are classified as either capital or operating leases. When a lease is essentially equivalent to a purchase of property (capital lease) and the value of the lease exceeds the DoD $100,000 capitalization threshold, an asset and a liability are recorded. Leases that do not transfer substantially all benefits of ownership are classified as operating leases and recorded as expenses as payments are made over in the current year.

P. Accounts Payable

Intragovernmental accounts payable consist of amounts owed to DoD, and other governmental agencies. Accounts payable consists of accounts payable with the public.

Q. Accrued Leave

Civilian annual leave and military 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 annual civilian and military 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.

R. Workers' Compensation Liability

Workers' Compensation is comprised of two components: (1) the accrued liability which represents money 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 DLA employees under FECA are administered by the Department of Labor and are ultimately paid by DLA.

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.

S. 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 to meet this requirement.

DLA'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. DLA 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.

T. Contingencies and Litigation

The SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss to DLA. The uncertainty will be resolved when one or more future events occur or fail to occur. A contingency is recognized as a liability when it is probable that the future event or events will confirm the loss or the incurrence of a liability for the reporting entity and the amount of loss can be reasonably estimated. Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility that a loss or additional loss will be incurred. Examples of loss contingencies include the collectibility of receivables, pending or threatened litigation, possible claims and assessments. DLA's loss contingencies arising from pending or threatened litigation or claims and assessments occur due to events such as vehicle accidents, property or environmental damages, and contract disputes.

DLA is a party in various administrative proceedings, legal actions, and claims brought against it. In the opinion of DLA 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 the Agency 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 DLA's operations.

U. Net Position

Net position consists of unexpended appropriations and cumulative results 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. DLA does not have unexpended appropriations in the current year.

Cumulative results of operations represents the difference between expenses and other losses, and financing sources including appropriations used, revenue, and other gains. Beginning in FY 1998, net position included the cumulative amount of 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 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.

V. Undelivered Orders

DLA is obligated for goods and services that have been ordered but not yet received (undelivered orders). DLA has undelivered orders of $1,910,575 thousand and $1,836,859 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.

W. Pricing Policy

The DLA provides logistic solutions to meet the needs of America's armed forces. Support begins with joint planning for parts used in new weapons systems, extends through production and contract support, and concludes with the disposal of materiel that is obsolete, worn out, or no longer needed.

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. DLA, a working capital fund, does not generally receive appropriated funding from the Congress; therefore, the rate review process is an integral component to the development of customer service rates.

X. 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.

Y. 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

	2001	2000
Fund Type		
Appropriated Funds	$ –	$ –
Revolving Funds	–	–
Trust Funds	–	–
Other Fund Types	–	–
Total	$ –	$ –

NOTE 3. ACCOUNTS RECEIVABLE (IN THOUSANDS)

	GROSS AMOUNT	ALLOWANCE FOR ESTIMATED UNCOLLECTIBLES	2001	2000
Entity Receivables:				
Intragovernmental	$ 692,660	$ –	$ 692,660	$ 846,981
With the Public-Net	287,030	(282)	286,748	137,050
Total Accounts Receivable	$ 979,690	$ (282)	$ 979,408	$ 984,031

NOTE 4. OTHER ASSETS (IN THOUSANDS)

	2001	2000
Intragovernmental:		
Other Assets - Advances and Prepayments	$ 240	$ 528
Total Intragovernmental	$ 240	$ 528
Other Assets:		
Outstanding Contract Financing Payments	$ 229,132	$ 185,916
Other Assets (with the Public)	6,472	338,141
Total Other Assets	$ 235,604	$ 524,057

NOTE 5. INVENTORY, NET (IN THOUSANDS)

Inventory, Net	INVENTORY GROSS VALUE	REVALUATION ALLOWANCE	2001 INVENTORY, NET	2000 INVENTORY, NET	VALUATION METHOD
Inventory Categories:					
Available and Purchased for Resale	$ 9,849,042	$ (419,331)	$ 9,429,711	$ 7,474,321	Adjusted LAC
Held in Reserve for Future Sale	–	–	–	1,828,911	LAC
Held for Repair	12,731	–	12,731	12,396	Adjusted LAC
Excess, Obsolete, and Unserviceable	1,596,616	(1,445,591)	151,025	170,765	NRV
Total	$ 11,458,389	$ (1,864,922)	$ 9,593,467	$ 9,486,393	

Operating Materials & Supplies, Net	OM&S AMOUNT	REVALUATION ALLOWANCE	OM&S NET	OM&S NET	VALUATION METHOD
OM&S Categories:					
Held for Use	$ 13,577	$ –	$ 13,577	$ 11,732	AC
Total	$ 13,577	$ –	$ 13,577	$ 11,732	

Legend for Valuation Methods:

Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses
LAC = Latest Acquisition Cost
NRV = Net Realizable Value
AC = Actual Cost

NOTE 6. GENERAL PROPERTY, PLANT, AND EQUIPMENT, NET (IN THOUSANDS)

Major Asset Classes:	DEPRECIATION/ AMORTIZATION METHOD	SERVICE LIFE	ACQUISITION VALUE	(ACCUMULATED DEPRECIATION/ AMORTIZATION)	2001 NET BOOK VALUE	2000 NET BOOK VALUE
Land	N/A	N/A	$ 954	$ –	$ 954	$ –
Buildings, Structures, and Facilities	S/L	20	1,699,759	(1,123,427)	576,332	628,397
Software	S/L	2-5 or 10	243,812	(190,654)	53,158	25,829
Equipment	S/L	5 or 10	501,079	(414,969)	86,110	94,964
Construction-in-Progress	N/A	N/A	303,819	N/A	303,819	189,459
Other			195,749	–	195,749	–
Total			$ 2,945,172	$ (1,729,050)	$ 1,216,122	$ 938,649

Capital Leases

DLA has no capital leases recorded for FY 2001 but will be undertaking an initiative to identify and quantify capital leases beginning in FY 2002.

NOTE 7. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES (IN THOUSAND)

	2001	2000
Intragovernmental Liabilities:		
Accounts Payable	$ –	$ –
Other	48,156	49,473
Total	$ 48,156	$ 49,473
Nonfederal Liabilities		
Accounts Payable	$ –	$ 27,541
Military Retirement Benefits and Other Employment - Related Actuarial Liabilities	245,648	242,304
Other	93,935	95,079
Total	$ 339,583	$ 364,924

NOTE 8. ACCOUNTS PAYABLE (IN THOUSAND)

	ACCOUNTS PAYABLE	INTEREST PENALITIES, AND ADMINISTRATIVE FEES	2001	2000
Intragovernmental Payables	$ 100,849	N/A	$ 100,849	$ 191,151
Nonfederal Payables	1,865,469	–	1,865,469	1,762,550
Total	$ 1,966,318	$ –	$ 1,966,318	$ 1,953,701

NOTE 9. ENVIRONMENTAL LIABILITIES

DLA had $198,963 thousand of environmental cleanup costs for FY 2001 relating to Defense Environmental Restoration Program (DERP) and Base Realignment and Closure (BRAC). However, this liability will be recorded on the DLA General Fund statements since they administer the Environmental Cleanup Program. Beginning in FY 2002, DLA will be undertaking an initiative to identify and record the environmental liabilities funded through the Working Capital Fund.

NOTE 10. OTHER LIABILITIES (IN THOUSAND)

	CURRENT LIABILITY	NONCURRENT LIABILITY	2001	2000
Intragovernmental:				
Advances from Others	$ 134,272	$ –	$ 134,272	$ 172,226
Judgment fund liabilities	2,284	–	2,284	–
FECA Reimbursement to DOL	23,936	21,936	45,872	49,473
Other Liabilities	5,625	–	5,625	7,919
Total	$ 166,117	$ 21,936	$ 188,053	$ 229,618
With the Public:				
Accrued Funded Payroll and Benefits	$ 20,083	$ 5,205	$ 25,288	$ 19,648
Advances from Other	47,185	–	47,185	–
Accrued Unfunded Annual Leave	93,934	–	93,934	95,079
Other Liabilities	5,429	–	5,429	5,626
Total	$ 166,631	$ 5,205	$ 171,836	$ 120,353

NOTE 11. MILITARY RETIREMENT BENEFITS AND OTHER EMPLOYMENT-RELATED ACTUARIAL LIABILITIES (IN THOUSAND)

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	–		–	–	–
Total	$ –		$ –	$ –	$ –
Other:					
Workers' Compensation (FECA)	$ 245,648	5.21%	$ –	$ 245,648	$ 242,304
Total	$ 245,648		$ –	$ 245,648	$ 242,304
TOTAL	$ 245,648		$ –	$ 245,648	$ 242,304

(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 DLA employees under FECA are administered by the Department of Labor and are ultimately paid by DLA.

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 using a method that utilizes historical benefit payment patterns related to a specific incurred period to estimate the ultimate payments related to that period.

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 by DOL 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 the current year, a change in the accounting method concerning the calculation of the actuarial FECA balance occurred. In previous years, the actuarial FECA balance was derived from the 1-year chargeback amount. In the current year, 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 provided by OPM Financial Management Letters regarding *Cost Factors for Pension and Other Retirement Benefit Expenses* were used to calculate the amount of additional expense to be recorded by DLA.

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 the "subsidy" being made by OPM for employees' retirement benefits. Based on the information provided by the OPM, DLA determined that the imputed cost for the Pensions and Other Retirement Benefits for the year ended September 30, 2001 were:

	2001	2000
Imputed Expenses:		
CSRS/FERS Retirement	$ 49,851	$ 46,020
Health	72,483	64,663
Life Insurance	205	175
Total	$ 122,539	$ 110,858

NOTE 12. DISCLOSURE RELATED TO THE STATEMENT OF NET COST (IN THOUSANDS)

	DISTRIBUTION DEPOT	SUPPLY MANAGEMENT	DAPS	DRMS	COMBINED
Operating Expenses	$ 1,238,808	$ 16,321,379	$ 390,791	$ 315,039	$ 18,266,017
Change in Actual FECA Liability	(1,172)	(2,180)	(203)	(296)	(3,851)
FECA Liability Paid in CY	(161)	(255)	–	(44)	(460)
Additional FECA due to Overallocation (Stockpile)	–	225	–	–	225
Upward Adjustment to A/P - Eliminations	–	152	–	–	152
Reversal of CY Expenses for PBD 416	–	(49)	–	–	(49)
Record PBD 426	–	159	47	–	206
Non-Production Costs	(1,525)	–	–	–	(1,525)
Recordation of Expenses Due to PY Advances	124	9,270	–	1,193	10,587
Expenses Rated to Imputed Benefit Costs	43,757	62,553	7,104	9,125	122,539
Gains on the Disposition of Assets	–	(5,169)	(903)	–	(6,072)
Inventory Stratification - Reevaluation	–	460,474	–	–	460,474
Other Losses for Changes in Actuarial Balance	1,018	1,893	176	257	3,344
Total Expenses	1,280,849	16,848,452	397,012	325,274	18,851,587
Operating Revenues	1,175,482	16,470,175	390,226	372,128	18,408,011
Other Revenue	–	62,146	–	–	62,146
Revenues Not Included in Activity Records	34,376	–	–	–	34,376
Future Funding - Judgment Funds	–	(1,570)	–	(714)	(2,284)
Total Revenues	1,209,858	16,530,751	390,226	371,414	18,502,249
Net Cost	$ 70,991	$ 317,701	$ 6,786	$ (46,140)	$ 349,338

	COMBINED (PER ABOVE)	ELIMINATIONS	TOTAL
Total Expenses	$ 18,851,587	$ (989,686)	$ 17,861,901
Total Revenues	18,502,249	989,686	17,512,563
Net Cost	$ 349,338	$ –	$ 349,338

NOTE 13. PRIOR-PERIOD ADJUSTMENTS (IN THOUSANDS)

Equipment, Materiel, and Supplies Inventory - DAPS	$ 9,893
Expenses - DRMS	5,621
Current Year Expenses for Prior Year Established Obligations	(141,609)
Writeoff of Accounts Payable (DLA Pacific) - Supply Management Operations	(5,924)
Writeoff of Contingent Liability	(573)
Total	$ (132,592)

NOTE 14. DISCLOSURE RELATED TO THE STATEMENT OF BUDGETARY RESOURCES (IN THOUSANDS)

	2001	2000
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	$ 7,343,834	$ 7,411,294
Available Borrowing and Contract Authority at the End of the Period	7,984,004	5,851,993

NOTE 15. OPERATING LEASES

Although DLA has operating leases, they are not managed in a manner that permits providing data on future outlays. Further, DLA has no lease arrangements where DLA is the lessor.

CONSOLIDATING AND COMBINING FINANCIAL STATEMENT INFORMATION (UNAUDITED)

Defense Working Capital Fund

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Department of Defense
Defense Logistics Agency
CONSOLIDATING BALANCE SHEET INFORMATION
As of September 30, 2001
(In Thousands)
(Unaudited)

	Distribution Depot	Information Services	Document Automation & Production Service	Reutilization & Marketing	Supply Management	Combined	Eliminations	2001	2000
ASSETS									
Intragovernmental									
Collections and Disbursements - Clearing	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –	$ –
Accounts Receivable	113,013	–	103,935	16,582	614,816	848,346	155,686	692,660	846,981
Other Assets	1	–	–	–	239	240	–	240	528
Total Intragovernmental	113,014	–	103,935	16,582	615,055	848,586	155,686	692,900	847,509
Accounts Receivable	1,271	–	2,758	17,762	264,957	286,748	–	286,748	137,050
Inventory and Related Property	–	–	13,577	113,245	9,480,222	9,607,044	–	9,607,044	9,498,125
General Property, Plant, and Equipment - Net	393,044	–	19,032	122,303	681,743	1,216,122	–	1,216,122	938,649
Other Assets	537	–	99	5,496	229,472	235,604	–	235,604	524,055
TOTAL ASSETS	$ 507,866	$ –	$ 139,401	$ 275,388	$ 11,271,449	$ 12,194,104	$ 155,686	$ 12,038,418	$ 11,945,388

Department of Defense
Defense Logistics Agency
CONSOLIDATING BALANCE SHEET INFORMATION
As of September 30, 2001 and 2000
(In Thousands)
(Unaudited)

	Distribution Depot	Information Services	Document Automation & Production Service	Reutilization & Marketing	Supply Management	Combined	Eliminations	2001	2000
LIABILITIES									
Intragovernmental									
Accounts Payable	$ 38,408	$ –	$ 5,981	$ 6,277	$ 205,869	$ 256,535	$ 155,686	$ 100,849	$ 191,151
Environmental Liabilities	–	–	–	–	–	–	–	–	–
Other Liabilities	17,158	–	2,685	5,286	162,924	188,053	–	188,053	229,618
Total Intragovernmental	55,566	–	8,666	11,563	368,793	444,588	155,686	288,902	420,769
Accounts Payable	258,155	–	123,418	170,047	1,313,849	1,865,469	–	1,865,469	1,762,550
Military Retirements Benefit and Other Employment-Related Actuarial Liabilities	82,372	–	12,706	22,251	128,319	245,648	–	245,648	242,304
Environment Liabilities	–	–	–	–	–	–	–	–	–
Other Liabilities	31,659	–	6,375	61,146	72,656	171,836	–	171,836	120,353
Total Liabilities	427,752	–	151,165	265,007	1,883,617	2,727,541	155,686	2,571,855	2,545,976
Net Position									
Unexpended Appropriations	–	–	–	–	–	–	–	–	1,556,200
Cumulative Results of Operations	80,114	–	(11,764)	10,381	9,387,832	9,466,563	–	9,466,563	7,843,212
Total Net Position	80,114	–	(11,764)	10,381	9,387,832	9,466,563	–	9,466,563	9,399,412
Total Liabilities and Net Position	$ 507,866	$ –	$ 139,401	$ 275,388	$11,271,449	$12,194,104	$ 155,686	$ 12,038,418	$11,945,388

Department of Defense
Defense Logistics Agency
CONSOLIDATING STATEMENT OF NET COST INFORMATION
As of September 30, 2001
(In Thousands)
(Unaudited)

	Distribution Depot	Information Services	Document Automation & Production Service	Reutilization & Marketing	Supply Management	Combined	Eliminations	2001	2000
PROGRAM COSTS									
Intragovernmental	$ 358,284	$ –	$ 56,259	$ 78,832	$ 1,483,846	$ 1,977,221	$ 989,686	$ 987,535	$ 939,019
With the Public	922,565	–	340,753	246,442	15,364,606	16,874,366	–	16,874,366	14,959,433
Total Program Cost	1,280,849	–	397,012	325,274	16,848,452	18,851,587	989,686	17,861,901	15,898,452
Less: Earned Revenues	(1,209,858)	–	(390,226)	(371,414)	(16,530,751)	(18,502,249)	(989,686)	(17,512,563)	14,194,501
Net Program Costs	70,991	–	6,786	(46,140)	317,701	349,338	–	349,338	1,703,951
NET COST OF OPERATIONS	$ 70,991	$ –	$ 6,786	$ (46,140)	$ 317,701	$ 349,338	$ –	$ 349,338	1,703,951

Department of Defense
Defense Logistics Agency
CONSOLIDATING STATEMENT OF CHANGES IN NET POSITION INFORMATION
As of September 30, 2001
(In Thousands)
(Unaudited)

	Distribution Depot	Information Services	Document Automation & Production Service	Reutilization & Marketing	Supply Management	Combined	Eliminations	2001	2000
NET COST OF OPERATIONS	$ 70,991	$ –	$ 6,786	$ (46,140)	$ 317,701	$ 349,338	$ –	$ 349,338	$ 1,703,951
Financing Sources (other than exchange revenue)									
Appropriations Used	1,385	–	244	–	1,557,250	1,558,879	–	1,558,879	–
Imputed Financing	43,757	–	7,104	9,125	62,553	122,539	–	122,539	110,858
Transfers-In	285,672	–	2	147	1,483,228	1,769,049	497,261	1,271,788	55
(Transfers-Out)	(340,714)	3,246	(5,067)	(98,921)	(774,872)	(1,216,328)	(497,261)	(719,067)	(463,593)
Other	–	–	–	–	(128,858)	(128,858)	–	(128,858)	224,700
Total Financing Sources (other than exchange revenue)	(9,900)	3,246	2,283	(89,649)	2,199,301	2,105,281	–	2,105,281	(127,980)
NET RESULTS OF OPERATIONS	(80,891)	3,246	(4,503)	(43,509)	1,881,600	1,755,943	–	1,755,943	(1,831,931)
PRIOR PERIOD ADJUSTMENTS	–	–	9,893	5,621	(148,106)	(132,592)	–	(132,592)	174,896
NET CHANGE IN CUMULATIVE RESULTS OF OPERATIONS	(80,891)	3,246	5,390	(37,888)	1,733,494	1,623,351	–	1,623,351	(1,657,035)
INCREASE (DECREASE) IN UNEXPENDED APPROPRIATIONS	–	–	–	–	(1,556,200)	(1,556,200)	–	(1,556,200)	1,556,200
CHANGE IN NET POSITION	(80,891)	3,246	5,390	(37,888)	177,294	67,151	–	67,151	(100,835)
NET POSITION, BEGINNING OF PERIOD	161,004	(3,246)	(17,154)	48,269	9,210,539	9,399,412	–	9,399,412	9,500,247
NET POSITION, END OF PERIOD	$ 80,113	$ –	$ (11,764)	$ 10,381	$ 9,387,833	$ 9,466,563	$ –	$ 9,466,563	$ 9,399,412

Department of Defense
Defense Logistics Agency
COMBINING STATEMENT OF BUDGETARY RESOURCES INFORMATION
As of September 30, 2001
(In Thousands)
(Unaudited)

	Distribution Depot	Information Services	Document Automation & Production Service	Reutilization & Marketing	Supply Management	2001	2000
BUDGETARY RESOURCES							
Budget Authority	$ 1,385	$ –	$ 244	$ –	$ 1,855,717	$ 1,857,346	$ 4,243,093
Unobligated Balance, Beginning of Period	74,407	(2,741)	29,306	50,602	1,274,932	1,426,506	204,595
Net Transfers, Prior Year Balance	–	3,990	–	–	(919,290)	(915,300)	(292,300)
Spending Authority from Offsetting Collections	1,237,649	–	389,279	364,617	16,019,543	18,011,088	14,879,902
Adjustments	(36,217)	(1,249)	(24,310)	(67,057)	(1,138,362)	(1,267,195)	(113,415)
TOTAL BUDGETARY RESOURCES	$ 1,277,224	$ –	$ 394,519	$ 348,162	$17,092,540	$ 19,112,445	$18,921,875
STATUS OF BUDGETARY RESOURCES							
Obligations Incurred	$ 1,171,853	$ –	$ 373,055	$ 298,895	$16,736,626	$ 18,580,429	$17,495,370
Unobligated Balances - Available	105,371	–	21,464	49,267	355,914	532,016	1,426,505
TOTAL STATUS OF BUDGETARY RESOURCES	$ 1,277,224	$ –	$ 394,519	$ 348,162	$17,092,540	$ 19,112,445	$18,921,875
OUTLAYS:							
Obligations Incurred	$ 1,171,853	$ –	$ 373,055	$ 298,895	$16,736,626	$ 18,580,429	$17,495,370
Less: Spending Authority from Offsetting Collections and Adjustments	(1,237,649)	–	(389,279)	(364,617)	(16,019,543)	(18,011,088)	(14,879,919
Obligated Balance - Net, Beginning of Period	318,641	3,865	64,881	185,867	6,048,554	6,621,808	5,144,929
Obligated Balance Transferred - Net	–	(3,865)	–	–	3,865	–	–
Less: Obligated Balance - Net, End of Period	(259,114)	–	(53,481)	(195,352)	(6,135,152)	(6,643,099)	(6,621,808
TOTAL OUTLAYS	$ (6,269)	$ –	$ (4,824)	$ (75,207)	$ 634,350	$ 548,050	$ 1,138,572

Department of Defense
Defense Logistics Agency
CONSOLIDATING STATEMENT OF FINANCING INFORMATION
As of September 30, 2001
(In Thousands)
(Unaudited)

	Distribution Depot	Information Services	Document Automation & Production Service	Reutilization & Marketing	Supply Management	2001	2000
OBLIGATIONS AND NONBUDGETARY RESOURCES							
Obligations Incurred	$ 1,171,853	$ –	$ 373,055	$ 298,895	$ 16,736,626	$ 18,580,429	$ 17,495,370
Less: Spending Authority for Offsetting Collections and Adjustments	(1,237,649)	–	(389,279)	(364,617)	(16,019,543)	(18,011,088)	(14,879,919)
Financing Imputed for Cost Subsidies	43,757	–	7,104	9,125	62,553	122,539	110,858
Transfers-In (out)	–	360	–	–	(360)	–	–
Less: Exchange Revenue not in the Entity's Budget	–	–	–	–	–	–	1,305
Total Obligations as Adjusted and Nonbudgetary Resources	(22,039)	360	(9,120)	(56,597)	779,276	691,880	2,727,614
RESOURCES THAT DO NOT FUND NET COST OF OPERATIONS							
Change in Amount of Goods, Services, and Benefits Ordered but not received/provided - (increases)/decreases	41,576	–	6,222	11,319	8,343	67,460	(1,419,093)
Change in Unfilled Customer Orders	27,791	–	(960)	(7,511)	54,458	73,778	121,534
Costs Capitalized on the Balance Sheet - (increases)/decreases	(24,949)	–	(1,700)	(5,775)	(411,452)	(443,876)	(15,557)
Financing Sources the Fund Costs of Prior Periods	(3,251)	(360)	(350)	(1,535)	(2,156)	(7,652)	30,628
Other - (increases)/decreases	–	–	8,309	6,162	(153,701)	(139,230)	139,439
Total Resources that do not Fund Net Cost, Cost of Operations	41,167	(360)	11,521	2,660	(504,508)	(449,520)	(1,143,049)
COSTS THAT DO NOT REQUIRE RESOURCES							
Depreciation and Amortization	50,845	–	4,208	6,826	36,845	98,724	120,089
Bad debts Related to Uncollectible Noncredit Reform Receivables	–	–	–	1	(2)	(1)	–
Loss on Disposition of Assets	–	–	–	–	(5,169)	(5,169)	(6,850)
Total Costs that do not Require Resources	50,845	–	4,208	6,827	31,674	93,554	113,239
FINANCING SOURCES YET TO BE PROVIDED	1,018	–	176	972	11,258	13,424	6,147
NET COST OF OPERATIONS	$ 70,991	$ –	$ 6,785	$ (46,138)	$ 317,700	$ 349,338	$ 1,703,951

REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION (UNAUDITED)

Defense Working Capital Fund

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Department of Defense
Defense Logistics Agency
HERITAGE ASSETS
For the years ended September 30, 2001 and 2000
(Unaudited)

	Measurement Quantity	As of 10/01/00	Additions	Deletions	As of 9/30/01	As of 9/30/00
Museums	Each					
Monuments & Memorials	Each					
Cemeteries & Archeological Sites	Sites					
Buildings & Structures	Each	1			1	1
Major Collections	Each					

Narrative Statement - Executive Order 11593 from the United States Department of the Interior, Heritage Conservation and Recreation Service entered Bellwood, Chesterfield County, Virginia in the National Register. Operated by the Defense Supply Center - Richmond (DSCR), the Bellwood home is an early nineteenth century plantation house highlighted by slender columns extending up two stories, it also serves as the DSCR Officer's Club.

The DSCR Officer's Club is in good repair. There are no deferred maintenance projects for this facility. Currently, only preventive maintenance/service calls are being performed. The Department of Historical Resources in Richmond ensures the historical integrity of the property by approving any repairs, major or minor. The Office of Installation Services at DSCR provides most maintenance.

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REQUIRED SUPPLEMENTARY INFORMATION (UNAUDITED)

Defense Working Capital Fund

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Department of Defense
Defense Logistics Agency
REAL PROPERTY DEFERRED MAINTENANCE
As of September 30, 2001
(Unaudited)

($ in Thousands) 1. Property Type		FY 2001			
	2. Restoration Prior	Annual Sustainment			6. Restoration Ending
		3. Required	4. Actual	5. Difference	
Buildings and Structures		503,800	281,400	222,400	

Property Type		Annual Deferred Sustainment Trend			
	FY 2000	FY 2001			
Buildings and Structures		222,400			

The total deferred real property maintenance was calculated as the difference between actual FY01 real property sustainment as reported in DBMS, $281,400 thousand and the required FY01 real property sustainment from the DoD Facility Sustainment Model (FSM), $503,800 thousand. The sustainment value was calculated by deflating the values derived from the FSM version 4.0 amounts for DLA's FY03 sustainment, $520,011 thousand, by 1.6% per year back to FY01 [$520,011,000/(1.016*1.016)].

The DoD FSM uses a standard commercial per-square-foot cost factor (for each type of facility) that represents the cost to maintain a facility in good condition. The total Agency sustainment value is calculated by multiplying the total size of each type of facility at a given location by the commercial cost factor. The standard DoD geographic area cost factor for that location then adjusts all the facility costs for a given location.

Comprehensive real property condition information is unavailable as the majority of the facilities for which the Agency is responsible for sustainment is not under DLA's operational control, e.g., fuel storage and handling facilities. If the Military Services regularly perform condition assessments on these facilities, the results have not been made available to DLA. The Agency has previously conducted comprehensive condition assessments only as part of Base Realignment and Closure analyses. Insufficient human and financial resources are available to annually assess Agency facilities and manage the resulting data.

Department of Defense
Defense Logistics Agency
SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
As of September 30, 2001 and 2000
(In Thousands)
(Unaudited)

	2001		2000	
	Accounts Receivable	Other Assets	Accounts Receivable	Other Assets
Library of Congress	$ 347	$ –	$ –	$ –
Other Legislative Branch Agencies	1	–	–	–
The Judiciary	–	–	–	–
Executive Office of the President	874	–	23,428	–
Department of Agriculture	10,887	–	(12,737)	–
Department of Commerce	302	–	614	–
Department of the Interior	1,764	–	2,698	–
Department of Justice	10,628	–	10,022	–
Department of Labor	5,972	–	4,936	–
Navy General Fund	96,819	–	143,080	–
United States Postal Service	168	–	234	–
Department of State	3,374	–	1,290	–
Department of Treasury	20,463	–	1,546	–
Army General Fund	74,709	–	63,833	–
Office of Personnel Management	20	–	24	–
National Credit Union Administration	–	–	(21)	–
Federal Communications Commission	1	–	–	–
Social Security Administration	303	–	156	–
Nuclear Regulatory Commission	10	–	34	–
Smithsonian Institution	–	–	–	–
Department of Veterans Affairs	2,457	–	1,994	–
U.S. Equal Employment Opportunity Commission	32	–	–	–
General Service Administration	15,494	–	6,126	–
National Science Foundation	125	–	391	–
Air Force General Fund	47,403	240	26,275	234
Federal Emergency Management Agency	1,007	–	469	–
Tennessee Valley Authority	16	–	(1)	–
Federal Maritime Commision	–	–	(1)	–
United States Information Agency	–	–	–	–
Environmental Protection Agency	621	–	77	–
Department of Transportation	16,830	–	21,151	–
Agency for International Development	55	–	13	–
Small Business Administration	–	–	1	–
Department of Health and Human Services	3,650	–	5,823	–
National Aeronautics and Space Administration	4,057	–	2,920	–
Department of Housing and Urban Development	–	–	111	–
Armed Forces Retirement Home	482	–	–	–
Department of Energy	963	–	791	–
Department of Education	8	–	3	–
Independent Agencies	18,712	–	12,782	–
U.S. Army Corps of Engineers	1,684	–	4,645	–
Other Defense Organizations General Funds	115,784	–	97,367	–
Other Defense Organizations Working Capital Funds	31,045	–	75,293	–
Army Working Capital Fund	48,362	–	83,965	261
Navy Working Capital Fund	113,674	–	128,131	–
Air Force Working Capital Fund	43,497	–	139,518	34
Totals	**$ 692,600**	**$ 240**	**$ 846,981**	**$ 529**

Department of Defense
Defense Logistics Agency
SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
As of September 30, 2001 and 2000
(In Thousands)
(Unaudited)

	2001		2000	
	Accounts Payable	Other Liabilities	Accounts Payable	Other Liabilities
Department of Labor	$ –	$ 45,872	$ –	$ 49,957
Navy General Fund	19,947	–	17,147	–
Department of Treasury	–	2,284	45,706	27,478
Army General Fund	14,457	23,496	15,126	23,612
Office of Personnel Management	–	5,625	–	7,434
Air Force General Fund	17,617	–	16,576	1
U.S. Army Corps of Engineers	197	–	871	–
Other Defense Organizations General Funds	2,273	–	12,427	1,609
Other Defense Organizations Working Capital Funds	25,949	–	49,947	441
Army Working Capital Fund	1,993	26,986	18,038	42,318
Navy Working Capital Fund	16,969	27,478	13,368	14,618
Air Force Working Capital Fund	1,447	56,312	2,945	62,150
Totals	**$ 100,849**	**$ 188,053**	**$ 192,151**	**$ 229,618**

Department of Defense
Defense Logistics Agency
SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
As of September 30, 2001 and 2000
(In Thousands)
(Unaudited)

	2001 Earned Revenue	2000 Earned Revenue
Library of Congress	$ 1,642	$ –
Government Printing Office	–	–
Other Legislative Branch Agencies	1	–
The Judiciary	1	9
Executive Office of the President	3,172	563,025
Department of Agriculture	42,488	32,622
Department of Commerce	1,827	1,298
Department of Interior	2,311	3,577
Department of Justice	21,683	20,118
Department of Labor	9,427	10,983
Navy General Fund	2,372,575	1,911,441
United States Postal Service	829	1,528
Department of State	5,201	2,192
Department of Treasury	9,882	6,163
Army General Fund	2,156,469	907,134
Office of Personnel Management	55	21
Federal Communications Commission	–	–
Social Security Administration	1,538	312
Nuclear Regulatory Commission	37	122
Department of Veterans Affairs	11,049	4,201
U.S. Equal Employment Opportunity Commission	32	–
General Service Administration	16,005	17,819
National Science Foundation	9,243	6,977
Air Force General Fund	1,007,380	172,855
Federal Emergency Management Agency	399	460
Tennessee Valley Authority	72	39
Federal Maritime Commission	–	(1)
United States Information Agency	–	–
Environmental Protection Agency	2,152	494
Department of Transportation	89,281	79,655
Agency of International Development	17	8
Department of Health and Human Services	14,848	6,117
National Aeronautics and Space Administration	22,549	16,008
Armed Forces Retirement Home	1,431	–
Department of Housing and Urban Development	243	175
Department of Energy	8,134	3,448
Department of Education	24	10
Independent Agencies	49,929	27,240
U.S. Army Corps of Engineers	48,840	4,576
Other Defense Organizations General Funds	1,409,823	795,486
Other Defense Organizations Working Capital Fund	653,901	318,939
Army Working Capital Fund	931,865	1,920,144
Navy Working Capital Fund	2,668,619	2,407,892
Air Force Working Capital Fund	4,825,898	4,633,479
Totals	**$16,400,872**	**$ 13,876,566**

Department of Defense
Defense Logistics Agency
SCHEDULE OF INTRAGOVERNMENTAL ACTIVITY
As of September 30, 2001 and 2000
(In Thousands)
(Unaudited)

	2001 Transfers-In	2001 Transfers-Out	2000 Transfers-In	2000 Transfers-Out
Navy General Fund	$ –	$ 309,094	$ –	$ –
Army General Fund	–	56,366	–	–
Air Force General Fund	–	423,676	–	–
U.S. Army Corps of Engineers	99	–	–	–
Other Defense Organizations General Funds	–	10,864	–	–
Other Defense Organizations Working Capital Funds	1,264,121	(196,233)	–	–
Army Working Capital Fund	–	6,100	–	–
Navy Working Capital Fund	7,568	43,700	–	–
Air Force Working Capital Fund	–	65,500	–	–
Totals	**$ 1,271,788**	**$ 719,067**	**$ –**	**$ –**

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INDEPENDENT AUDITORS’ REPORT

Defense Working Capital Fund

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Deloitte & Touche

Independent Auditors' Report on Internal Control Over Financial Reporting and Compliance based upon the Engagement performed in accordance with Government Auditing Standards

To the Audit Committee and the Director,
Defense Logistics Agency

We were engaged to audit the consolidated and combined financial statements of the Defense Logistics Agency (DLA) as of and for the year ended September 30, 2001, and have issued our report thereon dated January 31, 2002. In that report, we disclaimed an opinion on the DLA consolidated and combined financial statements because DLA accounting records did not provide sufficient evidential matter to support the recorded balances of inventory, aggregating approximately $9.6 billion, reflected on the consolidated balance sheet, and lacked the appropriate accounting systems and control procedures in place to accurately record the results of its activities (particularly the accuracy, completeness and cutoff of activity as of September 30, 2001 and 2000). Additionally, the financial statements for the year ended September 30, 2001, reflect departures from accounting principles generally accepted in the United States of America and certain reporting requirements of Office of Management and Budget (OMB) Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, including the requirements of Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software* (effective October 1, 2000), and SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, and SFFAS No. 6, *Accounting for Property, Plant and Equipment* (both as amended).

Internal Control over Financial Reporting

In planning and performing our engagement, we considered DLA'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 DLA'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 DLA'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 accounting principles generally accepted in the United States of America and 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 material weaknesses.

1. DLA reports inventory at approximate historical cost based upon Latest Acquisition Cost (LAC) adjusted for holding gains and losses. DLA's inventory valuation processes lack documentation of 1) transaction level support for inventory cost; and 2) the formulas and assumptions inherent in the valuation model used to adjust LAC inventory values. As part of the Business System Modernization (BSM) project, we understand that analyses are being performed in order to develop an inventory valuation strategy that will enable DLA to become compliant with SFFAS No. 3, *Accounting for Inventory and Related Property*. Presently, however, the amounts reflected on the principal statements cannot be assessed with respect to valuation.

2. Accounting principles generally accepted in the United States of America require Federal entities to adopt Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting for Internal Use Software,* effective October 1, 2000, under which certain development costs of internal use software are capitalized. Although DLA had development projects related to internal use software underway during the year ended September 30, 2001, DLA did not adopt SFFAS No. 10. DLA development projects underway during FY 2001 included BSM, the Fuels Accounting System (FAS) and a subsistence ordering system, STORES, for which DLA did not capture the full costs of the development for purposes of determining costs to be capitalized under SFFAS No. 10. The standard defines full costs as direct costs (i.e., DLA personnel costs), direct contractor costs and indirect costs (i.e., general and administrative services, operations and maintenance costs, etc.). Thus the principal statements for the year ended September 30, 2001, reflect a departure from accounting principles generally accepted in the United States of America.

3. Numerous adjustments were posted to the trial balances to correct or add data and to crosswalk the various accounts from subsidiary systems [i.e., the Defense Business Management System (DBMS), the Standard Automated Materiel Management Subsystem (SAMMS), the Base Operating Support System (BOSS), the Defense Fuels Automated Management System (DFAMS), and the Defense Integrated Subsistence Management System (DISMS), etc.] to the U. S. Standard General Ledger (USSGL) accounts. For financial statement preparation purposes, the adjusted information was input 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."

4. DLA provides goods and services and acquires services from many Department of Defense (DoD) agencies and components as well as other Federal government agencies. The governmental entities and activities that do business with DLA are referred to as "trading partners". Significant balances affected by trading partner activities include accounts receivable (DLA as the seller) and accounts payable (DLA as the buyer). Presently, DoD and its component agencies do not have a standard key or code identifier in the trading partner transactions to enable the appropriate elimination of such transactions and related balances during the preparation of consolidated financial statements. As a result, DLA financial accounting systems do not contain essential trading partner information at the transaction level to facilitate the reconciliation and identification of intra-DLA transactions activity, as well as transactions and activity with other DoD components and other government agencies.

   For FY 2001, the DLA financial statements were prepared relying on DoD guidance for the treatment and classification of intragovernmental balances and activity. The guidance essentially provides for situations where buyers have recorded accounts payable greater than the accounts receivable reported by the sellers. When this situation occurs, DoD components are instructed that the buyer-side entity shall reclassify a portion of "accounts payable Federal" to "accounts payable Nonfederal", in order to force the elimination of balances for DoD level reporting. As of September 30, 2001, DLA reclassified an amount in excess of $137 million to "accounts payable Nonfederal", resulting in unsupported balances in the financial statements.

5. 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 DLA's financial management systems do 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 DLA 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 the U. S. Treasury, and to monitor the financial management system to ensure integrity of financial data. OMB Circular A – 127, further states "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.

Our assessment is based upon various factors noted during our engagement. For example, we noted that corporate - level policies and consistent, effective business practices are not in place in a number of significant areas.

a. Reconciliations to ensure the completeness and accuracy of control to subsidiary records are not performed in a timely and reliable manner. We noted instances of weak or incomplete reconciliation controls affecting the following accounts on the principal statements:

   i. Fund Balance with Treasury (FBWT) was not reconciled to component level amounts. DLA does not reconcile all collections and disbursements that impact the principal statements. Thus, unreconciled amounts continue to be carried forward as undistributed and unsupportable disbursements and collections.

   ii. DLA was unable to reconcile the accounts receivable subsidiary ledgers to the general ledger trial balances for DISMS. In total, the unexplained difference between the subsidiary ledgers and the general ledger trial balances was $3.4 million as of September 30, 2001. The difference compromises the accuracy and reliability of DLA's financial statements.

   iii. Approximately 30% of recorded fuel inventory balances as of September 30, 2001 did not show indication of physical inventory counts prior to year-end. Although all counts appeared to have been performed within two months of year-end, improvements in the timeliness of year-end count processes should be implemented to increase the reliability of amounts reflected on the principal statements.

   iv. Reconciliations between the Defense Property Accountability System (DPAS) and general ledger balances [i.e., DBMS, the Defense Working Capital Accounting System (DWAS)] resulted in large variances that could not be supported. An unresolved difference of approximately $305.4 million was identified for DLA's Supply Management, Defense Reutilization and Marketing Services (DRMS), Defense Distribution Center, and Defense Automation and Production Service (DAPS) business activities.

b. Routine reviews and analyses of the validity of significant account balances are not performed. Corporate level policy guidance to ensure that accounts on the principal statements are fairly presented has not been communicated to field activities. The significant accounts affected include inventory, as discussed previously, accounts receivable and accounts payable. Some examples follow:

   i. DLA's unadjusted trial balances included approximately $3.2 billion in accounts payable as of September 30, 2001. Of this total, $1.1 billion was identified as over 180 days old. The aging of the balance indicates a concern that recorded balances may not be valid. Corporate level policies and supporting business practices to liquidate, review/evaluate, or adjust recorded amounts should be adopted.

   ii. DLA's unadjusted trial balances for SAMMS include approximately $55.3 million of accounts receivable over 120 days; non-SAMMS systems include $104.1 million of accounts receivable over 180 days; and DWAS records reflect $69.5 of accounts receivable over 120 days old. The aging of the balances indicates a concern that recorded balances may not be valid or collectible. Corporate level policies and supporting business practices to collect, review/evaluate, or adjust recorded amounts should be adopted.

   iii. DLA has not established a methodology to estimate uncollectible amounts, or established an allowance account for estimated uncollectible amounts with respect to accounts receivable. In one instance, an uncollectible amount was written off by decreasing the sales balance for the SAMMS Industrial commodity. However, no allowance account was established to recognize the net realizable value of the accounts receivable. Further, uncollectible accounts receivable were not written off in DBMS, DISMS, DFAMS, DWAS, and SAMMS (excluding the Industrial commodity). DLA's current business practices for uncollectible accounts receivable lead to an overstatement of accounts receivable, and understatement of income and expenses.

iv. DLA did not have procedures in place to ensure that all expenses were recognized in the proper year, nor were procedures in place to fully support prior-period adjustments made. In the current year, DLA included in net prior-period adjustments aggregating $132 million on the principal statements. The major adjustments were for equipment ($9 million), DRMS expenses ($5.6 million), accounts payable write-offs ($5.9 million), and expenses for prior-year obligations ($141.6 million). Corporate-level policies should be developed to address potential adjustments related to prior fiscal periods in a manner consistent with required accounting and reporting criteria.

c. DLA lacks corporate level policies and consistent business practices for the control, management and record retention related to its leasing activities for real and personal property. There is no process for the accumulation of data regarding aggregate lease commitments at the corporate level. Supporting documentation was not readily available at various primary level field activity (PLFA) sites. As a result, DLA could not properly record and disclose its leasing activities in the financial statements.

d. Corporate policy direction presently available for the management and accountability for property, plant and equipment is not consistently followed or does not address all appropriate control aspects. Examples of conditions noted include:

i. The Defense Energy Support Center (DESC) budget analysts are not recording personal property meeting the capitalization threshold in DPAS. Adequate training on DPAS input procedures has not been provided, resulting in a backlog of unrecorded DESC personal property transactions. As a result, the property, plant, and equipment balances may be understated on the FY 2001 financial statements.

ii. Certain PLFA locations have not followed available standard policies and procedures established in the DLA Property Handbook to ensure property is recorded consistently into DPAS. Generally, lack of adequate training and corporate oversight results in the property officers at the various PLFA locations processing property transactions based on their local interpretation of policies and procedures. In some locations, all property, plant, and equipment is input into DPAS, while at other locations only property exceeding the capitalization threshold is input into DPAS. During 2001, an instance occurred where land was capitalized, although DLA, as a working capital fund, may not own land. These inconsistent practices affect the fair presentation of the property, plant and equipment on the principal statements.

iii. Because Headquarters personnel (J-85) did not reconcile DPAS transactions with other property owners to verify what if any DPAS transactions may have previously been recorded, the potential for duplicate data entry exists.

iv. DLA does not have a process to identify, track and monitor personal property held by contractors, including major classes of software and equipment. In addition, DLA does not have adequate supporting documentation to determine whether this property should be classified as real property or personal property.

e. Conditions were identified affecting the reliability of the financial statements prepared for DLA. The conditions include departures from accounting principles generally accepted in the United States of America and the requirements of OMB Bulletin No. 01-09, lack of general ledger control for certain transaction types, and lack of oversight of the journal voucher process by the Defense Finance and Accounting Service (DFAS), DLA's accounting services provider. Some examples follow:

i. DLA has not fully assessed potential loss contingencies arising from environmental damages and/or remediation for purposes of recording and disclosure in accordance with SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, and SFFAS No. 6, *Accounting for Property, Plant* *and Equipment*, (both as amended). No process or procedure has been established or implemented to quantify and report environmental liabilities incurred by DLA.

ii. DLA did not fully assess potential loss contingencies arising from pending or threatened litigation or claims and assessments for purposes of recording a liability in accordance with SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, as amended. While liabilities arising from resolved matters are recorded in the financial statements, no process or procedure has been established or implemented to quantify and report liabilities arising from pending or threatened matters for financial statement purposes.

iii. The DBMS general ledger trial balance cannot be used to obtain amounts of transfers-in and transfers-out for financial reporting purposes. Because the general ledger amounts are not properly closed out during the year-end closing process, the trial balance amounts as of September 30, 2001 represent the cumulative transfer balances since 1992. For the financial statements, DFAS calculates the transfer amounts by subtracting the respective beginning balances from the ending Transfers-In and Transfers-Out balances, using a spreadsheet. No journal vouchers are prepared to account for this non-systematic determination of the current year transfers balances. As a result, the general ledger trial balances do not represent the appropriate opening balances for the new fiscal year, reducing the reliability of DLA's financial accounting and reporting processes.

iv. DFAS did not obtain proper supervisory approval for five journal vouchers comprising a total amount of $766.6 million posted to DLA'S accounting records. Individually, the journal vouchers fell within the $100 million to $500 million range, thus requiring the signature of the division chief.

v. DFAS uses spreadsheets to calculate the USSGL account balances reported in the DLA financial statements. The totals should reflect the amounts obtained from the trial balances and adjustments for undistributed collection and disbursement activities. However, the totals also include certain "hard-coded" adjustment amounts input to the spreadsheets. Such hard-coded adjustments include amounts for various errors and misclassifications that have occurred since FY 1992 and that have not been resolved. In some cases, these adjustments are one-sided entries to the account balances (i.e., with no corresponding debit or credit amount).

vi. For DLA, DFAS tracks amounts such as "sub head 5CHO" in the M204 process. Such amounts are not under general ledger control. This amount exists solely as an element that has been included in the financial statement preparation process each year. There is no current period activity affecting the balance nor is there documentation or a rationale of why the account exists outside any of the general ledger systems.

6. Our assessment of information systems at the computer processing locations used by DLA disclosed deficiencies in the design and operation of the disaster recovery plans, environmental controls and backup procedures. Additionally, our review of information system security access controls and security policies and procedures in place disclosed deficiencies in the design and operation of information system access controls at computer processing locations used by DLA.

   While the computer processing locations used by DLA are under the management control of others, including DFAS and the Defense Information Systems Agency, identified weaknesses may impact the integrity and security of DLA's financial data.

7. As directed by the Office of the Secretary of Defense (OSD), DLA 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 being met at the OSD level, compliance requirements apply to DLA because it is a component of OSD. DLA has legacy systems that were previously reported on as not being in compliance with federal financial management system requirements; they continue to be not in compliance. DLA is in the process of replacing the non-compliant legacy systems with migratory systems. This replacement process will take several 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, *Audit Requirements for Federal Financial Statements*. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not provide an opinion on such controls.

We plan to issue our separate report to you, also dated January 31, 2002, on our comments on DLA's internal control.

Compliance

In the effort to obtain reasonable assurance about whether DLA'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 engagement 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 DLA is not in compliance with the requirements of OMB Circulars A – 123 and A – 127.

2. The material weaknesses discussed above indicate the DLA is not in compliance with the FMFIA.

3. The financial management systems utilized by DLA 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 DLA's efforts to:

   a. Prepare financial statements and other required financial and budget reports using information generated by the financial management systems;

   b. Provide reliable and timely financial information for managing current operations;

   c. Account for their assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and

   d. Do all of the above in a way that is consistent with accounting principles generally accepted in the United States of America and the U. S. Standard General Ledger.

4. 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 Logistics Agency, 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 31, 2002

Deloitte
Touche
Tohmatsu

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